



The KDM Dairy Report - May 19th, 2006

On the bright side:

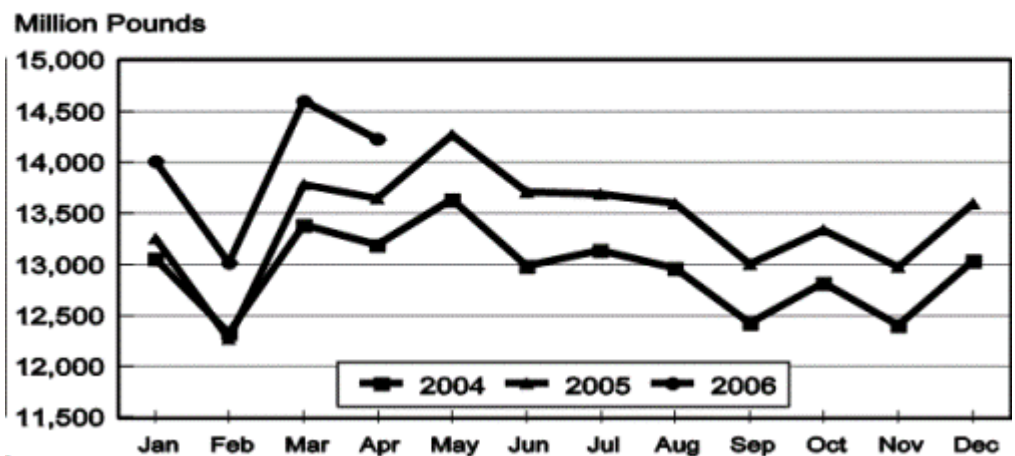
- The cash markets continued to show strength this week, with blocks increasing 3¢ to close at \$1.20/lb. The gain put blocks once again above barrels, which moved a penny higher to \$1.19/lb. The price increases motivated sellers who sold 6 loads of blocks and 4 loads of barrel.
- Lack of dairy quality hay continues to be a concern out West. Fluid Milk & Cream Review reports that due to earlier wet conditions which delayed harvesting, [new crop hay is testing lower](#) than where dairy cows need.
- The decline in fresh cows joining the milking string and above normal temperatures have combined to level off production in California, according to Fluid Milk & Cream Review.
- The bottom may be nearing for dry whey. Dairy Market News reports this week that both export and domestic buying is good, and the [tone is steadier](#) than it has been for several weeks. Though production is still heavy, stocks range from in balance to tight. Some wonder what the market will look like after the spring flush, as world stocks are still tight.
- Tight barrel supplies are pulling block prices along, according to Dairy Market News. Some processors are seeing a [surge in late orders](#) for Memorial Day weekend and June promotions.

Futures Month	Friday 05/19 Close	Friday 05/12 Close	Change	10-yr Average	Top 3rd Price
May-06	\$10.82	\$10.80	\$0.02	\$12.35	\$13.69
Jun-06	\$11.12	\$10.91	\$0.21	\$12.41	\$13.50
Jul-06	\$11.45	\$11.26	\$0.19	\$12.85	\$13.75
Aug-06	\$11.67	\$11.52	\$0.15	\$13.28	\$14.19
Sep-06	\$12.09	\$11.90	\$0.19	\$13.78	\$14.67
Oct-06	\$12.11	\$11.97	\$0.14	\$13.21	\$14.00
Nov-06	\$12.05	\$11.76	\$0.29	\$12.32	\$13.34
Dec-06	\$11.92	\$11.66	\$0.26	\$12.44	\$13.53
Jan-07	\$11.96	\$11.90	\$0.06	\$12.27	\$13.08
Feb-07	\$11.89	\$11.80	\$0.09	\$11.68	\$12.34
Mar-07	\$11.93	\$11.85	\$0.08	\$11.82	\$12.51
Apr-07	\$12.03	\$11.95	\$0.08	\$12.19	\$13.36
May-07	\$12.10	\$11.99	\$0.11	\$12.35	\$13.69
Jun-07	\$12.25	\$12.18	\$0.07	\$12.41	\$13.50
Jul-07	\$12.58	\$12.40	\$0.18	\$12.85	\$13.75
Aug-07	\$12.72	\$12.54	\$0.18	\$13.28	\$14.19
Sep-07	\$12.87	\$12.66	\$0.21	\$13.78	\$14.67
Oct-07	\$12.63	\$12.42	\$0.21	\$13.21	\$14.00
Nov-07	\$12.45	\$12.25	\$0.20	\$12.32	\$13.34
Dec-07	\$12.16	\$11.95	\$0.21	\$12.44	\$13.53

however....

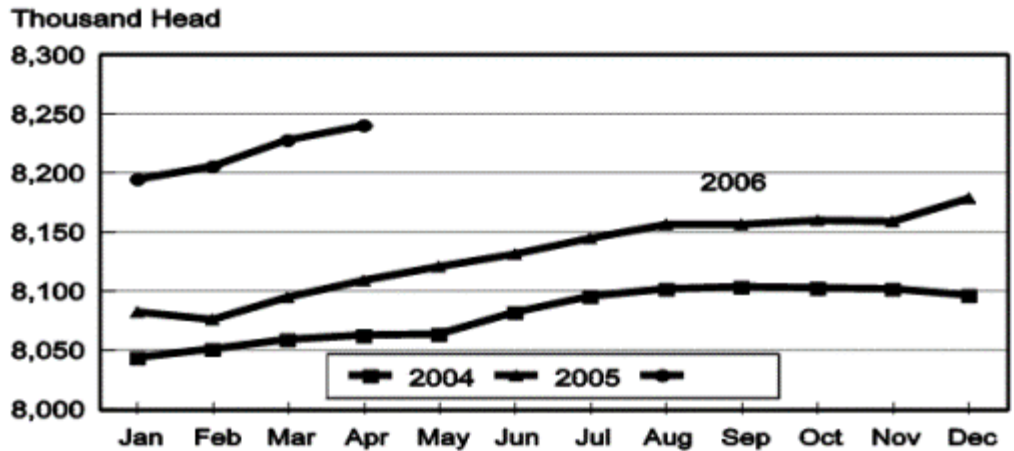
- Milk Production Report: April milk production in the 23 major states was up 3.7% from last April, USDA reported this week. Production per cow was up 37 lbs to 1,727 and probably most telling, [cow numbers increased 13,000 head](#) from March. For all 50 states, production was up 3.2% and cow numbers were up 14,000 head.
- Livestock Slaughter Report: Despite lower milk prices and small increases in weekly slaughter numbers, the dairy cull [still trails last year's](#), according to USDA numbers released this week. 170,100 head here culled in April vs. 172,600 last April. Jan-Apr '06 dairy cull was 748,700 head vs. 773,100 head in 2005, a decline of 3.2%.
- Cold Storage Report: Stocks of dairy end-products [continued to increase](#) in April. American cheese was up 3% vs. a year ago, and up 1% from the prior month. Total cheese was up 4% and 2%. Finally, butter in storage was up 20% vs. 2005 and 16% over March.
- Livestock, Dairy & Poultry Outlook Report: USDA's monthly update on the dairy industry has little positive in it for 2006. Low milk prices are forecast to last throughout the year, and cow numbers are [not expected to start to decline](#) until Q4.

Monthly Milk Production 23 States



- [Dry whey fell](#) another 0.8¢ to 27.7¢ in this week's NASS survey. Since its most recent high of 35.6¢ on Feb 24th, dry whey has lost 7.95¢, taking 47.7¢ off the Class III contract (see chart below).

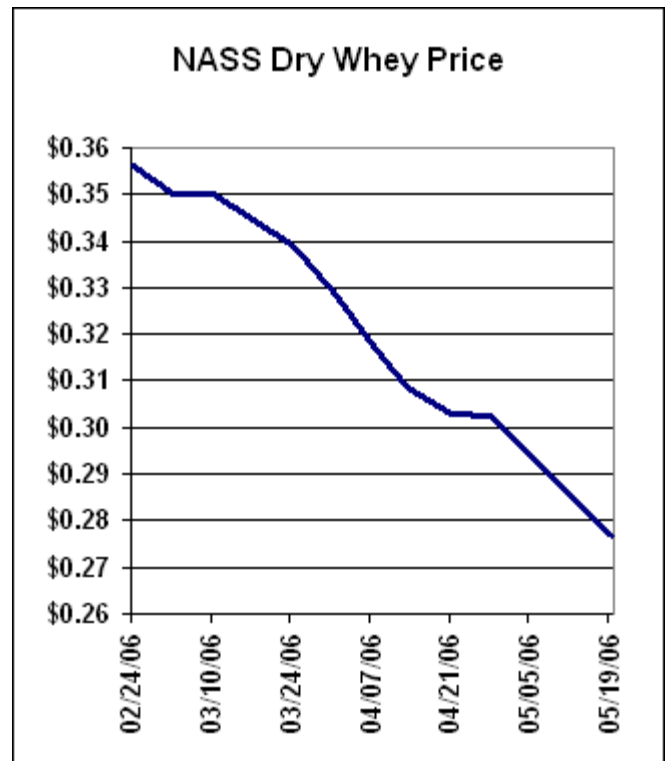
Monthly Milk Cows 23 States



- Weekly cold storage numbers have reversed from the first week, now showing a [3% increase in cheese](#) stocks for the first 15 days of the month. Stocks have increased 3.7 million lbs during the period.
- Midwest milk processors are having a more [difficult time handling milk volumes](#) this week, according to Fluid Milk & Cream Review. Spare capacity has nearly disappeared as Class I interest dries up, and spot offerings of surplus milk far exceed demand. Milk buyers in the upper Midwest continue to implement programs to increase hauling rates and decrease premiums due to profitability concerns.
- Weekly butter movement at CME-approved warehouses saw a net increase of 4.5 million lbs this week, vs. a 3.4 million lb increase last year. Total stocks now sit at 143.8 million lbs, a [47% increase over a year ago](#).

Recommendation:

Short liquidation and the increases in the cash cheese market helped push prices higher for the week. The Aug-Dec average improved 21¢ to average \$11.97. That met last week's goal of \$11.90 or higher. The 2007 average increased 14¢ and now stands at \$12.30, while Jan-Jun '07 is now at \$12.03, up 8¢. With increases in both price and volatility in the market the past couple weeks, milk option premiums have more than doubled in many months. This makes it hard to get calls bought to cover your sold milk contracts at a reasonable price. Enter the Bull Call spread! For this trade, you buy at-the-money options and sell out-of-the-money options to reduce the overall cost for market rally insurance. At the same time, it reduces volatility's influence on the option's cost. For example: August settled at 11.67. An 11.75 call closed at 50¢ today, and the 12.50 call traded at 25¢. Enter an open order to buy the 11.75 call and sell the 12.50 call at a net cost of 25¢. If August futures settle above 12.50, your net gain is 50¢, or \$1,000 per contract. If we settle at 12.00, you would break even. Use this to partially protect your sold futures or contract positions.



The 2007 average at \$12.30 looks fairly attractive, but from a technical perspective, it formed a bottom a few weeks ago and has risen ever since. While fundamentals remain firmly bearish, we would recommend being only up to 25% hedged in 2007 at this time, waiting for a potential seasonal push higher this fall before making further sales in 2007.

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