

The KDM Dairy Report – August 22nd, 2008

What's Bullish:

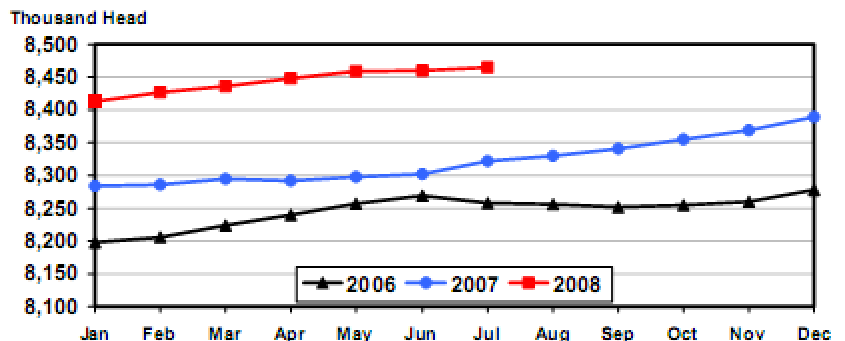
- Livestock Slaughter Report: Dairy cow slaughter for the month of July totaled 208,500 head, up a solid 15.7% from the 180,200 head a year ago, according to USDA. Jan-July, total dairy cow slaughter stands at 1.47 million head, up only slightly from last year at 1.42 million head.
- Cold Storage Report: Cheese stocks were higher (see bear point below), but butter stocks in July were down 9% compared to a year ago, and down 4% from June.
- Current cheese is generally available in the Midwest, according to Dairy Market News, however, orders are improved as retailers take advantage of lower prices to rebuild stocks for fall. In addition, increased bottling is expected next week ahead of schools reopening, and with shipments of milk into the Southeast increasing, less milk will be available for cheese production. Finally, the recent firmness in butter prices has less milk being diverted away from the butter/powder operations and into cheese production.
- Manufacturing milk interest in the Midwest far exceeds the limited supply available, according to Fluid Milk & Cream Review. Orders for non-cheddar varieties of cheese have picked up as lower cheese prices have stimulated orders. Milk receipts are slightly lower seasonally, while Class I needs are projected to increase as bottlers prepare for school milk programs.
- Milk production in the Northeast is continuing to back off, with one contact reporting receiving about 2/3's of the milk he took in just a few weeks ago, according to Fluid Milk & Cream Review.
- For the period 08/01 through 08/18, butter stocks at USDA selected storage centers were down 8%, or 2.5 million lbs, according to the Weekly Cold Storage Holdings report.
- Surplus milk and components in California are mostly in check, as production is steady and school milk programs increase demand. In Arizona, output has been subdued from hot and humid conditions. Surplus milk from nearby states has dried up and plants in the states are running on lighter schedules.
- Butter stocks at CME-approved warehouses fell 3.3 million lbs during the week ending August 16th, leaving 85.3 million lbs on hand. Last year at this time ending stocks were a much higher 144.8 million lbs.
- Dairy cow slaughter for the week ending Aug 9th totaled 51,400 head, up from 43,800 head during the same period a year ago.
- Dairy Market News reports Western butter production is heavy, but both domestic and international butter sales are strong, forcing some firms to bring out frozen butter to temper, in order to meet current needs. Stocks are tight and buyers are looking to firm up commitments sooner rather than later.

Futures Month	Friday 08/22 Close	Friday 08/15 Close	Change
Aug-08	\$17.18	\$17.12	\$0.06
Sep-08	\$16.30	\$16.48	(\$0.18)
Oct-08	\$16.75	\$17.20	(\$0.45)
Nov-08	\$17.00	\$17.41	(\$0.41)
Dec-08	\$17.08	\$17.55	(\$0.47)
Jan-09	\$17.00	\$17.49	(\$0.49)
Feb-09	\$17.10	\$17.70	(\$0.60)
Mar-09	\$17.18	\$17.71	(\$0.53)
Apr-09	\$17.43	\$17.85	(\$0.42)
May-09	\$17.46	\$17.87	(\$0.41)
Jun-09	\$17.85	\$18.13	(\$0.28)
Jul-09	\$18.05	\$18.33	(\$0.28)
Aug-09	\$18.07	\$18.35	(\$0.28)
Sep-09	\$18.37	\$18.50	(\$0.13)
Oct-09	\$18.40	\$18.45	(\$0.05)
Nov-09	\$18.36	\$18.55	(\$0.19)
Dec-09	\$18.44	\$18.50	(\$0.06)
Aug-Dec	\$16.86	\$17.15	(\$0.29)
2009 Avg	\$17.81	\$18.12	(\$0.31)

What's Bearish:

- Cash Market: Falling prices have slowed but buyers were still without an answer in this week's spot sessions. Block cheese lost 4¾¢ to settle at \$1.71¼/lb and barrels were down 3¾¢ to \$1.66¼/lb in very heavy trading. 42 loads of blocks and 17 barrels exchanged hands. Butter was again the lone bright spot, increasing 5½¢ to settle at \$1.70/lb, with 9 cars traded.
- Milk Production Report: July milk output was up 1.4% compared to a year ago, according to USDA. The milking herd grew to 9.281 million head, up 128,000 head from last July and up 4,000 head from June. Biggest percentage increases were seen in TX up 18.4%, NM up 9.0%, ID up 7.7% and KS up 7.3%. CA was down 1.0% and WI was up 0.3%.

**Monthly Milk Cows
23 States**



- Cold Storage Report: Stocks of American cheese in cold storage were up 2% vs. last July, according to USDA, and Total cheese stocks were up by the same percentage. For most of 2008, American cheese stocks had trailed year-ago levels, but increased production has allowed them to catch up.
- Livestock, Dairy & Poultry Outlook Report: USDA's monthly look at the domestic ag markets forecasts Class III prices to fall in 2009 from this year. Milk output is predicted to be up slightly on higher production per cow, despite an overall drop in cow numbers. The biggest hurdle is said to be the weak domestic economy, which will limit dairy end-product use, while a stronger dollar is expected to hurt 2009 exports.
- Prices for most Class III components fell in this week's NASS survey. 40-lb cheddar blocks dropped 6.2¢ to average \$1.90/lb and 500-lb barrels shed 9.2¢ to \$1.79/lb as cheese prices play catch-up with recent losses in the cash market. Nonfat dry milk prices averaged \$1.36/lb, a 3.6¢ decrease from the previous week, and dry whey continued to lose ground, down 0.5¢ to 24.6¢/lb. Butter was the lone gainer, picking up 3.4¢ to average \$1.59/lb.
- Tropical storm Fay has reduced the need to import milk into the Southeast and Florida, according to Fluid Milk & Cream Review. Some schools have missed 1 or 2 days, resulting in 20-40% less milk consumption, and it has brought cooler weather which has benefited cow comfort at a time when production is usually falling. In addition, more cows have been freshening than originally anticipated at this time of year.
- While butter stocks were down, the Weekly Cold Storage Holdings report showed a 3% increase in cheese stocks through the first 18 days of August. The increase represents a build of 3.2 million lbs of cheese.
- Fresh butter production in the Midwest is still not keeping pace with demand; however, weaker international prices may put pressure on domestic prices if they are to stay competitive, according to Dairy Market News. In addition, standardized cream will become increasingly more available as school milk bottling programs expand.
- Gains in the US dollar are making US-sourced nonfat dry milk more expensive, according to Dairy Market News. The market tone is weak as inventories are building. Buyers are holding off making purchases except for immediate needs as they sense lower prices ahead.
- Strong cheese sales are encouraging production, which is boosting dry whey output, according to Dairy Market News. The market remains weak as inventories are steady to building. Central whey prices hovered between 20 to 22½¢ this week.

Recommendation:

Butter prices look set to eclipse cheese prices if recent trends continue. Butter hit \$1.70/lb in the cash market this week, while cheddar blocks finished just slightly higher at \$1.71. At some point, better returns will begin diverting milk away from the vat and back to the churn, especially with fresh butter demand outstripping production. This may eventually bring some support to the market, but near term, it's quite obvious cheese sellers have product to offload. The cash market is breaking new volume records with the amount of cheese being traded. Some of our sources have indicated a major cheese marketer is turning back a lot of

cheese, which is why so much is showing up on the spot market. We may yet see a cheese rally this fall as milk is tightening up across the country. The milk production report indicated a 1.4% increase, which is the smallest increase this year. And output per cow was unchanged from a year ago. Higher feed costs this fall could potentially tip the balance to negative growth in output per cow. But, we do have a struggling economy to deal with, and we wouldn't expect a cheese rally to run too high. With manufacturing milk in high demand (see bull points above), and milk in short supply out East, we're going to continue with last week's recommendation and buy Oct-Dec 19.00 or 19.25 CALL options. Then enter orders to sell your milk at \$18.50 or higher in Q4. If successful, you'll have a decent floor price established, and give away less than \$1/cwt if the market rallies beyond expectations.

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**Monthly Milk per Cow
23 States**

