

The KDM Dairy Report – January 11th, 2008

Bullish Fundamentals:

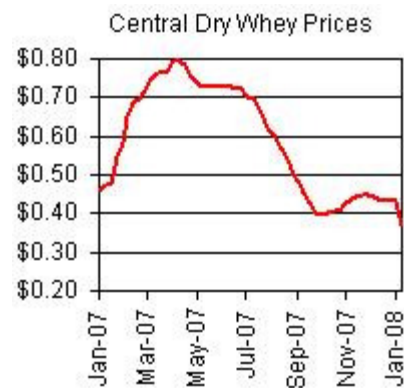
- World Ag Supply & Demand Report: USDA did not change their 2008 Class III price forecast from last month, but they did revise 2008 milk production lower in response to higher feed costs, which they expect will limit growth in cow numbers and gains in milk per cow. They did, however, revise cheese prices slightly higher and expect an average of \$1.68/lb, as they predict [demand for cheese will remain firm](#).
- Class I [demand has increased substantially](#) in the Southeast region of the country as school lunch programs have been reactivated. This has forced some handlers to redirect loads slated for manufacturing use into the fluid market. Fluid Milk & Cream Review reports retailers are also ordering to restock shelves. Cold weather in Florida has stopped forage growth, putting additional pressure on short hay supplies, while other areas of the Southeast continue to have decreased water availability. Production of sour cream and dips is increasing in preparation for Super Bowl needs. Last week 103 loads of Grade A milk were exported from the region, but only 16 went out this week.
- More Class I accounts are [shifting to rBST-free milk](#), but they are struggling to find adequate supplies, according to Fluid Milk & Cream Review. Segregating farm milk pickups is a growing problem and expense for handlers.
- Tight water supplies in the Pacific Northwest means that many hay growers in the region are seriously looking at switching to wheat, which needs much less water. Hay supplies are becoming more of a concern to dairy producers, while feed prices are adding financial stress.
- Dairy Market News reports that after hitting its lowest level since July 2006 (\$1.19¾/lb), butter has rallied to \$1.23/lb. Churning is still active, but lighter than in recent weeks. The show of strength in butter could be a result of [stronger than anticipated buyer interest](#), who appear to be securing additional stocks, beyond what's needed for near term needs.
- Today's [Daily Dairy Report](#) quotes Foreign Ag Service data released this morning showing cheese exports in November were up 34% from last year, and butter fat exports were up more than 1200% (yes, that's correct). The total value of November dairy exports hit a record high \$350.5 million, up 131% from November 2006. Wow!
- Grains: USDA released the Crop Report this morning, which resulted in limit up moves in corn, beans and meal. The average trade guess overestimated corn stocks by a huge 281 million bushels, which implies corn needs to maintain most of its 2007 acreage gains. In beans, ending stocks are at 175 million bushels, down from 573 million last year. Very strong export to growing Asian economies, a weak dollar and tighter corn stocks will make new acreage gains difficult for beans. For both, any spring planting delay or poor weather in other grain producing nations could have more explosive impact on prices. Corn finished the day above \$5/bu May through Dec 2010, while beans are now above \$13/bu May-Aug.

Futures Month	Friday 01/11 Close	Friday 01/04 Close	Change	5-yr Average	Top 3rd Price
Jan-08	\$19.30	\$19.95	(\$0.65)	\$12.50	\$13.33
Feb-08	\$17.85	\$18.88	(\$1.03)	\$12.53	\$13.21
Mar-08	\$17.20	\$18.06	(\$0.86)	\$12.78	\$13.50
Apr-08	\$16.55	\$17.23	(\$0.68)	\$14.14	\$15.36
May-08	\$16.34	\$16.95	(\$0.61)	\$14.50	\$15.85
Jun-08	\$16.50	\$17.00	(\$0.50)	\$14.54	\$15.63
Jul-08	\$16.60	\$17.02	(\$0.42)	\$14.66	\$15.57
Aug-08	\$16.72	\$17.11	(\$0.39)	\$14.47	\$15.40
Sep-08	\$16.88	\$17.16	(\$0.28)	\$15.14	\$16.02
Oct-08	\$16.43	\$16.50	(\$0.07)	\$14.78	\$15.58
Nov-08	\$16.27	\$16.30	(\$0.03)	\$14.75	\$15.73
Dec-08	\$16.22	\$16.29	(\$0.07)	\$15.09	\$16.18
Jan-09	\$16.10	\$15.91	\$0.19	\$12.50	\$13.33
Feb-09	\$16.10	\$15.99	\$0.11	\$12.53	\$13.21
Mar-09	\$16.13	\$16.00	\$0.13	\$12.78	\$13.50
Apr-09	\$16.10	\$15.96	\$0.14	\$14.14	\$15.36
May-09	\$16.10	\$15.95	\$0.15	\$14.50	\$15.85
Jun-09	\$16.10	\$15.70	\$0.40	\$14.54	\$15.63
2008 Avg	\$16.91	\$17.37	(\$0.47)		
Jan-Jun 2009	\$16.11	\$15.92	\$0.19		

Bearish Fundamentals:

- Cash Market: The up and down ride in the cash market continued with blocks plummeting 30¼¢ to settle at \$1.85/lb. Barrels fell a more modest 11¢ to \$1.98/lb, leaving a 13¢ inverted spread between the two. 16 loads of blocks and 5 loads of barrels exchanged hands, with unfilled offers left on most days. Butter managed a small gain, rising 1¼¢ to \$1.23/lb. 7 cars of butter exchanged hands.
- Milk [output is booming](#) in California, according to Fluid Milk & Cream Review. Despite heavy rains and wind damage from recent storms in some areas, farm production has been largely unaffected. There are continued reports of milk being dumped due to the very heavy volumes and no where to go with it. Processors in Arizona are running at capacity to handle their own, plus out of state milk offerings.

- Dairy cow slaughter for the week ending 12/29 [slumped](#) to only 34,900 head, compared to 40,600 during the same period last year. The drop was most likely due to the holiday period.
- Dry whey [prices are under pressure](#) in a weak market caused by heavy inventories. Dairy Market News reports plants are cutting deals at lower prices in an effort to move product. Prices in the Central region traded as low as 31¢/lb this week (see chart at right). Dry whey futures trading on the CME responded to the lower prices, breaking several cents, with the April contract settling at 29¢ today.
- Western dryers are still running on heavy schedules as they try to handle the heavy milk wave, according to Dairy Market News. Exports are light and domestic [sales are slow](#). Prices continue to head lower and averaged \$1.55/lb in the region. Prices are getting low enough to encourage more nonfat dry milk use in cheese production, which would increase yields.
- Cheese offerings in the Midwest have increased as producers try to [move extra product](#) generated during the holidays, according to Dairy Market News. Some of it is reaching the CME and pressured prices as sales increased. The widening spread between nonfat dry milk and cheese prices is providing cheese makers the opportunity to increase vat yields. Cheese production is now lighter, and retail customers are reordering to replenish depleted stocks, but are not yet rebuilding inventories.
- Most Class III [components were down](#) again in this week's survey. 40-lb blocks fell 0.9¢ to average \$1.98/lb while 500-lb barrels lost 2.8¢ to \$1.99/lb. Butter shed 6¢ to hit \$1.25/lb and dry whey averaged 44.1¢/lb, down 0.2¢. Nonfat dry milk was the only gainer, up 8.7¢ to \$1.73/lb.



Recommendation:

The 2008 average lost 47¢ this week as excess cheese hit the CME cash market; and more is expected. Strong milk production and weakening nonfat dry milk prices are giving cheese producers incentive to make more cheese. And for those that can direct milk to either cheese or butter production, cheese is the obvious choice right now. The other factor accounting for this week's Class III losses is the weakening dry whey market. Each penny move in dry whey results in a 6¢ move in Class III. The assumption for a long time was that 40¢ would be the floor, but we've quickly headed lower, with 30¢, or less, looking more likely. That 10¢ change from 40¢ down to 30¢ shaves 60¢ off Class III. With that in mind, we believe Feb and Mar could still see some significant declines and are worth defending. **Trade Alert:** Buy the Feb 17.00 PUT for 25¢ or better (it settled at 23¢) and the Mar 16.00 PUT for 25¢ or (it settled at 24¢). The market remains wild and volatile and this will at least put a floor price under your production should we continue with weakness in the near term.

Wow! If milk is wild, grains were even more crazy today. Have you thought about running your dairy on \$5-6 corn, \$13-15 beans and \$400/ton meal? You might have to. A downward revision in ending stocks combined with strong exports paints a bullish picture going forward for grains. While we don't hold ourselves out as grain experts, we would look at getting your input costs covered on any significant correction.

Without a doubt the biggest risk we see in 2008 and beyond is our domestic economy. The verdict is still out on whether we're headed towards recession, but a major drop in consumer spending, combined with nearly all commodity prices shooting skyward has us concerned. With the unpredictability in dairy input costs for the foreseeable future, we're still not recommending selling milk outright. That just doesn't make sense when your cost of production could continue to rise (unless you already have it hedged). But because the risk in the economy is very real, we would also begin to look at protecting 2008 further out. Target to buy the Apr-Oct 15.00 PUT for an average of 30¢ per month. On its face it may not look that attractive, but it's good "disaster" insurance should the worst happen. And if the economy doesn't tank and milk prices stay strong, you'll lose the money on the insurance but realize the benefit of much higher prices on your milk check. You need to get started on your 2008 risk management plan!

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