

The KDM Dairy Report – Oct 30th, 2009

What's Bullish:

- Weekly cold storage numbers are showing a drawdown in both cheese and butter stocks at USDA selected storage centers. For the period 10/01 through 10/26, cheese stocks are down 1.6 million lbs, or 1%, and butter stocks have fallen 4%, or 644,000 lbs.
- Most Class III components were higher in this week's NASS price survey. 40-lb blocks increased 3.2¢ from last week, averaging \$1.45/lb, while 500-lb barrels nudged 3¢ higher to \$1.46/lb. Butter was up 2.6¢ to average \$1.25/lb and dry whey inched up 0.6¢ to 32.6¢/lb, but nonfat dry milk decreased 1.2¢ to \$1.03/lb.
- Dairy Market News reports seasonal milk production declines in the Northeast continue to hamper cheese makers that wish to expand production. In the Midwest, current cheese supplies have tightened, but mainly for non-American varieties. Finally, some Western cheese producers are reporting output has been restricted due to lower milk supplies.
- Fluid Milk & Cream Review reports milk supplies in the Northeast and Mid Atlantic regions continue to tighten due to increased Class I demand and seasonal production declines. Manufacturing supplies are as tight as they have been for 2009 and some manufacturers are having difficulty covering contracts. New England farmers expect to be short of hay and silage due to reduced crop yields caused by excessive moisture during the growing season.
- Class I and II demand is expected to improve as production of holiday specialties, including eggnog, gears up. Some Central region manufacturers are already seeing increased production of dips, cottage cheese and sour/whipping cream, according to Fluid Milk & Cream Review. Milk supplies are tight, with spot loads of manufacturing milk going for \$2-3 above class. Wet fields and crops continue to hamper harvest, with growing concern over the corn and soybean crop condition.
- Economic conditions remain adverse to milk production in California, leaving output steady to slightly lower, according to Fluid Milk & Cream Review. Even though finished product prices are increasing, those increases are slow to work into milk price formulas. Milk is being moved around the state to service accounts, but some plants are receiving less milk than expected under supply contracts. The lack of milk in Arizona is causing processors to be more strategic with plant schedules. There are concerns that the latest CWT program will retire even more cows in the state and further limit output. Processors are running on reduced schedules in some areas of the Pacific Northwest due to seasonally lower milk production. Farm milk supplies are adequate to fill current contract interest, but little surplus is offered.
- Many domestic butter producers in the Central region have reported frequent international buyer inquiries for near term to early 2010 deliveries, according to Dairy Market News. However, many are hesitant to commit at this time since they want to meet domestic demand over the holiday period before entering into new international contracts. Butter demand continues to gain momentum, with retailers placing good orders for upcoming year end needs.
- Central dry whey prices were higher again this week, as they track with higher NDM prices, according to Dairy Market News. Product is clearing at prices within and above last week's range, with some producers reporting inventories are snug. Demand for Western dry whey is good, with interest for additional supplies. Current production is sufficient for contract orders, but spot supplies are limited, with some demand not being met.
- Western nonfat dry milk prices continue to firm in a strong market, according to Dairy Market News. Current drying schedules are lighter due to lower milk receipts and stock levels are light, with producers trying to maintain a working inventory.
- Commercial Disappearance: Some positives and some negatives, but commercial use of American cheese in August was up 1.2% compared to a year ago, and is up 4% during the first eight months of the year. Use of other cheese in August was down 0.4%, but is still up 1.3% for the year. Butter use dropped 27.3% in August, but use of nonfat dry milk shot up 38.9%. Fluid milk product use was up 1.3%, but use of milk in all products dropped 1.6% YTD.
- International: Milk production in Western Europe is lower than a year ago and sharply lower in Eastern Europe, according to Dairy Market News. General economic conditions have been the major factor for the reduced levels. Finished product stocks are lighter, with the result being a slowing of exports out of Europe. In addition, last week subsidies for skim milk powder were slashed to zero and reduced by half for butter and WMP. As a result, butter prices moved sharply higher and the market tone is firm to strong. Butter (82% butterfat) averaged \$2.08/lb this week. Stocks of whey powder are tight as well, with prices firming, averaging 49¢/lb.
- International: Milk output in both New Zealand and Australia is lower than year ago levels, according to Dairy Market News. Australian milk production in September was estimated to be 8% lower than last year, with milk year to date at

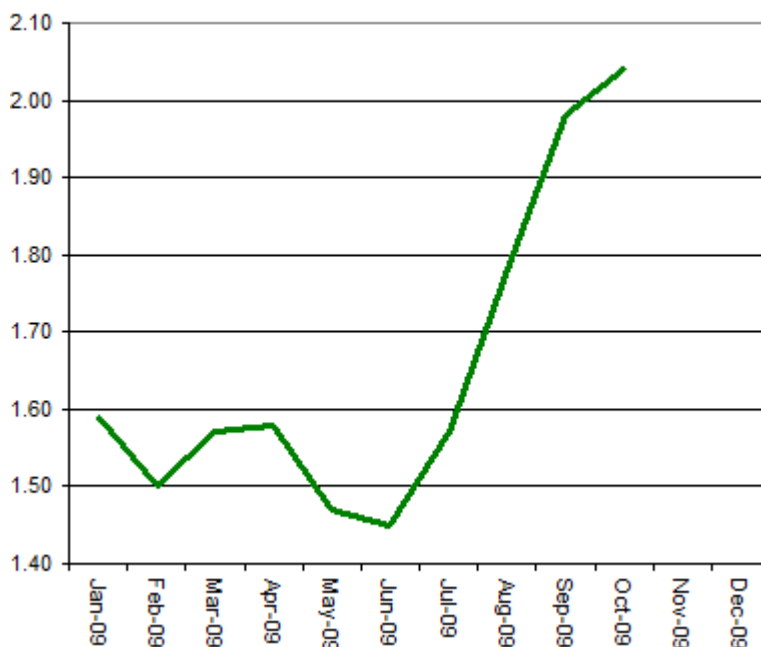
Futures Month	Class III 10/30 Close	Class III 10/23 Close	Change
Nov-09	\$13.93	\$13.80	\$0.13
Dec-09	\$14.87	\$14.68	\$0.19
Jan-10	\$14.96	\$14.75	\$0.21
Feb-10	\$15.06	\$14.79	\$0.27
Mar-10	\$15.14	\$15.03	\$0.11
Apr-10	\$15.24	\$15.20	\$0.04
May-10	\$15.18	\$15.22	(\$0.04)
Jun-10	\$15.20	\$15.24	(\$0.04)
Jul-10	\$15.33	\$15.34	(\$0.01)
Aug-10	\$15.50	\$15.55	(\$0.05)
Sep-10	\$15.66	\$15.73	(\$0.07)
Oct-10	\$15.54	\$15.55	(\$0.01)
Nov-10	\$15.62	\$15.63	(\$0.01)
Dec-10	\$15.68	\$15.70	(\$0.02)
2010	\$15.34	\$15.31	\$0.03

4% below 2008. Dairy product prices are sharply higher than two weeks ago as a result of the decrease in EU subsidies and tightening stock supplies. Butter averaged \$1.42/lb and cheddar cheese averaged \$1.66/lb.

What's Bearish:

- Cash Market: While butter made a new annual high at \$1.41/lb, up 6¢ for the week, cheddar blocks managed only a 1¢ gain to \$1.51/lb and barrels were ½¢ lower, settling at \$1.48¾/lb. Block buyers had to take on 11 loads for their one penny victory, while it took only one load of barrels to move prices lower. Grade A nonfat dry milk has also stalled out, picking up only a penny to reach \$1.33½/lb.
- Ag Prices Report: The milk-feed ratio rose to 2.04 in October (see graph), its highest reading since March, 2008. While still well below 3.0, above which is historically considered a signal for milk expansion, it indicates financial stress is in the process of easing.
- October Class III was announced at \$12.82/cwt, well below last October which came off the books at \$17.06/cwt.
- Increased milk production in Tennessee and Georgia contributed to a decline in the number of imported loads of Grade A milk into the Southeast, according to Fluid Milk & Cream Review. Florida has also experienced production increases this week, allowing total loads shipped in to drop from 160 last week to just 78 this week.
- American style cheese supplies in the Midwest are adequate, especially when considering the large volume in storage, according to Dairy Market News. Process line runs are steady to lighter and some producers have barrels to sell.
- Seasonal demand for Western cheese is adequate to good, but additional supplies of cheese are reported to be offered by some producers. Despite lower milk supplies in the region, cheese production remains a priority for available milk.
- Dairy cow slaughter for the week ending 10/17 was 50,600 head, 300 head less than a year ago at this time. Culling will likely be lighter until the next CWT round kicks in.
- Economy: Consumer spending fell in September and incomes were flat, according to the commerce department. The largest spending decline in nine months reflected the end of the government's Cash for Clunkers program, which cost U.S. taxpayers an estimated \$24,000 per car (crazy!). While the economy grew in the third quarter for the first time in more than a year, much of it was propelled by the biggest government intrusion into the economy since World War II. Harvard Professor Martin Feldstein warns, "The danger remains of a serious slowdown after this and a possible double dip of the economy in 2010," if consumer spending cannot replace government programs.

2009 Milk-feed Ratio



Recommendation:

We continue to travel through an uncertain market, where cheese appears to be the weakest component and butter and powder seem to carry the strength. It's very encouraging to see international inquiries increasing, but until we start hearing about actual sales, it's all just talk. Processors we spoke to this week said cheese sales have been "ok" but nothing spectacular. In addition, we have a situation where milk is very tight on both sides of the country, but much more available in the middle. This seems to roughly explain our current "tight butter/powder" but "loose cheese" conundrum since much of the first category is produced in the West and a whole lotta cheese still comes out of the Midwest. The market acted right confused this week, with price surges followed by price plunges within the same day and even during overnight sessions. The cash cheese market didn't inspire much confidence either as it struggled to move much higher. We would get some PUT protection on in the front months as they will be the most vulnerable if cheese prices start heading back down. Consider buying the Dec 14.25 PUT for 20-25¢ or just sell at \$15.00 or higher. Buy the Jan 14.25 PUT for 25¢ or sell at \$15.10 or higher. Buy the Feb 14.25 PUT for 30¢ or less, or sell at \$15.15 or higher. Sell no more than 25% of your monthly production. Our long-term rec remains the same: for Q2-Q4 2010 buy the 14.00 PUT and sell the 18.00 CALL for an average net cost of 30-35¢ per month. Consider selling up to 10% of your milk at \$16.00 or higher.

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