



## The KDM Dairy Report – September 3<sup>rd</sup>, 2004

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### On the bright side:

- Cash blocks reversed course and finished up 3¢ for the week, settling at \$1.58 today. Barrels also moved higher, up a penny for the week to settle at \$1.56. 17 loads of blocks exchanged hands, while there were no barrel trades.
- Interest in butter helped move the cash market up 13¢ for the week, to settle at \$1.72/lb. A total of 39 loads were traded.
- Dairy Products Report: In a bit of a surprise, July American cheese output was down 1.1% vs. 2003, and down 2.6% vs. June, according to numbers released today by USDA. Total cheese output was down 1.5% vs. 2003 and down 1.4% vs. June. Most analysts were expecting a slight increase vs. 2003 output.
- NASS surveyed cheese prices continued to rise. Blocks averaged \$1.55/lb, up 4.7¢ from the prior week, and barrels averaged \$1.56/lb, up 3.6¢. Butter also moved higher, up 2¢ to \$1.56/lb.
- Supplies are tight for non-cheddar varieties, especially pepper jack and colby/jack blends, according to Dairy Market News. In addition, they report process movement has been aided by continued shipments to CCC under established annual contracts.
- Fluid Milk & Cream Review reports that milk demand jumped sharply at midweek. Additional schools reopening and stronger retail interest were noted as prime factors.
- Florida and the Southeast states imported 267 loads of grade A milk this week, about the same as last week, but slightly lower than a year ago. And hurricane Frances, about to make landfall, could disrupt bottlers and suppliers as well as farm operations.
- Milk production in Western Europe is lagging the previous year, according to Dairy Market News. Producers are behind their quotas, but low availability of replacement animals is hindering their efforts.
- Federal Dietary Guidelines, updated every five years, now recommends increasing dairy intake to three servings a day instead of two. It's hoped that consumers, as well as school lunch programs, will increase demand for dairy products as a result.
- Economy: Employers added 144,000 jobs in August, according to the Labor Department, and the unemployment rate fell to 5.4%, the lowest since October of 2001. The data suggests that the economy is continuing to slowly expand and recover.

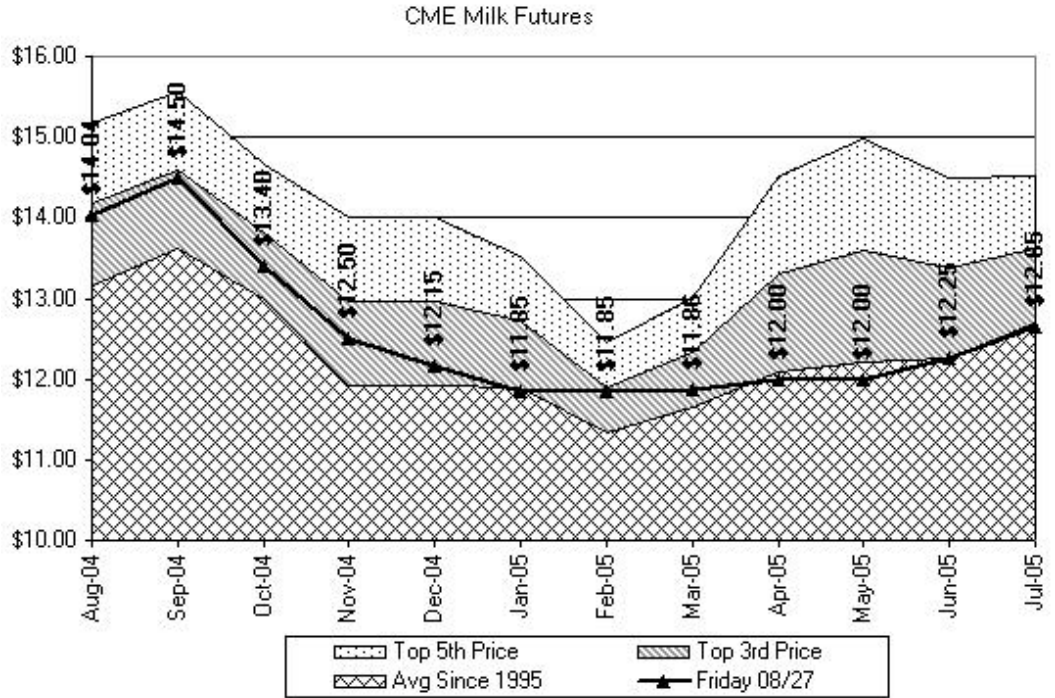
Futures Month	Friday 09/03 Close	Friday 08/27 Close	Change	Avg Since 1995	Top 3rd Price	Top 5th Price
Aug-04	\$14.04	\$14.00	\$0.04	\$13.16	\$14.17	\$15.17
Sep-04	\$14.50	\$14.04	\$0.46	\$13.61	\$14.59	\$15.56
Oct-04	\$13.40	\$12.79	\$0.61	\$12.98	\$13.82	\$14.65
Nov-04	\$12.50	\$12.16	\$0.34	\$11.92	\$12.97	\$14.00
Dec-04	\$12.15	\$11.98	\$0.17	\$11.92	\$12.97	\$14.01
Jan-05	\$11.85	\$11.85	\$0.00	\$11.89	\$12.71	\$13.52
Feb-05	\$11.85	\$11.90	(\$0.05)	\$11.34	\$11.90	\$12.45
Mar-05	\$11.86	\$11.85	\$0.01	\$11.66	\$12.34	\$13.01
Apr-05	\$12.00	\$12.05	(\$0.05)	\$12.08	\$13.31	\$14.52
May-05	\$12.00	\$12.05	(\$0.05)	\$12.21	\$13.60	\$14.98
Jun-05	\$12.25	\$12.25	\$0.00	\$12.26	\$13.38	\$14.49
Jul-05	\$12.65	\$12.73	(\$0.08)	\$12.70	\$13.62	\$14.53
Aug-05	\$12.90	\$12.90	\$0.00	\$13.16	\$14.17	\$15.17
Sep-05	\$13.20	\$13.20	\$0.00	\$13.61	\$14.59	\$15.56
Oct-05	\$12.65	\$12.65	\$0.00	\$12.98	\$13.82	\$14.65
Nov-05	\$12.15	\$12.15	\$0.00	\$11.92	\$12.97	\$14.00
Dec-05	\$12.15	\$12.15	\$0.00	\$11.92	\$12.97	\$14.01

### however....

- NASS prices for NDM and dry whey continued to fall. NDM lost 0.4¢ from the previous week to average 85.4¢/lb, and dry whey fell 0.4¢ to average 21.5¢/lb.
- Weekly dairy cow slaughter is continuing to trail last year's numbers. For the week ending 8/21/04, 45,000 head were culled, vs. 52,600 during the same period a year ago, a 14.4% drop.
- A cool August resulted in higher receipts for most milk processors in California, according to Fluid Milk & Cream Review. In addition, cow numbers are higher and freshening cows continue to enter the milking herd.
- Demand for cream has slowed as ice cream producers work down inventories and the season winds down.
- Cheese production is heavier than normal at many Western facilities, as the mild summer allowed for heavier than normal milk output, reports Dairy Market News.
- Milk output is reportedly 2-3% higher in New Zealand, and 1-2% higher in Australia vs. last year, according to Dairy

**Recommendation:**

What a difference a week makes! It was almost depressing last week, watching both the cheese and futures prices get hammered lower every day. While we certainly have growing production and cheese inventory issues to deal with, a buyer from a prominent co-op stepped up to the plate on Tuesday and started bidding for cheese, the same one who bought 500 loads earlier this summer. The resulting confidence took most front months higher for the week. In addition, today we saw heavy commercial buying of the 2005 contracts, lending support to the idea that we're not headed back to \$9 milk. We're still concerned that higher production will lead to lower prices, but very poor forage quality in the Midwest, particularly in Wisconsin, could keep milk output down in the #2 producing state next year.



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Consider this most recent bump in the cash cheese price yet another opportunity to get some price protection in place. While the current buyer generally sticks around for more than a few days, we just don't know how long they'll be there to buy cheese, or how high they plan to push the price, if at all. Go back to buying PUTs, in case this thing goes higher. Enter resting orders to buy the Sept 14.75 PUT for 10¢, the Oct 13.50 PUT for 25¢ and the Nov 13.00 PUT for 35¢.

For 2005, we suggest getting something done before the next production report on the 17th. Consider this conservative approach. Buy 11.25 PUTs for the year, Jan to Dec, which traded today at 35¢. This is an effective 10.90 floor, but leaves your upside open. Offering to buy them at 25¢ could be accomplished if the market in 2005 strengthens. It would at least ward off \$9 milk, and if higher prices prevail, you lose only 25¢ per CWT. This strategy is low cost baseline insurance to protect all of your milk. At a later date, if prices firm, you could roll up to higher put levels as the months arrive.

Taking this strategy and using it last year would have effectively managed your risk of \$11 milk and below, and enabled you to get the higher prices we've realized so far in 2004. For example, if your production is 1 million lbs (5 contracts) per month, you would need to buy 5 PUT options per month for the entire year to be 100% covered, and it would cost you \$42,000 (excluding commission) (that's \$700 per PUT option \* 5 PUT options per month \* 12 months). Recent conversations with dairy producers who contracted May 2004 milk at \$15 (which is a good price!) while trying to pick the eventual \$20.50 top, resulted in a loss of \$55,000 for that month alone. Or, if we have a year similar to 2002, where we had an average price of \$10.42/cwt, this strategy would add \$57,600 to your bottom line.

If this type of risk management plan interests you, please give us a call and we'll help you develop a plan for your dairy operation.

**Note:** Our offices will be closed on Monday, September 6th in observance of Labor Day.

Trading futures and commodities involves substantial risk and may not be suitable for all investors. You should carefully consider whether the risks involved in trading in commodities is suitable for you or your organization in light of your financial condition. While the information we gather and present is deemed to be reliable, it is in no way guaranteed. Neither the opinions expressed on this website nor in "The KDM Dairy Report", shall be construed as an offer to buy or sell any futures or options on futures contracts. In addition, past performance is not necessarily indicative of future results.