KDM Trading, Inc.
877.695.8538 www.kdmtrading.com
Dan Schindler, Mark Potter, Keith Schnese & Nick Potter

The KDM Dairy Report – Feb 19th, 2010

What's Bullish:

- December fluid milk sales were 0.6% higher than in 2008, according to Dairy Market News. About 4.9 billion lbs of packaged fluid milk were sold during the month. Sales of flavored milk led the increase.
- Outlook for U.S. Ag Trade Report: USDA's quarterly look at U.S. ag export prospects contains some good news. 2010 exports are expected to rise to $100 billion, up $2 billion from their November forecast and should be $3.4 billion higher than 2009 exports. Global economic recovery and healthy commodity prices were cited as reasons. Dairy exports are forecast to increase 7% due to firmer global dairy prices impacting export values. The longstanding drought in Australia and recent development of drought in New Zealand could further strengthen prices if the drought impact deepens.
- International: Dairy Market News reports that conditions remain much the same in Oceania. Prices are trending lower, but the pace is slowing. And surplus stocks of finished dairy products are limited for spot buyers. Buyer interest has been slow this week due to the Chinese New Year, but traders anticipate it will begin to gain momentum next week.

Futures Month	Class III 02/19 Close	Class III 02/12 Close	Change
Feb-10	$14.20	$14.25	($0.05)
Mar-10	$13.37	$13.77	($0.40)
Apr-10	$13.04	$13.50	($0.46)
May-10	$13.17	$13.49	($0.32)
Jun-10	$13.50	$13.88	($0.38)
Jul-10	$14.15	$14.56	($0.41)
Aug-10	$14.80	$15.15	($0.35)
Sep-10	$15.15	$15.47	($0.32)
Oct-10	$15.25	$15.45	($0.20)
Nov-10	$15.00	$15.28	($0.28)
Dec-10	$15.02	$15.26	($0.24)
2010	**$14.24**	**$14.55**	**($0.31)**
Jan-11	$15.00	$15.18	($0.18)
Feb-11	$14.95	$15.10	($0.15)
Mar-11	$14.89	$15.05	($0.16)
Apr-11	$15.04	$15.05	($0.01)
May-11	$15.10	$15.24	($0.14)
Jun-11	$15.24	$15.24	$0.00
Jul-11	$15.29	$15.30	($0.01)
Aug-11	$15.34	$15.35	($0.01)
Sep-11	$15.20	$15.34	($0.14)
Oct-11	$15.60	$15.60	$0.00
Nov-11	$15.60	$15.60	$0.00
Dec-11	$15.60	$15.60	$0.00
2011	**$15.24**	**$15.30**	**($0.07)**

What's Bearish:

- Milk Production Report: Jan milk production in the U.S. was down 0.6% vs. a year ago, which was in line with expectations. With a milking herd of 9.085 million head, we're starting 2010 with 227,000 fewer cows. However, cow numbers increased month-to-month for the first time in a year. 3,000 head were added from Dec to Jan. Oh oh. In addition, with a younger herd, milk per cow increased 33 lbs over last year.
- Cash Market: Blocks lost 9¼¢ this week to close at $1.41¼/lb, while barrels decreased 6¾¢ to settle at $1.37¾/lb. Trading was moderate with 11 loads of blocks and 12 barrels exchanging hands. Butter increased 2¢ to settle at $1.36/lb on heavy trading of 28 loads, but came off its mid-week high of $1.38.
- Cheese and butter stocks are rocketing higher so far in February. For the period 02/01 through 02/15, butter holdings at USDA selected storage centers increased 19%, or 1.6 million lbs, and cheese holdings jumped 15%, or 18.3 million lbs.
- Dairy cow slaughter for the week ending 02/06 totaled 56,200 head, down from 61,500 head during the same period a year ago and the sixth straight week of levels below 2009. YTD the dairy cow cull is already 50,000 head behind.
- Fluid Milk & Cream Review reports Class I demand has leveled off this week, resulting in increased milk supplies for manufacturing plants. In Florida, Class I sales are flat, allowing the state to export 100 loads of Grade A milk.
- Class I interest is uneven and milk volumes in the Central region are ample for needs, according to Fluid Milk & Cream Review. Plant inventories of finished products are mostly on the rise as buyers minimize purchases during falling prices. Some reports of discounts on spot loads of manufacturing milk are being reported, as more operations would rather sell some then use or buy it.
- Milk volumes in California are adequate to long when compared to demand for finished dairy products, according to Fluid Milk & Cream Review. In Arizona, solids levels are building, which is improving yields of dairy products. Cream supplies are moderate to heavy with little change in demand.
- Churning across the country continues to be seasonally active, with excess product clearing to inventory. Dairy Market News reports new orders have eased from food service accounts. Buyers indicate that for many, business has dropped off quite a bit from the yearend holidays.
- The market tone for Western nonfat dry milk remains weak, according to Dairy Market News. The weaker NDM complex has in essence cast a weaker tone over many dry dairy proteins and caused buying interest to slow. Export interest is slow as well, due to strengthening of the U.S. dollar and uncertainty as to whether the EU will offer NDM at lower levels after March 1st.
- Sales for current cheddar cheese are sluggish and inventories are building in the Northeast, according to Dairy Market News.
- Dairy Market News reports current cheese orders are light in the Midwest. More cheese is being offered on the CME Group as producers and packagers struggle for sales. Retail promotions thus far in the year have not been as

attractive to consumers as last years' and so sales have not seen a similar response. Inventories are increasing for some producers, so they are looking for ways to reduce cheese production and sell extra milk.

- Supplies of barrels are building out West, according to Dairy Market News. Cheese plants are operating on heavy schedules. While demand remains good for contracted cheese, excess supplies are meeting some resistance from buyers, who are trying to determine optimum pricing opportunities.
- International: Jan-Dec 2009 exports of cheese and curd declined 17% vs. 2008, according to USDA's Foreign Ag Service. Butter exports declined 68% and nonfat dry milk exports fell 27% over the same period.
- International: European butter and powder prices remain weak, according to Dairy Market News. Despite a recent cold spell that is limiting milk production gains, milk handlers are not overly concerned and state that milk growth will resume when weather conditions become more favorable.

Recommendation:

$15 milk is fast becoming a lost memory as producers began selling whatever "good" prices were left in 2010. There is very little supportive news out there and the next two months or so look bleak. While milk production down 0.6% in Jan is good, cow numbers increasing month-to-month is not. Unless international demand picks up, we probably need to get rid of another 100,000 head to right this ship. The cash market appeared driven by sellers, with buyers seemingly reluctant to hold prices. Punching in today's cash numbers gives us about $12.87 Class III. While the majority of the move south in the front months has already occurred, a slower grinding lower towards the cash price is likely if cheese doesn't find a bid. Easter/Passover demand should help some, but at this point it looks as if consumer demand has slowed and orders are sluggish. Even the Eastern region, which in the past few weeks mentioned strong Class I demand and little milk available for cheese, now says cheddar cheese inventories are building. In addition, a $90 million expansion by Southwest Cheese in Clovis, NM, one of the largest cheddar block makers in the U.S., is getting ready to open this spring. Block capacity is said to be expanding by 33%.

If you have very little of your milk hedged yet this year, we would consider selling some $15 milk if it is profitable for you, and then protect those sold positions with call options. Buy $13.00 put options Mar-Jun to stop the bleeding.

For those producers who have already hedged a large percentage of their milk for the first half of the year, you have time on your side. While we expect all 2010 milk contracts to head down in the near term, the lower we go now, the more bullish we get July-Dec. We would recommend buying calls at a discount to current prices as the 2nd half is sold off. Consider purchasing the following:

July 15.00 calls for 25 cents – settled at 43
Aug 16.00 calls for 25 cents – settled at 36
Sep 16.25 calls for 30 cents – settled at 43
Oct 16.25 calls for 35 cents – settled at 47
Nov 16.00 calls for 35 cents – settled at 50
Dec 16.00 calls for 40 cents – settled at 54

As your orders for these calls are filled, enter GTC orders to sell your milk at 50¢ below the strike price of the call. For example, if your Aug 16.00 call fills for 25¢, enter an order to sell your milk at 15.50. If the market then rallies, you will only give up a max 75¢ upside on the move. Get your plan in place now so that it executes itself. Take the emotion out of pulling the trigger!