



Insights on today's global dairy business from the Hoogwegt companies

**MARKET MATTERS**

**Managing Risk in Volatile Markets**

Volatility in any market increases a company's risk, but not every company needs to lay off risk. Managing risk is an attempt to protect one's business against the possibility that something bad will happen in the future. A company's financial situation—available capital, debt-to-asset ratio, ability to pass price increases on to its customers, the impact of price increases on demand, and other financial measures—will determine its risk profile. In general, the more highly leveraged a company, the lower its risk tolerance.

Looking at volatility first, global demand for food and high feed costs for dairy producers have supported world milk and dairy product prices in 2011. Global food demand is expected to remain buoyant well into the next decade, driven primarily by a rapid shift of people in China out of lower economic classes into the middle class. Two years ago, 100 million households in China were considered middle class. By 2020, 300 million households in China are expected to be middle class.

China is not alone in supporting demand for food. Per capita food consumption is also expected to grow rapidly in Eastern Europe, Latin America, and other Asian nations. Vegetable oils, sugar, meat, and dairy products will likely experience the highest demand growth, according to the United Nations' Food and Agriculture Organization. But that doesn't mean markets won't be volatile.

incomes in wealthier nations, which could send food commodity prices lower. If another global recession ensues, volatility could once again become extreme.

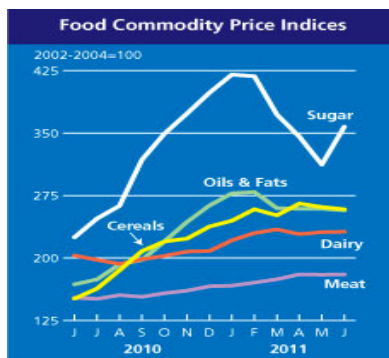
Milk price volatility is caused by three main factors: supply and demand, policy changes, and the long price change lags on supply and consumption. Because dairy products have a relatively inelastic demand profile in which large changes in price fail to translate into similarly large changes in demand, volatility results. For instance, even modest tightness in supply can cause prices to spike, while a modest surplus often results in an extreme price plunge designed to clear the market.

**The Problem with Extreme volatility**

Some amount of volatility is desirable because it signals to processors and producers alike to reconcile supply with demand. However, when volatility results in extreme price moves, adverse consequences can result. Extreme swings to the downside result in financial difficulties for both producers and processors, which can result in liquidation as well as decreased investment in research and development. When price moves to the upside are extreme, non-dairy substitutes can replace fat, protein, and lactose in food product formulations, and customers often begin to look to alternative suppliers who can guarantee stability in both price and volume.

For those looking to manage risk, recent high prices provided sellers of dairy products and milk suppliers an opportunity to lock in prices. A sharp downturn could offer end users and manufacturers an opportunity to hedge costs using one or a combination of tools, including futures and options, forward contracts, and financial swaps. By way of review, futures are legally binding contracts to buy or sell a commodity sometime in the future, whereas a futures option is similar to an insurance policy and gives the right, but not the obligation, to buy or sell a commodity in the future at a predetermined price.

Forward contracts are privately negotiated cash contracts in which a seller agrees to deliver a specific commodity to a buyer in the future. They are not cleared through an exchange, thus both parties are at risk if the other party defaults. A financial swap is an instrument in which a seller and buyer agree to a specific price, commodity, time period, and volume. Most buyers and sellers who use financial swaps enter into International Swaps and Derivatives Association (ISDA) master agreements.



Source: FAO.

As today's higher prices for food commodities are passed through the food chain and world economic growth slows, sharply lower prices could occur. Higher food prices coupled with potentially lower income growth could reduce both the purchasing power of poorer populations and disposable

## HOOGWEGT FORECAST

	U.S. Average Prices			EU Average Prices			Oceania Average Prices		
	\$/ton	\$/lb	Trend	\$/ton	\$/lb	Trend	\$/ton	\$/lb	Trend
SMP	3.300	1,50	Weak	3.275	1,49	Stable	3.400	1,54	Stable
FCMP / WMP	4.365	1,98	Stable	4.150	1,88	Stable	3.500	1,59	Weak
Butter	4.400	2,00	Weak	5.450	2,47	Stable	4.350	1,97	Stable
Cheddar	4.080	1,85	Stable	4.650	2,11	Stable	4.300	1,95	Stable
SWP	1.430	0,65	Stable	1.325	0,60	Stable			
Lactose	1.585	0,72	Firm	1.600	0,73	Firm			

U.S. prices stated ex-w orks / incl. expected CWT subsidy where applicable; world prices stated FOB main port; EUR/USD: this week 1,38

## WORLD COMMENT

Last week dairy markets were interesting, as always. In the last few days the EUR/USD exchange rate moved from 1,42 down to under 1,38 giving European exports a boost. Full cream prices in New Zealand lost further ground in the auction, challenging common logic on the values of protein and fat in the milk. FCMP is still lower priced than SMP; AMF was again sold around the same level as butter! The price range for products like FCMP and AMF between regions are of historic proportions. During Ramadan more business transpired than usual; indicating that many buyers are short covered. Cheese sales in the EU gained momentum in part due to demand from Russia. Rainy and cold weather during August curbed milk production in Northern Europe. SMP prices appear workable for all parties; supply and demand are quite balanced. The USA showed another strong export month in July with 37.000 MT SMP/NFDM shipped, 47% of total monthly output. Consumer demand growth in the Far East is falling below projections due to the high raw material costs during the first half of 2011 and overall inflation. Whey and lactose remain in tight supply with excellent returns for the manufacturers.

## BRINGING IT HOME

## Liquidity Still an Issue

For those companies with a low risk tolerance, locking in supply costs makes sense only if they can also book sales at a predetermined price to guarantee a profit margin. Without locking in a margin, a company actually increases risk. Laying off risk makes sense for some, but it also comes at a cost both in real terms and opportunity. For those companies who can handle more risk and who want to try to maximize profits, taking the market price—a form of cost averaging—can sometimes be the best course of action.

When considering futures and options markets, one needs to think about liquidity—the ability to get in and out of a contract. Of all the dairy exchanges, the CME Group in Chicago is by far the most liquid. For instance, as of September 2, open interest (the number of outstanding contracts) in cash-settled butter futures was 4,023, and on nonfat dry milk futures, open interest stood at 1,562. Open interest on the CME's Class III contract, the most heavily traded dairy contract in the United States and the world, was more than 37,857. (By contrast, open interest in corn futures was more than 1.2 million.)

In addition, open interest in the Class IV contract was 3,527. Trading volume in Class III options for the first half of 2011 was 168,972, or a 78% increase from the previous year. First-half trading volume for Class IV options was much lower at 2,467.

For companies selling dairy products into the United States or buying dairy products from the United States, implementing a hedging strategy using the CME's dairy futures and options contracts could make sense, but again only if a margin is also locked in.

For companies buying and selling in Europe, Germany's Eurex offers two dairy contracts, skimmed milk powder and butter. Both are cash settled based on reference price indexes that reflect current spot markets weighted equally on prices in Germany, France, and The Netherlands. Activity in the Eurex butter contract picked up substantially in August, with more than 1,000 metric tons of butter traded. Trading in butter futures was underpinned by significant activity in the over the counter (OTC) market.

Wellington's NZX has several dairy futures contracts that cash settle to prices on the global DairyTrade auction, including whole milk powder, skim milk powder, and anhydrous milk fat. While these contracts, like the Eurex contracts are still young, open interest for all of the NZX dairy contracts combined just recently exceeded 1,000.

And finally, trading in the CME Group's newest dairy contract, international skim milk powder, has been disappointing.

## Did you know?

- Currency fluctuations complicate risk management strategies when hedging across markets.
- According to Dairy Australia, milk prices in the United States, European Union, and New Zealand are starting to converge.
- The CME Group's Class III contract, which typically sees between 1,000 and 2,000 trades per day, is for 200,000 lbs. (90,718 kg.) of milk, or nearly 91 metric tons each.

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