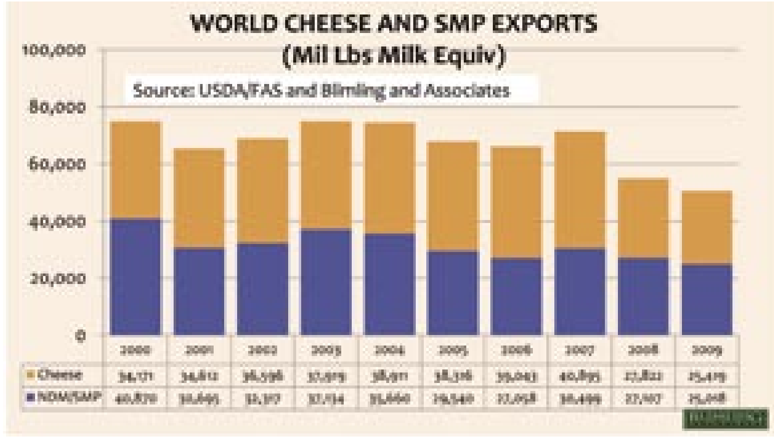
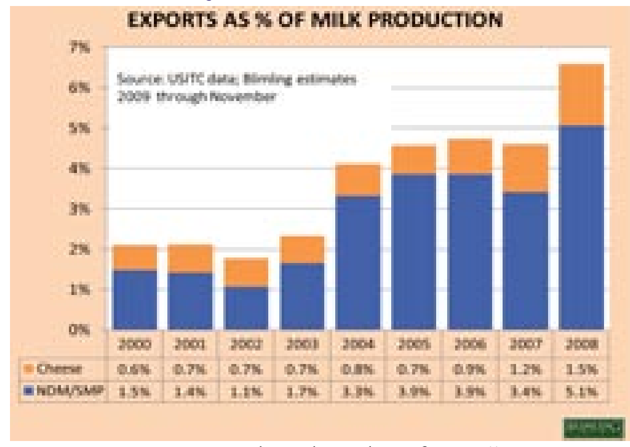
Summit offered eye-opening discussion on dairy boom-bust





By SHERRY BUNTING
Special for Farmshine

LANCASTER, Pa.—Healthy cynicism is a good thing to have if you're in the dairy business. In hindsight, the entire dairy industry could have used a few doses—along with a spade or two for digging into the conventional wisdom that emerged during the 2008 boom before the 2009 bust.

That was just one of the take-home messages from the eye-opening 'post-mortem' analysis provided by Bill Curley during the Pennsylvania Dairy Summit here earlier this month.

From start to finish, his review was jam-packed with insightful revelations, supported by charts and graphs, and an approach that made the numbers and analysis interesting.

Curley hails from a former dairy farm in Susquehanna County, Pennsylvania. Today, he uses his education and keen acumen for analysis as a co-owner and dairy market specialist for Blimling and Associates, Inc.

Cynicism is something that prompts Curley to question and evaluate just about everything he reads and sees. For example, in 2008 when conventional wisdom held that the dairy markets were experiencing a paradigm shift fueled by exploding global demand and surging U.S. dairy exports, he was asking questions.

In fact, he encouraged dairy producers and manufacturers, alike, to always do their own research, to look at the market fundamentals, not the price, and to manage the marketing of their product as aggressively as the production side of the business.

"Get engaged in policy decisions," said Curley. "Get involved in trade policy and look at price discovery and the cash market and the level of transparency and functionality and dysfunctionality. Do your own research and trust your instincts. Remember that price is only half the story, we have to look at the market fundamentals."

Aside from reviewing the market fundamentals of the past few years, he told the 500 producers and industry representatives attending the Summit that he sees "a little more ugliness ahead," as the market stabilized in the last two to three months of 2009, and herd liquidation slowed.

Curley sees the potential for this to get worse again before the industry finishes the job of getting the national herd down, which he and others see as necessary for a sustained rally.

The other complication he cited is that, "The heifer pipeline is stoked full." The numbers he cited "look a lot like 3% and I know what 3% too much milk does. I'm really reluctant to say it's going to get better on a sustainable basis until we deal with that."

In dissecting what happened during the recent boom-bust, Curley noted the effect on consumer behavior from the global economic meltdown. He also talked about dairy downsizing methods used by foodservice and manufacturers in response to 2008's high prices. "These are two things dairy producers can't do much about," he said. "But there are some things they can do in this volatile environment.

One is to do the 'due diligence' around expansion. "This goes for producers, processors and marketers," said Curley. "We have to look at the market coming at us and know how sustainable it is and if this is the place you want to invest capital—whether it's cows or manufacturing capacity."

He said the export boom in 2008 was totally misread. And he declared the dairy price discovery system is broken and "did not serve us well through all of this.

He also said export growth will be crucial if the U.S. dairy industry is to grow at the rate it grew before, but for that, policy changes are needed along with a totally different mindset about the customer and how milk is marketed.

Looking back on the boom-bust cycle of the past two years, Curley said the Class III milk price averaged $17.44 in 2008, as the unprecedented global demand for U.S. dairy products against a backdrop of exploding commodity prices, in general, propelled the industry.


Bill Curley, Blimling and Associates

"All we heard on the other end of the phone was that we were seeing a new baseline—$2 powder and cheese," Curley reflected. "But you can't put those prices in the market and not get large production. With the big price, we saw rapid expansion in the manufacturing sector with more cheese vats and dryers… it all made perfect sense. We had the milk, we had the bid, so giddyup let's go, and giddyup we did."

By any measure, the 2008 export market was very good to the industry, and there was no reason to question the growth in demand. Nonfat dry milk prices started to take off in 2007 heading to levels never reached before.

"The previous peak was $1.55 per pound in the mid to late 1980s," he explained. "While this was going on, I was having conversations with customers using or selling powder saying it's crazy. We were hearing China this, Thailand that... I better buy because it will never be cheaper."

But as Curley pointed out, if what was driving that growth in demand was demand from third world countries or developing countries, how is it that China would be able to sustain $2 powder when the U.S.—the largest economy in the world—could not support a powder price at $1.50?

"We were having the same discussion in cheese. There was ample reason to question whether these were really sustainable prices, but the news was surging demand and a new paradigm, and no one felt clear to even question it," Curley related.

Under the surface of 2008 conventional wisdom, said Curley, lay reality. New Zealand and Australia didn't have the products.

"They had the drought. They didn't have the milk. And we did," Curley reported. "It was something as simple as the Oceania milk situation. They were down substantially in their production and they couldn't serve their customers. They had bad weather and there was nothing they could do about it. They put their customers on allocation, and this set off a panic across the globe."

"No one bothered to ask: 'why can't I get what I want?'" he said.

"I don't want to totally dismiss the notion of international growth," he added. "There's a story there, a kernel. It's a piece of what was going on, but not the entirety. We were stealing market share. They were telling customers 'no.' But we had the cows. We had the milk. And we could tell them 'yes.'"

He showed (above) that at a time when U.S. dairy product exports were surging from 2007 through 2008, the cheese and nonfat dry milk trade actually declined, globally.

"The story we got was demand is expanding so much that they need our product to fill it, so grow your dairy and build your plants," said Curley. "We heard the export markets are here to stay. Everybody was caught up in the euphoria of being in the position they longed to be in for quite awhile."

The belief was that the U.S. share of the global market was going up, which led to the message: "We need your milk. Expand your business. Grow your dairy. Build more plants. The profit is here to stay," he added.

The story is uncannily familiar to what farm writers saw happen to grain farmers in the 1970s. Curley talked about going back through old copies of the *New York Times* and grabbing stories about a similar time when everyone believed the U.S. was experiencing a "new paradigm" in the grain industry due to exports and "feeding the world."

The time was the early 1970s under the Nixon administration, and the late Earl Butz was secretary of agriculture. The question was: Can we feed the world's people? He cultivated a large export deal to Russia in 1972, depleting the grain reserve. Prices rose as a drought followed, and supply management of grain production ended.

In 1972, Butz coined the mantra: "Plant fence row to fence row." Buoyed by high grain prices, millions of Midwestern farmers took on debt to buy more land, at inflated prices, and produced all they possibly could.

That bubble burst. By the time it did, farms were cranking out much more than the market could bear, and prices fell accordingly. Then, debt became a paralyzing burden and farm incomes fell, which together led to the deepest rural crisis since the Depression.

Looking at those old papers, Curly read the interviews with the grain growers dated 1972 and then few years later, an article by the same reporter interviewing one of the same grain growers, asking: "How did someone worth multiple millions ramping up to feed the world now a few years later cannot feed his family?"

"They did all the things we did in 2007-08 in the dairy business, and for a lot of folks, the story is the same today in the dairy business," said Curley.

The 2008 boom—and the lack of sufficient cynicism about the underlying fundamentals that supported it—helped to set up the bust in 2009, when milk production not only rebounded in Oceania, it exploded. New Zealand was back on the market bigtime.

"We were reading the press clippings out of New Zealand. Banks were putting out releases saying the returns to dairy were so good in 2007 and 2008 (due to low production)," he explained. "Their growing season begins counter to ours in September and October and goes through April or May. Our prices had begun shooting up in 2007 because they weren't in the market. New Zealand is a hard place to get real live data out of, but we were reading the press clippings. They were converting acres from other ag enterprises to dairy for an unprecedented number of cows."

Thus, it is not surprising that by 2009, the U.S. lost its surge in exports and was back to the baseline of 2004 through 2007.

"Now we had the 2% more cows and 15% more manufacturing capacity we had accumulated during the time of export growth," Curley explained. "We were counting on that larger share of the export market to be consistent, and it wasn't."

So why is it that the Oceania price (or world price) for cheese later on in 2009 rose higher than in the U.S.? Curley showed this on a graph and logic begs the question that if the U.S. had the price advantage, why were we not exporting more at that point?

Price is sometimes not the only thing that matters, exports stayed down right to end of last year as Fonterra worked to get its business back after New Zealand's milk production had recovered.

The problem stems back to the end of 2008, when the international powder price fell, and U.S. suppliers chose to sell their powder to the government for a nickel more instead of keeping their new-found customers and selling to the international market to get it out of here.

"New Zealand has every incentive to make the customer happy. Here in the U.S., we have policies that get in the way of being a consistent supplier to the international market," Curley observed.

On the domestic consumer market, the boom prices of 2008 caused downsizing in dairy user levels.

"When the cheese price got high, McDonalds took one of the two slices of cheese off their double cheeseburger, changed the name, and put it on the value menu," said Curley.

So, if 25% of all the cheese bought by McDonalds was going into the double cheeseburger, and then one slice of cheese is removed… "That's a 50% decline in a 25% supply, so it's a 12.5% hit on demand.

Then there is the shrinking ice cream containers. "A change from the 56 oz. container to 48 oz. represents a 15% reduction in demand for milk—for cream. There is no price elasticity there. It's just boom-bam-gone."

He cited other examples of food manufacturer "downsizing," where dairy was reduced or replaced as companies found ways to reduce their exposure to cheese.

"This is the anatomy of how your price collapses," he explained. "The markets get too high, and changes are made on a user level."

For consumers too, the profound impact was felt after the economic meltdown, and it was primarily felt in the "casual dining" sector. "People went to the dollar menu," said Curley. "They are trading down from casual dining to the dollar menu and from Pizza Hut to frozen pizza at home. Cumulatively, this also contributed to what happened in 2009."

As more people began eating at home, fluid milk consumption grew in 2009, but Curley maintains that is "a drop in the bucket compared with what we lost in the food trade, on which we rely for the growth of high value dairy usage. The good news is there has been a counterbalance in the retail sector, which looks better.

"2010 will be better," said Curley. "It won't be 2008, but it will be better than 2009."