

The KDM Dairy Report – April 9th, 2010

What's Bullish:

- Cash Market: For the week, blocks increased 6¾¢ to settle at \$1.49¾/lb and barrels picked up 6½¢ to close at \$1.44/lb. Trading was light with 3 loads of blocks and 9 of barrels exchanging hands. Butter picked up ½¢ to settle at \$1.50/lb, while Grade A NDM was 4¢ to close at \$1.26½/lb. There were 3 butter trades and 6 NDM trades.
- Most Class III components were higher in this week's NASS survey. 40-lb blocks fell 1.5 cents to average \$1.29/lb, but 500-lb barrels gained 1.1 cents to \$1.30/lb. Butter increased 0.1 cents to average \$1.45/lb, nonfat dry milk was up 1.4 cents to \$1.07/lb and dry whey jumped 1.3 cents to 38.2 cents/lb.
- Weekly dairy cow slaughter numbers were higher than year ago levels for the 3rd week in a row. 54,300 head were culled during the week ending 03/27, compared to 51,100 during the same period last year.
- Butter stocks at CME-approved warehouses increased by just 266,000 lbs for the week ending 04/03. That compares to a 5.2 million lbs increase during the same period last year. Stocks on hand total 55.5 million lbs, vs. 80.3 million lbs a year ago at this time.
- Cream is flying out the door in the Northeast, according to Dairy Market News. Drying is heavy and cream sales have been unusually heavy to both Class II and cheese plants. In the Midwest, ice cream production was running much heavier as recent temperatures in the 70's and 80's spurred demand. Cream offerings in the region have tightened and prices are higher.
- Dairy Market News report demand for Western butter is strong, as some buyers are buying ahead to insure adequate supplies for later use. Higher prices at the CME Group this week are keeping butter churns operating on busy schedules.
- Western nonfat dry milk prices are trending higher and the market has a firm undertone, according to Dairy Market News. The trade is assessing the results of the Fonterra auction this week and what that might mean to current domestic prices. Producers of nonfat dry milk in the Central region are holding product with confidence, in part due to the stronger prices on the world market. Inventories are in good shape and more buyers are interested in securing product for use later in the year.
- Economy: Wholesale inventories in February were up 0.6% and sales rose 0.8%, both numbers surpassing analyst expectations. The gains are an encouraging sign that stronger demand is prompting businesses to restock depleted shelves, which could help sustain the economy. The rise in sales marked the 11th straight month that sales have been up. The stock market was up on the news, with the Dow hitting 11,000 for the first time since September, 2008.
- International: Fonterra's Global Dairy Trade held their monthly auction Tuesday morning, with the result being a 25.5% spike in skim milk powder, 21% increase in whey milk powder, and 21.9% jump in anhydrous milk fat. The prices are well above U.S. domestic prices.
- International: Australia milk production in February declined 3.8% vs. Feb '09, according to Dairy Australia statistics. Year-to-date, production is down 6.4%.

| Futures Month | Class III 04/09 Close | Class III 04/01 Close | Change |
|---------------|-----------------------|-----------------------|---------------|
| Apr-10 | \$12.81 | \$12.72 | \$0.09 |
| May-10 | \$13.75 | \$13.28 | \$0.47 |
| Jun-10 | \$13.77 | \$14.00 | (\$0.23) |
| Jul-10 | \$14.35 | \$14.49 | (\$0.14) |
| Aug-10 | \$14.86 | \$14.80 | \$0.06 |
| Sep-10 | \$15.10 | \$15.08 | \$0.02 |
| Oct-10 | \$15.06 | \$14.94 | \$0.12 |
| Nov-10 | \$14.74 | \$14.87 | (\$0.13) |
| Dec-10 | \$14.68 | \$14.59 | \$0.09 |
| 2010 | \$14.35 | \$14.31 | \$0.04 |
| Jan-11 | \$14.53 | \$14.47 | \$0.06 |
| Feb-11 | \$14.51 | \$14.37 | \$0.14 |
| Mar-11 | \$14.50 | \$14.50 | \$0.00 |
| Apr-11 | \$14.62 | \$14.55 | \$0.07 |
| May-11 | \$14.75 | \$14.80 | (\$0.05) |
| Jun-11 | \$14.75 | \$14.90 | (\$0.15) |
| Jul-11 | \$15.02 | \$15.02 | \$0.00 |
| Aug-11 | \$15.02 | \$15.02 | \$0.00 |
| Sep-11 | \$15.10 | \$15.10 | \$0.00 |
| Oct-11 | \$15.35 | \$15.35 | \$0.00 |
| Nov-11 | \$15.45 | \$15.45 | \$0.00 |
| Dec-11 | \$15.55 | \$15.55 | \$0.00 |
| 2011 | \$14.93 | \$14.92 | \$0.01 |

What's Bearish:

- World Ag Supply & Demand Report: USDA raised their 2010 milk production forecast due to slower herd reduction than anticipated. They also reduced their cheese price projections due to weaker-than-expected exports and continued high stock levels. As a result, they lowered their Class III price forecast by 15¢ and now expect it to average \$14.35/cwt.
- Fluid milk sales are stagnant to flat throughout the Eastern region of the country, according to Fluid Milk & Cream Review. Balancing plants are being challenged to handle the supply and New England states are still weeks away from the peak of the flush. In the Southeast, auxiliary plants are being opened to handle milk that was destined to flow north, but is no longer needed because of excess supply there. The system is full which has caused back-ups due to fuller inventory levels at intended receiving plants. Florida shipped out 220 loads of Grade A milk this week, up from 190 last week.
- Fluid Milk & Cream Review reports Class I demand remained sluggish this week for most bottlers as schools were out on spring break. Manufacturing milk interest is steady, but some plants are starting to see cheese inventories building as sales slow. Many long-time cheese traders are surprised by recent strength in the cheese market, in the face of

another couple months of seasonal increases in milk receipts. They point out that the second CWT commitment for 3.5 million lbs is inadequate by itself to support recent price increases, and may even replace other would-be exports.

- Milk production in California is slowly building, according to Dairy Market News. Weather has been favorable for the cows, while decisions involving money are often being diverted to later times as producers look to get through the current period. Higher dairy product prices will provide some relief in the near term as they work into milk pricing formulas. Arizona output is near the top of the spring flush, which has closed the gap from year ago levels, while in New Mexico, production is moving higher on a weekly basis due to favorable weather. In the Pacific Northwest, milk receipts are trending higher as well. Surplus milk is heading to the dryer as cheese plants have what they need.
- Dairy Market News reports the Central Dry Whey market is steady at best, while interest is occasionally lighter. Drying is active as cheese production is increasing seasonally. Most manufacturers have some product available for sale.
- Increased production of Western dry whey has some buyers looking for discounts, according to Dairy Market News. Additional product is available as production problems at a regional plant have been resolved.
- Recent strong cheese prices on the CME Group cash market have encouraged cheese production in the Northeast, according to Dairy Market News. In addition, the increasing volume of milk in the region has forced the opening of some auxiliary cheese plants that are normally closed, but used occasionally to help handle periods of high milk receipts.
- Cheese production remains seasonally active in the Midwest and offerings continue to increase as plant inventories build, according to Dairy Market News. Recent price increases are causing new orders to decline. Business is slow for some firms and plants are operating on reduced hours. Experienced cheese marketers indicate that the higher the cheese price goes, the more likely prices will see another sharp price correction before summer.
- Dairy Market News reports western cheese production is steady, with some extra milk available due to lower Class I demand. Contract cheese sales are being easily met with current inventory.
- Fluid milk sales in February were down 0.1% compared to a year ago, according to Dairy Market News. About 4.4 billion lbs of packaged fluid milk products were sold.

Recommendation:

Better get ready next week. After a 20¢ run higher, the cash cheese market ran out of momentum today, with sellers offering blocks down 1¼¢ and barrels 1½¢ lower. After hitting a high of \$14.36 this morning on follow-through buying from Thursday, the June Class III contract settled at \$13.77 today, 59¢ off the high, as sellers hit hard after the cheese session. The cheese updates and general milk supply situation are a lot more bearish this week, and we're hearing first-hand evidence that cheese sales have slowed and inventory is building. We warned last week not to get too excited about this rally (other than to take advantage of it to hedge!), and said, "At the first sign of weakness, futures will be crushed"; we believe that started today and will continue next week. As so often happens, now that cheese is headed lower, buyers may sit on their hands waiting for the "bargain basement" price before reloading. Current cash cheese prices, plugged into the Class III formula, yields about \$13.75 milk. With May settling at \$13.75 today and beginning its pricing period in a week, further declines in the spot market will cause it to drop (possibly quickly). June will be punished as well. We would recommend selling May and June early next week, or buy May 13.75 PUTs at 45¢ or better. This means paying 12¢ above today's settlement, but we're seeing that with increased volatility, options are more often trading above settlement prices. Try buying the June 13.75 PUT at 50¢, which is 12¢ higher than its settlement at 38¢. The second half of the year will undoubtedly suffer as well, but we're not as anxious to sell. Look to buy the July-Dec 13.25 PUT at 35¢/mo avg, or buy the July-Dec 14.00 PUT at 55¢/mo avg. We would consider this a pretty urgent recommendation, as it would be weeks before we start moving back up again. Call us on Monday and let's see what we can get done before prices deteriorate further.

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