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The KDM Dairy Report – February 29th, 2008

What's Bullish:

Futures Month	Friday 02/29 Close	Friday 02/22 Close	Change	5-yr Average	Top 3rd Price
Mar-08	$18.19	$18.38	($0.19)	$12.78	$13.50
Apr-08	$17.26	$17.30	($0.04)	$14.14	$15.36
May-08	$16.94	$16.95	($0.01)	$14.50	$15.85
Jun-08	$16.95	$16.87	$0.08	$14.54	$15.63
Jul-08	$17.08	$16.96	$0.12	$14.66	$15.57
Aug-08	$17.24	$17.12	$0.12	$14.47	$15.40
Sep-08	$17.35	$17.27	$0.08	$15.14	$16.02
Oct-08	$17.17	$16.95	$0.22	$14.78	$15.58
Nov-08	$17.05	$17.04	$0.01	$14.75	$15.73
Dec-08	$16.95	$16.95	$0.00	$15.09	$16.18
Jan-09	$16.80	$16.85	($0.05)	$14.40	$15.24
Feb-09	$16.57	$16.58	($0.01)	$14.00	$14.69
Mar-09	$16.55	$16.53	$0.02	$12.78	$13.50
Apr-09	$16.55	$16.50	$0.05	$14.14	$15.36
May-09	$16.63	$16.57	$0.06	$14.50	$15.85
Jun-09	$16.60	$16.60	$0.00	$14.54	$15.63
Jul-09	$16.62	$16.64	($0.02)	$14.66	$15.57
Aug-09	$16.73	$16.66	$0.07	$14.47	$15.40
Sep-09	$16.75	$16.76	($0.01)	$15.14	$16.02
Oct-09	$16.73	$16.76	($0.03)	$14.78	$15.58
Nov-09	$16.70	$16.70	$0.00	$14.75	$15.73
Dec-09	$16.68	$16.70	($0.02)	$15.09	$16.18
Mar-Dec 2008	$17.22	$17.18	$0.04		
2009 Avg	$16.66	$16.65	$0.00		

- February Class III was announced today at $17.03/cwt, a new all-time historical high for this month. The next highest settlement was in 2005 at $14.70. However, Feb did settle $2.29 below Jan.
- Ag Prices Report: The milk-to-feed ratio in February fell for the second consecutive month as feed prices outpaced milk prices. The ratio dropped to 2.36, down from 2.66 in January, and just above last year's number at 2.33. A ratio below 3.0 typically discourages dairy expansion, and thus limits growth in the milk supply.
- Commercial Disappearance: Use of American cheese in December was up 5.1% vs. a year ago, according to USDA statistics released this week. For the year, use was down 0.4%, but that could be a result of less American cheese being produced. Other-than-American cheese use was up 5.7% in December, and up 3.5% for the year, while use of milk in all products was up 1.9% in December, and up 2.2% for the year.
- NASS cheese prices raced higher this week as they tried to catch up to the cash market. 40-lb blocks gained 12.7¢ from the previous week to average $1.88 and barrels were up 4.7¢ to $1.91/lb
- Current cheddar and natural American blocks are tight in the Midwest, according to Dairy Market News. Cheese makers are unwilling to make uncommitted loads, while buyers are utilizing a "just in time" approach. Unexpected or sudden large orders have made keeping enough cheese in short-term aging programs challenging. With supplies limited elsewhere in the world, foreign interest in cheese remains, especially when the net price is at or below $2.00/lb.
- U.S. dairy cow slaughter remains robust. 51,400 head were culled during the week ending 02/16 vs. 49,900 during the same period a year ago. YTD, slaughter numbers are 8,500 head above last year.
- Weird. Butter stocks at CME-approved warehouses for the week ending 02/23 were up only 40,000 lbs, compared to an increase of 4.6 million lbs during the same period a year ago. Maybe just an anomaly; we'll know next week.
- Dairy Market News reports the butter market is showing signs of firming. Sales have been active and demand for print butter for the upcoming Easter/Passover holidays is building. The weaker U.S. dollar is improving foreign interest, and exports of 82% butter continue to clear product.
- Most milk handlers expect stronger retail interest in March for Class I and Class II products, according to Fluid Milk & Cream Review, a result of the lower settlement price in February. In addition, despite long manufacturing milk supplies, cheese makers remain reluctant to make spot purchases without a committed cheese sale.
- Producers in the Pacific Northwest are reporting muddy conditions and stress on their herds, according to Fluid Milk & Cream Review. There is also a lot of concern over increasing feed costs. Hay in the region is running $40-50 higher than last year and grains are at records highs.
- Dairy Market News reports Western dry whey sellers indicate they are in better balance and not having to discount to get product to move. Powder is moving through both domestic and export channels.
- Central dry whey sellers are gaining confidence as tighter supplies of Western whey are lending support to their market. Requests for discounts are going unsatisfied, and loads from the Midwest are moving into the Southwest to fill needs there.
- Western nonfat dry milk inventories are in better balance this week, according to Dairy Market News. Production remains heavy and plants are running at capacity, but the export market is improved, as there are reports that New Zealand is trying to secure powder to help cover production shortfalls caused by their drought.

- International: In New Zealand, some drought areas have received rain, but conditions are still very dry in the Waikato region and other key dairy areas, according to Dairy Market News. Milk production continues to decline and is now forecast to be below last year's total. Current receipts are being used to manufacture and fill existing orders, with almost nothing additional available to sell.
- International: Exporters in Oceania are importing U.S. cheddar to cover the needs of key customers in the Far East, according to Dairy Market News. With the sharp decline in milk receipts in New Zealand, manufacturers are only able to fill contracts made previously and are not able to make additional sales.

What's Bearish:

- U.S. Economy: Stocks were down sharply today on weak economic data, adding to recession fears. The major indices have now fallen for the fourth consecutive month, the longest string of losses since 2002.
- While NASS cheese prices were strong, butter and powders remained weak. Nonfat dry milk lost 3.2¢ to average $1.27/lb, dry whey fell 1.3¢ to 24.9¢/lb and butter decreased 2.9¢ to $1.19/lb.
- Fluid Milk & Cream Review reports production in the Eastern region of the country continues to improve seasonally. Fluid sales have slowed as bottlers wait for Class I prices to drop 15% after the weekend. Florida exported 110 loads of Grade A milk this week, compared to 102 last week and zero a year ago.
- No change out West. Milk production in California remains strong and the weather is making the cows happy, according to Fluid Milk & Cream Review. Processors in the state continue to be stressed by the supply, with shipments to other states needed to alleviate the excess. New Mexico's output is growing as well, with total volumes higher than a year ago. Plant capacity is being filled as they run on extended schedules, and cream supplies are heavy.
- International: Dairy Market News reports milk production in Western Europe continues to build seasonally, especially in Germany and France which are well above year ago levels. Prices for many dairy end-products, including cheese, are under some pressure.
- International: Heavy rains have fallen in Australia, helping to refill many reservoirs, lakes and streams, according to Dairy Market News. It's also improved the prospect of better crops for feed and export. The weather has been cool and milk receipts are now close to last year's levels.

Recommendation:

Buyers want cheese. The cash cheese market at the CME started weak, but finished strong. After blocks reached a high of $2.09 (and an intra-session high of $2.12¼), buyers disappeared on Thursday, allowing blocks to fall 10¢ to $1.99. But today, buyers returned in force, picking up 11 loads of blocks and moving the price up 8¢ to settle at $2.07. You almost get the sense buyers got tired of bidding the price higher and getting little product, so allowed the price to fall on Thursday to send a message to sellers. And, it allowed them to buy at lower prices on Friday. For the week, 16 loads of blocks traded, and 9 barrels. With cheese makers continuing to limit production based on firm orders, and buyers going hand to mouth, it appears we'll remain in a somewhat tight cheese situation until these strategies change. With the drop in output in Oceania and the U.S. dollar making all-time record lows against the Euro this week, it bodes well for the potential of another record-setting dairy export year. It seems unimaginable that the countries of New Zealand and Australia, normally dairy exporters, are importing U.S. product! In other news, we feel for our California producers, as it's very rough going for their dairymen right now. We have confirmation that the two largest milk handlers in the state will be implementing a quota system by April 1st. Based on each individual farm's production last year, milk produced above that level will be pooled and sold, with the net proceeds of whatever it can be sold for going back to the producer. Some producers went off rBST last year, so already cull rates are increasing to adjust output lower. Also highlighting California's woes, a story this week about 22 producers whose contracts were cancelled by HP Hood, LLC due to a scaling back of the company's operations. By June, they'll need to find a new place to ship their milk, with virtually nobody willing to take it. We touched on this a few weeks ago, but it bears mentioning again that we believe it will be very difficult for California to substantially increase milk production this year. This all sounds very supportive for milk prices, and it is. But by far the biggest risk is the U.S. economy. Sentiment has changed from a "innocent until proven guilty" to a "guilty until proven innocent" as far as recession is concerned. It doesn't seem possible that a slowdown in the economy will support current high commodity prices from energy to metals to grains to milk. Some argue that Asian economies will keep demand firm regardless of what happens here, but that doesn't seem plausible. All this to say it's very difficult to make a recommendation this week. The July-Dec average is $17.13, which is about $1.80 cheese. Will we maintain that or go higher? At this point it still seems like there is more potential upside risk (exports, cheese stocks, input costs, cull rate) than downside risk (economy, milk supply), so we continue to recommend producers not sell milk there. But continue to look at buying PUT options on front months, or establish "disaster" insurance. Target to buy the $15.50 PUT Apr-Dec for an average price of 25¢ each. If the economy goes south, you'll hopefully be able to cash-flow with your premium added on, and if prices stay high or go higher, you can move the floor price higher as PUT option premium falls.