

**The KDM Dairy Report – Aug 28<sup>th</sup>, 2009**

**What's Bullish:**

- Milk supplies in the Northeast have become very tight, according to Fluid Milk & Cream Review. Persistent heat in many areas, combined with bottlers refilling pipelines for school openings were cited as the causes. Cream supplies are also tight, with some plants going to the spot market to acquire needed supplies. In the Southeast, there has been a dramatic decrease in milk availability. 50 loads were imported into the region this week, but it will not be nearly enough to cover needs. The sudden decline has plants scrambling to secure additional supplies, but there is little surplus milk available. Combined with Florida, 92 loads were imported, compared to just 43 last week.
- Fluid Milk & Cream Review reports milk production in CA is below processor needs. More milk is being used to fill school needs, and the effect is a further tightening of milk available to make other products. Milk is being imported from nearby states to fill needs. AZ is expected to reach 115 degrees this week, worsening conditions for the milking herds. Milk is being shipped out to fill bottling needs, so processing plants are being run on reduced schedules. Drying activity has all but ceased. Milk production in NM is also on the decline, with manufacturing plants running on reduced schedules due to limited intakes. Processors in the Pacific Northwest are also looking for additional milk supplies from lingering affects of recent heat. Supplies of spot milk are very tight.
- Milk supplies in the Central region of the country are appreciably tighter than they were a few weeks ago, according to Fluid Milk & Cream Review. Manufacturers are making shipments of milk to meet pool requirements so are forced to seek volumes to offset these shipments. In the upper Midwest, demand exceeds the limited fluid supply and few spot loads are available. Manufacturing schedules have been reduced as a result. In the southern states of the Central region, milk supplies are very tight, as poor dairy economics, CWT buyouts, heat and fluid demand are making it difficult to meet dairy product commitments.
- Cheese demand in August must be decent. Cold storage holdings at USDA selected storage centers fell 1%, or about a million lbs for the period 08/01 through 08/24. Butter stocks fell 4% over the same period.
- NASS cheese prices increased again in this week's survey, in light of recent strength in the cash market. 40-lb blocks averaged \$1.29/lb, up 7.1¢ from last week, while 500-lb barrels jumped 5.7¢ to \$1.32/lb. Butter gave up 1.5¢ to average \$1.19/lb and dry whey lost a penny to 28.8¢/lb, but nonfat dry milk increased 1.2¢ to average 88¢/lb.
- Dairy cow slaughter for the week ending 08/15 was strong, most likely due to the start of CWT culling. 52,900 head exited the milking herd, compared to 51,400 during the same period last year. YTD, 1.8 million cows have been culled, vs. 1.6 million in 2008.
- Recent price increases have helped stimulate cheese orders in the Midwest, according to Dairy Market News. Lead times have extended somewhat for bulk buyers as they are ordering larger volumes in anticipation of stronger fall cheese orders. Interest is good for current barrels, as well as specialty American varieties. Plant operators seeking spot milk supplies are finding them to be limited, while cheese yields are lower due to seasonal adjustment of rations.
- Commercial Disappearance: Domestic cheese demand remains very strong, despite the poor economy. Commercial use of American cheese in June was up 5.8% vs. June 2008, according to USDA statics release this week. Other-than-American cheese use was up 2% for the same period.
- International: Although Chinese dairy consumption fell in the wake of the melamine scare, it is expected to return close to pre-crisis levels by the end of the year, according to Rabobank ag analysts quoted in a Financial Times article. English cheddar will soon be sold in supermarkets along the country's east coast and natural cheese consumption is set to experience big growth, alongside the expansion of fast food chains such as Pizza Hut and McDonalds.

Futures Month	Class III 08/28 Close	Class III 08/21 Close	Change	Dry Whey 08/28 Close	Dry Whey 08/21 Close	Change
Aug-09	\$11.22	\$11.21	\$0.01	29.50¢	29.50¢	0.00¢
Sep-09	\$12.37	\$13.00	(\$0.63)	30.00¢	30.00¢	0.00¢
Oct-09	\$12.62	\$13.45	(\$0.83)	29.05¢	30.50¢	(1.45¢)
Nov-09	\$12.98	\$13.44	(\$0.46)	29.75¢	30.50¢	(0.75¢)
Dec-09	\$13.12	\$13.64	(\$0.52)	29.55¢	31.25¢	(1.70¢)
Jan-10	\$13.48	\$13.79	(\$0.31)	29.50¢	30.50¢	(1.00¢)
Feb-10	\$13.70	\$13.98	(\$0.28)	28.50¢	28.50¢	0.00¢
Mar-10	\$13.72	\$13.95	(\$0.23)	27.80¢	28.75¢	(0.95¢)
Apr-10	\$14.23	\$14.28	(\$0.05)	27.25¢	28.50¢	(1.25¢)
May-10	\$14.35	\$14.42	(\$0.07)	28.03¢	28.03¢	0.00¢
Jun-10	\$14.74	\$14.88	(\$0.14)	28.08¢	28.05¢	0.02¢
Jul-10	\$15.14	\$15.14	\$0.00	29.00¢	29.00¢	0.00¢
Aug-10	\$15.40	\$15.44	(\$0.04)	30.53¢	31.00¢	(0.48¢)
Sep-10	\$15.65	\$15.45	\$0.20	30.00¢	30.00¢	0.00¢
Oct-10	\$15.59	\$15.56	\$0.03	30.03¢	30.00¢	0.02¢
Nov-10	\$15.59	\$15.61	(\$0.02)	28.03¢	28.00¢	0.02¢
Dec-10	\$15.78	\$15.70	\$0.08	27.75¢	27.75¢	0.00¢
<b>Aug-Dec</b>	<b>\$12.46</b>	<b>\$12.95</b>	<b>(\$0.49)</b>	<b>29.57¢</b>	<b>30.35¢</b>	<b>(0.78¢)</b>
<b>2010</b>	<b>\$14.78</b>	<b>\$14.85</b>	<b>(\$0.07)</b>	<b>28.71¢</b>	<b>29.01¢</b>	<b>(0.30¢)</b>

## What's Bearish:

- Cash Market: After three weeks of moving higher, blocks gave up 2¼¢ for the week, settling at \$1.36¾/lb. Barrels dipped 3¢ to close at \$1.34/lb. Trading was heavy as sellers returned with 30 loads of blocks and 25 loads of barrels exchanging hands. Butter was unchanged for the week at \$1.17/lb on 19 trades.
- Cream offerings in the Midwest remain heavier than usual for this time of season, according to Dairy Market News. As bottling operations continue to gear up for school milk programs, there will be more standardized cream volumes available to butter producers.
- Interest in acquiring extra loads of Central dry whey over monthly allotments has waned, according to Dairy Market News. It appears buyers may have sufficient holdings for the next few weeks and are not interested in further inventory building at this time.
- Dairy Market News reports despite reduced milk intakes, Western cheese supplies remain adequate for demand due to good inventory levels.

## Recommendation:

In our June 12<sup>th</sup> report, we stated, "Our bold prediction is that come the last day in August, Class III prices from Oct '09 on out will be higher than they are now." Well, we technically have one more trading day left in August, on Monday, but it will probably do little to make us right. In fact, at today's closing, the Oct '09 – Dec '10 average is \$14.41, but on June 12<sup>th</sup>, it was \$14.95, so in a little self-accountability, we admit we were wrong. Why were we off? We'd like to offer a couple reasons. First, government meddling with the support price, which continues to distort market forces. When the government increased the cheese support price, and with a further increase in the works, the markets sold off in anticipation of an artificial incentive to make cheese. When support prices are raised, volatility leaves the market (look at a milk price chart from the '80s or before) and prices also migrate towards support. With the potential for \$1.40 cheese support waiting to be voted on by the house in Sept, the front Class III futures months are heading towards their cheese-equivalent price of about \$12.50/CWT. Higher support prices also delay meaningful supply and demand recovery, which was a factor in missing our prediction. Secondly, the tenacity and ability of the American farmer to produce milk in an incredibly poor economic situation has been amazing. Just check out last week's milk production report. So, where do we go from here? We are still bullish long-term on the market. The wave of tight milk supplies, which started and formed in the West, has finally reached East coast, with even the Midwest now seeing some tightness. Something has to give... soon. It may be weeks yet, due to the amount of cheese we have yet to clear out of inventory, but strong domestic dairy demand and an improving international situation will eventually pull prices higher. Let's see where we are a month from now. We would continue to target the Jan-Dec 2010 min-max strategy, buying the 14.00 PUT and selling the 18.00 CALL for a net cost of 30-35¢ per month on up to 25% of your production. Get your orders in so they are ready to hit when the market rallies. For Q4 2009, consider buying Oct 13.75 CALL for 10¢, Nov 14.25 CALL for 17¢ and the Dec 14.50 CALL for 25¢. Then place orders with us or your co-op to sell milk at or near those levels.

Grains: Corn strategy for the rest of 2009 and into 2010. Fear of an early or average frost date has northern corn belt silage quality and corn yields in check. This has us trading a \$3.20/bu to \$3.40/bu price range on December 2009 corn. We recommend buying put options in December 2009 covering half of your corn needs for the next year. 3.20 PUTs are currently trading at 15¢. Then target to buy from your supplier at \$3.05 December futures. On a set back to \$2.90 December 2009, buy December 2010 futures at \$3.40 or better. This will give you a position for 2010/11 corn. With the cost of raising corn above that level, we should see prices rise in the winter months to buy acres for planting corn. If not, we could lose 2 million acres to beans and other crops. Call and we can discuss your situation.

Trading futures and commodities involves substantial risk and may not be suitable for all investors. You should carefully consider whether the risks involved in trading in commodities is suitable for you or your organization in light of your financial condition. While the information we gather and present is deemed to be reliable, it is in no way guaranteed. Neither the opinions expressed on this website nor in "The KDM Dairy Report", shall be construed as an offer to buy or sell any futures or options on futures contracts. In addition, past performance is not necessarily indicative of future results.