The KDM Dairy Report - June 2nd, 2006

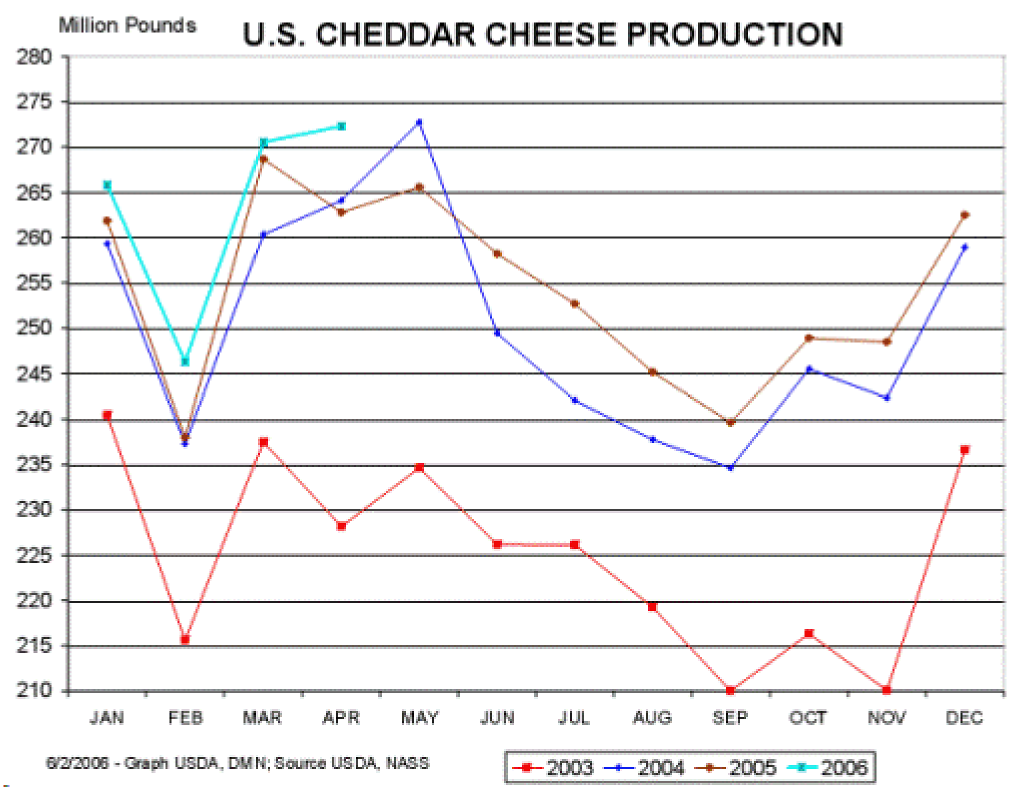
On the bright side:

Futures Month	Friday 06/02 Close	Friday 05/26 Close	Change	10-yr Average	Top 3rd Price
Jun-06	$11.32	$11.45	($0.13)	$12.41	$13.50
Jul-06	$11.93	$11.99	($0.06)	$12.85	$13.75
Aug-06	$12.30	$12.33	($0.03)	$13.28	$14.19
Sep-06	$12.50	$12.50	$0.00	$13.78	$14.67
Oct-06	$12.55	$12.50	$0.05	$13.21	$14.00
Nov-06	$12.49	$12.40	$0.09	$12.32	$13.34
Dec-06	$12.25	$12.18	$0.07	$12.44	$13.53
Jan-07	$12.40	$12.27	$0.13	$12.27	$13.08
Feb-07	$12.25	$12.10	$0.15	$11.68	$12.34
Mar-07	$12.35	$12.11	$0.24	$11.82	$12.51
Apr-07	$12.43	$12.23	$0.20	$12.19	$13.36
May-07	$12.40	$12.19	$0.21	$12.22	$13.51
Jun-07	$12.49	$12.43	$0.06	$12.41	$13.50
Jul-07	$12.70	$12.63	$0.07	$12.85	$13.75
Aug-07	$12.85	$12.74	$0.11	$13.28	$14.19
Sep-07	$12.96	$12.92	$0.04	$13.78	$14.67
Oct-07	$12.75	$12.67	$0.08	$13.21	$14.00
Nov-07	$12.55	$12.49	$0.06	$12.32	$13.34
Dec-07	$12.40	$12.30	$0.10	$12.44	$13.53

- This week's NASS survey reflects recent gains in the cash cheese market. Blocks gained 1.7¢ to average $1.17/lb, while barrels gained 2.5¢ to $1.18/lb.
- Processors in the Midwest were able to handle the milk during the holiday weekend better than expected, according to Fluid Milk & Cream Review. Plants did run on extended schedules, but slowdowns were minimal.
- Fluid Milk & Cream Review reports the milk supply in California appears to be in balance, and processors were able to handle the milk over the holiday weekend quite well. In addition, lack of dairy quality hay continues to be an ongoing concern for producers.
- Dairy Market News reports less milk flowed into dryers than was anticipated over the holiday weekend. As a result, nonfat dry milk prices are steady to higher. No NDM was offered to the CCC from either the central or eastern regions.
- The cheese market is surprisingly strong despite heavy production, according to Dairy Market News. As a result, buyers are placing new orders, trying to beat the next price increases. Good promotional activity at the retail level is keeping inventories from building.
- A recent article in Western Dairy Business suggests that the cost of running a dairy has gone up by $1/cwt due to price increases for feed, energy, environmental compliance and higher interest rates. The author suggests $14/cwt is needed to break even for the average dairy in the West, yet current fundamentals don't suggest we'll reach those levels in 2006. The implication here, is that today's lower prices may hasten a price recovery sooner rather than later if some operations are forced to exit.

however….

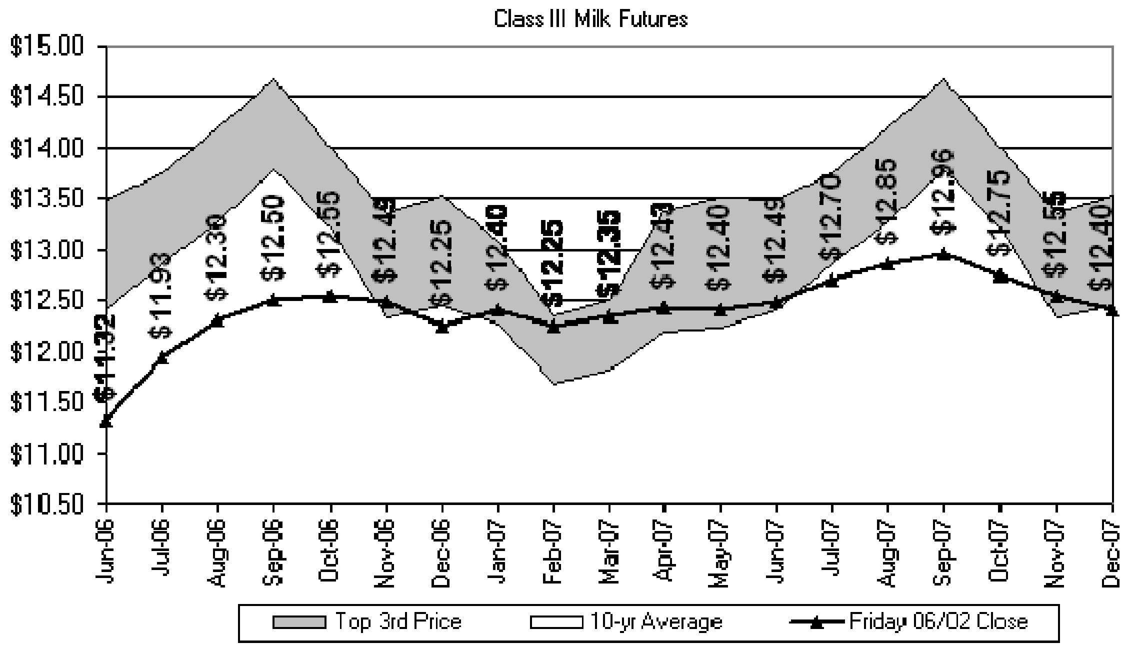
- The April Class III price was announced today at $10.83/cwt, its lowest close since June 2003, and well below its average since 1995 of $12.22.
- The cash market continues to be volatile, but for the week, blocks shed 2½¢ to finish at $1.20/lb on Friday. However, barrels managed to gain a penny, closing at $1.20/lb. Butter was mostly quiet, but it did drop ¼¢ to $1.17½/lb.
- Dairy Products Report: April cheddar cheese production was a 3.6% higher than a year ago, according to USDA figures released today. American-type cheese was up 1.9%, total cheese output was up 3.3% and butter output



was 9.2% higher. Finally, strong demand pushed dry whey production 10.3% higher than last April.

- Though NASS cheese numbers showed an increase, dry whey was on the decline again, losing 0.5¢ to 27.7¢/lb.
- Weekly cold storage numbers continue to reflect increases in inventory. Through 5/29, cheese stocks were up 2% and butter stocks up 14%.
- Butter continues to pile up at CME warehouses. For the week ending 05/27, 2.6 million lbs were added vs. only 933,000 lbs during the same period a year ago.
- A local cheese plant we work with indicates sales are starting to slow down.
- Warm weather is slowing milk output in the Southeast, but with schools out, volumes remain excessive in all areas. Fluid Milk & Cream Review reports plants in the Northeast continue to run at full capacity as well.

Recommendation:



Class III continued to be a volatile market as the short squeeze continued to play out this week. On Tuesday, prices resumed their upward climb, but on Wednesday, cash cheese provided some direction when blocks were offered lower. Futures quickly sold off. However, by week's end, support in the deferred contracts returned with incremental but steady gains. The most recent commitment of traders report shows that from 5/16 to 5/30, 1,285 non-commercial short positions were liquidated, vs. only 254 long positions, putting the long-to-short ration at a much more even level. Continued strong production took its toll on the front months this week as they all registered losses, but strong demand and higher operational costs for dairies are starting to lend support to the 2007 contracts. The 2007 average increased another 12¢ this week to stand at $12.54, while the first half of 2007 improved 17¢ to average $12.39. That's 29¢/cwt higher than the Jan-Jun 10-yr average of $12.10. In particular, the Feb and Mar 2007 contracts are nearing their top-third historical averages of $12.34 and $12.51 (see chart). You may want to consider hedging some of your 1st quarter production at these levels or defend them with PUT options. For the balance of 2006 we would continue to use PUT options to place a floor under your production. Call us for specific strike prices and targets!