

The KDM Dairy Report – February 1st, 2008

Bullish Fundamentals:

- Cash Market: Block buyers appeared in droves this week, picking up a stunning 38 loads before the just settled. In the process, they drove the price up 15¢ to settle at \$1.80/lb today. Barrels were up 3¢ vs. last week, but up 6¢ from yesterday's low. 8 barrels exchanged hands. Butter fell a penny to \$1.22¼/lb on light trading of 9 cars.
- January Class III milk was announced today at \$19.32/cwt, a [new record high](#) by more than \$3/cwt. The previous high for January was \$16.27, set in 1999.
- Ag Prices Report: The milk-feed ratio dropped again in January, falling from 2.85 in Dec to 2.55. With Class III futures pointing to much lower prices in Feb and grains staying relatively strong, [another drop is likely](#) next month. This should begin to put a brake on current expansion activities (see graph below).
- Higher feed costs and impending lower milk prices appear to be forcing producers into making economic decisions. This week's dairy cow slaughter of 57,600 head is the [highest weekly total in nearly three years](#). It hasn't been since the week of 01/15/05 that a higher number were culled, when 58,800 head were slaughtered.
- Weekly cold storage numbers are showing a [sudden drop in cheese stocks](#) during the last week of January. In the previous three weeks, inventories were mostly unchanged, but in Wednesday's report, cheese stocks are down 4% during the period 01/01 through 01/28.
- Dairy Market News calls the Midwest cheese market unsettled to weak, however, lower market prices have led [resurgence in international interest](#), and some tightness is noted on milk cheddar blocks. Demand for rBST-free milk from bottling plants is affecting milk movement and volumes available for manufacturing.
- Western cheese buyers seem to be operating on very minimal working inventories and [need to make purchases](#) on a regular basis, according to Dairy Market News. Barrels appear to be tighter than blocks, and new export interest is noted.
- Major storms in the Pacific Northwest are not disrupting milk production or transportation to any extent, but it is causing consumption of feed and hay to go up, according to Fluid Milk & Cream Review. Actually [running out of hay](#) supplies is a real concern, along with the higher costs.
- Butter stocks at CME-approved warehouses are still higher than last year, but the [gap is narrowing](#). For the week ending 01/26, 3.4 million lbs were added to inventory, compared to 9.1 million lbs added during the same period last year.
- Commercial Disappearance: Use of American cheese in November, the most recent data available, was up 1% vs. a year ago, according to USDA. However, use of other-than-American cheese was down 1.9%. Butter use was up a strong 10.5% and nonfat dry milk use up an even stronger 17.2%. Finally, use of [milk in all products was up 2%](#).
- International: Ongoing drought conditions in Australia are now affecting New Zealand as well, according to an article this week in the National Business Review. Many farmers in the top dairying region have cut milking to once per day as feed and pasture runs out. Milk production in the region is expected to [drop by 20%](#).
- International: Cheddar cheese stocks in Oceania are [fully committed](#) through mid 2008, according to Dairy Market News. Traders feel no significant volumes of uncommitted cheese will be available in the future.

Futures Month	Friday 02/01 Close	Friday 01/25 Close	Change	5-yr Average	Top 3rd Price
Feb-08	\$17.04	\$16.95	\$0.09	\$12.53	\$13.21
Mar-08	\$17.20	\$16.95	\$0.25	\$12.78	\$13.50
Apr-08	\$16.52	\$16.35	\$0.17	\$14.14	\$15.36
May-08	\$16.10	\$16.20	(\$0.10)	\$14.50	\$15.85
Jun-08	\$16.10	\$16.13	(\$0.03)	\$14.54	\$15.63
Jul-08	\$16.34	\$16.25	\$0.09	\$14.66	\$15.57
Aug-08	\$16.49	\$16.45	\$0.04	\$14.47	\$15.40
Sep-08	\$16.70	\$16.60	\$0.10	\$15.14	\$16.02
Oct-08	\$16.36	\$16.35	\$0.01	\$14.78	\$15.58
Nov-08	\$16.27	\$16.20	\$0.07	\$14.75	\$15.73
Dec-08	\$16.25	\$16.15	\$0.10	\$15.09	\$16.18
Jan-09	\$16.14	\$16.10	\$0.04	\$14.40	\$15.24
Feb-09	\$15.95	\$16.05	(\$0.10)	\$12.53	\$13.21
Mar-09	\$16.05	\$16.08	(\$0.03)	\$12.78	\$13.50
Apr-09	\$16.05	\$16.05	\$0.00	\$14.14	\$15.36
May-09	\$16.08	\$16.08	\$0.00	\$14.50	\$15.85
Jun-09	\$16.05	\$16.05	\$0.00	\$14.54	\$15.63
Feb-Dec 2008	\$16.49	\$16.42	\$0.07		
Jan-Jun 2009	\$16.05	\$16.07	(\$0.02)		

Bearish Fundamentals:

- Cattle Inventory Report: USDA's twice annual counting of cows indicates we have [plenty of replacement animals](#) available. First, the total number of milk cows as of January 1st is estimated at 9.22 million head, up 1% from last year. Milk replacement heifers totaled 4.46 million head, up 3% vs. a year ago. Of those, 2.928 million are expected to calve this year, up 3% from last year. With the substantial increase in replacement heifers, the ratio of replacements to herd size is at a record high.

- NASS numbers were [down for all Class III components](#) this week. 40-lb blocks lost 9.9¢ to average \$1.91/lb and barrels shed 8.7¢ to \$1.95/lb. Butter was down 1.4¢ to average \$1.20/lb in the survey, while dry whey decreased 4¢ to 34.8¢/lb. Nonfat dry milk gained 1.1¢ to average \$1.46/lb, but is not part of the Class III formula.
- Milk production in the Eastern region of the country is trending seasonally higher, according to Fluid Milk & Cream Review. Class I use is steady, which is allowing balancing plants to [receive extra volumes](#). However, most of the extra milk is headed toward butter/powder operations, and not Class II or Class III plants.
- Milk continues to [flow out of California](#) and in to other states in an effort to manage supply. Fluid Milk & Cream Review reports processing capacity is still stretched, so milk is headed to Arizona and New Mexico. But Arizona processors are now starting to turn away surplus offerings.
- Cream supplies are heavy, churning remains active, and cheese milk interest is slow in the Central region, according to Fluid Milk & Cream Review. Milk intakes are [well above a year ago](#), so manufacturing plant operating schedules are higher as well.
- Dairy Market News reports Central dry prices [remain under pressure](#), ranging from 25¢ to 28½¢ per pound this week. Stocks are generally readily available, with some locations promoting discounts to clear excess inventories.
- Nonfat dry milk [prices continue to fall](#) out West, as manufacturers try to keep product moving, and inventory from building, according to Dairy Market News. Production remains strong in light of heavy volumes of milk in the region, but demand is light to fair.
- International: Dairy Market News reports Western Europe is off to a [strong start](#) to the upcoming milk production season. Output in France is up 4% vs. a year ago, and stocks for manufactured dairy products are available.

Recommendation:

Last week we were scratching our heads at the strength in the Feb and Mar contracts as heavy buy volume kept them from collapsing. While we had a bias that milk futures would head lower this week, we did talk about the idea of \$1.70 cheese being seen as a "value" by commercials as a possible explanation for the support we were witnessing. As we stated above, buyers had a fire under them this week as they purchased 38 loads of blocks. I guess we found out which side had more bullets; at least for this battle. A lot of producers have called, wondering why cheese is going up in light of strong milk production, arguably across the entire country. It's true, California is still awash with milk, yet this week's Dairy Market News said cheese buyers were operating under "minimal working inventories" and that barrel cheese stocks were "tighter than blocks". Even in the Midwest, where milk output is "well above a year ago", "some tightness" was noted for cheddar blocks. Cheese plants, looking ahead at milk futures, were probably not enthusiastic about making cheese in Jan with \$19+ base milk when cheaper milk was just around the corner. But this is the time of year that cheese buyers need to be doing some inventory building for aging programs or we won't have any sharp cheddar this fall. And it still seems we're in a situation with too little processing/cheese making capacity, but plenty of milk. While cheese margins remain razor thin, expect most of that excess milk to continue heading to butter/powder operations. Finally, it appears as if international buy interest, asleep since the holidays, is picking back up. On another note, the sale of two major cheese operations in Wisconsin this week to large Canadian firms is also supportive. It shows that companies are not afraid to spend significant capital in the U.S. dairy market, and see it as a long-term investment. We're not arguing for a run back to \$20 milk, but on the other hand, it appears as if the floor is not going to fall out from under us either. So, what do you do with this? Buy PUT options on the front months to protect your floor (yes, we know, same old boring strategy). We'd also consider selling anything in the first half of 2008 that hits \$18 or higher. Ask yourself, in light of current production trends, how much upside you'll be giving up. Leave the last half of 2008 alone.

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Milk-feed Ratio

