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The KDM Dairy Report – Jan 22nd, 2010

What's Bullish:

Futures Month	Class III 01/22 Close	Class III 01/15 Close	Change	Dry Whey 01/22 Close	Dry Whey 01/15 Close	Change
Jan-10	$14.49	$14.43	**$0.06**	38.50¢	38.50¢	**0.00¢**
Feb-10	$14.18	$14.25	**($0.07)**	36.25¢	37.00¢	**(0.75¢)**
Mar-10	$14.16	$14.62	**($0.46)**	36.50¢	37.00¢	**(0.50¢)**
Apr-10	$14.21	$14.75	**($0.54)**	35.68¢	35.75¢	**(0.08¢)**
May-10	$14.70	$15.18	**($0.48)**	33.75¢	34.50¢	**(0.75¢)**
Jun-10	$15.15	$15.65	**($0.50)**	35.73¢	37.50¢	**(1.78¢)**
Jul-10	$15.60	$15.97	**($0.37)**	34.73¢	36.70¢	**(1.98¢)**
Aug-10	$15.77	$16.15	**($0.38)**	35.50¢	37.00¢	**(1.50¢)**
Sep-10	$16.05	$16.26	**($0.21)**	36.00¢	36.58¢	**(0.58¢)**
Oct-10	$15.95	$16.26	**($0.31)**	34.50¢	36.00¢	**(1.50¢)**
Nov-10	$15.79	$15.99	**($0.20)**	34.00¢	36.00¢	**(2.00¢)**
Dec-10	$15.79	$15.93	**($0.14)**	37.00¢	36.00¢	**1.00¢**
2010	**$15.15**	**$15.45**	**($0.30)**	**35.68¢**	**36.54¢**	**(0.87¢)**

- Cash Market: On very few sales, bidders moved both the block and barrel prices higher. Blocks picked up 7½¢ on the week to settle at $1.48/lb while barrels tacked on 4¢ to close at $1.50½/lb. There were just 4 block trades and 1 barrel trade. Butter lost 5¾¢ to settle at $1.46¾/lb on 14 trades.
- Milk Production Report: December milk output in the U.S. was down 0.9% vs. a year ago, the first time production has fallen in Dec since 2001. On an annual basis, production in 2009 was 0.4% lower than in 2008. The number of milk cows in the U.S. fell by 252,000 head, but only dropped 3,000 head from Nov to Dec. Milk per cow increased 32 lbs as the age of the herd decreased. Production declines were led by CO down 11.1%, AZ down 10.9% and MO down 8%. CA output was down 4.6%, but WI production increased 4.3%.
- Butter stocks at CME-approved warehouses remain well below year-ago levels and are increasing at a much slower rate. For the week ending 01/16, stocks on hand were 15.4 million lbs under year ago levels. They did increase by 1.1 million lbs, but that was much less than the 7.4 million lb increase during the same period last year.
- Class I demand in the Northeast region of the country remains strong, according to Fluid Milk & Cream Review. Manufacturing milk supplies are adequate to somewhat tight, while bottlers looking for rBST free milk are faced with tight supplies. Milk production is steady with no noticeable increases. Supplies are in better balance in the Southeast and Florida, but the Southeast imported 54 loads of Grade A milk into the region this week, up from 25 loads last week. Likewise, Florida had no loads in or out, but during the same week last year, they exported 133 loads.
- Butter inventories in the Northeast are building, but are held in confidence, according to Dairy Market News. Manufacturers are preparing for the upcoming Easter holiday, and butter prices remain below foreign prices, continuing to draw export interest.
- Central dry whey prices are higher and the market is firm, according to Dairy Market News. Production is about steady, while contract demand is solid. Any spot loads being offered are moving readily to buyers on the waiting lists most sellers have handy, at prices that are a premium to the market. Some Central dry whey is filling unmet eastern demand.
- Dairy Market News reports increased Class I demand has lowered manufacturing milk supplies and resulted in decreased cheese/whey production. Whey supplies are tight, while production decreases have caused some shipments to be delayed. Prospective customers are looking to the Midwest and West for additional product.
- In the Midwest, the cheese market is unsettled, but there are a few bright signs, according to Dairy Market News. Bulk and finished orders are steady to improved as buyers try to reload before prices move higher. In addition, many plant operators have worked down their 2009 inventory. However, interest in extra cheddar for aging programs is sluggish and cheese production is heavier.
- Western cheese producers report that sales have been good. Cheese plants have been trying to run at full capacity, but milk supplies in some states have limited that option, according to Dairy Market News. Inventories are reported to be clearing on a timely basis, and interest is picking up as end users try to determine when and how much product should be purchased.
- International: Milk output in some parts of New Zealand is down 15% from projections, according to Dairy Market News. Some plants are being shuttered six weeks early, while other parts of New Zealand are being impacted by lack of rainfall. In Australia, November milk output was down 6.8% compared to Nov '08. Manufacturing schedules are declining in both countries with stocks being generated for needs. Traders indicate that buyer interest is present, but no product is available to fill these inquiries from the Oceania region. They state that if they had more supply, they would be able to sell it. Cheddar cheese prices are falling, but still averaged $1.88/lb in the region.

What's Bearish:

- Cold Storage Report: Ugh! At the end of December we had 13% more total cheese in storage than in Dec 2008. American cheese stocks were 9% higher than a year ago, and 1% higher than the prior month.

- NASS Class III components were mostly lower this week. 40-lb blocks plummeted 9.3¢ to average $1.55/lb and barrels inched 0.1¢ higher to $1.48/lb. Butter increased 0.9¢ to average $1.34/lb and dry whey ticked 0.2¢ higher to 39¢/lb, but nonfat dry milk declined 6.3¢ to $1.34/lb.
- Both cheese and butter stocks are higher at USDA selected storage centers. For the period 01/01 through 01/18, cheese holdings have increased 446,000 lbs, while butter holdings have increased 1.07 million lbs.
- Dairy cow slaughter for the week ending 01/09 totaled 56,600 head, well below the 71,700 head culled during the same week last year.
- Many plants in the Central region are operating on heavier schedules than a year ago, according to Fluid Milk & Cream Review. Manufacturing milk demand is steady, but fluid demand was occasionally lighter, and out-of-area shipments were down.
- Milk production in California is steady to slightly higher, and current levels are indicated to be closing the negative gap from year ago levels, according to Fluid Milk & Cream Review. Arizona output is also coming on stronger despite lower cow numbers, while milk receipts in New Mexico are trending higher, allowing processing plant schedules to increase slightly.
- Softness in the world powder markets is impacting U.S. demand, according to Dairy Market News. Nonfat dry milk buying interest has slowed from both domestic and export accounts, and additional product is available through resale channels, creating more competition. Producer stocks are building at many locations while drying activity is increasing due to milk production gains.
- Cheese inventories in the Northeast are building under sluggish domestic demand, according to Dairy Market News. However, some producers have indicated increased export activity.
- International: European traders and handlers indicate that stocks of finished dairy products are readily available for both domestic and international interest, according to Dairy Market News. Prices are trending lower as many manufacturers would like to clear these stocks before the new milk production season resumes. Sales are slow, but buyer inquiry is starting to pick up.

Recommendation:

We were in touch with a few folks that attended IDFA's annual conference this week, and there was a decidedly bearish tone there. Apparently there is talk from industry participants that domestic demand is slow and that international orders have not yet materialized. Perhaps that is why Class III futures were pummeled this week, despite a nice correction in the cash cheese market, where sellers seemed to let bidders move prices higher with little resistance. Volatility is definitely on the increase as +20 gains on the board regularly turned into -20, even after a nice gain in the spot cheese market. From a futures perspective, sellers were in control as they aggressively hit bids. Plugging in current spot cheese, butter and powder prices yields a Class III of about $14.27. This puts Feb, Mar and Apr at a slight discount to cash. Either selling has been overdone a bit, or there is an expectation that cheese prices are headed right back down. Weekly cheese updates this week, however, seem to indicate cheese is moving pretty well and demand is picking up. Stocks appear heavier in Europe, but tight in Oceania. It may be more likely that cheese prices could be stuck in a tight range for 3 months or more, especially in light of our bearish Cold Storage Report showing cheese stocks way up. In that case, the selling of Q1 and Q2 this week could be the anticipation of limited upside in cheese, thus taking premium out of the market. We unfortunately missed our hedge rec from last week to sell Feb at 14.50 or higher, by just 5¢. However, if the cash cheese market continues to move higher next week, futures will be forced to respond. This week we successful with a min-max strategy, or fence, buying the 15.00 PUT and selling the 19.00 CALL, Jun-Dec for an average of 35¢/mo. With this week's decline, the average cost has risen to 46¢/mo, but we wouldn't be afraid of loading up on this order again at 35¢ for up to 50% of your production. It's hard to know what to do with Q1Q2. We would try to buy PUT options Mar-May on any day we rally. Enter orders to buy the Mar-May 14.25 PUT for an average of 35¢ or better. We'll need a rally to get it, but maybe we get a relief rally next week, after the brutal beating we just took.