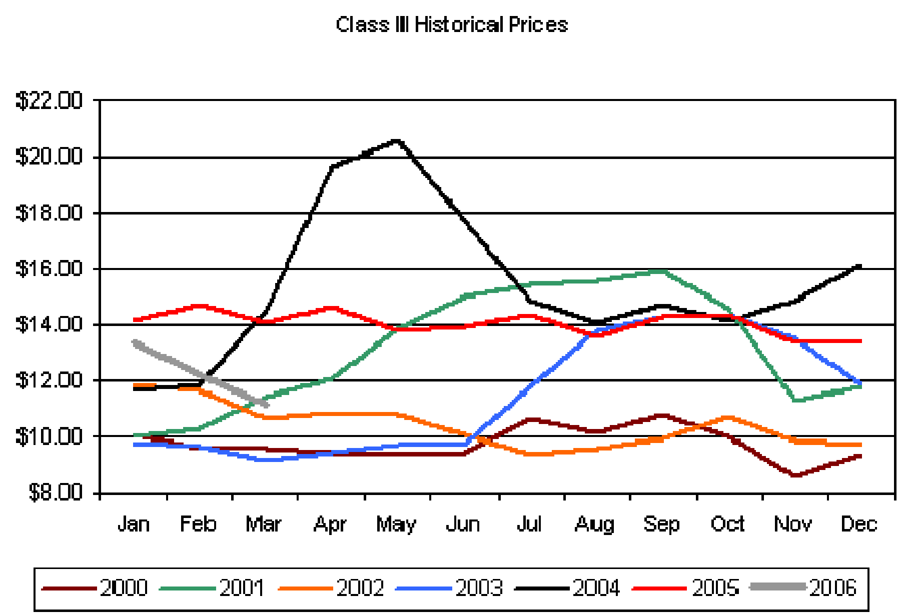
The KDM Dairy Report - March 31st, 2006

On the bright side:

Futures Month	Friday 03/31 Close	Friday 03/24 Close	Change	10-yr Average	Top 3rd Price
Apr-06	$10.96	$10.98	($0.02)	$12.31	$13.52
May-06	$10.88	$10.93	($0.05)	$12.35	$13.69
Jun-06	$10.97	$11.06	($0.09)	$12.41	$13.50
Jul-06	$11.28	$11.37	($0.09)	$12.85	$13.75
Aug-06	$11.74	$11.97	($0.23)	$13.28	$14.19
Sep-06	$11.83	$12.02	($0.19)	$13.78	$14.67
Oct-06	$11.86	$12.00	($0.14)	$13.21	$14.00
Nov-06	$11.77	$11.94	($0.17)	$12.32	$13.34
Dec-06	$11.67	$11.83	($0.16)	$12.44	$13.53
Jan-07	$11.67	$11.75	($0.08)	$12.27	$13.08
Feb-07	$11.71	$11.77	($0.06)	$11.68	$12.34
Mar-07	$11.69	$11.72	($0.03)	$11.82	$12.51
Apr-07	$11.97	$11.95	$0.02	$12.31	$13.52
May-07	$11.95	$11.99	($0.04)	$12.35	$13.69
Jun-07	$12.15	$12.19	($0.04)	$12.41	$13.50
Jul-07	$12.25	$12.30	($0.05)	$12.85	$13.75
Aug-07	$12.35	$12.35	$0.00	$13.28	$14.19
Sep-07	$12.35	$12.35	$0.00	$13.78	$14.67
Oct-07	$12.20	$12.20	$0.00	$13.21	$14.00
Nov-07	$12.00	$12.00	$0.00	$12.32	$13.34
Dec-07	$11.65	$11.65	$0.00	$12.44	$13.53

- Commercial Disappearance: Cheese demand was strong in January, according to commercial disappearance numbers release this week by USDA. American cheese use was up a strong 3.6% vs. January '05, while other varieties of cheese were up an even stronger 8.3%. Finally, use of milk in all products was up 7.7%.
- The Milk-Feed ratio fell to 2.77 in March, according to the Ag Prices report released on Thursday. Last March, the ratio was 3.35. A sustained ratio below 3.00 is conducive to a reduction in the milk supply, as profitability becomes more difficult.
- NASS surveyed cheese prices made the first increases in several weeks. Blocks gained 1.3¢ to average $1.15/lb while barrels moved 0.6¢ higher to $1.13/lb.
- Weekly cold storage holdings now show a 2% drop in cheese stocks for the period 03/01 through 03/27, a possible sign of strong cheese demand in March.
- Dairy cow slaughter for the week ending 03/18 again outpaced last year. 44,900 head were culled vs. 43,700 during the same period a year ago.
- Fluid Milk & Cream Review reports milk production in California remains very heavy; however, rainfall in the northern region is way above normal and has caused a double-digit negative impact on milk output there. In addition, hay quality for first cutting is dropping because growers can't get it off the field, causing a loss in feed value.
- International: In Oceania, two consecutive months of negative production gains in Australia has the 7-month increase down to 0.1%. Suppliers continue to report they will have very little or no additional dairy products available at the end of the season for spot or new buyer interest.

however….

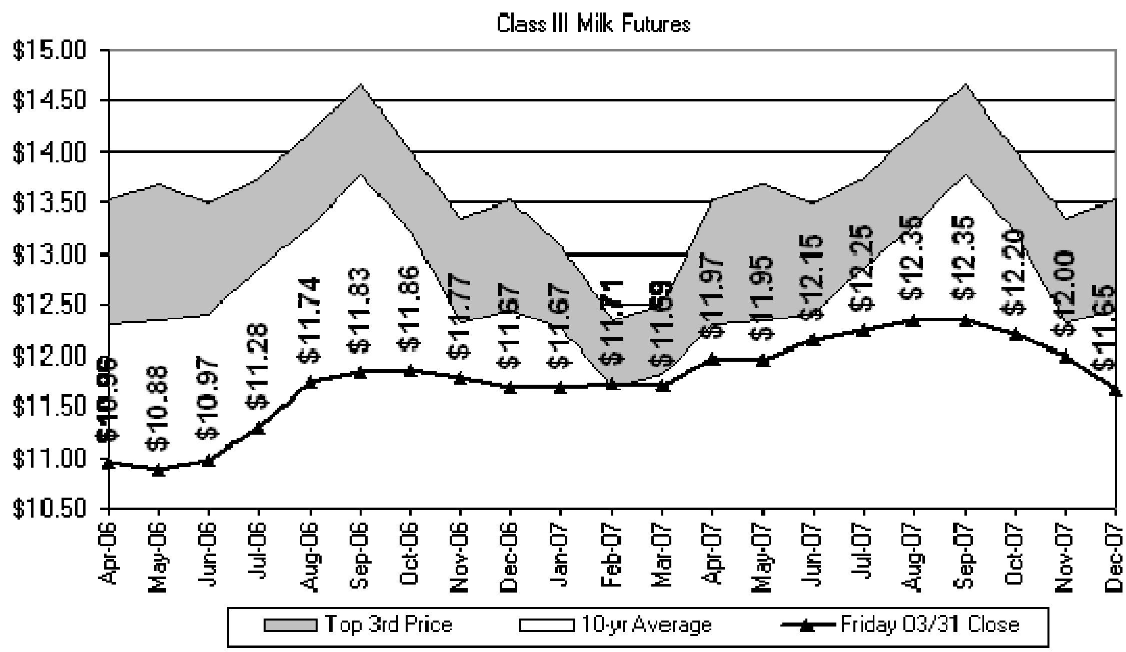


- The Class III price for March was announced at $11.11 today, 71¢ below its 10-yr average. It marks the first time in 25 consecutive months that Class III has closed below it's 10-yr average, but it probably won't be the last for some time.
- Dry whey fell a full penny to 32.9¢/lb in this week's NASS price survey, confirming what we have been predicting for a few weeks. Whey is headed lower.
- Dairy Market News reports demand for dry whey is fair at best in the Midwest. Buyers expect prices to trend lower so are hesitant in picking up loads.
- Despite a ¼¢ gain in cash blocks today, they finished the week 1¾¢ lower at $1.16¾. Barrels were ½¢ higher for the week, settling at $1.13½, while

butter managed a penny gain to $1.16. However, sellers were ready to pounce on any attempt to push prices higher, so the small gains are largely meaningless.

- Butter continues to pile up. For the week ending 03/25, 2.3 million lbs of butter were **added** to CME-approved ware houses. That compares to a 65,000 lb **drawdown** for the same period last year.
- Despite the lower price, Dairy Market News reports there has been little feature activity for butter, and orders over the Easter/Passover holiday appear to be below last year's.
- In the Midwest, Fluid Milk & Cream Review continues to highlight ample supply and plant capacity issues. Plant operators are working together to balance their operations and spot milk is available for 60¢ under class.
- The peak has not been reached in the Southeast, according to Fluid Milk & Cream Review. Florida exported 158 loads of Grade A milk this week, vs. 125 last week. Surplus milk volumes are building as winter residents head back north. The loss of these consumers is having a negative impact on bottled sales.
- The NDM market remains weak, according to Dairy Market News. Dryer capacities out East are being stretched by the heavy volumes of milk, and most expect prices to fall further. Buyers are purchasing only for immediate needs. In Western regions, sellers continue to be aggressive on price to move product. Stocks of powder are heavy, with some plants needing to use outside storage to handle the growing inventories.

Recommendation:



Trading this week continued a pattern of temporary double-digit gains followed by a sell-off near the end of each day's session. On Thursday, the November contract hit a high of 11.95 before settling at 11.71. There are still opportunities to get near 12.00 milk sold Aug-Dec! Inventories of butter, nonfat dry milk and dry whey are building and will keep prices in check. The sharp drop in the NASS dry whey price this week could spill over into the futures market if the price looks like it will fall below 29¢. We may have already seen the start of this. Looking at the week-to-week comparison above, the months with the biggest losses were Aug-Dec, falling from an 11.95 average last week to 11.77 today. We still believe rallies above 12.00 should be sold. Prices have fallen slightly from last week, making our risk reversal recommendation a tough one to fill. But, today we were able to buy the August and September 11.50 PUT and sell the 12.50 CALL for 10¢ each, and earlier this week we did Oct-Mar'07 with the same options for about 14¢ each. This gives the producer an 11.50 floor (less premium & commission) with upside to 12.50, at which point he's capped. Consider using both strategies: sell rallies and use the risk reversal Aug-Dec and into 1st quarter 2007. We still remain rooted in a bearish market, despite the cash market showing some signs of bottoming. The market could remain choppy before making another leg down.