



The KDM Dairy Report –December 17th, 2004

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On the bright side:

- Milk Production Report: November output in the 20 major states was 11.8 billion lbs, up 1.2% vs. last year, coming in on the low side of expectations. Production was up 1.0% for all 50 states. The number of milk cows was 44,000 head above a year ago, but remained unchanged from the prior month for the second month in a row. October milk production was revised upward 0.1%, and when measured on a per day basis, exceeded November output. This is usually not the case, as historically, more milk is produced in November. Heavy precipitation in the Southwest was a likely culprit. New Mexico was up 6.2% in 2003, but fell 2.6% even with 4,000 more animals, as production per cow fell 65 lbs. Texas had recorded an 8.8% gain in 2003, but was up only 2.2% this year.
- Livestock, Dairy, and Poultry Outlook Report: In this update, released Thursday, USDA predicts another solid year of milk prices in 2005. They expect milk production to increase, but not at a rapid pace, and write that good demand and commercial exports will likely absorb most domestic surplus of milk solids. Heifer replacements prices for 2004 are expected to average a record \$1,600, with supplies remaining tight in 2005. Cow numbers, after peaking in early autumn, are expected to resume their decline in the coming months as expansions stay moderate and farm exits resume.
- During a period when inventories are typically replenished, weekly cold storage holdings are showing a 24% drop in butter stocks and 3% drop in cheese stocks for the first 13 days in December.
- Butter stocks at CME approved warehouses was reduced by 2.66 million lbs this week, leaving 9.95 million lbs on hand. That's the lowest level since December of 2000, according to Dairy Market News.
- Fluid Milk & Cream Review reports that California production is still having a hard time moving off seasonal lows. Apparently, more cows are currently dry and fewer are freshening, keeping output close to last year's levels.
- Demand for current cheese remains strong, according to Dairy Market News, and offerings are often not sufficient for buyer interest. Cheese production will likely be limited during the remainder of the month as plants struggle with making \$1.40 cheese out of \$16 milk.
- Dairy Market News reports that supplies of nonfat dry milk are unusually tight for this time of year. World supplies are not readily available, and direct exports have reduced domestic stocks to such an extent that buyers recently purchased 2 million lbs from the CCC.
- The CWT Export Assistance program awarded a bid from Land O'Lakes to export 110,000 lbs of cheddar cheese to South Korea.
- Restaurant industry sales are expected to increase 4.9% over last year, according to a forecast released by the National Restaurant Association. Sales are projected to be a record \$476 billion.
- Economy: Consumer prices were up only slightly in November, as energy prices started to decline and easing concerns over rising inflation.
- Economy: Jobless claims dropped a whopping 43,000 last week and the sharpest decline in three years, according to numbers released by the Labor Department. Total unemployment dipped to 317,000, a 5-month low.

Futures Month	Friday 12/17 Close	Friday 12/10 Close	Change	Avg Since 1995	Top 3rd Price	Top 5th Price
Dec-04	\$16.49	\$16.55	(\$0.06)	\$11.92	\$12.97	\$14.01
Jan-05	\$13.43	\$13.58	(\$0.15)	\$11.89	\$12.71	\$13.52
Feb-05	\$13.10	\$12.95	\$0.15	\$11.34	\$11.90	\$12.45
Mar-05	\$12.71	\$12.68	\$0.03	\$11.66	\$12.34	\$13.01
Apr-05	\$12.79	\$12.77	\$0.02	\$12.08	\$13.31	\$14.52
May-05	\$12.80	\$12.68	\$0.12	\$12.21	\$13.60	\$14.98
Jun-05	\$12.92	\$12.92	\$0.00	\$12.26	\$13.38	\$14.49
Jul-05	\$12.94	\$12.93	\$0.01	\$12.70	\$13.62	\$14.53
Aug-05	\$13.45	\$13.36	\$0.09	\$13.25	\$14.21	\$15.16
Sep-05	\$13.68	\$13.65	\$0.03	\$13.72	\$14.66	\$15.58
Oct-05	\$12.95	\$12.98	(\$0.03)	\$13.10	\$13.91	\$14.71
Nov-05	\$12.50	\$12.30	\$0.20	\$12.22	\$13.29	\$14.34
Dec-05	\$12.25	\$12.22	\$0.03	\$11.92	\$12.97	\$14.01
Jan-06	\$12.09	\$12.09	\$0.00	\$11.89	\$12.71	\$13.52

however....

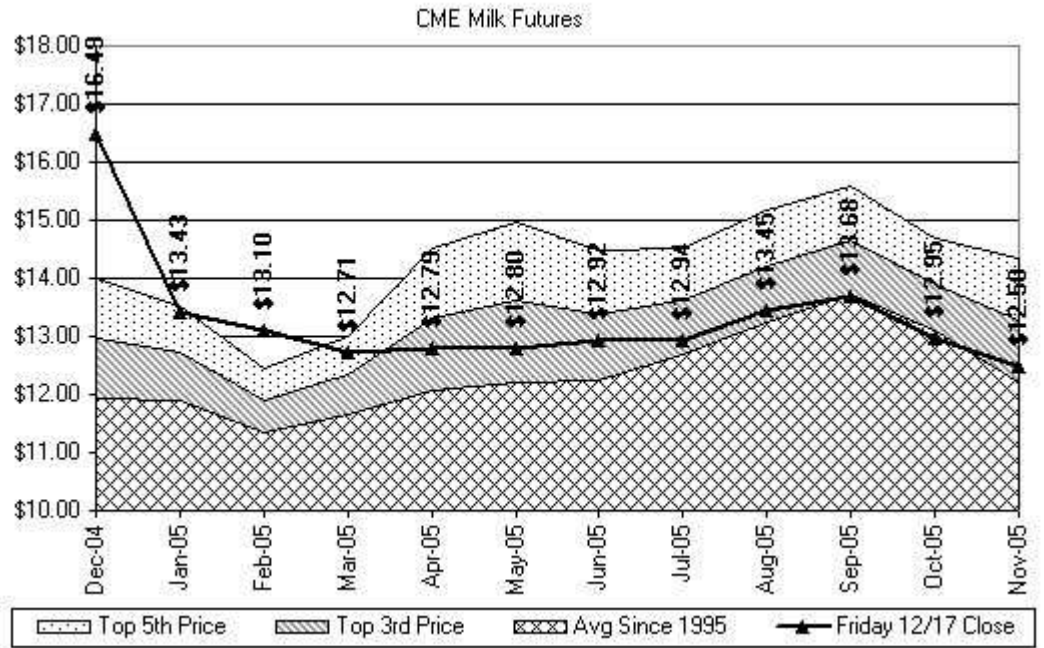
- The cash markets continued to be crushed this week. Monday saw the single biggest 1-day decline in block cheese of 28¢ to \$1.42/lb. Prices recovered slightly by week's end, but still finished 24¾¢ lower vs. last Friday, settling at \$1.45¼/lb today. In addition, sellers showed up with 19 loads exchanging hands. Barrels finished 21¾¢ lower

settling at \$1.37¾ today, while butter shed another 5¢ to close at \$1.55/lb.

- While weekly NASS prices were up for cheese, they did not go as high as recent cash prices, and other components were lower. Blocks averaged \$1.80/lb, up 7.3¢ for the week, while barrels were \$1.75/lb, up 2.9¢. Butter dropped 3.9¢ to \$1.98/lb and nonfat dry milk decreased 0.2¢ to 86.7¢/lb. Finally, dry whey continued to move higher, up 0.3¢ to 24.4¢/lb.
- The recent drop in the cash market has milk buyers taking a cautious approach, according to Fluid Milk & Cream Review. Cheese producers are reducing their milk inventories, and when spot loads are needed, demanding and getting it for \$3 to \$5 under class.
- Weekly dairy cow slaughter for the week ending 12/04 was 51,500 head vs. 61,100 during the same period a year ago.

Recommendation:

The cash market certainly fell further and quicker than most, including us, anticipated. However, today's milk production report should provide some support for the 2005 contracts. Indeed, milk production did come in below expectations and cow numbers remained flat. In the coming weeks, the CWT herd retirement program could help swing numbers into the negative territory for next month's report. But, cheese manufacturers will be trying to find a home for any extra milk as they struggle with an unfavorable milk to cheese price ratio, with most milk likely headed to the churn.



With bidders continuing to look for short-term cheese needs, the cash market has likely neared the bottom for now, but once holiday orders are completed, we could see some additional price pressure. We may be entering a phase of narrow trading ranges. And with milk production struggling, cow numbers flat to declining and quality feed an issue for many dairies, we're getting a little more optimistic about 2005 prices. If you have existing sold positions, we'd recommend buying call options to get upside protection in place on any dips in the market. Also buy call options for any unsold milk and use them to sell into any future rally, should it occur. Finally, with a negative PPD likely for your December milk check, followed by a positive PPD in January, we'd focus on buying PUT options for January and February, the months most vulnerable to the extra milk that may be floating around after the holidays.

If you would like to discuss this, or other hedge opportunities further, please call us toll free - 877.695.8538

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