

**The KDM Dairy Report – Sep 4<sup>th</sup>, 2009**

**What's Bullish:**

- Cheddar prices continued to swing higher in this week's NASS survey. 40-lb blocks averaged \$1.33/lb, up 4¢ from last week, and 500-lb barrels increased 4.2¢ to \$1.36/lb. Butter was down 2.7¢ to \$1.17/lb, but nonfat dry milk increased 4.9¢ to average 93¢/lb and dry whey was up 0.3¢ to 29.1¢/lb.
- Both butter and cheese stocks declined during the month of August, according to USDA weekly cold storage numbers. Butter stocks fell 1.5 million lbs at USDA selected storage centers, while cheese stocks dropped 808,000 lbs.
- 58,200 dairy cows were removed from the milking herd this week, up sharply from last week, and 4,200 head higher than a year ago. The increase is most likely the result of CWT activities.
- Milk continues to be tight in the Northeast, according to Fluid Milk & Cream Review. Herd culling and increased Class I demand are causing reductions in production schedules, with shorting of contracts seen in some areas. In the Mid Atlantic, plants are scrambling to secure enough supply to meet their contract needs, and balancing plants running on shorter schedules. Milk supplies are very tight in the Southeast. 128 loads were imported this week, 36 more than last week, but it still fell short of providing adequate supplies, with some orders left uncovered.
- Fluid Milk & Cream Review reports the milk supply has tightened appreciably in the Midwest, aided by additional fluid shipments made to bottlers further south. Plant operators did not have much success in finding spot loads to offset this milk lost to pool shipments.
- Processors in California are noting a 3-5% drop in milk receipts this week, according to Fluid Milk & Cream Review. Economic factors were the reasons primarily cited. In the Pacific Northwest, processors are reducing schedules to adapt to available supplies since schools have started.
- As milk has become less available, cheese plants in the Northeast have reduced production schedules, according to Dairy Market News. And in the West, lighter milk intakes and lower cheese yields are being seen, while demand for cheese has increased due to the start of the school year.
- Extra loads of current cheese are now hard to come by in the Midwest, according to Dairy Market News. Lead times on new orders are least normal as the start of school has increased the bottlers' milk pull out of cheese operations.
- International: Hot weather is reducing milk volumes in Western Europe at a more rapid rate, according to Dairy Market News. This is causing demand for milk to be very aggressive. The butter supply is tight and prices are rising, along with prices for most manufactured dairy products. Whey prices are higher to sharply higher, as cheese production in Europe this summer is not as strong as in past years.
- International: The new milk production season in New Zealand is off to a slow start, with milk volumes about 3% behind a year ago, according to Dairy Market News. Pasture development is slow, in part due to some farmers deciding not to fertilize due to cost cutting measures. Lack of moisture continues to be a concern for dairymen in Australia, whose milking season is about to begin. In some northern regions that depend on irrigation, water allocations are basically zero, which will force producers to use more expensive, supplemental feed. Prices for all manufactured dairy goods are firming and buyer interest is gaining momentum.
- International: Prices for powder in the 15<sup>th</sup> round of the globalDairy Trading platform held on Sept 1<sup>st</sup> jumped 24.2%, according to Dairy Market News. It's seen as a sign that international demand for dairy is improving.

Futures Month	Class III 09/04 Close	Class III 08/28 Close	Change	Dry Whey 09/04 Close	Dry Whey 08/28 Close	Change
Sep-09	\$12.13	\$12.37	(\$0.24)	29.75¢	30.00¢	(0.25¢)
Oct-09	\$12.13	\$12.62	(\$0.49)	29.10¢	29.05¢	0.05¢
Nov-09	\$12.84	\$12.98	(\$0.14)	29.55¢	29.75¢	(0.20¢)
Dec-09	\$13.15	\$13.12	\$0.03	30.03¢	29.55¢	0.47¢
Jan-10	\$13.43	\$13.48	(\$0.05)	30.00¢	29.50¢	0.50¢
Feb-10	\$13.52	\$13.70	(\$0.18)	28.53¢	28.50¢	0.02¢
Mar-10	\$13.54	\$13.72	(\$0.18)	27.85¢	27.80¢	0.05¢
Apr-10	\$13.90	\$14.23	(\$0.33)	27.55¢	27.25¢	0.30¢
May-10	\$14.09	\$14.35	(\$0.26)	28.75¢	28.03¢	0.73¢
Jun-10	\$14.57	\$14.74	(\$0.17)	28.13¢	28.08¢	0.05¢
Jul-10	\$14.78	\$15.14	(\$0.36)	29.00¢	29.00¢	0.00¢
Aug-10	\$15.00	\$15.40	(\$0.40)	30.53¢	30.53¢	0.00¢
Sep-10	\$15.34	\$15.65	(\$0.31)	30.03¢	30.00¢	0.02¢
Oct-10	\$15.40	\$15.59	(\$0.19)	30.03¢	30.03¢	0.00¢
Nov-10	\$15.37	\$15.59	(\$0.22)	28.03¢	28.03¢	0.00¢
Dec-10	\$15.52	\$15.78	(\$0.26)	27.75¢	27.75¢	0.00¢
Sep-Dec	\$12.56	\$12.77	(\$0.21)	29.61¢	29.59¢	0.02¢
2010	\$14.54	\$14.78	(\$0.24)	28.85¢	28.71¢	0.14¢

**What's Bearish:**

- Dairy Products Report: Cheddar cheese output in July was up 0.7% from a year ago, and total cheese output was 2% higher over the same period. Butter production fell 2.2% vs. July 2008, and was down 11% from June.
- Cash Market: Blocks plunged 9¾¢ for the week to settle at \$1.27/lb, below the new U.S. gov't support price of \$1.31. Barrels fell 9¼¢ to close at \$1.24¾/lb. Trading was heavy as sellers dumped early-August made cheese before it was

too old to market at the CME Group. 30 blocks exchanged hands and 11 barrels. Butter was steady at \$1.17/lb on 11 trades.

- Despite cream supplies beginning to tighten, and churning schedules lower, overall output is often running ahead of previous years at this time, according to Dairy Market News. Butter demand remains good at the retail level, but food service orders are lower.
- While cheese production has declined in recent weeks, cheddar produced 30 days ago, in early August, is still eligible to sell at the CME, according to Dairy Market News. Many operations have inventoried large quantities of cheese earlier in the year, while reports indicate movement out of storage has been light.
- Butter stocks at CME-approved warehouses increased contra-seasonally, for the week ending 08/29. 2.1 million lbs were added to CME-approved warehouses, compared to a drawdown of 3.9 million lbs during the same period a year ago.
- While still well below 3.0, the milk-feed ratio for August was 1.76, up from 1.57 in July. Lower feed costs and a slightly higher milk price accounted for the increase.
- Economy: The U.S. unemployment rate hit a 26-year high of 9.7%, according to the Labor Department; this despite \$787 billion in federal stimulus money.

### **Recommendation:**

This is the third report in a row that is largely more bullish than bearish, yet Class III futures took it on the chin this week. Prices were hit due to cheese sellers, who were quite aggressive and from what we could gather, were trying to get rid of cheese made in early August, before the 30-day age deadline at the CME Group. Once cheddar is older than 30 days, it can no longer be traded there. With all this bullish news, including an improving international picture, it begs the question, when will 30-day cheese get tighter? As we commented last week, something has to give soon. We know that right now, milk is tight across the country. It should only be a matter of 30 days or so before we see some improvement. However, we may have over-estimated the power of the cash cheese market to influence prices, in light of the apparently large supply of cheese still in warehouses. 90%+ of cheese in this country is bought and sold "off exchange", meaning a private buyer and seller agree on terms and the deal is done. It could be that the sheer amount of cheese in storage is keeping more buyers away from the cash market. The old school of thought was that if 30-day cheddar became tight, it didn't matter how much cheese was out there, someone would push prices higher simply because they could. We're not sure which side is right, but it's probably somewhere in between. Despite the dose of humility this market has given us, we are still long-term optimistic about price recovery. The damage has been done at the farm level and production is down. Our recommendation is nearly identical to last week: 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 13.25 CALL for 10¢, Nov 14.25 CALL for 17¢ and the Dec 14.25 CALL for 25¢. Then place orders with us or your co-op to sell milk at or near those levels.

Grains: With the Informa/(Sparks) September estimates of final crop corn above 13 billion bu and a yield of 168 per acre, along with the possibility of another 30 days of frost free growing weather, we need to be patient as we look for an opportunity to contract corn needs for the next year. We would get started at 3.00 December 2009, then step in with more, buying 2.90 and finally finish with 2.75. At the same time, you should cover 2010/2011 corn needs. For 2010/11 corn prices will likely increase next winter and spring as we anticipate replacing corn acres with higher value beans. Historically, the corn to bean ratio went from a high in 1973 of 3.9-1 (world stocks of soybeans were close to 0) to 1.54-1 in 1996. The average over the years is 2.3-1. Currently with December corn at 3.13 and November soybeans at 9.41, the ratio is 3 to 1, which bodes well for an acre shift to more beans planted. We would recommend taking long positions in December 2010 corn to secure a reasonable price for your 2011 corn feeding needs. Buy Dec 2010 corn futures when they reach 3.45, or put on a bull call spread. To do that, buy the Dec 2010 3.40 call and sell the 4.40 call for a net cost of 30¢.

**Announcement:** For the past four years, KDM Trading, Inc. has traded a very small number of accounts (fewer than ten) on a "for profit" basis. These accounts are traded in such a way as to attempt to profit from milk price movement in both directions. Following are the annual rates of return for the accounts under management: 2005: **-25.31%**, 2006: **+73.04%**, 2007: **+546.57%**, 2008: **+54.76%**, 2009 (YTD): **+25.58%**. We are now opening this program to our customers and newsletter subscribers through a recently established CTA (Commodity Trading Advisor). Minimum investment is \$50,000. Please contact us for further information if you are interested in participating in this program.

**Note:** Our offices will be closed on Monday in observance of Labor Day. Have a great weekend!

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.