

Dairy Farmers Should See Red: U.S. Cor

by John Bunting and Pete Hardin

Somebody is literally giving away U.S. dairy products on the global market.

In a dramatic tandem of events, global dairy commodity prices have skyrocketed, as the U.S. dollar has plunged. Suddenly, in the global dairy market, U.S. butter, Cheddar cheese and nonfat dry milk are THE low-cost commodities among global trading nations. Hard to believe.

Worst of all ... not only are U.S. dairy farmers' milk prices being depressed by declining dairy commodity values here at home, but it looks like the next big milk pricing scandal is coming into focus: butter. (See related story, page 4)

Critical questions, few good answers

U.S. dairy farmers are hunkering down, being warned by some "experts" (and CME Class III futures prices) that the bottom could fall out of U.S. farm milk prices. Near-term Class III price futures project declines of several dollars per cwt. from July-September 2007 farm milk price levels. U.S. farm milk pricing is taking some precarious turns—dairy commodity prices threaten to pull down farm milk prices from summer 2007 peaks, while global shortages of grain and energy drive up key production costs for this nation's dairy producers. For at least the past year, milk pricing has not "made a lot of sense" ... but lately, it's making even less sense. Key questions demand answers:

*Why are U.S. dairy commodity prices so dramatically underperforming global market prices?

*Why all the "doom and gloom" predictions and projections about U.S. farm milk prices, when current global dairy commodity prices would translate, literally straight-line, into U.S. farm milk prices in the \$30/cwt. range ... or HIGHER???

*Why, at the Chicago Mercantile Exchange (CME)—the supposed best cash market measure of U.S. dairy commodity values—do commodity prices for domestic butter, Cheddar and nonfat dry milk hover far, far below global prices?

Global/domestic dairy commodity price relationships shattered!

No single source of dairy information is guaranteed perfect. But information and analysis of global dairy commodity markets that appears in USDA's Dairy Market News weekly bulletin is as good as it gets. Dairy Market News is USDA's information and analysis branch. International reporter Steve Schneeberger has evolved as one of the most important figures in the global dairy market, through his comprehensive international dairy price analyses appearing every other week in Dairy Market News.

Butter:

*CME prices for Grade AA have fallen to less than half the global value of commodity butter prices for western Europe.

—On Thursday, October 11, CME Grade AA butter prices (80-score, or 80% butter fat) closed at \$1.28 per pound.

—But that same day, Dairy Market News reported Western Europe butter prices at \$5700-6100 per metric ton, or \$2.56 - \$2.77 per pound in U.S. currency.

Cheddar:

*U.S. Cheddar cheese commodity prices are presently around 50 cents per pound lower than the price of commodity Cheddar at the dock in Auckland, New Zealand.

—On October 11, CME block Cheddar prices closed at \$1.8475 per pound.

—But that same day, Dairy Market News reported Cheddar prices in Oceania (F.O.B. the dock in Auckland, New Zealand, for all practical purposes) at \$4700-5200 per metric ton, or \$2.13 to \$2.35 per pound in U.S. currency.

*U.S. commodity prices for nonfat dry milk lag behind global prices.

—At CME on October 11, the price for Grade A nonfat dry milk totaled \$2.11 per pound.

—But that same day, Dairy Market News reported Skim Milk Powder (SMP—the global "cousin" to nonfat dry milk) prices in Western Europe at \$4900-5200 per metric ton. In U.S. dollars, those values equate to a price range of \$2.22 to \$2.36 per pound.

Somebody is literally "giving away" U.S. dairy products on the global market.

"World markets/world market prices" — Free-Trade mantra fails

For years U.S. dairy farmers were told they needed to be able to produce milk at world prices. Of course, that "Free Trade" logic was liberally applied when global dairy commodity prices were lower than U.S. Such logic dictated that U.S. dairy farmers simply had to become "lower cost producers" to stave off global competitors eager to fill this nation's needs. If U.S. dairy farmers griped about low milk prices, "Free Traders" gave the stock answer: "Shut up and get more efficient ... or get out."

That "Free Trade" logic took us down another twisted path: cheap imports of dairy products and ingredients (such as Milk Protein Concentrates) were used by major dairy processors to depress U.S. dairy farmers' prices. For years, starting in the late 1990s, the U.S. served as a magnet for cheaper, imported dairy proteins that were largely used in cheese vats to "stretch" cheese yields ... while "dumbing down" cheese quality.

But now that world prices are high, most dairy "experts" say very little

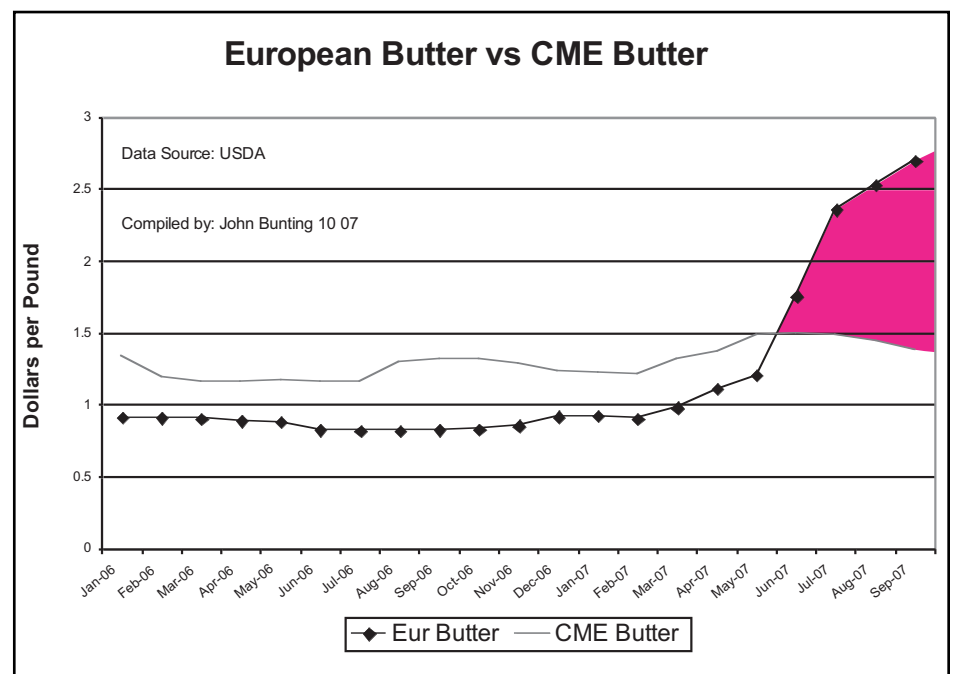
about global dairy commodity prices and their relationship to U.S. farm milk prices. An exception to this trend, of course, is Penn State's omniscient dairy economist, Dr. Ken Bailey. In his September 2007 dairy report, Bailey says world prices will moderate. [Bailey is also under the misperception that milk production in Oceania (New Zealand and Australia) is rebounding from last year's milk out. Sorry, but milk production "down under" is NOT what's up, doc.]

IF and WHEN U.S. dairy farmers ever comprehend the current disparities between U.S. and global dairy commodity prices ... and the failure of this nation's milk pricing system to more accurately reflect global values ... they'll go ballistic. Now that the "Free Trade" tide has reversed ... and U.S. dairy commodities are far cheaper than global prices, any notion of "global markets and global prices" has evaporated from officialdom.

U.S. butter market completely out of what with global prices!

For starters, let's focus on global vs. domestic butter prices. Right now, U.S. commodity butter prices are distinctly out of whack, relative to global prices.

The October 11, 2007 Western European butter report by USDA's Dairy Market News stated, "Supplies are tight to short of needs." Adjusted to 80% butter fat, the high side of the European butter market is \$2.77 per pound. That is \$1.49 more than the October 11, 2007 close for Grade AA butter on the Chicago Mercantile Exchange (CME).



Dairy Market News informs readers that high tariffs are limiting U.S. butter exports to Europe. That's accurate, at least for the present and perhaps until early 2008. But simultaneously, Dairy Market News reports the high end of the "Oceania" price range for butter, adjusted to 80% butter fat, is \$1.77 per pound. Why, then, can Oceania export butter to the global market, which is western Europe at this time, and register a price range peaking at \$1.77 per pound ... when U.S. prices for Grade AA butter at the Chicago Mercantile Exchange (CME) grovel along near the \$1.30/lb. range? A person doesn't need a Global Positioning Device to realize that the U.S. is thousands of sea miles closer to western Europe than New Zealand!

Conflicting U.S. butter inventory data. Believe CME or NASS?

Some analysts point to the NASS "Cold Storage" butter report for August 31, 2007, which projected commercial butter inventories at 260.7 million pounds—an increase of 21% from August 2006.

But wait! CME also publishes a weekly U.S. butter inventory report of "Certified Deliverable Stocks". The October 7, 2007 CME butter stocks report show U.S. inventories of 9,120,000 pounds— 20.1% less butter this year than for the corresponding week one year ago.

Which data to believe regarding U.S. butter inventories? NASS "Cold Storage" data for August 31, 2007 says a 21% INCREASE. But CME's October 7, 2007 butter inventory analysis indicated a 20.1% DECLINE. The aggregate divergence of these two key estimates (+21% and -20.1%) is a whopping 41.1% split, comparing year-ago inventory changes between these two butter inventory estimates. (Hint: Put more stock in CME's butter inventory data, which includes only table - grade butter.)

High-profile dairy analysts pound on the NASS "Cold Storage" data as gospel—as a "market" justification for the current rock-bottom Grade A butter prices at CME. Such wisdom was reflected by the October 9, 2007 comments by Downs-O'Neill economist Bill Brooks, who spoke on the October 9, 2007 broadcast of "Dairyline"—a nationally syndicated radio program, stating:

"Butter continues to be oversupplied as evidenced in last week's Dairy Products Report which Brooks said showed another strong month for butter output. Inventories are also very strong compared to a year ago, he said, so prices are now below a year ago and he sees little prospect for any kind of rebound even though we are coming into the period where retailers buy product for the Thanksgiving and Christmas holidays. Brooks doubts that there will be enough to buoy prices, even to the \$1.50 level that we saw earlier."

Despite the fact that his firm actively trades dairy commodities at CME, trades dairy futures and options at CME, and provides supposedly sage market wisdom for clients, Downs-O'Neill's Bill Brooks completely ignored the divergent butter inventory data and chose only to present the NASS "Cold Storage" side of things.

Commodity Prices Way Below World Levels

Déjà vu??? Unaudited NASS numbers justify lowball U.S. prices.

After the milk powder pricing fiasco that started last summer, where NASS prices were manipulated to understate values of nonfat dry milk used to price farm milk by USDA ... the uneasy feeling of “déjà vu all over again” strikes an increasingly loud and haunting cord. Unaudited NASS numbers again being used to justify low-ball U.S. dairy commodity prices, in dire contrast to sky-high global dairy commodity values? Hmmmm.

Think about it: without the unaudited NASS “Cold Storage” numbers for butter, “dairy watchers” would have “only” the world butter price data from Dairy Market News’ sterling analyst, plus better-regarded (than NASS) CME weekly butter stocks’ report on which to base present and future price assumptions. One must wonder: is there a degree of untruthfulness taking place in reporting butter inventory figures to NASS??? If so, could the culprits be some of the same five plants that misreported NFDM price data to NASS during the past year???

Maybe it’s not quite time to “arrest the usual suspects,” but the notion that these “usual suspects” might be brought in for a CIA-style “interrogation” might actually be an acceptable use for modern U.S. interrogation tactics.

2007 price trends: CME butter up 6% ... Oceania up 100% & Oceania up 200%!

As of October 11, 2007, Grade AA butter prices at CME are 6 percent higher, compared to early January 2007! In that same time, the “Oceania” (New Zealand) butter price has 100 percent!! And ... hold on ... the European price has 200 percent!!!

World prices for butter continue to rise, but CME domestic prices for butter stopped rising in June, and have turned down sharply in late September/early October.

Butter in western Europe is more than twice as much as the CME Grade AA butter price. Smells like a rat.

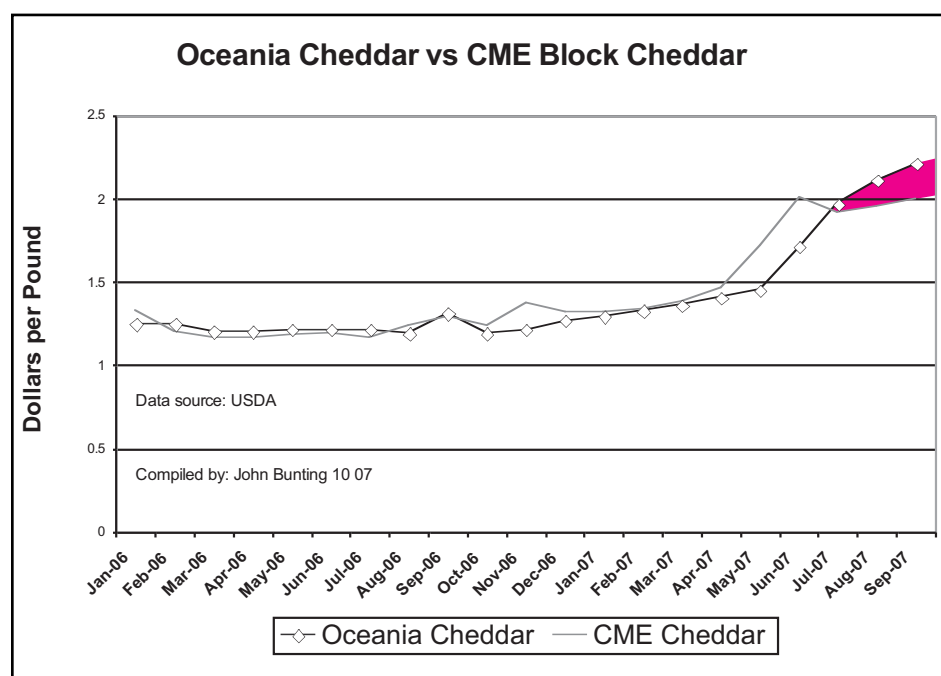
Naturally, if U.S. butter prices continued to rise with world price, the price of cheese would have to rise through various state/federal pricing systems would have to rise. That’s because cheese-making generally requires a close fat to protein ratio. But, oddly enough, block Cheddar on the CME peaked in June.

Turning again to Dairy Market News, the September 27, 2007 report of Oceania Cheddar states, “Some Oceania customers are sourcing cheddar and mozzarella from the U.S. to fill in the gap until regional cheese production improves seasonally.” The price for Oceania Cheddar in that report was \$2.3587 per pound. Meanwhile, block Cheddar at CME for the week ending September 28, 2007 averaged \$1.86 per pound.

REPEAT: According to Dairy Market News, U.S. Cheddar is moving into international markets to compensate for product shortfalls in New Zealand and Australia. World markets! But where are the world market prices? Oceania’s Cheddar prices are \$.28 to \$.50 per pound higher than current CME cash prices.

Canadian dairy farmers are getting over \$30.cwt. for their milk. If the U.S. dollar and the Canadian “Looney” are equal, what’s keeping U.S. milk prices down?

Blocks on October 11, 2007 closed on the CME at \$1.475 per pound. Keep in mind the Oceania Cheddar price is FOB Auckland, New Zealand, so the global buyer pays any additional freight from the dock.



The “Cold Storage” report for inventories held on August 31, 2007 indicated that total cheese in U.S. storage was 2% less than the same period in 2006. Should CME Cheddar prices have been so low last summer?

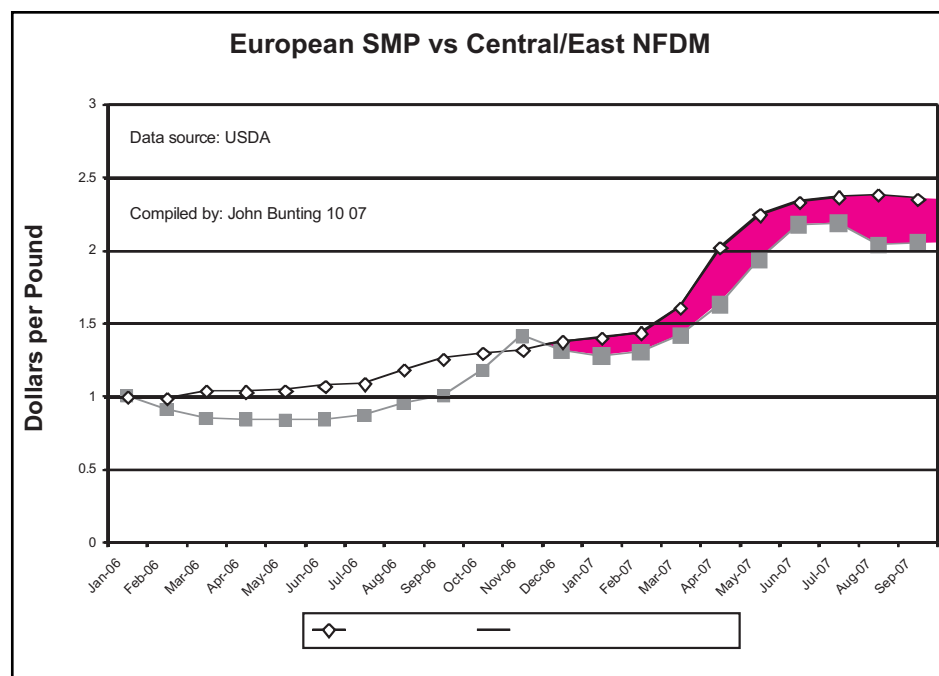
This is not to say that the handful of powerful dairy traders at the CME don’t know what they are doing. Dry whey prices rose steadily in early 2007 to about \$.80 per pound. Dry whey prices are part of the Class III price formula. High whey prices mean additional costs in producing cheese. To solve that problem dry whey futures began trading on the CME on March 19, 2007. Within a month dry whey futures prices started to fall ... and fall hard. One of the stated goals at the time CME inaugurated whey futures was to hold down whey prices. That goal is being accomplished. In one point in recent weeks, whey price futures at CME varied no more than one cent per pound, for every month in the coming year-plus. On October 11, though, whey prices started to show some spark.

Now we come to NFDM, which is where all the illegal price reporting shenanigans began sometime in summer 2007. By this point no one will be surprised to find that NFDM prices, domestic prices, peaked in June 2007, while European SME prices continued to rise.

Looking at the most recent “Dairy Products” production report of October 4, 2007, which covered August 2007 production, it should be noted that cumulative NFDM production for the year was on 1% above the January through August 2006 level. However, production of Skim Milk Powder was 41.1% less than the January through August 2006 production level. Obviously, the U.S. has produced less overall dry milk powders in 2007, to date, than in 2006. SMP has no “standard of identity” and should not be used in domestic food processing.

Skim Milk Powder (SMP) is produced by first making NFDM and then adjusting the protein level with small additions of other dry dairy ingredients. Adding SMP and NFDM production together the January through August 2007 production was 6.4% less than the same period in 2006.

The problem in nonfat dry milk pricing – indeed, all U.S. dairy commodities – originates from concentration. A real, genuine, price discovery system needs many players with fully independent opinions. Each player will have unique information plus error regarding the correct price. The high and low error will cancel each other out leaving accurate information.



Summary: Few players, no functioning market

With the present system of a few, powerful players, there is no functioning market. In the end, it is price determination, not price discovery. The two should not be confused.

The only plausible explanation for the vast discrepancies between U.S. dairy commodity prices and global prices is the fact that the U.S. “price discovery” system is seriously and intentionally flawed.

When global dairy commodity prices were low, relative to U.S. prices, U.S. dairy farmers were told to get more efficient or get out. Cheap imports were used as a price lever to unfairly pound down milk prices paid to U.S. milk producers.

But it’s a new dairy world today! Global dairy production has constricted, in Europe and Oceania. Global demand, driven by surging economies in China, India and Southeast Asia, has stripped clean available dairy product supplies—particularly dairy proteins and butter. The U.S. dollar has dramatically collapsed in value, compared to certain other currencies.

USDA’s own market news reports tell that:

*Butter is \$2.56-\$2.77 in Western Europe (about \$1.27-\$1.49 per pound higher than butter at CME).

*Cheddar is \$2.13-\$2.35 per pound in Oceania (about \$.28-\$.50 per pound higher than CME block Cheddar).

*Skim Milk Powder is \$2.23-\$2.35 per pound in Western Europe. U.S. nonfat dry milk prices at CME hover in the \$2.11 per pound range.

The world of international dairy prices has turned completely upside down. U.S. dairy commodities are now the lowest-priced, most readily available such products in the industrial world. But U.S. dairy farmers—in virtually every price signal, and in most of the “expert” advice they’re hearing on milk pricing—are expected to silently accept the unacceptable: that their milk pricing institutions are fair and market-driven.

In this new, upside down world of dairy, however, one constant remains. Coming or going in the dairy export/import game, the U.S. dairy farmer continues to suffer, price-wise.

The combined import of U.S. dairy commodity prices being so far below world market levels probably equals about \$10 per cwt. on farm milk prices.

\$30 milk? That sounds like a lot ... until folks start seeing the costs of fertilizer, fuel, grain, interest rates, equipment, etc. Those inputs prices are all based on global prices. So should farm milk prices in these times.

2006’s low milk prices were a wake-up call. The U.S. milk pricing system--USDA, co-ops and CME--are corrupt.