

The KDM Dairy Report – December 12th, 2008

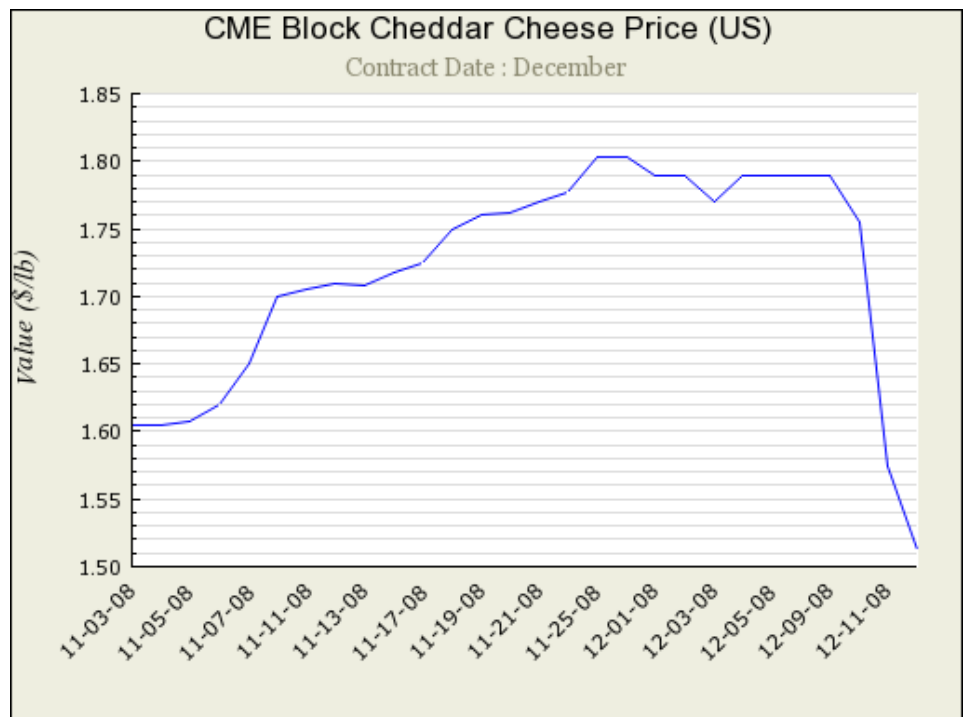
What's Bullish:

- NASS cheese prices managed another gain this week, although that won't last long in light of what happened in the cash market this week. Blocks gained 5.4¢ to average \$1.75/lb while barrels jumped 8.5¢ to \$1.82/lb.
- Butter stocks at CME-approved warehouses fell by 1.9 million lbs for the week ending 12/06, leaving 37.2 million lbs on hand. A year ago at this time there was 67 million lbs in warehouses.
- Fluid Milk & Cream Review reports Class I and II milk use was strong in the Central region this week, as bottlers and manufacturers fill orders for the yearend holidays. A lack of r-BST free milk had some bottlers struggling to fill orders, while interest was good for sour and whipped cream, eggnog and dips.
- Milk supplies in much of the Eastern region of the country remain mostly in balance, according to Fluid Milk & Cream Review. Balancing plants are reporting lower intakes and manufacturing activity, although that will likely change during school holiday breaks. States in the Southeast imported 25 loads of milk on a surge in pre-holiday fluid orders, and in the Mid-Atlantic region, very little manufacturing or drying is occurring.
- While lower than a year ago, stocks of butter are available for current and future needs, according to Dairy Market News. Some producers are growing more concerned about uncommitted stock levels and the potential for increasing supplies due to declining demand. Churning activity is being limited, as butter producers do not want to make butter with relatively expensive cream, unless they have a firm order.
- CWT announced this week that they had accepted 184 bids representing 61,000 cows in their second herd retirement program of 2008. The cows will be removed mostly during the month of January.

Futures Month	Friday 12/12 Close	Friday 12/05 Close	Change
Dec-08	\$15.11	\$15.33	(\$0.22)
Jan-09	\$13.20	\$14.13	(\$0.93)
Feb-09	\$13.10	\$13.63	(\$0.53)
Mar-09	\$13.15	\$13.60	(\$0.45)
Apr-09	\$13.15	\$13.55	(\$0.40)
May-09	\$13.22	\$13.60	(\$0.38)
Jun-09	\$13.29	\$13.80	(\$0.51)
Jul-09	\$13.77	\$14.22	(\$0.45)
Aug-09	\$14.15	\$14.55	(\$0.40)
Sep-09	\$14.41	\$14.78	(\$0.37)
Oct-09	\$14.54	\$14.80	(\$0.26)
Nov-09	\$14.56	\$14.80	(\$0.24)
Dec-09	\$14.56	\$14.79	(\$0.23)
Jan-10	\$14.50	\$14.75	(\$0.25)
Feb-10	\$14.45	\$14.74	(\$0.29)
Mar-10	\$14.65	\$14.75	(\$0.10)
Apr-10	\$14.58	\$14.69	(\$0.11)
May-10	\$14.80	\$14.84	(\$0.04)
Jun-10	\$15.01	\$15.20	(\$0.19)
2009 Avg	\$13.76	\$14.19	(\$0.43)
q1q2 2010	\$14.53	\$14.75	(\$0.21)

What's Bearish:

- Cash Market: Cheese finally crashed. Blocks plummeted 27¾¢ to settle at \$1.51¼/lb on Friday, while barrels shaved 22½¢ off their price to close at \$1.52¼/lb. Just 9 blocks and 5 barrels traded during the week, as buyers had their hands full with offers. Cheese is now at its lowest price since April, 2007. Butter fell 14¾¢ to \$1.11/lb, just 6¢ above the government support price of \$1.05/lb and the lowest butter price since June, 2003. 3 cars of butter traded during the week.
- World Ag Supply & Demand Report: USDA reduced its 2009 milk production forecast slightly from last month, due to a slowdown in the growth in output per cow. However, they again reduced their Class III price forecast on the basis of weaker demand both domestically and in international markets, caused by the global economic slowdown. They project Class III to average \$14.90/cwt in 2009, down 30¢/cwt from last month's forecast. Cheese is expected to average \$1.69½/lb, down 2½¢ from last month's report.
- While NASS cheese prices were up, other Class III components fell in this week's survey. Butter dropped 11.8¢ to average \$1.42/lb, nonfat dry milk slipped 2¢ to 85¢/lb and dry whey lost 1.3¢ to 17.3¢/lb.



- Most large cheese buyers are finishing up on their committed cheese supply agreements for 2009, according to Dairy Market News. The year end holiday period will cause an increase in surplus milk, and the big question in a struggling economy is who will purchase and store the extra cheese produced during the holidays. Some of the bigger packagers are noticing slower movement as a lot of product is already at the retailers. Current cheese interest is light as buyers are expecting prices to decline, so are only covering immediate needs. Offerings of cheddar blocks and generic mozzarella have increased. The stronger US dollar has made exporting cheese more difficult, and reports this week indicate **some exported cheese is being returned from overseas**.
- Cheese offerings in the West have increased and buyers are being very cautious, according to Dairy Market News. Mozzarella sales are slower and producers are attempting to keep production in line with demand. More milk is heading to cheese production rather than to butter/powder at this time.
- Cheese milk interest in the Central region was light this week as most holiday orders have likely been filled at the plant level, according to Fluid Milk & Cream Review. Handlers are struggling to place projected excess milk after schools close for the holiday break, and reports indicate steep discounts are being offered to book space. Unsalted butter supplies are rising as producers who had expected to export product have seen their prospects dim due to increased offerings from other parts of the world.
- Florida exported 54 loads of milk this week, up from 35 last week, according to Fluid Milk & Cream Review. Even with increases in winter residents, more milk is likely to "head north" as production continues to improve.
- Cheese stocks at USDA selected storage centers increased 8% during the first week of December, according to figures released this week. 7.2 million lbs were added to inventories. However, butter stocks fell by 8%, or 1.2 million lbs.
- Dairy cow slaughter for the week ending 11/29 was just 43,900 head, after being above 50k for several weeks. It's most likely due to the Thanksgiving holiday falling on a different week than a year ago, when 51,400 animals were culled.
- After showing some signs of recovery, the dry whey market is displaying some weaker undertones, according to Dairy Market News. Producer inventories aren't growing, but they're not declining much either. Production is expected to be higher for the next few weeks as plants scramble to handle all of the year end milk.
- International: Milk production in Australia is up 1.6% YTD, according to the latest statistics released by Dairy Australia.
- Economy: Facing a record drop in sales, businesses in October cut inventories by the largest amount in five years, according to the Commerce Department. Retail sales fell for the 5th straight month in November and weekly jobless claims jumped to a 26-year high. The Big Three continue to look for money while many state government budgets are in the red and Fortune 500 companies continue to announce major layoffs.

Recommendation:

It finally happened, and with an exclamation point! The dairy market nearly always comes down faster than it goes up, and that held true again this week. With most of the spot market price declines coming on Thursday and Friday, an amazing \$2.42/cwt was gutted from the Class III calculation. On Friday, the cheese/butter/powder equivalents worked out to \$15.59 milk; today, \$13.17. And the short-term future looks bleak. We may see another small push or two, but for the most part, it appears holiday buying is done. In the mean time, more cheese will be made over the holidays as schools close and milk looks for a home. With butter just above the support price and powder already there, much of that milk looks headed toward the vat as it still represents a better economic return. Lots of folks calling now wondering how low we'll go. We don't know the answer, but it appears lower before higher. Multiple sellers lined up in this week's cash markets, with the one major buyer present in previous weeks, largely absent this week. It's likely sellers will return again next week, with \$12 milk prices not too far away. At this point, however, we're pretty reluctant to sell milk, unless you can cash flow. We would, however, recommend starting to cover your second half sold positions with call options. To fund them, you may want to sell July-Dec 2009 12.00 puts and buy July-Dec 17.50 calls for an average cost of 10¢ per month. With this trade you keep your downside protection unless we go below \$12 in those months, and protect your sold positions from a rally above \$17.50. Give us a call if you're interested in putting this trade on or want a further explanation.

Grains: December '09 corn reached \$3.50/bu just a week ago today settled at \$4.19/bu. It is following crude oil, which was at 38 now at 46. We believe \$3.50/bu represents good value for the Dec '09 contract, and think if crude returns to the sub \$40's and farmer selling comes in after the first of the year, we could see new lows in that contract. That maybe a good time to lock in some corn. Thoughts of \$25 crude, while possible, seem remote at best and will only come about with a collapsed world economy, and even startlingly bearish new ending stocks projections from USDA Thursday couldn't keep the corn market from moving higher, confirming the outside markets' overwhelming influence. For proteins, consider buying soybean meal at \$248/ton and look for a rally into the end of this year to \$280/ton using the January contract.

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