WHERE'S YOUR FOCUS?

Dairy producers are certainly struggling right now with negative operating margins as a result of soaring feed costs. This year's historical drought has taken a big toll on dairies across the country, as searing heat and a lack of rainfall has not only impacted pasture conditions and yield prospects for the corn and soybean crops, but has also compromised milk production.

While a dairyman may understandably be concerned about current conditions and what the outlook will be as we move forward through the remainder of the year, it is important to keep things in perspective. While it is true that operating margins are negative and dairies are now losing money based upon current production costs against the value received for milk, the futures market is signaling a different forecast for forward profitability if one focuses further out in time.

The futures market is considered a "price discovery" mechanism in that it allows for the value of a commodity to be determined in a transparent and competitive environment. With the terms of a contract being standardized by an exchange, buyers and sellers can place bids and make offers to determine what the value of that contract is on a daily basis.

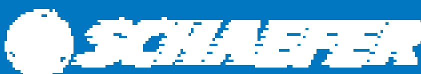
Because it is a futures market however, this value can be thought of in more than one dimension. One can consider the "spot" value of the commodity or what it is worth today based upon a contract that is close to expiration. One can also consider the forward value of the commodity based upon a contract that will expire sometime in the future. Because there are several futures contracts trading for a particular commodity at any given point in time, the price discovery process is in essence determining how that value is perceived to change over time by all the participants in the market. This is referred to as the forward price curve, and it is an important dimension of the price discovery process.

The value of a commodity futures contract such as corn, soybean meal or milk is changing on a daily basis as a function of new information streaming into the marketplace. How traders perceive and process this information affects where they are willing to place bids and make offers on the contract, and this activity causes prices to either rise or fall. Just as the general price level is changing on a daily basis (prices are either rising or falling), so too is the slope or shape of the forward price curve.

This is because traders process the impact of new developments on the perceived value of a commodity moving forward through time. In other words, some contracts are treated differently than others. A bullish or bearish development may have more of a perceived impact on a nearby or deferred expiration, and thus affect the value of various contracts differently. This causes the forward price curve to change over time as some contracts are bid up or offered down more than others on a relative basis.

Where this comes into play with regards to a dairy's profit margin is leveraging the futures market as a price discovery tool to become a profit margin discovery tool by extension.

How does one do this? You begin by modeling your dairy around both fixed and variable costs, as well as revenues coming into the operation. A big portion of a dairy's variable costs will be tied to feed expenses,



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and in many cases these expenses in certain parts of the ration will correlate to either corn or soybean meal which trades on the futures exchange. For that matter, a dairy's milk check will also correlate to Class III milk futures on the exchange, such that costs paid and revenue received can be accurately modeled looking forward in time. Making certain assumptions about future "fixed" costs, a dairy can look at deferred futures prices and discover an unrealized profit margin that the marketplace is implying at any given point in time.

Using a demonstration operation modeled after a sample dairy, nearby or "spot" margins in current Q3, 2012 are implying a loss of about $0.20/cwt. which would represent a profit margin at the 10th percentile of the past 10 years. This means that 90% of the time over the past 10 years, this dairy has done better than earning a loss of 20 cents in the third quarter of the year. Obviously feed costs against corn priced over $8/bushel and meal over $500/ton is not helping matters very much, even with milk around $17/cwt.

Looking further out in time however, the futures market signals something quite different. If you examine the fourth quarter of next year, margins look much more attractive. With corn now forecast below $6.50/bushel and meal around $350/ton, milk around $18/cwt. projects a Q4 2013 profit margin at $2.70/cwt., around the 85th percentile of the past 10 years. Thought of another way, this model dairy has only been more profitable than $2.70/cwt. during the fourth quarter of the year around 15% of the time.

Why are nearby and forward values so different in the futures market? Perhaps traders feel that large South American crops and normal production in the U.S. next season will allow corn and soybean meal prices to ease from current levels. They may also perceive that dairy herds will be liquidated and milk production will decline such that the forward value of milk next year will be worth more than it is today. These may very well be realistic assumptions based upon what we know today.

The thing to keep in mind though is that new information flows into the market all the time. Today's assumptions may or may not become tomorrow's realities when we reach that point in time. What really matters is what level of profitability these values represent at any given point, and that is where the focus of a dairy should be.

It should be noted that the present loss in spot Q3 based on current values was projected to be a profit of around $2.70/cwt. back in January. Something can still be done to protect next year's margins. Is that where your focus is right now? ❐

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