

The KDM Dairy Report – December 5th, 2008

What's Bullish:

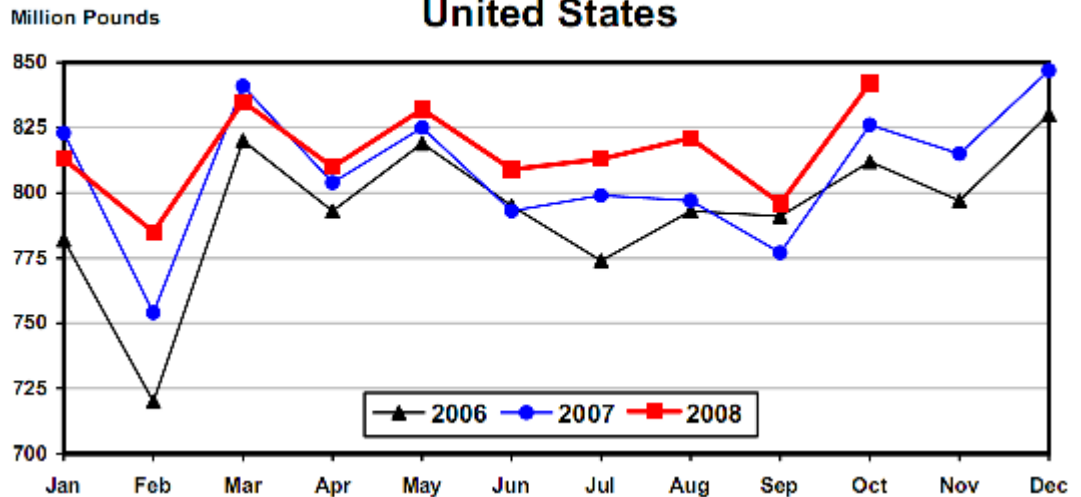
- NASS cheese prices were up from last week, according to USDA's survey. 40-lb cheddar blocks increased 2¢ to average \$1.69/lb and barrels gained 4.1¢ to \$1.74/lb. Nonfat dry milk saw it's first increase in weeks, jumping 2.2¢ to average 87¢/lb, but butter lost 5.2¢ to sit at \$1.54/lb and dry whey fell 0.5¢ to 18.6¢/lb.
- Dairy cow slaughter for the week ending 11/22 totaled 50,800 head, up 10,200 head from a year ago.
- Milk production in California is steady, but at levels lower than last year at this time, according to Fluid Milk & Cream Review. There are more concerns over farm income as milk prices fall, but many producers have grains and forages locked in at higher prices. In Arizona and New Mexico, milk output is trending higher, but plants are easily handling milk volumes since little outside milk is coming in.
- Dry whey prices are holding steady across the country, though production is near capacity in some areas, according to Dairy Market News. Interest in contracting 2009 needs by end users is increasing, and several buyers are upping their monthly contracted load numbers. Inventories are mostly comfortable, but not burdensome.
- Economy: Some analysts predict crude oil may hit \$25/barrel if the global economic slow down affects energy demand in China. That would put prices at the pump below \$1/gal.
- International: After a strong start, milk production in New Zealand is declining at rates heavier than expected, according to Dairy Market News. Lack of moisture is affecting pasture growth and quality. Australian milk output is also suffering due to lack of rain, and the general outlook now is for production to move to levels lower than a year ago as the season progresses. There are also predictions for higher than normal temperatures, and there is a lack of irrigation water.

Futures Month	Friday 12/05 Close	Friday 11/28 Close	Change
Dec-08	\$15.33	\$15.36	(\$0.03)
Jan-09	\$14.13	\$14.24	(\$0.11)
Feb-09	\$13.63	\$14.15	(\$0.52)
Mar-09	\$13.60	\$14.16	(\$0.56)
Apr-09	\$13.55	\$14.14	(\$0.59)
May-09	\$13.60	\$14.32	(\$0.72)
Jun-09	\$13.80	\$14.70	(\$0.90)
Jul-09	\$14.22	\$15.10	(\$0.88)
Aug-09	\$14.55	\$15.42	(\$0.87)
Sep-09	\$14.78	\$15.60	(\$0.82)
Oct-09	\$14.80	\$15.70	(\$0.90)
Nov-09	\$14.80	\$15.50	(\$0.70)
Dec-09	\$14.79	\$15.41	(\$0.62)
Jan-10	\$14.75	\$15.50	(\$0.75)
Feb-10	\$14.74	\$15.50	(\$0.76)
Mar-10	\$14.75	\$15.20	(\$0.45)
Apr-10	\$14.69	\$15.20	(\$0.51)
May-10	\$14.84	\$15.25	(\$0.41)
Jun-10	\$15.20	\$15.40	(\$0.20)
2009 Avg	\$14.19	\$14.87	(\$0.68)
Q1Q2 2010	\$14.75	\$15.40	(\$0.65)

What's Bearish:

- Cash Market: Blocks and barrels were both down marginally this week, but butter took its biggest plunge of the year. Blocks lost 1¼¢ to settle at \$1.79/lb while barrels lost 4¼¢ to \$1.74¾/lb. Butter, however, fell 24¼¢ to close at \$1.25¾/lb. Trading was light with 11 loads of blocks, 6 barrels and just 1 car of butter needed to bring prices down.
- Dairy Products Report: We made a lot of cheese in October (see graph). Production of cheddar cheese during the month totaled 254.4 million lbs, up 3.8% from a year ago and up 8.1% from September. Total cheese output was higher as well, notching 2% and 5.8% gains over the same period. Butter output was down 0.3% vs. the prior year, but up 7.4% from September.
- Ag Prices Report: The milk to feed ratio, a measure of dairy profitability, went up for the second month in a row. The Nov ratio came in at 2.13, up from 2.00 in Oct (see graph below). Huge declines in grain prices were the primary factor in the increase.
- Cheese production is strong across the country and some holiday demand is covered, according to Dairy Market News. The big gap in prices between cheese, at relatively high levels, and butter/powder, has some feeling that the spread

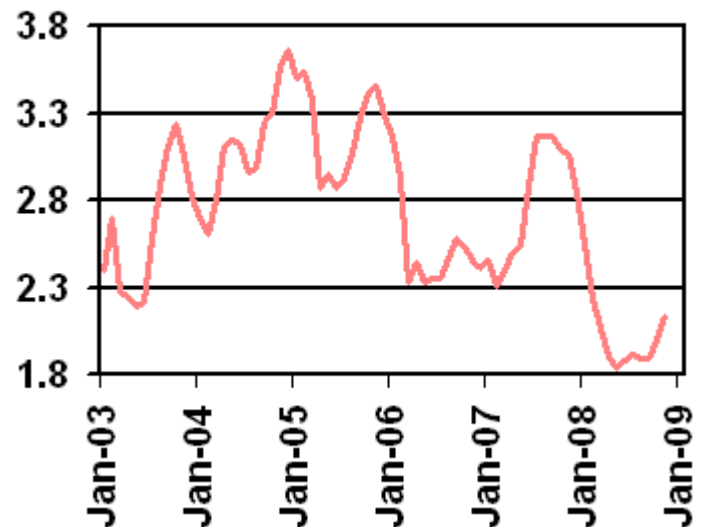
**Total Cheese Production
United States**



has to narrow. Sales are strong at the moment in the East and Central regions, but Western contacts say cheese is no longer in as close supply and demand. Cheese plants are watching production closely to make sure they do not make expensive cheese that can't find a home.

- Fluid Milk & Cream Review reports milk production in the Eastern region of the country has hit its low point and is now starting to increase. Last week 26 loads of milk were imported into the Southeast, but this week the total was zero.
- Demand for fluid milk in the Central region was steady to lower this week, as retailers work off inventory built up prior to Thanksgiving weekend. Fluid Milk & Cream Review reports cream supplies are long and balancing plants are not aggressively buying spot cream offerings. Some Western cream is clearing to churns in the Central region.
- The steep drop in the butter price this week has many buyers waiting for lower average prices before filling needs, according to Dairy Market News. This has resulted in slow reorders after Thanksgiving. Churns are being very careful about how much cream they buy on a down butter market, with some churning only orders in hand.
- Economy: U.S. employers cut 533,000 jobs in November, the most in 34 years, according to the Labor Department. That pushed unemployment up to 6.7%, the highest since 1993. To add to the depressing economic headlines, a record 1 in 10 American homeowners with a mortgage were either at least a month behind on their payments or in foreclosure at the end of September, the state of California may run out of cash by February and the Big 3 automakers were pleading to congress this week for a bailout.
- International: Economic and world financial issues continue to plague the international markets and the ability for sales to be finalized, according to Dairy Market News. EU farmers are concerned that lower dairy product prices will erode milk prices in the near future.
- International: Dairy Market News reports marketers of finished dairy products in Ocean continue to suffer from poor sales. Buyers are waiting for lower prices and only making purchases for the short term. Demand remains repressed because of world economic conditions, currency devaluations, ample offerings and declines in purchases.
- International: Oceania cheese prices were sharply lower this week, according to Dairy Market News. Prices got as low as \$1.27/lb in order to move existing stocks. Cheese production is seasonally strong with ample product available.

Milk-feed Ratio



Recommendation:

Class III was hammered hard this week, even in the 2010 months, as a combination of disbelief in the longevity of the current cheese price and negative economic headlines took their toll. Trying to predict what would happen day to day was near impossible. On Tuesday we saw a short-covering rally as cheese was bid up to \$1.80 unopposed in the spot market, but when sellers showed up, it evaporated and markets quickly turned much lower. On other days, cheese would actually finish higher, but it was as if sellers had had enough waiting and were willing to pounce on bids. Perhaps they're looking at the glaring gap between the current cheese price, which is 40-50¢ higher than global prices, and domestic butter/powder prices which are now much more in line with the global market. There's a conviction out there that it must come down, and they're probably right, but we may see more of an orderly decline over the next couple weeks vs. a plunge like we saw in butter. Demand is still good and New Year's / Super Bowl needs are still being assessed. This may keep cheese from absolutely tumbling, but ultimately we believe it's heading lower. We've been recommending getting 75% sold in the first half of the year now for the last several weeks. It's hard to sell at current prices, but the reality is if we eventually move towards \$1.40ish cheese, we'll be looking at milk prices that start with a \$12. We can't guarantee this is going to happen, but when we see crude oil off more than \$100/barrel from its highs of just a few months ago, it reminds us anything is possible. Between now and then there will be opportunities, so continue to look to sell rallies Feb-Jun on any short-covering activity. Jan will begin pricing in a couple weeks so could see some support soon, due to it's \$1.50 discount to the current cash price, so hold off selling it for now. It's no fun watching prices move lower so methodically like this, but hang in there. We do see a light at the end of the tunnel. If and when the economy starts turning around, world demand for protein will return and spectacular moves to the upside are quite possible. If the drought situation in Oceania doesn't improve, perhaps that even happens some time in 2009! Those with milk sold in the 2nd half of the year should start looking at buying call options to protect those sold positions.

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