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The KDM Dairy Report – Feb 12th, 2010

What's Bullish:

- Class III components were mostly higher in this week's NASS survey. 40-lb blocks averaged $1.48/lb, up 2.5¢ and 500-lb barrels picked up 2.3¢ to $1.53/lb. Butter declined 1.3¢ to average $1.39/lb, but nonfat dry milk increased 1.2¢ to $1.14/lb and dry whey inched 0.1¢ higher to 39¢/lb.
- Butter stocks at CME-approved storage centers increased by just 3.2 million lbs for the week ending 02/06. That compares to a 5.4 million lb increase during the same period last year. Total stocks on hand are about 10 million lbs under year ago levels.
- Fluid Milk & Cream Review reports very strong Class I demand in the Eastern region of the country. There was a rush on milk just before winter storms hit, which left retailers scrambling to restock nearly empty shelves before another approaching storm. These is also some concern in the New England states that feed energy levels are inadequate and may cause lower conception rates.
- California milk output is trending lower as the impact of weather conditions is felt, according to Fluid Milk & Cream Review. In addition, feeding decisions and time in lactation are resulting in intake declines of 1-3%. The rainfall and wet field conditions are also impacting the start of alfalfa hay in Southern California.
- Dairy Market News reports last week's winter storm and the forecast for another storm have increased Class I demand and put a crimp in cheese production schedules.
- Economy: U.S. retail sales in January increased a better-than-expected 0.5%, according to the Commerce Department. It suggests consumers are spending more despite high unemployment.
- International: December milk production in Australia was down 9.6% compared to Dec '08, according to Dairy Australia. July-Dec, output is 6.2% below the prior milking season.
- International: China's latest milk tainting scandal may cut the risk of a slide in global dairy prices, by stimulating demand for imports at a time when other buyers are backing off, according to a Rabobank dairy analyst. China's imports of whole milk powder tripled in 2009 after the initial melamine scandal, but were expected to drop by 25% in 2010.

Futures Month	Class III 02/12 Close	Class III 02/05 Close	Change
Feb-10	$14.25	$14.10	$0.15
Mar-10	$13.77	$13.55	$0.22
Apr-10	$13.50	$13.24	$0.26
May-10	$13.49	$13.40	$0.09
Jun-10	$13.88	$14.00	($0.12)
Jul-10	$14.56	$14.76	($0.20)
Aug-10	$15.15	$15.06	$0.09
Sep-10	$15.47	$15.37	$0.10
Oct-10	$15.45	$15.32	$0.13
Nov-10	$15.28	$15.25	$0.03
Dec-10	$15.26	$15.26	$0.00
2010	**$14.55**	**$14.48**	**$0.07**
Jan-11	$15.18	$15.20	($0.02)
Feb-11	$15.10	$15.25	($0.15)
Mar-11	$15.05	$15.20	($0.15)
Apr-11	$15.05	$15.15	($0.10)
May-11	$15.24	$15.25	($0.01)
Jun-11	$15.24	$15.25	($0.01)
Jul-11	$15.30	$15.30	$0.00
Aug-11	$15.35	$15.37	($0.02)
Sep-11	$15.34	$15.35	($0.01)
Oct-11	$15.60	$15.67	($0.07)
Nov-11	$15.60	$15.77	($0.17)
Dec-11	$15.60	$15.80	($0.20)
2011	**$15.30**	**$15.38**	**($0.08)**

What's Bearish:

- Cash Market: Blocks managed to register a small 1¼¢ increase for the week to settle at $1.50½/lb, but barrels fell 2¾¢ to $1.44½/lb. Trading was light with 4 loads of blocks and 6 loads of barrels changing hands. Butter remains fairly range-bound but did increase 1¼¢ to $1.34/lb on 11 trades.
- February is NOT starting out well in terms of stocks. Weekly cold storage holdings at USDA selected storage centers indicate a 10% (11.8 million lbs) increase in cheese stocks and 12% (1 million lbs) increase in butter stocks in just the first eight days of the month.
- Weekly dairy cow slaughter, while above 50k, trailed last year's cull during the same week. 54,300 head were removed from the milking herd for the week ending 01/30, compared to 63,000 head in 2009.
- Winter storms in the Midwest did not seem to stimulate retail Class I sales like they did out East, according to Fluid Milk & Cream Review. Class I demand was about steady, while Class II interest was average at best. Cheese milk interest is light and offerings are in good balance. Milk intakes are trending higher, leaving plants with little interest in adding patrons until perhaps summer.
- Fluid Milk & Cream Review reports Arizona milk output continuing to increase and narrow the gap from year ago levels. Fat and protein levels are also building, which is welcomed by available processing plant capacity. The cream markets are weak and is characterized by heavy offerings. The Pacific Northwest has avoided many of the severe winter storms and is enjoying mild temperatures. This has allowed milk production to remain near year ago levels. Supplies are sufficient for bottling and extra supplies are being distributed between cheese and butter/powder manufacturers. Milk solids are increasing and yields are reported as good, while inventories of cheese, butter and powder are building.
- Western churns continue to produce more butter than needed for immediate needs, according to Dairy Market News. Excess inventory is being put into storage, while some extra butter is being offered on the spot market. Retails orders

are heavier, leading into Easter/Passover, but food service orders have eased, with many buyers indicating business has dropped off quite a bit from the yearend holiday period.

- Central dry whey prices declined for the first time in several weeks, according to Dairy Market News. Spot loads are available from both manufacturers and resellers. A weak undertone remains for Eastern dry whey as well. Many buyers are sitting on the sidelines waiting to see how low prices will go, and export demand has slowed as the dollar has strengthened. Western whey exports to China have slowed as the Chinese New Year celebration begins February 14th. Increased production schedules from busy cheese factories have allowed inventory to build in some instances.
- Stocks of western nonfat dry milk are moderate to heavy, according to Dairy Market News. Demand has slowed as buyers anticipate lower prices and export inquiries are sluggish.
- The cheese market in the Midwest is "flat" as demand has slowed and cheese production is increasing seasonally. Dairy Market News reports new orders are down for many packaging firms and offerings are increasing for standard varieties. Interest in spot purchases of cheddar for aging programs remains light, while current cheese production remains above year ago levels.
- Western cheese plants continue to receive the lion's share of milk production in the region, according to Dairy Market News. Plants are working on full schedules, and that is resulting in cheese supplies being adequate to long. Contracted cheese is moving well, but surplus inventory sales are described as sluggish. Buyers are reluctant to purchase ahead for more than immediate needs.

Recommendation:

Class III futures had their biggest one-day gain in more than 10 months on Wednesday, only to see most of those gains disappear the following two days. The rally was prompted by both blocks and barrels increasing in Wednesday's cash market, which triggered furious short-covering. It was a perfect opportunity for producers to get on some coverage and an excellent example of why you need a plan in place with orders set to execute. For the past few weeks we have been buying call options Mar-Jun, and this rally, which was over in a matter of hours, allowed us to get several producers covered through May. For example, we had purchased March 13.75 call options on Feb 2nd. We sold March at 13.70 on Feb 9th. We bought Apr 14.00 calls on Feb 2nd and sold it at 13.75 on Feb 10th. Finally, we bought May 14.50 calls on Feb 2nd and sold May at 14.00 on Feb 11th. Compare those sell prices with where we are at today. The point is, you need a plan and have it ready to execute. Having the calls bought in advance took the emotion out of it as we knew we would give up less than 75¢ upside if the markets kept moving higher. Now these guys are covered through May, which might give the market enough time to recover, because in the near term, things don't look good. Just check out the bear bullets above: cheese inventory building, dry whey weakening, butter building, slow sales, milk production increasing in key areas. Long term our bias is much more bullish, but it looks like it will take awhile before we get there. Things in Oceania continue to look tight, while $13 milk now could be the final straw for many domestic operations. We would continue to look for call options to sell into on the way down. Between now and May we are bound to have a few up days to sell your milk. Otherwise, you may need to just buy disaster insurance in the form of 13.00 PUT options Apr-Jun which average about 22¢. We're still OK with selling some 2nd half milk, but make sure you purchase call options on anything sold. The second half could see some real upside later this year. We wouldn't mess at all with 2011 yet.