

The KDM Dairy Report – January 25th, 2008

Bullish Fundamentals:

- NASS surveyed cheese prices have yet to reflect the recent drop in the cash market. 40-lb cheddar blocks averaged \$2.01/lb this week, up 1.4¢ from last week, and 500-lb barrels were up 0.2¢ to \$2.03/lb.
- Dairy cow slaughter for the week ending 01/12 was strong at 56,000 head, compared to 54,200 head during the same period a year ago. That's the highest weekly number in [more than two years](#).
- Fluid Milk & Cream Review reports feed costs are becoming a growing issue. In the Pacific Northwest, operating loans are under review, but hay and feed inventories are [disappearing at a faster rate than planned](#). Dairies are paying more than they can remember for both feed and hay.

Bearish Fundamentals:

- Livestock Slaughter Report: Dairy cow slaughter for the month of December was [down 3.3%](#) vs. 2006. 204,700 head were culled compared to 211,600 during the same period a year ago. For the year, however, 6.1% more dairy cows were culled than in 2006.
- Cash Market: Blocks managed to hold steady at \$1.65/lb this week, while barrels tried to close the inverted spread, falling 5¼¢ to \$1.75/lb. Butter continued to be range bound, settling up 1¼¢ to \$1.23¼/lb. It was the quietest spot market in months with 0 trades in blocks, 2 barrels and 4 cars of butter. If could be because many of the market participants were at IDFA's Dairy Forum 2008 conference this week, so we'll see if things change going forward.
- Although cheese was up, other NASS [components were down](#) this week. Dry whey fell 4.4¢ to average 39.2¢/lb, nonfat dry milk plummeted 19.3¢ to \$1.45/lb and butter was down 3.9¢ to \$1.21/lb.
- Weekly cold storage holdings at USDA selected storage centers are reflecting an increase in both butter and cheese stocks through the first 21 days in January. Butter stocks are up 3.6 million lbs, [a gain of 14%](#), and cheese stocks are up 531,000 lbs, or 1%.
- Demand for fluid milk was lighter this week in the Eastern region of the country. Steady to slightly higher milk production has allowed some balancing plants to receive more intake volumes, according to Fluid Milk & Cream Review. The [slower fluid sales](#) and steady milk output allowed Florida to export 34 loads of milk, compared to last week when they imported 69 loads.
- The milk supply in the Central region remains [well above year ago levels](#), according to Fluid Milk & Cream Review. Spot loads of manufacturing milk are going from between \$2 to \$5 under class.
- Fluid Milk & Cream Review reports continued strong milk output in California, with production estimated at [3-6% higher](#) than a year ago and climbing. Processors remain stressed as they try to deal with limited capacity, and transportation issues have compounded the problem.
- Despite growing butter inventories, churning activity remains active as cream supplies are often [heavier than anticipated](#) for this time of year, according to Dairy Market News. Food service outlets are cautious about placing future orders due to the potential of economic conditions negatively impacting restaurant sales.
- The Central dry whey price dipped as low as 25¢/lb this week, according to Dairy Market News. Both manufacturers and resellers have [heavy inventories](#) and are working to clear them.
- There is ample milk for making cheese in the Northeast, according to Dairy Market News. Production of cheddar and Italian cheese is steady, and plants are alternating between use of condensed skim and nonfat dry milk [to boost yields](#).
- Dairy Market News reports cheese buyers have an incentive to wait for recent price declines in the spot market to lower monthly or weekly average numbers before making further purchases. The cheese market is described as "weak", as food service and retail [orders have slowed](#). Current cheese offerings are adequate to meet demand.

Futures Month	Friday 01/25 Close	Friday 01/18 Close	Change	5-yr Average	Top 3rd Price
Jan-08	\$19.35	\$19.28	\$0.07	\$12.50	\$13.33
Feb-08	\$16.95	\$17.15	(\$0.20)	\$12.53	\$13.21
Mar-08	\$16.95	\$16.85	\$0.10	\$12.78	\$13.50
Apr-08	\$16.35	\$16.37	(\$0.02)	\$14.14	\$15.36
May-08	\$16.20	\$16.42	(\$0.22)	\$14.50	\$15.85
Jun-08	\$16.13	\$16.51	(\$0.38)	\$14.54	\$15.63
Jul-08	\$16.25	\$16.66	(\$0.41)	\$14.66	\$15.57
Aug-08	\$16.45	\$16.77	(\$0.32)	\$14.47	\$15.40
Sep-08	\$16.60	\$16.96	(\$0.36)	\$15.14	\$16.02
Oct-08	\$16.35	\$16.70	(\$0.35)	\$14.78	\$15.58
Nov-08	\$16.20	\$16.54	(\$0.34)	\$14.75	\$15.73
Dec-08	\$16.15	\$16.48	(\$0.33)	\$15.09	\$16.18
Jan-09	\$16.10	\$16.30	(\$0.20)	\$12.50	\$13.33
Feb-09	\$16.05	\$16.28	(\$0.23)	\$12.53	\$13.21
Mar-09	\$16.08	\$16.20	(\$0.12)	\$12.78	\$13.50
Apr-09	\$16.05	\$16.20	(\$0.15)	\$14.14	\$15.36
May-09	\$16.08	\$16.25	(\$0.17)	\$14.50	\$15.85
Jun-09	\$16.05	\$16.25	(\$0.20)	\$14.54	\$15.63
2008 Avg	\$16.66	\$16.89	(\$0.23)		
Jan-Jun 2009	\$16.07	\$16.25	(\$0.18)		

Recommendation:

We saw the Dow make a single day move of more than 600 points from low to high, and a massive sell off in both the equities and commodities markets this week.

However, most everyone who's involved in trading milk is scratching their head.

Yes, Class III futures suffered losses as well, but by all accounts and measures, the Feb and Mar contracts, which both settled at \$16.95, should be trading much lower. Block cheese is stuck at \$1.65 and barrels fell a nickel to \$1.75. With Super Bowl orders nearly complete, strong milk production across the country and crashing dry whey prices, the prevailing opinion is that the current inverted block / barrel spread will be fixed by barrels coming down, not blocks heading back up. The current cash price, with the inverted spread, works out to about \$16.40 milk. Should barrels drop next week to equal blocks, it falls to \$15.83. But today, Feb finished up 20 and Mar up 42. The "buy" side strength we're seeing, despite weak fundamentals is nothing if not impressive. It's not like sellers haven't been there with conviction. A full 456 contracts traded today in Feb alone, and 526 in Mar. The big question is, who's doing the buying? It certainly isn't dairy producers, and from what we're hearing, most speculators are bearish short-term too. That leaves commercials. We could be wrong here, but in 2007, commercials were caught waiting for cheese to drop and it really didn't. From May on, \$1.80 cheese was as low as we'd go. So, while we could certainly go lower, relatively speaking, today's Class III annual average of \$16.66 represents about \$1.70 cheese. To some commercials, that could be seen as value and should be bought. We'll see how many bullets the buyers have, but if blocks don't start heading higher soon, or if barrels show up next week, Feb and Mar will take a precipitous tumble. For that reason, we strongly recommend getting PUT option coverage to protect these prices. Buy the Feb 16.50 PUT for 15¢ and the Mar 16.00 PUT for 25¢. We're still long-term supportive, however, and would not sell milk outright. Cheese exports made up 2.5% of total milk production in 2007. With a big increase in the cost of production set for 2008 and a shortage of hay, big increases in domestic milk output is not that likely. The US dollar looks set to remain weak relative to other currencies and export demand should remain strong. Short of a global recession, this sets up a year where we may have some rough waters to navigate in the near term with over production, but long term, we believe there is more upside risk to prices than downside.

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