

The KDM Dairy Report – September 12th, 2008

What's Bullish:

- Cash Market: Sellers backed off this week, allowing bidders to rather painlessly move prices higher. Blocks shot up 11¾¢ to settle at \$1.90¼/lb today while barrels gained 10¾¢ to \$1.88¼/lb. Only 1 block load and 4 loads of barrels exchanged hands for the week. Butter was even more quiet, settling the week unchanged at \$1.66/lb on 2 transactions.
- Between increased cheese orders, seasonal increases in milk volumes needed by bottlers and tighter milk supplies in general, current cheese supplies in the Midwest have tightened, according to Dairy Market News. Buyers are being limited to committed volumes as producers have already cleared extra supplies. Mozzarella interest remains strong and some buyers are finding tightness in mild cheddar and other natural American varieties. Interest in aged varieties has started to pick up seasonally.
- Out West, price increases in the cash cheese market have motivated buyers into making purchases off of averages that are lagging current price movements. Dairy Market News reports some buyers were in short positions as they waited for further price declines, but not have to pay higher prices to secure cheese. Cheddar blocks are often tightest, while Swiss holdings are lighter than projected.
- Early cold storage numbers are showing a drawdown in both cheese and butter stocks. For the period 09/01 through 09/08, butter inventories at USDA selected storage centers fell 2 million lbs, or 7%, and cheese inventories fell 1.5 million lbs, or 1%. That's the first drop in cheese stocks in several weeks.
- Dairy cow slaughter for the week ending 08/30 remained strong at 55,900 head, up from 51,000 head a year ago.
- Plants in the Mid-Atlantic are straining this week to meet Class I demand, according to Fluid Milk & Cream Review. The milk supply has reached the lowest level during the year so far. Fluid sales are strong in the Northeast, although the tightness from last week has eased. Milk production in the Southeast remains stable and at higher levels than a year ago, but sales of fluid milk are strong and increased from last week. Shipments of milk into the area were up 79 loads from last week.
- The milk supply is tight in the Central region of the country, according to Fluid Milk & Cream Review. The resumption of milk shipments south and improved Class I interest has had milk buyers inquiring about obtaining extra supplies. Milk available for manufacturing is particularly tight as cheese buyers have increased purchases in recent weeks.
- Fluid Milk & Cream Review reports processing plants in California continue to run on lighter than expected schedules. Less milk is leaving the state, while bottled milk interest is steady. In Arizona, plants are running on light schedules because local milk is at seasonally low levels and outside milk is very limited. Output is also trending lower in the Pacific Northwest, but more due to feed ration adjustments needed to mitigate costs. More hay is said to be available, but often because producers are unwilling or unable to pay at this time.

Futures Month	Friday 09/12 Close	Friday 09/05 Close	Change
Sep-08	\$16.17	\$16.10	\$0.07
Oct-08	\$16.90	\$16.68	\$0.22
Nov-08	\$16.56	\$16.59	(\$0.03)
Dec-08	\$16.52	\$16.66	(\$0.14)
Jan-09	\$16.27	\$16.42	(\$0.15)
Feb-09	\$16.28	\$16.37	(\$0.09)
Mar-09	\$16.40	\$16.65	(\$0.25)
Apr-09	\$16.52	\$16.90	(\$0.38)
May-09	\$16.60	\$16.97	(\$0.37)
Jun-09	\$16.70	\$17.23	(\$0.53)
Jul-09	\$16.75	\$17.24	(\$0.49)
Aug-09	\$16.85	\$17.37	(\$0.52)
Sep-09	\$16.95	\$17.56	(\$0.61)
Oct-09	\$16.93	\$17.56	(\$0.63)
Nov-09	\$16.98	\$17.63	(\$0.65)
Dec-09	\$16.98	\$17.51	(\$0.53)
Sep-Dec	\$16.54	\$16.51	\$0.03
2009 Avg	\$16.68	\$17.12	(\$0.43)

What's Bearish:

- World Ag Supply & Demand Report: USDA's monthly look at the world ag markets includes some negative updates on the U.S. dairy sector. They revised their 2008 and 2009 milk production estimates higher, as cow numbers are expected to decline less rapidly than previously thought. They also predict 2009 milk per cow to increase slightly. Prices for butter, cheese, NDM, and whey were forecast lower as milk production is forecast higher. USDA's Class III price forecast for 2009 was reduced 35¢/cwt from last month as a result, and is now expected to average \$17.25.
- NASS cheese prices fell again in this week's survey, as they lag the cash market by about two weeks. 40-lb barrels averaged \$1.74/lb, down 1.7¢ from last week, while 500-lb barrels decreased 3.8¢ to \$1.69/lb. Butter increased 2.2¢ to average \$1.61/lb, but nonfat dry milk decreased 4.2¢ to \$1.33/lb and dry whey continued its downward spiral, losing 0.8¢ to average 22.7¢/lb.
- Butter stocks at CME approved warehouses fell only 2.5 million lbs this week, compared to a drop of 2.8 million lbs during the same period last year. Stocks on hand, however, are still far below last year at 78.4 million lbs vs. 136.3 million lbs.
- Dairy Market News reports butter production in the Central region is still not keeping pace with demand, however, handlers are wondering how long current price levels can be maintained. International shipments continue to clear,

but new commitments are lighter, while current economic conditions are impacting consumer spending which is seen in slower retail sales.

- Western butter producers is still active and any extra butter production is welcomed, but new export orders have slowed as butter prices have increased to their highest levels in 3 years. The strengthening US dollar is further increasing the cost to foreign buyers.
- Dry whey prices continue to weaken, according to Dairy Market News. Offering prices are being reduced to stimulate interest and export business has slowed from the U.S. as the dollar has strengthened. Offerings from other areas have been better priced, near the bottom of the range of U.S. prices. Domestic interest is light as buyers are scaling back.
- Dairy Market News reports the nonfat dry milk market continues to be weak. Buyers are seeing additional product on the world market come under pricing pressure and have become more cautious. Production levels remain moderate to heavy.
- International: The summer holiday season is over in Europe and buyers are now looking at their fall and winter needs. However, stocks of manufactured dairy products are reported to be available, with prices lower to sharply lower than just 4-6 weeks ago. Dairy Market News reports buyers may be hesitant to procure significant volumes of product in a weakening market.
- International: Both New Zealand and Australia are off to a good start in their new production season, according to Dairy Market News. New Zealand remains almost too wet, with muddy conditions common, but milk volumes are on track with projections. In Australia, early numbers for July indicate output was 6.5% higher than last year. Timely rain has fallen, sufficient to establish early pasture growth in Australia, but more regular rainfall is needed to help with water reserves, many of which remain depleted, for the rest of the summer. Like Europe, traders indicate that buyers are very reluctant to commit to any type of long term contract as prices continue to decline.
- International: Cheddar cheese prices in Oceania have fallen from near \$2.25/lb a few weeks ago, to about \$2.00/lb. Cheese output in the region continues to build as milk volumes increase, and price negotiations have become a stumbling block to getting long-term contracts done.

Recommendation:

It's a little hard to be excited about the strong showing in the cash cheese market this week when the 2009 futures average loses 43¢. Suffice it to say, there is a lot of pessimism out there right now, and for some valid reasons. More and more reports are showing weakness in international dairy prices, right when the U.S. dollar has made a rally. We are at serious risk of a dramatic slowdown in dairy exports in 2009, if demand doesn't pick up. It was the export market that played a major role in elevating prices for so long in 2007 and 2008. After more than 18 months of a weakening economy at home, European economies are starting to feel the pain as well. After years of spectacular price increases, housing prices in London are down and heading lower. Sound familiar? It appears our "biggest risk", the economy, will be a powerful factor we have to reckon with for the months to come. But, we have been given a second opportunity! Seasonal forces are moving cheese prices higher and they may hold for the next 1-3 weeks. **You need to get something done in Q4 through Q1 2009 during this window of opportunity.** With world cheddar prices around \$2.00/lb (and falling), we will have no export market for our cheese at \$1.90/lb (and climbing). When seasonal buying is done, there will be no place for new production, and we could quite easily make new lows in the cash market, with some in our industry tossing out \$1.50's as a possibility. **That's \$13.00 milk!** Are you willing to risk that? **TRADE ALERT:** We have a couple recommendations. Current cash prices work out to about \$17.10/cwt including the new make allowance. Sell Oct milk above \$17.20 and any month Nov-Mar above \$17.00. Or, consider a fence strategy. Buy the Oct-Mar 16.00 PUT option for an average of 57¢ per month, and sell the 17.50 CALL option for an average of 40¢ per month. For a net cost of 17¢, you'll establish an effective floor of \$15.83 with upside to \$17.33, at which point you'll be capped. We may have some painful months ahead, and it might take 4-6 months of low prices before market signals force milk production lower. For that reason, however, we would not sell the last half of 2009.

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