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MCTCOMPASS

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Trade Rules Challenge Buyers

Most of the time, when CME cheese markets unexpectedly move up or down, data soon becomes available—within a few hours, days, or weeks—to support the price change. Occasionally, however, a price change appears to be out of step with market reality. When this happens, often a rule allowed the sale. Once buyers receive the paperwork, they realize something was amiss. Word gets out about the transaction, and buyers step away from the market to avoid owning a product that may be hard to market commercially. The trade refers to it as catching a falling knife — a risk-prone transaction that needs a large discount for buyers to even entertain the transaction. A falling knife and other rules led to a steep drop in cheese prices a few weeks ago.

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Freight discounts have been the bane of CME rulemaking for decades. Dairy markets require sell-side liquidity, and if freight differentials are adjusted to commercial rates, a market risks losing sell-side participants. On the other hand, CME freight rates have been in place for over 20 years, but under today's freight costs, buyers view reimbursements as inadequate for some shipping lanes. Despite efforts to rectify this, the industry has maintained current rates, and occasionally a seller's shipping lanes are so expensive that buyers are reluctant to procure the cheese.

The introduction of the Food Safety and Modernization Act (FSMA) has also presented challenges. For example, the law's traceability provisions require buyers to procure products from qualified sellers, those whose products and plants have been inspected. Exhaustive discussions have occurred about providing adequate paperwork to satisfy FSMA requirements under electronic trading where the seller's and buyer's identities remain unknown at the point of sale. However, if a new seller from a new plant arrives at the market, the product may meet CME specifications, but the seller may not have been audited. In this case, most buyers would be unlikely to accept the product until a complete internal review could be conducted.

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Ken's Corner

by Ken Meyers
President, MCT Dairies Inc.

The United States continues to be best positioned to meet the world's dairy needs. U.S. milk production has held up relatively well, and U.S. dairy producers are some of the most efficient and resilient in the world.

Since June 2021, New Zealand milk collections have dropped below year-earlier levels in every month except June 2022, when production was even with the previous year. In addition, a dwindling supply of milk powder in New Zealand, along with political fallout following New Zealand's criticism of China's stance toward Taiwan, has spurred the world's most populous country to accelerate its effort to seek out alternative suppliers of dairy products.

In Europe, many countries are struggling through an unprecedented drought, and indications are that several, including France and Switzerland, could post lower annual milk collections this year, compared to last. In Italy, the water level in lake Garda, the country's largest lake, fell to its lowest recorded level, and the Swiss have been airlifting water into the Alps to provide dairy herds with needed supplies as rivers and alpine lakes evaporate. In response, EU cheese prices have started to move higher.

These and other rising dairy prices overseas could further benefit U.S. exporters, as international buyers seek out more cost-effective product. **MCT**

Prices Battle to Find Balance

The final August Global Dairy Trade auction revealed modest improvements. CME futures absorbed the information, and butter and nonfat dry milk futures pushed higher in anticipation that the lows for this downturn have already been put in and that prices could improve through fall. Competition between supply- and demand-side weakness has left markets guessing which side will have more influence on prices this fall. So far, concern over a shrinking milk supply has kept buyers on edge that price hikes could be coming. And futures prices into 2023 for Class III and IV milk are now back above $20/cwt. These anticipated higher prices could encourage more milk in an effort to balance global supplies. **MCT**

MCT Forecast

	Block*	Barrel*	Class III	Butter*	Class IV	Whey**	NFDM**
Aug	2.1900	2.2050	22.88	2.9575	26.02	0.6225	1.8175
Sep	2.2425	2.2525	23.31	2.9700	25.94	0.6100	1.8000
Oct	2.3350	2.2325	24.01	2.9550	25.82	0.5975	1.7950
Nov	2.3850	2.2775	23.99	2.9050	25.72	0.5950	1.8075
Dec	2.2950	2.2050	23.20	2.9525	26.14	0.5875	1.8325
Jan	2.1775	2.1825	22.44	2.7825	25.50	0.5875	1.8425

** CME prices.*
***NASS prices.*

...as sellers retreated markets reverted to normal

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These rules came into play in early August when sellers with expensive shipping lanes and sellers with products from a new plant arrived in Chicago. These sales resulted in spot cheese prices that fell from the $1.90s into the $1.70 range, resetting prices to January levels. Subsequently, the commercial market and data provided no indication that the market had fallen into disarray. To the contrary, 2022 U.S. cheese exports are on pace to exceed 1 billion pounds and food service sales have continued to recover. While retail scanning data has been lagging last year, improvements from other channels have been sufficient to offset those declines. Why then did the CME cheese market decline? For a few weeks, the market represented a subset of the commercial market's value rather than the overall market. As soon as that subset of sellers stepped away from the market, prices rose.

In late July, cheese prices legitimately eased to accurately reflect the commercial market, but the severe price drop that occurred in spot and futures prices in early August piqued buyers' interest; U.S. cheese prices were inexpensive relative to prices in Europe. While these unusually low CME spot and futures markets likely encouraged more hedging and forward purchasing by those expecting a fall rally, a decline in demand could keep cheese prices from racing above $2/lb. this fall. Consumers appear to be modestly reducing their dairy purchases given today's decades-high inflation. In addition, some cheese makers have reduced package sizes, which could mean fewer overall pounds sold, and China's 2022 purchases appear like they will be lackluster compared to 2021's. Through midyear, China has imported 20.8% less cheese than it did in the same period last year. However, China has imported enough cheese in the first six months of this year to put 2022 on track to claim the second-highest annual cheese import volume on record, following 2021. However, if the large year-over-year gap remains, which appears likely, between 70 million and 80 million pounds of cheese will need to find a new home this year.

Currently, reports indicate that China's economy has slowed more significantly than expected and cheese demand could remain substandard through the end of this year. If U.S. consumers continue to slow purchases and demand from China continues to fall behind last year's pace, cheese prices could flounder right into early 2023. **MCT**

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