As published in

DairyAdvisor™

Risk Management

Caution 2015: Polygraph no basis for hedge strategy

By Brendan Curran
Risk Management Consultant
INTL FC Stone

"Markets never lie." Then again, they may not always "tell the whole truth and nothing but the truth." Truth or half-truth, when it comes right down to it, they're always right.

At the close of 2014 and as 2015 got underway, the commodity markets were making some questionable statements that sent polygraph needles spiking around the world. Heart and respiration rates were up in the U.S. dairy markets, pushed higher by greater stress in the macro commodity markets as well, especially the oil market.

Consider the precipitous drop in crude oil prices to below $50 per barrel. It sent shockwaves through equity markets, so that shivers rippled through investors worldwide. They shuddered at the possibility that a global economic slowdown lurked somewhere in the dim and twisting alley ahead.

And 2014 was a heart-pounder in terms of "geo-political uncertainty." The destabilizing effects of economic and diplomatic anxiety reinforced the U.S. Dollar Index as the safe haven of choice, which then tracked to five-year highs.

Other observers have noted that the dairy market fundamentals in 2014 were relatively easy to forecast. The year began with high prices and feedstuffs prices in line for strong income over feed costs. Not surprisingly, the combination encouraged greater milk production. Without concurrent demand side pressure – in particular, dairy-hungry China – milk prices had to slide.

The USDA expects downward pressure on dairy prices in 2015 and dairy producers to face shrinking margins. The Foreign Agriculture Service anticipates milk output among major exporters – including the U.S. – to slow, estimating expansion at only 1% this year. They're projecting U.S. dairy exports to total $6.7 billion for fiscal 2015 – down 9% from around $7.4 billion for fiscal 2014.

Now would be a good time to take a step back, draw a deep breath, and contemplate the path ahead.

I spend a lot of time talking to buyers and sellers of dairy products about short-term and long-term price direction based on supply and demand assumptions. Although it's valuable to get a sense of market tenor, many market participants fall for "polygraph readings" — trying to construct hedges on the basis of their market outlook.

However, the best hedging decisions are made when you acknowledge that market movements are largely unpredictable. Therefore, a hedge should always seek first to minimize risk. It should not represent a gamble on the direction of market prices.

A well-designed hedge — one that balances the probabilities of future market conditions — reduces both risks and costs to your operation. Hedging stabilizes earnings, frees up resources, and allows you to focus on the basic competitive advantages of the quality and quantity of your products.

As we roll into 2015, take some time to review your risks — which risks you can tolerate and which you know are going to push your polygraph needle. Make a plan. Be prepared. Breath easier.

Diamond V®

The Trusted Experts In Nutrition & Health™