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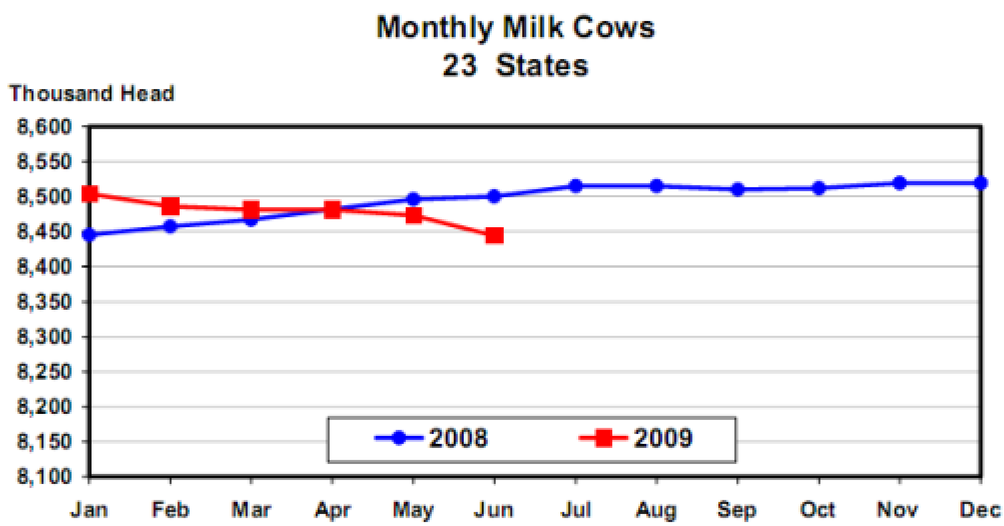
The KDM Dairy Report – July 17th, 2009

What's Bullish:

Futures Month	Class III 07/10 Close	Class III 07/10 Close	Change
Jul-09	$10.00	$9.88	$0.12
Aug-09	$10.52	$10.35	$0.17
Sep-09	$11.65	$11.17	$0.48
Oct-09	$12.46	$12.03	$0.43
Nov-09	$13.42	$12.94	$0.48
Dec-09	$13.98	$13.35	$0.63
Jan-10	$14.25	$13.80	$0.45
Feb-10	$14.49	$14.03	$0.46
Mar-10	$15.05	$14.49	$0.56
Apr-10	$15.30	$14.71	$0.59
May-10	$15.40	$14.82	$0.58
Jun-10	$15.84	$15.37	$0.47
Jul-10	$15.77	$15.43	$0.34
Aug-10	$15.95	$15.47	$0.48
Sep-10	$15.94	$15.55	$0.39
Oct-10	$15.80	$15.40	$0.40
Nov-10	$15.74	$15.32	$0.42
Dec-10	$15.84	$15.31	$0.53
Jly-Dec	**$12.01**	**$11.62**	**$0.39**
2010	**$15.45**	**$14.98**	**$0.47**

- Cash Market: Blocks picked up 5½¢ for the week to settle at $1.14½/lb while barrels gained 5¢ to close at $1.14/lb as sellers backed away in the latter part of the week. Trade activity was lighter, with 15 loads of blocks and only 3 barrels exchanging hands. Butter increased 2¾¢ to settle at $1.25/lb on 26 trades.
- Milk Production Report: Output in June was down 0.2% compared to last year and cow number dropped 34,000 head from May, due in part to CWT. There are now 9.235 million cows in the milking herd, down 86,000 from last year (see graph). However, milk per cow was up 13 lbs vs. 2008. Big drops in output were seen in some Southwest states, including AZ down 6.1% and CA down 4.1%.
- This week's NASS survey was mostly supportive of the Class III complex. While the block price decreased 0.7¢ to average $1.13/lb, barrels jumped 1.1¢ to $1.11/lb and dry whey increased 1.2¢ to 29.3¢/lb. Non fat dry milk gained 0.6¢ to average 85¢/lb, but butter decreased 0.2¢ to $1.17/lb.
- Dairy cow slaughter for the week ending 07/04 was a strong 52,600 head, 16,800 head higher than a year ago. YTD, the dairy cow cull is now ahead of last year by 215,000 head.
- Butter stocks at CME-approved warehouses finally went into a drawdown this week. 1.2 million lbs were pulled from storage, which was more than the 703,000 lbs pulled a year ago at this time.
- Exports of milk from Florida declined to 124 loads this week, from 140 last week, according to Fluid Milk & Cream Review. Further reductions are expected in the coming weeks as heat and humidity have resumed.
- Milk production in the southern sections of the Central region were noting large declines, according to Fluid Milk & Cream Review. Hot weather, feed costs, ration adjustments, CWT buyouts, financial stress and credit availability are all contributing factors to the drop.
- Fluid Milk & Cream Review reports processing plants in California are now running on reduced schedules, reflecting lower milk receipts. Production is declining in California as hotter weather has rolled in. Lower fat and protein levels due to feeding decisions are compounding the situation. Cows are giving less milk in Arizona as well, with temps often above 110 degrees, despite heat abatement measures. Output in New Mexico is 5-7% below a year ago in recent weeks, and is attributed to poor production conditions and feed.



- Milk output is trending lower in the Pacific Northwest, according to Fluid Milk & Cream Review, as more culling of marginal cows is taking place in an effort by producers to reduce costs. Plants are running on reduced schedules.
- Exports of dry whey for the first five months of the year were up 15%, according to the Foreign Ag Service. The top destination was China, which increased its purchases by 89%.
- Seasonal reductions in milk output, while less than normal, have still resulted in lower cheese manufacturing, particularly in southern portions of the East, according to Dairy Market News. This is expected to marginally reduce the quantity of cheese moving to consumers.
- Dairy Market News reports cheese output is trending lower in the Western region, and yields on incoming milk are below expectations.

- Economy: June housing construction rose in June to the highest level in seven months, according to the Commerce Department. Construction of new homes jumped 3.6% to and adjusted annual rate of 582,000 units, well above analyst expectations of 530,000.
- International: Packaged milk sales in Australia are up 1.9% YTD through June, according to Dairy Australia.

What's Bearish:

- Livestock, Dairy & Poultry Outlook Report: USDA is bearish in their most recent look at the dairy market. They say moderating feed prices and gains in milk per cow will result in only a slight decrease in milk production, despite lower cow numbers. That, and continued weak exports, they say, will keep cheese prices in the $1.21 to $1.24 range for the balance of 2009, and between $1.53 and $1.63 in 2010. That puts Class III milk between $13.90 and $14.90/cwt next year (we think that's too low, however).
- Weekly cold storage numbers indicate both cheese and butter stocks are on the increase in July. For the period 07/01 through 07/13, butter holdings at USDA selected storage centers jumped 3% and cheese holdings were up 1%.
- Milk production in the Northeast and Mid-Atlantic regions continues to be above normal seasonal levels, according to Fluid Milk & Cream Review. Unusually cool weather, with some areas experiencing high's in the 40's this week, are contributing to the higher output under perfect milking conditions. Plant receipts are high enough that normal maintenance, usually performed at this time of year, has to be postponed due to increased operating schedules.
- Manufacturing milk offerings were heavier this week in the Midwest, according to Fluid Milk & Cream Review. Prices for spot loads of milk were steady to slighter weaker, as milk volumes are declining very slowly due to ideal, cool weather conditions.
- Exports of butter and milkfat for the first five months of the year were down 79%, according to the Foreign Ag Service. Exports of nonfat dry milk were down 53% over the same period, while exports of cheese and curds were down 30%.
- Central dry whey prices firmed slightly this week, but re-sellers were "shopping" their product to potential buyers more aggressively, according to Dairy Market News. Sales were slower as buyers believe prices are nearing potential peak levels.
- Dairy Market News reports export demand for Western dry whey is backing off. The market tone is leveling as domestic demand is only fair and some additional offerings were being shown from resellers.
- The supply of cheddar cheese under 30 days old remains ample for needs in the Midwest, according to Dairy Market News. They conclude that prices are likely to remain low until the volume of cheese "in the pipeline" declines appreciably. Few packagers need overtime to fill orders unless to make up for the recent holiday, and many process lines are having difficulty filling a full 40-hr schedule. A lot of cheese is already in storage, so most buyers are reluctant to add more.
- Demand for Western cheese of all varieties is often below expected levels, according to Dairy Market News. Buyers are being offered cheese and they realize that pricing is at the low point, but they also don't anticipate the upswing starting soon.

Recommendation:

We may have rounded the corner, but we're not ready to call the bear market over….yet. Class III powered higher this week on the back of a cash cheese market that stormed higher. Short term fundamentals are still bearish, but the job of the futures market is to predict the future, and right now, it's **anticipating** that supply will be in much better balance with demand soon. Trade volume was very heavy on the move up, with even the 2010 contracts attracting a lot of attention. It's been pointed out by others that "open interest", the total number of active positions, in the 2010 contracts was 60% below year-ago levels. It's an indication that long hedgers, commercial end-users of milk and cheese, had not substantially begun their risk management programs yet. It may be that they have now, figuring that downside from current prices in those months is limited. Long hedgers buy milk futures to protect themselves from higher milk and cheese prices. this activity, of course, puts upward pressure on the market. While we still have plenty of cheese kicking around, one can't help but notice the repetitive emphasis on declining milk receipts, lower yields and lighter manufacturing schedules. Sure, it's seasonal and happens every year at this time, so we take it into perspective, but we note it nonetheless. If the milk supply does contract substantially this month, due in part to the heat in the Southwest, we could see current cheddar aged 30 days or less, get quite a bit tighter than it is now, and a milk production report in August that shows July output down significantly. If that happens, it may not matter how much cheese is stuffed into warehouses, cheese will move higher in the cash market. Be prepared for some volatility down the road. Our rec from last week is unchanged. Continue to go after PUT options in the balance of the '09 contracts. Big players in the cheese market could move it back down at any time. Aug-Oct are still especially vulnerable, so aggressively go after the PUTs in those months. Continue to be patient with 2010. We feel it has just begun to correct.