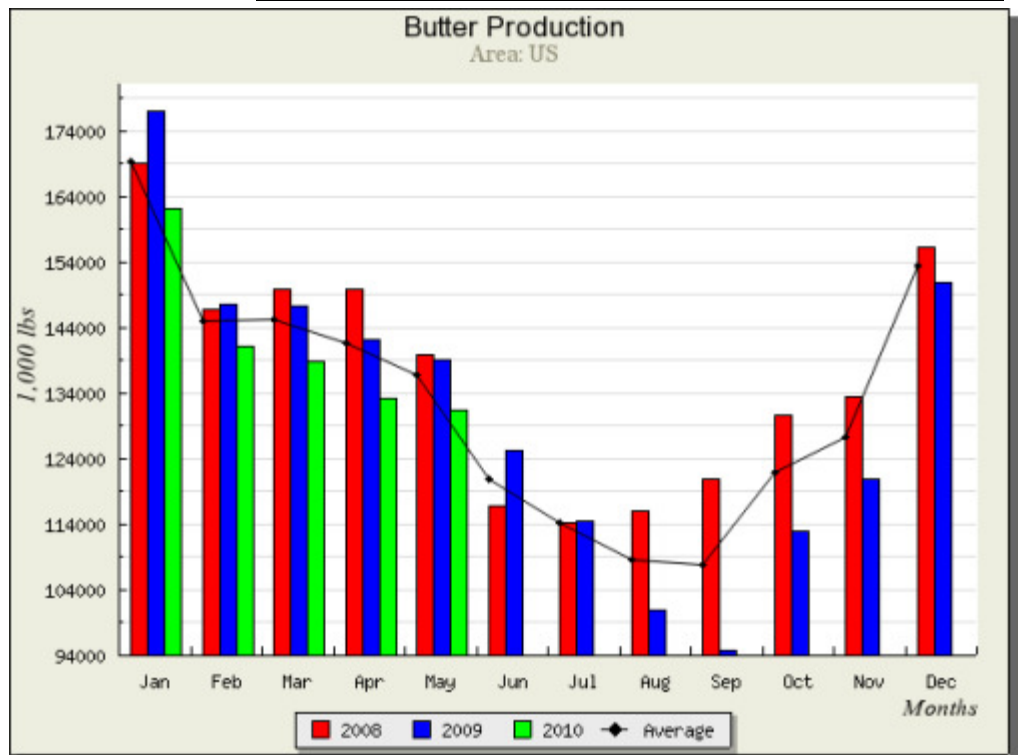


**The KDM Dairy Report – July 2<sup>nd</sup>, 2010**

**What's Bullish:**

- Sport Market: Block cheese jumped 4½¢ for the week to settle at \$1.45½/lb in this week's cash market. Barrel cheese gained ½¢ to close at \$1.40/lb. Trading was light with just 10 blocks and 3 barrels exchanging hands. Butter kept at its steady climb, gaining 3¢ to settle at \$1.75/lb on just 1 trade for the week.
- Dairy Products Report: Butter output in May was down 5.6% compared to a year ago, according to USDA, and fell 1.3% from April.
- Butter stocks at CME-approved warehouses fell by a very strong 8.9 million lbs for the week ending 06/26. This week's reduction was more than double the largest one week reduction for the year. A year ago at this time stocks increased 480,000 lbs. 54.9 million lbs are on hand, vs. 101.4 million at this time last year, which puts current stocks down 46%.
- Butter prices are approaching levels not seen since 2004, according to Dairy Market News. Cream demand is very strong, with ice cream manufacturers taking butterfat from churns. Retails sales to grocery stores and food clubs have been good. Some butter producers are selling their cream vs. sending it to the churn, taking the instant return; but those that are producing are clearing it to storage with confidence.
- Cream supplies in the Eastern region remain very tight, according to Fluid Milk & Cream Review. Milk components are significantly below last year's levels and are raising concerns about future butterfat availability.
- Fluid Milk & Cream Review reports cream supplies continue to be tight in the Central region, and manufacturing milk interest was steady to improved due to lighter volumes of surplus milk. Low milk components continue to be a problem, with plants needing more milk to produce manufactured products due to low yields.
- Commercial Disappearance: Milk use by commercial entities was strong in April. American cheese use in April was up 7.7% from a year ago, according to USDA. Butter use jumped 10.5% and nonfat dry milk use was up 23.3%. Use of milk in all products increased 3.8%.

Futures Month	Class III 07/02 Close	Class III 06/25 Close	Change	Dry Whey 07/02 Close	Dry Whey 06/25 Close	Change
Jul-10	\$13.45	\$13.55	(\$0.10)	36.00¢	36.00¢	0.00¢
Aug-10	\$14.36	\$13.85	\$0.51	34.50¢	34.50¢	0.00¢
Sep-10	\$14.82	\$14.64	\$0.18	35.50¢	35.00¢	0.50¢
Oct-10	\$14.86	\$14.68	\$0.18	34.00¢	35.00¢	(1.00¢)
Nov-10	\$14.73	\$14.59	\$0.14	33.00¢	35.00¢	(2.00¢)
Dec-10	\$14.59	\$14.50	\$0.09	35.00¢	35.00¢	0.00¢
<b>2010</b>	<b>\$14.47</b>	<b>\$14.30</b>	<b>\$0.17</b>	<b>34.67¢</b>	<b>35.08¢</b>	<b>(0.42¢)</b>
Jan-11	\$14.45	\$14.45	\$0.00	34.50¢	36.00¢	(1.50¢)
Feb-11	\$14.43	\$14.33	\$0.10	31.50¢	34.50¢	(3.00¢)
Mar-11	\$14.42	\$14.40	\$0.02	34.50¢	36.00¢	(1.50¢)
Apr-11	\$14.37	\$14.24	\$0.13	32.00¢	35.00¢	(3.00¢)
May-11	\$14.33	\$14.32	\$0.01	32.00¢	34.00¢	(2.00¢)
Jun-11	\$14.32	\$14.33	(\$0.01)	32.00¢	35.00¢	(3.00¢)
Jul-11	\$14.46	\$14.40	\$0.06	35.00¢	39.00¢	(4.00¢)
Aug-11	\$14.53	\$14.53	\$0.00	36.00¢	40.00¢	(4.00¢)
Sep-11	\$14.66	\$14.60	\$0.06	35.75¢	40.00¢	(4.25¢)
Oct-11	\$14.75	\$14.70	\$0.05	37.00¢	42.00¢	(5.00¢)
Nov-11	\$14.76	\$14.84	(\$0.08)	42.00¢	42.00¢	0.00¢
Dec-11	\$14.77	\$14.84	(\$0.07)	42.00¢	42.00¢	0.00¢
<b>2011</b>	<b>\$14.52</b>	<b>\$14.50</b>	<b>\$0.02</b>	<b>35.35¢</b>	<b>37.96¢</b>	<b>(2.60¢)</b>



**What's Bearish:**

- Ag Prices Report: The June milk to feed ratio increased to 2.33 from 2.19 in May. The ratio is at its highest level since January 2008.

- Dairy Products Report: Cheddar cheese output declined 0.3% vs. last year, but jumped 5.7% from April. Total cheese output was 2.5% higher than last May and 1.8% higher than the prior month.
- NASS cheese prices dropped in this week's survey, responding to recent declines in the cash market. 40-lb blocks fell 3.6¢ to average \$1.41/lb while barrels gave up 0.2¢ to \$1.39/lb. Nonfat dry milk lost 9.5¢ to average \$1.22/lb and dry whey gave up 0.8¢ to 36.3¢/lb, but butter jumped 4.7¢ to average \$1.65/lb.
- Weekly cold storage numbers indicate both cheese and butter stocks rose in June. For the period 06/01 through 06/28, cheese stocks increased 3.6 million lbs, or 3%, while butter stocks increased 495,000 lbs, or 5%.
- Just 49,900 head were culled during the week ending 06/19. That compares to 59,500 head during the same period last year. YTD the cull is now 66,800 head behind last year.
- Class I milk sales in the Eastern region are down 20-25% from their peak, according to Fluid Milk & Cream Review. Despite production trends heading lower, the reduced demand is increasing the supply of manufacturing milk available. Auxiliary cheese plants are once again being used to help process the surplus milk and plants will be full going into the holiday weekend. Florida has reported declines in the number of vacationers and conference events due to the sluggish economy and oil spill in the gulf. 264 loads of Grade A milk were exported from the state this week, up from 216 last week.
- Higher temperatures have not yet affected milk production in the Southwest, according to Fluid Milk & Cream Review. Improved milk prices are also helping producers' bottom lines. Class I usage is down, leaving more milk for manufacturing purposes. In the Pacific Northwest, lower feed costs have helped farmer profitability and some producers are increasing herd sizes. Milk output is above year ago levels.
- The dry whey market has a soft undertone, according to Dairy Market News. Heavy cheese production is keeping whey production lines full, while export interest has weakened recently.
- Nonfat dry milk inventories are growing at most locations, according to Dairy Market News, giving a weaker tone to the market. Many spot buyers are delaying purchasing decisions to see how low prices will go before reordering.
- Dairy Market News reports cheese production in the Eastern region remains fairly active. Mozzarella sales have slowed from recent weeks and inventories are building. Swiss and aged cheddar inventories are also on the rise, so production has been slowed in an attempt to balance supplies.
- Cheese demand is moderate in the Midwest and standard varieties remain readily available, according to Dairy Market News. Offerings of mozzarella are increasing as pizza sales slow down.
- Higher cheese prices in the spot market have slowed buyer demand in the Western region, according to Dairy Market News. Inventories of cheese continue to be large and buyers are in no hurry to acquire product. Some discounts are being offered to reduce inventory for end of quarter reports.
- Economy: The U.S. unemployment rate fell from 9.8% last month to 9.5% in June, according to the Labor Dept. However, the rate dropped because the labor force shrank even more rapidly, as discouraged workers stopped looking for work. The U.S. lost 125,000 jobs in June, the first monthly loss this year, as the total was dragged down by the ending of 225,000 temporary gov't census jobs.

### **Recommendation:**

With nearly a 30¢ spread between butter and cheese, and a firm outlook for butter prices the remainder of the year, many are thinking, hoping, that it will eventually help cheese prices. No doubt it is a positive that butter prices are strong, but we're not holding out a lot of hope for that in the near term. One reason is that most of the heavy production gains have been in the Midwest, whose manufacturing operations are heavily weighted towards cheese output. Secondly, the Western region's mailbox prices have benefitted from the strong butter price. Less than a year ago we spoke about how Western producers were enduring a negative basis relative to Class III settlement prices of \$1.00-1.50. While Midwest and Eastern producers still enjoy a positive basis of \$0.50-1.50 on average, the Western basis has closed to about even with Class III settlement. What that means is that instead of enjoying a \$2-3/cwt higher pay price than their Western brethren, the gap has closed to about \$1.00/cwt. All this to say that Western producers are getting paid more, which is helping their bottom line. We're not saying they're wildly profitable by any means; the financial struggle is still there. But lower feed costs and high cull cow prices is going to keep Western output up there. We're even hearing of some expansion. In summary, despite the great news over butter, burdensome cheese supplies, location of cheese plants, a struggling economy and weak fluid demand will most likely keep Class III gains in the second half of the year rather muted. Short of a weather event, we'll be surprised if we see a \$16 this year. With that in mind, we still really like the Aug-Dec \$13.50 by \$15.50 fence strategy. We got it done this week for even money. Or, just buy Aug-Dec \$13.50 PUT options for an average of 20¢ per month and leave yourself 100% open to higher prices.

**Note:** Our offices will be closed on Monday, July 5<sup>th</sup> in observance of Independence Day. Have a happy and safe July 4<sup>th</sup> and remember what it means to live in "the land of the free and the home of the brave."

Trading futures and commodities involves substantial risk and may not be suitable for all investors. You should carefully consider whether the risks involved in trading in commodities is suitable for you or your organization in light of your financial condition. While the information we gather and present is deemed to be reliable, it is in no way guaranteed. Neither the opinions expressed on this website nor in "The KDM Dairy Report", shall be construed as an offer to buy or sell any futures or options on futures contracts. In addition, past performance is not necessarily indicative of future results.