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Perspective:
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Taming volatility

The past three years have been a ferocious rollercoaster ride for dairy prices, and that has raised a critical question about the U.S. industry's future health: "How do you handle dairy's inherent volatility to ensure success?"

A segment of the business still clings to a bygone era, where government support programs and the insular nature of the U.S. industry made volatility a non-issue. But this isn't the dairy industry of 1980 or even 1990, when support mechanisms provided a workable floor and kept prices relatively stable, and the concept of a "global" dairy market was more expectation than reality.

Like virtually all businesses these days, dairy is increasingly global and affected by international events, where a drought in Australia or a tainted milk scandal in China could shift the precarious world supply/demand balance and change international and U.S. prices quicker than you could say Commodity Credit Corp.

The paradigm has shifted. We can no longer surround ourselves in a cocoon that insulates us from the rest of the world. Volatility is an enduring market condition. The dairy industry

cannot eradicate it. It cannot regulate or legislate away unpredictability.

If, as some are talking, support systems are removed altogether in the 2012 farm bill, or even at a later date (taxpayers will not be footing the bill forever), the elimination of a safety net could heighten volatility. With no floor, for example, the lows could dip lower to clear the market.

The U.S. industry needs to accustom itself to volatile markets and learn how to manage risk *now*—both to handle today's price swings as well as to prepare for a potentially more impulsive future. The Innovation Center for U.S. Dairy is studying the issue as part of a broad industry effort to address the major challenges related to globalization—in this case, identifying solutions (such as enhanced risk management tools) as quickly as possible to manage supply chain volatility.

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The industry will soon have one new tool to mitigate risk when CME Group debuts its new skim milk powder (SMP) futures contract early this year.

The international SMP contract is the type of tool the industry needs to stay healthy, providing income stability and allowing companies to manage their business and protect margins. The contract, as well as existing futures contracts on Class III and Class IV milk, butter, nonfat dry milk and whey, helps dairy farmers, processors and

buyers offset the risk of rapid and deep price swings.

The SMP contract is the first of its kind, filling a need for a globally acceptable instrument to provide price discovery and price dissemination and manage risk. It will be, at least for the time being, the only option to do so on a world level.

This mechanism that is essential for the industry's health will only succeed if enough people participate – if there is, in other words, liquidity.

Both Europe and New Zealand plan to launch dairy futures markets this year because volatility has become a worldwide problem. Europe, for example, is where the United States was 15 years ago, seeing its intervention prices ratcheted down and looking for ways to manage price swings. But the U.S. dairy sector has the advantage of more than a decade of experience in futures trading and an established and accepted system in place.

That being said, too few producers, processors and buyers currently utilize futures, instead subscribing to one of the many myths that surround them—myths like “futures contracts are essentially gambling,” “futures have nothing to do with the real physical markets” or “it all averages out in the end.”

These and other oft-cited myths are inaccurate. Far from gambling, futures are a defensive action used to manage exposure to the physical market.

Futures can facilitate business by allowing sellers to offer long-term contracts.

A strong futures market also underpins the physical market price. And results simply do not average out in the end without futures—

ask the thousands of dairy farmers fighting to survive the past year.

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All sides of the business—producers, processors, sellers and end users—can benefit from futures and ideally would participate. Hedging may not universally fit the needs of all companies involved in each sector, but *all* companies have an obligation to learn more about the choices that are available and not fall victim to myth or misunderstanding of how futures work and what exactly their object is. Not fully examining this tool could not only be detrimental to the future your business, it could be damaging to the entire industry that finds its competitiveness eroded by the inability to manage volatility.

U.S. dairy concerns certainly could make the strategic decision to concentrate on physical markets alone, but recent trends suggest that could be a recipe for disaster.

We have tangible tools to manage risk. The industry has no excuses for falling victim to the volatile nature of dairy markets when it has been given alternatives. **CMN**