

The KDM Dairy Report – Jan 29th, 2010

What's Bullish:

- Midwest bottlers are having a good sales week, according to Fluid Milk & Cream Review. Upper Midwest milk is being shipped to bottlers in Kentucky to supplement local supplies ahead of an expected winter storm. Orders for dips and sour cream have been stronger the past couple of weeks, tied to the playoffs and Super Bowl parties. Cheese milk interest is spotty but improved with recent price increases.
- Producers in the Pacific Northwest are expressing concern about breakevens as they watch Class III prices fall, according to Fluid Milk & Cream Review. High quality forage supplies are becoming harder to find, and many hay brokers are operating on a cash and carry policy. Bankers continue to finance most operations, but spring financial meetings could be tense.

Futures Month	Class III 01/29 Close	Class III 01/22 Close	Change	Dry Whey 01/29 Close	Dry Whey 01/22 Close	Change
Feb-10	\$14.05	\$14.18	(\$0.13)	34.50¢	36.25¢	(1.75¢)
Mar-10	\$13.62	\$14.16	(\$0.54)	31.00¢	36.50¢	(5.50¢)
Apr-10	\$13.55	\$14.21	(\$0.66)	27.00¢	35.68¢	(8.68¢)
May-10	\$13.90	\$14.70	(\$0.80)	27.00¢	33.75¢	(6.75¢)
Jun-10	\$14.50	\$15.15	(\$0.65)	27.00¢	35.73¢	(8.73¢)
Jul-10	\$15.20	\$15.60	(\$0.40)	30.00¢	34.73¢	(4.73¢)
Aug-10	\$15.50	\$15.77	(\$0.27)	31.50¢	35.50¢	(4.00¢)
Sep-10	\$15.78	\$16.05	(\$0.27)	32.00¢	36.00¢	(4.00¢)
Oct-10	\$15.71	\$15.95	(\$0.24)	32.00¢	34.50¢	(2.50¢)
Nov-10	\$15.55	\$15.79	(\$0.24)	33.50¢	34.00¢	(0.50¢)
Dec-10	\$15.56	\$15.79	(\$0.23)	34.00¢	37.00¢	(3.00¢)
2010	\$14.81	\$15.21	(\$0.40)	30.86¢	35.42¢	(4.56¢)

What's Bearish:

- Cash Market: Blocks managed to pick up 3½¢ to close at \$1.51½/lb, but barrels were unchanged for the week at \$1.50½/lb. The real story was the fall in Grade A nonfat dry milk, which lost 11¢ to \$1.19/lb, and butter, which careened down 13¾¢ to settle at \$1.33/lb. There were ten trades each in blocks and barrels, 13 butter trades and just one nonfat trade.
- Ag Prices Report: The January milk-feed ratio climbed to a 24-month high at 2.45. While still below 3.0, farm profitability has been steadily improving since June.
- Cattle Inventory Report: USDA's twice annual report released this afternoon indicates there are plenty of replacement animals available. As of Jan 1, there were 4.52 million replacements, up from 4.41 million heifers a year ago. That means there are 49.7 replacements for every 100 cows, up from 47.2 per 100 last year. The number of replacement animals is the highest since 1986.
- Commercial Disappearance: While still ahead for the year, commercial use of American cheese slowed way down in November, declining 7.7% compared to a year ago, according to USDA. However, other cheese use increased 6%. Use of butter declined 6.3% vs. last Nov, while nonfat dry milk use fell 5.3% and use of milk in all products dropped 1.3%.
- Class III components were mostly lower this week, following recent weakness in the cash markets. 40-lb blocks declined 8.4¢ to average \$1.46/lb and barrels dipped 0.3¢ to \$1.48/lb. Butter jumped 4.6¢ to average \$1.39/lb, but nonfat dry milk plummeted 19.6¢ to \$1.09/lb and dry whey gave up 0.3¢ to 38.7¢/lb.
- Butter stocks at CME-approved warehouses increased a net 3.6 million lbs during the week ending 01/23, a jump of about 400,000 lbs compared to the same period a year ago.
- Dairy cow slaughter for the week ending 01/16 totaled 58,100 head, down from the CWT-aided 65,500 head during the same period a year ago. After just 3 weeks, the 2010 cull is already 30,000 head behind 2009.
- Fluid Milk & Cream Review reports slightly softer Class I demand has Florida back to a milk surplus state. 27 loads were exported compared to zero last week. Class I demand is also weaker in the Northeast, while production is flat, and in the Mid-Atlantic, the first signs of seasonally increased milk production were noted.
- California processing plants continue to see increased milk intakes, according to Fluid Milk & Cream Review. The extra milk is attributed to seasonal increases, better feeding and fresh heifers entering the herds. Arizona milk output is building and narrowing the gap from last year. Moderate weather, higher milk prices, better feed costs and the addition of fresh heifers were all cited.
- Churning activity across the country is seasonally active, according to Dairy Market News. As the cash price has declined this week, buyer interest has slowed, with longer term purchases being put on hold. Buyers are waiting until the current trend stabilizes. Butter stocks are readily available and currently are entering inventory programs at a faster rate than in recent weeks.
- Western dry whey prices are beginning to show some weakness, according to Dairy Market News. Cheese plants are working near full time and this has increased whey supplies for dryers. Supplies are adequate for both domestic and export markets, and weakness in the nonfat dry milk market has some buyers feeling that whey may be overpriced.

- Western nonfat dry milk supplies are moderate to heavy and expected to build, according to Dairy Market News. Prices were sharply lower in active trading, with some large sales at reduced pricing. Drying schedules are active and building to handle seasonal milk increases. Export demand is light and there are concerns about how much powder will become available from the EU into the world market, and how competitive U.S. sourced powder will have to be.
- Dairy Market News reports Midwest cheese buyers are trying to cut back on their contracted volume for the short term, as they have their needs covered. Interest in rebuilding stocks in aging programs is light, while cheese production remains seasonally heavy, due to milk volumes above year ago levels.
- Western cheese is moving well, but most plants are operating at full schedules, according to Dairy Market News. Buyers are showing some hesitancy to purchase at current prices levels, as other dairy products are showing price weakness. Stocks of cheese are adequate to fulfill contract needs, while some surplus cheese is being offered on the spot market.
- Dairy Market News reports finished product buyers entered 2010 with inventories often above last January, so refilling the finished product pipeline does not need as much cheese. Cheese promotions have been minimal thus far, and bulk orders have been filled under normal lead times.

Recommendation:

Nonfat dry milk? – down hard. Butter? – down hard. Dry whey? – down hard. Cheese? – steady. Everything around the cheese world is falling apart, but spot buyers are hanging in there and supporting \$1.50/lb.... so far. But it didn't take traders long to see the big picture, and you guessed it: milk futures – down hard, and pricing in a drop in cheese prices. We had hints about this from last week's IDFA feedback, but perhaps it was best said in this week's Dairy Market News updates. That is, that buyers have entered 2010 with inventories above last year's levels, and are holding back on purchases. Combine that with a plentiful supply of replacement animals and milk increasing across the country seasonally, and it all adds up to what looks to be a messy Q1 and maybe Q2. We won't kid around here; we were too bullish. But we can't reverse time, so let's roll up our sleeves. While the market appears overdone to the downside, there really is no reason it can't keep falling. Some cheap disaster insurance may be in order. Feb is half priced already, so let's start with March 13.00 PUTs at 15¢, April 13.00 PUTs at 20¢, May 13.00 PUTs at 18¢ and June 13.00 PUTs at 11¢. They're cheap and will probably expire worthless, but it is a floor. If this thing come back sooner than expected, great, not much lost. On the flip side, these lower prices could be the final spike for many in the dairy industry who are still reeling and haven't even begun to rebuild equity, much less make a profit. Cheese may not go as low as some expect, in light of the growing potential that cheese and milk get tight in the second half of 2010. We would start buying CALL options May-Dec and sell into them WHEN not IF prices recover. Seriously, can we have sub \$14.00 milk all year? Seems hard to fathom that as a possibility. Buy May 15.00 CALLs at 16¢, June 16.00 CALLs at 18¢, July 17.00 CALLs at 18¢, Aug 17.50 CALLs at 21¢ and Sep-Dec 18.00 CALLs at an avg 20¢ each. Once purchased, get your sell orders in place. Lock and load! As painful as Q1 is shaping up to be, we are entering a real opportunity here for some great hedges in 2010.

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