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The KDM Dairy Report – Sep 18th, 2009

What's Bullish:

Futures Month	Class III 09/18 Close	Class III 09/11 Close	Change	Dry Whey 09/18 Close	Dry Whey 09/11 Close	Change
Sep-09	$12.08	$12.04	$0.04	30.13¢	30.00¢	0.13¢
Oct-09	$12.55	$12.17	$0.38	32.50¢	30.00¢	2.50¢
Nov-09	$13.37	$13.13	$0.24	32.75¢	30.53¢	2.23¢
Dec-09	$13.97	$13.45	$0.52	33.00¢	30.78¢	2.23¢
Jan-10	$14.03	$13.72	$0.31	32.05¢	31.23¢	0.82¢
Feb-10	$14.18	$13.84	$0.34	30.58¢	29.55¢	1.03¢
Mar-10	$14.22	$13.84	$0.38	31.00¢	29.00¢	2.00¢
Apr-10	$14.45	$14.13	$0.32	31.25¢	29.05¢	2.20¢
May-10	$14.47	$14.26	$0.21	31.28¢	30.50¢	0.77¢
Jun-10	$14.68	$14.75	($0.07)	30.75¢	30.00¢	0.75¢
Jul-10	$15.03	$14.90	$0.13	29.53¢	29.00¢	0.52¢
Aug-10	$15.38	$15.20	$0.18	31.00¢	30.53¢	0.48¢
Sep-10	$15.68	$15.50	$0.18	30.08¢	30.08¢	0.00¢
Oct-10	$15.56	$15.55	$0.01	30.03¢	30.03¢	0.00¢
Nov-10	$15.67	$15.55	$0.12	28.05¢	28.05¢	0.00¢
Dec-10	$15.80	$15.65	$0.15	28.03¢	28.03¢	0.00¢
Sep-Dec	**$12.99**	**$12.70**	**$0.29**	**32.09¢**	**30.33¢**	**1.77¢**
2010	**$14.93**	**$14.74**	**$0.19**	**30.30¢**	**29.59¢**	**0.71¢**

- Milk Production Report: August milk production was down 0.3% vs. a year ago, and July output was revised lower, leaving it at a negative 0.1% vs. July 2008. Cow numbers fell 30,000 head from July, and are down 170,000 head from last August. Production per cow continued to increase, at 55.4 lbs/cow, as culling improves the quality of the remaining herd.
- Cash Market: Buyers appeared to take the upper hand in a hard fought battle in the spot market this week. Blocks jumped 6¢ to settle at $1.33/lb today and barrels gained 4¢ to $1.29/lb. Trading was fairly active with 30 loads of blocks and 10 loads of barrels exchanging hands. Butter rebounded as well, settling at $1.27/lb, up 9¢ for the week. Buyers took on 41 loads. Finally, while rarely traded, Grade A nonfat dry milk increased 3½¢ to $1.04/lb on just bids, as no trades took place.
- For the second week in a row, dairy cow slaughter topped 64,000 head, reflecting action by the latest CWT herd retirement program. 64,200 head were culled during the week ending 09/05, 16,300 more than last year during the same period. YTD, the dairy cull is 247,000 head higher than last year.
- Fluid Milk & Cream Review reports weather is not affecting milk production in California, but more dairies have left as a result of the most recent CWT program. Many processing plants are shorter on milk supplies than they would like with several calling on patrons for more milk. Additional offerings of milk are limited. The same is true in Arizona, where processors would like to have more milk to meet finished product needs. Some production adjustments are being made due to lack of supply. In the Pacific Northwest, feed rations, prohibition of rBST and poor forage quality are affecting the milk supply. Processors are reporting lower milk intakes than desired so are working at below capacity levels.
- Butter prices are strengthening as demand has increased with seasonal improvement in foodservice orders and additional export orders under the DEIP program, according to Dairy Market News. Churning activity has declined and often current production is not meeting demand. Some butter producers are purchasing spot loads on the CME to secure butter volumes that they are not able to generate themselves.
- Central dry whey manufacturers are working nearly 24x7 but are challenged to keep up with contract commitments, according to Dairy Market News. Inventory levels are balanced, but continuing buyer interest could begin to deplete manufacturer inventories.
- Dairy Market News reports Western dry whey supplies are adequate to tight, with offerings limited. Demand is good for available supplies.
- Prices for Western nonfat dry milk are trending sharply higher, according to Dairy Market News. Offerings have declined while buyer interest has increased as buyers attempt to secure coverage. Many are not finding the volumes they thought they could get. Drying schedules are often below projected levels due to lower than expected milk output in the region.
- Dairy Market News reports cheese plants in the Eastern region are receiving adequate supplies to meet their reduced production schedules. However, some plants would like to expand their schedules but are unable to do so with the current available supplies of milk.
- Cheese prices fell, but butter and powder prices were higher in this week's NASS survey. Butter prices increased 0.4¢ to average $1.17/lb. With the cash market now at $1.27/lb, more weekly increases are likely. Nonfat dry milk is also rising. It averaged 97¢/lb, up 3¢ from last week, and dry whey gained 0.7¢ to 29.8¢/lb.
- Economy: The U.S. dollar fell to a new annual low against the euro this week. As more evidence points to an end in the recession, traders are dumping "safe" dollars and switching to riskier assets. The lower dollar makes our exports more price competitive.
- International: Financial hardship is hitting European dairy producers hard, just as they are in the U.S., according to Dairy Market News. Farmer groups are staging strikes and milk withdrawals, stating they are selling milk at half their

production costs. Some predict initial removals could impact some supermarkets as early as next week. Prices for manufactured dairy products are firm across the board.

- International: Dairy Market News reports the milk production season got off to a slow start in New Zealand. Economics of dairy production continue to impact managerial decisions in both New Zealand and Australia. Commercial powder prices have firmed as demand is building and stocks of uncommitted powder are low. Cheese production has slowed as milk is often being channeled toward other manufactured products when possible. This is causing cheese prices and markets to firm.

What's Bearish:

- Livestock, Dairy & Poultry Outlook Report: USDA projects 2010 dairy exports will not improve much over this year. And milk production is forecast to contract slowly due to rising output per cow. Therefore, they predict a recovery in prices is unlikely until 2010, and even then it will be mild, averaging just $14.25 for the year.
- World Ag Supply & Demand Report: USDA raised its milk production forecast for 2010 from last month, citing improving milk per cow. Lower feed costs and plentiful supplies of alfalfa hay are expected to support higher quality rations in 2010.
- NASS cheese prices fell in their weekly survey for the first time in several weeks. 40-lb blocks decreased 0.1¢ to average $1.37/lb and 500-lb barrels gave up 4¢ to $1.34/lb.
- Fluid milk supplies are less tight in the Eastern region of the country than they were in previous weeks, according to Fluid Milk & Cream Review. Cooler weather has helped production in some areas, with current volumes meeting Class I needs and allowing for some increases in manufacturing milk supplies. However, 90 loads of milk were imported into the area this week, compared to 39 last week.
- Milk production in parts of the upper Central region remain much higher than normal and at levels that are "beyond expectations", according to Fluid Milk & Cream Review. Bottling sales are down slightly and more milk is available for manufacturing due to less being pulled into the Southeast. The increased availability of milk is being used for cheese manufacturing.
- Orders for process cheese in the Midwest were down this week, according to Dairy Market News. Manufacturing inventory levels are in balance and bulk shipments are intact and being accepted on schedule.
- Western cheese production has slowed along with farm milk intakes, but supplies of cheese for contract needs are adequate, according to Dairy Market News.
- The Foreign Ag Service reports butter exports for the first seven months of the year are down 81% from last year, while imports from Jan-Aug were triple what they were a year ago. Exports of cheese and curd for the first seven months of the year were down 27% from the same period last year, while quota imports of cheese for the first eight months of the year were up 18% over the same period in 2008.

Recommendation:

Lots of news and reports this week. Despite the weekly USDA cheese updates looking less bullish than they did over the past few weeks, the bigger story is probably the financial hardship now being seen by dairymen around the world and the resulting tightening of dairy products globally. Two weeks ago Oceania cheddar averaged $1.26/lb, while this week it's jumped to $1.40/lb. And the powder markets have strengthened due to less milk and lower cheese output. Nonfat dry milk prices climbed well above support and dry whey futures saw solid gains in Q4 '09 (see above). The cash cheese market shrugged off any bearish news with persistent bidders all week long. We expect to see more of the same next week. We were successful in getting our $14 x $18 min-max strategy done for July-Dec '10 this week and still think it is a good place to start your hedge program. We also bought Jan 15.00, Feb 15.75 and Mar 16.00 calls for 30¢ each, then promptly entered orders to sell milk in those months at 14.75, 15.25 and 15.50, respectively. We're only 70¢ away from getting that done for Jan, and $1 to $1.25 away on the other months – well within striking distance. If we get the milk sold at these prices, we'll have our floor, plus have no need to worry about further upside from there since we own the calls. If prices continue to move higher next week, we would recommend a similar strategy for Q1 and possibly do a $14.50 x $18.50 min-max strategy July-Dec '10 if you haven't marketed any milk in those months yet. Call us next week for target prices.

New CTA program offers diversification: If you are looking for a way to diversify your investment portfolio and income, consider opening a managed futures account in the "Dairy Advantage" program. The program tries to take advantage of the volatile swings in the milk market, both up and down, on a "for profit" basis. Using this method, accounts under management earned the following annual rates of return: 2005: -25.31%, 2006: +73.04%, 2007: +546.57%, 2008: +54.76%, 2009 (YTD): +25.58%. Please contact Dan for a copy of the most recent disclosure document to learn more about this program.