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Dairy Outlook 2000

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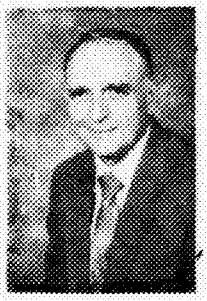

DAIRY OUTLOOK 2000

by

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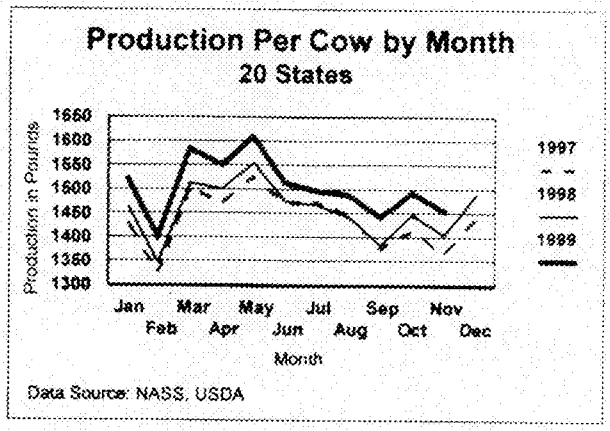
Introduction

Over the past two years, hog, beef, and crop farmers have been dealing with unprofitable prices, while dairy has enjoyed relatively good times. But, there is trouble ahead for dairy in the near term, while the long term is more optimistic. For some dairy producers, the phrase from the song Four Strong Winds, "The good times are all gone and its time for moving on," all too well describes their situation. The industry has over expanded, leading to unprofitably low prices, despite high levels of consumption of dairy products. So far this year, milk production has expanded 3.3% compared to the same period in 1998. Such an increase is more than the market can handle without depressing prices.

Source of the Problem

The start of the problem was good growth in demand at a time when there was a decline in production. In 1998, the West, especially California which is the biggest milk producing state, had to deal with prolonged wet weather. Cows were in mud for extended periods of time, causing stress and herd health problems. Production ran below expectations at the same time that there was an increase in demand. During the months of July and August 1998, production per cow in the 20 major dairy states dropped below 1997 levels for those months (see Figure 1). The total increase in milk production during 1998 was only 1.1% over that of 1997. The demand for dairy products remained strong during 1998. Consumers had developed a taste for dairy products as a result of the low prices partially caused by the government reducing its

Figure 1.

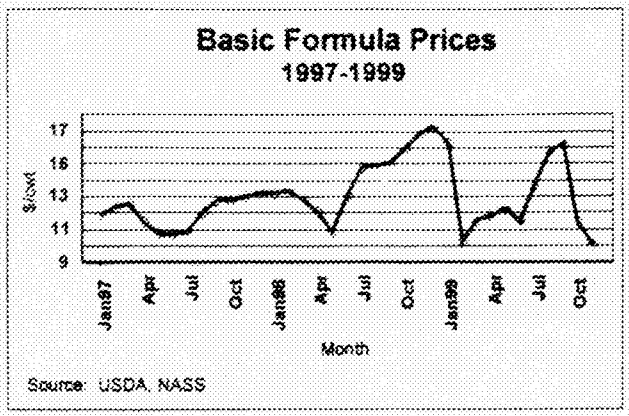


inventories in prior years. Also, there was an especially strong growth in the demand for cheese by the food service sector. As a result, butter prices set new record high prices at the Chicago Mercantile Exchange (CME) for seven consecutive weeks during July and August 1998, and block cheese prices set new record high prices for 14 consecutive trading weeks from September into December of that year. Prices then held at record level for another four weeks.

With the price of cheese determining 90% of the price of milk, the high cheese and butter prices produced record high monthly basic formula prices (BFP) for the six months of February, March, July, October, November, and December of 1998 (see Figure 2).

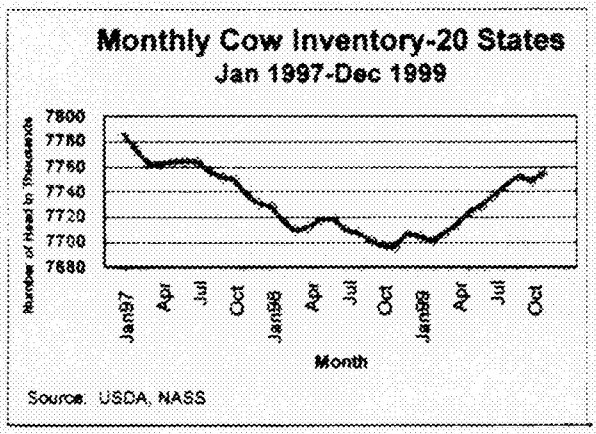
The year 1998 also set a new record average high BFP of $14.20 per cwt. for the year. Butter prices at the CME hit the previous all time high price in late June and continued upward to set a new all time high of $2.81 per pound in early September. Cheese prices started to break record highs in early September and peaked in early December with barrels at $1.86 and 40 pound blocks at $1.90 per pound. These record high prices contributed to record high milk prices which induced dairy operators to embark on expansion, especially in the

Figure 2.



West. The increase in cow numbers was first evident in the November 1998 Milk Production Report and continued monthly through November 1999, with the exceptions of January and October 1999 (see Figure 3).

Figure 3.



The good times continued into 1999. January witnessed a new record high milk price of $16.27 per cwt. set for that month (see Figure 2). The February price dropped by $6.00 to $10.27. But then the market improved during the spring and summer due to strong demand for cheese, mainly from the food service sector, and fears of short cheese supplies by year's end. Although the Southeast and Middle Atlantic States had a hot, dry summer that stressed cows, California and the Pacific Northwest had near ideal production conditions. Also, weather conditions in the Midwest and Northeast were conducive to high levels of milk production. CME cheese prices dipped after the first of the year, held about steady until late April, and then began an erratic increase, peaking at record high prices in mid August when barrel prices at the CME hit $1.8750 and blocks hit $1.9725 per pound (see Figure 4). The National Agricultural Statistics Service (NASS) weekly average price for block cheese peaked about the first of September. As a result, record high BFPs were set in the months of August and September at $15.79 and $16.26 per hundred weight, respectively.

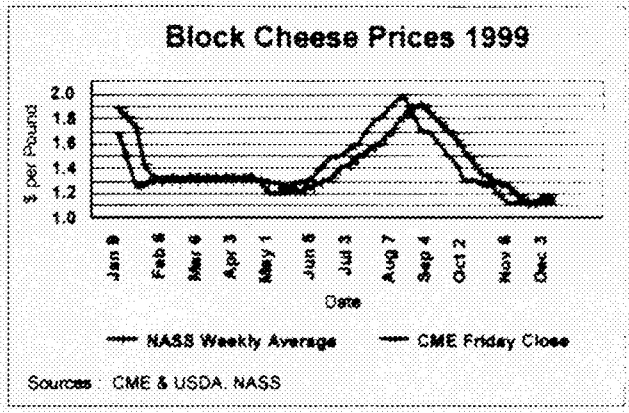
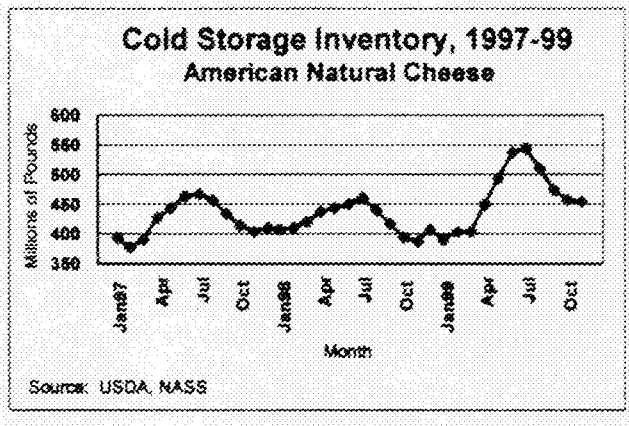


Figure 4.

Much of the market strength came from buyer's fears of a shortage at year's end as happened in 1998. CME cheese prices then began to wane in late August when the August Cold Storage Report (released August 20) put the July Natural American cheese inventory at 545.0 million pounds and revised the June inventory up to 539.1 million pounds (See Figure 5).

Figure 5.



This relieved the fear of a shortage of cheese for the year end holidays. Block cheese prices broke on August 25, dropping 5 cents a pound that day. Buyers started delaying orders in hopes of lower prices while production levels remained. By

October 29, the CME price of barrels was down to $1.0975 and blocks were down to $1.1250 per pound. Milk prices followed, and the BFP for October was announced at $11.49 per cwt., down $4.77 from September and $1.55 under the October 1998 price. The November BFP was announced at $9.97, the lowest price since September, 1978. Cheese inventories declined with falling prices, but remained above year earlier levels through November.

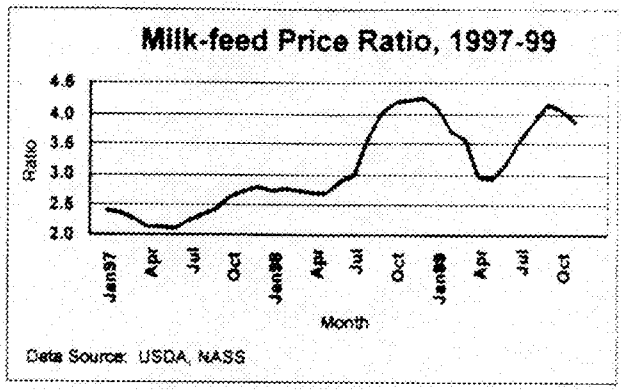
Outlook

From here, the outlook is not good for the near future, but somewhat better for the long term. The good news is rather limited. Production growth is expected to slow somewhat in the year 2000 and demand is expected to remain strong. But, when combined with the 3.3% production growth in 1999, demand will be struggling to catch up with supply. Feed costs are expected to remain low, which is good, but it encourages heavy feeding. Culling increased during October, reducing cow numbers by 5,000 head from September 1999, but then cow numbers increased 7,000 again during November (see Figure 3). Dairy cows numbered 7.755 million head on November 30th, up 58,000 head from November 1998. Those operations that have committed to expansion will likely continue with their plans, despite lower milk prices. Once facilities have been expanded, leaving them empty is not an option. Western US producers are not showing any inclination to revise their expansion plans--at least not yet. In addition to more cows, milk production per cow for the first 11 months of 1999 averaged 3.5% over the same time period in 1998. This is over three times the historical growth rate.

The milk-feed price ratio is expected to decrease somewhat due to lower milk prices, but feed prices are expected to remain low. Thus, the milk-feed price ratio is expected to remain well above the more common levels of 2.2 to 2.75 seen prior to 1998 (see Figure 6).

With feed prices as low as they are, and feed being of good quality, we can expect continued high milk production for some time. The low feed prices are of significant advantage to the large dairies which buy most of their feed, because it reduces their cash costs. Furthermore, most western dairies have locked in their feed costs for the next year through forward contracting or the use of futures, making them unresponsive to feed price changes for the near term. Here, in the Upper Midwest, most dairies produce most of their own feed. Given current grain prices, the cost of growing feed exceeds the market price for many dairies, putting them at a competitive disadvantage. Luckily, with the current farm program, farmers who feed their own grain can receive loan deficiency payments on the grain fed, which helps the cash flow situation. But they still need to ask themselves, "Can I make a higher return per acre by selling cash crops than by selling milk?"

Figure 6.



BFP milk futures do not show highly profitable levels for the next 3 months, averaging about $10.65 for the first quarter and $11.25 for the second quarter of next year. Some, but not all, producers can make satisfactory profits at such price levels.[1] The USDA projected BFP for the first quarter of year 2000 is $10.65 per cwt., plus or minus $.30, with the second quarter price a little higher at $10.95 per cwt., plus or minus $.45.

The longer term has more going for it. Demand is expected to stay strong during 2000. International buyers are becoming more active. By mid-November, two-thirds of the Dairy Export Incentive Program (DEIP) allocations through mid-2000, including unused allocations from previous years, have been committed. There are expectations/ hopes that recently completed talks between the US and China will quadruple US dairy exports to China in coming years. This could be as much as $135 million per year, but will take time to develop. However, such deals are always subject to international and internal politics as well as monetary policy in either county. The USDA projects the BFP for the third quarter of 2000 to average $11.95 per cwt., plus or minus $.50 with the annual average to be about $11.70 per ctw.,

[1] Prices as of 17 December 1999.

plus or minus $.45. The futures market is more optimistic, with the futures for the third quarter averaging $12.76 per cwt.

Conclusion

The expansion that has occurred, and is occurring, is based heavily on three short term phenomenon: (1) one year of bad weather for western dairies, (2) followed by a year of unfounded fear of short cheese supplies, and (3) exceptionally low feed costs. The first two of these have already vanished. The third will take longer to abate, but feed prices will increase again, either because of improved world trade or government response to calls for help from grain producers. Consequently, we now have greater milk producing capacity than the market can support at profitable levels, especially once feed costs return to more normal levels.

To survive, Midwestern dairy producers will need to do some sharp marketing, taking advantage of favorable price movements in the futures markets or good opportunities to forward contract. They will also have to keep an eagle's eye out for cutting costs wherever they can, and send any poor producing cows on their way to the hamburger shop. It looks like this could be a long struggle, with red ink flowing before it is over. Next summer's weather could have a big influence on the outcome. Weather conditions which would reduce milk production without reducing feed production, such as happened in 1988, would give some immediate relief, but only postpone the need to deal with the recent over expansion. Weather that would drive feed costs higher, such as a drought over a larger area, might be the quickest, but a very painful way to get supply back in line with demand. Many dairies would be forced out of business. But relying on bad weather, here or in the West, to save the situation is very risky and may only postpone the need to deal with the over expansion problem.

Looking ahead, it seems that for the producer who is thinking about retirement or dropping out of the dairy business, now may be a good time to exit before losing equity through producing milk. But before doing so, one needs to do some careful economic analysis and planning for exit, checking on expected profitability and/or tax implications. Producers who want to stay in the dairy business have a more difficult task, and that is surviving the over production phase until supply and demand meet at more profitable prices. If expected prices are not sufficient to cover all costs, they need to ask themselves, "Can I get my costs lower than the expected prices, or am I willing and able to withstand the expected financial losses until the market improves?" This will entail carefully scrutinizing costs, eliminating any expenses that won't cut sales more than the cost saving, and locking in profitable prices if, or when, they occur.

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