

The KDM Dairy Report – Oct 23rd, 2009

What's Bullish:

- Cash Market: Blocks picked up 7¢ for the week as they caught a bid, settling at \$1.50/lb and barrels jumped 6¼¢ to close at \$1.49¼/lb. Everyone says we have more barrels than blocks, but there were no barrel trades all week, while blocks traded 14 times. Nonfat dry milk inched a penny higher to close at \$1.32½/lb, and butter vaulted up 10¾¢ to settle at \$1.35/lb, a new high for the year, on 34 trades.
- Milk Production Report: U.S. milk production in September was down 0.7% compared to a year ago. The decrease was slightly more than most analyst expectations. Milk per cow increased 24/lbs, but cow numbers fell 36,000 head from Aug to Sep leaving the nation with 197,000 fewer cows than a year ago. Big production declines were seen in several Western states, with AZ down 10.8%, CO down 7.1% and CA down 6.4%. Western states accounted for 82% of the total milk cow loss nationally for the period.
- Livestock Slaughter Report: Dairy cow slaughter in September totaled 236,500 head, up 13,000 head from a year ago, an increase of 5.8%. Jan-Sep 2.1483 million head have been culled vs. 1.9181 million over the same period in 2008, an increase of 230,200 head.
- Cheddar cheese prices in this week's NASS survey were up sharply from last week. 40-lb blocks averaged \$1.42/lb, up 5.4¢ while 500-lb barrels increased 4¢ to \$1.43/lb. Butter dropped a penny to average \$1.22/lb, but nonfat dry milk increased 3¢ to \$1.05/lb and dry whey bumped up 0.3¢ to 32¢/lb.
- Butter stocks at CME-approved warehouses fell 4.2 million lbs during the week ending 10/17, which was much more than a year ago, when just 210,000 lbs were pulled.
- Fluid Milk & Cream Review reports strong Class I demand in the Northeast is continuing to pull fluid supplies away from manufacturing plants. Cool, wet weather has also restricted harvest activities and contributed to the lack of regrowth and deteriorating pasture conditions. Imports into the Southeast jumped from 5 loads last week to 70 this week, as seasonal production declines limit the milk supply. Florida imported 90 loads of milk this week, up from 45 last week, as Class I demand was stronger due to the arrival of more winter residents. Class II demand is strong as holiday orders are beginning to pick up for butter, cream cheese, sour cream and dips.
- Though student illness and scattered school closings are impacting Class I sales in the Central region, manufacturing milk supplies are limited, with some demand going unfilled, according to Fluid Milk & Cream Review.
- Declines in cow numbers due to CWT participation and selloffs are keeping California milk output well below year ago levels, according to Fluid Milk & Cream Review. Production per cow is also trending below expectations due to changes in feeding practices. Processing plants are running on reduced schedules, reflecting lower milk intakes, and with higher finished product prices developing, many processors would like more milk to fill demand. In Arizona, the decline in milk receipts has reached double digit percentage lower than a year ago. Severe financial stress is resulting in herd selloffs, and there is concern that the latest CWT round will move more cows out of production in the state. With less milk, processors are struggling to keep pace with contracted outlets for milk, resulting in lower output of finished products. Processing plants are also running on reduced schedules in New Mexico as less milk is available. Butter production is absorbing a lot of cream as holiday orders are prepared, while other class item outputs are strong and building. In the Pacific Northwest, processors would like increased supplies of farm milk to complement higher prices for dry products, but the milk supply is lower in the region. Some plants are running on lighter schedules. Financial stress continues to impact operations, as there are reports of feed suppliers refusing to sell without adequate funding.
- Some international buyers are looking to U.S. butter suppliers as possible sources in the coming months, according to Dairy Market News. Butterfat is tight internationally, with butter averaging \$1.35/lb in Oceania and over \$2.00/lb in Europe. Cream supplies are becoming less available as production of Class II holiday cream based products increases.
- Dairy Market News reports Western nonfat dry milk supplies are tight. Contract deliveries are often lagging as producer stocks are trending lower and being held with confidence. The recent elimination of EU subsidies on skim milk powder could help support domestic nonfat dry milk values in the near term.
- Western dry whey prices are firm, climbing a penny in the last week, according to Dairy Market News. Production is adequate for contract needs, but little is available for spot sales. Buyer demand is good with some demand going unfilled.
- Demand for Mozzarella, provolone, low fat cheddar and cream cheese remains strong in the Northeast, according to Dairy Market News. Tight fluid supplies continue to hamper those cheese producers wishing to expand production schedules.

Futures Month	Class III 10/23 Close	Class III 10/16 Close	Change
Oct-09	\$12.78	\$12.73	\$0.05
Nov-09	\$13.80	\$13.80	\$0.00
Dec-09	\$14.68	\$14.19	\$0.49
Jan-10	\$14.75	\$14.29	\$0.46
Feb-10	\$14.79	\$14.46	\$0.33
Mar-10	\$15.03	\$14.70	\$0.33
Apr-10	\$15.20	\$14.73	\$0.47
May-10	\$15.22	\$14.75	\$0.47
Jun-10	\$15.24	\$14.90	\$0.34
Jul-10	\$15.34	\$15.15	\$0.19
Aug-10	\$15.55	\$15.33	\$0.22
Sep-10	\$15.73	\$15.40	\$0.33
Oct-10	\$15.55	\$15.50	\$0.05
Nov-10	\$15.63	\$15.64	(\$0.01)
Dec-10	\$15.70	\$15.64	\$0.06
Q4	\$13.75	\$13.57	\$0.18
2010	\$15.31	\$15.04	\$0.27

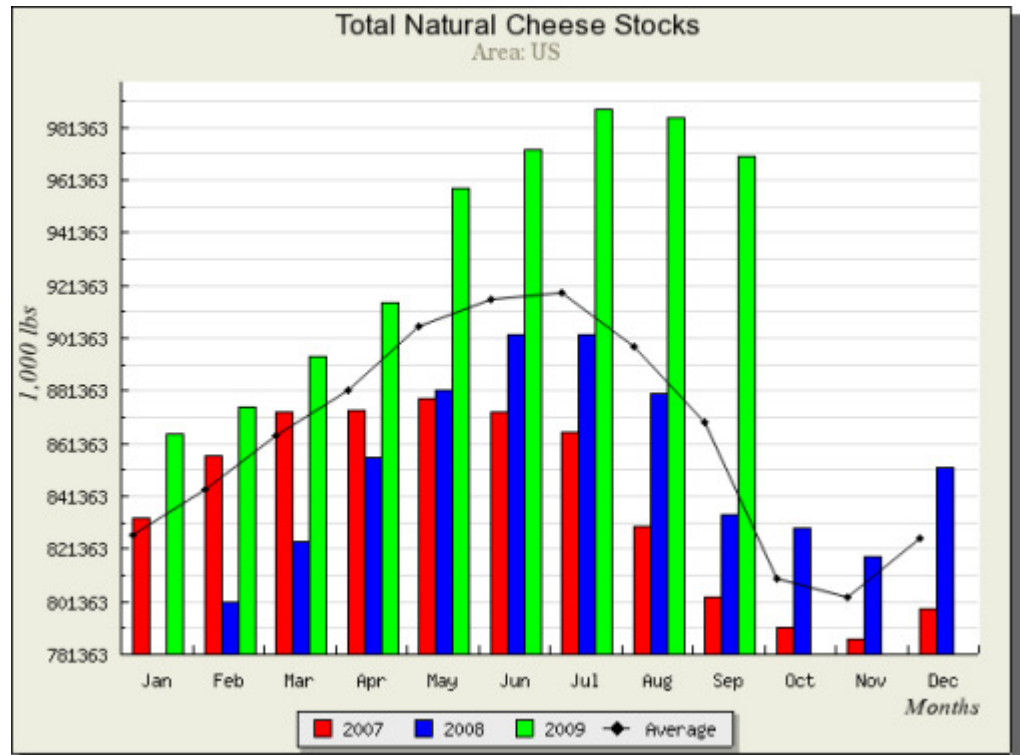
- Crude oil prices have surged 25% in less than a month, while harvest delays are pulling grains higher. Corn is trading over \$4/bu and beans are over \$10/bu through March.

What's Bearish:

- Cold Storage Report: Stocks of cheese in U.S. warehouses in Sep were sharply higher than a year ago. American cheese stocks were up 10% vs. 2008 and Total cheese stocks were up an even stronger 16%. Butter stocks were 23% higher over the same period.
- Dairy cow slaughter for the week ending 10/10 totaled 50,600 head, which was up slightly from last week, but well below a year ago during the same period, when 53,300 head were culled.
- Supplies of natural American cheese are adequate in the Midwest, according to Dairy Market News. Mozzarella, provolone and Swiss remain tight to short of needs, but aged cheddar buyers are very price conscious and process demand is spotty to moderate at best.
- Dairy Market News reports Western cheese production is steady and overall supplies are adequate to fill current demand.

Recommendation:

After showing some weakness early in the week, it was buyers who again took control of the cash cheese market, forcing prices higher. The cash market has been in quite a see-saw the past few weeks, briefly pushing past \$1.50/lb cheese, then swinging back down to \$1.40/lb where it found solid support, and now back to \$1.50/lb. Sellers dug in their heels at this level, but we ended today's session with an unfilled bid. It will be interesting to see if we now swing back down or continue to head higher. Aside from the massive amount of cheese we have in storage (see scary graph at right), it was difficult to find bearish news for this week's report; butter and barrels both made new highs for the year, so we're leaning towards blocks breaking through and heading higher next week. Your



heart just has to break for Western dairymen. It was shocking to see that 82% of the drop in cow numbers is coming from their region. We've said it before but we'll say it again – the damage has been done to the milk supply. The current CWT buyout is not likely to garner large numbers, but they will again most likely come from this region of the country, making it difficult if not impossible for the milk supply to rebound in any significant way for quite some time. 80% of the nation's nonfat dry milk is manufactured in CA, so it seems reasonable to assume the processors and dryers are going to continue to run on reduced schedules for the foreseeable future. Milk is tight out East too, with supplies more or less in balance in the Midwest. As we suggested last week, the dip cheese prices was temporary. Those Jan 15.00 CALLs we recommended buying for 35¢ settled at 50¢ today. It was a perfect opportunity to buy at a discount before the sale ended. At this point we would begin looking at PUT options again. If you can cash flow at \$14.00 base price, consider buying the Jan-Mar 14.25 PUT for an average of 30¢ each (settled at avg 41¢). Also consider getting some coverage Q2-Q4 2010 with a fence strategy, buying the 14.00 PUT and selling the 18.00 CALL for an average 30-35¢ per month. Or, sell up to 10% of your milk at \$16.00 or higher.

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