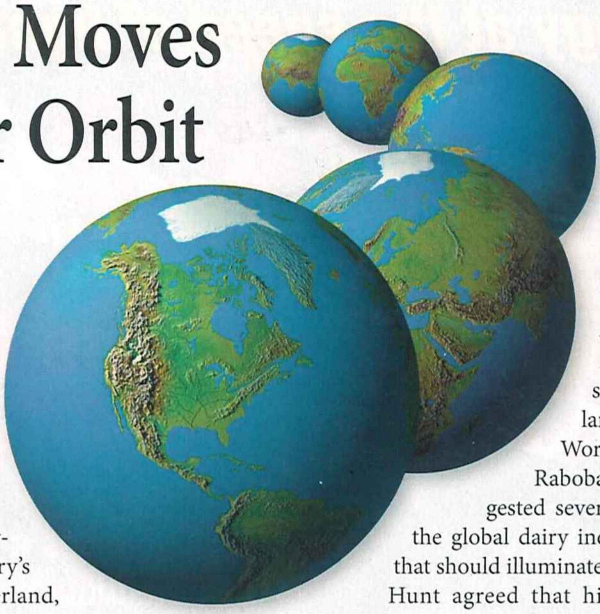
Dairy Pricing Moves Into A Higher Orbit



Like Halley's Comet, milk pricing "paradigm shifts" come along every so often and make us sit up and take notice. The last sighting was in the 1970s. Over the course of the decade, the farmgate milk price doubled and never looked back — the effect of a new, higher baseline in the cost of production.

Here we are again trying to get our bearings under an altered firmament. At January's World Economic Forum in Davos, Switzerland, delegates cited inflation as their No. 1 concern. The daily headlines remind us about the price run-ups of 2008 and resulting food riots. Like three years ago, northern Africa is under siege.

Our skeptical nature requires that we assume this trajectory will burn itself out in the atmosphere. And it's true: economic cycles will always prevail. Rallies will come and go. Supply will overshoot demand for a time and prices will fall back to earth.

But there's a growing consensus that the cost of food, including dairy, has moved into a higher trading orbit. In today's conversations about food inflation, we may be looking at a structural price increase rather than a cyclical one.

The foundational shifts in the global dairy industry over the last four years have been profound, leaving the market with a bias toward undersupply for the foreseeable future. On the demand side, an influx of consumers has joined the middle class in developing countries, led by China. In 2007, the Asian giant accounted for less than 4% of world dairy imports. Today, that share is more than 8% and showing no signs of slowing.

On the supply side, the cost structure of "dairying" has been altered (if not permanently, at least for some time) by the linkage of energy and grain prices. At the same time, global grain stocks sit at a 15-year low, leaving prices more vulnerable to weather and policy shocks. All this volatility flows through to world dairy prices, which were once buffered by hefty government inventories but are now fully exposed.

The United States has been a clear-cut beneficiary of the new pricing paradigm. The U.S. share of global dairy exports jumped from about 11% in 2006 to 15% (of an expanding pie) last year.

Of course, competitive dynamics are in constant motion. An elevated pricing band affects everyone in the dairy supply chain, from farm to fork, across the globe. For the U.S. dairy industry, it affects the policies and strategies we choose. We must decide:

- What is our role in a global market of higher average prices?
- Where do we fit in?
- Where are our opportunities?
- Where are our vulnerabilities?

Factors that affect supply, demand

A good place to start our situation analysis is Auckland, New Zealand. At the World Dairy Summit last fall, Rabobank analyst Tim Hunt suggested several changes to the face of the global dairy industry in the years ahead that should illuminate the horizon.

Hunt agreed that higher grain costs would have significant impacts for dairy. For one thing, dairy-import demand will rise faster than can be met from pasture-based regions. For another, high grain prices will increase costs to all farmers, thus lifting the returns to dairy required to attract resources to the sector. In addition, it will put even more pressure on dairy farmer margins because the mismatch of movements in grain and dairy prices create constant fluctuations in profitability for producers who rely on grain inputs.

That means that pasture-based regions should sustain a milk-production cost advantage, he said. On the other hand, it suggests that countries targeting grain self-sufficiency (think China) face particular challenges.

There are implications on the demand side as well. Defending market share for milk products in an inflationary climate will be daunting, Hunt warned. Dairy occupies a premium position, and there are limits to substitution. But necessity is the mother of invention, and much of the potential growth in consumption is taking place in less discerning markets that lack a deeply entrenched history of dairy in the diet.

Perhaps the most important strategic consequence is that it appears we're going to see world prices and domestic prices on par going forward. The long-held conviction that emerging market consumers cannot afford Western products at Western prices hasn't been accurate for years. In fact, since 2006, world benchmark spot prices have, on average, run 15-20% higher than U.S. benchmark prices.

That changes everything. We will continue to endure market peaks and valleys – that law of economics hasn't been repealed. But if the new dairy-pricing paradigm says the world is flat, that overseas markets bring the same (or better) returns as domestic and that the growth curve in supply has to go through the United States, then U.S. dairy exporters will truly find the sky is the limit. DFR

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