# HOT TOPICS FOR COLD TIMES

Blimling and Associates, Inc.
October 2009

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# VOLATILITY REDUCTION 1

- Manage volatility on a macro or market-wide level
  - Regulated pricing schemes
  - Trade barriers
  - Production quotas/supply management

GOAL IS TO LIMIT PRICE MOVEMENT FOR ALL MARKET PARTICIPANTS

- Dairy in Canada and in Europe
- Sugar in the United States

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# VOLATILITY REDUCTION 2

- Manage volatility on a micro or individual level
  - Forward contracts
  - Futures and options contracts

GOAL IS TO LIMIT THE IMPACT OF PRICE MOVEMENT ON A FIRM-BY-FIRM OR FARM-BY-FARM BASIS

- Most agricultural commodities in the US
- Energy products worldwide

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# DEFINING THE GOAL

Rigid system with strict production quotas and limited participation in global markets. High barriers to entry given value attached to quota. Predictable. Seductive… but static.

National supply quotas set to be phased out. Producers receive direct payments. Once a global powerhouse, but role is fading as export subsidies wane and high production costs inhibit competitiveness. Processors have pricing power; producers often unhappy. Beyond quota, growth is limited by land-base, environmental regulations. Conventional wisdom: will be self sufficient and little more.

Heavily regulated in a loosely structured way. Dual safety net: price supports and some direct payments. Lots of diversity… and strife. Generally has a growing role in the global marketplace, but regulatory structure makes sustained engagement difficult. Viewed as a nation that can be a bigger and bigger player on the world stage… if it wants to be. Caught in the murky middle…

Largely unregulated – no producer safety net. Intense export focus, leveraging role as low-cost producer. Power centralized (Fonterra) which fosters an element of focus. Future growth is limited, though, and marginal cost of additional production will be high. Solution: making significant investments elsewhere in the world.

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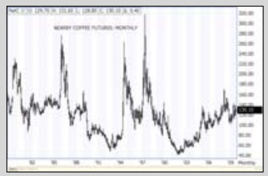
# "GROWTH MANAGEMENT"

- History does not offer examples of success… Coffee? OPEC? Sugar?
- Any program designed to minimize volatility (that means reducing peaks as well as valleys) must be designed to accelerate expansion when demand advances and accelerate contraction when demand declines.
- As such, some measure of volatility would be the byproduct of a governing board's failure to foresee demand changes before they materialize.
- Supply management as envisioned could erode the long-term base of expansion that is gradual and smooth – such as the internal growth of small- and medium-sized diaries that expand by managing cull rates – and replace it with a much choppier pattern of large, discrete expansions.



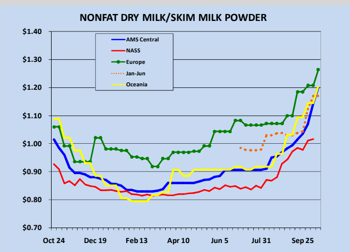


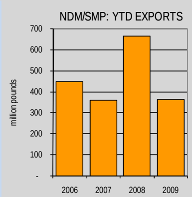
# PICK A PATH

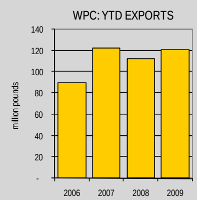
| EQUAL OPPORTUNITY | EQUAL OUTCOME |
|---|---|
| Market picks winners and losers | Rules (and those who set the rules) pick winners and losers |
| Higher risks, but higher rewards | Reduced risk, but reduced rewards |
| Broader range of outcomes | Narrow range of outcomes |
| Preserves freedom of individual decision making with the presumption that the collective interest is best served by amalgamated impact of individual decision making | Relies on centralized decision making with the presumption that the collective interest is best served by directing individual actions to a societal goal |
| Dynamic and adaptive | Slow moving and rigid |

*Here's what we often secretly want:*
*privatized gains with socialized losses*

# SUPPORT DISTORTS




- We don't necessarily make the "right" products for customer base – domestic or global
  - We make NDM because it is what the government buys
- When prices get to support levels, we exit the world market stage
- Is a bolstered MILC approach a better safety net?



# FEDERAL *DIS*ORDER?

- The Federal Milk Market Order System is too antiquated and too complicated.
- Does not provide for easy allocation of milk to its most valuable uses.
- Barrier to innovation.
- Prospective global customers are not impressed.
- Price transmission is painfully slow

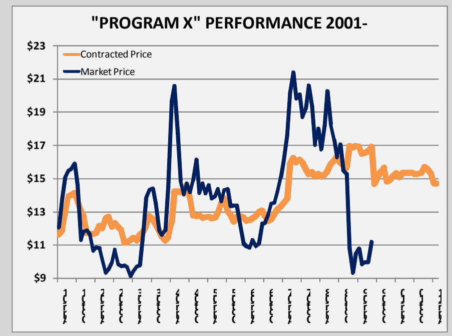
# FEDERAL *DIS*ORDER?

- Makes risk management much more difficult than necessary
  - Compare and contrast: hedging corn versus hedging milk
  - A quick remedy: trim down to one or two classes of milk that can be easily traded by a large proportion of producers, processors and end-users
- A reasonable question: why should anyone believe “they” or “we” will get it right *the next time*?
  - Industry has spent decades and untold dollars fiddling with the system with few, if any, obvious benefits

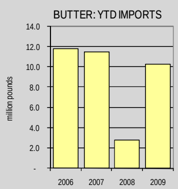


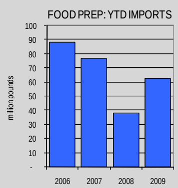
# A NARROWER BAND

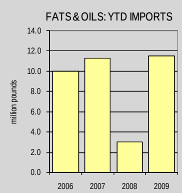
- Examined data from one of the more active farmer programs we have managed for several years
- From April 2001 through August 2009:
  - Contracted milk: $13.53 average with $16.96 high and $11.14 low
  - Market milk: $13.78 average with $21.38 high and $9.11 low
- Huge difference: $5.83 high/low spread versus $12.27

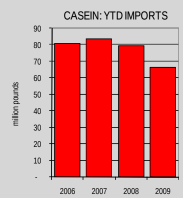


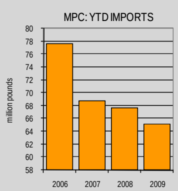
# KEY US IMPORTS 2009 YTD

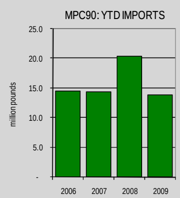


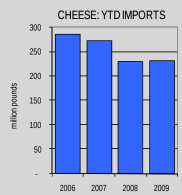




- US dairy import activity was mixed through August
- Outperformers such as butter underperformed a year ago

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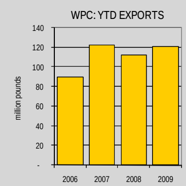
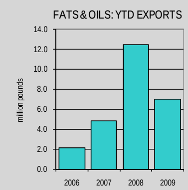
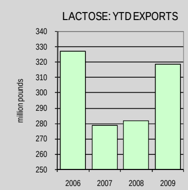
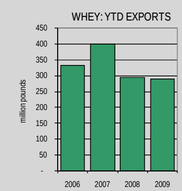
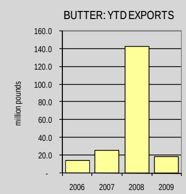
# KEY US EXPORTS 2009 YTD

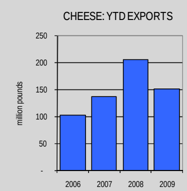


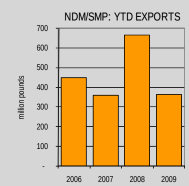




- **Through August:**
  - Cheese exports -27%or 55 million pounds
  - NDM exports -45% or 299 million pounds
  - Butter exports -87% or 124 million pounds

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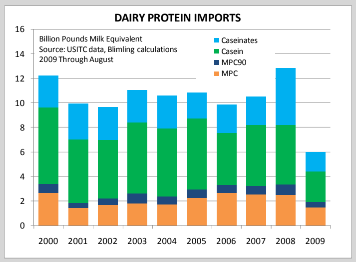
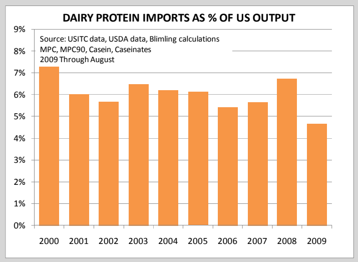
# THE IMPORT QUESTION




- Protein import volumes are variable over the years – no discernable trend in either real terms or relative to US milk production
- If global supply/demand gap is growing, reasonable to wonder whether go-forward potential is limited
- Are imports in part a function of distortions created by US regulatory structure?
- Erecting barriers would have both obvious and unintended consequences

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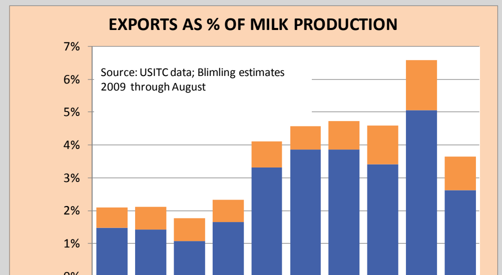
# EXPORT GAP: STILL BIG




| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
|---|---|---|---|---|---|---|---|---|---|---|
| Cheese | 0.6% | 0.7% | 0.7% | 0.7% | 0.8% | 0.7% | 0.9% | 1.2% | 1.5% | 1.0% |
| NDM/SMP | 1.5% | 1.4% | 1.1% | 1.7% | 3.3% | 3.9% | 3.9% | 3.4% | 5.1% | 2.6% |

- Is this *the* chart that explains everything about where markets are at today?

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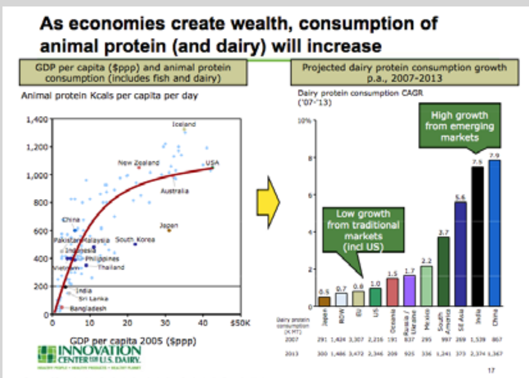
# WELL POSITIONED




- The United States is as well positioned as anyone to fill gaps in the global market as demand continues to grow and "traditional" suppliers cannot keep pace
- The US dairy farmer is exceptional – demonstrated ability to perform
- Other potential competitors don't have as much infrastructure, political stability or know how

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# SUPPLY AND DEMAND

- Domestic milk production has been fading, but process has been slow (as is always the case)
- Global milk production has been uneven, too
- Critical difference between today and 2007/08: Oceania has product
- Demand has undergone major changes as a function of economic upheaval
- Major questions:
  - Can emerging markets create meaningful demand pull?
  - Will US Dollar continue to erode in a way that enhances competitive position?

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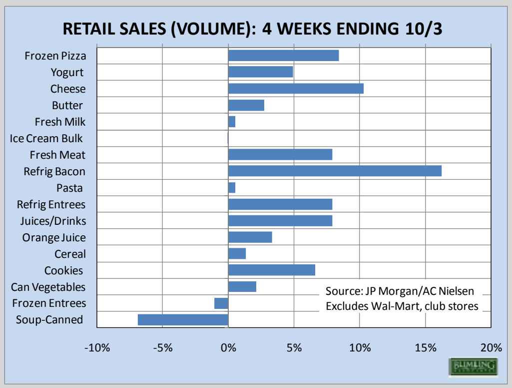
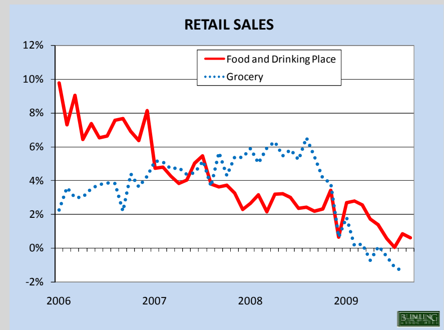
# RETAIL: SOLID





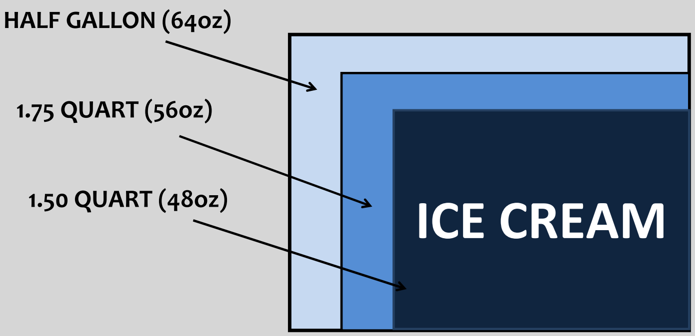


# FOOD SERVICE SOFT




- Restaurant sales have been up some in dollar terms
  - Jan: +2.7%
  - Feb: +2.8%
  - Mar: +2.5%
  - Apr: +1.7%
  - May: +1.4%
  - Jun: +0.6%
  - Jul: +0.0%
  - Aug: +0.8%
  - Sep: +0.6%
  - 2004-2008 avg: +5.6%
- Customer counts down
  - Knapp-Track (Aug): -5%

# DEMAND'S SILENT KILLER




- Comparatively high prices in 2007 and 2008 triggered numerous formula and package size changes
- When does the pendulum swing the other way?

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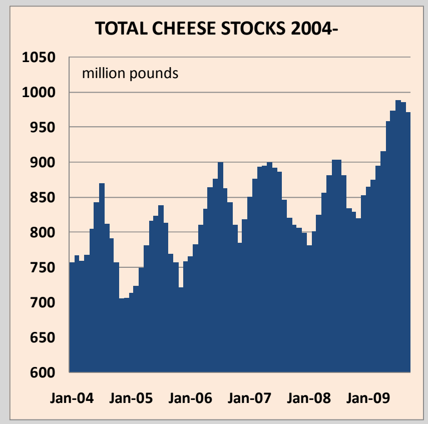
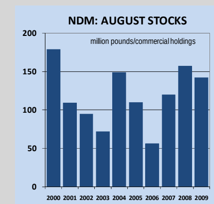
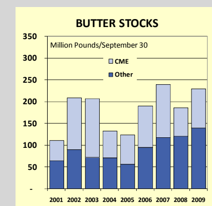
# HEAVY STOCKS

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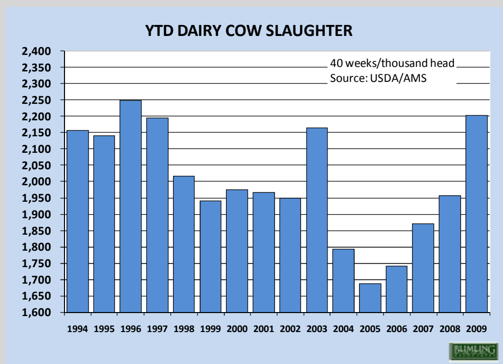
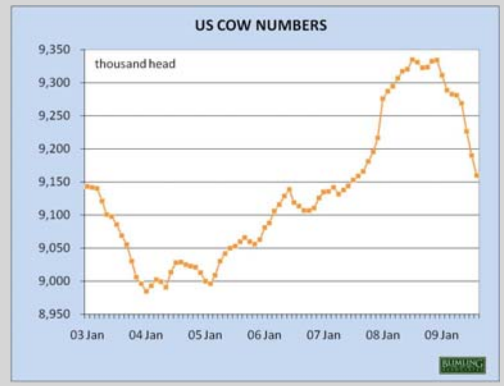
# HEAVY CULLING…

- Year-to-date slaughter activity is at the highest levels since 1996
- Sexed semen?
- Extra 161,00 heifers in 2010; almost 300,000 in 2011
- Have killed almost 250,000 cows more than last year; but cow numbers only down 186,000 (kill 1.34 to remove 1.0)
- Higher prices slowing things down



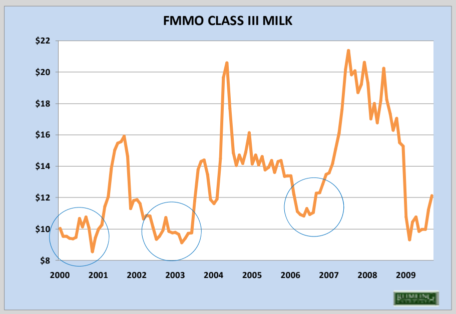



# …COW NUMBERS DOWN




- Year began with widespread agreement that US herd was too large by 250,000-400,000 head
- Herd contraction so far: about 210,000 from the peak
- September at 9,126,000
- Heifer pipeline still strong… means slaughter activity has to be all the greater to get cow numbers down

# IT ALWAYS TAKES TIME




- In reality, the current period of low prices is not especially extended relative to historical price troughs
- Now, however, we are in month 11 of the low price period… by virtue of the passage of time alone we are probably getting closer to the period's end

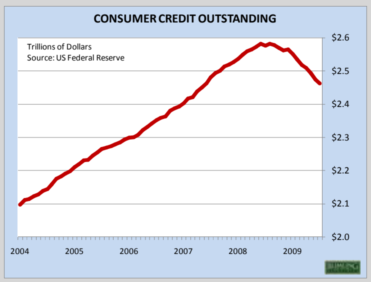


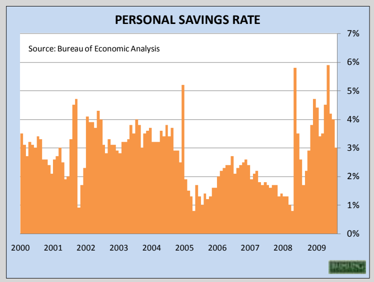
# THE ECONOMY

- We are one year removed from cataclysmic events in the global economy and massive unwinding in equity and commodity markets
- While the system has stabilized and growth has resumed – particularly in Asia – challenges remain
- Fate of US consumer spending still very much in doubt, raising profound questions for food and dairy product demand



# DELEVERAGING

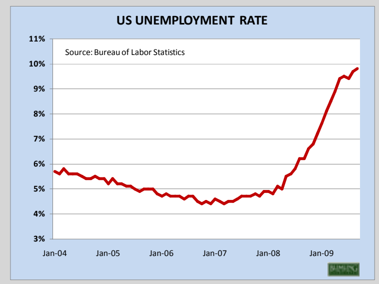


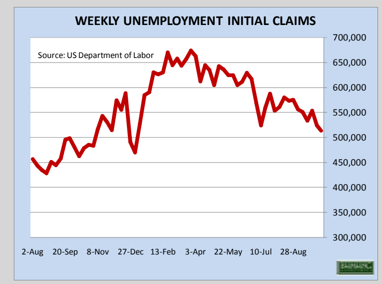




- Consumer retrenchment is also illustrated by looking at credit outstanding as well as in the personal savings rate
- Credit numbers for July were remarkable:
  - 0.9% month-to-month decline was the greatest since 1975
  - 4.2% year-to-year decline was the greatest since 1944
- Savings rate generally trending higher



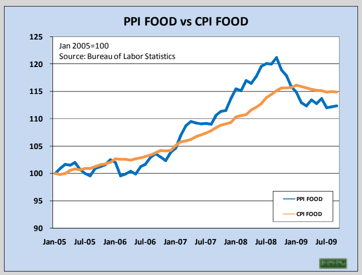
# JOBS, JOBS, JOBS



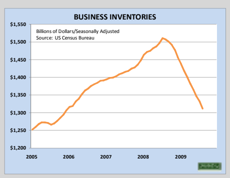



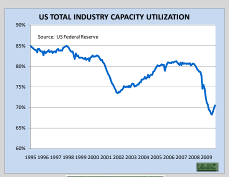

- Sobering statistics:
  - 15.1 million formally unemployed
  - 9.2 involuntary part-timers
  - 2.2 “marginally attached” workers

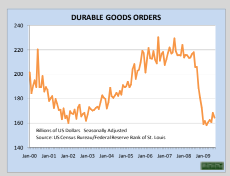
# WHAT ABOUT INFLATION?




- Consumer and producer prices are lower, though latest PPI/CPI data showed a bit more month-to-month inflation than expected
- But is the US economy over-heating? Hard to believe that is the case given labor markets, capacity utilization, etc.
- US Dollar is near year-to-date lows
- Fed does not seem likely to raise interest rates anytime soon… but gold, oil are perky

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# CURRENCY



- Few are bullish the US Dollar
- Sense in some quarters is that the Administration is not especially eager to defend the US Dollar's value… some even suspect that some sort of stealth devaluation is one way out of the mounting debt situation
- We would view currency has having a generally positive bias for US dairy prices, though the impact is not the same for every commodity

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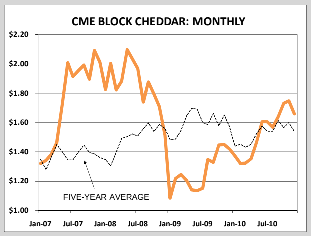
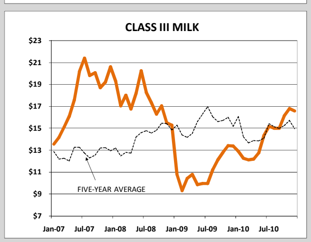
# FORECAST




| | CME Blocks | CME Barrels | CME Butter | NDM (NASS) | Whey (NASS) | Class 3 | Class 4 |
|---|---|---|---|---|---|---|---|
| Oct-09 | $1.45 | $1.42 | $1.25 | $1.04 | $0.32 | $12.81 | $11.94 |
| Nov-09 | $1.45 | $1.43 | $1.26 | $1.14 | $0.33 | $13.42 | $12.87 |
| Dec-09 | $1.42 | $1.41 | $1.24 | $1.12 | $0.33 | $13.36 | $12.58 |
| **2009 Avg** | **$1.26** | **$1.24** | **$1.21** | **$0.91** | **$0.25** | **$11.17** | **$10.66** |
| Jan-10 | $1.37 | $1.36 | $1.23 | $1.07 | $0.31 | $12.91 | $12.18 |
| Feb-10 | $1.32 | $1.31 | $1.23 | $1.02 | $0.31 | $12.25 | $11.65 |
| Mar-10 | $1.32 | $1.31 | $1.32 | $1.01 | $0.30 | $12.11 | $11.98 |
| Apr-10 | $1.35 | $1.34 | $1.30 | $1.00 | $0.30 | $12.18 | $11.88 |
| May-10 | $1.46 | $1.45 | $1.29 | $0.99 | $0.30 | $12.77 | $11.72 |
| Jun-10 | $1.60 | $1.59 | $1.32 | $1.00 | $0.32 | $14.34 | $11.87 |
| Jul-10 | $1.61 | $1.59 | $1.41 | $1.02 | $0.34 | $15.16 | $12.32 |
| Aug-10 | $1.57 | $1.55 | $1.48 | $1.08 | $0.35 | $15.00 | $13.23 |
| Sep-10 | $1.64 | $1.63 | $1.54 | $1.14 | $0.35 | $14.98 | $13.98 |
| Oct-10 | $1.73 | $1.72 | $1.59 | $1.17 | $0.37 | $16.16 | $14.48 |
| Nov-10 | $1.75 | $1.73 | $1.59 | $1.20 | $0.38 | $16.80 | $14.82 |
| Dec-10 | $1.66 | $1.64 | $1.52 | $1.19 | $0.39 | $16.57 | $14.49 |
| **2010 Avg** | **$1.53** | **$1.52** | **$1.40** | **$1.07** | **$0.33** | **$14.27** | **$12.88** |

# BACKGROUND

- Blimling and Associates is a dairy market analysis and consulting firm located in Wisconsin, USA publishing multiple reports and working closely with numerous entities both producing and consuming milk/dairy products
- Roger W Blimling, Inc is a licensed introducing broker guaranteed by ADM Investor Services; >95% transactions are in the dairy markets (almost exclusively commercial)

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