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The KDM Dairy Report – Aug 7th, 2009

What's Bullish:

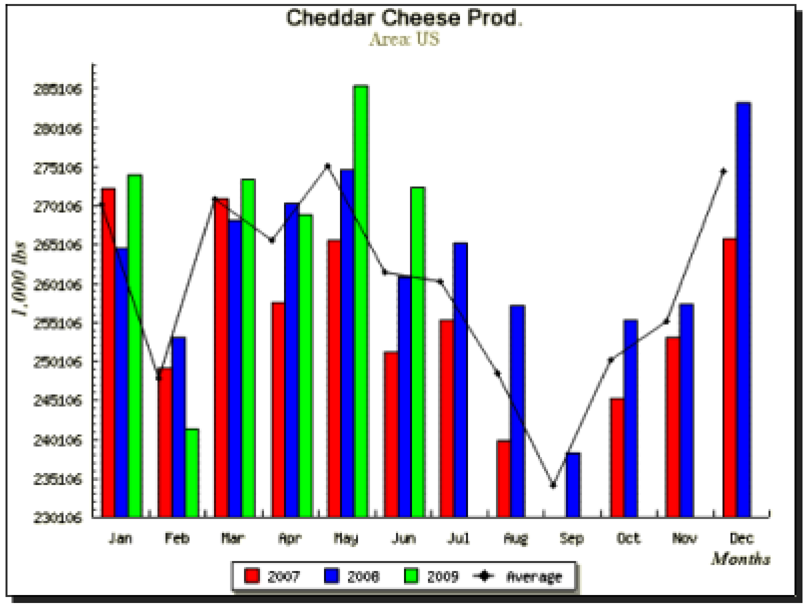
Futures Month	Class III 08/07 Close	Class III 07/31 Close	Change	Dry Whey 08/07 Close	Dry Whey 07/24 Close	Change
Aug-09	$11.09	$11.05	$0.04	29.53¢	29.25¢	0.27¢
Sep-09	$12.69	$12.40	$0.29	30.25¢	30.00¢	0.25¢
Oct-09	$13.25	$12.96	$0.29	30.25¢	30.00¢	0.25¢
Nov-09	$13.49	$13.50	($0.01)	30.25¢	30.00¢	0.25¢
Dec-09	$13.80	$13.80	$0.00	30.25¢	30.00¢	0.25¢
Jan-10	$13.90	$14.11	($0.21)	27.75¢	27.50¢	0.25¢
Feb-10	$13.97	$14.24	($0.27)	27.65¢	27.50¢	0.15¢
Mar-10	$14.03	$14.59	($0.56)	27.25¢	27.75¢	(0.50¢)
Apr-10	$14.32	$15.02	($0.70)	26.75¢	27.50¢	(0.75¢)
May-10	$14.40	$15.08	($0.68)	28.00¢	28.00¢	0.00¢
Jun-10	$15.15	$15.61	($0.46)	28.00¢	28.00¢	0.00¢
Jul-10	$15.55	$15.76	($0.21)	30.00¢	31.00¢	(1.00¢)
Aug-10	$15.60	$15.75	($0.15)	31.00¢	31.00¢	0.00¢
Sep-10	$15.64	$15.75	($0.11)	30.50¢	30.50¢	0.00¢
Oct-10	$15.81	$15.80	$0.01	31.00¢	31.00¢	0.00¢
Nov-10	$15.82	$15.78	$0.04	28.00¢	28.00¢	0.00¢
Dec-10	$15.89	$15.94	($0.05)	27.75¢	27.75¢	0.00¢
Aug-Dec	**$12.86**	**$12.74**	**$0.12**	**30.11¢**	**29.85¢**	**0.25¢**
2010	**$15.01**	**$15.29**	**($0.28)**	**28.64¢**	**28.79¢**	**(0.15¢)**

- Cash Market: Block cheese increased 2½¢ to $1.31/lb and barrels picked up 3¢ to $1.29 as bidders became more aggressive near the end of the week. 14 loads of blocks exchanged hands and just 2 barrels. Butter, however, lost 1½¢ to settle at $1.23/lb on heavy volume of 26 loads. Nonfat dry milk which rarely trades during the spot session, saw bidders come in and move the price up from 91¢/lb on Monday to 98¢/lb by Friday. There were two trades.
- CWT announced this week that it had accepted 294 bids representing 86,710 cows in their latest herd retirement program. Audits will completed by August 31st, with culling to be done by the end of September. CWT said they would be ready to conduct additional herd retirements this year to help address the supply-demand imbalance.
- The U.S. Senate voted to provide an additional $350 million for milk price supports. The new floor for cheddar blocks would be $1.40/lb and barrels would increase to $1.37/lb. The House still needs to approve the measure in September.
- Ag Prices Report: The milk to feed ratio for July was 1.65, up from last month's 1.45, but below a year ago at 1.90 and well below the 3.0 threshold usually held out as a level needed to encourage growth.
- NASS surveyed cheese prices increased this week as they begin their two-week lag catch-up to the cash market. 40-lb blocks averaged $1.13/lb, up 1.2¢ from the previous week, while 500-lb barrels increased a strong 3.5¢ to $1.16/lb. Butter lost 0.4¢ to average $1.22/lb and nonfat dry milk was down 0.9¢ to 84¢/lb, but dry whey increased 0.1¢ to average 29.6¢/lb.
- Fluid Milk & Cream Review reports milk production in the Northeast was steady this week, but rainy conditions in New England are stressing forage and grain crops to the point that producers are wondering whether their feed stock supplies will be adequate going into fall. The first notable reduction in the milk flow is being seen in the Mid Atlantic as heat and humidity rolled in. Bottlers are very busy, preparing for schools which are opening soon. Florida exported 68 loads of milk this week, down from 92 last week. Cream supplies are tightening.
- Processing plants in California are running on reduced schedules and have extra capacity, according to Fluid Milk & Cream Review. The effects of recent hot weather are still being felt as surplus milk offerings are limited. Recent sellers of milk have now become buyers, if supplies can be found. Yields have also been affected by the decline in milk solids of incoming milk. Extreme temps have eased in Arizona, but the drop in milk production remains. Plants in the state continue to run on reduced and limited schedules, and the start of schools is beginning to pull additional milk to bottling operations. In the Pacific Northwest, processors are reporting a 5-10% drop in milk receipts due to the heat. Manufacturing schedules are being adjusted to the lower intakes.
- Dairy Market News reports the market tone for nonfat dry milk is firmer, due to the government announcement that the support price will be raised. During the 3-month window of increased support pricing, producers are expecting to clear any uncommitted product to the CCC support program, which will keep current stocks cleared.
- Domestic consumption has increased and has offset the loss in sales to exports, according to Dairy Market News. Cheese production is steady in the Northeast, yet reduced fat cheddar is moving well.
- Dairy Market News reports the new support prices for block and barrel cheese have increased the value of inventoried product. In the Midwest, demand for natural varieties of cheese is good, with some operations needing overtime on certain lines. Lower milk and cheese output in California and the Southwest has resulted in some bulk short ordering from supplies in the Midwest.
- Stress from weather and seasonal drops in milk production have combined to lower total cheese production in the Southwest, according to Dairy Market News. The increase in the cheese support price resulted in immediate sales after the announcement, as buyers abandoned their "wait and see" attitude.
- International: The new milk production season in Oceania is about to begin, but it will start with moisture levels short of desired needs in many regions, according to Dairy Market News. An El Nino weather pattern continues to be

forecast, with hot temperatures and limited rainfall likely to brunt pasture growth. Producers have adjusted by instituting supplemental feed to their dairy rations, but this adds additional expense to an already discouraging financial picture.

- International: Dairy Market News reports Oceania cheese prices are holding steady, and that sales negotiations for the upcoming season are going well. In many instances, buyers are looking for additional volumes this season over previous years.

What's Bearish:



- Dairy Products Report: We made lots of cheese and butter in June. Cheddar cheese output in June was up 4.4% compared to a year ago and butter production was up 7.5%, according to USDA. Total cheese output increased 2.0% over June 2008.
- Weekly cold storage stats indicate cheese stocks at USDA selected storage centers increased 6% during the month of July. 7.4 million lbs were added to inventories during the month. Butter stocks, however, declined 8%, or 1.8 million lbs.
- Dairy cow slaughter for the week ending 07/25 was 49,700 head, equal to the number during the same period a year ago. Numbers should pick up again soon, however, as the cattle in the latest CWT round are removed from the herd.
- After being below last year's levels for all of 2009, butter stocks at CME-approved warehouses are now higher than in 2008. For the week ending 08/01, 95.7 million lbs were on hand, compared to 90.9 million lbs during the same period a year ago.
- Manufacturing milk interest in the Central region remains spotty at best, according to Fluid Milk & Cream Review. Most upper Midwest cheese plants continue to operate on much heavier schedules than anticipated, as milk supplies have held up better than expected by the cooler temperatures.
- Churning activity in the Central region of the country is often heavier than anticipated for this time of season, according to Dairy Market News. Sales activity is mostly domestic related, with very little international sales being reported. Food service buyers in resort and vacation areas report traffic flow is steady, but not at levels of previous years.
- Dry whey demand throughout the country is weak, according to Dairy Market News. Buyers feel that the price needs to be reduced in order to spur demand and are holding back on additional purchases.
- Cheese production in the Midwest remains seasonally active, according to Dairy Market News. Most plant operators would appreciate real summer heat to cause declines in milk receipts to allow for extra maintenance. Traders feel that CME cheese prices need to be further below the new support prices to warrant clearing any product to the CCC, while the current cheese supply/demand does not seem tight enough to maintain higher prices.
- International: Milk output in Western Europe is running slightly ahead of last season, according to Dairy Market News. Milk handlers are often diverting to butter/powder as it offers the best returns. International sales remain slow and unaggressive, with most sales activity centered on internal demand.

Recommendation:

Futures finished higher in the front months as news from CWT and the potential for an even higher support price for cheese influenced the market. On the flip side, the deferred contracts all lost ground on the week on the idea that the higher support price will ultimately lead to a longer recovery. It's hard to say who's right at this point. The new support price, if implemented, yields about $12.70 Class III, still not even close to cash flow for many operations. And it won't be implemented until October at the earliest, which may be too late for many. Milk production continues to fall in the Southwest to the point where they are now short of milk. However, the Midwest and East are still cranking it out. But school is starting soon which will draw milk away from manufacturing. At this point we still feel there is stronger upside risk than downside from now through June 2010. Futures had a strong "up" day today; should the rally continue into next week, we would go after 50¢ PUT options in those months. For July-Dec 2010, consider the strategy from last week to buy $14.00 PUT options and help pay for them by selling $18.00 CALL options. That's giving you a floor of $1.55 cheese with a cap at $1.96 cheese. On 20-25% of your production, this does not seem like a bad hedge at all. Call us next week for a quote on this min-max strategy.