

Milk prices to lag as economy sags

Dairy Outlook

By JOHN OTTE

ON the bull side, two factors support milk prices.

"One is lofty corn and soybean meal prices," says Ken Bailey, Penn State University economist. "Higher feed prices rapidly boost the cost to feed a milking cow, which should slow milk output growth."

The second is our dollar continues to sink against the euro as our economy slows. The weakening dollar means more potential cheese exports, which buoy the outlook for Class III prices.

Cash butter is trading at just over \$1.20 per pound and futures indicate it may rise to \$1.38 per pound by July.

Despite the bullish tone, Bailey remains firm that, barring a decline in milk per cow yields, we'll see a lot more milk this year, and it will overwhelm the markets. More milk and higher retail prices will build inventories of cheese, butter, nonfat dry milk and dry whey.

Key Points

- High feed costs should slow milk output growth, which is constructive for prices.
- Rising product inventories and lagging consumer income growth are drags.
- First-half dairy profits are likely to give way to losses in 2008's second half.

Butter, dry whey and nonfat dry milk prices will all head lower as production and inventories climb.

"Yes, traders are bidding Class III prices up to \$17 per cwt.," he admits. "But it will take market fundamentals to keep them there."

Domestic and global income plus inflation also intertwine to impact milk prices. For example, one would expect the high cost of fuel would reduce U.S. disposable income to the point of cutting into fast-food sales. As this occurs, domestic commercial disappearance should decline. Thus the very factors that are driving the value of the dollar lower, which help exports, are also adversely affecting domestic sales.

"Clearly producer margins will tighten as market fundamentals drive milk prices lower and feed prices rise," says Bailey.

"Cow numbers, which depend on past earnings, will continue to grow despite declining earnings. Thus, we don't see production moderating until late spring. In the meantime, the supply of manufacturing milk will continue to rise, as will inventories of cheese, butter, nonfat dry milk and dry whey."

Bailey expects the all-milk price to drop to \$18 per cwt. and gradually decline to \$16 per cwt. by year end. "Given feed costs, we'll be at the breakeven level by midyear. Then milk producers will face negative margins similar to those experienced in 2006."

"Our forecast is much more bearish than the market," concludes Bailey. "We think milk producers may want to lock in prices on part of their 2008 milk production."

An economic flu ahead

FALLOUT from the subprime mortgage debacle created the financial, liquidity and investment banking crisis. Fears that the economy in general will deteriorate further can feed on themselves. That can cause consumers to worry that their own financial situations will erode. In response, consumers tighten their purse strings.

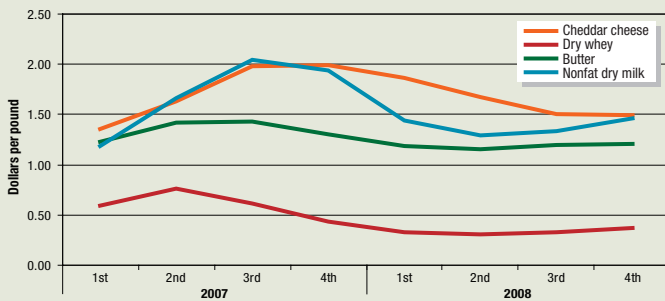
Consumers are the engine of the U.S. economy. As consumers ease up on the spending foot feed, consumption slows. Lagging consumption trims demand. Weakening demand applies the economic brake.

Bob Cropp, University of Wisconsin economist, thinks slowing economic growth will negatively impact milk and dairy product sales. Restaurant business is particularly important for cheese and butter. Recent restaurant traffic is the lowest since February 2003.

Cropp expects Class III could stay above \$16 through at least July.

"With some strengthening of cheese prices and dry whey prices by late summer and fall, a \$17 Class III is quite possible by September and October," he says.

Dairy product prices will likely be 25% lower in 2008



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