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Dear Ag Industry Associate,

Now that a few months have passed since the enrollment deadline for the Dairy Margin Protection Program that rolled out as part of the new Farm Bill, we thought it would be informative to revisit MPP and consider its impact on dairies that elected to participate. Our feature article, “Revisiting MPP” explores coverage that the program offers in light of where current margins may exist for a sample dairy operation. As the program is new and individual dairies are still in the process of trying to understand how it protects their unique margins, we examine where gaps may exist and discuss considerations that a dairy may want to think about as they evaluate their existing coverage. This may also impact how a dairy views coverage decisions for the upcoming year as enrollment for 2016 begins in July.

In addition to this month’s featured article, the current Margin Manager also reviews the latest outlook for profitability in the crop, swine, cattle and dairy industries. While margins have remained relatively stagnant over the previous month, the improvement in dairy margins has been noticeable. Hopefully, we will begin to see margin improvement in other sectors also as we thaw out from winter and move into the spring season.

Chip Whalen
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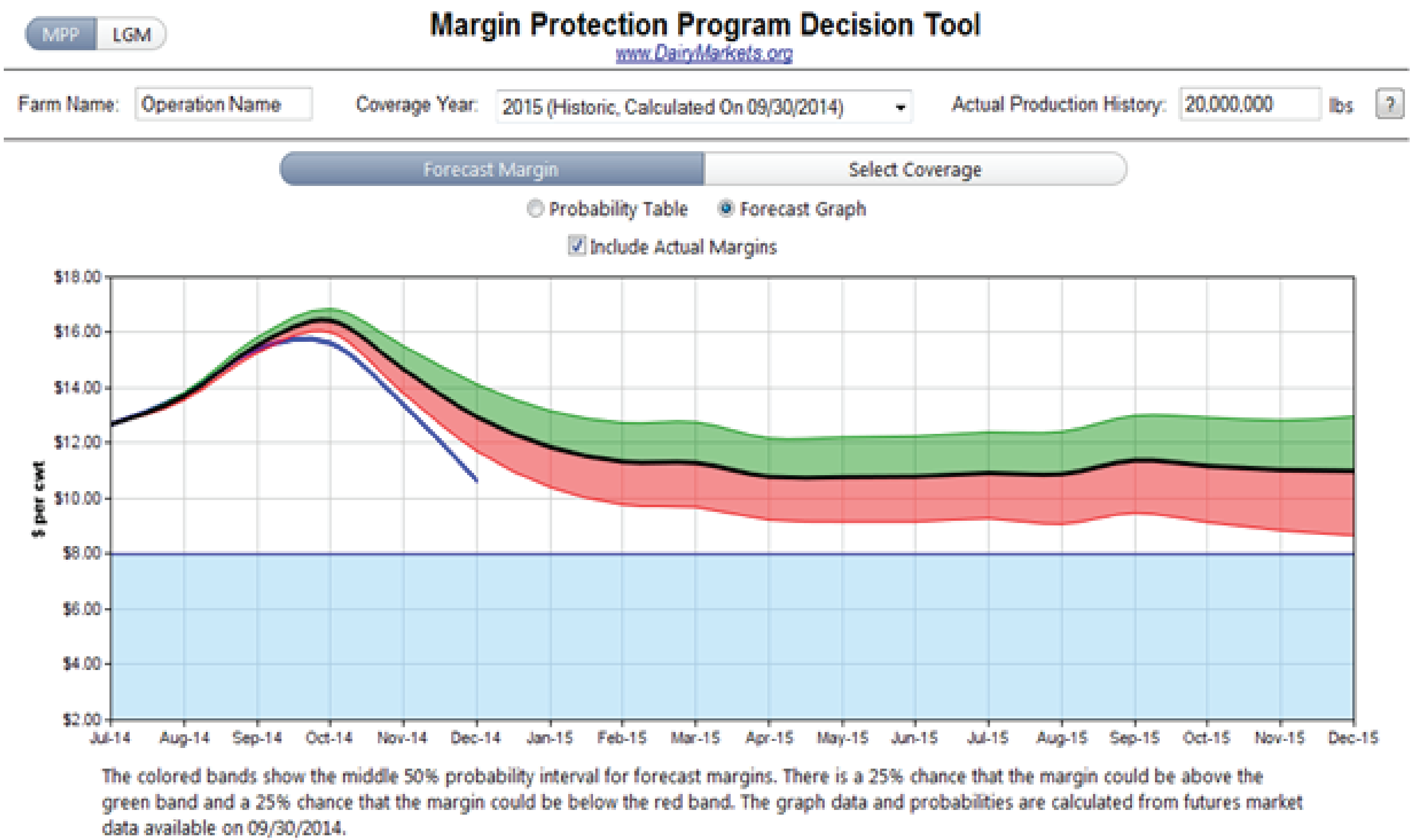
Revisiting MPP

Now that we are almost through the first quarter of 2015 and hopefully done with what has been a particularly challenging winter across much of the U.S., particularly in the Northeast, it seems like a good time to revisit the Margin Protection Program which was recently implemented. The USDA extended the signup deadline to December 19, 2014, and recent reports suggest that many dairies took advantage of this new tool to protect forward profit margins following extensive outreach and a series of informational sessions to educate producers on features and benefits of the program. According to enrollment figures for 2015 released by USDA, 23,807 dairy herds enrolled in MPP which collectively represent about 51% of all herds commercially licensed to sell milk in 2013. In addition, approximately 55% of those enrolled or 13,091 dairy herds also elected “buy-up” coverage in the program, meaning that they paid an additional premium to cover margins above the $4.00/cwt. threshold that is offered for free. Although dairy margins have been recovering recently due to a sharp rebound in milk prices, the actual MPP margin had been moving steadily lower through the fall into the first half of December which likely motivated many dairies to enroll in the program (see blue line in graph).



Revisiting MPP

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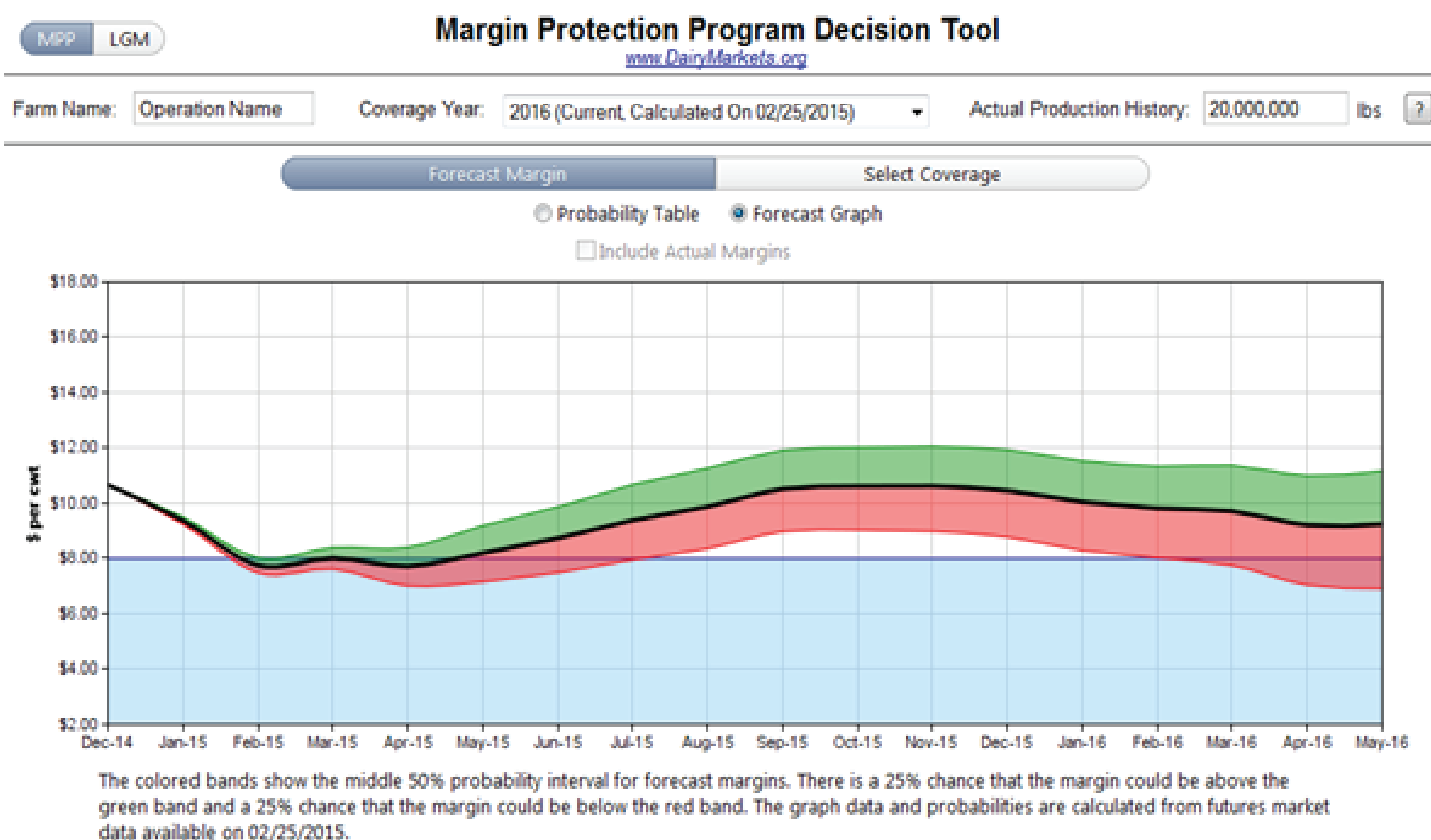
While the MPP margin calculation has been moving lower, it remains above the highest insurable threshold at $8.00/cwt. However, looking out through the remainder of 2015, the MPP Decision Tool does suggest that there is a possibility that MPP could fall within the insurable range. Moreover, there is quite a bit of uncertainty surrounding the future direction of milk prices and feed costs given recent announcements from Fonterra as well as the normal concerns tied to spring acreage and weather as new-crop corn and soybean dynamics come into greater focus from market participants. The following graph depicts the current forecast for MPP as of February 25, 2015:



Revisiting MPP

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For those dairies that did elect to buy up coverage beyond the $4.00/cwt. threshold offered for free, anecdotal reports suggest that most chose not to insure above the $6.50/cwt. level. This is due to the fact that the premiums are heavily subsidized for margin coverage at lower levels while little or no subsidy is offered at higher levels. This can be seen by looking at the column for MPP premiums above 4 million pounds of milk production in the MPP cost table below. You will notice that the cost to insure margins below the $7.00/cwt. threshold is $0.83/cwt. while the cost to ensure below the $6.50/cwt. threshold is $0.29/cwt., a difference of $0.54/cwt. What this means effectively is that a dairy is paying 4 cents more to insure the range between $7.00 and $6.50 than the range is actually worth. This would not make sense unless there was a high probability that MPP margins would remain below $6.50/cwt.

MPP Cost Table

To calculate MPP premium levels for your operation, enter your annual milk production 20000000 lbs, and desired coverage level 90 %

Protection Level	MPP Premium Below 4M	MPP Premium Above 4M	Your MPP Premium
$4.00	$0.000	$0.000	$ 0.000
$4.50	$0.010	$0.020	$ 0.018
$5.00	$0.025	$0.040	$ 0.037
$5.50	$0.040	$0.100	$ 0.087
$6.00	$0.055	$0.155	$ 0.133
$6.50	$0.090	$0.290	$ 0.246
$7.00	$0.217	$0.830	$ 0.694
$7.50	$0.300	$1.060	$ 0.891
$8.00	$0.475	$1.360	$ 1.163

Calculations are for a 20000000 lb yearly operation at 90% coverage.

One feature of the new MPP program that may not be fully understood is that it is meant to be more disaster insurance coverage than robust margin protection to help ensure a dairy's profitability. To see this, consider the fact that MPP does not include operating costs but is simply an income over feed calculation. Therefore, a dairy will need to back out their non-feed expenses to arrive at an equivalent level of margin protection where the coverage would actually kick in. As a simple example, let's assume a model dairy operation that has a 1,000 cow milking herd which produces 20 million pounds of milk annually. Let's further assume that this model dairy has non-feed operating expenses of $8.00/cwt. This would mean that the highest level of MPP coverage available through the program would roughly protect a breakeven scenario at best for this dairy. Now let's assume that this dairy signed up for MPP in 2015 and elected to buy up coverage at the $6.50/cwt. threshold. For simplicity, we will also assume that the dairy has secured forages for the year so that we can isolate milk as the only variable which will affect their margin for the remainder of the year.

Revisiting MPP

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Suppose that the dairy has calculated their projected profit margin to be a positive $1.00/cwt. for the year based upon current CME futures prices for Class III Milk, exclusive of PPD or any premium received for their components. This suggests that there is a gap in their coverage equivalent to approximately $2.50/cwt. This difference is derived from their projected margin of $1.00/cwt. plus the difference between the current MPP projection of $8.00/cwt. and where their coverage kicks in below $6.50/cwt. Given that their feed has already been priced and assuming no significant changes to their projected operating costs, this essentially means that Class III Milk futures could decline about $2.50/cwt. from current levels before MPP would provide them any protection from deteriorating margins. While a strong increase in feed costs could also cause the MPP calculation to drop and trigger an indemnity payment sooner; likewise, a decline in the USDA prices for alfalfa, soybean meal and corn could conversely mean that milk prices would have to drop even more before an indemnity payment would be triggered.

Either way, deteriorating milk prices would be the main risk for this dairy through the remainder of the year. To address this risk, the dairy may consider a strategy where they would "bridge the gap" between the current value of milk and where their MPP coverage would become effective triggering indemnity payments. In this example, if the gap is equivalent to $2.50/cwt., the dairy would need to protect Class III Milk from declining over a similar range of lower prices from current values. Exchange-traded option strategies might be one way in which the dairy could protect this risk. A structured product off-exchange such as a swap might be another means of bridging this gap. Regardless of how the dairy chooses to address this risk if they elect to do so, it is important to realize that there may be a significant difference between where a dairy's projected margins actually are right now and where their protection to deteriorating margins through the new MPP program will effectively begin.

Thinking ahead to coverage decisions for 2016, the sign-up period will begin July 1 and continue through September. Many dairies will likely wait towards the end of the sign-up period to gain greater visibility on projected margins for 2016. One consideration to bear in mind is whether or not you purchase your forages on the open market. To the extent that you grow your own feed, you may not need the coverage that MPP is offering and you might be better to focus on other strategies in the marketplace. Do you know the relationship between your dairy's margins and MPP?

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With the exception of spot Q1, dairy margins improved over the second half of February supported by a slight uptick in milk futures along with feed costs which remained largely steady over the past two weeks. From a historical perspective, deferred margins are quite strong, at or above the 80th percentile of the past 10 years even with last year's margins taken into consideration. Milk is drawing support from a resolution of the labor dispute between the International Longshore and Warehouse Union (ILWU) and Pacific Maritime Association that has significantly impacted exports from West Coast ports. This issue has hit dairies in the Western U.S., particularly California, quite hard as much of their dry milk and whey products go to the export market. On that note, dairy cow slaughter has picked up so far in 2015, with year-to-date weekly slaughter up 6% or 23,000 head over 2014, with culling in the western states making up 96% of that increase. According to USDA's monthly Milk Production report, January output totaled 17.64 billion pounds, up 2.1% from last year on a seasonally adjusted basis and 1.8% higher than December 2014. USDA also convened their Annual Outlook conference last week which featured acreage projections including a 1.6 million acre decline in corn area for this season to 89 million acres. Soybean acreage is also projected down 200,000 from last year, with USDA currently surveying producers for the Prospective Plantings report that is due out at the end of March. Our clients continue scaling into new coverage in deferred periods in response to the improving margin outlook. Our consultants are also helping clients evaluate strategic adjustments on existing positions, particularly strengthening milk hedges in light of the significant price advance recently.

The Dairy Margin calculation assumes, using a feed price correlation model, that for a typical dairy 62.4 lbs of corn (or equivalent) and 7.34 lbs of meal (or equivalent) are required to produce 100 lbs of milk (includes dry cows, excludes heifers not yet fresh). Additional assumed costs include $0.90/cwt for other, non-correlating feeds, $2.65/cwt for corn and meal basis, and $7.00/cwt for non-feed expenses. Milk basis is $0.75/cwt and non-milk revenue is $1.00/cwt.

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Hog Margin Watch: February

Margins improved since the middle of February on a combination of higher hog prices and steady feed costs with corn slightly lower and meal higher over the past two weeks. From a historical perspective, hog finishing margins remain at or below average over the past 10 years with spot losses continuing in Q1 along with a projected loss in Q4 while the spring and summer periods of Q2 and Q3 still indicate positive margins. Hog prices rebounded on news that a deal had finally been struck between the International Longshore and Warehouse Union (ILWU) and the Pacific Maritime Association to resolve the labor dispute in West Coast ports. While it will take time to clear the backlog created from the work slowdown, the development is certainly positive given that pork exports represent about 30 percent of total U.S. pork production. USDA's latest Cold Storage report showed that pork inventories at the end of January totaled 618.746 million pounds, 3.6% lower than a year ago but up over 18% from December and also about 5% higher than the 5-year average. USDA also convened their annual Outlook Conference last week which highlighted acreage projections anticipating a 1.6 million acre decline in corn seedings from last year. Soybean acreage was also expected to be down 200,000 acres from 2014. USDA's Prospective Plantings report will be released at the end of March and those figures will go into the first new-crop balance sheet to be released in May. Our clients continue to focus mainly on making strategic adjustments to existing positions; in particular, adding flexibility back to hog strategies while strengthening feed hedges.

The Hog Margin calculation assumes that 73 lbs of soybean meal and 4.87 bushels of corn are required to produce 100 lean hog lbs. Additional assumed costs include $40 per cwt for other feed and non-feed expenses.

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Beef Margin Watch: February

Beef margins were mixed since the middle of February, weakening slightly in nearby marketing periods but strengthening slightly in forward slots. Feed costs moderated over the past two weeks along with cattle prices, with lower projected feeder costs explaining the deferred margin improvement in marketing periods where feeders have not yet been priced. Beef finishing margins remain deeply negative throughout 2015 into February 2016, existing in the bottom quartile of profitability over the past 10 years. Nearby margins are even worse, existing below the 10th percentile of the previous decade through the August marketing period. USDA's latest Cattle on Feed report showed the February 1st cattle inventory in feedlots of over 1,000 head at 10.711 million, up 0.3% from a year ago. January placements totaled 1.787 million head, 2.4% higher than pre-report estimates but down 11.3% from last year. Meanwhile, supplies of boneless beef in Cold Storage totaled 445.1 million pounds according to USDA, 14.4% higher than a year ago and 11.3% higher than the 5-year average. Imports of beef have surged since September and poor domestic demand in foodservice channels has led to a 70-80 cent spread between domestic and imported lean beef. USDA also convened its Annual Outlook conference last week which featured projections for 2015 acreage, including a 1.6 million acre decline in corn area from 2014. Producers are currently being surveyed for the Prospective Plantings report due out at the end of March. Those figures will be included in the first new-crop balance sheet which comes out in May. Our clients continue to monitor opportunities for deferred placements while evaluating strategic adjustments on existing positions, particularly adding flexibility to cattle hedges while strengthening corn hedges following recent price action.

Live Cattle Marketing Periods:

Apr '15 2014 2015 — Apr 2015: HIGH **$16.34** LOW **($22.77)** LAST **($16.80)** 10YR PERCENTILE **0.8%**

FEBRUARY

Jun '15 2014 2015 — Jun 2015: HIGH **$7.24** LOW **($24.65)** LAST **($20.05)** 10YR PERCENTILE **1.1%**

FEBRUARY

Aug '15 2014 2015 — Aug 2015: HIGH **$21.15** LOW **($14.73)** LAST **($11.43)** 10YR PERCENTILE **9.8%**

FEBRUARY

Oct '15 2014 2015 — Oct 2015: HIGH **$25.83** LOW **($11.91)** LAST **($5.35)** 10YR PERCENTILE **21.0%**

FEBRUARY

The Beef Margin calculation uses Feeder Cattle futures to price inbound animals and assumes each will consume 55 bushels of corn and cost approximately $250 per head (for other feed and non-feed expenses) to gain 550 pounds and reach a market weight of 1,250 pounds.

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Crop Margin Management
Jul 8-9

Hog Margin Management
Jul 22-23

Dairy Margin Management
Aug 5-6

Margin Management for Ag Lenders
Oct 21-22

Beef Margin Management
Nov 11-12

Dairy Margin Managment
Nov 18-19

Hog Margin Management
Dec 9-10

Crop Margin Management
Dec 16-17

Trading futures and options carry the risk of loss. All dates subject to change. Please check cihedging.com/education for more information and the latest additions to the schedule.

Corn Margin Watch: February

Nearby corn margins have increased slightly since the middle of February while deferred 2015 margins have fallen modestly. Revenue protection insurance prices are now established for Midwest farmers coming in at $4.15/bushel for this year's plantings. For reference, last year's insurable price was $4.62/bushel. With rising land and input costs, the insurable level likely represents a value below breakeven for most producers, but still offers the producer disaster insurance in the event market prices remain subdued. The USDA recently released their annual Baseline Projections report which highlights macroeconomic expectations for the next ten years and is meant more as a general expectation than anything exact. The report shows expectations for farmers to plant 89 million acres to corn this spring, down 1.6 million acres from last year. At the end of March, NASS will release its Prospective Plantings report which will be given greater weight by market participants as to the extent of this year's potential supply. Old-crop demand has been steady over the last few weeks. Export sales continue to move along above the average needed to meet the USDA estimate while the shipment pace has lagged somewhat. Mid-March typically represents the time of year where corn shipments gain priority over soybean loadings, and could help bring the shipment pace closer to average. Ethanol production continues to exceed the USDA expectation as profitability in the sector provides an economic incentive to produce, albeit at a much lower profitable situation than just a few months ago. Ethanol stocks are bumping up near 4-year highs for this time of year which has pressured ethanol prices to some degree. While inventories typically rise into the middle of March, elevated supplies could lead to negative profitability and a slower weekly grind. Our consultants are working with clients to help make strategic adjustments to existing protection strategies particularly focusing on new crop production. Producers have favored flexible strategies that would protect all lower prices while still preserving the opportunity to benefit should prices rise.

The estimated yield for the 2015 crop is 180 bushels per acre and the non-land operating cost is $612 per acre. Land cost for 2015 is estimated at $243 per acre [1]. Basis for the 2015 crop is estimated at $-0.12 per bushel.

The estimated yield for the 2016 crop is 174 bushels per acre and the estimated operating cost is $615 per acre. Land cost for 2016 is estimated at $238 per acre [1]. Basis for the 2016 crop is estimated at $-0.25 per bushel.

[1] The Corn Margin Watch yield, land and non-land operating cost values are based upon central Illinois low productivity farmland crop estimates in the "Historic Corn, Soybean, Wheat, and Double-crop Soybeans" report published by the Department of Agricultural and Consumer Economics at the University of Illinois.

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Soybeans Margin Watch: February

Soybean margins have increased modestly since the middle of February as both price and basis levels have risen. Revenue protection insurance prices are now established for Midwest farmers coming in at $9.73/bushel for this year's plantings. For reference, last year's insurable price was $11.36/bushel. With rising land and input costs, the insurable level likely represents a value right at breakeven for most producers, but still offers the producer disaster insurance in the event market prices remain subdued. The USDA recently released their annual Baseline Projections report which highlights macroeconomic expectations for the next ten years and is meant more as a general expectation than anything exact. The report shows expectations for farmers to plant 83.5 million acres to soybeans this spring, down slightly from last year. At the end of March, NASS will release its Prospective Plantings report which will be given greater weight by market participants as to the extent of this year's potential supply. Old-crop demand has remained firm as export sales and shipments continue to exceed the USDA estimate. The crush pace has been firm over the last four months and remains on pace to meet the USDA forecast. On the world front, Brazilian harvest is progressing on pace with 23% of the crop harvested and above-trend yields reported. Recently there have been some transportation disruptions as truckers strike due to a national diesel tax imposed by the Brazilian government. This situation has put some premium in U.S. soybean prices as some fear Brazilian exporters will not have adequate supplies at port to meet demand. Our consultants are working with clients to help manage existing protection strategies for both old and new crop. Some of our clients are considering adjustments to coverage that would increase the delta of current hedges to capitalize on the higher price continue while maintaining price protection to all lower prices.

The estimated yield for the 2015 crop is 52 bushels per acre and the non-land operating cost is $364 per acre. Land cost for 2015 is estimated at $243 per acre [1]. Basis for the 2015 crop is estimated at $-0.08 per bushel.

The estimated yield for the 2016 crop is 52 bushels per acre and the estimated operating cost is $365 per acre. Land cost for 2016 is estimated at $238 per acre [1]. Basis for the 2016 crop is estimated at $-0.25 per bushel.

[1] The Soybeans Margin Watch yield, land and non-land operating cost values are based upon central Illinois low productivity farmland crop estimates in the "Historic Corn, Soybean, Wheat, and Double-crop Soybeans" report published by the Department of Agricultural and Consumer Economics at the University of Illinois.

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Wheat Margin Watch: February

Wheat margins have lost ground since the middle of February and are back near the lowest levels seen for the marketing year. On the domestic front, cold temperatures have blanketed the Plains states as is typical for this time of year. However, February 2015 will go down as one of the coldest on record for many areas and has some market participants talking about winterkill particularly in Nebraska where snow cover is lacking. Damaging effects from cold temperatures will be better known this spring as the crop comes out of dormancy. Although winterkill is a distinct possibility, domestic stocks remain large and above the average of the last ten years. The USDA recently released their annual Baseline Projections report which highlights macroeconomic expectations for the next ten years and is meant more as a general expectation than anything exact. The report shows expectations for farmers to plant 55.5 million acres to wheat this year, down roughly 1.3 million acres from last year. Export sales and shipments continue to disappoint each week as U.S. prices remain uncompetitive on a global level. Egypt recently tendered twice for U.S. wheat. The first tender was entirely rejected as prices offered were nowhere close to international offers. Egypt has a $100 million line of credit with U.S. exporters and just recently used a good part of the credit line to secure U.S. wheat. Other than Egypt, international demand is lacking as the U.S. dollar rally continues to put U.S. exporters at a disadvantage in the international marketplace. On the world front, the E.U. remains the world's cheapest origin along with Black Sea supplies. Although not resolved, geopolitical conflicts in the Black Sea region have had little impact on export operations as shipments continue to load. Our consultants continue working with clients to protect these forward margins with flexible strategies on existing coverage that will allow for potential margin improvement over time. Some of our clients that made adjustments to protection strategies capitalizing on the previously higher price are now considering strategies that would reduce the delta of their hedges in order to preserve the opportunity to participate in higher prices.

The estimated yield for the 2015 crop is 67 bushels per acre and the non-land operating cost is $366 per acre. Land cost for 2015 is estimated at $163 per acre [1]. Basis for the 2015 crop is estimated at $0.05 per bushel.

The estimated yield for the 2016 crop is 72 bushels per acre and the estimated operating cost is $328 per acre. Land cost for 2016 is estimated at $158 per acre [1]. Basis for the 2016 crop is estimated at $0.04 per bushel.

[1] *The Wheat Margin Watch yield, land and non-land operating cost values are based upon central Illinois low productivity farmland crop estimates in the "Historic Corn, Soybean, Wheat, and Double-crop Soybeans" report published by the Department of Agricultural and Consumer Economics at the University of Illinois.*

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