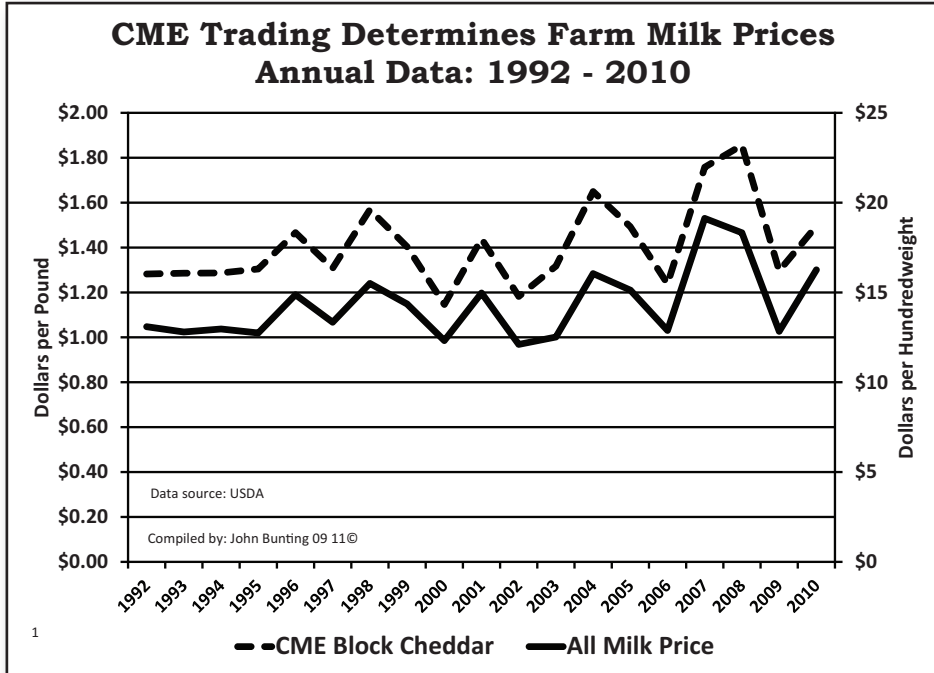


Kraft Foods Up to Its Old Tricks ... As Cheddar P

by John Bunting

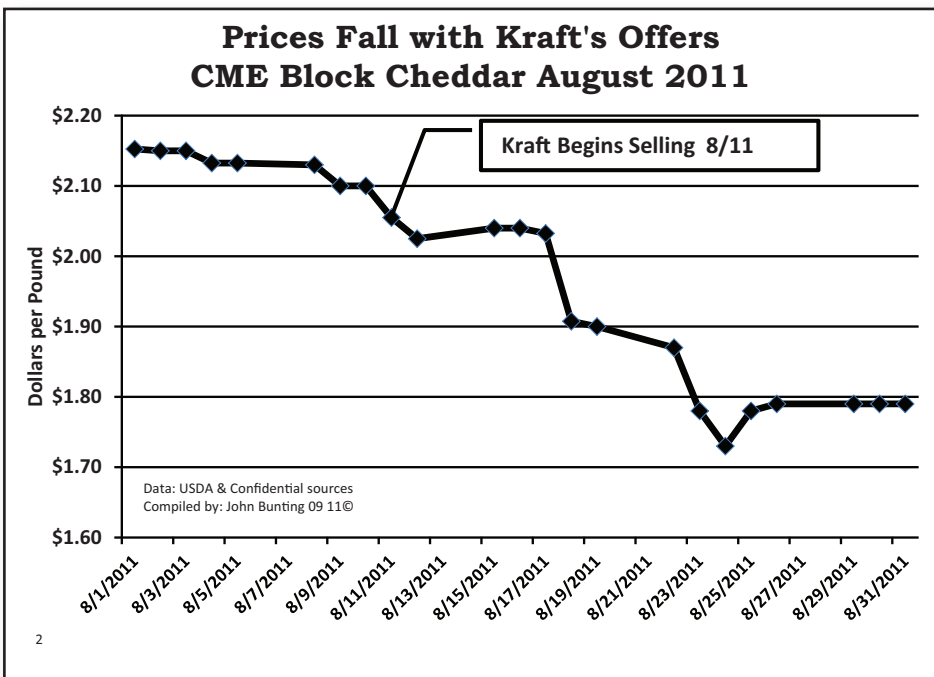
The concept of absolute monarchs, with divine rights, has long been discredited. But, in dairy, we see a general acceptance of the “divine rights of markets.” For dairy farmers, “the market” is the cash commodity trading of Cheddar, Grade AA butter, and nonfat dry milk at the Chicago Mercantile Exchange (CME). Farm milk checks are essentially produced from cash market data originating at CME.



Some of the ups and downs of CME cash Cheddar trading should not be misinterpreted as an accurate or honest “market.”

Statistically, a near perfect correlation – 95.9% — exists between Cheddar trading at the CME and dairy producers’ “all milk price.” The “all milk price” is a compilation of USDA’s National Agricultural Statistical Service (NASS) and includes data from all states. The “all milk price” includes quality, quantity, and other premiums, before hauling charges are deducted. Hauling subsidies are excluded.

All factors determining dairy farm milk prices should be open and transparent. However, the myths of the market and transparency are not compatible. Nevertheless, the “secrets” of dairy trading are known to insiders. There are several confidential suppliers of daily trading data, which generally include the floor traders’ symbols. *The Milkweed* obtains data from several sources in an effort to confidently understand the CME trading. Keep in mind: CME floor trading information is technically not verifiable – because the CME rules prohibit revealing trader’s activity.



August 2011: Kraft’s signals help pull down Cheddar market

August 2011, was an important month at the CME. For August 2011, there were 45 loads of block Cheddar traded at CME, compared with a total of only four loads traded in August 2010.

The month began with Darigold initially dropping prices. Darigold is the predominant dairy farmers’ cooperative in the Pacific Northwest. On August 11, 2011 Kraft moved into the market. Since the spot cash Cheddar trading moved from the old National Cheese Exchange in Green Bay, Wisconsin in early 1997, Kraft has tended to use surrogates at the CME. This year, Kraft boldly offered both block Cheddar and barrel Cheddar.

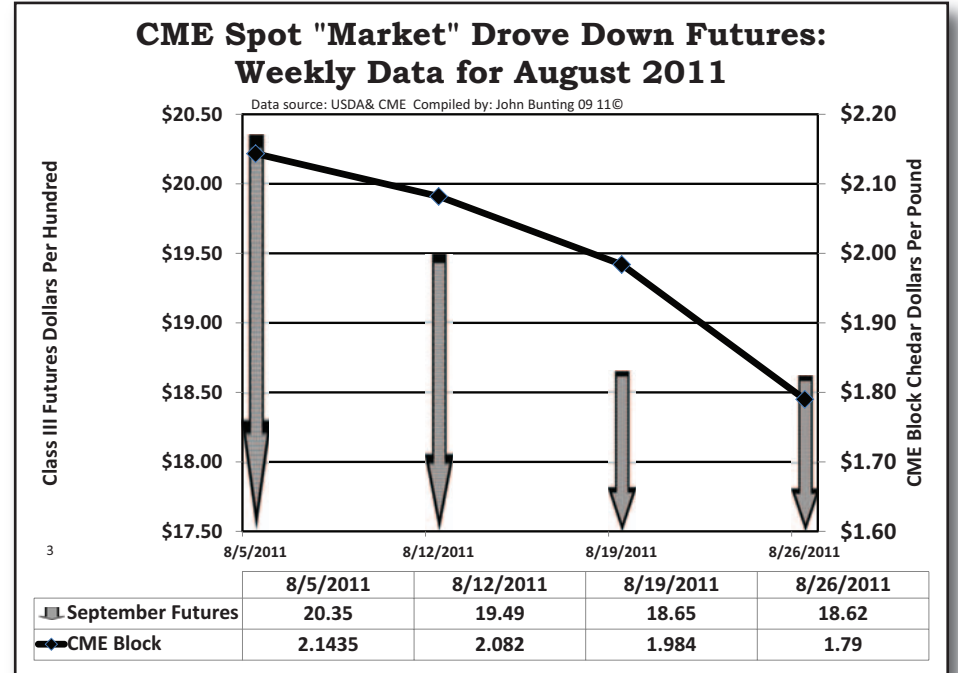
In a report titled “Cheese Pricing: A Study of the National Cheese Exchange” was released by the University of Wisconsin-Madison and Wisconsin Department of Agriculture, trade and Consumer Protection in March 1996. After two years of legal struggle, the authors W.F. Mueller, B.W. Marion, M.B. Sial and F.E. Geithman released Working Paper 116.

On page 5 of that document the authors stated “This result indicates that as NCE barrel prices decreased by \$.10 per pound, Kraft’s gross profit margin on processed cheese increased by 9.88 cents per pound.” The authors found that

“when NCE block prices decreased by \$.10 per pound, Kraft’s gross profit margins for natural cheese increased by 7.3 cents per pound.”

There is no reason to think Kraft’s motivations in 2011 are any different than they were in the 1990s: cheaper Cheddar boosts net profits. Kraft, in order to sell the cheese at the CME, first had to buy relatively expensive Cheddar to crash the price. Kraft has closed its U.S. Cheddar plants in recent years.

The CME is purported to be a place where “surplus” Cheddar is sold. Kraft, nevertheless, walked away from a bid for barrel Cheddar on August 23, 2011, which would have raised the price. The bid was by Grain Millers (based in Minneapolis), which might have gotten its signals crossed, because the next day the opening bid by Grain Millers was less than the closing price of the previous day.



Class III futures: incentives for induced volatility

A new road to profitability in Cheddar trading has opened up in the U.S. since the trading moved to Chicago and Class III milk futures were instituted. There are only two commodity markets in which a thin cash market determines the price of futures. One is natural gas, which brings up memories of Enron. And the other is dairy trading primarily Cheddar at the CME.

The above graph only shows the data for September 2011. However, Class III (cheese) milk futures crashed month after month. According to CME, the volume for August 2011 Class III milk futures was 37,989. For August 2010, the Class III milk futures volume was 17,900, which means August 2011 the volume was an increase of 112.2% over August 2010. Each contract represents 200,000 pounds of milk. Millions were made and lost on futures alone.

Note should be taken that the Commodities Futures Trading Commission (CFTC) has twice reached plea agreements with traders in dairy futures. On July 19, 2011 the CFTC ordered Ecoval Dairy Trade, Inc. to pay \$1,425,000 penalties to settle charges of attempted manipulation of nonfat dry milk futures prices.

In December 2008, the CFTC levied a \$12 million fine (plus penalties) against Dairy Farmers of America (DFA). DFA has not been an active participant in the spot cash market at the CME from January 2009 until DFA purchased cheese on the spot cash market on August 26, 2011.

Cold Storage report data blamed CME Cheddar downturn

There are two concepts which the defenders of the status quo “divine market” have launched regarding the August 2011 crash of prices on the CME. The first has to do with the “Cold Storage” numbers for July, which were released August 22, 2011 by USDA’s National Agricultural Statistical Services (NASS), total natural cheese stocks were up 3% from the June 2011 “cold storage” numbers.

Maybe those NASS numbers are right, but, since they are not audited, maybe they are wrong. The Bureau of Economic Analysis (BEA) tracks “Personal Consumption Expenditures” (PCE) for a wide variety of items including “processed dairy products.” The PCE for process dairy products in July of 2011, which unlike scanner data includes Wal-mart and the big-box stores, indicates consumers spent slightly more in July 2011 than they did in June 2011. The consumer price index data for June and July 2011 suggest the Cold Storage data was likely erroneous.

Since total U.S.cheese production was 4% less in July 2011 than for June 2011, the increase in Cold Storage is hard to swallow.

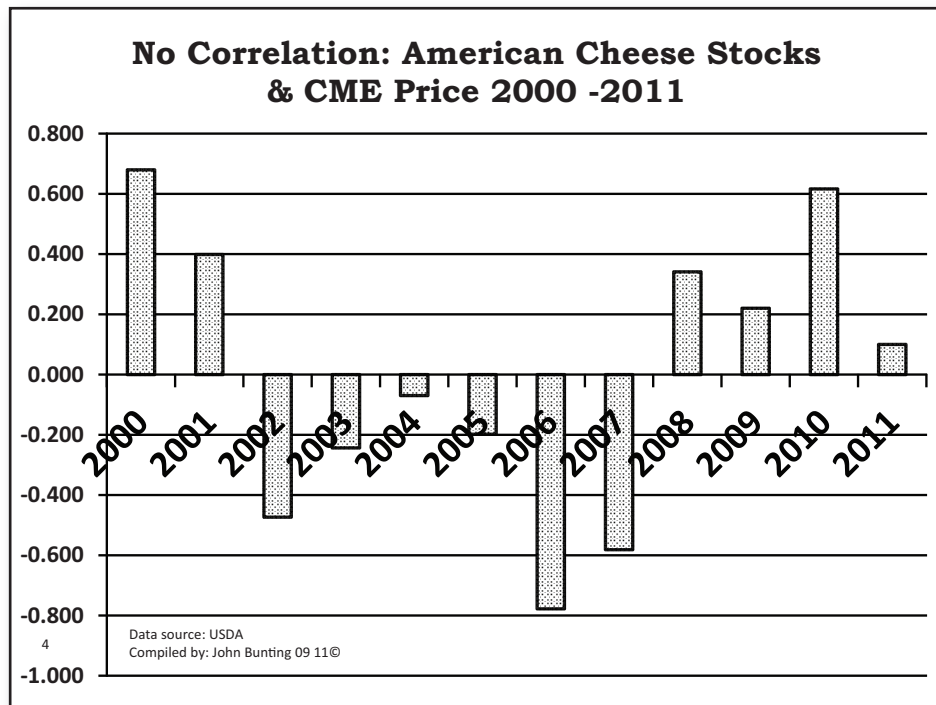
Nonetheless, for the experts to make a claim, relative to Cold Storage data, there should be some correlation between prices on the CME and cold storage data. A perfect statistical correlation is one. The correlation can be either be positive or negative. In the case of the relationship of cold storage data to CME cheese prices, if the so-called experts are correct the data should indicate a negative number one. That data should be consistent throughout several years in order to be trusted. The correlation based upon historic data, not speculation, it is just not there. (Refer to charts in top left column on page 9.)

Look at all the junk in cheese: MPCs, water, sodium gluconate

IF there actually is an excess amount of cheese in storage, Kraft has played a part by increasing cheese yields through the use of unapproved food ingredients such as, milk protein concentrate (MPC).

On December 18, 2002, the U.S. Food and Drug Administration (FDA) sent a stinging letter to Betsy Holden, CEO of Kraft Foods. The letter stated, “These products declare milk protein concentrate in their ingredients listings.

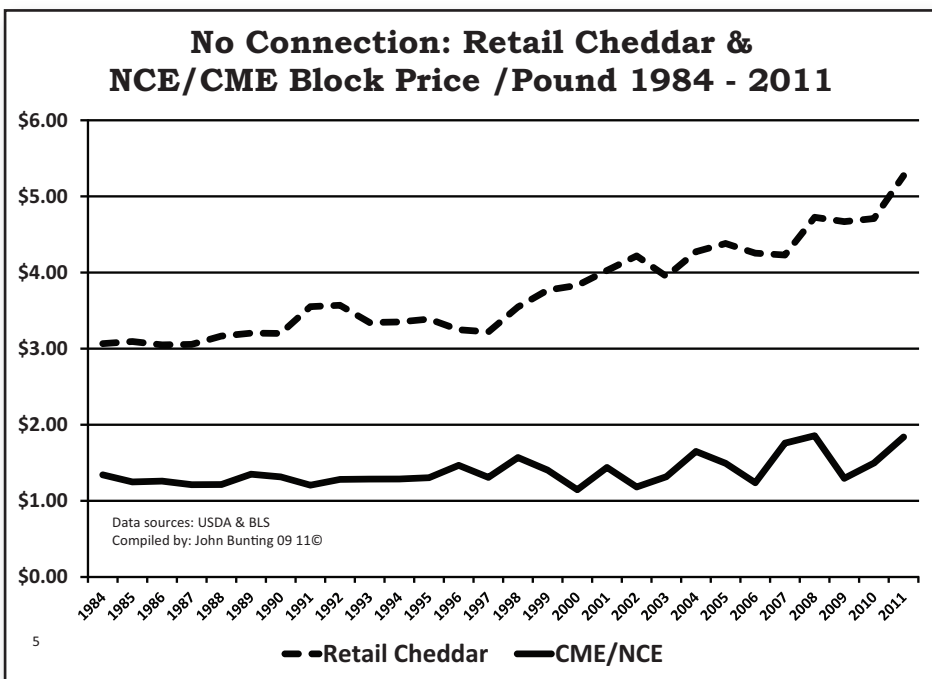
Prices Nose-Dive at Chicago Mercantile Exchange



Milk protein concentrate (MPC) is not listed as an optional dairy ingredient in any of the standardized cheese products governed by a standard of identity, and therefore standardized cheese products are not permitted to contain MPC as an ingredient.”

At issue: Kraft’s failure to comply with federal standards of identity, by using an unapproved ingredient in a food for which a federal standard of identity existed. Kraft was never punished or fined by FDA for these violations. Kraft continued to use MPC and simply changed the name of the “Singles” product from “processed cheese food” to “processed cheese product.”

Kraft has continued to “scheme” around the standards of identity embedded in the Code of Federal Regulations (CFR). U.S. patent number 6,406,736, granted on June 18, 2002 is for a “cream cheese” which has a moisture content of 65%. CFR§ 133.133 (cream cheese) limits the moisture content to 55%. More water equals less cheese is needed boosting profits, if not compromising product integrity. (Editor’s note: Look closely at the Kraft offerings in the array of products in the “cream cheese section” of you local supermarket’s dairy case. Most of the “Philadelphia” branded products are technically not cream cheese. Kraft has simply taken the good name of its old-line, “Philadelphia Cream Cheese,” kicked out the “Cream Cheese” label (along with requisite ingredients), and continues selling the “stuff” with the implication that “Philadelphia” is cream cheese!



Then U.S. patent number 6,183,804, granted February 6, 2001 promotes the use of MPCs stating, “The powdered milk protein concentrate can be directly converted processed cheese... Thus the manufacture of processed cheese is uncoupled from, or independent of, the supply of milk.”

Federal Standards of Identity for foods were instituted by FDA to promote honesty and fair dealing in the interest of consumers. Regulations were promulgated fixing and establishing for any food, under its common or usual name so far as practicable, a reasonable definition and standard of identity, a reasonable standard of quality, and/or reasonable standards of fill-of-container.

Processed cheese products have increasingly become repositories for *ersatz* cheap ingredients: water, starch, fillers, etc. According to U.S. government data, in 2009, the percent of cheese in processed cheese products in the U.S. dropped five percentage points – from 89% to 84%! Cheese costs were rock-bottom that year.

When a consumer buys a container of Cheez Whiz®, does that person believe (s)he is buying cheese? Is the product even made in this country? Sometimes not. A couple years ago, Kraft’s Cheez Whiz® from the Philippines was detained by U.S. import authorities. The Philippines has no major dairy industry. Yet Kraft has the power to depress American dairy farmer’s milk checks.

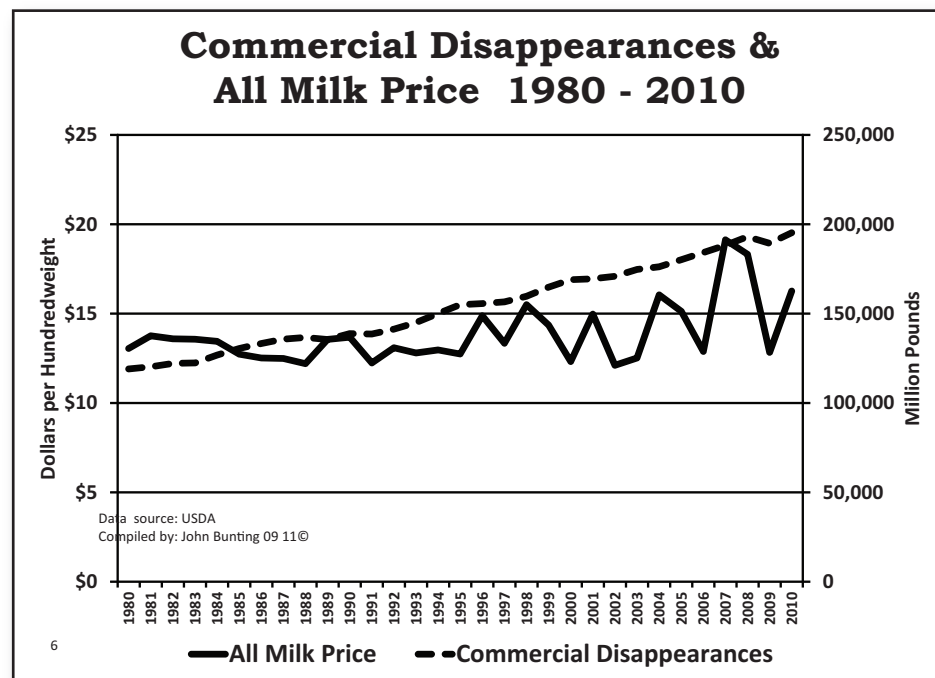
“Buyer resistance” to cheese prices? Don’t blame farmers!

The next argument made by the “market” apologists has to do with “buyer resistance” with CME prices over two dollars per pound. The thinking is sup-

posed to go, with Cheddar prices falling on the CME more cheese will be consumed. The obvious flaw in that argument is the Kraft does not consume any cheese, nor do any other traders on the CME for all practical purposes.

It is the public who consumes cheese, which they buy at retail price.

In 1984 the spread between the NCE block Cheddar price and the retail price was \$1.724 per pound. In 2011, the average spread between the CME block Cheddar price and retail Cheddar price is \$3.434 per pound. For July 2011 the spread was \$3.481 per pound. Clearly, if there is “buyer resistance” to the “high cheese prices” at the supermarket, the commodity price (per pound) is



not to blame.

However, even the argument about price at the CME fails because there is absolutely no correlation between commercial disappearances and farm milk price – none.

The root problem here lies in the willing acceptance of bullies as representatives of a functioning market. In theory, a market is a knowledge tool and as Nobel laureate F.A. Hayek stated in his 1945 essay “The Use of Knowledge.”

“The problem of a rational economic order is determined precisely by the fact that the knowledge circumstances of which we must make use never exist in concentrated or integrated form but solely as dispersed bits of incomplete and frequently contradictory knowledge which all the separate individuals possess.”

That is to say, it isn’t possible for a corporation such as Kraft to be “the market.” Essentially, the value of the market over centralized planning, and centralized planning can either be state or corporate, is efficient allocation of resources.

How far dairy has strayed from fundamentals

Look at the dairy industry in America. The dairy cow is a wonderful creature capable of taking renewable resources, primarily grass grown on hillsides unsuitable to cultivated crops, and converting that grass to a fine human food. The process is a perfect example of the efficient allocation of resources.

What we now have in America, is a system which takes primarily imported fossil fuel-based fertilizer, which is dumped in excess amounts in the corn states, thereby creating a “dead zone” in the Gulf of Mexico, to be trucked for hundreds, or thousands of miles to feed dairy cows in dry lot settings.

Kraft Foods represents a system which reduces margins on its suppliers to such an extent that efficient allocation of all resources is no longer even talked about. Kraft is corporate planning with official sanctioning from government officials – to the detriment of dairy farmers and consumers.

August 22 & August 23, 2011 at CME Strange Barrel Cheddar Trading Patterns

Barrels close at the CME August 22, 2011 at \$1.8625 and on August 23, 2011:

- Kraft Offer \$1.7950 Gavilon buys
- Kraft Offer \$1.7550 EOJ Buys
- Kraft Offer \$1.7750 EOJ Buys
- Kraft Offer \$1.7550 EOJ Buys
- Grain Millers Bid \$1.7575

Kraft walks away from higher bid.

Then on August 23, 2011:

- Grain Millers Bid \$1.7000 Kraft Sells
- Kraft Offer \$1.6950 Grain Millers Buys
- Kraft Offer \$1.6925 Bongards Buys

The last bid on August 23, 2011 and the first bid on August 24, 2011 are very strange.

Analysis by John Bunting