

The KDM Dairy Report – Feb 26th, 2010

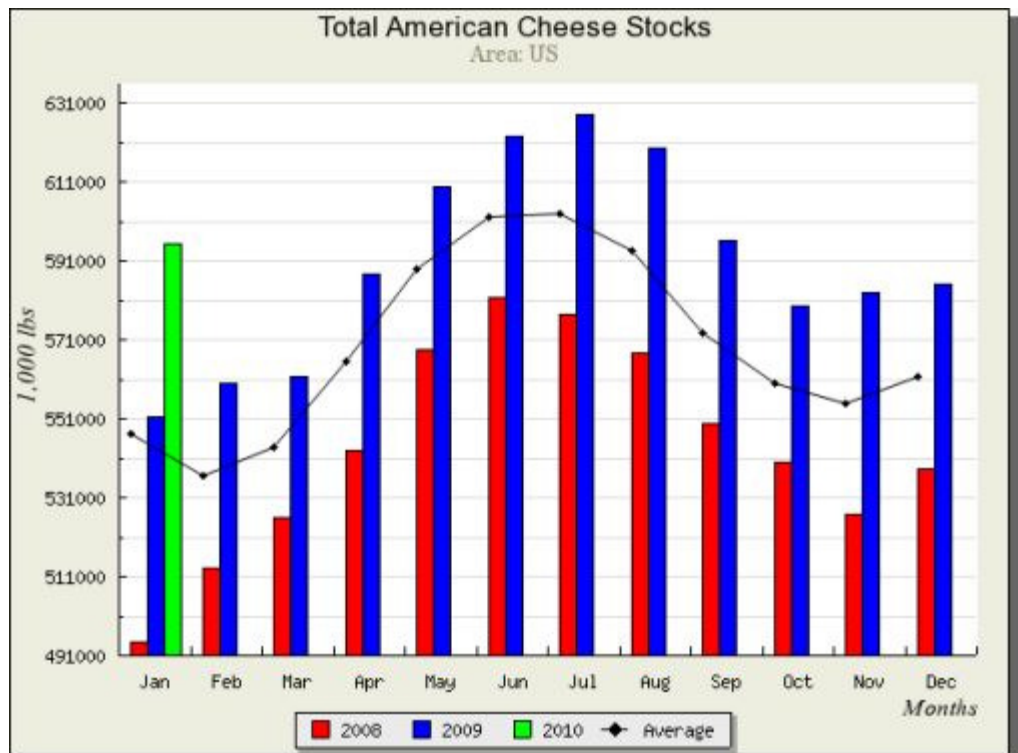
What's Bullish:

- **Livestock, Dairy & Poultry Outlook Report:** USDA increased their Class III price forecast for 2010 by 10¢/cwt from last month's report, now expecting an average of \$15.25/cwt for the year. While acknowledging that higher than expected replacement heifer numbers will result in a more gradual herd size decline, exports are forecast to rise substantially in 2010 compared with 2009. Factors cited were an expectation of Australian output to fall 1% due to drought and high feed prices, and vigorous economic recovery in developing countries.
- Butter stocks at CME approved warehouses declined 460,000 lbs during the week ending 02/20. The net drawdown is anti-seasonal and compares to a 2.9 million lb increase during the same period in 2009. Stocks on hand total 56.7 million lbs, down 12.2 million lbs from a year ago.
- Fluid Milk & Cream Review reports auctioneer schedules are filling for the month of March, as producer profitability and weak prices play a role in decision making.
- Milk production in California and Arizona is flat, while output in New Mexico is slightly lower, according to Fluid Milk & Cream Review. Lower milk, cheese and dry milk prices are becoming a bigger concern as fixed costs have remained high. Ice cream demand is starting to pick up in southern areas, giving the cream market a firm tone. Milk supplies are in good balance with demand in the Pacific Northwest, as processors are able to clear any extra supplies easily. Falling Class III prices have ag lenders looking closely at costs, while farmers are feeling more pressure to meet payments to suppliers and creditors.
- Dairy Market News reports butters sales and clearance of contracted inventory are good. Spot loads of butter continue to find willing buyers, while sales into retail and club stores is decent. Demand from the food service sector remains below expectations, but manufacturer inventories are increasing at a slower rate. Export interest remains, despite the stronger dollar.
- Central dry whey prices were steady this week, with instances of production shortages for contracted needs, according to Dairy Market News. Contract sales are active for Western whey. Heavy cheese production is supplying whey manufacturers ample quantities for drying, but exporters are looking to return to the market as Chinese New Year celebrations have ended. Spot loads of whey remain hard to come by while second quarter sales are being negotiated.
- Whey supplies in the Northeast are fairly tight, as drying decreased due to reduced cheese production. Producers are still trying to catch up on contracts, forcing prospective buyers to look to the Midwest to secure available loads.
- International: Packaged milk sales in Australia were up 0.2% in Jan compared to Jan '09, while July-Jan sales are up 2.1%, according to Dairy Australia.

What's Bearish:

- **Cash Market:** Buyers became more interested but sellers retained control, pressing prices

Futures Month	Class III 02/26 Close	Class III 02/19 Close	Change
Feb-10	\$14.28	\$14.20	\$0.08
Mar-10	\$13.05	\$13.37	(\$0.32)
Apr-10	\$12.90	\$13.04	(\$0.14)
May-10	\$13.16	\$13.17	(\$0.01)
Jun-10	\$13.60	\$13.50	\$0.10
Jul-10	\$14.09	\$14.15	(\$0.06)
Aug-10	\$14.65	\$14.80	(\$0.15)
Sep-10	\$14.84	\$15.15	(\$0.31)
Oct-10	\$14.90	\$15.25	(\$0.35)
Nov-10	\$14.80	\$15.00	(\$0.20)
Dec-10	\$14.75	\$15.02	(\$0.27)
2010	\$14.09	\$14.24	(\$0.15)
Jan-11	\$14.70	\$15.00	(\$0.30)
Feb-11	\$14.55	\$14.95	(\$0.40)
Mar-11	\$14.70	\$14.89	(\$0.19)
Apr-11	\$14.75	\$15.04	(\$0.29)
May-11	\$15.10	\$15.10	\$0.00
Jun-11	\$15.10	\$15.24	(\$0.14)
Jul-11	\$15.15	\$15.29	(\$0.14)
Aug-11	\$15.34	\$15.34	\$0.00
Sep-11	\$15.20	\$15.20	\$0.00
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	\$15.12	\$15.24	(\$0.12)



lower. Blocks lost 7¼¢ for the week to close at \$1.34/lb and barrels gave up 8¾¢ to settle at \$1.29/lb. Buyers took on 31 loads of blocks (about 1.3 million lbs) and 15 loads of barrels in heavy trading. Butter jumped 4½¢ to close at \$1.40½/lb on 13 trades.

- **Cold Storage Report:** U.S. cold storage holdings of butter totaled 169.8 million pounds, 28% more than a month ago, but 4% less than last year. Natural American cheese holdings total 595.3 million pounds, 2% more than a month ago, and 12% more than a year ago (see graph above). Total cheese stocks were 980.8 million pounds, 1% more than a month ago and 11% more than the same period last year. Nonfat dry milk holdings at the end of December total 288 million pounds, 3 million pounds more than last month and 34 million pounds more than a year ago.
- **Livestock Slaughter Report:** 232,100 cows left the milking herd in January, but that was 49,000 cows fewer than Jan 2009, according to USDA.
- **Ag Prices Report:** The Feb milk-to-feed ratio was 2.38, up from a revised 2.31 in Jan, but slightly below the high in Dec of 2.42.
- Weekly cold storage numbers continue to reflect growing inventories in a sluggish sales environment. Cheese stocks at USDA approved warehouses are up 16%, or 19.5 million lbs for the period 02/01 through 02/22, while butter stocks have increased 25%, or 2.1 million lbs over the same period.
- Weekly dairy slaughter remains below last year's CWT-enhanced levels. For the week ending 02/13, 52,000 head were culled, compared to 64,500 head during the same week in 2009. YTD the cull is behind by more than 61,000 head.
- Manufacturing milk supplies have increased in the Northeast as Class I demand levels off, according to Fluid Milk & Cream Review. Some cheese plants have reduced production schedules, so drying operations have expanded in order to handle the additional milk. In the Mid-Atlantic, production has increased enough to where additional trucks will be added to routes. 116 loads of Grade A milk were exported from Florida this week, up 16 loads from last week. Cheese plants are reducing production schedules in the face of lower prices and growing inventories.
- Large volumes of milk are available in the upper Midwest, allowing bottlers to acquire extra loads with little difficulty, according to Fluid Milk & Cream Review. Manufacturing milk interest is light and Class I demand is average. There is concern about plant level cheese inventory growth and how to manage it in a falling market. Few plants are interested in adding producers until spring flush is over and intakes are on the decline.
- Buyer interest for Western nonfat dry milk is slow, unless discounted, according to Dairy Market News. Recent price declines have buyers sitting on the sidelines, though the lower prices have stimulated some large movement. In the Central region, sizeable offerings and light demand continues to pressure price. Buyers are still reluctant to purchase for more than short term needs, expecting weakness into the spring flush. Current production remains heavy.
- Northeast cheese manufacturers are attempting to limit production schedules in the face of declining prices and expanding cold storage inventories. Dairy Market News reports sales for current and flavored cheese are sluggish and inventories are building.
- The Midwest cheese market is weak and many traders expect additional price declines, according to Dairy Market News. Buyers are content with making minimal fill-in orders until prices reach a bottom. Processors have line time available to run additional orders, and some in the industry do not expect prices to turn around until summer heat or some other event sharply reduces milk volumes. Current promotional activity for Lent and other cheese specials have not been as effective as last year. Cheese production remains seasonally active and extra milk is readily available.
- Weaker prices have not dampened Western cheese production schedules, according to Dairy Market News. Contract orders are good, but some buyers are sitting on the sidelines to place orders after prices decline further.
- **Economy:** Home sales in January fell a more-than-expected 7.2% according to the National Association of Realtors. The number of sales was the weakest since June, evidence that high unemployment and tight lending standards are undercutting the government's attempts to prop up the market.

Recommendation:

\$15 milk disappeared this week, not to be seen until May 2011 if Class III futures are correct. The spot cheese market pushed to new lows for the year and doesn't look done yet. Growing manufacturer inventory and a sluggish economy are not boding well for the near term, while our Cold Storage report this week shows Jan at record levels of American cheese sitting in coolers. One way to move inventory faster is lower prices, which is what we believe is happening now. While many thought \$1.35/lb block was a hard and fast line in the sand (us included), buyers in the spot market this week couldn't hold it and we sit at \$1.34. Plugging in current cash numbers puts us at about \$12.05/cwt, and some now think we're headed to \$1.25 cheese. That would give us sub-\$11.50 milk so whether we like to admit it or not, there is still plenty of downside potential up front. We would scramble to get PUT options bought Apr-Jun as we said last week, to "stop the bleeding". Or, sell now to your plant and buy call options to protect the sale. We think \$15 milk will be back before May 2011, but it doesn't look like we'll see it before the second half of 2010. We would still look to buy call options in the second half and use them to sell into.

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