

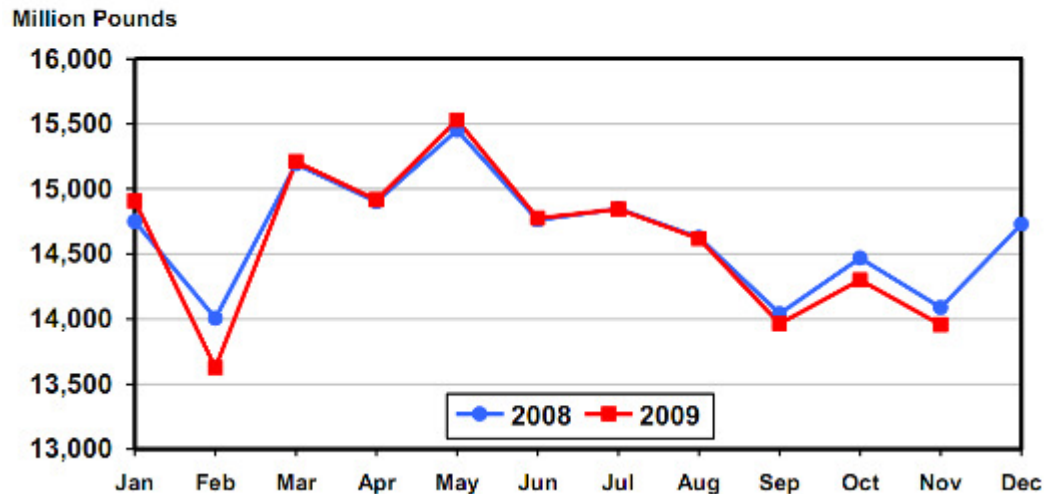
The KDM Dairy Report – Dec 18th, 2009

What's Bullish:

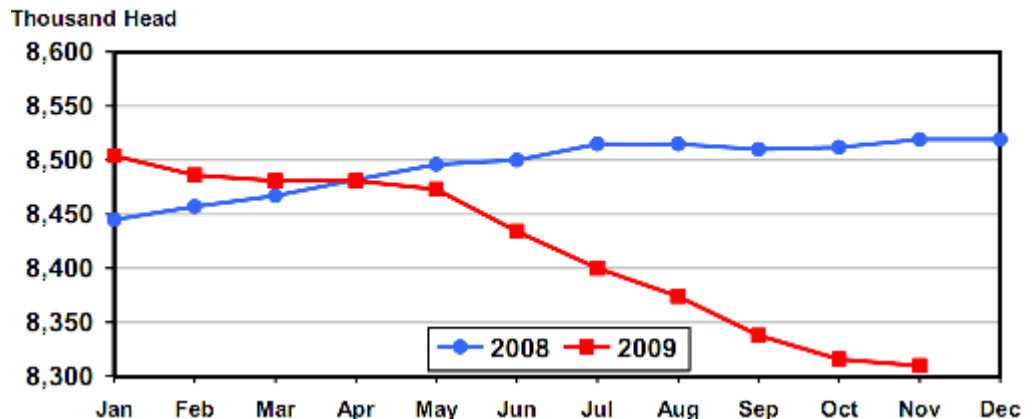
- Milk Production Report: November milk production fell 1% vs. 2008 according to USDA. While output increased 27 lbs/cow, the milking herd declined 242,000 head from a year ago, and dropped 7,000 head from October. Biggest declines were seen in AZ down 10.7%, CO down 9.2%, FL down 6.4% and CA down 5.4%. CA accounted for 80,000 of the annual drop in cow numbers. WI output increased 4.5%.
- Livestock, Dairy & Poultry Outlook Report: USDA lowered their 2010 milk production forecast and raised the milk price forecast as they predict a firm recovery in product exports. USDA now expects cheddar cheese to average \$1.65½/lb and Class III to average \$15.55/cwt, up 15¢ from last month's forecast.
- Block cheese increased in this week's NASS survey but barrels were steady. 40-lb cheddar blocks jumped 3.8¢ to average \$1.62/lb while 500-lb barrels were steady at \$1.52/lb. Butter fell 4.6¢ to average \$1.45/lb, but nonfat dry milk increased 1.4¢ to \$1.28/lb and dry whey inched 0.1¢ higher to average 36.3¢/lb.
- Weekly cold storage numbers are indicating strong demand for both cheese and butter stocks so far in Dec. Butter holdings at USDA selected storage centers fell 28% during the first 14 days of December, with 2.7 million lbs being pulled. Cheese stocks fell 2%, or 2.1 million lbs over the same period.
- Dairy cow slaughter for the week ending 12/05 totaled a solid 54,000 head, up from 52,300 during the same period a year ago. YTD, the cull is 241,200 head higher than last year.
- Butter stocks at CME-approved ware houses dipped below year ago levels for the first time. For the week ending 12/12, stocks on hand totaled 31.9 million lbs, down 2 million lbs from 2008.
- Milk supplies in the Northeast and Mid-Atlantic remain rather tight, according to Fluid Milk & Cream Review. Despite increasing milk production throughout the region, bottling demand remains fairly heavy; this is soaking up most of the supply. The upcoming holidays are not expected to stress facilities, as balancing plants have churns and driers ready to handle the influx of milk. Southeast milk production is holding steady and supplies remain limited due to strong Class I demand and steady Class II production runs.
- Fluid Milk & Cream Review

Futures Month	Class III 12/18 Close	Class III 12/11 Close	Change
Dec-09	\$14.83	\$14.83	\$0.00
Jan-10	\$14.76	\$14.93	(\$0.17)
Feb-10	\$14.68	\$15.00	(\$0.32)
Mar-10	\$15.02	\$15.39	(\$0.37)
Apr-10	\$15.25	\$15.48	(\$0.23)
May-10	\$15.35	\$15.52	(\$0.17)
Jun-10	\$15.77	\$15.85	(\$0.08)
Jul-10	\$16.10	\$16.20	(\$0.10)
Aug-10	\$16.13	\$16.27	(\$0.14)
Sep-10	\$16.16	\$16.30	(\$0.14)
Oct-10	\$16.02	\$16.12	(\$0.10)
Nov-10	\$15.95	\$16.03	(\$0.08)
Dec-10	\$15.99	\$16.05	(\$0.06)
2010	\$15.60	\$15.76	(\$0.16)

**Monthly Milk Production
23 States**



**Monthly Milk Cows
23 States**



reports milk output in California is generally steady, with only slight week to week increases. With some processing capacity added in the last year, production facilities expect no issues handling the milk supply over the holiday weekend. The same is true in Arizona, where milk output remains sharply below year-ago levels. The impact of the economy and loss of herds to CWT continues to be a factor in the milk supply. In the Pacific Northwest, rain and snow nearly every day for a week is making for very wet conditions that are stressing herds to some extent. Some plants in Utah and Idaho continue to search for additional milk supplies.

- Central dry whey prices were mostly higher this week and the market tone remains firm, according to Dairy Market News. Barrel cheese production is declining, and therefore the whey stream is lighter. Demand for dry whey is active and most sellers are demanding a premium. Contracting for 2010 is active and at higher prices than in 2009. Producers expect whey production for 2010 to run behind 2009 levels, potentially tightening supplies. Some buyers may be unable to fulfill contract needs from specific manufacturers.
- Western whey stocks remain balanced to short of needs, according to Dairy Market News. Sales remain strong going into the holiday season for both domestic and export accounts.
- Dairy Market News reports Eastern dry whey supplies remain tight with good demand. Export interest is picking up as European whey prices are higher than the US market. Due to the tight supplies, dry whey users seeking additional loads are looking to the Central and Western regions to meet their needs.
- Reports of export activity, including some Midwestern product, is adding some stability to the block market, according to Dairy Market News, and a late spurt in orders has added overtime for many natural lines. In addition, some Midwestern churns are producing 82% butter to build inventories for possible future exports.
- International: Milk production in Australia July-Dec is down 5% vs. a year ago, according to Dairy Australia, while packaged milk sales July-Nov are up 2.6%. Lower milk production and higher fluid consumption is affecting other finished product output. Butter production July-Oct is down 14.8% and cheese output is down 1.3% (with cheddar output down 15.3%). What they are producing is being exported. Cheddar exports July-Oct increased 8.3% vs. 2008, with total dairy product exports up 12%.

What's Bearish:

- Cash Market: Persistent buyers managed to keep block prices supported, with even a small gain on Friday. Blocks settled at \$1.70¼/lb, up ¼¢ for the week. But barrels fell 2¢ to close at \$1.44, butter declined 12½¢ to \$1.32½/lb and nonfat dry milk gave up a penny to \$1.37/lb. Block buyers picked up 45 loads while only 2 barrels exchanged hands, and 8 cars of butter.
- Florida exported 102 loads of Grade A milk this week, up from 69 last week, according to Fluid Milk & Cream Review. Class I sales are described as sluggish, unless promotions are present. Cream supplies are becoming more readily available as ice cream plants shut down for the holidays.
- There's plenty of milk in the Midwest. Fluid Milk & Cream Review reports spot loads of manufacturing milk are selling mostly below class with the possibility of declining down to nearly \$10/cwt over the last two weeks of 2009. Handlers are having difficult finding homes for surplus milk over the holidays. Some plants will close or reduce schedules, and with the large block/barrel spread, most plants are cautious in making milk purchases. Many have product in inventory already and are reluctant to build and store more, particularly barrels.
- Holiday butter orders are in the books and final shipments have occurred, according to Dairy Market News. Demand for cream is declining, as butter producers do not want to accumulate significant, unsold inventories.
- Availability of American varieties in the Midwest, particularly of barrels, is adequate for current demand. Most holiday orders are in transit and early orders for next year are lighter as buyers try to work down 2009 inventory. Some plants are expecting to operate on heavier schedules due to the milk supply into early January.

Recommendation:

USDA announced that the remaining \$290 million dollars slated to assist dairies will be in direct payments. The DELAP (Dairy Economic Loss Assistance Payment Program) will add approximately 35¢/cwt to farmer milk checks on a maximum of 6 million lbs of milk. The max benefit will be \$19,200, hardly enough to help even a smaller dairy a whole lot, so it is unlikely this will affect the market much. More likely to make a long-term impact is the continued decline in milk production and cow numbers. While we still have some excess barrels to deal with and a holiday period where extra milk will go into manufacturing, the long-term outlook still bodes well for prices in our opinion. Current prices in 2010 may in fact be too low. USDA which historically under-estimates future prices, is predicting 2010 to average \$15.55/cwt. As of today's close 2010 is at \$15.60. But prices could come under pressure in the near term. Consider buying Mar-May 14.00 PUTs and selling 17.00 CALLs at even money on up to 50% of your production. Consider also buying Jun-Dec 15.00 PUTs and selling 18.00 CALLs, paying 25¢ average per month, on up to 25% of your production. This will offer decent downside protection while allowing you to rally with the market up to your cap at the CALL strike price.

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