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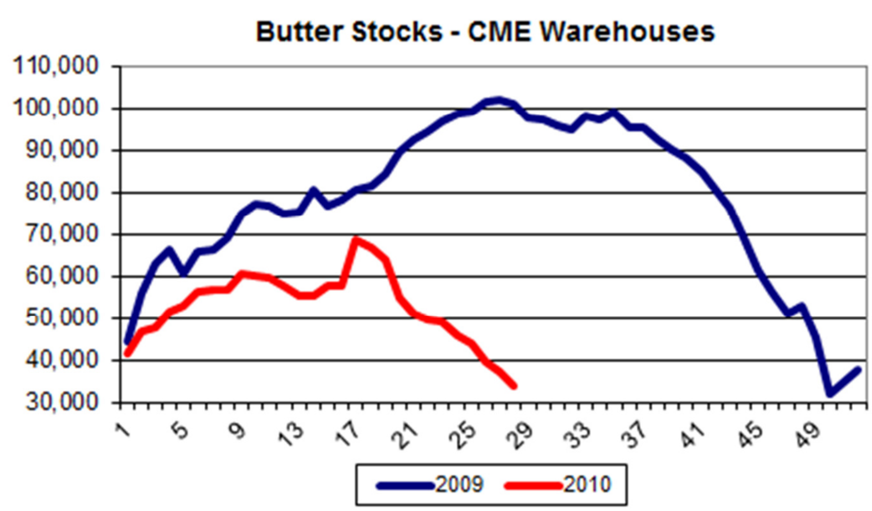
The KDM Dairy Report – August 27th, 2010

What's Bullish:

Futures Month	Class III 08/27 Close	Class III 08/20 Close	Change	Dry Whey 08/27 Close	Dry Whey 08/20 Close	Change
Aug-10	$15.15	$15.14	$0.01	36.00¢	36.00¢	0.00¢
Sep-10	$15.88	$15.55	$0.33	36.95¢	37.55¢	(0.60¢)
Oct-10	$15.60	$15.21	$0.39	36.75¢	36.75¢	0.00¢
Nov-10	$15.01	$14.76	$0.25	35.50¢	35.00¢	0.50¢
Dec-10	$14.56	$14.46	$0.10	35.00¢	35.00¢	0.00¢
2010	**$15.24**	**$15.02**	**$0.22**	**36.04¢**	**36.06¢**	**(0.02¢)**
Jan-11	$14.17	$14.20	($0.03)	34.50¢	34.50¢	0.00¢
Feb-11	$13.98	$14.05	($0.07)	33.25¢	33.25¢	0.00¢
Mar-11	$14.04	$14.00	$0.04	29.50¢	30.50¢	(1.00¢)
Apr-11	$14.00	$14.00	$0.00	28.75¢	28.75¢	0.00¢
May-11	$14.10	$14.21	($0.11)	29.00¢	29.00¢	0.00¢
Jun-11	$14.12	$14.20	($0.08)	29.00¢	29.00¢	0.00¢
Jul-11	$14.40	$14.49	($0.09)	31.00¢	32.00¢	(1.00¢)
Aug-11	$14.60	$14.78	($0.18)	32.00¢	32.00¢	0.00¢
Sep-11	$14.80	$14.95	($0.15)	33.00¢	33.00¢	0.00¢
Oct-11	$14.80	$14.95	($0.15)	31.00¢	32.75¢	(1.75¢)
Nov-11	$14.80	$14.94	($0.14)	33.75¢	33.75¢	0.00¢
Dec-11	$14.80	$14.90	($0.10)	33.00¢	33.00¢	0.00¢
2011	**$14.38**	**$14.47**	**($0.09)**	**31.48¢**	**31.79¢**	**(0.31¢)**

- Cash Market: Bidders continued to have their way in the cash market this week. Blocks were pushed 4¾¢ higher for the week to close at $1.69½/lb while barrels jumped 5¢ to settle at $1.66½/lb. Trading was light with just 1 block and 4 barrels exchanging hands. Spot butter jumped 14¢ to $2.18/lb on just 5 trades.
- Prices for most Class III components were higher in this week's survey. 40-lb blocks increased 0.6¢ to average $1.60/lb while 500-lb barrels gained 1.6¢ to $1.61/lb. Butter jumped 4.3¢ to average $1.89/lb and nonfat dry milk increased 1.4¢ to $1.15/lb, but dry whey decreased 0.3¢ to average 35.5¢/lb.
- Butter continues to fly off the shelves at CME-approved warehouses. For the week ending 08/21, 3.3 million lbs were removed, leaving 33.7 million lbs on hand, less than a third of 2009 levels (see graph).
- Fluid Milk & Cream Review reports that manufacturing milk supplies continue to tighten in the Eastern region of the country. Class I demand is up as more schools open, along with steeper declines in output from the Southeast to Mid-Atlantic areas. Heat and humidity remain a problem, with some tanker loads being rejected. Cream supplies remain very tight, while demand is very strong, with cream cheese, ice cream and butter makers vying for available supplies. Some manufacturers are being forced to purchase spot loads of cream to secure adequate supplies. 110 loads of Grade A milk were imported into the Southeast this week, up from 25 last week.



- Milk supplies are very tight in the Central region, according to Fluid Milk & Cream Review. Some bottlers are even seeing some delayed deliveries as manufacturers are reluctant to give up their supplies. Class I demand was stronger this week as school demand combined with retail feature activity increased required volumes. Shipments from the Midwest to the Southeast are on the increase, while reports that the Southwest may not ship as much fluid this year decreases the possibility that manufacturers will be able to obtain extra milk supplies. Current demand far exceeds the supply of available milk, even when offering hefty premiums. Cream remains tight and churning light. Manufacturing plant schedules are shorter, with a few even taking a down day or more per week due to the lack of available milk. Components and yields are at very low levels.
- Milk output in California is steady, but recent heat could impact intakes, according to Fluid Milk & Cream Review. Production is also steady in Arizona, with milk continuing to be shipped out on contracts to help with shortages in other areas. The cream market remains hot, even in the face of rising prices. Cream demand remains good, putting manufacturers in the dilemma of either making products or selling the cream for attractive prices.
- Dairy Market News report the CWT program has awarded export assistance for nearly 33 million pounds of butter and/or anhydrous milk fat for export to eleven countries during the next six months. This export activity has some suppliers and handlers questioning what the domestic supply situation might be for the balance of the year.

- Orders for butter continue to be placed by buyers, but more reports are starting to surface that orders are lighter, according to Dairy Market News. However, current churning is often not keeping pace with demand, thus suppliers are reaching into lighter than desired inventories to supplement shortages.
- Interest for Western dry whey is beginning to build for export, and some domestic accounts are looking for any extra supplies, according to Dairy Market News. Spot loads that become available are being cleared quickly with no discounting. Eastern dry whey supplies continue to be viewed as tight with most supplies moving through contracts, leaving those looking for additional loads having to look out of region.
- Dairy Market News reports that NDM supplies are tightening as more has been committed to domestic and export accounts. Offering volumes are lower as the sales of recent weeks have cleared product.
- Cheese sales remain in balance with production across the West, according to Dairy Market News. Some manufacturers expressed concerns about a tariff for exports to Mexico, but overall, sales are good, with schools beginning and increased demand to institutional accounts. Italian cheese sales are showing strength as pizza demand is increasing. Stocks are adequate for needs, although spot offerings are harder to find.
- Commercial Disappearance: Commercial use of milk in all products in the 2nd quarter was up 3.6% compared to a year. Stats USDA released this week also show commercial use of butter was up 2.8%, nonfat dry milk use up 14.1% and American and "other" cheese use up 3.8% over the same period.

What's Bearish:

- Weekly slaughter numbers indicate 52,300 head were culled for the week ending 08/14. That's down from 53,000 head last year at this time, and there's supposed to be a CWT cull going on right now.
- Fluid Milk & Cream Review reports weather in the Pacific Northwest has remained conducive to milking. Daytime highs have not affected output, while increased cow numbers have kept receipts above year ago levels, with processors utilizing the extra supplies.
- Cheese production in the Northeast remains fairly steady despite strong Class I pulls for school openings, according to Dairy Market News.

Recommendation:

Last week we said, "Short-term bull, long-term bear". There's quite a lot to be excited about in this week's report, but look how impressed 2011 contracts are with developments. While the front months saw decent gains, the 2011 average lost 9¢ for the week. A recent flip-flop, mostly due to weather, is now seeing decent production in the Western and Pacific Northwest states, while everything east of the Rockies is dropping. Even in the upper-Midwest, milk is tight. It appears in the short-term we'll be well supported, but the market is getting more sophisticated. In years gone by, sudden tightness in the markets (think 50% BST cut, mad cow) would cause nearly all the contracts to rally. No more. Traders and hedgers alike are savvier now. The steady increase in cow numbers combined with what looks to be some profitable months ahead is actually depressing the deferred contracts in anticipation of the end of the party. We agree. For the balance of 2010, take advantage of these prices and defend them. Buy the Oct 15.25 PUT for 25¢ or better. That's defending $1.60 cheese. Also consider selling October outright at $15.90 or higher. Oct hit a high today of $15.74. Begin selling Nov at $15.10 or higher, and sell more in 25-35¢ increments. It's likely that prices could be lower by the time we reach Nov. Same for Dec; sell at $14.80 or higher. PUT options may become more attractive in Nov/Dec, depending on how long this rally lasts, so if you're willing to wait a couple weeks, look for premiums to drop. Now to 2011. If you are a large operation, we would consider outright selling some of Q1 at current prices. Feb dipped below $14.00 and selling could increase next week. You can still lock in $1.50/lb cheese equivalent in these months, and the higher we go in the nearby months, the less likely it is we'll see cheese that high post holidays. If we do rally these months, sell more. For smaller operations, you may want to consider at 14.00 floor with 15.25 cap for a net cost of about 30¢ per month. Call us next week for specific markets on them. We would also consider selling up to 25% of your production July-Dec 2011 at the current $14.70 average. Market volatility looks to be on the increase, and we can't emphasize enough that these stronger prices will not last.