

**The KDM Dairy Report – January 23<sup>rd</sup>, 2009**

**What's Bullish:**

- Western United Dairymen is calling on Congress for immediate action on the dairy crisis, according to their weekly newsletter. A proposal, adopted at their board meeting on 01/16, calls for additional funds to be allocated from the US House stimulus package, for the CWT herd retirement program to target the immediate removal of 320,000 milk cows. It isn't without controversy. The National Cattlemen's Beef Association subsequently sent a letter to members of the US Senate opposing such an effort, as it could drastically reduce the price of beef cattle.
- Cash Market: Block buyers continued to chew through offers this week, picking up 21 loads and bumping the price up ½¢ to \$1.07½/lb. Barrels were much quieter, with just one load traded, while the price gained a penny to \$1.10/lb. 8 cars of butter exchanged hands, but butter gave up a penny to settle at \$1.10¼/lb.
- Livestock Slaughter Report: Dairy cow slaughter in December totaled 228,900 head, up 24,200 head from last year, and the highest December total since 2003. On an annual basis, 2.6 million head were culled, 94,400 head more than in 2007.
- Cheese plants in the Northeast continue to run on heavy schedules to meet strong retail ordering, according to Dairy Market News. Retail promotions are in place to take advantage to lower cheese prices, especially in advance of the Super Bowl.
- In the Midwest, cheese orders are steady to improved for retail, with features underway generating additional consumer interest, according to Dairy Market News. Buyers report tighter supplies of mozzarella and provolone, as many pizzerias have loaded up at current market prices. Food service accounts are preparing for the usually stronger Super Bowl related pizza promotions, and buyers have to wait at least normal lead times to get orders filled.
- Fluid Milk & Cream Review reports milk production in the Northeast has been below expectations, which is puzzling some balancing plant managers. In the Mid Atlantic, fluid demand was particularly strong, attributed partly to the large number of people who travelled to Washington, D.C. this week. Milk sales were also strong in the Southeast, with order "add-ons" being reported.
- Manufacturers and handlers of butter in the Central region are surprised at the fairly good demand there is for butter. Low prices and feature activity by retailers are helping move product.
- Producers are implementing ways to reduce milk production costs, which is lowering milk output in California, according to Fluid Milk & Cream Review. Slaughter volume has been high in the state, and heifer calf prices have fallen \$50-75 per head. In the Pacific Northwest, producers are very concerned about hay prices for the first quarter. Many are trying to cut costs as much as they can, which includes cheapening rations even further.
- Dairymen have begun to trim their herds in a big way. Dairy cow slaughter for the week ending 01/10 totaled 71,700 head, the biggest weekly cull in 12 years.
- International: Carryover influences from last season's drought, dryer than usual conditions in some dairy areas and poor economic factors have resulted in a downward revision of milk production in New Zealand. Dairy Market News reports early season projections of an 8% increase have been replaced with just a 2-3% gain.
- International: Dairy output in December crashed in China, slumping 20% compared to a year ago, according to the country's National Bureau of Statistics.

Futures Month	Friday 01/23 Close	Friday 01/16 Close	Change
Jan-09	\$10.78	\$10.67	<b>\$0.11</b>
Feb-09	\$9.38	\$9.35	<b>\$0.03</b>
Mar-09	\$10.03	\$9.74	<b>\$0.29</b>
Apr-09	\$10.57	\$10.28	<b>\$0.29</b>
May-09	\$11.00	\$10.65	<b>\$0.35</b>
Jun-09	\$11.98	\$11.55	<b>\$0.43</b>
Jul-09	\$12.90	\$12.22	<b>\$0.68</b>
Aug-09	\$13.77	\$13.08	<b>\$0.69</b>
Sep-09	\$14.25	\$13.46	<b>\$0.79</b>
Oct-09	\$14.28	\$13.50	<b>\$0.78</b>
Nov-09	\$14.38	\$13.66	<b>\$0.72</b>
Dec-09	\$14.40	\$13.69	<b>\$0.71</b>
Jan-10	\$14.35	\$13.64	<b>\$0.71</b>
Feb-10	\$14.40	\$13.67	<b>\$0.73</b>
Mar-10	\$14.42	\$13.83	<b>\$0.59</b>
Apr-10	\$14.20	\$13.99	<b>\$0.21</b>
May-10	\$14.73	\$14.25	<b>\$0.48</b>
Jun-10	\$14.56	\$14.56	<b>\$0.00</b>
<b>2009 Avg</b>	<b>\$12.31</b>	<b>\$11.82</b>	<b>\$0.49</b>
<b>Q1Q2 2010</b>	<b>\$14.39</b>	<b>\$13.71</b>	<b>\$0.68</b>

**What's Bearish:**

- Cold Storage Report: Stocks of American cheese in December were up 6% from a year ago and up 3% from November, according to USDA. Total cheese stocks were up by the same amounts. Butter stocks, however, were down 23% vs. last year and down 1% from Nov.
- Livestock, Dairy & Poultry Outlook Report: Flagging demand will likely continue to depress prices and producer profitability in 2009, according to USDA. The U.S. dairy herd is forecast to decline modestly in 2009, and milk production is expected to be up less than 1%. The milk-feed ratio in 2009 is forecast to be the lowest since the 1980's. Dairy prices are anticipated to remain low until at least mid-year, with higher prices dependant on lower production to be more in line with demand. Class III is forecast to average \$11.00 for 2009, down \$3.90/cwt from last month's forecast.

- Even with very little downside price risk, Western cheese sales are slow, according to Dairy Market News. Some buyers are uncertain about future demand so are holding back, while others are unable to get the credit they need to make additional purchases. Retail orders are steady, but food service orders are a problem. Block offerings are particularly heavy in the region.
- Prices for all Class III components fell in this week's NASS survey. 40-lb blocks shed 12.4¢ to average \$1.22/lb, while 500-lb barrels fell 1.7¢ to \$1.26/lb. Butter decreased 4.2¢ to average \$1.08/lb, nonfat dry milk lost 0.4¢ to 83¢/lb and dry whey was down 0.2¢ to 16.9¢/lb.
- Weekly cold storage stats have cheese stocks up 4% and butter stocks up 27% at USDA selected storage centers, over the period 01/01 through 01/19. Roughly 4 million lbs were added to each.
- Churning schedules across the country remain very active, and often cream must move great distances to find willing buyers, according to Dairy Market News. Bulk butter was again offered to the CCC under the support program this week, bringing the total to 1.5 million lbs since the beginning of the year.
- Butter stocks at CME-approved warehouses increased 11.2 million lbs during the week ending 01/10. A year ago stocks increased by just 5.1 million lbs.
- Although orders are up for Class II items like dips and sour cream in preparation for the Super Bowl, discounts remain common in the Central region for manufacturing milk. Few, if any, plant operators are looking to add producers at this time to due their already heavy operating schedules and anticipation of even more milk in the spring.
- Fluid Milk & Cream Review reports processing plants in the Southwest are still full and at working capacity to handle the available milk and components. Class I interest is flat, cream supplies are heavy and churning output is near capacity to handle available supplies. In the Pacific Northwest, plants have access to all the milk they want, with weather conditions having no impact on milk production.
- Central dry whey inventories are building at several locations, according to Dairy Market News. This is spurring price concessions to manage stocks, with buyers finding few reasons to purchase beyond immediate needs. Prices dropped on the bottom end of the range to as low as 13¢/lb this week.
- Western nonfat dry milk prices remain stuck at the support price of 80¢, according to Dairy Market News. Sellers have to work hard to find sales and domestic interest is subdued. Cheese makers are using cheaper condensed skim and discounted milk before even considering NDM to enhance yields. Export interest is trending down, and with lower prices in Oceania and the reinstatement of subsidies in the EU, there is little incentive to go after export business that is priced below the CCC support price.
- International: The reintroduction of subsidies for finished dairy products has traders in the EU hopeful they can once again become more active in international trade, according to Dairy Market News. Sales have been minimal up to this point as European prices were generally higher than other international competition. Buyers remain selective in their purchases and are proceeding very cautiously.
- International: Manufacturers and handlers of dairy products in Oceania continue to report slow sales activity, according to Dairy Market News. Buyers are only procuring for short-term needs, so manufacturers are still being forced to find additional warehouse space for uncommitted volumes. Cheddar cheese prices in the region continue to fall, averaging just \$1.18/lb this week. Accounting for moisture and transportation differences, the U.S. equivalent would be about 99¢/lb.

### **Recommendation:**

Class III futures were finally able to establish a rally as cheese refused to drop any lower. Buyers picked up a lot of cheap cheese to stash away in aging programs. The rumor mill was in high gear as news of a potentially massive herd retirement program hit the street, and was later substantiated. A combination of covering spec short positions and long hedging was likely the cause of this week's welcome rally. We're still on the fence as to whether smoother sailing is ahead. From a supportive view, early this week you had to go out to May 2010 before prices got above \$14/cwt. As Bob Cropp wrote in his monthly Dairy Situation and Outlook report this week, "Market fundamentals don't support prices staying this low." We agree, and think the rally was in large part justified, especially for the last half of the year and into 2010. Word from our producers as well is telling us that things are getting very tough out there, and it seems a foregone conclusion that sadly, we will not have as many dairy operators with us this time next year. Beef and cull cow prices are already falling, making it more difficult to cash out. Grain prices are hanging in at high levels, making running a profitable dairy at current milk prices impossible. For the survivors, however, these factors, plus the potential of a large herd reduction, should combine to reduce milk production and support prices. However, from the negative side, there's still plenty of valid arguments to be made. Number one is the economy and how long and bad it gets. The "psychological" effect from the CWT herd buyout rumor could fizzle in a jiffy if dairy stays under the new administration's radar and gets no funding. The current buying also concerns us, as we wonder who will step up to buy cheese in 3-4 weeks when the coolers are full. And despite taking on a lot of cheese in the past couple weeks, prices are only marginally higher, with a Class III equivalent of \$8.90/cwt. Clearly the front months are still very vulnerable. It's hard to make a recommendation, but PUT options are always a good bet to protect milk you haven't sold, and we'd continue to target CALL options in the second half of the year for milk you have already marketed. It will be a very interesting 3-4 weeks.

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