2-10-1993

Milk Futures May Be Coming Soon; Winter Wheat Situation

Donald Peterson  
*South Dakota State University*

Richard Shane  
*South Dakota State University, richard.shane@sdstate.edu*

Follow this and additional works at: [http://openprairie.sdstate.edu/econ_comm](http://openprairie.sdstate.edu/econ_comm)

Part of the [Agricultural and Resource Economics Commons](http://openprairie.sdstate.edu/econ_comm), and the [Regional Economics Commons](http://openprairie.sdstate.edu/econ_comm)

Recommended Citation

MILK FUTURES MAY BE COMING SOON

by

Don Peterson
Extension Economist/
Marketing and Management

New marketing alternatives soon may be available for milk producers. The Coffee, Sugar and Cocoa Exchange (CSCE) in New York City is considering offering futures contracts in nonfat dry milk and cheddar cheese. Years ago, when butter was a primary product of the dairy industry, the Chicago Mercantile Exchange traded butter futures. With the initiation of government price supports for dairy products in the late 1940s and the rise of substitute spreads, the trading volume in butter futures fell and the butter contracts were discontinued.

The farm bills of 1985 and 1990 cut the support price of milk to $10.10, a decrease of nearly $3 per hundred weight (cwt.). A number of factors, including the lower support price, the dairy buyout, the drought of 1988, and last year's cool wet summer, have caused milk prices to show a volatility similar to that of pork bellies according to the CSCE. Consequently, some dairy companies and dairy product users have been looking for ways to reduce their price risk without necessarily reducing profits. If it is not possible to reduce price risk, higher average profits will be necessary so that processors can survive the low return periods. This will likely mean lower prices to milk producers or higher prices to consumers or both.

One alternative is to institute a futures market where the risk of price swings is shifted to those who are willing and able to assume such risks in hope of making a profit. The use of futures provides 3 useful functions to the industries which use them; (1) it allows producers and buyers to avoid speculation (Continued on p.2)

WINTER WHEAT SITUATION

by

Richard Shane
Extension Economist/
Grain Marketing Specialist

USDA has estimated winter wheat seedings for 1993 at 51.5 million acres, one per cent above 1992. Prior to the release of the seedings report on January 12, grain traders had expected an acreage figure of around 53.5 million acres. So, the report definitely helped to strengthen the deferred wheat futures prices.

The trade had expected an increase from last years 51.06 million acres predominantly because the set aside rate for wheat program participation was decreased from five percent to zero percent. The immediate question is "how accurate is this report?" The "Winter Wheat Seedings" report has been very accurate historically. The estimated acreage has been within one percent of actual acreage most years or within one half million acres of the 51.5 million acre estimate for 1993.

A state by state analysis helps to explain why the acreage increase wasn't as large as expected. Ohio, Indiana and Iowa all planted less than 90 percent of last year's acreage due to very wet conditions at planting time. This would have been bullish for soft red winter (SRW) wheat prices which are reflected on the Chicago Board of Trade, but a 200,000 acre increase in Illinois plantings lessened the impact on price.

Hard red winter (HRW) wheat plantings were 100 to 103 percent of 1992 except in Kansas, which is the largest wheat producing state in the nation. Kansas acreage is down two percent or 200,000 acres. Texas acreage was increased a like amount. Overall HRW wheat acreage is expected to increase. This market factor (Shane ... Continued on p.2)
by passing the price risk on to willing speculators, (2) it provides a very efficient price discovery mechanism, helping the market to quickly find the equilibrium price given the current market information available, and (3) it provides long range price signals to producers and users so they can adjust their production or purchase plans accordingly.

The New York Coffee, Sugar and Cocoa Exchange approved nonfat dry milk and cheddar cheese contracts on January 13 and presented its proposals to the Commodity Futures Trading Commission (CFTC) for approval. A decision by the CFTC usually takes 3 to 4 months. Thus, if the proposal is approved, trading could begin by early summer.

The cheese contract specifications are 40,000 pounds of Grade A cheddar cheese in 40 pound blocks, 4 to 30 days old with standard moisture content and priced at Green Bay, Wisconsin. The nonfat dry milk contract specifies 44,000 pounds of Grade A powdered milk with 1.25% milk fat, 4% moisture, low heat, in 40 pound bags and priced FOB the West Coast. Delivery months for both contracts will be February, May, July, September and November.

The size of the contract will make it difficult for most dairy farmers in the Midwest to directly hedge their milk production. It takes about 370,000 pounds of raw milk to produce 44,000 pounds of nonfat dry milk. Likewise, 40,000 pounds of cheese takes about 400,000 pounds of milk. Thus, one should have a herd of at least 225 cows each producing 20,000 pounds of milk per year to produce one dry milk contract per month. However, even if a dairy is too small to directly hedge its milk, the futures contracts still offer some marketing advantages. The futures contracts will make it possible for milk cooperatives to offer cash forward contracts to milk producers, allowing them to lock in a known price. Futures contracts also will provide long range price signals for future production plans.

Probably the main reason for the large contract size is that it is the cheese producers and milk buyers, not the producers who are promoting the introduction of milk futures. Currently, cheese makers have no way of protecting the value of their inventory, and at times have suffered severe financial loss due to falling cheese prices. The major promoter is the candy industry which uses milk in the production of milk chocolate and other candies. While the candy industry is not as concerned about the value of inventories, it is troubled by changes in milk prices because these changes affect production costs. Adjusting candy prices by small amounts is extremely difficult because of the way candy is marketed. By protecting input cost fluctuations, it will be able to operate with lower profit margins and increase the volume of candy sold.

There is apparently enough milk suppliers and users to provide a sufficient number of hedgers to make a futures market work. The concern is whether there will be enough speculators. Speculators are needed to provide liquidity to the market. That is, speculators serve as immediate sellers or buyers for hedgers who want to buy or sell. Speculators need price volatility to get and keep their interest in hopes of making a profit on price moves. Currently, the CSCE believes there is enough volatility. However, an increase in government price support for milk could remove that volatility and kill the milk futures market.

Some dairy cooperatives, which have had experience using futures as a risk management tool in other commodities, see a milk products futures market as a way to improve their prices to farmers while reducing risk. Others, who do not understand the use or function of futures, do not like the idea and will not likely use them. They will remain at the mercy of the cash market and likely will continue to advocate government protection. However, with the large government deficit and the desire to keep taxes from going higher, increased government price support seems politically unacceptable. It is going to be interesting to see how well these contracts work out, if initiated.

*****************************************************************
(Shane ... continued from p.1) showed up as a negative price move in the Kansas City Board of Trade wheat
futures market.

Given the locations of the acreage reductions and the smaller than expected increases, it is unlikely that spring wheat will be planted on these acres. Corn belt SRW wheat acreage not planted to wheat will most likely be planted to soybeans or corn and Kansas HRW acreage will most likely be planted to sorghum or some other feed grain. All this leads one to believe that the "Winter Wheat Seedings" estimate will be accurate.

Hard red spring (HRS) wheat acreage was up from 14 million acres in 1991 to 17.8 million acres in 1992. Another increase in HRS wheat acreage is not expected. Even if it were to change by five percent, the increase in acreage would be less than one million acres. Therefore, total wheat acreage for 1993 could be the same as 1992 at 72.3 million acres. With an increase in HRS and Durum acres, total wheat acres could reach 73.8 million.

Harvested wheat acreage averaged 83.6 percent of plantings from 1985-91 and was 86.3 percent in 1992. Most likely 84 percent of 1993 plantings will be harvested or about 62.8 million acres.

Wheat yields averaged 35.6 bushels per acre from 1985 to 1991 and 39.4 bushels per acre in 1992. At this time, an estimate for 1993 wheat yield is 37 bushels per acre. Combined with 62.8 million harvested acres, this yield leads to expected production of 2.32 billion bushels compared to 2.46 billion bushels in 1992.

Beginning stocks of wheat in the U.S. are very reasonable according to the USDA estimate of 486 million bushels. This figure is not statistically different from the stocks on hand at the beginning of the 1992 marketing year. Stock and production should make a total U.S. supply of around 2.86 billion bushels as long as 1992-93 exports remain around 1350 million bushels. This supply is 126 million bushels less than in 1992.

Price potential for the 1993 marketing year is $3.10 to $3.45 per bushel, national average. This is 5 cents higher to 10 cents lower than 1992. The level of demand will determine which end of this price range is achieved. The biggest demand problems are continued exports to the Former Soviet Union (FSU) and Most Favored Nation (MFN) status for China. The market is currently discounting deferred futures due to these large "if's" in the demand picture.

South Dakota harvest time prices could easily drop to $2.50 to $2.60 per bushel. The producer who is interested in making pre-harvest wheat sales should consider opportunities at $2.90 to $3.00 per bushel to sell the first increment for harvest delivery. Cash forward contracts and hedging currently offer prices near this level. Buying a put offers a minimum price of 15 to 20 cents per bushel less than the cash forward contract or hedge due to the cost of the option premium.

Participation in the government program will be high this year. The zero set aside and $5.25 per bushel advanced deficiency payment is attractive to most producers. The expected total deficiency payment is $1.05 per bushel and is indicative of a national average wheat price for the first five months of the marketing year of $2.95 per bushel. Fundamental market factors currently support a higher price than this, but downside risk is considerable if China and the FSU do not continue to import wheat.

<table>
<thead>
<tr>
<th>USDA 1992</th>
<th>SDSU 1993 Estimates</th>
</tr>
</thead>
<tbody>
<tr>
<td>Drought</td>
<td>Normal</td>
</tr>
<tr>
<td>(million acres)</td>
<td>(bushels)</td>
</tr>
<tr>
<td><strong>Planted</strong></td>
<td>72.3</td>
</tr>
<tr>
<td><strong>Harvested</strong></td>
<td>62.4</td>
</tr>
<tr>
<td><strong>Yield</strong></td>
<td>39.4</td>
</tr>
<tr>
<td><strong>Beginning Stocks</strong></td>
<td>472</td>
</tr>
<tr>
<td><strong>Production</strong></td>
<td>2,459</td>
</tr>
<tr>
<td><strong>Imports</strong></td>
<td>55</td>
</tr>
<tr>
<td><strong>Supply</strong></td>
<td>2,986</td>
</tr>
<tr>
<td><strong>Food</strong></td>
<td>830</td>
</tr>
<tr>
<td><strong>Seed</strong></td>
<td>95</td>
</tr>
<tr>
<td><strong>Feed</strong></td>
<td>225</td>
</tr>
<tr>
<td><strong>Exports</strong></td>
<td>1,350</td>
</tr>
<tr>
<td><strong>Demand</strong></td>
<td>2,500</td>
</tr>
<tr>
<td><strong>Ending Stocks</strong></td>
<td>486</td>
</tr>
</tbody>
</table>

Expected Price: 3.20-3.40, 3.40-3.70, 3.10-3.45, 2.90-3.20
ECONOMICS
COMMENTATOR

EDITOR: Don Peterson, Agricultural Economist

ECONOMICS DEPARTMENT
South Dakota State University
Box 504A
Brookings, SD 57007
Phone: (605) 688-4141

400 copies of this publication were produced at a cost of less than $100.