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The KDM Dairy Report – October 31st, 2008

What's Bullish:

Futures Month	Friday 10/31 Close	Friday 10/24 Close	Change
Nov-08	$15.46	$15.57	($0.11)
Dec-08	$14.47	$14.30	$0.17
Jan-09	$14.50	$14.23	$0.27
Feb-09	$14.56	$14.15	$0.41
Mar-09	$14.58	$14.18	$0.40
Apr-09	$14.83	$14.46	$0.37
May-09	$14.98	$14.59	$0.39
Jun-09	$15.33	$15.10	$0.23
Jul-09	$15.58	$15.17	$0.41
Aug-09	$15.75	$15.31	$0.44
Sep-09	$15.76	$15.32	$0.44
Oct-09	$15.79	$15.33	$0.46
Nov-09	$15.65	$15.24	$0.41
Dec-09	$15.65	$15.21	$0.44
Jan-10	$15.69	$15.23	$0.46
Feb-10	$15.73	$15.31	$0.42
Mar-10	$15.66	$15.35	$0.31
Apr-10	$15.62	$15.40	$0.22
May-10	$15.50	$15.50	$0.00
Jun-10	$15.80	$15.80	$0.00
2009 Avg	**$15.25**	**$14.86**	**$0.39**
Q1Q2 2010	**$15.69**	**$15.30**	**$0.40**

- Commercial Disappearance: Use of American cheese in August was up a solid 6.2% in August, according to USDA figures released this week. However, other-than-American cheese use was down 3.7%. Commercial use of butter was up 20.8%, which helped bring use of milk in all products up 2.8%.
- For the period 10/01 through 10/27, USDA reports butter stocks down 21 million lbs and cheese stocks down 4.2 million lbs at selected storage centers.
- Milk production in the Mid-Atlantic region is slighter weaker than last week, according to Fluid Milk & Cream Review. Milk flowing into balancing plants is at its lowest level of the year. Colder than normal temperatures in the Southeast is keeping milk output from building as cows adjust.
- Interest in barrel and aged cheddar cheese is generally good, according to Dairy Market News. Barrel supplies in the Midwest remain limited.
- Central butter traders are reporting holiday orders holding up quite well, according to Dairy Market News. Thanksgiving orders have been placed and shipped, with Christmas/New Years orders still being booked.
- Butter stocks at CME-approved warehouses fell by 3.4 million lbs for the week ended 10/25. That leaves 54.7 million lbs on hand, compared to 97.8 million lbs during the same period a year ago.
- Ag Prices Report: The milk-to-feed ratio in October came out to 2.12, up from last month's 1.89, but still well below the 3.0 level, which is considered a signal to expand and increase milk output.

What's Bearish:

- Cash Market: Blocks nosedived 13¢ to settle at $1.60¾/lb while barrels were unchanged at $1.68½/lb this week. 13 loads of blocks traded and no barrels. Butter showed signs of weakness, falling 6½¢ to settle at $1.68½/lb. Just 2 cars of butter exchanged hands.
- October Class III was announced at $17.06/cwt, up from $16.28 last month but down from $18.70 a year ago. And it appears that Nov and beyond are likely to settle much lower than that.
- NASS prices were a mixed bag this week, but with recent drops in the cash market, we're calling it bearish. 40-lb block cheese averaged $1.86/lb, down 2.2¢ from the previous week, but 500-lb barrels managed to increase 1.4¢ to $1.88/lb. Butter gained 2¢ to average $1.72/lb, but nonfat dry milk continued its freefall, dropping 6.2¢ to 92¢/lb, while dry whey increased 0.1¢ to average 19.2¢/lb.
- The big holiday push may not be as strong as usual, according to Fluid Milk & Cream Review. While many bottlers are seeing strong sales, particularly in recent chocolate milk promotions, orders for dips and sour cream are not much above ordinary. Manufacturing milk interest is lighter and offerings have increased. Some handlers are already trying to book surplus milk sales for Thanksgiving and year-end with limited interest. With cheese sales slowing as prices decline on the CME, and the expectation of sharply lower Class III prices, operators are not looking to purchase extra milk volumes.
- Fluid Milk & Cream Review reports milk output is slowly but steadily increasing in the Southwest. Weather has been favorable for cow comfort and feed prices have continued to decline, lowering ration costs. In the Pacific Northwest, weather has not been much of a factor, and dairy plants generally have as much milk as they desire. Heifer prices continue to fall and are now at their lowest in the region since Feb 2007.
- Despite declining milk production in the Northeast, two recent cheese plant closures have resulted in a surge of milk needing to be accommodated, according to Fluid Milk & Cream Review. Most of it is headed into drying operations, with some being churned so it can be stored.
- Trade expectations for lower prices have cheese buyers delaying orders temporarily, according to Dairy Market News. Many packagers remain busy, but not at the frantic pace usually associated with this time of year. Uncertainty with the struggling economy may impact holiday gift pack sales.
- Offerings of Western cheese are becoming heavier and some buyers are indicating they have enough short-term coverage in light of current economic conditions, according to Dairy Market News. At the same time, more milk is headed into cheese production as returns from nonfat dry milk drop even more rapidly.

- Dairy Market News reports that while butter orders are still strong, most feel it will not be long before yearend sales will be completed and the cash price will adjust lower. Handlers feel stocks will be sufficient to carry them through the final quarter of the year.
- With European butter prices ranging from $1.29 - $1.41 per pound and the U.S. price still above $1.70/lb, new export sales are hard to come by, according to Dairy Market News. Domestic orders seem to be average at best, with no aggressiveness noted.
- Central dry whey prices headed lower this week, according to Dairy Market News. Despite several plants in the region reporting inventories are balanced to short, a few others were actively trying to reduce their current holdings.
- Western dry whey prices were also under pressure this week, with a weak export market cited as the major cause. Inventories range from in balance to higher than anticipated.
- Dairy cow slaughter for the week ending 10/18 totaled 50,900 head, down from 56,000 head during the same week a year ago.
- International: Brazil's fluid milk production is forecast to increase 5% in 2009 and reach 30.3 billion liters. This is down from an 8% increase this year, according to a USDA report released last week. Much of this year's gains were in exports as the devaluation of the Brazilian currency improved their competitiveness. The economic slowdown is expected to slow their export growth, but further devaluation of their currency should allow them to compete well against the U.S., who's currency is rising.

Recommendation:

Pretty scary report this week, which in a strange way seems appropriate on Halloween! There are just not a lot of positive things out there, and the situation appears to be getting worse. The rallies we saw this week were a gift, and we had no hesitation selling in to them. Yes, it makes you question your convictions when cheese drops 4¢ in the cash session and Class III futures rally hard, but in the long run, we have to respect the direction cheese is going. The Dec-Mar contracts look ripe for further big drops if cheese keeps heading lower. The current cash price for cheese works out to about $14.77 milk, which is not much of a premium to today's settlement prices. We hate to repeat ourselves here, but word we're hearing from industry players is not good. The world price for cheese is around $1.30/lb so we're still not competitive and exports stink. We may even start to see more cheese come IN to the country from cheaper sources. The dollar continues to rally which is not helping things. USDA cheese updates this week seem much less supportive. With the exception of some tightness in barrels (reflected in the cash market), and some solid commercial disappearance numbers (which are old), it appears holiday buying is starting to come to a close and cheese out West is getting heavier. In our opinion, the only reason we're above $1.60 cheese now is due to seasonal demand, but when that ends, we'll make new lows in cheese and Class III. You should get up to 75% covered Dec-Mar, 50% covered Apr-Jun and 25% covered July-Dec. Let's hope the market continues to move higher next week so you can get this done! Sell!

Comment on covering your inputs: It now seems "normal" to have daily swings in the grain markets of 20-50¢ and limit moves at least once per month. This makes finding a trend higher or lower or the continuation of that trend very difficult. For corn, we are moving into the 2nd biggest crop ever harvested. The question is, who in the world is going to buy all that corn? The livestock industry is contracting, ethanol is unprofitable, foreign buyers have limited credit and the rising dollar is making our product expensive. How do you protect your cost of feed inputs and not get into bottom picking the corn and soybean meal market? Buy puts on corn previously bought or on corn you are going to buy for the upcoming year. Use contracts that are out at least 2 months or more. Use a premium of 15-20¢ and buy as high a put as possible for better value. 20¢ = $7.14/ton. That may sound high from the past, when corn ranged from $80/ton ground, and delivered at $125/ton, but we have heard numbers of $300/ton and as low as $170/ton this year. That makes the insurance premium for the PUT option only 3-6% of the total cost of the corn. For example, several of our clients bought $5.00 corn puts on or about August 29th for 10¢ each, and today those puts are trading at 90¢. The put could be cashed in at this time for a gain of 80¢/bu. This would result in a net price for the corn of $3.20 per bushel ($4.00/bu - $0.80 gain on the trade) or $115/ton. A current opportunity would be to book your corn when Chicago reaches $3.90/bu, then bid for 3.50 March puts paying, 15¢ ea. If the market continues higher, you will give up your insurance money. If we head to $3.00/bu, your gain could be 35¢ or better. $3.90 corn is $139/ton ground or about $159/ton delivered. On the flipside, if we go to $6.00 corn, your cost is 148/ton plus grind and deliver, local basis. Bottom line: We know we cannot pick the bottom of the corn or soybean meal market, but we can buy insurance in the form of put options after we have contracted the corn/soybean meal, and doing this enables you to participate in lower prices should they occur.