

# CHEESE MARKET NEWS®

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

Volume 29

January 1, 2010

Number 49

GUEST COLUMNIST



CMN Exclusive!



## Perspective: Market Insight

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## Looking to the latter half of 2010

For many, 2009 was hardly a year that people expected or knew how to analyze in terms of historical perspective. At the tail end of 2008, with commodity prices throughout the world plummeting, dairy prices came tumbling down too. We entered December 2008 with block cheese prices in the \$1.80s and by Jan. 7, 2009, blocks were trading at \$1.04, representing a 42 percent decrease in market value in just a 30-day period. Chicago Mercantile Exchange butter made it as low as \$1.09, and the nonfat dry milk price spent several months at \$0.80. International prices, operating without government support levels, were reported in at prices much lower than the United States.

Feeling that this market drop could only be short term in nature, many market participants approached the market in ways that seem to still be affecting the market today. End users, or those with upside market risk, used the lower prices as an opportunity to begin building stocks. These stocks were purchased with the intent of being a physical hedge, so that when prices ultimately recovered, end users would simply draw down on these stocks, as opposed to being forced to purchase at the higher levels that were sure to come.

Dairy producers on the other hand, feeling equally convinced the break would only be a few weeks to a month long, did everything they could to keep

from reducing their milk output. While some had used the earlier premiums in the futures markets to lay off their downside risk (the equivalent of end users buying futures or building physical stocks), most felt no reason to forward contract their milk at the low levels the futures were offering.

The lending institutions, who had lent very large sums of money in order to fund the enormous expansion of milk during the last four years, seemed to find themselves caught in the downdraft of lower prices as well. With many feeling that their competitors had made loans to borrowers with questionable debt/equity ratios, the banks appeared to take on the same "this can't last" attitude, and many did very little to force the hand of producers to begin liquidating.

As time went on, stocks built, production maintained, and prices remained low. In fact, it wasn't until late August, with what many feel was precipitated by the increase in Commodity Credit Corp. support levels, that blocks were able to move above \$1.40 level. This means that almost eight months were spent with milk prices at an average of \$10.28 on a Class III basis. With even the most efficient producers reporting that their break-evens were in the \$14.00 area, it becomes obvious that there was a very significant hit to the already fragile equity levels of most dairy producers.

At the same time, the physical stocks that were put up in the spring didn't seem to be needed until holiday demand season, if they were needed at all. The most recent cold storage report indicates that total cheese stocks stand at 17 percent higher right now than they were at this same time last year. Milk production, while hindered, is only down slightly more than 1 percent as compared to last year. In other words, the elements of a sustained recovery have yet to fall into place, and the decisions made during the first part of the year by the buyers/sellers/lenders are still haunting the market today.

I will make the argument that those very same decisions were not incorrect decisions. I just think they were off in terms of their timing. In fact, I believe those decisions are what are going to lead to prices in the tail end of 2010 moving back to historically high levels.

From the end user perspective, much of the cheese that was purchased for the use of physical hedges is going to be rounding the year-old mark and was purchased at levels less than \$1.30 per pound. End users likely will look to turn that product into cash and with current spot levels still above their purchase plus carry levels, they will start the process of clearing the market. At the very least, they will likely stop building inventories.

As we move into a period of declining prices, the producers who have been skating by on razor thin debt/equity ratios and the good graces of their lenders and feed suppliers will likely begin having to make more tough decisions, and I think both cow numbers and production per cow will start to drop again. In fact, I think the liquidation stands to be more wicked than many expected, as the banks simply won't want to go through another round of pain like they did last spring as the equity levels are in much worse shape today than they were then. At the very least, there won't be the necessary expansion that many believe the annual 2 percent increase in domestic dairy demand will require to satisfy the market.

This process of clearing the physi-

cal market and simultaneously reducing production levels will of course take several months to work through, but I think as we move into the July-December period, typically thought of as the demand period, we will find that our stocks have been liquidated and our ongoing production capabilities will have been severely damaged. This, I believe, will cause our markets to move back to historically high, if not record high, levels.

So for those who have upside price risk as it pertains to dairy prices, I suggest you look for ways to mitigate that risk and that you focus your attention on the second half of 2010. There are certainly several methods you can employ to conquer that task, one of which is the futures and options market, which offers a default free, transparent method of mitigating that risk.

Currently, futures are pricing cheese during the July-December time horizon around \$1.71, which sounds like a historically high level to be building stocks. However, when put in the perspective that we just came off the \$1.72 level during a time with milk production only down 1 percent, more than ideal weather conditions throughout most of the year, world economic conditions that are shaky at best, and inventory levels at 17 percent higher than last year, \$1.71 may ultimately be seen as a very cheap level if the factors mentioned above begin to turn in even the slightest fashion. In other words, I find it wise to prepare for higher prices in the second half of the year. **CMN**

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