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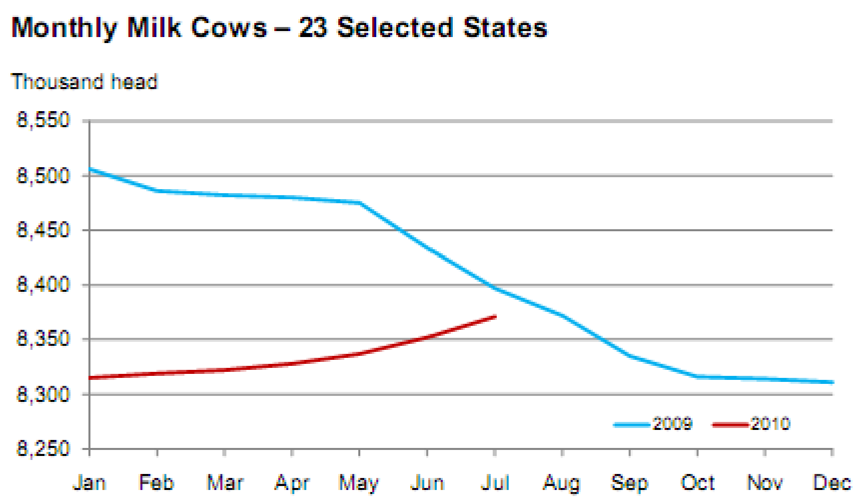
The KDM Dairy Report – August 20th, 2010

What's Bullish:

Futures Month	Class III 08/30 Close	Class III 08/13 Close	Change
Aug-10	$15.14	$15.05	$0.09
Sep-10	$15.55	$15.40	$0.15
Oct-10	$15.21	$15.04	$0.17
Nov-10	$14.76	$14.74	$0.02
Dec-10	$14.46	$14.56	($0.10)
2010	**$15.02**	**$14.96**	**$0.07**
Jan-11	$14.20	$14.21	($0.01)
Feb-11	$14.05	$14.10	($0.05)
Mar-11	$14.00	$14.09	($0.09)
Apr-11	$14.00	$14.20	($0.20)
May-11	$14.21	$14.20	$0.01
Jun-11	$14.20	$14.24	($0.04)
Jul-11	$14.49	$14.50	($0.01)
Aug-11	$14.78	$14.70	$0.08
Sep-11	$14.95	$14.91	$0.04
Oct-11	$14.95	$14.94	$0.01
Nov-11	$14.94	$14.95	($0.01)
Dec-11	$14.90	$14.92	($0.02)
2011	**$14.47**	**$14.50**	**($0.02)**

- Cash Market: After being flat the prior w
- Livestock, Dairy & Poultry Outlook Report: Cheese prices are expected to remain relatively high for the balance of 2010, according to USDA. Stronger exports and competition for milk from higher butter prices were cited as factors. Higher feed prices are forecast to keep the milk-feed ratio below a level that usually signals expansion.
- NASS cheese prices were up again over last week as they play catch-up to the spot market. Both blocks and barrels increased 1.4¢ to average $1.60/lb and $1.59/lb respectively. Butter jumped 4.8¢ to average $1.85/lb, but nonfat dry milk decreased 4.1¢ to $1.14/lb and dry whey lost 0.1¢ to 35.8¢/lb.
- Dairy cow slaughter for the week ending 08/07 was a solid 56,600 head, up from 49,900 head during the same period a year ago.
- Butter stocks at CME-approved warehouses fell 2.6 million lbs for the week ending 08/14. This compares to an *increase* of 3.2 million lbs last year at this time. Just 36.9 million lbs remain on hand, compared to 98 million lbs a year ago.
- Fluid Milk & Cream Review reports the milk supply is tightening in all the Eastern regions. School openings have significantly increased Class I demand, limited volumes available for manufacturing. Continued heat and humidity are resulting in more pronounced output declines in the Mid Atlantic and Southeast. Cream supplies are very tight while demand is good, with strong pulls from cream cheese and ice cream production facilities.
- Milk supplies in the upper Midwest are very tight, according to Fluid Milk & Cream Review, and some manufacturing operators are unable to acquire extra supplies. Class I interest is stronger as additional schools reopen, while shipments from the Midwest to the Southeast continue. Weather has cooled in the upper-tier states, but so far there has been no production rebound. Some think there won't be a rebound in volume and components until the cows freshen again.
- Cream supplies remain tight from coast to coast, according to Dairy Market News. Many butter producers continue to sell a portion of their cream versus churning. Most are selling their cream for the immediate financial benefit on cash flow. Churning that continues to occur is often not keeping pace with demand, thus many producers and handlers are reaching into lighter than desired inventories to fulfill current orders.



- Dairy Market News reports Central dry whey production is below plant capacities at many locations, due to the steady drop in milk production and increased demand from the fluid market. Prices were steady to higher this week and spot market offers cleared readily.
- Cheese production in the Northeast was steady this week, but was supported by good vacation sales and increased mozzarella orders, according to Dairy Market News. In the Midwest, tightening manufacturing milk volumes have reduced current cheese production and offerings. Mozzarella is tight, as food service accounts prepare for the reopening of schools and universities. Barrel production is lower, with a number of plants on sharply reduced schedules. This has resulted in the current barrel supply tightening.
- Despite firming cheese prices, Western cheese sales are in balance with current supplies, according to Dairy Market News. Contracted needs are handling the bulk of production. Inventories are higher than in previous years, but handlers are confident in moving supplies. Yields are lower and milk supplies are expected to be reduced as schools begin.

What's Bearish:

- Cold Storage Report: American cheese stocks in July were 6% higher than a year ago (see graph) and 2% above June, according to USDA. Total cheese stocks were 5% and 2% higher over the same periods, respectively. Butter stocks were 24% lower than a year ago, but 1% higher than in June.
- Cattle Report: In USDA's twice-yearly report on cattle, as of July 1 there were 4.05 million replacement heifers on hand, an increase of 3% from last year. With an overall herd size that is smaller than last year, the increase in replacements means an even greater replacement-to-herd ratio.
- Milk Production Report: Output in July was up a surprisingly strong 2.9%, according to USDA. Even more frightening, cow numbers jumped 20,000 head (see graph) from June and milk per cow increased 68 lbs. Gains were led by AZ 8.8%, OR 8.3%, WA 6.2% and ID 5.2%. Only 4 of the top 23 milk producing states showed declines.
- Livestock Slaughter Report: 225,600 dairy cows exited the milking herd in July, 2,200 head fewer than in July 2009. YTD 1.595 million cows have gone to slaughter vs. 1.673 million over the same period a year ago, a decline of 4.6%.
- Weekly cold storage numbers indicate cheese stocks have increased 1% at USDA selected storage centers over the period 08/01 through 08/16.
- California output levels are mostly steady, according to Fluid Milk & Cream Review. Daytime temperatures have been followed with cool nights, helping mitigate production loss. Plants in the state are running along at expected levels. Arizona output is also steady, as the cows have acclimated to the conditions. Milk continues to be shipped out of state to supplement other areas. In the Pacific Northwest, farm milk price returns are better than recent months and farmers are looking to increase cow numbers. Forage quality has increased on second and early third crop alfalfa.
- International: June milk production in Western Europe was 2% higher than a year ago, according to Dairy Market News. Sales activity has been slow due to summer holiday activity, with finished dairy products available for immediate and future needs.
- Fluid Milk sales in June were 1.8% lower than in 2009, according to Dairy Market News.
- International: The new milk production season is still a number of weeks away for Australia, but New Zealand is reporting noticeable increases in output, according to Dairy Market News. Australian farmers are optimistic about the upcoming season as conditions are very good for a strong start. Much needed moisture replenished depleted water levels over the winter.
- International: Dairy Market News reports effective, August 19, the Mexican government announced 20 - 25% import tariffs on some U.S. cheese varieties as retaliation for the U.S. lack of compliance with Mexican cross-border trucking access to the U.S. The varieties affected include cheddar, mozzarella, jack, and cream cheese, among others. Mexico is the largest U.S. export market and exports totaled 44 million pounds of affected cheese varieties during the first six months of 2010.
- Economy: New unemployment claims jumped to 500,000 this week, the highest level in nine months. And a leading indicator of manufacturing activity, the Philly Fed index, fell to -7.7 from +5.1 in June. Analysts had expected an improvement to +7.1.

Recommendation:

Let's keep this short and sweet. Short-term bull, long-term bear. In the near term, 30-day and younger cheese is getting tighter due to heat and humidity, schools pulling for Class I, low components and a strong butter market. This should keep Sep-Oct well supported for now. Dry whey is a bit higher as well, putting the current cash prices to about $15.70 Class III. Both Sep and Oct are trading at a discount, so as long as cheese prices hold or go higher, which they should in the short-term, these months are going to go up with them. Plenty of dark clouds coming though. The milk production report usually doesn't shake the markets anymore, but with 4 consecutive months of increasing cow numbers at an increasing rate, people start putting 2 and 2 together. This report was very bearish for the long-term outlook. Likewise, the number of replacement heifers relative to the herd is increasing. Cheese stocks are still very high and slaughter numbers are down. Oh, did we mention the economy? Wild cards are exports and grains, but we're quickly putting ourselves into a situation where we'll need strong exports and high grains prices to support these milk prices. We've been looking to begin selling 2011 at $14.75 for the first half. We may not get there. We would lower your targets to $14.30-$14.50. Or, consider selling the entire year on a percentage of your production at $14.50 avg. Hopefully the short-term bull will help pull all prices up, but if it does, don't expect it to last all that long. You should be ready now, to execute your 2011 hedge plan. Aggressively buy PUT options Oct-Dec, or be ready to pull the trigger once this rally gets going.