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The KDM Dairy Report – Dec 4th, 2009

What's Bullish:

Futures Month	Class III 12/04 Close	Class III 11/25 Close	Change	Dry Whey 12/04 Close	Dry Whey 11/25 Close	Change
Dec-09	$14.73	$14.83	($0.10)	36.03¢	36.75¢	(0.73¢)
Jan-10	$14.54	$14.94	($0.40)	38.00¢	38.05¢	(0.05¢)
Feb-10	$14.62	$15.08	($0.46)	37.80¢	38.05¢	(0.25¢)
Mar-10	$15.08	$15.37	($0.29)	38.00¢	38.00¢	0.00¢
Apr-10	$15.30	$15.50	($0.20)	38.75¢	39.25¢	(0.50¢)
May-10	$15.50	$15.67	($0.17)	36.78¢	38.00¢	(1.23¢)
Jun-10	$15.79	$15.85	($0.06)	37.98¢	40.48¢	(2.50¢)
Jul-10	$16.14	$16.15	($0.01)	38.50¢	39.23¢	(0.73¢)
Aug-10	$16.20	$16.20	$0.00	38.75¢	40.48¢	(1.73¢)
Sep-10	$16.17	$16.11	$0.06	39.00¢	39.00¢	0.00¢
Oct-10	$16.06	$16.00	$0.06	37.25¢	38.48¢	(1.23¢)
Nov-10	$15.95	$15.93	$0.02	36.75¢	37.25¢	(0.50¢)
Dec-10	$15.98	$15.95	$0.03	36.50¢	37.73¢	(1.23¢)
2010	**$15.61**	**$15.73**	**($0.12)**	**37.84¢**	**38.66¢**	**(0.83¢)**

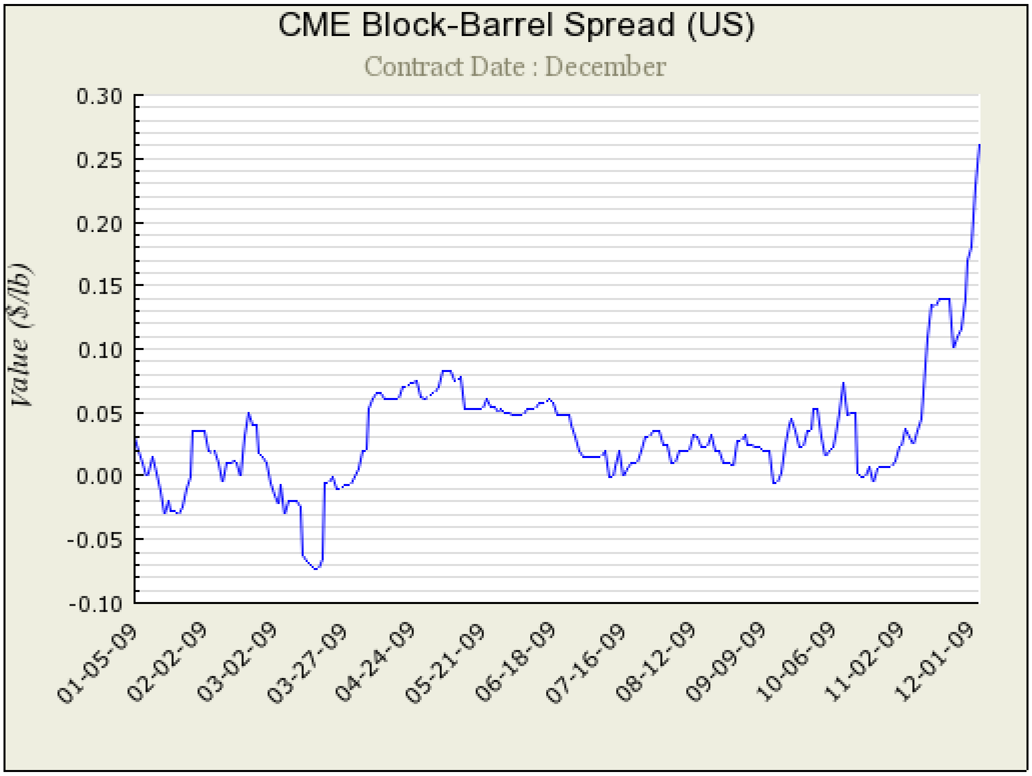
- U.S. Ag Trade Report: USDA's quarterly look at agricultural trade includes a 10% increase in their forecast for dairy exports in 2010, compared to their prior report in August. The increased exports represent an additional $200 million of product leaving the country, and is based on an improving global economic climate.
- Most Class III components were higher in this week's NASS survey. 40-lb blocks increased 1.7¢ to average $1.56/lb, but 500-lb barrels, reflecting heavier supplies, decreased 0.3¢ to $1.50/lb. Butter was up 1.3¢ to average $1.49/lb, nonfat dry milk jumped 3.1¢ to $1.20/lb and dry whey inched 0.2¢ higher to 35.4¢/lb.
- Weekly cold storage numbers for the month of November show a strong butter drawdown. Butter holdings at USDA selected storage centers fell by 31% during the month, a drop of 4.3 million lbs. Cheese stocks declined by 3%, or 3.7 million lbs.
- Dairy cow slaughter for the week ending 11/21 was a strong 54,300 head, up from 50,800 during the same period last year.
- Milk supplies in the Northeast were adequate over the holiday weekend, but are expected to lessen as bottlers and manufacturers resume normal production schedules, according to Fluid Milk & Cream Review. Milk production has reached its low point in the region, and cream supplies are tightening as Class II plants resume holiday item production.
- Fluid Milk & Cream Review reports milk output in California is steady, and supplies were easily handled over the holiday weekend. Higher milk prices are helping the economic situation, but are still below costs of production.
- Milk output in the Pacific Northwest is lagging somewhat due to ration balancing for cost, according to Fluid Milk & Cream Review. Holiday weekend milk was handled without a problem.
- Dairy Market News reports many Western churns are looking for additional cream supplies but are having a hard time finding extra loads. Orders on the books for the year end holidays are reported at or above recent averages.
- Western dry whey prices remain firm, as supply gaps are being met by importing Midwestern supplies, according to Dairy Market News. Some additional powder was manufactured over the holiday weekend, but not as much as anticipated. Both domestic and export buyers continue to take good volumes of powder, with any additional offerings clearing easily. Some buyers are not getting as much powder as they want in a timely fashion.
- Dry whey buyers in the Eastern region are finding only limited quantities on the spot market, according to Dairy Market News. Most production is going towards filling current contracts and demand is very good. Supplies remain tight.
- Nonfat dry milk supplies in the Eastern region continue to be tight, according to Dairy Market News. Buyers wanting extra loads have to pursue Western sources.
- Dairy Market News reports milk supplies to cheese plants in the Northeast were adequate over the holiday weekend, but demand is strong as plants actively fill holiday orders.
- Commercial Disappearance: Commercial use of American cheese for the first ten months of the year was up 4.5% compared to a year ago, according to USDA numbers released this week.

What's Bearish:

- Cash Market: Blocks started the week at $1.66/lb, went as high as $1.72/lb, then declined to $1.71¾/lb on Friday. Barrels lost 3¢ during the week to settle at $1.46/lb, and butter under heavy selling dropped 7½¢ to $1.45/lb. For the week there were 15 block trades, 7 barrel and 40 cars of butter. Nonfat dry milk was bid ¾¢ for the week to close at $1.40¾/lb.
- Dairy Market News reports the Midwest cheese market is steady on blocks and weak on barrels. Post holiday replacement orders have been slow to develop. Ample supplies of barrels and processing solids are available with interest only fair at best. Efforts continue to lighten cheese inventories that were placed into storage earlier in the year, before year's end in roughly 30 days. For barrels in particular, cheese in storage is affecting current sales.
- Excess milk over the holiday weekend was predominantly turned into cheese barrels and dairy powders by Northeast processors, according to Fluid Milk & Cream Review. Florida is benefitting from favorable weather as they exported 96 loads of Grade A milk, unchanged from last week.

- Cheese production in the Midwest was heavy over the holiday weekend, according to Fluid Milk & Cream Review, as extra fluid milk was diverted to cheese plants.
- Fluid Milk & Cream Review reports Class I and II demand in the Midwest has recovered after the long holiday weekend. However, they also report that some cheese plants are cutting back on barrel production and to a lesser degree, cheddar blocks, due to extra loads available. In addition, milk components are around annual peak levels, improving yields.
- After 11 straight weeks of drawdown, butter stocks at CME-approved warehouses increased by 2.2 million lbs for the week ending 11/28, likely due to extra milk available over Thanksgiving.
- Commercial Disappearance: Butter use for the first ten months of the year declined 7.8% compared to 2008, according to USDA.
- Ag Prices Report: While still well below 3.0, the November milk-to-feed ratio increased to 2.19, up from 2.09 last month, and the highest milk-feed ratio in 21 months. Next month's ratio will likely be higher still.

Recommendation:



The block-barrel spread sits at 25¾¢ and is unsustainable at this level for any length of time, despite reflecting current supply conditions. Barrel makers paying farmers Class III prices lose money with every pound made, which is why we're reading about attempts to limit barrel production in the news. With block demand pretty decent at the moment, it was thought last week and earlier this week that it was more likely for barrels to come up to close the gap. But with blocks declining on Friday for the first time in several sessions, and barrels losing 3¢ during the week, the pendulum of thought has changed, with the market now predicting a drop in blocks to bring the spread down. Using current cash numbers, Class III works out to about $14.90/cwt, which is now a premium to Jan-Feb futures. More often than not, futures are an accurate predictor, so we wouldn't be surprised to see further weakness in the cheese market, and thus Class III futures, in the near term. If you can cash flow at Q1 prices, we would consider selling some milk here, with the intention of getting CALL options purchased to protect the upside. Or, buy "disaster" insurance to avoid the possibility of more dramatic market drop. You should be able to purchase Jan-Mar 14.00 PUT options for an average 25¢ per month. Overall, however, our long-term view is still bullish. While holders of cheese are trying to lighten inventories before year's end, new again programs will begin in the New Year, and an improving export outlook should limit downside for Q2 and beyond. In fact, if the market does take a major drop in the coming weeks, use it as an opportunity to buy call options Q2-Q4, selling in to them when the market recovers. Give us a call to discuss ways we can put together a 2010 marketing plan for your operation!