

The KDM Dairy Report – October 24th, 2008

What's Bullish:

- Livestock Slaughter Report: Dairy cow slaughter in September was up 12% from a year ago, according to USDA figures released today. 223,500 head were culled, compared to 199,600 a year ago. Jan-Sep the dairy cull is up 4.8% compared to last year.
- Cold Storage Report: Butter stocks in September were down 23% from last year, and fell 13% from August.
- CWT announced their second herd buyout program of 2008 today. Citing the lowest milk prices in 18 months, the goal is to decrease the number of cows in production and thus milk output. Bids must be postmarked by Nov 24th.
- Weekly cold storage numbers continue to show a seasonal drawdown in both cheese and butter stocks. For the period 10/01 through 10/20, cheese holdings at USDA selected storage centers fell 5.5 million lbs, or 5%, and butter holdings declined 3.6 million lbs, or 17%.
- Butter stocks at CME-approved warehouses are still about half of last year's levels. For the week ending 10/18, 58.1 million lbs were on hand, compared to 104.5 million lbs at this time in 2007.
- Dairy Market News reports Western cheese supplies are tight barrels, as they are in the Midwest as well. Manufacturers are cautiously optimistic about fall holiday sales, but are concerned about the relatively high prices in the midst of a worsening economy.
- Fresh butter production in the Midwest often lags demand, so inventoried stock continues to be tempered and micro fixed to supplement shortages, according to Dairy Market News. Demand is holding steady, at fairly good levels. Butter sales, especially at the retail level, are holding up better than anticipated. Feature activity is also clearing good volumes and food service orders are holding steady. Upcoming year end holiday orders are developing at better levels than projected.
- Processors in the Southwest still have extra capacity available as the milk supply was remained relatively flat, according to Fluid Milk & Cream Review. Some farmers are stuck with feed bought under contract at prices substantially higher than today's levels, with changes in rations affecting milk per cow. Plants looking for milk from outside sources are finding only limited supplies.
- Dairy Market News reports the Central dry whey market is steady, as buyers are willing to cover needs at current prices, since downside risk is seen as minimal. Inventories are described as, "fairly tight".

Futures Month	Friday 10/24 Close	Friday 10/17 Close	Change
Oct-08	\$16.98	\$16.95	\$0.03
Nov-08	\$15.57	\$15.69	(\$0.12)
Dec-08	\$14.30	\$15.12	(\$0.82)
Jan-09	\$14.23	\$14.78	(\$0.55)
Feb-09	\$14.15	\$14.76	(\$0.61)
Mar-09	\$14.18	\$14.78	(\$0.60)
Apr-09	\$14.46	\$15.01	(\$0.55)
May-09	\$14.59	\$15.12	(\$0.53)
Jun-09	\$15.10	\$15.45	(\$0.35)
Jul-09	\$15.17	\$15.50	(\$0.33)
Aug-09	\$15.31	\$15.68	(\$0.37)
Sep-09	\$15.32	\$15.76	(\$0.44)
Oct-09	\$15.33	\$15.75	(\$0.42)
Nov-09	\$15.24	\$15.62	(\$0.38)
Dec-09	\$15.21	\$15.72	(\$0.51)
Jan-10	\$15.23	\$15.71	(\$0.48)
Feb-10	\$15.31	\$15.70	(\$0.39)
Mar-10	\$15.35	\$15.62	(\$0.27)
Apr-10	\$15.40	\$15.80	(\$0.40)
May-10	\$15.50	\$15.75	(\$0.25)
Jun-10	\$15.80	\$15.80	\$0.00
2009 Avg	\$14.86	\$15.33	(\$0.47)
Q1Q2 2010	\$15.30	\$15.68	(\$0.38)

What's Bearish:

- Cash Market: The inverted block/barrel spread was fixed in one fell swoop in today's cash session. Barrels plunged 16½¢ to settle at \$1.68½/lb, which made it down 21½¢ for the week. Blocks fell 5¾¢ in today's session, which was down 5¼¢ for the week. 9 loads of blocks and 8 loads of barrels exchanged hands. Butter hung in there and actually gained a penny from last Friday to settle at \$1.75/lb today. 5 cars of butter exchanged hands.
- NASS surveyed dairy product prices were all down this week. 40-lb cheddar blocks averaged \$1.88/lb, down 4¢ from last week, while 500-lb barrels shed 5.1¢ to \$1.86/lb. Butter lost 0.1¢ to average \$1.70/lb, nonfat dry milk decreased 3.9¢ to \$0.98/lb and dry whey averaged 19.2¢/lb, down 0.1¢.
- Cold Storage Report: While butter stocks were down, American cheese stocks were up 2% vs. a year ago but down 2% from August. Total cheese stocks were also 2% over 2007, but down 5% from the prior month.
- Milk is being shifted from butter/powder operations into cheese production, according to Dairy Market News. Midwest plants have additional capacity and the returns are better than in the weak powder market. Cheese movement is steady but seems to lack some of the usual fall aggressiveness. Barrels remain tight, but a reopened barrel plant is stepping up production as they gear up.
- Manufacturing milk offerings are higher and interest is lower in the Central region, according to Fluid Milk & Cream Review. Some plant operators are expecting lower prices in November so are trying to limit extra purchases until then.
- Fluid Milk & Cream Review reports demand for bottled milk in the Northeast is weak. Milk production is near the cyclical low and even starting to increase in some areas. The first frost of the season was seen in the Southeast and expectations are for milk output to expand in the coming weeks.

- Milk is available to make cheese in the Northeast, and a number of plants are operating 7 days a week, according to Dairy Market News.
- New export sales of butter are slower to develop, with U.S. prices firm and foreign prices declining, according to Dairy Market News. Sellers are attempting to use the CWT export program more as a means of moving product.
- Western dry whey prices were generally lower this week as steady domestic sales are countered by declining exports, according to Dairy Market News. Currency issues are becoming much more critical in making export sales work, with some sales being cancelled because credit has tightened dramatically. Production is heavier than anticipated and more milk is now entering cheese plants that had been going into butter powder operations. Inventories had been shrinking, but that may no longer be the case.
- The Western nonfat dry milk market remains weak, according to Dairy Market News. Demand is slow from both domestic and export sources as buyers watch more product being offered to the CCC at support prices. International prices are also trending lower, so buyers continue to hold off, waiting for cheaper prices in the future.
- International: Dairy Market News reports that stocks of manufactured dairy products in Europe are readily available for both domestic and international buyer interest, despite plants reducing their production schedules. Sales are occurring, but mostly for domestic needs, while international buyers are still absent from the market place. Prices for most products continue to trend lower as economic unsettledness plays a role in slow international dairy product sales.
- International: Plants are running full in New Zealand with excess milk moving into balancing locations, according to Dairy Market News. Milk intakes are steady compared to a year ago, with the seasonal peak coming in the next 2-4 weeks. A full range of products is being produced. Australian milk production is steady to higher, with forecasts calling for 1-2% increases over last season.
- International: Cheddar prices in Oceania slipped to their lowest level in 16 months, averaging \$1.75/lb. Factoring in the difference in moisture content and transportation cost, that equates to about \$1.40 cheese in the U.S.
- International: Major international dairy analysts Rabobank published an article this week saying global growth in demand for dairy products could be cut in half following the Chinese milk contamination scandal. Demand is still supposed to grow, but not by the 2-3% annually from previous years. 2008/09 growth has been revised to 1.7%. The domestic population in China has lost confidence in its local supply, and Rabobank estimates Chinese dairy consumption has fallen 20% in the wakes of the crisis. In addition, UK and EU consumption of cheese, milk and yoghurt is dropping.

Recommendation:

Milk futures showed that they are not immune to a crumbling stock market, tumbling crude oil and an eroding grain market. After cheddar barrels dropped 16¢ today, Class III sellers got aggressive and pushed most months to new contract lows. The current cash price works out to about \$15.33 milk, so Dec and beyond are still trading at a significant discount. But weeks ago they predicted a fall in the cheese price, and they were right. With the dollar making a 5-year high against the British Pound and a nearly 2-year high against the Euro, our dairy products continue to get more expensive on the world market. Combined with troubled economies outside the U.S., exports appear to have a bleak outlook. Anecdotal evidence from Dairy Market News this week seems to back this up, with many reports of slow orders. As mentioned above, U.S. cheese needs to be \$1.35 to \$1.45 per pound to be competitive right now. We may not head there right away; barrels still seem to be a little on the tight side, cow slaughter was strong in Sep and perhaps the new CWT herd retirement will take out more cows than the last round (like triple would be nice). But we would still sell any and all rallies. You may not want to sell milk at unprofitable levels, but the bottom line is we could easily see \$12-13, maybe even \$11 milk if cheese keeps dropping. For those that have sold milk at higher prices, be prepared to start buying CALL options to protect your upside risk. If cheese does indeed head to the \$1.40's or lower, there will be a lot of hurt out there and call option prices should be much cheaper. You'll want to get covered Q2 and beyond where ever you've sold milk. The reason this insurance is important is we think we're headed much lower; lower than anyone expects it to go. But this may actually be a catalyst for a rally in the 2nd half of 2009. The lower prices go now, the shorter the downtrend will last. Hang on – more extreme volatility appears headed our way.

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