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The KDM Dairy Report – Mar 5th, 2010

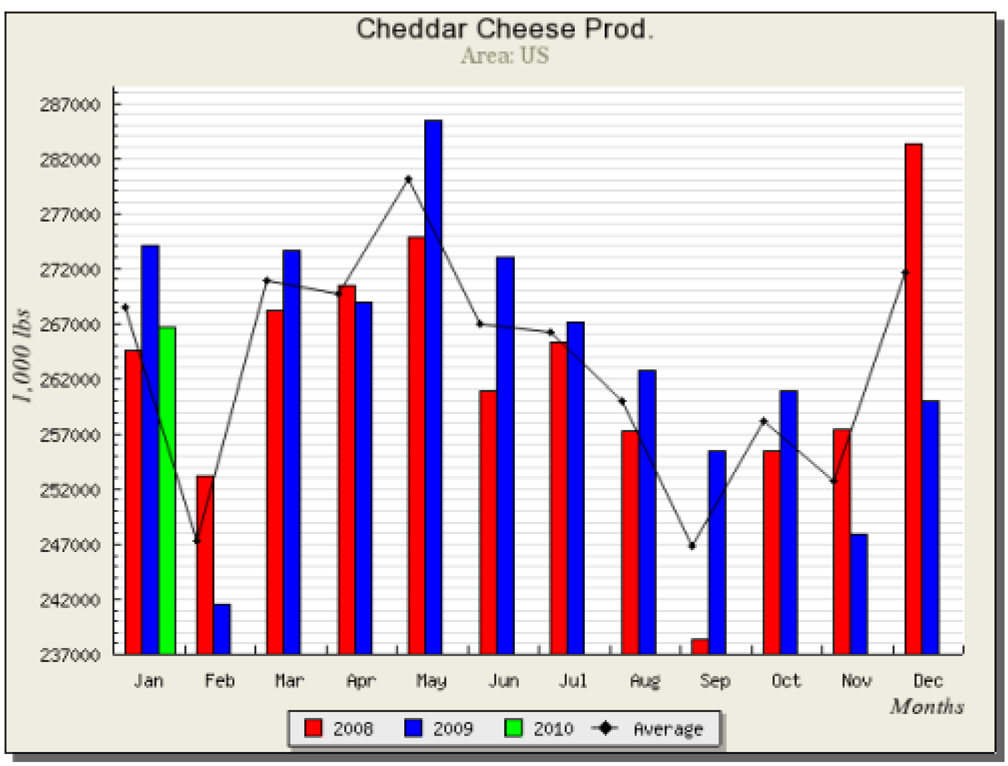
Futures Month	Class III 03/05 Close	Class III 02/26 Close	Change
Mar-10	$12.89	$13.05	($0.16)
Apr-10	$12.89	$12.90	($0.01)
May-10	$13.14	$13.16	($0.02)
Jun-10	$13.95	$13.60	$0.35
Jul-10	$14.55	$14.09	$0.46
Aug-10	$15.10	$14.65	$0.45
Sep-10	$15.23	$14.84	$0.39
Oct-10	$15.20	$14.90	$0.30
Nov-10	$14.98	$14.80	$0.18
Dec-10	$14.94	$14.75	$0.19
2010	**$14.29**	**$14.07**	**$0.21**
Jan-11	$14.55	$14.70	($0.15)
Feb-11	$14.30	$14.55	($0.25)
Mar-11	$14.37	$14.70	($0.33)
Apr-11	$14.45	$14.75	($0.30)
May-11	$14.70	$15.10	($0.40)
Jun-11	$14.75	$15.10	($0.35)
Jul-11	$15.10	$15.15	($0.05)
Aug-11	$15.10	$15.34	($0.24)
Sep-11	$14.85	$15.20	($0.35)
Oct-11	$15.40	$15.60	($0.20)
Nov-11	$15.50	$15.60	($0.10)
Dec-11	$15.60	$15.60	$0.00
2011	**$14.89**	**$15.12**	**($0.23)**

What's Bullish:

- Dairy Products Report: January cheddar cheese output fell 2.7% (see graph) compared to Jan '09, according to USDA. Butter production was down 7.2% over the same period; however, total cheese output increased 2.2%.
- Fluid Milk & Cream Review reports Class I demand in the Northeast is good. Cream supplies have become somewhat tight as butter and cream cheese production is very active ahead of the Easter and Passover holidays.
- Dry whey supplies in the Northeast remain fairly tight, according to Dairy Market News. This is resulting in light spot activity, keeping inventories from building and providing a firm undertone to the market.
- The consumer price index (CPI) for all food fell 0.4% from January 2009, according to USDA. The dairy products index was down 5.1% from a year ago. Lower prices typically stimulate demand.
- Economy: Major stock market indices climbed more than 1% Friday on a better-than-expected jobs report. 36,000 jobs were cut in Feb, less than the 50,000 expected, while unemployment came in at 9.7%, unchanged from Jan. Economists had expected it to rise to 9.8%.
- International: A cold winter is impacting milk production in Western Europe, according to Dairy Market News. Milk intakes are trending lower with Ireland reporting a 10% drop and France down 2%. Exporting is light, but prices for manufactured dairy products are stabilizing. Whey demand is steady, while skim milk powder prices are higher with an undertone that is firmer than in recent weeks.
- International: January milk production in Australia trailed 2009 levels by 9.1%, according to Dairy Market News. July-Jan milk production was 6.6% lower than the prior season.

What's Bearish:

- Cash Market: Spot cheese continued its downward slide with blocks falling 4¼¢ during the week to settle at $1.29¾/lb. Barrels followed, shedding 4¢ to close at $1.25/lb. There were just 8 block trades, but heavy barrel supplies resulted in 34 trades for the week. Butter jumped 4½¢ to settle at $1.45/lb on just 1 trade and Grade A NDM fell 1¢ to $1.11/lb.
- Most Class III components were lower in this week's NASS survey as they play catch-up to the cash market. 40-lb blocks decreased 1.4¢ to average $1.49/lb while barrels shed 3.4¢ to $1.47/lb. Expect bigger drops in the weeks to come. Butter increased 1.9¢ to average $1.36/lb, but nonfat dry milk gave up 2.5¢ to $1.04/lb and dry whey inched 0.5¢ lower to 38.9¢/lb.
- Weekly cold storage numbers don't paint a pretty picture. For the month of Feb, cheese stocks increased 19.8 million lbs, up 16%, while butter stocks jumped 25%, or 2.1 million lbs.
- Dairy cow slaughter for the week ending 02/20 totaled 57,300



head, down 2,200 head during the same period last year. The weekly cull needs to really ramp up before we can expect milk prices to improve.

- Manufacturing milk supplies have increased in the Northeast, according to Fluid Milk & Cream Review, a result of winter storms backing up milk in some areas. The spring flush may be starting in the Mid Atlantic as milk production is on the rise there. The Southeast reported exporting 55 loads of Grade A milk this week, the first exports out of the region in over a year. Florida exported 132 loads, up from 116 last week.
- Demand for manufacturing milk in the Midwest is light, and the offerings exceed demand, according to Fluid Milk & Cream Review. Plant operators are aggressively attempting to sell milk as a way to slow cheese inventory accumulation, putting pressure on spot milk prices. Many plant operators are nervous over whether they have enough plant capacity to handle spring receipts from their current producers.
- Dairy Market News reports Central dry whey prices edging lower this week as weakness in other dry products put downward pressure on the market. Cheese production levels are heavy and more whey is available for drying.
- The Western dry whey market is steady to weak, according to Dairy Market News. Production schedules are significantly higher than year ago levels, while buyers are watching current price trends before committing to future purchases.
- Stocks of Western nonfat dry milk remain moderate to heavy, according to Dairy Market News. Production is active to process available milk supplies, but buying interest is light, with loads clearing at discounted pricing levels. Export interest remains light.
- Cheese supplies in the Midwest remain readily available, according to Dairy Market News. Increases in milk production are keeping cheese production steady thought efforts to try to minimize inventory expansion remain.
- Dairy Market News reports Western cheese production levels are above a year ago, as milk is channeled to cheese plants to maintain production efficiencies. Previously contracted cheese continues to move large inventories, but new buyers are content to wait the market out. Export sales are being offered, but meeting resistance until buyers feel the market has reached a bottom. The stronger U.S. dollar has also made for tougher sales.
- Commercial Disappearance: Commercial use of American cheese in Dec '09 was down 1.9% vs. Dec '08, while Q4 '09 use fell 2.4% compared to the prior year. Butter use declined 4.3% in Dec and 8.8% for Q4, while use of milk in all products was down 0.5% in Dec and fell 1.9% for the year, compared to 2008. The report confirms what is thought to be a weaker '09 holiday sales period for the dairy sector.
- International: Dairy Market News reports rainfall in recent weeks is helping milk production in Australia close the production gap from a year ago. Feed prices have remained relatively low, allowing for supplemental feeding while pasture growth improved from the added moisture. Cheddar cheese demand is fair, with some buyers covered for the season and others filling in some needs. Cheese prices have trended lower, most reflecting pressure in other world markets.

Recommendation:

February Class III milk was announced at $14.28/cwt, down 22¢ from Dec and probably the last $14 milk we'll see for awhile. With coolers still unusually full of cheese, excess product, especially barrels, put pressure on the spot market all week. 34 barrels exchanged hands, representing 1.5 million lbs of cheese. Buyers appear ready to take on product at these levels, so hopefully we're carving out a bottom here, but plugging in current cash prices to the Class III formula yields about $11.75 milk. With April beginning its calculation in a couple weeks, it's pricing in more than $1/cwt premium. Unless the spot market starts to move up, both April and May will continue to grind lower as traders force more premium out of the contracts. We're not too excited about selling milk down here, but with significant risk of further price pressure, we'd still recommend getting PUT options bought to protect any unsold milk. The April-Jun 12.75 can be had for about 20¢/month average and would be worth buying for some peace of mind. Our contacts are telling us that despite bearish current fundamentals and hemorrhaging cash in 2009, banks are not looking to shut down many operations for the next 6-12 months. If that were to happen and our economy and exports remain weak, we could see more price weakness into the 2nd half of the year. Consider buying the July-Dec 13.25 PUT options at an average of 21¢/month to at least get a floor established for your milk. This is a reasonable level of insurance and if feed costs continue to decline, the bottom line would be helped. Nearly everyone underestimated how low and how long prices would go. **Don't get caught this time**. If prices rally from here and you lose your entire PUT premium, it should be celebrated.