WHAT ACCOUNTS FOR THE CHEESE PRICE COLLAPSE?[1]

- Commercial disappearance of cheese in 2008 closely matched production. Through October, total natural cheese production for the year was up 1.5 percent from 2007 while commercial disappearance was up 1.6 percent. However, growth in commercial use slowed from a 1.8 percent gain during the first half of the year to 1.5 percent from July through October (latest month available).

- Cheese stocks in the first quarter of 2008 were six percent below 2007, but began building rapidly and exceeded year-earlier levels beginning in May. August 2008 stocks were 6 percent larger than 2007. The normal seasonal depletion of stocks between August and November 2008 exceeded last year, leaving November total cheese stocks only 4.3 percent larger than November 2007.

- Cheese exports were at record high levels during the first half of 2008, but tailed off rapidly and were 11 percent under 2007 in November. Further declines from year-earlier levels are expected well into 2009 as more cheese is available from competing exporters. Cheese exports through the first 11 months of 2008 totaled 271 million pounds, 3 percent of U.S. cheese production. While small in volume, foreign sales were important on the margin in tightening domestic cheese markets.

- Nonfat Dry Milk and Skim Milk Powder exports showed a pattern similar to cheese, with larger volumes through most of the year but down sharply (44 percent) from 2007 in November. Export prospects in 2009 are poor because of a sharp decline in world powder prices due to larger volumes from New Zealand and some European Union countries.

- The collapse in powder exports resulted in U.S. powder prices falling to near support and large CCC purchases to replace lost exports. In November, CCC purchases were 24 percent of Nonfat Dry Milk production. Powder surpluses caused some milk to be diverted from dryers to cheese vats. Cheese production averaged 1 percent over 2007 during the first half of 2008; 2.1 percent from July through November. American cheese production has been 5-8 percent above 2007 since July. However, diversion is limited by cheese manufacturing capacity constraints in California, which produces more than half of U.S. nonfat dry milk and is second to Wisconsin in cheese production. For the near term, California will continue to make powder regardless of price.

- U.S. milk production increased in 2008 at an average monthly rate of 2.4 percent over 2007 during the first half of the year (28-day rate for February to account for 2008 being a leap year). The average monthly year-over-year increase during the second half of the year was 1.5 percent. The slow-down occurred because of diminishing profitability due to higher feed costs, despite decent (by historical standards) milk prices through year-end. With a precipitous fall in milk prices coming in January and depressed prices through at least the first quarter of 2009, year-over-year changes in milk production will become even smaller and could turn negative.

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[1] Prepared by Ed Jesse, Professor and Extension Agricultural Policy Specialist, UW-Madison/Extension. Based in part on participant and audience remarks at a roundtable discussion held during the Wisconsin Agricultural Economic Outlook Forum, January 16, 2008. Roundtable participants included Jesse, Emeritus Professor Robert Cropp and Associate Professor Brian Gould, Department of Agricultural and Applied Economics, UW-Madison, and Dr. Larry Salathe, senior staff economist, Office of the Chief Economist, U.S. Department of Agriculture.

- Consolidating these developments—anemic domestic consumption gains, poor export opportunities, and incentives to divert milk away from dryers to cheese vats—market fundamentals are generally bearish for cheese prices. But at the same time, market fundamentals do not appear to be dismal enough to justify cheese prices under CCC support levels, especially in light of moderating milk production and an anticipated increase in domestic cheese sales in response to much lower wholesale cheese prices. A key factor is that cheese stocks are not out of line with commercial use, are not growing, and will likely decline as milk production falls and consumption increases.

- Market psychology is having an impact on cheese prices. The CME spot cheese market commonly over-reacts on both the up and down sides. On the up side, wholesale buyers are fearful of stock-outs and lost sales and bid up prices to maintain inventories. On the down side, buyers play a "wait for the bottom" game, maintaining hand-to-mouth inventories with little risk of substantially increasing their acquisition costs. Potential sellers are reluctant to fill low-ball bids in anticipation of better prices ahead. Prices increase only when there are unambiguous indications that supply is tightening.

- This kind of market psychology is amplified by the "thinness" of the CME spot cheese market. Little cheese is sold on the CME and there are few buyers and sellers. But trading activity has an enormous impact because most cheese is priced via formulas linked to the CME price. This concentrates and leverages market opinions and adds volatility to the market.

- The bottom line is that cheese prices will materially improve; the question is when. Current depressed milk and cheese prices will undoubtedly reduce milk supply and increase cheese demand. Timing is the issue.

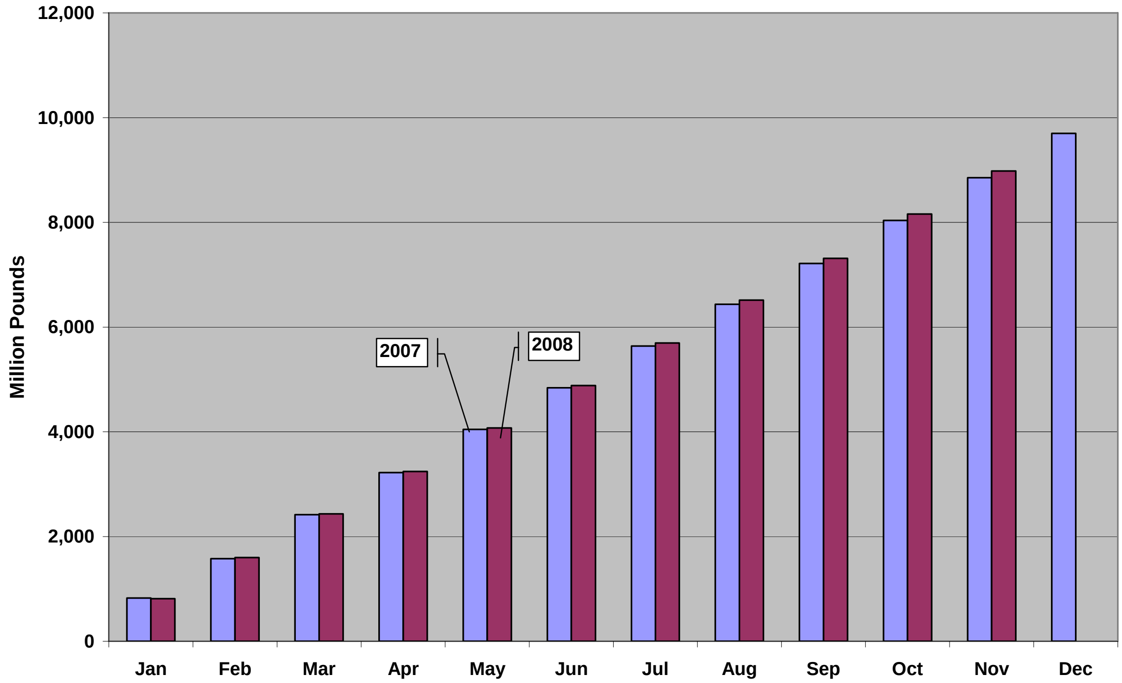
- Factors that would stimulate a rapid supply adjustment include:

    - Extensive dairy farm attrition, perhaps motivated by inability to make timely payments on long-term debt or obtain operating loans;
    - A substantial increase in culling, perhaps encouraged by an expanded CWT buyout;
    - Significant ration adjustments resulting in lower per-cow milk yields or at least smaller gains.

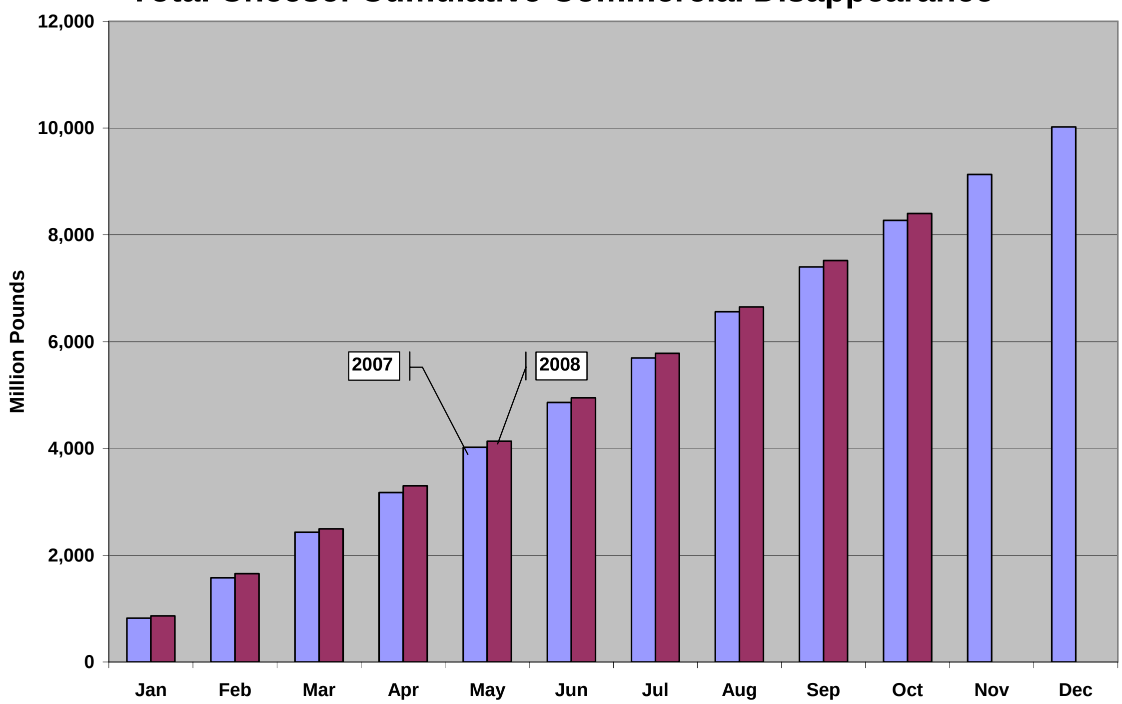
- Factors that would contribute to a rapid cheese demand adjustment include:

    - A quicker than usual response of retail cheese prices to current wholesale prices;
    - Extensive retail cheese promotions;
    - Substitution of cheese for meat in at-home and institutional meals;
    - Expanded federal cheese purchases for feeding programs.

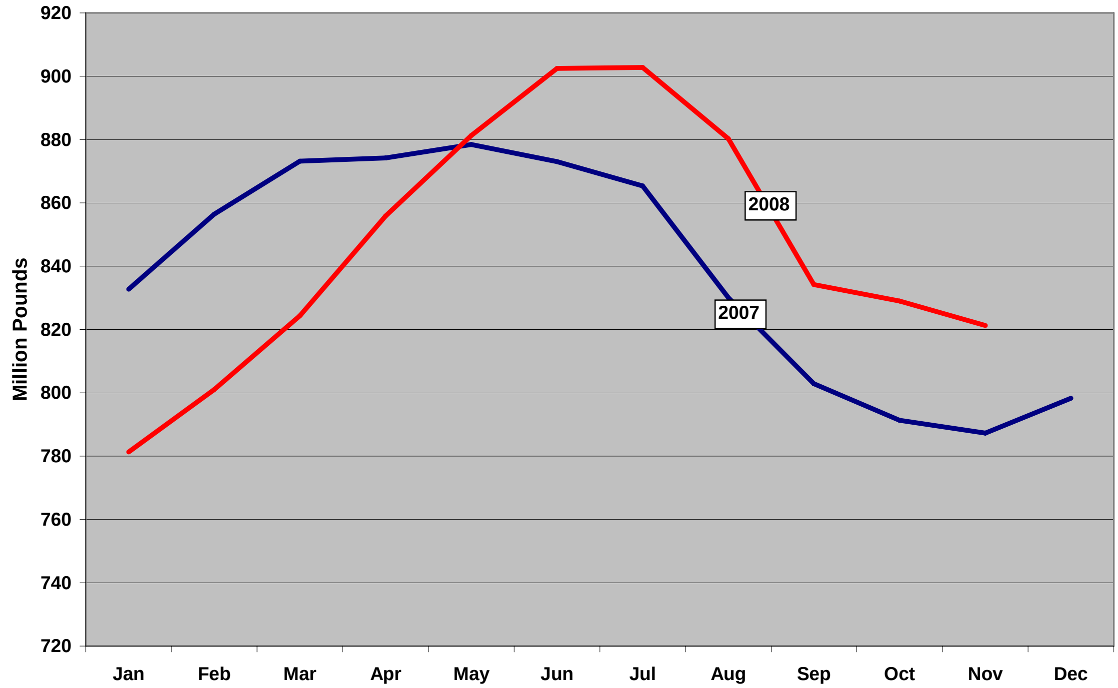
Total Cheese: Cumulative U.S. Production



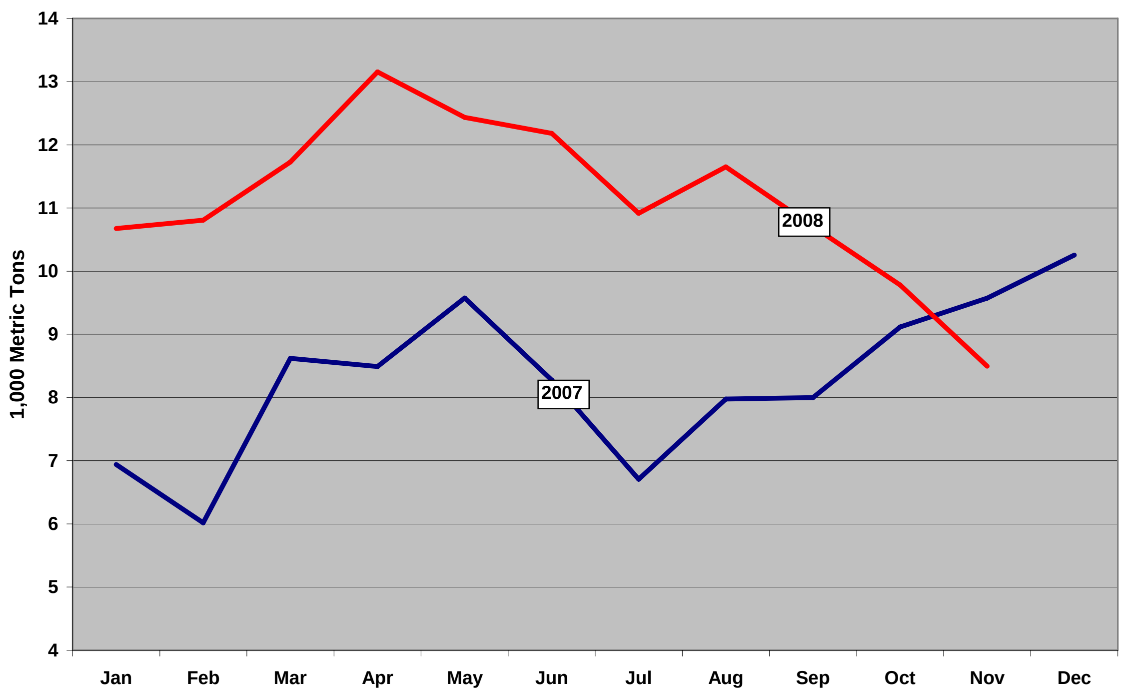
Total Cheese: Cumulative Commercial Disappearance



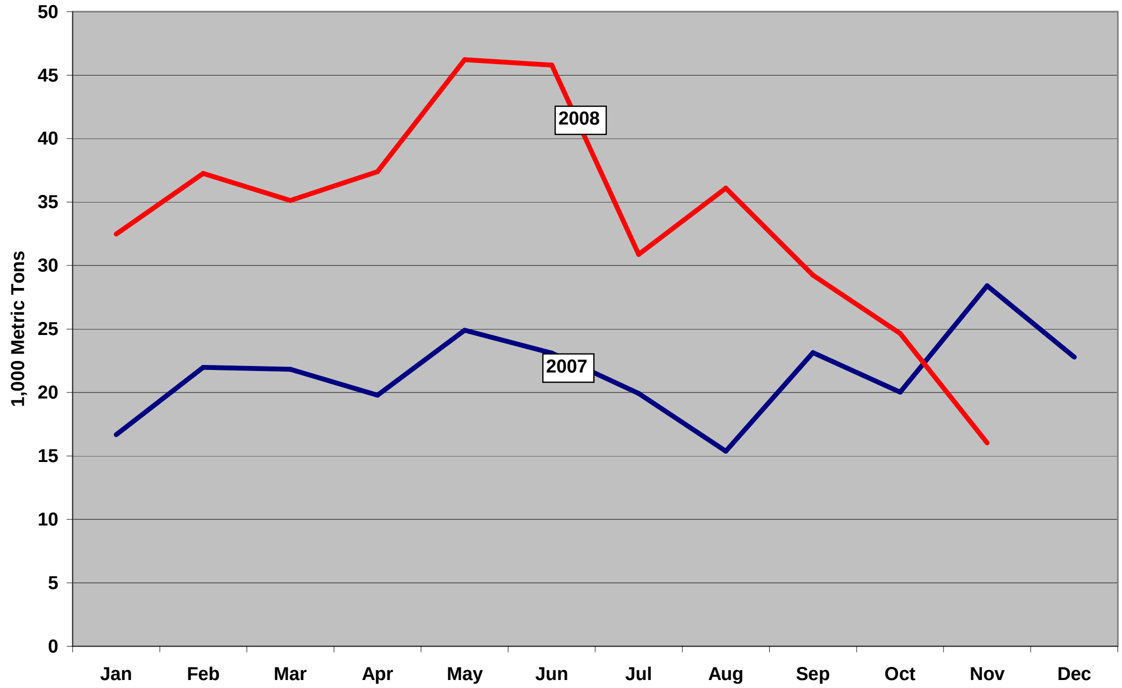
Total Cheese Stocks, 2007 and 2008



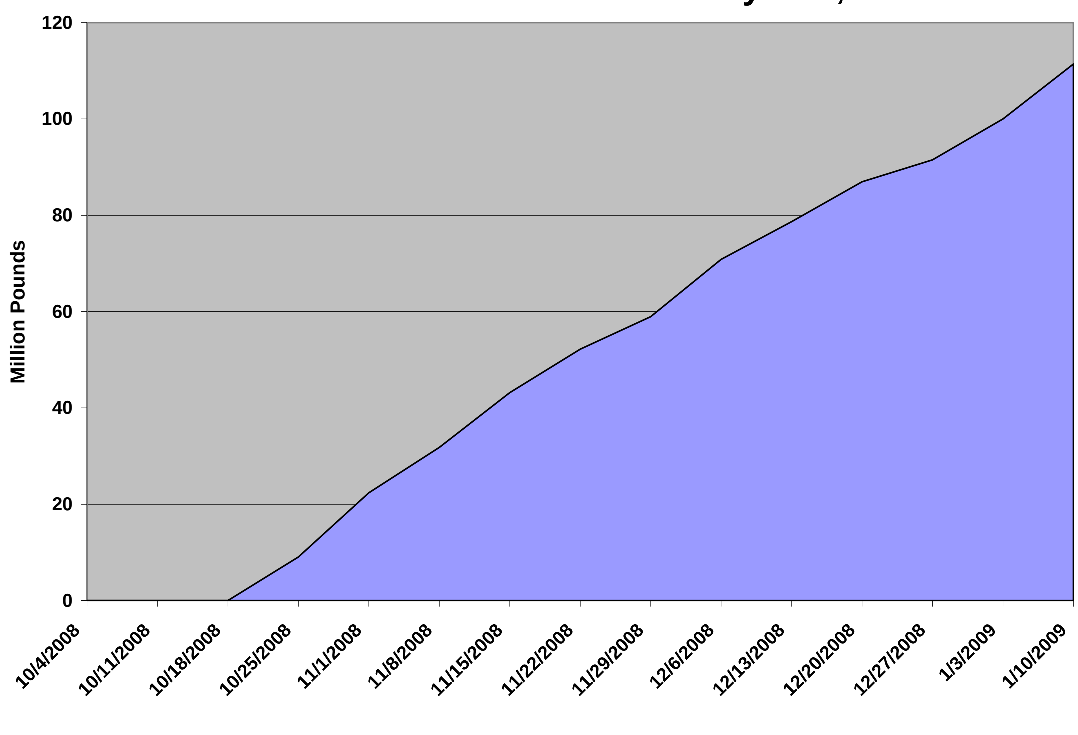
U.S. Cheese Exports, 2007 and 2008



U.S. Nonfat Dry Milk/SMP Exports, 2007 and 2008



CCC Cumulative Purchases of Nonfat Dry Milk, FY2009



U.S. Milk Production, 2007 and 2008