



## The KDM Dairy Report - March 24<sup>th</sup>, 2006

### On the bright side:

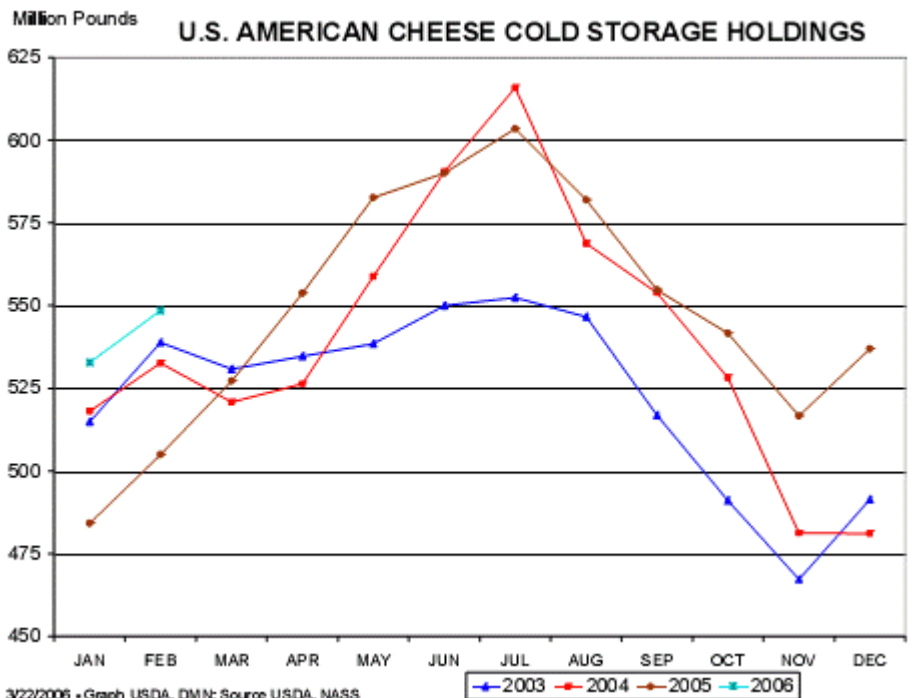
- While butter stocks continue to rise, cumulative [cheese stocks are actually down](#) 528,000 lbs for the period 03/01 through 03/20, according to USDA weekly numbers.
- In the cash market, blocks eked out a ¼¢ gain to close at \$1.18½ with bidders coming up empty on zero trades.
- Call it a trend! For the [second week in a row](#), the weekly dairy cow cull exceeded year ago numbers. For the week ending 03/11, 46,400 head were slaughtered vs. 45,200 last year.
- The CWT export program announced this week that it has accepted a bids to export 495,000 lbs of butter to Turkey and 42,240 lbs of cheddar cheese to Tunisia.
- Economy: U.S. jobless claims fell by a larger-than-expected 11,000 last week, according to the Labor Department, suggesting there is a healthy labor market.

### however....

- Cold Storage Report: Everyone expected a large increase in butter stocks, and the report did not disappoint. Inventories were up 38% from last month and 37% from a year ago. But the bigger surprise was [the larger than expected increase in cheese stocks](#). American cheese holdings in February were 9% higher than the prior year and 3% higher than the previous month. The 548.3 million lbs on hand is the most ever for February. Total cheese stocks were 7% higher than a year ago and 3% higher than in January. Finally, January inventories were revised 6.6 million lbs higher.
- Livestock Slaughter Report: February dairy cow slaughter was 170,600 head, down 7.8% vs. a year ago, when 185,000 head were culled. YTD the [dairy cow cull is off 7.3%](#).
- While blocks managed a gain, cash barrels fell ½¢ to \$1.13 and butter lost 2¢ close at \$1.15 for the week. Two loads of barrels and 14 loads of butter exchanged hands.

- Butter stocks at CME-approved warehouses [continue to pile up](#). For the week ending 03/18, 2.2 million lbs of butter were added to inventory, vs. a drawdown of 1.7 million lbs during the same period a year ago.
- Milk output remains seasonally heavy in the Midwest, according to Fluid Milk & Cream Review. Some ice cream makers are holding off building inventories due to their confidence [that milk and cream supplies will remain heavy](#) until at least summer.
- Fluid Milk & Cream Review reports manufacturing plants in the Southeast are generally full and [capacities are being tested](#). And Florida exported 125 loads of Grade A milk this week vs. 112 last week, due to a drop in bottled milk sales because of schools and universities being off for spring break.
- Milk supplies continue to trend higher in California, according to Fluid Milk & Cream Review, and processors remain concerned about handling peak output. Down days are being discouraged. In New Mexico, output is increasing and [surplus milk is being shipped nearby and regional processors](#) to find a home, despite new plant capacity now available.

Futures Month	Friday 03/24 Close	Friday 03/17 Close	Change	10-yr Average	Top 3rd Price
Mar-06	\$11.12	\$11.11	\$0.01	\$11.88	\$12.60
Apr-06	\$10.98	\$10.97	\$0.01	\$12.31	\$13.52
May-06	\$10.93	\$10.96	(\$0.03)	\$12.35	\$13.69
Jun-06	\$11.06	\$11.18	(\$0.12)	\$12.41	\$13.50
Jul-06	\$11.37	\$11.50	(\$0.13)	\$12.85	\$13.75
Aug-06	\$11.97	\$12.07	(\$0.10)	\$13.28	\$14.19
Sep-06	\$12.02	\$12.15	(\$0.13)	\$13.78	\$14.67
Oct-06	\$12.00	\$12.11	(\$0.11)	\$13.21	\$14.00
Nov-06	\$11.94	\$12.05	(\$0.11)	\$12.32	\$13.34
Dec-06	\$11.83	\$12.00	(\$0.17)	\$12.44	\$13.53
Jan-07	\$11.75	\$11.95	(\$0.20)	\$12.27	\$13.08
Feb-07	\$11.77	\$11.90	(\$0.13)	\$11.68	\$12.34
Mar-07	\$11.72	\$11.95	(\$0.23)	\$11.88	\$12.60
Apr-07	\$11.95	\$12.15	(\$0.20)	\$12.31	\$13.52
May-07	\$11.99	\$12.10	(\$0.11)	\$12.35	\$13.69
Jun-07	\$12.19	\$12.20	(\$0.01)	\$12.41	\$13.50
Jul-07	\$12.30	\$12.45	(\$0.15)	\$12.85	\$13.75
Aug-07	\$12.35	\$12.30	\$0.05	\$13.28	\$14.19
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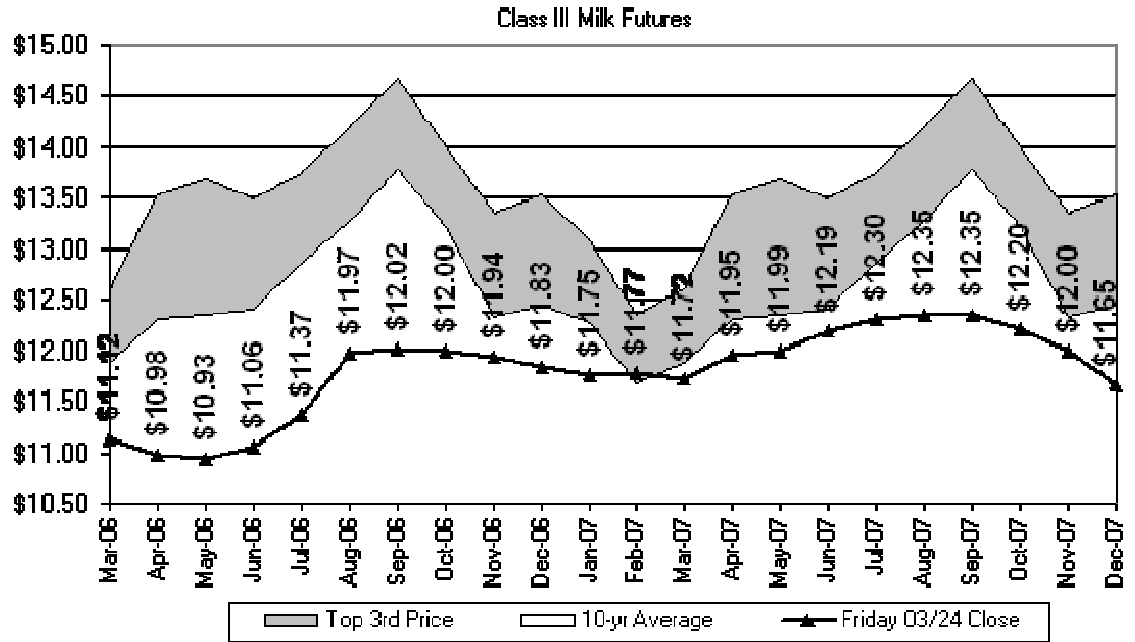


3/22/2006 - Graph USDA, DMN; Source USDA, NASS

- Dairy Market News reports [prices for NDM continue to fall](#) as current production increases to process building milk supplies. There is an expectation that producers will use the government support program as a tool to balance stocks.
- Whey prices look to be on their way down. Dairy Market News reports that prices are lower in the Central region on a weak market. Recent record high prices are keeping reluctant buyers at bay as they see the price begin to decline, and as a result, [supplies are building](#). It's not any better out East as stocks are growing due to heavy cheese and dry whey production, while demand is lackluster. Some traders are [selling at a loss](#) to keep from building their own inventories. Things are a little better in the West, as inventories do not seem to be building, but [producers and brokers are being price aggressive](#) to keep product moving.

**Recommendation:**

Following last Friday's bearish milk production report, Monday's markets were called sharply lower. But while we did open 10-15 lower, a big sell-off never occurred. There were several reasons for this. First, the front months were already beaten up pretty bad and had no where to crash to. And despite the burdensome report, producers found little appeal in selling July-Dec at an \$11.98 average. And finally, commercial interests with bids just below the market kept prices from plummeting much lower. Wednesday



brought yet another bearish report, showing American cheese stocks at an all-time high for the month of February (see graph above). Once again, Thursday morning defied logic as after opening slightly lower, we actually finished the day double-digits higher. An important lesson can be learned here. Everybody but everybody expects the market to eventually crash. When it didn't, short speculators became nervous and new long speculators added positions, and with few sellers in the market, it didn't take a whole lot of buying to push prices higher. As a hedger, you need to take a big picture look and not get caught up in the market's gyrations, but instead, sit calmly by and let it do what it's going to do. For those with heavy sold positions, yes, it's hard to watch, but about the worst thing you can do is get out of your positions and then watch the market come down again --- which is exactly what happened today. Just as suddenly as this new buy interest entered the market, it dissipated today. As a hedger, you need to take advantage of these types of opportunities when they come around. So, continue to target selling Aug-Dec at a 12.10 average or higher. Or another strategy would be to use risk reversals for those months, which look quite attractive right now. For example, using today's closing prices, you could buy 11.50 PUTs Aug-Dec for total premium of \$2.19 and sell the \$12.75 CALLs for the same months for total premium of \$1.79. The net cost of your transaction could be 40¢ (less commissions), or about 8¢ per month. What that means is that for 8¢/cwt/month, you could establish an 11.50 floor for your milk in those months, yet participate in upside all the way to 12.75, at which point you would be capped. It's a decent and inexpensive strategy to put a floor under any unprotected milk. We remain concerned about dry whey (see bullet point above), which has now fallen in two consecutive NASS surveys. A drop from 34¢ to about 29¢ (about 30¢ equivalent in Class III) is already factored into the fall months, but any further declines, say to 23-24¢, would trigger additional price erosion. Give us a call and we'll help you put together a strategy!

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