

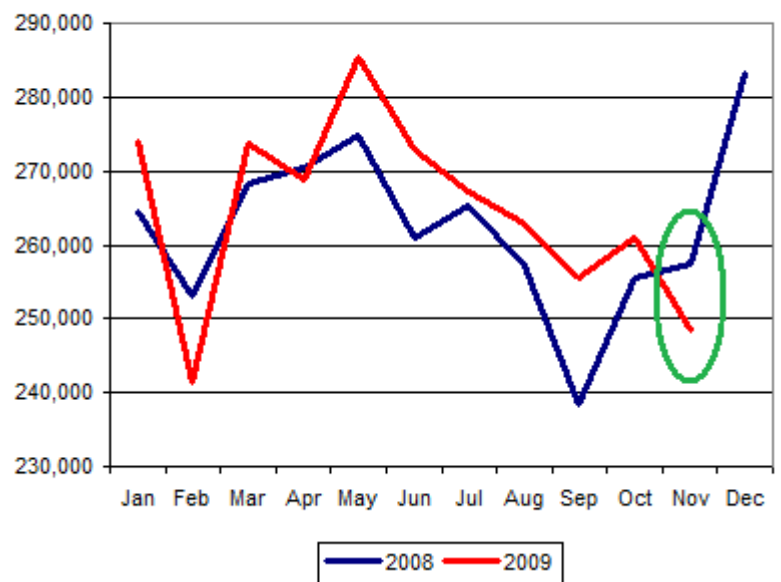
The KDM Dairy Report – Jan 8th, 2010

What's Bullish:

- Dairy Products Report: Cheddar cheese output in Nov declined 3.5% vs. Nov '08 (see graph below) and fell 4.8% from Oct, according to USDA stats. Total cheese output increased a modest 1.9% year over year, lead by a 7.5% jump in mozzarella production. Butter output was also lower, falling 9.7% from a year ago.
- Butter stocks USDA selected storage centers fell 34%, or 3.2 million lbs, over the period 12/01 through 01/04. Cheese stocks fell less than 1%, or 197,000 lbs.
- Dairy cow slaughter during the last week of the year totaled 39,300 head, up from 37,100 during the same period a year ago. For the 52 weeks of this report, the 2009 dairy cow cull exceeded 2008 by 243,800 head.
- Total butter stocks at CME-approved warehouses stood at 41.6 million lbs on Jan 2nd, down 2.9 million lbs from the 44.5 million lbs on hand at the same time last year.
- Northeast bottling plants are now pulling heavy volumes and the turn around from surplus supplies to fairly tight supplies is rapidly occurring, according to Fluid Milk & Cream Review. The cold spell and schools reopening have significantly increased Class I demand, while households are stocking up for the winter storms.
- Fluid Milk & Cream Review reports manufacturing milk interest in the Central region was in better balance with supply due to improved bottling demand. Most plants were able to clear the holiday backlog of milk early in the week, and several loads of milk were sent to Kentucky to bolster local supplies ahead of the storm.
- Milk output in California is trending seasonally higher, but is still several percentage points below year ago levels, according to Fluid Milk & Cream Review. Processors have returned to normal levels as Class I outlets have been reestablished to many schools. Arizona has adequate plant capacity to handle the available milk supply, even with milk per cow levels higher.
- Dairy Market News reports butter producers churning heavily during the holiday period, but most cleared to inventory for future use or was readied for export during the first quarter of 2010. Manufacturers and handlers were generally pleased with butter sales during the final quarter of 2009. Strong retail sales and increased food service orders cleared heavy volumes.
- Cheese production in the Central region is lower, which has decreased dry whey production and created some backlogs in order fulfillment. Plants are readily able to any spot loads of dry whey that become available, according to Dairy Market News.
- Good export demand has offset sluggish domestic demand for dry whey in the Eastern region, according to Dairy Market News. Prices were at the upper end of the range and inventories are held with confidence.
- Cheese production schedules in the Northeast are contracting, according to Dairy Market News. Holiday milk supplies are rapidly decreasing due to stronger Class I and II demand.
- The Foreign Ag Service this week reported that the recovery in international dairy prices that was initially viewed as a short term phenomenon appears to have solidified. The sharp recovery suggests that import demand is staging a comeback and was probably not as negatively affected by the global recession as initially anticipated. In addition,

Futures Month	Class III 01/08 Close	Class III 12/31 Close	Change	Dry Whey 01/08 Close	Dry Whey 12/31 Close	Change
Jan-10	\$14.33	\$14.22	\$0.11	38.50¢	37.75¢	0.75¢
Feb-10	\$13.83	\$13.89	(\$0.06)	38.75¢	38.25¢	0.50¢
Mar-10	\$14.18	\$14.49	(\$0.31)	38.00¢	38.50¢	(0.50¢)
Apr-10	\$14.38	\$14.77	(\$0.39)	37.73¢	38.00¢	(0.27¢)
May-10	\$14.83	\$15.15	(\$0.32)	36.25¢	37.00¢	(0.75¢)
Jun-10	\$15.36	\$15.58	(\$0.22)	37.73¢	38.50¢	(0.77¢)
Jul-10	\$15.71	\$15.96	(\$0.25)	38.25¢	38.53¢	(0.27¢)
Aug-10	\$15.82	\$15.99	(\$0.17)	38.25¢	38.00¢	0.25¢
Sep-10	\$16.05	\$16.11	(\$0.06)	37.25¢	36.50¢	0.75¢
Oct-10	\$16.01	\$16.07	(\$0.06)	36.23¢	37.00¢	(0.77¢)
Nov-10	\$15.82	\$15.87	(\$0.05)	35.73¢	35.00¢	0.73¢
Dec-10	\$15.83	\$15.92	(\$0.09)	35.48¢	35.00¢	0.48¢
2010	\$15.18	\$15.34	(\$0.16)	37.34¢	37.34¢	0.01¢

Cheddar Cheese Output



— 2008 — 2009

available exportable milk supplies are likely to remain limited as domestic milk output in the U.S. and EU is forecast to decline in 2010, while the outlook in Oceania is mixed.

- International: Milk production in Oceania continues to wind down, with reports that projected peak levels were not attained, according to Dairy Market News. New Zealand output is up just 1.5% from last season and Australia output is down 5%. Stocks continue to clear Oceania ports with prices unchanged to lower. Handlers state that stocks are in close balance to short, with some Oceania suppliers looking to outside sources for supplemental stocks. Butter averaged \$1.75/lb and cheddar cheese at \$1.93/lb. Cheese manufacturers are hoping that milk output does not decline too rapidly so that volumes will be sufficient to maintain steady production schedules for known cheese needs.

What's Bearish:

- Cash Market: Blocks continued their downward spiral, falling 4¢ this week to settle at \$1.41/lb. Barrels gained ¼¢ to close at \$1.43¼/lb. Buyers started to see value and picked up 24 loads of blocks and 12 barrels. Each load is 40,000 – 44,000 lbs, so not for the casual trader. Butter closed the week 1¾¢ higher at \$1.34½/lb, with 28 loads exchanging hands.
- This week's NASS price survey saw drops in several Class III components. 40-lb blocks increased 0.9¢ to average \$1.70/lb, but 500-lb barrels slipped 1.2¢ to \$1.49/lb. Butter decreased 1.9¢ from the previous week to average \$1.34/lb, and nonfat dry milk gave up 5.2¢ to \$1.28/lb, but dry whey increased 1.3¢ to average 38.6¢/lb.
- The cheese market in the Midwest remains sluggish after the recent drop in prices, according to Dairy Market News. Buyers are reluctant to make sizable new purchases until prices settle, and many traders expect prices to stick to a tight range for awhile. Extra cheese is available to fill bulk orders.
- Western cheese plants have been running heavy over the holiday period and have been able to build inventory with the extra milk supplies that have been available. At the same time, cheese sales have slowed after the holiday rush, according to Dairy Market News, although increased orders are expected for the Super Bowl. Buyers are holding back on orders to see where the market will settle.
- International: Dairy Market News reports milk production is at seasonally low levels but indications of increases are being reported. Manufacturers and handlers report that stocks of finished dairy products are available for immediate and near term buyer interest. Market activity has been very light the past few weeks but is expected to pick up as the new year unfolds.

Recommendation:

It wasn't long ago that we wrote a pretty bullish report, only to see block cheese crumble and Q1 futures hit with relentless selling in the weeks that followed. While the move lower was no fun and far exceeded our expectations, it's worth stepping back as the new year begins and taking in the big picture. Since summer, prices have recovered over 40%, so it's worth asking, "Is the long-term uptrend over, or is this a correction?" With Christmas and New Year's now behind us, buyers are on the sidelines, evaluating what their needs will be for next year. Hindsight is 20/20 and we should have known this lull would happen and been more aggressive on coverage in Q1. We also have quite a large inventory of cheese in the country that we do need to trim down. However, global forces are still in play. With world prices for cheese and butter still much higher than in the U.S., phones should start ringing with orders. And as FAS wrote this week, with milk production set to decrease in both the U.S. and EU this year and average output out of Oceania, it should at a minimum keep our market from returning to the \$9-11 milk we saw this summer. With many in the biz saying \$1.35-1.40 cheese is the bottom, think of it as a free PUT option at about \$13.25 milk. So, to answer our question above, no, we do not believe the long-term trend towards price recovery has ended, and that this is a correction in the market. Corrections can last for some time, so we're not implying we're off to the races next week. Cheese could trade lower, but it looks like we're carving out a bottom here. At this point we would not be sellers of milk, and PUT options in Q1-Q2 aren't the best value. Hedgers should instead be looking to buy CALL options Feb-May, and then entering orders to sell milk close to their CALL strike price. Buy the Feb 14.00 call for 25¢ or better, Mar 14.75 call for 25¢ or better, Apr 15.25 call for 25¢ or better and the May 15.75 call for 30¢ or better. We'd leave the 2nd half of 2010 and beyond alone for now.

Trading futures and commodities involves substantial risk and may not be suitable for all investors. You should carefully consider whether the risks involved in trading in commodities is suitable for you or your organization in light of your financial condition. While the information we gather and present is deemed to be reliable, it is in no way guaranteed. Neither the opinions expressed on this website nor in "The KDM Dairy Report", shall be construed as an offer to buy or sell any futures or options on futures contracts. In addition, past performance is not necessarily indicative of future results.