The KDM Dairy Report

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On the bright side:

Contract Month	Friday 02/20	Friday 02/13	Change	Avg Since 1995	Top 3rd Price	Top 5th Price
Feb-04	$11.82	$11.78	$0.04	$11.28	$11.86	$12.44
Mar-04	$13.40	$12.65	$0.75	$11.35	$11.91	$12.47
Apr-04	$13.90	$13.09	$0.81	$11.24	$11.76	$12.27
May-04	$13.93	$13.27	$0.66	$11.27	$11.94	$12.59
Jun-04	$14.15	$13.52	$0.63	$11.65	$12.48	$13.30
Jul-04	$14.45	$13.88	$0.57	$12.46	$13.38	$14.28
Aug-04	$14.56	$14.20	$0.36	$13.16	$14.17	$15.17
Sep-04	$15.05	$14.70	$0.35	$13.61	$14.59	$15.56
Oct-04	$14.26	$14.00	$0.26	$12.98	$13.82	$14.65
Nov-04	$13.17	$13.14	$0.03	$11.92	$12.97	$14.00
Dec-04	$12.55	$12.35	$0.20	$11.92	$12.97	$14.01
Jan-05	$12.10	$12.07	$0.03	$11.89	$12.71	$13.52
Feb-05	$11.90	$11.90	$0.00	$11.28	$11.86	$12.44
Mar-05	$11.80	$11.71	$0.09	$11.35	$11.91	$12.47

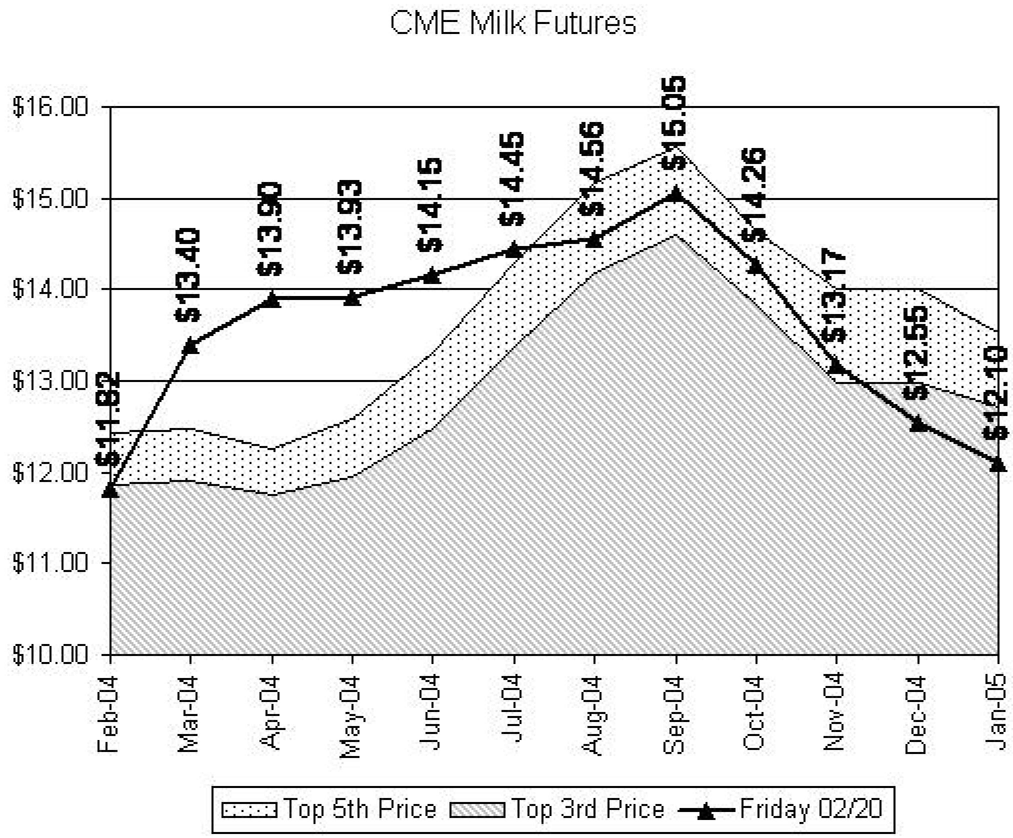
- Support for the market started this week with Monday's Milk Production Report. January production was down 0.9% in the top 20 states, and down 1.3% in all 50 states vs. a year ago, coming in lower than expectations for only a 0.4% decline. Of special note was the fact that California was down 0.2%, despite generally good milking conditions. Eastern states led the decline, with PA down 7% and NY down 3.8%.
- In the same report, there were 92,000 fewer milk cows on farms in the top 20 states than a year ago, but 5,000 more than in December 2003.
- This afternoon, the monthly Cold Storage report was released, showing stocks of both Total and American cheese down 1% from a year ago, while butter stocks down 29%.
- Wednesday's Livestock, Dairy & Poultry Outlook report noted there were 2% fewer replacement heifers vs. a year ago. They write that the, "*absence of imported Canadian heifers and cows will add extra tightness to replacement supplies. Live animals can no longer be brought in from Canada because of BSE-related restrictions. In recent years, imports of female dairy breeding stock from Canada have been equivalent to 1 to 2 percent of the U.S. heifer herd. It is uncertain when these restrictions will be relaxed.*"
- Dairy Market News reports current demand for cheese is exceeding supply. Buyers are trying to increase their inventory now for use later in the year, while manufacturers are seeing milk intakes decline and yields going down.
- In a new, more accurate report put out by USDA, the number of licensed dairy operations decreased 5% in 2003. Total operations in 2003 averaged 70,410, down from 74,110 in 2002. The Licensed Dairy Herds report will be put out annually in February of each year.

however....

- Annual milk production for 2003 was up 0.1% over 2002.
- Also in the Cold Storage report, butter stocks were up 45% vs. last month.
- Weekly dairy cow slaughter continues to lag behind year ago levels. 50,100 head were removed from the herd vs. 58,400 during the same period a year ago, down 14%. In addition to aggressive culling in the fall, a shortage of replacements may now be slowing the rate.

- And, the monthly Livestock Slaughter report had the January dairy cow cull down 48,600 head vs. a year ago, an 18% decline. The January number was also down 10% from the prior month.
- Florida continues to be a next exporter of milk, shipping 96 loads out of state this week.
- Butter prices are reaching a level where high-tariff, above-quota imports are looking more attractive. "*Oceania traders indicate that they have been receiving some inquiries from U.S. buyers looking for butter*."

Recommendation:



What an incredible week! A bullish production report followed by a wild cash cheese trade that saw an 8.75¢ gain in blocks and a 10.75¢ gain in barrels, pushed the market on Thursday to *all-time-historical* highs in several front months. Despite the profit taking and subsequent losses during today's session, one still has to look in awe at the week's gains, and just how much above the top-5th price we are in the March - June contracts. We've received LOTS of calls this week questioning whether one should lock in more of their production at these levels. While one could hardly be criticized for locking in the current $13.94 March - Dec average, or the 12-month $13.62 average, we are becoming more convinced that the fundamentals affecting the milk supply could take this market higher. Don't mistake that for a call to *inaction*, it's just that we don't want to call the top of this market. You *should* be doing something to defend current prices, and the best way to do that while remaining open to the upside is once again our friend the PUT option. This week we entered lots of orders for PUT options May - Sep at the 13.25 to 13.50 strike, for 15-20¢. That's a guaranteed $13.00+ floor, with unlimited upside. For larger producers, enter open orders for additional PUTs at strike prices one and two levels higher, for similar premium. If the market continues upward, you will get successively higher levels of protection for the same price.

With prices at these levels, expect volatility to be high. As producers continue to look at current prices over the weekend, we wouldn't be surprised to see additional downward pressure on Monday and even the days following as folks start to lock in at these levels. But if cash cheese starts moving up again, those losses should quickly be recouped and potentially make the move higher that will get your PUT options bought.

Hang on tight and have a great weekend everyone!

To discuss this and more advanced strategies, give us a call! 877.695.8538