

**The KDM Dairy Report – May 29<sup>th</sup>, 2009**

**What's Bullish:**

- Cash Market: We give the edge to the buyers this week as they managed to move blocks up 1¼¢ for the week, closing at \$1.15¼/lb today. Barrels were 2¢ higher than a week ago, settling at \$1.10/lb. Trading was heavy, with 37 loads of blocks and 24 barrels exchanging hands. Butter was unchanged for the week at \$1.26½/lb on 14 trades.
- Fluid Milk & Cream Review reports milk output in California is trending lower. Temperatures are increasing, which is affecting the herds, while low milk prices and moderate feed costs continue to hamper profitability. Production in Arizona is lower as well, declining from the seasonal peak. Hay sellers are finding little demand from the financially strapped dairy sector. Finally, in the Pacific Northwest, bankers and producers are negotiating operating loans, but neither side is happy with the current situation.
- Dairy Market News reports that despite exceptionally high production over the holiday weekend, dry whey prices in the Central region remain firm, and some contract buyers continue to experience delays in delivery. Spot market offerings are very limited and there is generally more demand than available product. Some brokers and resellers are intentionally holding inventory, hoping to offer sales at higher prices in the future.
- Western dry whey buyers are aggressively looking for additional supplies for current needs, according to Dairy Market News. Prices are rising at a faster rate. Both domestic and export buyers are snapping up any available offerings. Whey production levels are less than anticipated at some plants, leaving inventories tight to short of trade needs.
- The Eastern dry whey market remains very firm, according to Dairy Market News. Prices are rising and it is difficult to find product on the spot markets. Some contract deliveries are late and orders have been shorted.
- Commercial Disappearance: Use of American cheese in March was up a strong 9.1% vs. March 2008. For the first quarter, commercial disappearance of American cheese was up 3.7%. Butter use was up 0.3%, however, use of milk in all products fell 2%.
- NASS surveyed butter and dry whey prices increased again this week. Butter pushed 2.1¢ higher to average \$1.24/lb and dry whey bumped up 0.4¢ to 23.9¢/lb.
- The United States moved to subsidize some of its dairy exports on Friday, saying it was forced to respond to new European subsidies that have made it hard to compete in global markets depressed by the economic downturn. The DEIP (Dairy Export Incentive Program) program will help dairy exporters market products in areas where U.S. prices are not currently competitive, and help clear extra dairy product supplies.
- Despite a general drop in eating out by consumers, quick service restaurants reported the most favorable results from December to April, with 52% reporting higher sales and 38% reporting lower sales. This category also saw the largest overall improvement, with 6% more operations reporting higher sales and 11% fewer reporting lower sales.
- The recent run higher in crude oil and grain prices will put additional stress on dairy operations, hastening the eventual recovery.
- Economy: Consumer confidence in May hit its highest level in eight months, according to a survey released today. Durable goods orders in April were an unexpectedly strong 1.9%, while unemployment claims fell to 623,000 in the past week, a better reading than forecast by analysts.
- The U.S. dollar sank to a 2009 low against the Euro this week, as an improving U.S. economy lessened demand for the dollar as a "safe haven" currency. A weaker U.S. dollar makes our exports more competitive on the world market.

Futures Month	Friday 05/29 Close	Friday 05/22 Close	Change
May-09	\$9.83	\$9.82	<b>\$0.01</b>
Jun-09	\$10.22	\$10.12	<b>\$0.10</b>
Jul-09	\$11.16	\$11.02	<b>\$0.14</b>
Aug-09	\$12.52	\$12.39	<b>\$0.13</b>
Sep-09	\$13.78	\$13.62	<b>\$0.16</b>
Oct-09	\$14.34	\$14.25	<b>\$0.09</b>
Nov-09	\$14.77	\$14.61	<b>\$0.16</b>
Dec-09	\$14.95	\$14.76	<b>\$0.19</b>
Jan-10	\$14.97	\$14.85	<b>\$0.12</b>
Feb-10	\$14.95	\$14.69	<b>\$0.26</b>
Mar-10	\$15.32	\$15.10	<b>\$0.22</b>
Apr-10	\$15.68	\$15.45	<b>\$0.23</b>
May-10	\$15.68	\$15.50	<b>\$0.18</b>
Jun-10	\$15.90	\$15.75	<b>\$0.15</b>
<b>Jun-Dec</b>	<b>\$13.11</b>	<b>\$12.97</b>	<b>\$0.14</b>
<b>Q1Q2 2010</b>	<b>\$15.08</b>	<b>\$14.88</b>	<b>\$0.20</b>

**What's Bearish:**

- NASS cheese prices continued to slip this week. 40-lb blocks decreased 1.7¢ to average \$1.15/lb in this week's survey, while barrels slipped 0.7¢ to \$1.10/lb.
- Weekly cold storage numbers show both cheese and butter stocks increasing during the period 05/01 through 05/25. Cheese holdings at USDA selected storage centers increased 3.7 million lbs over the period, while butter holdings increased a more modest 204,000 lbs.
- Dairy cow slaughter for the week ending 05/16 was 47,600 head, up from 44,200 a year ago, but down 3,000 head from last week.
- Fluid Milk & Cream Review reports plants in the Eastern region of the country were "running out of things to do" with the tremendous amount of milk received over the holiday weekend. Northeast plants were full, dryers were operating

at capacity and cheese plants had discounted milk readily available. In the Mid-Atlantic, plants were offered milk that they couldn't take, due to already being at max capacity, and in Florida, milk sales are strong, but milk production also remains strong due to lack of heat and humidity. 172 loads of Grade A milk were exported from the state this week, compared to just 83 a year ago.

- Milk and component supplies in the Central region were heavy over the holiday weekend, according to Fluid Milk & Cream Review. Manufacturing milk supplies were discounted as low as \$4-5 below class. Milk components are lower, but seem to be holding up better than many expected.
- Butter production in the Central region continues to outpace demand, according to Dairy Market News. Surplus stocks are clearing to inventory for use later in the year.
- Surplus milk in the Northeast is fueling heavy cheese production, according to Dairy Market News. So much discounted milk was available that normally idled auxiliary cheese plants were in full operation, making process and cheddar varieties.
- Dairy Market News reports the cheese market in the Midwest is being pressured by increasing volumes of cheese offerings and near peak volumes of milk. Class I needs are dropping as more schools let out for the summer, and the extra milk is generally going into cheddar production.
- International: New Zealand's output is projected to be about 7½% ahead of last season by the end of the fiscal year, according to Dairy Market News. In Australia, output is projected to be flat to slightly higher than last year on a cumulative basis.

### **Recommendation:**

Fundamentally, there is still nothing very bullish for the short-term. The Midwest and Eastern regions of the country were flooded with milk over Memorial Day weekend and even idled cheese plants were put in to service to handle the surplus. A lot of cheap cheese was made as steeply discounted milk was widely available. Buyers in the cash market were very aggressive this week, and we'll give them the upper hand as they took on a combined 61 loads of blocks and barrels. Either demand is very good or they continue to fill warehouses for the fall, or both. Bottom line is they don't feel there's much downside from current prices, so why not stock up. We can't argue with that. As a result of the active buying, Class III futures managed a gain for the week. Today's trade was wild. As futures slowly moved higher during the week, more and more short-covering occurred, until this morning when the market burst as much as 25 higher in the front months as traders scrambled out of positions. However, when cheese buyers only moved blocks a ¼¢ higher, sellers slammed the markets well into negative territory. It proves that psychology still plays a major role in trading. The aggressive buying all week gave the impression that prices were ready to take off, yet, even with the gains in the cash market, the current cheese, butter and powder prices still only work out to about \$9.90 milk. The June contract has two weeks of its calculation under its belt at sub \$10 milk prices, yet is still carrying a 30¢ premium to cash. If cheese doesn't start rallying very soon, June will again grind lower, quite possibly below \$10. That also leaves July and Aug very vulnerable due to their large premiums to current cheese prices. Longer term, the market has decided that there isn't much downside to the deferred months, and they may be right. The biggest net gains for the week were in the 2010 contracts. Stories of financial hardship / bankruptcies / liquidations on the farm are on the increase, and it hardly seems possible that prices could stay sub-\$14 for too much longer. And word on the street is that CWT will announce the next round of the herd buyout sooner rather than later. We view the next two months as critical to determining who's left standing and what impact it will have on production. Wall Street is beginning to wake up to the fact of the weakening dollar as well, with the word "inflation" suddenly on more and more people's lips. Take crude oil, with near record inventories at storage locations, still on a bull run. Crude oil is denominated in U.S. dollars world wide, so as the value of the dollar has fallen, crude has risen since it now takes more dollars to buy a barrel of crude. Grains are running higher as a result, in addition to a cold, wet spring delaying planting in major grain states. All these factors are supporting higher milk prices in Q4 and beyond. As far as what to do with this market, we would buy at-the-money PUT options Jun-Aug to protect your milk from further price declines. Despite the aggressiveness of cheese buyers this week, we also need to remember that sellers appeared more than happy to be rid of those 61 loads of cheese and did not allow much of a gain in cheese prices. We would expect this pattern to continue next week, ie. fairly heavy trade volume and incremental gains in the cheese prices. But incremental gains will only serve to bring the front months lower. Get your hedge on!

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