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Risk Management

Riding a wave of residual demand

By Brendan Curran
Risk Management Consultant
INTL FC Stone

Standing at the halfway mark of 2015, any look at the dairy markets today drives home the point, "What a difference a year makes!" Last year's historic price action is fading into the distant past, but the high water mark still affects the market in the form of residual demand.

The demand that continues to buoy our domestic market, as it has done for the better part of the year, is proving its resilience by sponging up increasing U.S. milk production. However, one gets the feeling that the high tide is coming in, which could start as a trickle but eventually swamp where the market stands today.

Answers to a couple of questions can give us a better idea whether we're going to start sinking or continue to float along in the backwater of post-2014 demand.

What about California?

Indeed, there are enormous issues to deal with in the dairy juggernaut, but no realistic solutions in sight. Moving forward in 2015, California production may become even more problematic, with major impacts on prices in 2016. At present, however, most observers believe projected California production has been factored into the market as it was most likely the catalyst for the recent spike in butter prices. Yet, the real driver of this market is not the situation in the Golden State, but the overall demand factor.

Although recall of the 2014 bull market is fading, the experience remains fresh in memory of those who felt the pain during the run up in prices.

The next question is, how is that experience guiding end users who are loath to repeat it?

Stalwart end-user demand has continued to keep prices afloat. After rebounding off the January 2015 lows, it became more a question of whether prices made sense enough to lock in for long term. The answer proved to be a resounding “Yes!”

A look at the forward curve in the futures market had suggested upside price action would remain subdued as the market was in a carry state. However, that was not assurance enough for most and therefore the marching orders were to “lock it up.” That has been exactly what end users did and have continued to do. At current demand levels, it has made sense. And, against year-ago price levels, it has been a gift all wrapped up with a bow on top.

This dynamic has kept both Class III milk and cheese trading in a volatile range that has ripped higher and plunged sharply time and again for the past few months without really going anywhere. However, the dynamic may be about to change as we have reached a period where the deferred demand that has been pulled to the forefront may be approaching exhaustion.

If we ultimately exhaust the residual and deferred demand, then prices could slide down the wave to retest the trough in the 2015 range to date.

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