



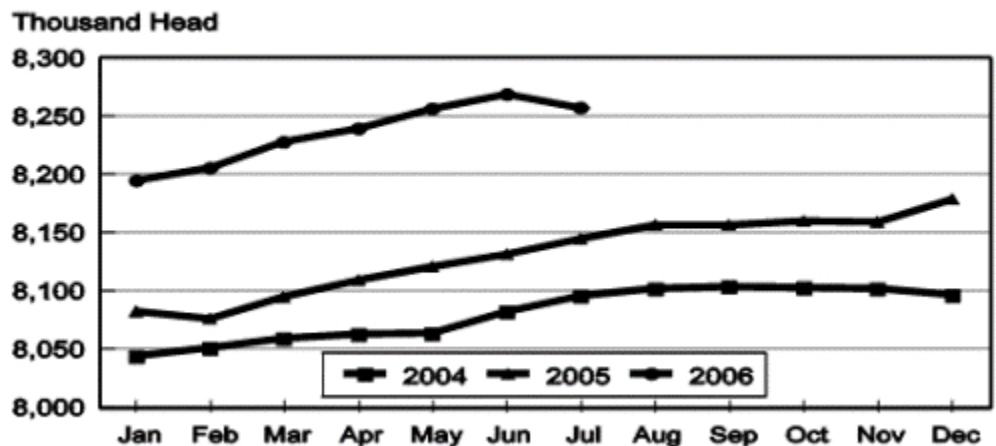
## The KDM Dairy Report - August 18<sup>th</sup>, 2006

### Bullish Fundamentals:

- Livestock, Dairy, and Poultry Outlook Report: USDA [raised their Class III price forecast](#) for fourth quarter by 17¢/cwt due to the affect of the recent heat wave. They now expect the price to average \$11.87/cwt, up from their \$11.70/cwt estimate from last month. USDA also reduced their Q4 milk per cow estimate from 19,965 lbs to 19,890 lbs.
- Cash Market: Buyers continued to be the aggressors as the spot cheese price continued to increase. Blocks gained 4¢ to finish at \$1.24/lb this week while barrels increased 5¢ to \$1.24¼/lb. However, butter lost ½¢ to settle at \$1.28½/lb today, and near the end of the week, it felt more like buyers were on the defensive than on offense. 18 loads of blocks, 11 of barrel and 43 cars of butter exchanged hands.
- Dairy cow slaughter for the week ending 08/05 was 42,900 head, an [increase of 4,200 head](#) vs. the same period a year ago.
- Dairy Market News reports that the [cheese market is firming](#) as buyers are starting to realize that cheese prices could rise. Current cheese (aged 3 to 30 days) offerings continue to tighten and barrel supplies are short of needs. Milk shipped from the upper Midwest into southeastern fluid markets is further reducing production schedules. In addition, reduced solids content of the milk is reducing yields, but attempts to secure nonfat dry milk to fortify the vat are met without much success.
- Milk supplies remain tight in the Central region of the country. Fluid Milk & Cream Review reports that manufacturing milk [demand exceeds offerings](#) and plants are running on lighter summer schedules.
- All [Class III components increased](#) in this week's NASS survey, as they follow recent strength in the cash markets. Cheddar blocks gained 1.9¢ to average \$1.16/lb while barrels were up 0.6¢ to \$1.15/lb. Butter shot up 6.1¢ to \$1.21/lb, nonfat dry milk increased 0.2¢ to 84.8¢/lb and dry whey got close to breaking above 30¢, increasing 0.9¢ to average 29.7¢/lb. Each penny increase (or decrease) in dry whey moves Class III by 6¢.
- Milk is also [still tight](#) in the Northeast and Southeast according to Fluid Milk & Cream Review. Competition for available milk is strong, especially in the Southeast where school bottling pipelines continue to fill. 364 loads of Grade A milk were imported into the area last week vs. 204 last year. Cream supplies remain very limited as butterfat levels have been greatly reduced and no significant recovery is occurring.
- The nonfat dry milk market as firm due to reduced production. Plants [can't satisfy spot interest](#) so some resellers were able to command more than \$1/lb for stored loads. Milk moving to Class I is limiting new production and some buyers are getting shorted on contracted loads.

Futures Month	Friday 08/18 Close	Friday 08/11 Close	Change	10-yr Average	Top 3rd Price
Aug-06	\$11.05	\$10.99	\$0.06	\$13.28	\$14.19
Sep-06	\$12.22	\$11.90	\$0.32	\$13.78	\$14.67
Oct-06	\$12.68	\$12.58	\$0.10	\$13.21	\$14.00
Nov-06	\$12.70	\$12.75	(\$0.05)	\$12.32	\$13.34
Dec-06	\$12.67	\$12.80	(\$0.13)	\$12.44	\$13.53
Jan-07	\$12.70	\$12.78	(\$0.08)	\$12.27	\$13.08
Feb-07	\$12.35	\$12.50	(\$0.15)	\$11.68	\$12.34
Mar-07	\$12.36	\$12.45	(\$0.09)	\$11.82	\$12.51
Apr-07	\$12.65	\$12.75	(\$0.10)	\$12.30	\$13.47
May-07	\$12.55	\$12.70	(\$0.15)	\$12.32	\$13.61
Jun-07	\$12.70	\$12.72	(\$0.02)	\$12.39	\$13.44
Jul-07	\$13.24	\$13.20	\$0.04	\$12.82	\$13.71
Aug-07	\$13.40	\$13.45	(\$0.05)	\$13.28	\$14.19
Sep-07	\$13.42	\$13.34	\$0.08	\$13.78	\$14.67
Oct-07	\$13.22	\$13.19	\$0.03	\$13.21	\$14.00
Nov-07	\$13.00	\$13.08	(\$0.08)	\$12.32	\$13.34
Dec-07	\$12.87	\$12.82	\$0.05	\$12.44	\$13.53

Monthly Milk Cows  
23 States

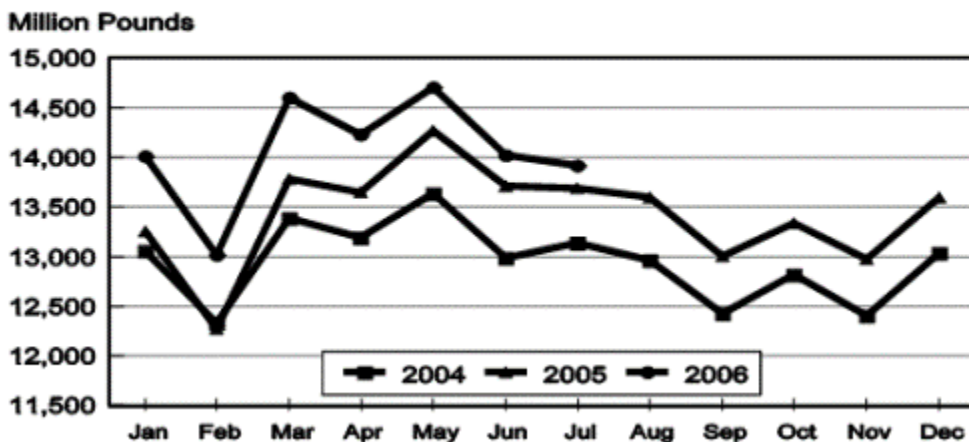


- The dry whey [supply is limited](#) as good domestic and export sales are taking place. Exports through June were 9.4% higher than in 2005, according to Dairy Market News. The mostly price in much of the country is now over 30¢/lb.
- Cream [supplies are very tight](#) for churning purposes, according to Dairy Market News. As a result, the butter market is firm as plants are limited in what they can produce. Some plants are temporarily halting churning activity and selling their cream to very interested Class II buyers.
- A net 5.5 million lbs of butter was moved out of CME-approved warehouses for the week ending 08/12, [an increase of 2.2 million lbs](#) during the same period a year ago.
- Milk Production Report: While primarily a bearish report, the lone supportive fundamental was the drop in milk cow numbers from June to July by 13,000 head in the 50 states (see graph above). That's the first drop in cow numbers since February 2005.

#### Bearish Fundamentals:

- Milk Production Report: Despite widespread heat in July, milk production was up 1.5%, surprising most analysts, including ourselves. Most predicted less than a 1% increase. Production per cow even managed a 3 lb/cow gain over last year! Production was up primarily due to the [107,000 more milk cows](#) in the top 23 states. Production in CA was down 0.3%, but up 12.6% in NM, 7.9% in TX, 6.8% in CO and 6.4% in ID.
- Milk receipts in California are [back to the level before the heat spell](#) in July, according to Fluid Milk & Cream Review. A cool start to August has helped limit further stress on the cows and they are responding. Production is steady in NM and AZ, but rebounding in the Pacific Northwest with cool nights and limited humidity. Our own monitoring of a major co-op in California substantiates this.
- Weekly cold storage numbers show a 1% [increase in cheese stocks](#) for the period 08/01 through 08/14.
- A local cheese plant we work with said a week ago they were tight on milk; now they have more than enough.

Monthly Milk Production  
23 States



#### Recommendation:

We were flat out wrong on California. Of course, so was nearly everybody else. We are nothing short of amazed at how quickly production has recovered there, and with cooler temperatures in the Midwest and East, production has been rebounding everywhere. The milk production report was quite a surprise as most analysts were expecting less than a 1% increase, but we were all proved wrong again. Perhaps the impact of the heat will show up in the September report for August, or in one of USDA's infamous revisions. Despite an abundance of supporting fundamentals in this week's report, much of the bullish enthusiasm has been sucker-punched out of us. It's not to say that we still can't see a price rally this fall, it just looks less likely in light of the production rebound we're seeing. Contacts in the cheese biz we spoke to this week indicate plenty of cheese is still being produced and warehouses are still on the full side. This should temper any rally in the cash market. Predicting what will happen this fall feels akin to flipping a coin due to strong factors on both sides of the equation, so what's a producer to do? We feel this is an ideal time to put on a risk reversal, or fence. Consider buying the 12.25 PUT option and selling the 13.50 CALL option Oct through Dec at a cost of 9¢ each. If successful, you'll have a floor under your milk at 12.25 with a ceiling at 13.50 with a minimal cost of \$180 per contract.

We still have some optimism for 2007. Rumor has been confirmed as fact that at least one and probably several large Western co-ops will be going rBST free as early as October of this year. While the real impact to milk production may be minimal, the emotional impact on the market may be greater. Demand for organic and hormone-free milk is strong and growing. If this type of policy is adopted in other regions, it would be supportive of prices. We continue to recommend getting 25% sold at a 12.90 average or better. Yesterday we hit 12.92 but gave up a few cents today to average 12.87. Consider additional sales at \$13.25 or higher.

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