

The KDM Dairy Report – June 5th, 2009

What's Bullish:

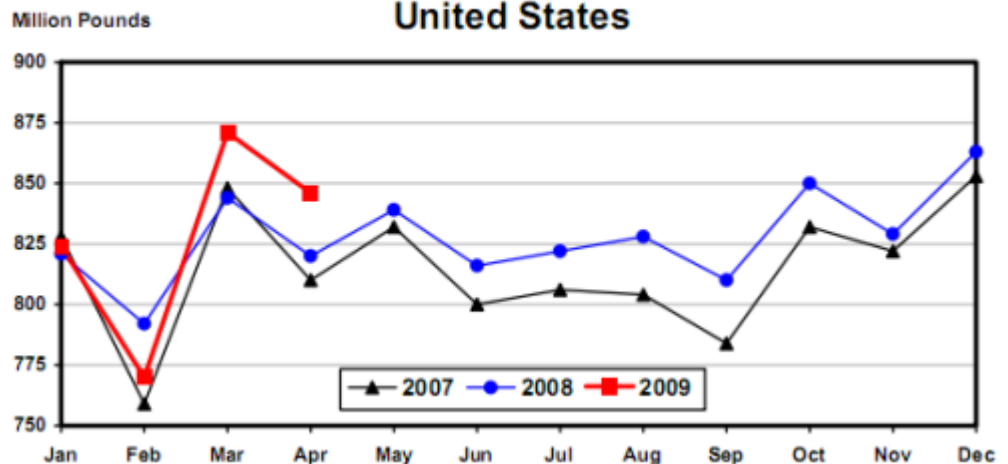
- Ag Prices Report: The May milk to feed ratio dropped to a new all-time low of 1.47, according to USDA, and April was revised lower to 1.58. The milk-feed ratio has been below 1.6 for all of 2009.
- Dairy cow slaughter for the week ending 05/23 was 52,600 head, up 5,000 head from last week and up 7,000 head from the same period a year ago. CWT culling efforts are likely under way.
- California milk production is moving lower across the state, and processing plants are easily handling the milk supply, according to Fluid Milk & Cream Review. Financial stress at the producer level is ratcheting higher, and major coops in the state this week announced a plan to reduce base levels of producers by 5%, in an effort to bring supply and demand into balance. Milk output in Arizona and New Mexico is falling as well, as heat becomes more of a factor, and the first CWT herds are cleared out. Fluid sales are up in the region as supermarkets are featuring milk as low as \$1.47/gal. Record-setting heat in the Pacific Northwest is stressing both cattle and crops. Contacts expect this may put a cap on milk production, along with the start of the CWT buyout reducing the number of cows in the area. Processing plants are running with no capacity issues.
- Central dry whey prices were unchanged to higher on a firm market, according to Dairy Market News. Product continues to move to Western and international destinations, despite the freight costs involved.
- Western dry whey buyers need and want powder and are willing to pay what it takes to find it, according to Dairy Market News. Export sale are also strong, with no real push back on prices. Stocks are light to nonexistent, and the market has a firmer undertone than just a few weeks ago.
- Dry whey is a seller's market in the Eastern region, according to Dairy Market News. Buyers have to work hard to find sources of available product on the spot market, and inventories are very tight.
- Economy: Unemployment jumped to 9.4% in May, the highest in more than 25 years; however, the pace of layoffs eased much more than expected, with employers cutting 345,000 jobs, the fewest since September. Analysts had expected 520,000 jobs would be cut.
- Big net gain in grains and crude oil this week could hasten dairy closures.

Futures Month	Friday 06/05 Close	Friday 05/29 Close	Change
Jun-09	\$9.89	\$10.22	(\$0.33)
Jul-09	\$10.65	\$11.16	(\$0.51)
Aug-09	\$11.57	\$12.52	(\$0.95)
Sep-09	\$12.85	\$13.78	(\$0.93)
Oct-09	\$13.60	\$14.34	(\$0.74)
Nov-09	\$14.16	\$14.77	(\$0.61)
Dec-09	\$14.39	\$14.95	(\$0.56)
Jan-10	\$14.55	\$14.97	(\$0.42)
Feb-10	\$14.60	\$14.95	(\$0.35)
Mar-10	\$15.05	\$15.32	(\$0.27)
Apr-10	\$15.05	\$15.68	(\$0.63)
May-10	\$15.20	\$15.68	(\$0.48)
Jun-10	\$15.66	\$15.90	(\$0.24)
Jul-10	\$15.80	\$15.95	(\$0.15)
Aug-10	\$15.82	\$15.96	(\$0.14)
Sep-10	\$15.80	\$15.93	(\$0.13)
Oct-10	\$15.68	\$15.77	(\$0.09)
Nov-10	\$15.85	\$15.95	(\$0.10)
Dec-10	\$15.80	\$15.75	\$0.05
Jun-Dec	\$12.44	\$13.11	(\$0.66)
2010	\$15.41	\$15.65	(\$0.25)

What's Bearish:

- May Class III milk was announced at \$9.84/cwt today, down from \$10.78 last month and May's lowest close since 2003.
- Cash Market: Cheddar blocks lost 1/2¢ for the week to settle at \$1.143/4/lb, while barrels were unchanged at \$1.10/lb. Trading was fairly active with 21 loads of blocks and 5 loads of barrels exchanging hands. Butter saw its first loss in weeks, falling 1 1/4¢ to close at \$1.25 1/4/lb today. Trading was active with 29 cars exchanging hands.
- Dairy Products Report: American cheese output in April was up 3.2% vs. a year ago, according to USDA, and Total cheese output was up an identical 3.2% (see graph). Butter production, however, fell 3.9% compared to last year
- Milk production in the Eastern region of the country is unusually high for this time of year, according to Fluid Milk & Cream Review. Weather is playing a factor as temperatures have only reached the high 50's and 60's. Some balancing plants received more milk last weekend than they did over Memorial Day weekend, causing some surprise. Milk intakes

**Total Cheese Production
United States**



are described as “massive” in the Mid-Atlantic; and the high level is straining equipment capacity and delaying needed maintenance. Southeast milk production is extremely burdensome. The full plants have resulted in 15 to 18 hour waits for tankers before they could unload milk. Auxiliary production capacity used only during heavy production periods, continued to be operated this week. The summer recess of schools continues, further lowering fluid demand. Florida exported 238 loads of Grade A milk this week, compared to 172 last week and just 86 a year ago.

- Fluid Milk & Cream Review reports Class I demand as slower due to most schools closing for the summer. Cheese milk interest is low, with big discounts needed to move surplus loads. Many operations are full with their own patron milk and are unable to handle extra volumes. Some milk handlers are saying this may be the worst spring for handling the heavy supply of surplus milk in a number of years.
- Substantial milk is available to Eastern cheese manufacturers, according to Dairy Market News. Retail price promotions are moving product, but cheese output is still surpassing current demand. This is leading to increasing inventory levels. Cheese continues to be manufactured by plants usually only seasonally operated to help clear heavy milk intakes.
- Dairy Market News reports a larger share of Midwest milk is now available to cheese plants as schools close for the summer. Cheese demand is moderate. Some in the industry report bulging warehouses full of bulk cheese, placed into storage for later year use and to rebuild aging programs. Standard varieties of cheese are readily available.
- Western cheese buyers are taking cheese to replace current sales, but they are not doing much ordering for future needs, according to Dairy Market News. Offering of cheese in the West are sufficient for current levels of interest, and market contacts don't see much of a reason for prices to change in the short run. Ample milk is still available to allow for plenty of cheese production for the next few weeks to cover any additional interest.
- USDA's Weekly Cold Storage report shows a big build in cheese stocks over the month of May. Holdings at selected storage centers were up a strong 6%, or 6.8 million lbs. Butter stocks were about unchanged over the same period.
- NASS cheese prices continued to slip in this week's survey. 40-lb blocks averaged \$1.14/lb, down 0.6¢, while 500-lb barrels decreased 0.1¢ to \$1.10/lb.
- Butter stocks at CME-approved warehouses increased 1.5 million lbs for the week ending 05/30. This compares to a drawdown of 102,000 lbs during the same period a year ago. Stocks, however, are still 36 million lbs below 2008 levels.
- The U.S. dollar was sharply higher on Friday, as domestic jobs data sent hopeful signs about the economy. The dollar rise against the Euro was its biggest advance since April. A stronger dollar could potentially hurt ag exports as our goods become more expensive on the world market.

Recommendation:

Total cheese production in April was up 3.2%, despite milk production being down 0.1% that month. Unfortunately there's not much positive to say. The milk and cheese markets are sick, sick, sick, and look to stay that way for the next 30-60 days. Despite the harshest economic climate dairies have ever faced, we have yet to reduce the milk supply enough to right the ship. This week's USDA cheese updates and fluid milk reviews were downright nasty. With the exception of dry whey and the Western milk supply, all other parts of the country appear to still be awash in milk, with warehouses “bulging” with cheese. We see the next 60 days as critical in determining who survives and who doesn't. The economic hardship seems to be moving from West to East. Early on, it was Western dairies who felt the economic pain first, and it's gone on long enough that their milk supply is now trending lower and their plants are not so full. Contrast that with the Midwest and East, where production is still very strong and plants are struggling to process all the milk. However, we are beginning to hear more and more stories of financial struggle in the Midwest and Eastern regions, as the economic tsunami sweeps eastward across the country; no one can turn a profit at these prices. Then we will finally see milk production drop in these areas. Cheese buyers in the cash market were aggressive early in the week, but as they were dumped load after load of cheese with no success in moving prices higher, sellers took the upper hand and even moved the blocks lower on the week. Traders began realizing, along with bearish fundamental updates coming in, that the cash market would be going nowhere in the short run, and hit milk futures hard. With cash cheese still pricing about \$9.90 milk, the Aug and Sep contracts took the biggest hit, losing nearly \$1.00 for the week. With little expectation for basic fundamentals to improve soon, we expect prices in '09 and Q1 '10 to continue to fall near term. This is a tough time to trade. It's hardly palatable to sell July-Dec at current prices, but the fact is they will most likely fall further before we see any substantial rally. As we recommended several weeks ago, those producers who are more aggressive and willing to take higher risk, should sell these contracts, but be ready to buy them back or cover them with call options to protect themselves from a breakout to the upside. For the conservative risk taker, consider buying \$12.50 PUT options Sep-Dec to get a floor under your milk. Low prices will eventually cure low prices, it's just taking longer than anyone thought possible.

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