

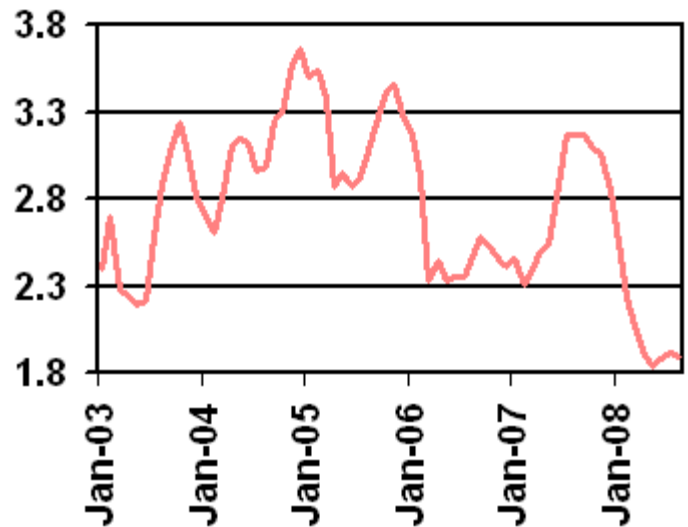
**The KDM Dairy Report – September 5<sup>th</sup>, 2008**

**What's Bullish:**

- Cash Market: After weeks of being battered by relentless cheese sellers, the spot market finally made a move higher. Blocks were up 8¼¢ from last Friday to settle at \$1.78½/lb today and barrels jumped 14¼¢ to close at \$1.77½/lb. Trading was light as only 7 blocks and 18 barrels exchanged hands. Butter made a new 2008 high midweek at \$1.69½, before losing some steam and settling at \$1.66/lb, still up 4¾¢. Only 2 loads exchanged hands. Butter has not been above \$1.70/lb since September 2005.
- Ag Prices Report: The August milk to feed ratio remained historically low at 1.89 (see chart), down from 1.91 in July according to USDA figures. Recent declines in both milk and grain prices are likely to keep it low in September as well.
- Mozzarella interest is strong in the Midwest, with some producers having difficulty filling orders, according to Dairy Market News. Natural American supplies are adequate, and private label packagers are operating on strong seasonal schedules, with extended overtime needed on most natural lines due to handle demand. Branded product sales are still sluggish, but some firms are seeing a boost in orders to inland areas where Gulf Coast evacuees have moved to.
- Manufacturing milk interest in the Central region is good, as it competes with increased bottling activity for a shrinking pool of milk. Demand for supplemental spot loads of milk exceeds the local supply and prices are firm, according to Fluid Milk & Cream Review. Reported prices this week ranged from \$1.00 to \$1.50 over class.
- Fluid Milk & Cream Review reports demand for Class I milk is strong in the Northeastern region of the country, particularly for rbst-free. This has led to some tightness in milk needed to meet bottler interest.
- In the Western region, surplus milk supplies are limited and some manufacturers would even like additional milk, according to Fluid Milk & Cream Review. Recent heat is resulting in milk receipt declines from 3-7%, while at the same time, Class I sales have picked up with more school openings.
- Fluid Milk & Cream Review reports feed is a big concern for producers in the Pacific Northwest. Corn is behind enough that it may not reach full maturity, and hay growers are worried they might not get a final cutting of hay due to cool weather. A reduction in feed value of rations is possible, while at the same time, components on farm milk output are lower than anticipated.
- The weekly cold storage report is showing butter stocks fell 14% at USDA selected storage centers for the period 08/01 through 09/01. However, cheese stocks during the same period increased 4%.
- Butter stocks at CME-approved warehouses also fell, dropping 3.9 million lbs for the week ending 08/30. Total butter stocks on hand remain well below year ago levels at 80.9 million lbs vs. 139.1 million lbs in 2007.
- Dairy cow slaughter for the week ending 08/23 was a strong 54,000 head, up from 47,500 head during the same period last year.
- Dry whey inventories in the Central region are less frequently described as burdensome, according to Dairy Market News. Sales have chewed through inventory and some buyers have increased contracted purchases. There are also some reports of increased buying from the Far East and South America.

| Futures Month | Friday 09/05 Close | Friday 08/29 Close | Change   |
|---------------|--------------------|--------------------|----------|
| Sep-08        | \$16.10            | \$15.83            | \$0.27   |
| Oct-08        | \$16.68            | \$16.13            | \$0.55   |
| Nov-08        | \$16.59            | \$16.53            | \$0.06   |
| Dec-08        | \$16.66            | \$16.71            | (\$0.05) |
| Jan-09        | \$16.42            | \$16.58            | (\$0.16) |
| Feb-09        | \$16.37            | \$16.75            | (\$0.38) |
| Mar-09        | \$16.65            | \$16.88            | (\$0.23) |
| Apr-09        | \$16.90            | \$17.11            | (\$0.21) |
| May-09        | \$16.97            | \$17.18            | (\$0.21) |
| Jun-09        | \$17.23            | \$17.63            | (\$0.40) |
| Jul-09        | \$17.24            | \$17.78            | (\$0.54) |
| Aug-09        | \$17.37            | \$17.83            | (\$0.46) |
| Sep-09        | \$17.56            | \$18.09            | (\$0.53) |
| Oct-09        | \$17.56            | \$18.11            | (\$0.55) |
| Nov-09        | \$17.63            | \$18.04            | (\$0.41) |
| Dec-09        | \$17.51            | \$18.12            | (\$0.61) |
| Sep-Dec       | \$16.51            | \$16.30            | \$0.21   |
| 2009 Avg      | \$17.12            | \$17.51            | (\$0.39) |

**Milk-feed Ratio**



## What's Bearish:

- Dairy Products Report: Cheese production has recovered! After being behind much of the year, cheddar cheese output in July was up 3.4% vs. a year ago, and up 1.9% from June. American cheese output was 4.9% above last year, while total cheese production was up 1.5%. Butter production in July was basically flat, up 0.1% over last July, but down 2.7% from June.
- August Class III was announced today at \$17.32/cwt, down from \$18.24 in July and the lowest close since February. September looks to settle even lower, below \$17.00.
- Western cheese buyers are only taking what they need for current use, according to Dairy Market News. Many are waiting to see if prices will decline further before making additional purchases. Cheese demand has backed off at both the retail level and through food service accounts when prices firmed this summer, but current lower prices have not yet brought buyers back into the market yet in any great number.
- The nonfat dry milk market remains weak, according to Dairy Market News. Demand is subdued from both domestic and export accounts, as world market pricing continues to trend lower. Output is still active seasonally and producers' inventories are often building.
- All Class III components fell in this week's NASS survey. 40-lb blocks averaged \$1.75/lb, down 7.4¢ from the previous week, and 500-lb barrels lost 3.6¢ to average \$1.73/lb. Butter decreased 3.9¢ to average \$1.59/lb, nonfat dry milk was down 2.8¢ to \$1.47/lb and dry whey shed 0.8¢ to average 23.5¢/lb.
- In the Southeast, fluid milk sales are flat as school pipelines are now full and the affects of tropical storms have curtailed demand. Florida imported 59 loads of Grade A milk last week, but zero this week, according to Fluid Milk & Cream Review.
- Direct export interest in butter has slowed as U.S. pricing has gone up, the U.S. dollar has strengthened and other international butter supplies have surfaced, according to Dairy Market News. Domestic demand is light, following the holiday weekend.
- Economy: The U.S. jobless rate jumped to 6.1% in August, the highest in five years, according to the Labor Department. Employers slashed 84,000 jobs, showing the increasing toll housing, credit and the financial markets are taking on the economy.

## Recommendation:

It looks like we may enjoy higher cheese prices in the near term, as the cash market made an about turn this week and moved higher on much lighter volume. Sellers were largely absent, allowing bidders to have their way. Three weeks ago and every week since, we've written about the tightening supply of milk available to manufacturers. Don't get us wrong, milk output is still strong, but the seasonal draw into school milk programs, movement into the churn and lower components is cutting into cheese plants' ability to make product, while yields decrease. But don't expect the return of \$20 milk any time soon. With the new make allowance now going in to affect in October and a dry whey price hovering around 20¢, \$1.90 cheese gets us only to about \$17.10 milk and \$2.00 cheese to \$18.05. A full \$2.18 cheese price is now needed to get there. This week, we bought \$17.00 to \$18.25 CALL options Oct through Dec for 30¢ or less, better than the \$19.00 calls we had recommended the past couple weeks. The dramatic fall in milk futures into the first part of this week allowed us to get them at those prices. Now that futures have started to rally, we'll place standing orders to sell milk at those levels. If we can get that high we'll have the perfect hedge, since we're protected from a price decline by the sold milk AND from a continued rally by the purchased call options. We would consider selling milk above \$18.00 Q4-Q1 as we don't expect this rally to last that long. However, as the high costs of production hit producers this fall and winter, it could set up the second half of 2009 to move significantly higher. We remain concerned, however, about the deteriorating economy, weakening export market and milk production recovery in Oceania.

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Total Cheese Production  
United States

