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MARKET SNAPSHOT

Dairy

September 30, 2023

12-Month Profitability Outlook

Executive summary

AgWest Farm Credit's 12-month dairy profitability outlook suggests slightly unprofitable returns. Dairies face headwinds from weakening milk prices and elevated feed costs. Dairy income over feed cost margins fell below $4 per cwt in June and July, triggering catastrophic coverage payments.

Industry drivers

Weakening dairy exports

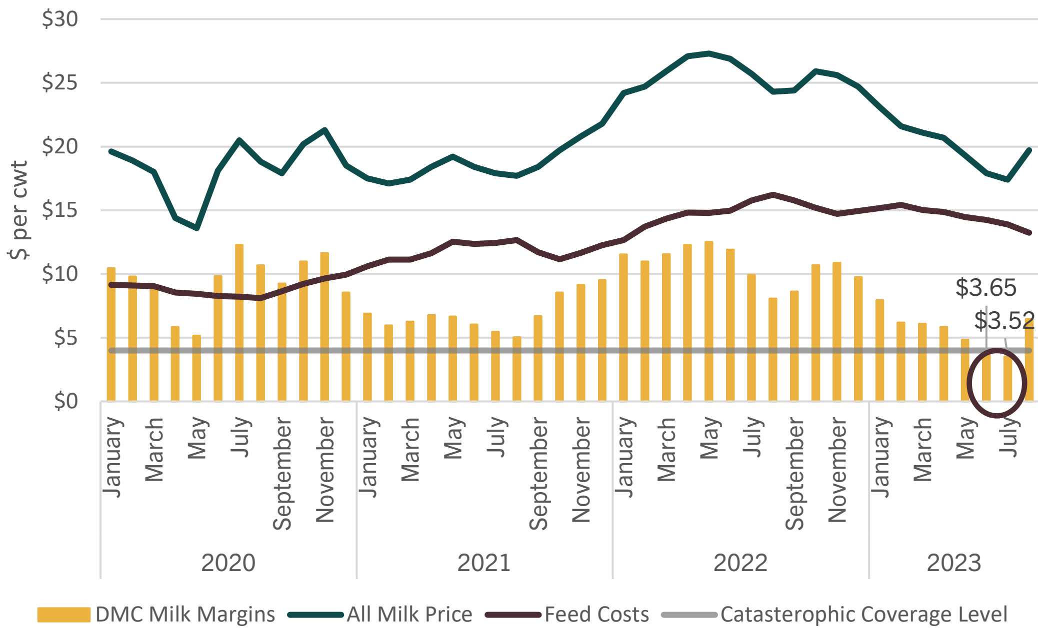
Dairy export demand declined by 2.3% in the first half of 2023. Weaker demand from China and Southeast Asia has been the primary driver of low U.S. exports. A strong U.S. dollar and competition from European and New Zealand dairy products have also hindered U.S. dairy exports. It is difficult to predict how long the impact of these factors will last, but export markets could remain weak into 2024.

U.S. inflation has reached rates last seen in the 1980s. Despite these challenges, domestic dairy demand has remained stable. Milk and butter are grocery staples for most consumers. Domestic use has increased since February. Dairy consumption typically picks up in the fall once school starts and again in the winter with holiday baking demand. If real consumer income continues to fall, consumers may restrict their budgets to essential items only. For dairy, consumers will likely cut back spending on higher-end dairy products but will continue to purchase staples like milk and butter.

Catastrophic coverage levels reached for Dairy Margin Coverage

The Dairy Margin Coverage (DMC) program issued its first catastrophic coverage level payments since the program began in 2019. DMC payments trigger when the margin between milk prices and feed costs falls below a certain level. This level is the catastrophic coverage level and is currently set at $4 per cwt. In June, feed costs over milk prices reached $3.65 per cwt before further falling to $3.52 per cwt in July. DMC payments are a welcome relief for dairies in the short term, but dairy margins need to improve. If they don't, further culling and liquidations could occur. Milk prices improved throughout August, boosting milk margin levels to $6.46 per cwt. Increases in the All-Milk price take time to translate into higher milk checks for producers and tight margins are a challenge for all dairies. Implementing risk management strategies, like Dairy Margin Coverage or Dairy Revenue Protection insurance, helps to provide a financial safety net against weakening dairy prices. Both programs have paid substantial indemnities this year to support dairies.

DMC Milk Margin Levels



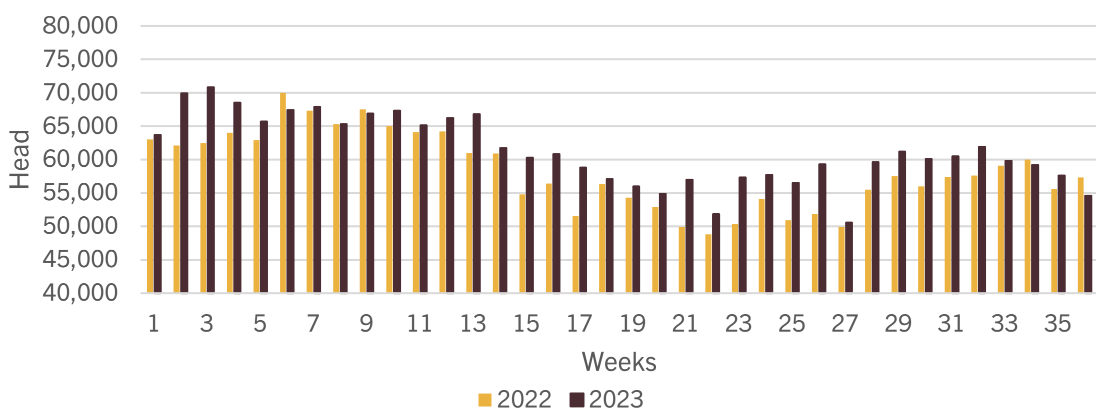
Dairy Margin Coverage's catastrophic coverage levels (margins under $4 per cwt) were reached in June and July.

Source: USDA FSA, compiled by AgWest.

Margin decline expediting dairy slaughter

Dairy margins hit a seven-year low during the second quarter of 2023. The ongoing margin squeeze intensified as Class III prices hit a three-year low of $13.75 per cwt on July 24. Poor margins have expedited dairy cow slaughter. August dairy slaughter rates reached the highest levels since 1986 (when the Whole Herd Buyout program encouraged producers to cull cows). As a result of increased culling, dairy prices rose. Even so, Class III and Class IV futures prices have been volatile, and prices are still not enough to cover costs for many dairy farmers. It will be a few months before the higher prices in the futures markets reach producers' milk checks. In the meantime, margins will likely remain low. Some dairies will continue to operate in a negative cash flow mode until prices rebound or milk production adjusts.

Weekly federally inspected milk cow slaughter



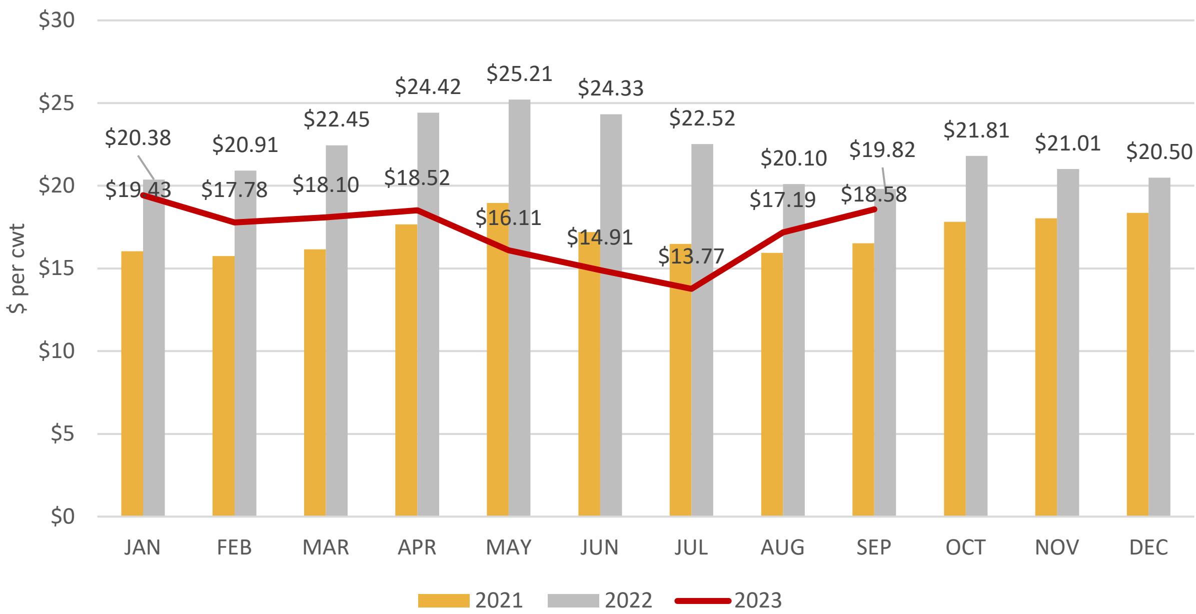
Dairy cow slaughter increased 5.1% year over year.

Source: USDA Cow Slaughter Under Federal Inspection Report.
Note: Slaughter date available through September 9, 2023.

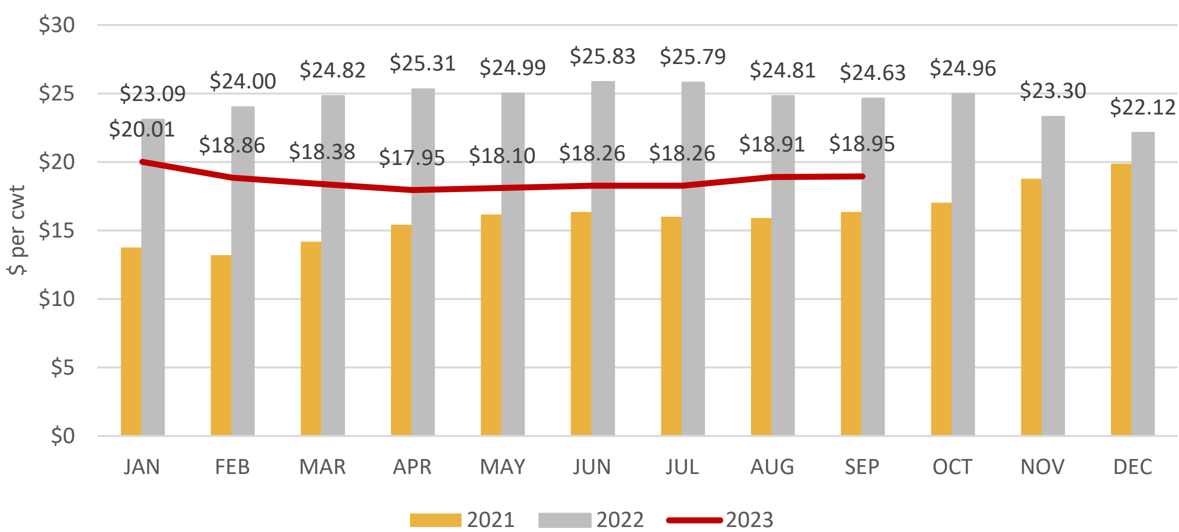
Profitability

Federal Milk Marketing Order (FMMO) Northwest milk prices reached a two-year low of $13.77 per cwt. in July. Persistent high production costs are creating headwinds to dairy profitability. While declines in feed costs should provide relief, it is not enough to offset weak milk prices. Dairy cooperatives face many of the same profitability pressures as dairies. This has led some cooperatives to increase milk check deductions. These deduction increases will put further pressure on dairy producers.

Northwest FMMO Class III Milk Price



Northwest FMMO Class IV Milk Price



Source: Pacific Northwest FMMO, compiled by AgWest.

**FMMO order is for Washington and Western Oregon. September 2023 prices are based on the September 19, 2023 update.*

Looking forward over the next 12 months, margins will take time to recover. Production costs are forecasted to remain a mixed bag. Feed costs have declined and hay prices are 50% lower than 2022 (see the Hay Snapshot for more information). Labor challenges and overtime laws will remain an ongoing issue. Fuel and energy expenses while lower than 2022 highs, remain volatile and elevated. Dairy farmers are likely to cull more cows through the first half of 2024, as margins remain under pressure. Lower cow inventory and milk production will support higher prices. However, milk price increases tend to lag several months behind production declines. Even with fewer cows, milk supplies and prices will take time to adjust to a smaller national herd. Dairy analysts are expecting Class III prices to rise to the mid-$21 range in 2024. Higher prices will be vital to improving dairy margins.

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Additional Information

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