



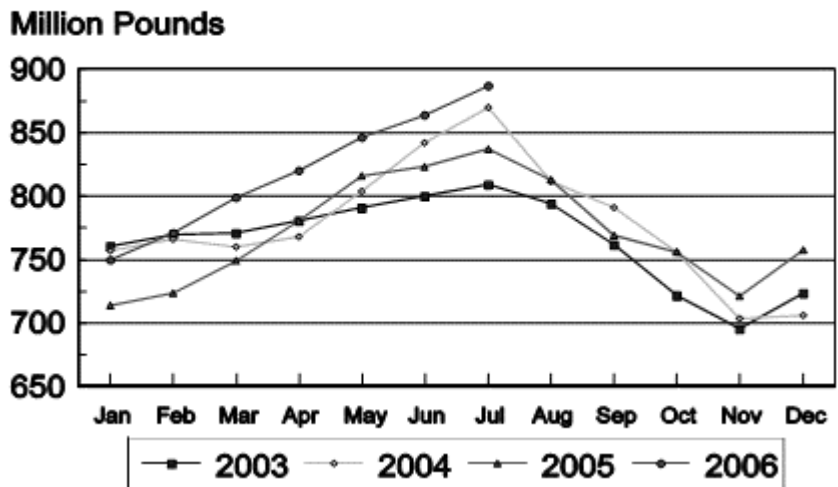
The KDM Dairy Report - August 25th, 2006

Bullish Fundamentals:

- The spot markets made a dramatic move higher on Thursday and Friday of this week. Blocks jumped 5½¢ higher to settle today at \$1.29½, while barrels gained 4¾¢ to close at \$1.29. Spot butter made an even more impressive move as a tight cream situation has buyers lining up for product. Butter increased 7¢ from last week to close at \$1.35½. 13 loads of blocks, 3 of barrel and 61 cars of butter exchanged hands.
- Livestock Slaughter Report: USDA's monthly slaughter numbers show 174,600 head exited the milking herd in July, up 12,200 head vs. last July. The [YTD dairy cull is above last year](#) as well, with 1.282 million head going to slaughter vs. 1.264 million for the same period last year, an increase of 1.4%.
- NASS surveyed cheese prices [continued their upward trend](#) this week. U.S. 40-lb blocks were up 1.0¢ to average \$1.17/lb. 500-lb barrels were also at \$1.17/lb, up 2.2¢. Butter increased 0.2¢ to \$1.22/lb and dry whey gained 0.1¢ to 29.8¢/lb but nonfat dry milk decreased 0.1¢ to 84.6¢/lb.
- Weekly cold storage numbers show cheese stocks virtually unchanged for the first 21 days of August, but [butter stocks are down 12%](#) during this period.
- CME butter storage numbers confirm that demand is strong. A net 8.7 million lbs were drawn out of warehouses for the week ending 08/19, the [largest weekly decline](#) since November 2004. The decline over the last five weeks has been the most ever for late summer.
- Dairy cow slaughter for the week ending 08/12 was [up a BIG 16.3%](#) compared to last year. 47,000 head were culled vs. only 40,400 during the same period a year ago.
- Fluid Milk & Cream Reports 413 loads of Grade A milk were shipped into the Southeast this week, 49 more than last week and [96 more than last year](#). Temperatures have moderated, but a dry spell is causing feed crops to suffer, with yields below desired levels. At the same time, demand for milk is increasing as more schools resume classes.
- The [milk supply is still tight](#) in the Central region of the country, according to Fluid Milk & Cream Review. The combination of heavy shipments to the Southeast to satisfy Class I needs and good manufacturing interest are the cited reasons. As a result, requests to purchase extra milk are going largely unfilled.
- Heavy rains have had a negative impact on production in NM, according to Dairy Market News. Daily rains with substantial totals have left operations wet and muddy with little chance to dry out, so shipments to local balancing plants have slowed.
- Dairy Market News reports the dry whey market continues to be [firm on tight supply](#). As more milk is directed into Class I instead of Class III facilities, some buyers have been forced to pay 3-4¢ premiums from resellers when they have not been able to secure product direct from the manufacturer. In addition, the export market has been very good for this time of year, as European whey prices continue to increase and offerings are limited.

Futures Month	Friday 08/25 Close	Friday 08/18 Close	Change	10-yr Average	Top 3rd Price
Aug-06	\$11.05	\$11.05	\$0.00	\$13.28	\$14.19
Sep-06	\$12.47	\$12.22	\$0.25	\$13.78	\$14.67
Oct-06	\$12.90	\$12.68	\$0.22	\$13.21	\$14.00
Nov-06	\$12.87	\$12.70	\$0.17	\$12.32	\$13.34
Dec-06	\$12.80	\$12.67	\$0.13	\$12.44	\$13.53
Jan-07	\$12.65	\$12.70	(\$0.05)	\$12.27	\$13.08
Feb-07	\$12.37	\$12.35	\$0.02	\$11.68	\$12.34
Mar-07	\$12.40	\$12.36	\$0.04	\$11.82	\$12.51
Apr-07	\$12.70	\$12.65	\$0.05	\$12.30	\$13.47
May-07	\$12.70	\$12.55	\$0.15	\$12.32	\$13.61
Jun-07	\$12.70	\$12.70	\$0.00	\$12.39	\$13.44
Jul-07	\$13.25	\$13.24	\$0.01	\$12.82	\$13.71
Aug-07	\$13.45	\$13.40	\$0.05	\$13.28	\$14.19
Sep-07	\$13.48	\$13.42	\$0.06	\$13.78	\$14.67
Oct-07	\$13.22	\$13.22	\$0.00	\$13.21	\$14.00
Nov-07	\$13.09	\$13.00	\$0.09	\$12.32	\$13.34
Dec-07	\$12.90	\$12.87	\$0.03	\$12.44	\$13.53

Total Natural Cheese - United States Cold Storage Stocks, 2003-2006



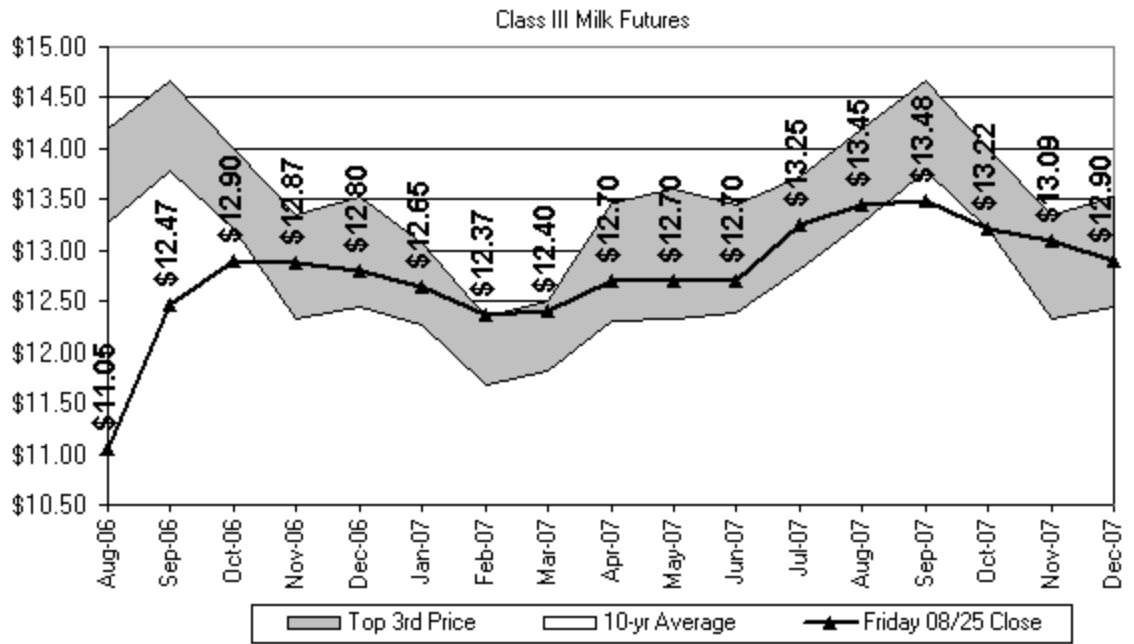
- Dairy Market News reports [the cheese market is firm](#), as producers are having problems filling orders for provolone, pepper jack, Colby/jack and fresh mozzarella. Cheese shipments from the West and Southwest are needed to supplement reduced output in the rest of the country. Some operators are not able to secure enough milk to fill cheese orders while at the same time, school openings are further reducing manufacturing milk supplies.

Bearish Fundamentals:

- Cold Storage Report: Total [cheese stocks in July were 6% higher](#) than the previous year and 3% higher than June, according to USDA numbers released this week, while American cheese stocks were down 1% from a year ago. It's indicative of the trend of more cheddar being produced at larger plants out West, with smaller Midwest and Eastern plants switching from cheddar to specialty varieties. Butter stocks were 30% higher than last year but 1% lower than June.
- USDA contacts continue to express surprise at the extent of the milk production recovery in California, according to Fluid Milk & Cream Review. Levels are now [at or near](#) those experienced just before the heat wave in July, largely due to additional cows freshening and available replacements. The increase has allowed processing plants to return to projected schedules.

Recommendation:

Cheese prices early in the week seemed stalled out with reports of adequate inventory of product. As the week progressed and cheese prices moved higher, orders picked up, taking advantage of the lower weekly averages. On Thursday, a significant buyer of cheese showed up in the pit that had been absent for several months. This continued the drive to get product purchased and pushed the cash cheese price higher.



Futures today reached a \$12.92 average in the last quarter, which is close to \$1.40 cheese, and a 10¢ premium to cash cheese. NASS numbers will need to come up quickly for September to hold the \$12.50 level, as today's NASS averages were only at \$1.17 for both blocks and barrels. Current tight 30-day cheese inventories and disbelief in the production report (which could be revised next month) should keep us heading higher, with a showdown between the two 800-lb gorillas at the \$1.35 to \$1.40 cheese level. Stay tuned as the match approaches. We've revised our 2007 targets slightly higher, and now recommend being patient, starting to sell your 2007 production at a \$13.05 average (currently \$12.91). Increase coverage at intervals of 10 to 20 cents above that level, getting 50% covered by the end of September. Then look for opportunities to cover your short positions with call options \$1.00 higher than your sell price, paying 15¢ premium each. This rally will send a signal to those involved in expansion to charge ahead, and that could leave us in a situation with more milk to deal with in a U.S. economy that may see a downward correction. New housing is one of the leading indicators and is off 30%. Will the S&P 500 follow?

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