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The KDM Dairy Report – September 28th, 2007

Bullish Fundamentals:

Futures Month	Friday 09/28 Close	Friday 09/21 Close	Change	5-yr Average	Top 3rd Price
Sep-07	$20.11	$20.17	($0.06)	$13.11	$13.99
Oct-07	$18.26	$18.26	$0.00	$13.19	$13.98
Nov-07	$17.21	$17.41	($0.20)	$12.88	$13.86
Dec-07	$16.83	$17.15	($0.32)	$12.92	$14.01
Jan-08	$16.13	$16.47	($0.34)	$12.50	$13.33
Feb-08	$15.66	$15.93	($0.27)	$12.53	$13.21
Mar-08	$15.73	$15.97	($0.24)	$12.78	$13.50
Apr-08	$15.61	$15.76	($0.15)	$13.09	$14.31
May-08	$15.64	$15.73	($0.09)	$13.14	$14.49
Jun-08	$15.83	$15.79	$0.04	$12.54	$13.63
Jul-08	$16.05	$15.98	$0.07	$12.25	$13.16
Aug-08	$16.09	$16.04	$0.05	$12.41	$13.34
Sep-08	$16.24	$16.16	$0.08	$13.11	$13.99
Oct-08	$15.82	$15.71	$0.11	$13.19	$13.98
Nov-08	$15.62	$15.53	$0.09	$12.88	$13.86
Dec-08	$15.51	$15.40	$0.11	$12.92	$14.01
Sep-Dec Avg	**$18.10**	**$18.25**	**($0.15)**		
2008 Avg	**$15.83**	**$15.87**	**($0.05)**		

- Blocks and barrels both gained 4¢ over last week's NASS survey, averaging $2.09/lb and $2.07/lb respectively. Nonfat dry milk was up 1.7¢ to $2.06/lb after several weeks of slight drops, but butter lost 1.1¢ to average $1.37/lb and dry whey continued falling, off 2.9¢ to 44.3¢/lb.
- Weekly cold storage numbers are indicating a 3% drop in cheese stocks for the period 09/01 through 09/24, unchanged from last week.
- Weekly dairy cow slaughter numbers were strong this week. 51,200 head were culled for the week ending 09/15, compared to 49,000 head last year. YTD, slaughter numbers are up 7.8% compared to a year ago.
- Fluid Milk & Cream Review reports 408 loads of milk flowed in to the Southeast this week, compared to 359 last week and 345 last year. School and retail accounts are taking in considerable volumes for Class I use, and buying patterns are better than hoped for despite the higher prices in the grocery aisle. Balancing plants are running on limited schedules and condensed skim supplies remain tight.
- Milk supplies are seasonally tight in the Central region, according to Fluid Milk & Cream Review. Bottler orders were stronger this week as retail sales have been reasonably good in the face of high prices. Handlers in the upper Midwest pool have announced they will segregate and sell rBST-free milk early next year.
- Current cheddar, other natural Americana and mozzarella cheese stocks are tight in the Midwest, according to Dairy Market News. Some buyers have been unable to secure bulk volumes from their preferred suppliers, but other buyers are holding back on larger orders in anticipation of further price reductions, and barrels are readily available.
- Dairy Market News reports increased trade activity for dry whey for both domestic and export accounts. Both buyers and sellers indicate they think the market is nearing a bottom which is stimulating sales.
- Feed: In case you haven't noticed, we have $10 beans from Nov '07 through Aug '08, and meal is pushing $290/ton. Most corn contracts are again trading above $4/bu despite bearish old crop fundamentals. The low dollar and tight world grain stocks could keep feed expenses high again next year. Dairy quality hay is also expensive and in short supply.
- International: Dairy Market News reports that despite substantially higher milk prices in Europe, producers have not responded with higher output. Big increases in the cost of production and very expensive replacement heifers are limiting gains.
- International: Milk production in New Zealand, while above last year's levels, is below earlier forecasts, according to Dairy Market News. The weather has not been conducive for milk production so output is up only 1%. In Australia, some dairy areas are still very dry and processors are struggling to meet early season contracts, as early spring receipts are not as high as was hoped for. Feed and water are costly, so producers are limiting herd numbers to what they can afford.
- International: Cheese stocks in Oceania are light, as manufacturers are emphasizing powder production over cheese. Much of the season's production is already committed, so some customers are sourcing cheddar and mozzarella from the U.S. to cover their needs.
- Economy: The U.S. dollar traded at new record lows vs. the Euro today, making U.S. goods more affordable to foreign buyers.
- Dairy Market News reports that commercial disappearance of dairy products during May-July 2007 was up 3.4% compared to the same period a year ago. American cheese use was up 1.3% and other cheese up 5.1%.

Bearish Fundamentals:

- Ag Prices Report: The milk-feed ratio rose again in September, but not by as much as in previous months. The ratio that tends to indicate conditions conducive for expansion when above 3.0, sat at 3.21, up from 3.17 in August and far higher than last year at 2.61.
- The August Consumer Price Index (CPI) for all food was up 4.3% compared to last year, and up 12.1% for dairy products, according to U.S. government statistics. Fresh whole milk led with way, up 23.9%.
- California milk production is heavy and stretching processing capacity in the state, according to Fluid Milk & Cream Review. Volumes lost during the heat at the beginning of the month have been regained, as weather has been conducive to cow comfort. Excess milk and components are moving out of state to find a home.
- More milk is heading to Western cheese plants now that school pipelines are full, according to Dairy Market News. USDA contacts note that more cheese is available as a result.
- Dairy Market News reports that despite the tight supply situation and high world prices for butter, export demand is evident but not resulting in a lot of orders. Domestic demand is fair, but some buyers are waiting for lower weekly averages before making additional purchases.
- Butter stocks continue to build. 124 million lbs are sitting in CME-approved warehouses for the week ending 09/22, compared to only 99.3 million lbs in storage last year at this time, a 30% increase.

Recommendation:

The cheese spigot was opened this week as 31 loads of blocks and 9 loads of barrels exchanged hands in quite a price discovery battle in the cash cheese market. Blocks ended up 8½¢ for the week to close at $1.90/lb, but barrels lost 5¢ to settle at $1.85/lb and restore the block/barrel relationship. Butter continued to grind lower, losing 5½¢ to $1.31½/lb on 26 trades. We have a complex market right now. Earlier this summer we were tighter on barrels than blocks, but now the opposite seems to be true as we've heard from several sources barrels are now more available. In addition, we seem to have a geographical difference to deal with. California has more milk than they can handle and cheese is more readily available. We heard some producer reports this week of milk being dumped and a cheese plant going bankrupt leaving 40 producers with no where to go with their milk. Nobody wants it. While the excess milk situation is not positive, on the other hand it would seem to imply that dramatic milk production expansion in California in 2008 could be somewhat limited due to sheer lack of processing capacity, unless more milk moves out of state. East of the Rockies we appear to be tight on current cheese and slightly short to in balance on milk. A lot of loads are still making their way south from the Midwest to supply deficit areas, and after several months of news hype about high milk prices, the media seems to have dropped the story. Consumers appear to have accepted the higher prices are the new "norm", just like $3 gas, as evidence is showing steady buying despite the increased costs. So, where does that leave us? Further price erosion in the front months and Q1 2008 contracts could happen if the barrel price slips further next week. But the market has already factored that in. Unless we see another real freefall in cheese, Class III futures should find some support. Holiday cheese buyers have been waiting for lower prices, and now that they're here, they could get more aggressive. The fact that 31 loads of blocks were bought this week speaks for itself. Consider buying call options in Nov and Dec if prices overdo it to the downside next week, and then use them to sell in to if prices recover. For 2008, we would still hold out for $15.90 or higher before selling anything, and then, limited to under 25%. With the potential for much higher production costs next year, downside below $15/cwt seems limited, at least for an extended period. So why sell at the current average?

Note: Next week's report will not be published until Saturday due to being out-of-town on Thursday and Friday.