CHEESE MARKET NEWS®

The Weekly Newspaper Of The Nation's Cheese And Dairy/Deli Business

Volume 29 | November 27, 2009 | Number 44

GUEST COLUMNIST — CMN Exclusive!

Perspective: Dairy Markets

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Cheese futures? Benefits outweigh risks for dairy industry

Some key players in the dairy industry have made a compelling case that the Chicago Mercantile Exchange (CME) should list futures on cheese as an additional hedge instrument. This thought has gained a lot of support, and the CME is judiciously researching the pros and cons of doing this while floating potential contract specifications for consideration.

The supporters of a cheese contract say that the existing exchange traded futures and options (ETFOs) that serve them, Class III, exclude significant swaths of the dairy industry because of the multiple components that are all included in the Class III index. The supporters say that a cheese contract would allow additional sections of the dairy industry to enter the world of dairy ETFOs, benefiting the formerly excluded by offering superior price risk management tools and benefiting the industry as a whole by providing much needed additional liquidity into the CME Dairy Complex.

The benefits for listing such a contract are many, to name a few:

- A more efficient and appropriate hedge instrument for some processors/converters.
- A more efficient and appropriate hedge instrument for some end users.
- A more efficient and appropriate hedge instrument for some dairy producers … i.e. Idaho at ~6.5 percent of total U.S. milk production.
- A more efficient and appropriate hedge instrument for many in the entire dairy value chain.

Another benefit: A hedge instrument that doesn't "make users eyes glaze over."

Imagine a mid-sized food company that doesn't live in the arcane world of dairy pricing; they just buy cheese. When they ask us to help them hedge their cheese use and we start explaining the Class III price and tell them they will need to trade whey futures too, not to mention if they just want a price ceiling (calls) and then they have to buy a Class III call and buy a whey put and … they are saying, "Are you serious? Goodbye."

And risks? The only important risk of listing ETFOs on cheese is that this could cannibalize liquidity away from existing CME dairy contracts (Class III, whey). This risk is legitimate and significant. The other and most important attribute about this risk is that it can be mitigated with relative ease by participants committing to trade the make spread. The antidote for the risk is to make sure liquidity is there and committed on day one to bridge any gaps between Class III and cheese (further detail below). If this liquidity is not committed and properly resourced, then I would find the risk too great to move ahead with listing a contract. It is my thought, though, that the endeavor of lining up the liquidity and making this happen is worthwhile.

• *What does cannibalizing liquidity mean?*

Although the dairy complex at CME has matured markedly in the past few years, it is still vulnerable to missteps. If market participants do not step in to fill the void between cheese futures and Class III/whey, all three contracts could fail, or at least witness severe liquidity problems in the form of decreasing volumes and open interest. This is an unacceptable and unnecessary risk.

• *What is the "make spread"?*

The make spread would consist of three futures positions: Class III against cheese and whey. This futures spread position mimics the physical process of a cheese plant buying Class III milk and making/selling the products, cheese and whey. If the combined cheese/whey price gets out of line with the "equivalent" Class III, price traders can step in and capture the difference. The beauty of this for the futures trader is that these positions will all be cash-settled; it is purely math.

This isn't a new concept as these types of spreads have been prevalent for years in the energy and soy complexes. The soy crush spread (soybeans against soy meal and soybean oil) and the crack spread (crude oil against gasoline and heating oil) are staples of the ETFO markets and the commodity industries they serve.

• *How can the risk be avoided? How can you make sure liquidity will be there?*

Hire a liquidity provider. There are hundreds of professional market-making firms that exist to provide liquidity in ETFOs. The CME is very familiar with this type of relationship. If that doesn't seem to be the best option …

Establish a commodity fund (pool) whose purpose is primarily to "bridge the gap" between the new cheese contract and the existing Class III and whey contracts. The secondary purpose of the fund is to not lose money; if administered properly, it should be profitable.

• *How would this mitigate the risk of liquidity cannibalization?*

The market maker or fund would make sure that for every market that exists in Class III and whey, there will be a close equivalent made in cheese futures. It also will make sure that for every market that exists in cheese futures and whey, there will be a close equivalent made in Class III.

• *What about whey ETFOs liquidity?*

To be blunt, the liquidity that whey ETFOs get now from cheese hedgers will be lost. But should the future success of whey ETFOs really be dependent upon this reluctant liquidity? Cheese hedgers are getting stuck with whey exposure when they take on Class III positions and are only using whey futures to get rid of this newfound exposure. Are we really to mourn the loss of this "liquidity"? Not if we are serious.

This liquidity would likely be more than replaced by arbitrage liquidity through the make spread.

In the end it all comes back to the fact that there is a real demand for exchange-traded futures and options on cheese. Although there is some complexity to the situation, it is my opinion that taking the steps to reduce the associated risk and then listing the cheese contract will yield a deeper and stronger market for cheese price risk management that will benefit the entire value chain. **CMN**

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