



Overview

The reaction of the financial markets so far this year seems to reflect rather accurately the muddled state of both economic and political affairs. Most major stock indices are trading steady for the year as better than expected corporate profits continues to be spurred by cost cutting as opposed to increased sales and investment. The U.S. dollar was strong for the first half of the year, continuing the rally that started last December with the greenback peaking in June, coinciding with the worst of this year's European financial crisis where Portugal, Spain, Greece, and Ireland among others were seen close to default. The second half of 2010 has featured steady dollar depreciation where now the U.S. currency is at a 15 year low vs. the Japanese yen, and a 2 1/2 year low vs. the Swiss Franc, while the formerly beleaguered euro has climbed to a six month high against the greenback. Spurring this dollar weakness has been the aforementioned slow economic growth and sentiment that the Federal Reserve Board may have to resort to some creative policy measures to further stimulate the economy or in a worst case scenario, prevent a second, or double dip recession. This task is no doubt complicated by the fact that interest rates are already close to zero and massive Federal budget deficits would seem to preclude any additional fiscal measures. Against this backdrop, the long end of the yield curve has fallen to record lows while the value of most commodities has risen. Of particular interest to California dairy producers has been the favorable increase in milk and manufactured dairy product prices and the less than welcomed jump in feed ingredient values. Milk prices have moved to two year highs with the most recent Class III cash settle over \$16.00 per cwt. Spurring these gains had been falling production, tight butter stocks, and very brisk U.S. dairy exports for much of this year - no doubt helped by favorable currency developments. On the other hand, feed ingredient prices which were under pressure for the first half of the year have snapped back, linked to a devastating drought in large areas of the Former Soviet Union that severely pared global wheat and coarse grain production. Furthermore, hopes for a record 2010 U.S. corn crop have been tempered by less than ideal summer weather in large areas of the Midwest. Looking ahead, the forward values of milk, grain, and other markets will no doubt be influenced by events in both the political and financial arenas. In particular, expectations that power will now be shared between a Democratic executive branch and a Republican led Congress could result in a more balanced, nuanced form of government that may yield surprisingly positive results. Or it may result in a total impasse with nothing much getting done. That certainly would be unsettling to the markets, investors, and the electorate as a whole.

GRAIN AND COMMODITY Comments

MILK

After an extended period of very depressed milk prices combined with a huge surge in costs leading to an unprecedented financial crisis in the U.S. dairy industry, there is some light at the end of the tunnel. As mentioned in the overview, milk prices have climbed to their highest levels in two years, helped in part by robust U.S. exports of key dairy products, tight domestic butter supplies, and up until recently a reduced rate of domestic production, due in part to the hot summer temperatures in key producing areas of the U.S. as mentioned earlier. Global dairy prices have also been on the upswing enhancing the export competitiveness of U.S. products, helped in part by the falling dollar. Take note of the fact that for much of last year and this year, the decline in U.S. milk production was tilted heavily toward the western U.S., especially California. Much of this state's milk goes to the production of Class IV products, and lower milk here has helped drop butter production and sent this product's value over \$2.25 per pound - the second highest level ever.

Reduced U.S. milk production, buoyant exports, super strong butter prices, rising international dairy product values are the glass is half full side. There is that other side, however, one that is being reflected in milk futures prices from January 2011 going forward. The current strip of 2011 milk futures from January to December as of the beginning of October 2010 is \$14.39, more than \$2.00 per cwt. below the current price. Questions include why the 2011 contracts are trading at such a discount to the nearby market, and whether this price inversion will continue. Certainly the market recognizes that U.S. milk production has picked up rather substantially in recent months with output over the past three months up 2.8%, well above the 2.0% increase in annual total milk demand seen over the past few years. U.S. milk cow numbers have increased 53,000 since the beginning of the year while milk per cow numbers have been off the charts, helped by rather mild summer weather conditions in much of the western U.S. One of the problems in assessing dairy demand is you never know what really happened till after the fact. A very large share of U.S. dairy products moves in the fourth quarter of the year coinciding with Thanksgiving, Christmas, and New Year's. Since the economy tanked in the fall of 2008, both the 2008 and 2009 holiday periods have been dismal for consumption and sales of dairy products. This has been reflected in much higher than anticipated cold storage figures for January and February of the following year. Hopefully, this year a robust holiday period will support dairy sales, and cold storage figures to be released down the road will not show a large overhang of manufactured dairy products. Such a development would go a long way to assuring that the more discounted future milk prices appreciate in value, closer to the higher priced nearby contracts. This would be opposite the pattern of the past two years where the deferred milk futures contracts receded in price the closer to expiry.

PROTEIN MEALS

As opposed to corn or wheat, the domestic and international outlook for oilseeds features comfortable stocks created by record production. Following up on the largest Brazilian and Argentine soybean crop ever produced, the USDA is forecasting record U.S. production this fall based on an all-time high in planted area and the second consecutive year for record yields. It appears that this year's soybean crop handled the generally wet and warm growing year far better than corn. This will help swell ending stocks of U.S. soybeans to 350 million bushels for the 2010-11 marketing year, a four year peak and 233% above the 150 million ending last marketing year this past August 31st. Yet the increase in supplies here and in South America has not prevented soybean and product values (protein meals and vegetable oils) from marching higher in concert with rising coarse grain and wheat prices. One reason is that record oilseed production in recent years has barely been able to keep up with booming demand. China itself will import more than 1.0 million metric tons of soybeans each week this year or 2.00 billion bushels for the year - over 55% of the U.S. crop. Now realize that there are many up and coming Chinas out there (Vietnam, India, and certain African and Eastern European nations). The bottom-line is much of the trade is feeling that final 2010-11 domestic soybean stocks could be far smaller than currently estimated, as the USDA appears perhaps to be grossly understating potential U.S. soybean export sales. Another reason for the push in soybean prices to two year highs has been, after a year's abeyance, the resumption of the acreage battle. With global feed grain stocks essentially at record low levels and a far smaller global wheat stocks cushion, corn and wheat are going to make a strong play to garner increased acreage for the 2011-12 market season. This may leave soybeans with the

short end of the stick and could come back to haunt if Argentina and Brazil do not see a repeat of last year's superlative soybean crop. Hence, soybean prices cannot retrench too far if plantings are to remain at adequate levels for 2011. Helping maintain acreage will be the surge in fertilizer prices increasing corn planting costs and rather poor corn - on - corn yields this year, suggesting U.S. farmers reverting back to a more regular corn-soybean rotation after going continuous corn for the past few years.

CORN

Interesting three-quarters of a year for this market as a six month slide in prices from January to June was reversed starting June 30th. Now a breath-taking three month rally that had taken values to levels not seen since 2008 may have ended just as the final quarter of the year commences. Recall back in early January when the USDA reported 2009 national production far greater than the trade had imagined and much higher than expected stocks as of December 1st implying poor feed demand for the Sep-Nov 2009 period. This precipitated a six month slide in corn prices helped by the second highest U.S. planted acreage figure since the early 1940's this year, an exceptionally fast completion to spring seedings, and the rally in the dollar seen the first half of this year. As June was coming to a close, the corn market was in a free-fall with generally favorable weather suggesting to some in the trade that final 2010 corn yields could come in as high as 170-172 bushels per acre, far above the 164.7 record figure set just the year prior. End users were salivating at the prospect of corn prices falling well under \$3.00 per bushel, perhaps moving to levels not seen since the fall of 2006. Such was not the case as the USDA on June 30th threw the markets a couple of major league curveballs. First, the June acreage report showed farmers planting 1.30 million acres less of corn than had been indicated in the March 30th intentions report. Second was a shockingly low June 1st stocks figure implying much stronger feed demand in the Mar-May period than had been seen the prior two quarters. The net impact was a loss of 500 million bushels from the 2010-11 balance sheet. As fate would have it, weather conditions became more adverse both here and abroad further accentuating gains. Weeks of heat and dryness torched many of the crops in large swaths of Russia, Kazakhstan, and Ukraine. This sent the wheat market higher as all three countries are among the largest exporters of this grain in the world. Corn soon followed as those countries also saw drastically reduced output of key feed grains including barley, oats, and sorghum. The major implications here are much enhanced export prospects for U.S. corn and wheat and global shift from wheat to coarse grain feeding.

Meanwhile, after a nice first half of the U.S. growing season, conditions became less favorable featuring excess rains in the Western Corn Belt and dryness in the Delta and wide areas of the Eastern Corn Belt. Add to this high August temperatures through all areas of the Midwest which appears to have compromised grain fill in the kernels leading to lower ear weights. Hopes of a record 2010 corn yields have faded with the trade consensus on final yields now in the 158-160 bushel per acre range. This will result in the tightest ending stocks and stocks - to - use ratios in many years and has contributed to the recent surge in corn prices. A compelling fundamental story for corn, along with the falling dollar has seen the managed funds bringing their speculative long positions in the futures markets to record highs. For now, the push higher, which has lifted December 2010 corn futures from \$3.40 on June 29th to a high of \$5.28 on September 27th, may have run its course. The just released September 1st corn stocks report appears to have rediscovered some of the missing bushels from the last stocks report. Furthermore, it is hoped that yield reports which so far have been rather disappointing may improve as harvest pushes more into the northwest sections of the Corn Belt which saw more favorable growing conditions all year. Funds bailing out of recently established long positions have also accentuated the recent sell-off. Still, given the need for corn acreage to increase by at least 3-5 million acres to stave off an intolerably low 2011-12 ending stocks situation, should result in corn values being well supported into next spring.

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