As published in

DairyAdvisor™

Risk Management

Dairy prices "punch drunk"

By Brendan Curran
Risk Management Consultant
INTL FC Stone

Dairy prices are punch drunk and just can't seem to get up off the mat. The one-two hammer blows of ramped up European Union production and weak export sales are making prices vulnerable to a flurry of other punches that seem to keep our domestic pricing just one solid sock away from a knockout.

A standing eight count would be welcome right now to gain time to reassess because our weak and wobbly market is not solely the fault of the Europeans or poor exports. It's a function of supply and demand on a larger scale. Although the market is at or near fresh contract lows in many cases, it remains a fool's game to try to pick the bottom of the market. But we can take some deep breaths, look around the ring and the arena beyond, and try to picture the situation as accurately as possible—so here goes.

Since the bell that sounded the previous round, I've been fielding a lot of questions about the timing of recovery in the dairy market. Besides the obvious answer of "who knows," I've said that recovery is farther off than many think. A small bullish crowd has felt that the second half of 2016 may offer some glimmer of hope. But the fact has persisted that nothing has changed in this arena – bears crowded the bleachers and have not budged.

With EU production at full throttle in the post-quota era, large volumes of SMP (skimmed milk powder) are being steered into government intervention. At some point, this product inevitably must clear back through the market, which casts a long, bearish shadow over ideas of recovery.

China and large-scale buyers remain on the sidelines as well. We all know their reticence will not last forever. Even so, there will be a lag in our recovery phase once they do emerge from dormancy. It would be like spitting into the wind to bank on a second half recovery based on their return. What makes that headwind even stronger is the ongoing Russian ban on ag products, which shows little sign of diminishing.

As we head into the spring flush, more milk will flow into the cheese vats. With inventory levels already bursting, we will reach a point where we're totally stocked up. Without a material increase in domestic demand or an about face in the export arena, those inventories will swell to the point of breaking the market down to a level more in line with international prices. That's where cheddar is staring about $1.25/pound USD equivalent.

Consider also the precarious state of global macroeconomic conditions, including the moribund crude oil market and the resulting negative impacts in the commodity sector. Other factors are rattling the nerves of investors, including the Bank of Japan sending interest rates into negative territory and the European Central Bank (ECB) cutting their rates to zero. There is also the recent divergent and untimely interest rate hike from the U.S. Federal Reserve.

Under these conditions, many are looking into the roiling clouds and seeing omens. You can't rule out some kind of "black swan" to fly upon the scene, which might just take us past a tipping point and take prices drastically lower from current levels.

So what will it take to transform the current slugfest into a love-in, a market which makes a 180-degree turn and carves out a bottom for recovery to take hold?

In the U.S., how about higher cull rates, throttled back production, and a lower U.S. dollar, which could spark exports and curb imports? And for the EU, how about higher cull rates and less production, too? And, wouldn't everybody benefit from an uptick in emerging market demand?

The odds are good that a culmination of the conditions described above – and more as yet unknown – that happen about the same time can get the bulls in the bleachers to cheer once more. But also consider the possibility of an unfavorable transition from El Nino to La Nina, which holds the potential for hot and dry growing conditions for the 2016 calendar. The scenario is not implausible. It would have the potential to take grain prices sharply higher while crushing dairy margins in the process. The end result would likely ring in higher dairy prices, but it would come with higher costs, for which industry at large is likely ill prepared.

Diamond V®

The Trusted Experts In Nutrition & Health™