

Milking Profits From Dairy Sector

If the Village People had included one dairy farmer in their ensemble, their 1978 camp classic surely would have been written "U-S-D-A" in honor of the massive subsidies and price supports bestowed upon the industry by the federal government over the years. Besides, it would be a lot more fun watching someone trying to form an "S" with their body than any of the letters in "Y-M-C-A."

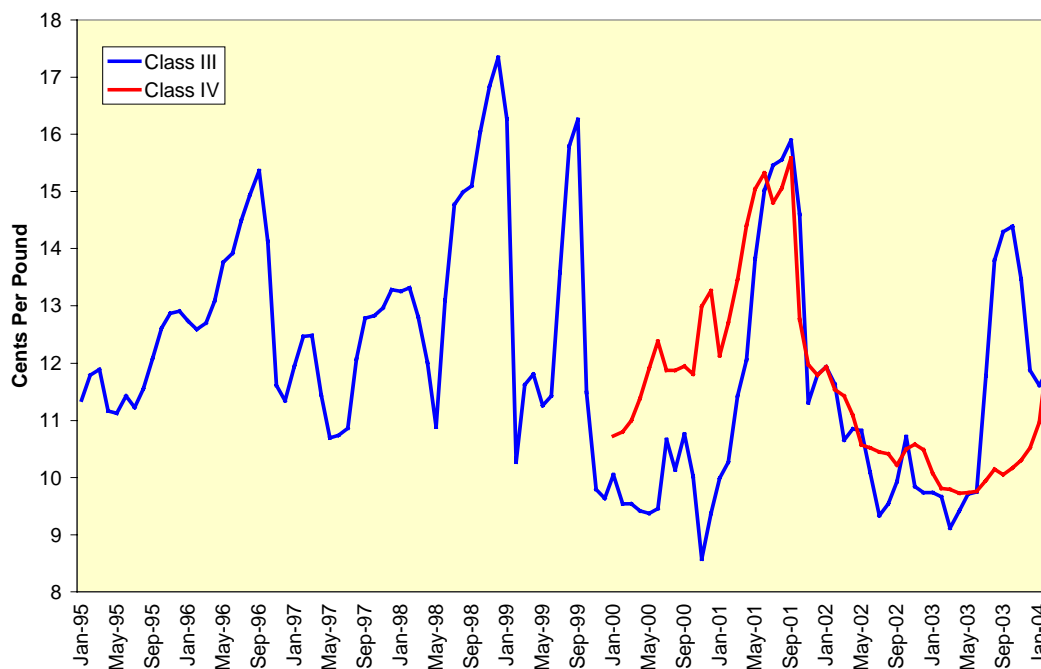
But lamenting the presence of market distortions in the agricultural industry and its dairy sector, especially in an election year or in any years either before or after an election year, is likely to be an unproductive endeavor. This, after all, is an industry characterized for years by the Depression-era Eau Claire rule, which allowed dairy farmers to collect a bonus for their milk based on how far their cows were located from Eau Claire, Wisconsin.

Enough of policy, let's turn to economics and see whether a bull market exists in cow products as it does in so many other physical commodities. Or, alternatively, is the dairy sector one of those corners of the economy in which inflation is missing in action as the official data suggest?

Skimming Profits

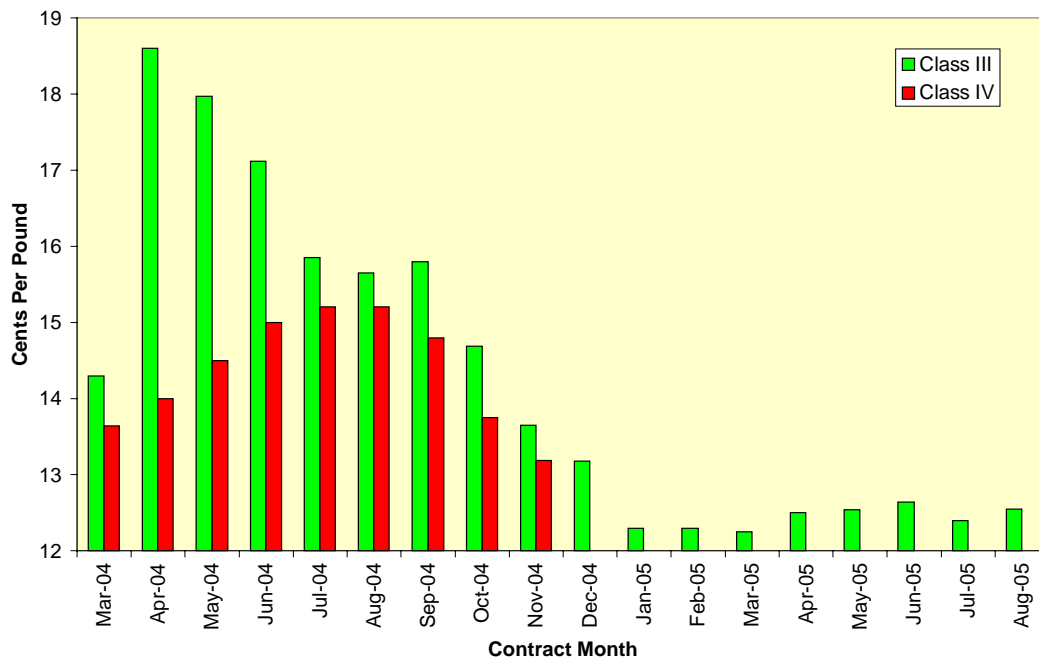
USDA Class III milk, formerly known as basic formula milk, serves as the basis of a futures contract at the Chicago Mercantile Exchange and, more importantly, is the marker grade for the manufacture of cheese, and by extension to life-sustaining pizza. The CME also lists a contract on Class IV milk, used in the making of butter and non-fat dry milk products, but this contract is less liquid.

No Squeeze In Milk Prices



While both classes of milk certainly exhibit a great deal of monthly price volatility and a surprisingly erratic seasonality, neither market appears to be in any immediate danger of a runaway uptrend at the moment, which perhaps can be attributed to the high production encouraged by the subsidies. This is not idle speculation; the forward curves of the CME futures reflect expectations for tame prices over the remainder of 2004. The Class IV contract does not extend into 2005 yet.

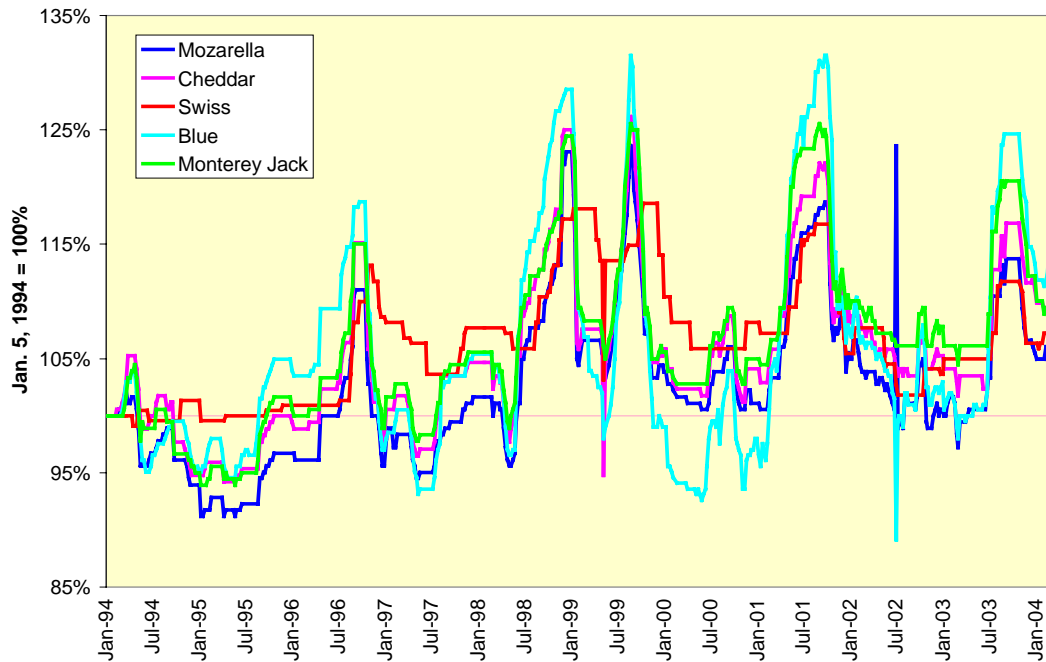
No Expectation Of Rising Prices



Say Cheese

We should expect cheese prices to be more volatile than those for milk as it has a greater shelf life and is subject to the vagaries of manufacturing cycles. Moreover, despite the best efforts of the major *fromageurs* to appeal to the lowest common denominators of taste, cheese still is a value-added product with a very wide range of qualities. Sneer if you will, but only one country has developed both Spam and Velveeta, and it's the world's only superpower, so there.

No Cheese Inflation... Yet

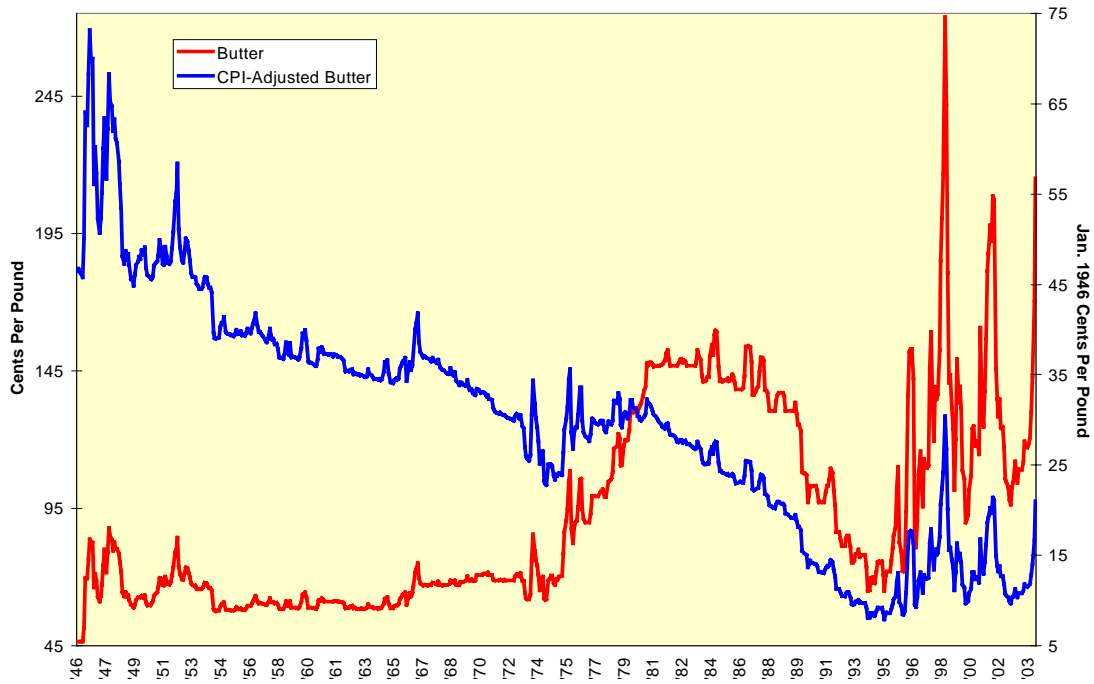


Cheese prices certainly have been volatile over the past decade, but volatile within a range and with a defined pattern of returns. The quick jumps higher and returns to a base level, or embedded call options, are characteristic of many industrial processes such as refining margins for crude oil and spark spreads for electricity. Cheese, whether you find the comparison appealing or not, is processed milk in the same way gasoline is processed crude oil.

Butter - Where The Action Is

If milk is quiet and only the occasional price spike interrupts cheese charts, butter has been all over the place for the last decade. The long-term inflation-adjusted price ended its fifty-year slide in 1994 and has been moving higher in fits and starts ever since. Nominal butter prices surged to a record in the fall of 1998, and presently appear ready to challenge those levels.

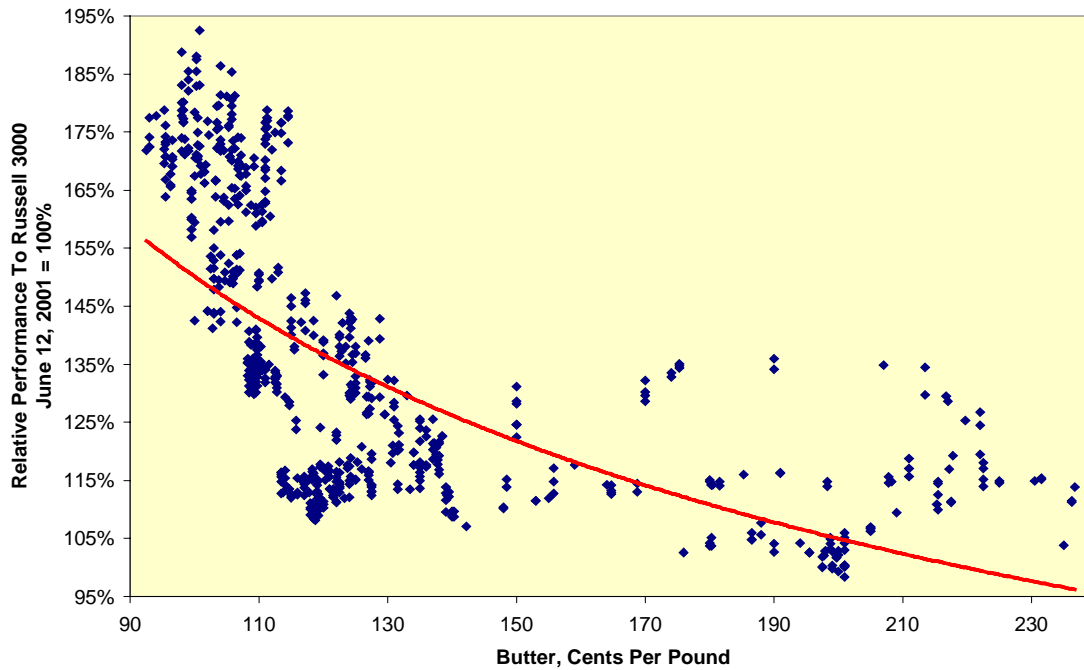
Butter's Long Slide Has Ended



Whenever an industry becomes characterized by extreme commodity price volatility, vertical integration becomes a favored method of risk management; witness the historic vertical integration in the petroleum industry. It is no accident that the last decade has seen the disappearance of independent ice cream producers such as Ben & Jerry's Homemade and Dreyer's Grand.

The 1998 price surge in butter produced downward pressure on the margins of restaurant operators such as Yum! Brands, then Tricon Global, the operator of Pizza Hut and on big buyers of dairy products such as Kraft Foods. Kraft's sensitivity to butter prices is such that its performance relative to the broad Russell 3000 index since it became an independent stock in June 2001 actually describes a put option on butter prices.

Kraft As An Embedded Put On Butter



A Visible Piece Of Inflation

Just as the public is unusually sensitive to the price of gasoline and measures inflation by its gyrations, the public is aware of price changes in life's little treats such as movie tickets, ice cream and pizza. Regardless of where the price of milk goes, the prices of both cheeses and butter can go much higher quickly, and this will start to create an inflationary mentality regardless of the official price index reports.

It is said that money is the mother's milk of politics. Wouldn't it be ironic if the public starts to frame economic perceptions in terms of dairy products?