



The KDM Dairy Report - February 10th, 2006

On the bright side:

- Dry whey rose another 0.3¢ in this week's NASS numbers to reach 35.4¢/lb.
- Demand for dry whey remains steady to firm, according to Dairy Market News. December production for human consumption was up only 0.1% vs. December '04, and 0.1% below November. Month-end stocks were [8.5% below a year ago](#).
- The rapid drop in Class III prices over the past couple weeks should give incentive enough to begin more aggressive culling over the next few months. In addition, producers 1-2 years from retirement may call it quits after having a long period of high prices, a valuable herd and the prospect of much lower prices for the foreseeable future.
- Dairy Market News reports [Western demand for current blocks is very good](#), with some buyers coming up short for March needs, despite the heavy increase in milk production.

however....

- World Ag Supply & Demand Report: USDA increased its 2006 milk supply forecast as a result of increased availability of heifer replacements, as reported in the semi-annual Cattle Report on January 1st. They also [lowered their 2006 Class III forecast by 25¢](#), now expecting it to average \$12.20.
- NASS cheese [prices continued to drop](#) in last week's survey. Blocks fell 3.8¢ to \$1.32/lb and barrels slipped 5.6¢ to \$1.28/lb. Butter decreased 4.2¢ to \$1.28.
- Weekly cold storage numbers for the first week in February show a [continued build in inventory](#). Cheese stocks were up 1%, while butter stocks climbed 6%.
- Dairy cow slaughter [continues to lag](#) last year's levels (which were slower than the year before that!). For the week ending 01/28, 45,800 head were culled vs. 48,700 during the same week a year ago.
- Butter continues to [pile up](#) in cold storage facilities. Stocks at CME-approved warehouses grew by 10.5 million lbs last week, more than twice the rate of last year.
- Cream supplies remain [plentiful from coast to coast](#), according to Dairy Market News. Butter production is surpassing demand and continues to clear to storage, as operations switch from print to bulk output.
- Fluid Milk & Cream Review continues to report about heavy milk supplies in the Midwest, and concern over plant capacities which are [nearing spring flush levels in February](#).
- In the Northeast, milk flow is [well ahead of a year ago](#) due to the mild winter and quality feed, according to Fluid Milk & Cream Review. And in the Southeast, Florida exported 55 loads of Grade A milk this week, vs. 30 last week.
- Fluid Milk & Cream Review reports Southwest milk production is ["several percentage points"](#) above a year ago, and continues to move higher. In the Pacific Northwest, windy conditions have allowed operations there to begin to dry out, and the cows are responding.
- Dairy Market News reports the NDM market has a weak undertone. While exports are fair, domestic interest is slow as buyers anticipate lower prices. Inventories are building, as California production of NDM [jumped 30.2%](#) December to December.
- The federal order emergency "make-allowance" meeting concluded on Friday, after several days of testimony. The request is to increase the make-allowance for Class III and IV milk as the current level is based on 5-yr old prices and no longer covers the increased expenses, such as higher energy costs, for cheese manufacturers. The decision is expected as early as June and [would decrease the Class III price paid to farmers](#).
- In a bit of circular logic, the proposed 2007 USDA budget includes a 3¢/cwt deduction to help pay for the MILC program which has been renewed.

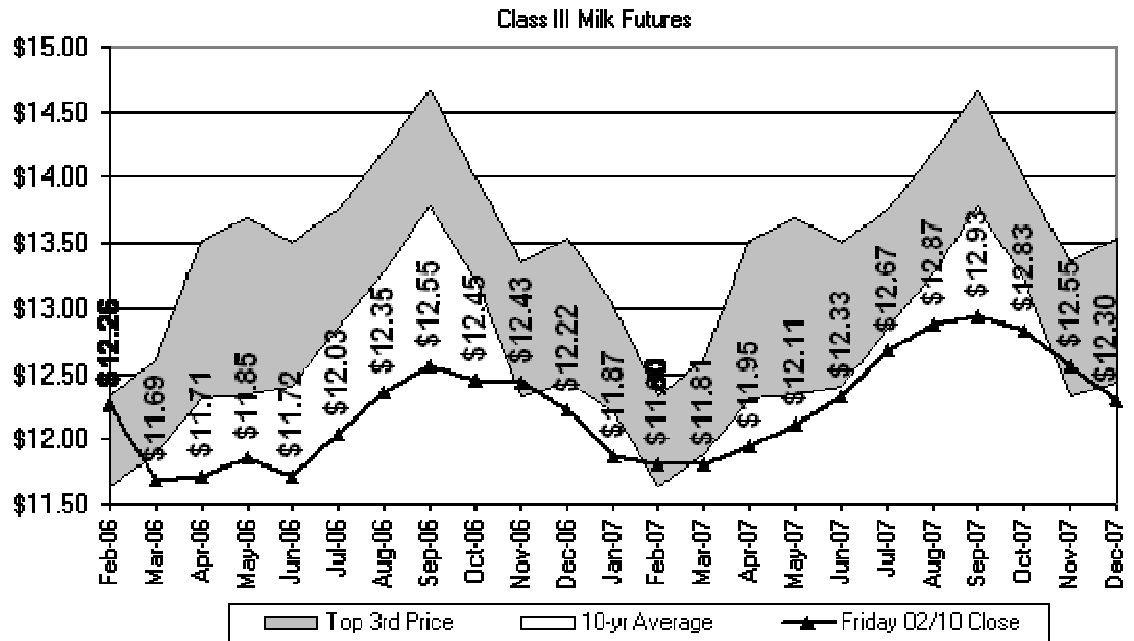
Futures Month	Friday 02/10 Close	Friday 02/03 Close	Change	10-yr Average	Top 3rd Price
Feb-06	\$12.26	\$12.32	(\$0.06)	\$11.64	\$12.33
Mar-06	\$11.69	\$12.07	(\$0.38)	\$11.88	\$12.60
Apr-06	\$11.71	\$12.12	(\$0.41)	\$12.31	\$13.52
May-06	\$11.85	\$12.20	(\$0.35)	\$12.35	\$13.69
Jun-06	\$11.72	\$12.20	(\$0.48)	\$12.41	\$13.50
Jul-06	\$12.03	\$12.50	(\$0.47)	\$12.85	\$13.75
Aug-06	\$12.35	\$12.85	(\$0.50)	\$13.28	\$14.19
Sep-06	\$12.55	\$13.01	(\$0.46)	\$13.78	\$14.67
Oct-06	\$12.45	\$12.83	(\$0.38)	\$13.21	\$14.00
Nov-06	\$12.43	\$12.78	(\$0.35)	\$12.32	\$13.34
Dec-06	\$12.22	\$12.57	(\$0.35)	\$12.44	\$13.53
Jan-07	\$11.87	\$12.23	(\$0.36)	\$12.20	\$13.01
Feb-07	\$11.80	\$12.05	(\$0.25)	\$11.64	\$12.33
Mar-07	\$11.81	\$12.23	(\$0.42)	\$11.88	\$12.60
Apr-07	\$11.95	\$12.25	(\$0.30)	\$12.31	\$13.52
May-07	\$12.11	\$12.42	(\$0.31)	\$12.35	\$13.69
Jun-07	\$12.33	\$12.58	(\$0.25)	\$12.41	\$13.50
Jul-07	\$12.67	\$12.80	(\$0.13)	\$12.85	\$13.75
Aug-07	\$12.87	\$12.97	(\$0.10)	\$13.28	\$14.19
Sep-07	\$12.93	\$12.95	(\$0.02)	\$13.78	\$14.67
Oct-07	\$12.83	\$12.85	(\$0.02)	\$13.21	\$14.00
Nov-07	\$12.55	\$12.55	\$0.00	\$12.32	\$13.34
Dec-07	\$12.30	\$12.34	(\$0.04)	\$12.44	\$13.53

Recommendation:

Ugh! What a week. Producer selling appeared in earnest as it became painfully obvious we are awash with milk. Mark was on the road this week visiting producers north of Seattle, and gave the following report:

I saw no signs of milk production suffering, contrary to recent USDA comments on the Pacific NW. No frost in January meant excellent milk production; up to 10%

higher than last year. Expanding operations have grown internally this year, and those at capacity have enjoyed an excellent income stream selling middle to lower end cattle at \$2,000 per head and up.



There were no trades this week in the cash market, but both blocks and barrels were offered lower today, refuting the idea that we had found a bottom. Butter dropped 4¾¢ for the week and looks to be headed lower. Clearly there is more downside risk in both butter and cheese, and little risk of prices going higher in the near term.

For those you of who sold milk in 2006-07 ahead of the recent collapse, well done! You should now start looking at buying call options to mitigate your upside risk. For example, many sold September at \$13.65-\$13.70. The September 13.75 call traded today at 15¢. Enter GTC orders to buy it at less than a dime. Do the same for July-Oct.

For those who have not yet hedged or need to hedge more, it's become a bit tricky as no one knows where the bottom is. The July-Dec average fell a full 42¢ this week and now sits at \$12.34. We would consider selling Aug-Dec at \$12.43 average (currently \$12.40), and then defend the sale with a call strategy. We've heard that if USDA approves the make allowance discussed above, it could knock an additional 10-35¢ off the Class III price, making current prices seem a whole lot better. In addition, your PPD should be positive with Class III and IV at the lower ends of the spectrum, leaving Class I to again take the lead, which should improve your hedge.

We would also consider selling 25-50% of your production for all of 2007. The average fell from \$12.52 to \$12.34 this week, a loss of 18¢. Very bearish fundamentals and the lasting affects of a revised make allowance compel us to recommend this.

All eyes will be on the milk production report, due out next Friday after the close.

Give us a call and we'll help you put together a risk-management plan for your operation!

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