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Risk Management

Butter… the Yellow Giant

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It was a year ago when we all held our collective breaths and watched in awe as the spot price of butter went on its meteoric bull run to heights no one thought possible. Finally it stalled at a frothy $3.06 for about a week in September, like a climber admiring the view from the apex of the mountain.

However, at those heights it didn't take long before the air got a bit too thin for a little too long. The Yellow Giant slipped and broke its bullish horns. Over the cliff it went, hurtling down the slippery slope back to reality, shedding more than $1.30 in about a months' time.

Markets heat up and markets cool down.

But for those unprepared for butter's 2014 climb, the anthem for 2015 was "never again." They were not so much thinking that prices could never boil up to the dizzy heights of 2014, but that if and when such prices did recur, then hedges would be in place to mitigate the severity of ensuing fall.

Such thinking certainly proved to be a fundamental aspect of the market in early 2015 as end users became quite proactive in securing either physical hedges, financial hedges, or a little of both. And, as 2015 progressed, domestic markets remained quite resilient in the face of massive global bearishness. Few were suffering from short-term memory loss, so hedging activity began to pick up, even out into 2016.

Then we entered late summer this year. Price action had been quite subdued up to that point. Sure, the persistent California drought remained on everybody's mind and there remained concerns about butter production. However, the general consensus was that a run past $2.20 would be a stretch, considering that stocks easily exceeded 200 million pounds.

That was about the time when little rumblings began: A somewhat bullish cold storage tally; sub 1% milk production; an erratic El Niño weather pattern that cast a shadow of doubt on whether it would answer prayers and deliver drought-busting precip to the West Coast.

Those rumblings turned out to be little tremors beneath the surface, a warning of the volcano to erupt. And, without warning, it erupted. Butter began to rocket higher, racing up the slope and taking out levels that most scoffed at just a few days prior.

Oxygen-starved, we entered the "five stages of denial" and printed a fresh, all-time butter high at $3.14. Astonishing? Not really.

Hedge activity had been brisk throughout the year, which in a way convoluted the stocks numbers that, at face value, were deemed adequate because the U.S. Department of Agriculture doesn't specify ownership of that inventory. Does the manufacturer really have product to move? Or, is it spoken for already by end users, essentially limiting available product to be brought to market?

In addition, USDA not only includes consumer packaged butter and bulk butter alike in the cold storage tallies, but also accounts for AMF (anhydrous milk fat) and concentrated milk fat. With strength in the U.S. dollar, imports of butter fat reached our shores and inflated the cold storage numbers, which bred confusion over the latest spike in butter prices.

Long story short: There wasn't as much grade AA available as previously thought, which tripped the panic button on prices at the peak.

Looking ahead, a second consecutive year of record pricing should only add to the hedging aspect of the market into 2016 and beyond – from a physical standpoint and a financial one as well. We could expect prices to ease once holiday purchases wrap up. But if El Nino fails to deliver and alleviate the drought situation in California, then the Yellow Giant could have sharp horns again next year.

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