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TO: Directors & Members **FROM: John Kaczor**

MPC FRIDAY MARKET UPDATE

CHICAGO MERCANTILE EXCHANGE

Blocks	*+$.0225*	$1.3650
Barrels	*+$.0025*	$1.3425

Weekly Average

Blocks	*+$.0205*	$1.3510
Barrels	*+$.0055*	$1.3405

CHICAGO AA BUTTER

Weekly Change	*+$.4300*	$2.1000
Weekly Average	*+$.1805*	$1.8380

DRY WHEY

WEST MSTLY AVG	w/e 12/31/10	$.4038
NASS	w/e 01/01/11	$.3903

NON-FAT DRY MILK
Week Ending 12/31 & 1/1

Calif. Plants	$1.1896	10,647,112
NASS Plants	$1.2172	13,115,540

CHEESE MARKET COMMENTS: A fresh new year, some decent data on supply and demand, ever present speculation, and less than perfect communication resulted in small but appreciated price increases on CME's spot cheese market this week. Trading was fairly active. There still are many more buyers than sellers – always a good sign. It's still too early to see if the buying will continue; December sales were reported to be strong, stocks are being rebuilt, orders are being reviewed. Current prices should encourage immediate buys. The price gains thus far have been small. November's cheese sales, including exports, exceeded production, but more cheese is on the way as plants seem to not be able to resist offers that really can be refused. The current market is described as unsettled. CME's class III milk futures are again moving upward; February, at $14.15 per cwt, is the low for the year; September, at $15.99 is the high. Compare them to Fred's calculations below.

BUTTER MARKET COMMENTS: There is no rational explanation for what has happened to butter prices this week. Clearly, the supply of butterfat is tight relative to demand. Also production, at least in the U.S., is responding to the shortages. The market was responding in what had been an orderly fashion through last week, but that all changed this week when two trades and very aggressive bidding on the CME caused the butter price to increase $.43 per lb, the largest weekly increase in ten years. Yes, there's a precedent, but the lesson learned back then was that the "rally" was short-lived. Prices rose $.60 per lb in two weeks, held there for three weeks, and were back below where they started in short order. The butter market is presently in shambles; the daily limits on butter futures was temporarily increased to $.10 per lb, and the February price rose to $1.93 per lb; buyers are likely to disappear for a time, exports will drop (or at least be postponed), and consumers will vote with their pocketbooks – all as should be expected. Think of what happen like people in the northeast think about weather: if you don't like it, wait awhile, it will change. This week's action wasn't much of an endorsement for our industry's price discovery programs. Shocks like this, up or down, simply should not happen.

POWDER MARKET COMMENTS: Yes, the market for nonfat dry milk this week was not left out of the dairy market rally. The February NFDM futures price rose by $.055 per lb and June's price rose by $.14 to $1.37 per lb. These changes likely were caused by the week's sharp increases in the NFDM spot prices: grade A powder increased $.06 per lb and extra grade powder added $.115 per lb, finishing the week at $1.34 per lb. Those changes could have been sparked by Fonterra's auction on Tuesday, where prices for March deliveries rose by about $.19 per lb. Prices reported by NASS and CDFA are back to where they were prior to last week's inventory sale; volumes are also back to where they were. Dairy Market News tells of some confusion from last week's report, and it looks like that confusion may have undergone some kind of transmogrification on its way to the CME. Let us hope the spot and futures market is leading to sustainable price levels.

WHEY PRODUCTS MARKET COMMENTS: Demand for dry whey and whey protein concentrates continues steady to strong, led by buyers for the export market. Through October of last year, 50% of dry whey production and 60% of whey protein concentrate was exported. Domestic demand is reported to be steady, with some buyers showing concern about not having ready access to supplies. Production of both products is expected to increase in a normal seasonal pattern.

FRED DOUMA'S PRICE PROJECTIONS…

Jan 7 Est:	**Quota cwt. $15.82**	**Overbase cwt. $14.12**	**Cls. 4a cwt. $16.24**	**Cls. 4b cwt. $11.72**
Dec 2010 Final:	**Quota cwt. $15.61**	**Overbase cwt. $13.91**	**Cls. 4a cwt. $14.67**	**Cls. 4b cwt. $12.22**

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TIME TO DUST OFF THE MILC CONTRACT FOR YOUR DAIRY: *(By Rob Vandenheuvel)* For many dairies throughout the Western U.S., the job of choosing a "start month" for the Milk Income Loss Contract (MILC) Program is a potentially valuable (or costly) task. Since the program only makes payments on 2.985 million pounds per dairy operation (which the average 1,000 cow dairy in California produces in about 1 ½ months), it's important to choose the "start month" that will maximize the payment for your operation.

Producers have been watching some key websites (such as **http://dairy.cornell.edu**) that project what the monthly MILC payment could be based on the futures markets for the various commodities. As we get closer to those payments becoming a reality, we get a better look at what month producers may want to choose.

As of the close of markets today, the projection on Cornell University's website showed that February and March of 2011 are set to be the months with the highest payment this year ($0.52 and $0.48 per cwt, respectively) with little or no payment the rest of the year. **So for dairies that have not yet signed up for their 2010-11 MILC contract to start up, you will want to consider starting in February 2011.** That means your paperwork must be received by your local Farm Services Agency office by January 14, 2011. **Once January 14th passes, you can no longer select February 2011 as your start month.** MPC members looking for assistance can contact the office at (909) 628-6018.

TAKING NOTE OF OUR CURRENT ECONOMIC SITUATION: *(By Rob Vandenheuvel)* In case you didn't notice, it's worth pointing out that according to Fred Douma's price projections above, there is a projected $4.52 per cwt gap this month between the Class 4a (butter/powder) and 4b (cheese) milk prices, given the commodity prices through today. While that gap may or may not narrow (or widen) by month's end, it's important to recognize what this means to producers.

In California, the butter/powder price is currently driving the value of almost 60 percent of our pooled milk *(that figure may be slightly lower now as reports indicate that previously "depooled" milk sold to cheese plants last year have "rejoined" the pool as of January 1st)*. While the depressed cheese price has certainly had an impact on the California pool, the butter/powder prices are generating much-needed additional revenue for dairy farmers.

Across the country, this gap will have significance as well, even in areas with no butter/powder manufacturing. Because of the way the Federal Order Class I formula uses the "higher-of" the butter/powder or cheese values to establish a base Class I price, these higher butter/powder prices are generating much needed additional revenue for those dairymen as well.

So not only in California, but throughout the country, the importance of this additional revenue cannot be overstated. These dollars could very well be the difference between survival and failure for thousands of dairy farmers across the nation. As our industry is on the verge of considering important policy reforms, we need to keep that very important fact in mind.

DAIRY PRODUCT PRODUCTION, INVENTORIES, CLASS 1 SALES, AND RELATED THOUGHTS: *(by J. Kaczor)* USDA's report on usage of milk in November contained few surprises which, in these anxious times of rising feed costs and lagging milk prices, should be considered good news. With class 1 usage falling and milk production increasing, it's expected that what is normally called surplus production will be converted into more of the major market clearing (or market balancing) products – butter and powder – and more recently, cheese. So it's not surprising that production of butter in November increased by 11.2 million lbs over October (with one fewer day, of course), a variety of non by-product powders increased by 4.2 million lbs, and cheese increased by 7.7 million lbs. Hidden in the cheese numbers is a gem of great news: production of American cheeses **fell** by 12.8 million lbs and Italian cheeses rose by 11.5 million lbs. [Starve the beast and feed…the Italian cheese eaters?]

Other product categories using extra milk in November included cottage cheese, sour cream, ice cream, and, of course, yogurt. By-product production increases included dry whey, whey protein concentrates and isolates, dry buttermilk, and lactose.

The bad news regarding milk usage, at least up to November, is the continuing drop in class 1 sales. USDA's best estimate of total U.S. class 1 sales shows each month in 2010 (through October) is lower than the same month in 2009. (The string of negative months began with December 2008.) October's sales fell by the most during this eleven month period – by the largest amount (204 million lbs) and the largest percentage (4.2%). 204 million lbs represents 1.3% of October's total milk production, and increased by half the additional amount of milk manufacturing plants had to handle during the month. The weakness appears to be nationwide. California's class 1 pool usage in October was 2.8% below a year earlier, and the total amount of class 1 products processed in California and sold in or out of the state decreased by 4.3%. November's results improved somewhat, but class 1 pool usage of total solids for the two months in 2010 is 15.5%, down from 16.3% a year earlier. The volume of class 1 products processed in California and sold outside the state, once a sizable market for California processors (and producers), fell by 7% last year. What on earth is happening to class 1 sales?

With the publication of November's dairy product production numbers, a full report and comparison of end of month inventories can be made. The table shown to the right compares the end of month stocks of eight major product categories. Cheese inventories improved (that is, fell) across the board in November, by the equivalent of about one day's production. The drop in butterfat stocks in the face of the jump in production indicates very strong continuing sales for that product. Sales of NFDM, dry whey, and WPC kept pace with production; the demand for the whey by-products appears to continue to strengthen. The increase in stocks of whole milk powder reflects the increase in November production; sales did not keep up. [Whole milk powder is by far the highest volume product traded internationally; it is the product that most countries consider to be the most valued.] The increase in the stock of BMP reflects steady production and weakening sales.

	Stocks On Hand At End Of Month (Million Pounds)			Production November 2010
Product	November 2009	October 2010	November 2010	
American Cheese	583,056	638,911	625,637	350,261
All Other Cheese	378,689	396,720	380,639	539,298
Butter	142,661	108,809	70,023	132,804
Nonfat Dry Milk	115,794	123,982	127,894	115,483
Dry Whey	41,630	44,049	42,105	80,019
Whole Milk Powder	6,626	4,781	7,009	9,242
Whey Protein Conc.	38,394	29,633	31,911	34,590
Buttermilk Powder	5,312	9,848	11,550	6,752

Six of the products in the table have impressive volumes through October of last year. Exports of cheddar cheese, other cheeses, and whey protein concentrates have already topped previous annual records, with two months still to go. Exports of dry whey, butter, and nonfat powders are having second best years, outperformed only by the records set in the 2007 or 2008 "bubble" years. Anhydrous milkfat, coupled with butter in the end of month inventory figures for butter in the table, is also having a near record export volume year.

Despite the increased volumes of cheese exports, it is clear U.S. exporters are still only nibbling around the edge of a huge and potentially profitable market, while inventories continue to hover around record high levels and some manufacturers simply cannot seem to find a ready market for their products but still continue to produce because, well, perhaps just because they can. **The question has been asked why can't an export program be crafted that would generate the volume of cheese exports sufficient to materially impact what seems to be a chronic surplus of cheese in the U.S.** That's a good question, isn't it? Instead of a program with real potential, we have, through CWT, a program that effectively pits coop plants against proprietary plants. Perhaps they do not realize that. It doesn't appear that CWT's leadership is able to grasp the concept that cooperation (get it?) is sometimes as good as or better than foisting minimal programs that get minimal results. Yes, cheddar cheese exports are really, really high through October 2010 – up to a total of 2.2% of U.S. production through October of last year. It's not difficult to visualize the benefit that would result **to all producers** if cheese that would otherwise be offered on the CME spot market for whatever price it takes to get rid of it would instead be sent to a U.S. port of embarkation. What an idea. A program like that would require vision and a change in the mindset of CWT's leadership. Surely there are some on the present CWT board who has the necessary vision. What seems

to be lacking is the necessary mindset and leadership. Until that mix happens – vision, mindset, leadership – expect to see small results, not great ones.

PRICES ARE SHARPLY HIGHER FOR ALL PRODUCTS IN FONTERRA'S LATEST INTERNET AUCTION: *(by J. Kaczor)* The catastrophic flood in the northeast section of Australia should not have a significant effect on total milk production in that country, but whatever the effect it is it's likely to last for some time. Likewise, the New Zealand on again, off again, drought is having as yet an unknown effect on milk production; there are daily stories coming from that country, and elsewhere, reflecting more uncertainty than clarity. None of these reports foresee milk production through midyear to be more than somewhere close to the low end of what was expected six months ago. Fonterra appears to be taking a conservative approach regarding what they believe may happen to their milk supply over the next twelve months. That having been said, the results from this week's internet auction seem to indicate, at least for the immediate period, a consensus among buyers that international dairy supplies will be tighter than expected at least through midyear.

Past recaps of the auction in *MPC's Weekly Update* tracked price levels and changes for selected products. Starting with today's recap, the weighted average winning prices for each product category will be used. The following table identifies the different styles of products within each product category. Because the volume of buttermilk powder offered in the auction is low, the prices bid may not be reflective of true values and will no longer be reported.

The **skim milk product category** includes low heat, medium heat, high heat, high heat stable, and UHT products. The **whole milk product category** includes regular, instant, and UHT products. The **anhydrous millkfat product category** includes regular in drums, premium in drums, and premium in 1,000 kg bins. Review of results from past auctions show that use of weighted average prices give a fair representation of price levels and price changes for each product category for each of the three contract periods for each auction.

Following are the winning prices from the January 4th auction. The first contract month, the "spot" delivery month, is March; it is the month that offers the largest volume of product. The second contract period covers deliveries of product in April, May, and June. The third contract period covers deliveries of product in July, August, and September.

- **Skim Milk Powder:** 1st contract: $1.545 per lb, up $.188 per lb
  2nd contract: $1.586 per lb, up $.136 per lb
  3rd contract: $1.674 per lb, up $.061 per lb
- **Whole Milk Powder:** 1st contract: $1.650 per lb, up $.018 per lb
  2nd contract: $1.750 per lb, up $.093 per lb
  3rd contract: $1.785 per lb, up $.155 per lb
- **Anhydrous Milkfat:** 1st contract: $2.711 per lb, up $.418 per lb
  2nd contract: $2.715 per lb, up $.444 per lb
  3rd contract: $2.728 per lb, up $.512 per lb

Fonterra's comments on these results emphasized the positive – that the results reflect strong demand from a strengthening international marketplace. They again recalculated how much of each product is expected to be offered over the next twelve months. The total volume is basically unchanged, but the skim milk volume (the product they and other exporters believe provides the lowest return to their members) was reduced by about 42 million lbs, whole milk volume was increased by about 33 million lbs, and AMF volume was increased by about 1 million lbs. Those changes are believed to generally reflect a reconfiguration of Fonterra's usage pattern for the milk they expect to have available for exportable products over the next year.

CALIFORNIA DAIRY INDUSTRY LOSES A WELL-KNOWN INDIVIDUAL: *(By Rob Vandenheuvel)* This afternoon, John Vander Schaaf, Sr. passed away at the age of 84. Mr. Vander Schaaf was a well-known member of the California dairy industry. He and his family moved their dairy into the Chino Valley in the early 1960's, where they operated for several decades before moving to Escalon, CA. He's well-known not only as an leader in the California dairy industry, but as a key figure in starting Chino Valley Bank. He is survived by his wife, Henrietta, their son, four daughters and many grandchildren and great-grandchildren. He was preceded in death by their daughter Thelene Dotinga. Our thoughts and prayers go out to the entire Vander Schaaf family.