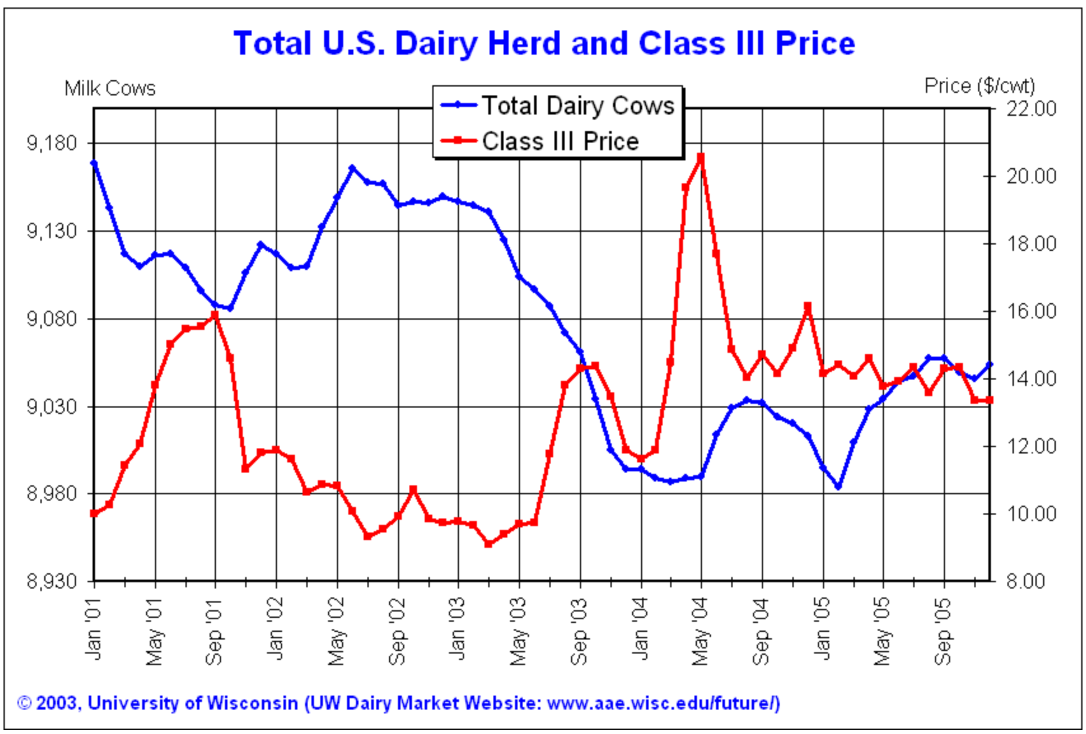
The KDM Dairy Report - January 20th, 2006

On the bright side:

- Fluid Milk & Cream Review reports that the wet conditions in the Pacific Northwest have the cows under almost constant stress. Herd health is suffering and local culling rates are increasing, as even free stall operations are having a difficult time providing dry bedding. They also report that U.S. hay production in 2005 was down 4.8%, and hay supplies in the Western states are tight.
- Both domestic and export sales of dry whey remain strong, according to Dairy Market News. Offerings are easily clearing and stocks are not building.
- In light of strong demand and tight supply, the NASS average dry whey price hit a record high 34.4¢/lb this week, up 1¢ from the previous week. Dry whey went nowhere but up in 2005. Class III futures would be nearly 60¢ lower if we were at last January's dry whey price.
- International: Dairy Market News reports New Zealand milk production remains about 2% behind last year. As a result, traders feel they may have to find outside sources to fulfill commitments to buyers.
- Economy: U.S. jobless claims fell to their lowest level in six years, according to numbers released Thursday by the Labor Department.
- Economy: U.S. consumer sentiment rose for the third straight month, surpassing expectations of Wall Street analysts. Stable energy prices, an improved job market and the stock market rally were all cited as reasons for the brighter outlook.

Futures Month	Friday 01/20 Close	Friday 01/13 Close	Change	10-yr Average	Top 3rd Price	Top 5th Price
Jan-06	$13.38	$13.35	$0.03	$12.10	$12.93	$13.74
Feb-06	$12.67	$12.78	($0.11)	$11.64	$12.33	$13.00
Mar-06	$12.48	$12.75	($0.27)	$11.88	$12.60	$13.30
Apr-06	$12.48	$12.77	($0.29)	$12.31	$13.52	$14.71
May-06	$12.56	$12.75	($0.19)	$12.35	$13.69	$15.01
Jun-06	$12.71	$12.87	($0.16)	$12.41	$13.50	$14.56
Jul-06	$12.94	$13.18	($0.24)	$12.85	$13.75	$14.64
Aug-06	$13.22	$13.39	($0.17)	$13.28	$14.19	$15.09
Sep-06	$13.42	$13.60	($0.18)	$13.78	$14.67	$15.54
Oct-06	$13.09	$13.17	($0.08)	$13.21	$14.00	$14.77
Nov-06	$12.84	$12.90	($0.06)	$12.32	$13.34	$14.35
Dec-06	$12.71	$12.80	($0.09)	$12.44	$13.53	$14.60

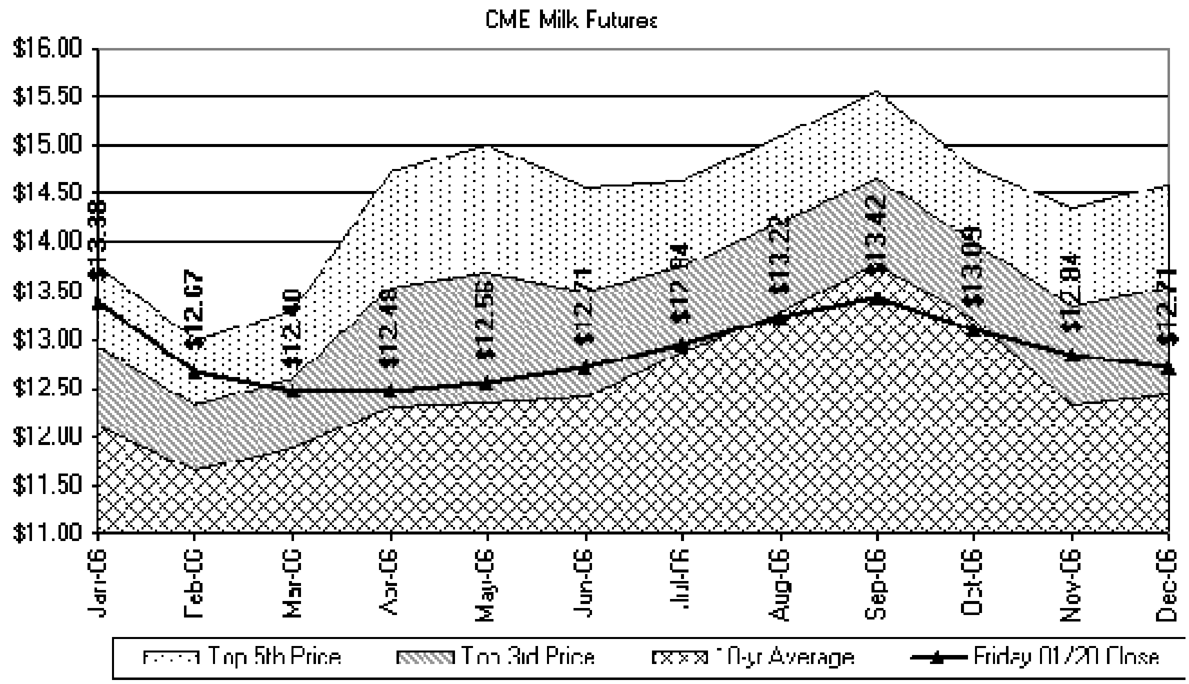


however….

- Milk Production Report: As anticipated, December milk production in the 23 major states was up 4.3% vs. a year ago. For the year (Jan-Dec), production was up 3.3% vs. 2004, which is also the highest annual increase since 1999. Increases were led by NM, up 13.8%, TX up 12.3% and ID up 10.9%. CA managed a 2.8% gain while WI was up a solid 4.6%. Despite the CWT herd retirement program, cow numbers were on the rise. The number of milk cows in the 23 major states was 8.16 million head, 67,000 head more than December 2004 and 4,000 head more than the previous month. Production per cow was up 55 lbs.
- Livestock Slaughter Report: December dairy cow slaughter was 199,600 head, 25,300 fewer than last December. For the year, 2.252 million head were culled vs. 2.365 in 2004, a decline of nearly 4.8%.
- After holding steady since December 28th, the cash cheese was finally pushed lower today. Blocks fell 1¾¢ to settle at $1.35/lb with no trades and 3 offers remaining. Barrels followed suit, falling the same amount on one offer, and settled at $1.31.
- NASS cheese prices fell again, with blocks losing 1.3¢ to average $1.38/lb, while barrels shed 2.1¢ to average $1.36/lb. NDM continued to slide, dropping another penny to average 97.4¢/lb.
- Dairy cow slaughter numbers start out the New Year at reduced levels. 42,800 head were culled the first week of 2006 vs. 52,200 during the first week of 2005.

- Fluid Milk & Cream Review reports Midwest manufacturing plants continue to run on heavy schedules, despite lackluster demand. Some operators are concerned with concerned having enough capacity in the spring to handle all the milk.
- Butter stocks continue to build at CME warehouses. For the week ending 01/14, 9.7 million lbs were added to bring stocks up to 41.9 million lbs. That compares to last year's total stocks of 29.1 million lbs.
- Milk output is up in the Southeast, according to Fluid Milk & Cream Review. Milk haulers have added trucks to farm pick-up routes in Florida, Georgia and the Carolinas.
- Dairy Market News reports buyers are taking a "wait and see" approach to procuring nonfat dry milk in light of increased supply and availability. The recent drop in the NASS price also gave buyers reason to "shop around" for the best deal.
- Western nonfat dry milk sellers report export demand remains slow. They are having to give direct discounts, drop energy surcharges and lower prices in attempts to move product. At the same time, cheese makers are not fortifying the vat with NDM because they have plenty of milk.

Recommendation:



Wednesday's Milk Production report held few surprises, showing continued robust production and higher cow numbers. One of the reasons for the increase in cow numbers is the decline in the cull rate. Friday's Livestock Slaughter report revealed monthly and annual cull numbers, and they were not encouraging. While the long-term trend is for fewer dairy cows, the herd has been building the past six months and looks set to continue well into 2006. High Class III prices have given enough profit incentive to hang on to animals longer, and so the herd has grown internally, despite the Canadian border being closed for replacement animals. There's a very strong and obvious correlation between cow numbers and milk prices. Check out the chart above. During the time we enjoyed strong milk prices, the red line (Class III price) was above the blue line (cow numbers). But if we look to the end of the chart (where we are today), the blue line has recently crossed above the red line, and it appears we could be heading for an unfriendly trend as far as milk prices go. What affect will this have on inventories? Monday's Cold Storage Report should give us a better picture of where we're headed on that front as well. We hope you've heeded our advice over the past several months and taken some action to protect your milk price. After today's drop in cash cheese, trade volume picked up and we saw aggressive selling in all 2006 futures contracts. Near term, it looks like February and perhaps March are too low. Even after today's drop in the cash market, the Class III price works out to about $12.97. It would take a block price of $1.31 and a barrel price of $1.28 to get down to $12.65, assuming dry whey stays near its current price (it should), and one would expect the CWT export program to be more aggressive at those levels, so it doesn't appear that there is a lot of downside risk from there. We would continue to target buying the Feb and Mar 13.00 calls for 4-8¢, and then place orders with your plant or broker to sell near 12.90. If filled, you would have a great floor, plus your upside covered. April-June are a bit tougher to call. We could have $11 milk or $13 milk depending on demand and exports. If you do decide to sell at current prices, consider selling "out-of-the-money" options to enhance your price. For example, you could sell May at $12.56 and then target to sell a May 12.00 put for 15¢ and a May 13.00 call for 20¢. This would add a net premium of 35¢ to your sold $12.56, giving you $12.91 for your milk that month. There is added risk to this trade, however. You would begin losing money below $11.65 or above $13.35 and would need to send in margin money. But given today's fundamentals, this could be an effective strategy for these months. If you're still unclear on how this would work, give us a call and we'll explain it more detail. The July-Dec average fell from $13.17 to $13.04. You should still consider selling it, with the intention of buying upside protection (call options) later in the year if they are cheaper.