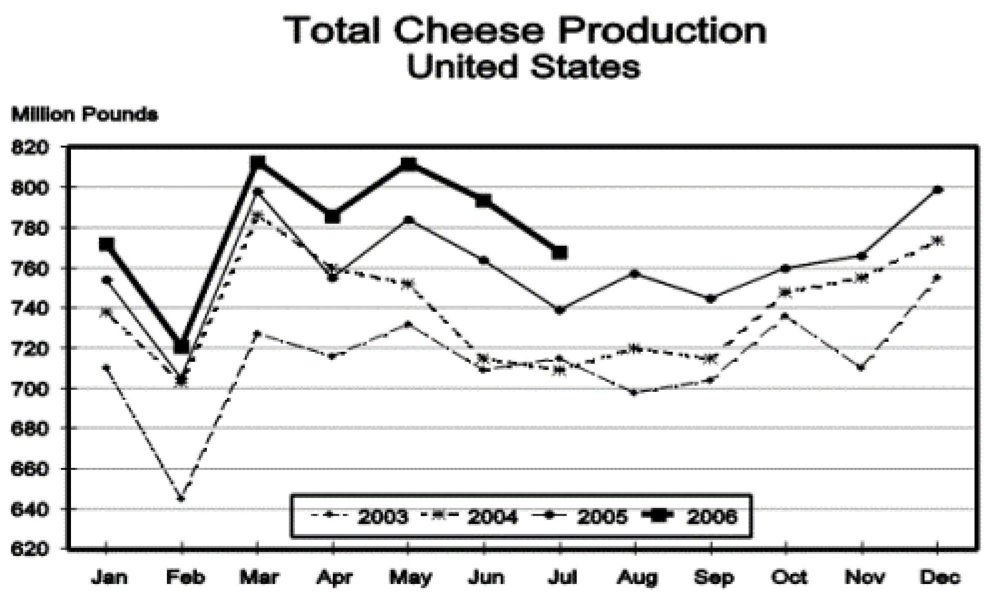
The KDM Dairy Report - September 1st, 2006

Bullish Fundamentals:

Futures Month	Friday 09/01 Close	Friday 08/25 Close	Change	10-yr Average	Top 3rd Price
Sep-06	$12.35	$12.47	($0.12)	$13.78	$14.67
Oct-06	$12.75	$12.90	($0.15)	$13.21	$14.00
Nov-06	$12.60	$12.87	($0.27)	$12.32	$13.34
Dec-06	$12.54	$12.80	($0.26)	$12.44	$13.53
Jan-07	$12.46	$12.65	($0.19)	$12.27	$13.11
Feb-07	$12.32	$12.37	($0.05)	$11.68	$12.37
Mar-07	$12.33	$12.40	($0.07)	$11.82	$12.54
Apr-07	$12.49	$12.70	($0.21)	$12.30	$13.51
May-07	$12.50	$12.70	($0.20)	$12.32	$13.67
Jun-07	$12.64	$12.70	($0.06)	$12.39	$13.49
Jul-07	$13.30	$13.25	$0.05	$12.82	$13.74
Aug-07	$13.45	$13.45	$0.00	$13.23	$14.17
Sep-07	$13.50	$13.48	$0.02	$13.78	$14.67
Oct-07	$13.22	$13.22	$0.00	$13.21	$14.00
Nov-07	$13.10	$13.09	$0.01	$12.32	$13.34
Dec-07	$12.92	$12.90	$0.02	$12.44	$13.53
2007 Avg	**$12.85**	**$12.91**	**($0.06)**		

- Commercial Disappearance: Use of milk in all products in June increased 1.7% vs. last year's levels, according to supporting tables released by USDA. Use of American cheese was up an even stronger 5.7% while other cheese use was up only 0.3%. Butter managed a gain of 1.2%. For the first six months of the year, commercial disappearance of milk in all products is up 2.8%, and American cheese use is up 6.4%.
- Cash market: Buyers continued to secure product this week, resulting in weekly gains for cheese and butter. Blocks increased 5¼¢ to $1.34¾, barrels were up 2¼¢ to $1.31¼ and butter closed today's session at $1.36¾, up 1¼¢. 18 loads of blocks, 7 barrels and 40 cars of butter exchanged hands.
- All Class III components scored gains in this week's NASS survey. Cheddar blocks increased 1.9¢ to average $1.19/lb while barrels were up an impressive 3.9¢ to $1.20/lb. Butter gained 1.8¢ to $1.24/lb, nonfat dry milk was up 0.8¢ to 85.4¢/lb and dry whey increased 0.5¢ to reach 30.4¢/lb.
- After being flat most of the month, weekly cold storage numbers show a sudden 4% decrease in cheese stocks for the period 08/01 through 08/28. Butter maintained its 15% drawdown from last week.
- Butter stocks at CME-approved warehouses were down a strong 7.9 million lbs this week, compared to a 2.6 million lb drawdown for the same period last year.
- Butter demand remains good, with school accounts picking up slack from the end of vacation season. Buyers are trying to stay ahead of recent price increases at the CME, which are at their highest levels since January.
- Dairy cow slaughter for the week ending 08/19 was 47,400 head, 3,000 head above last year at this time.

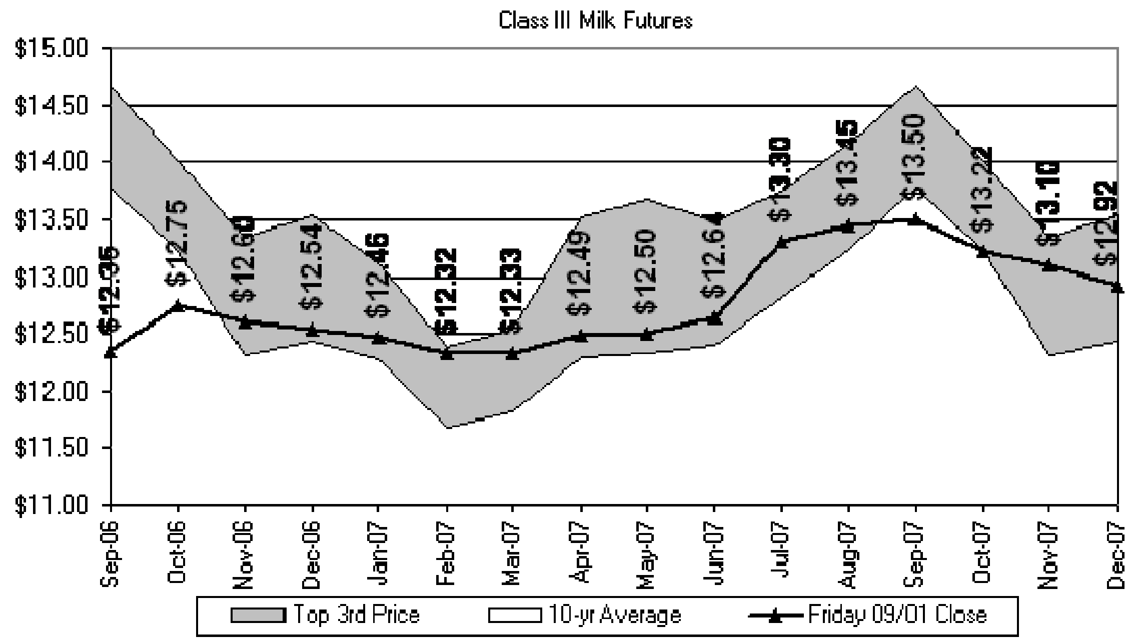


- Milk supplies are "very tight" in the Central region of the country, according to Fluid Milk & Cream Review. A trucker shortage is compounding the problem, making it difficult to move product. Manufacturing milk demand is exceeding the limited supply, pushing the spot price to $1.60-$3.25 over class.
- Dairy Market News reports that the reopening of schools in the Midwest is spurring Class I demand from bottlers. As a result, current cheese production is being impacted, and there are reports that a barrel producer has reduced production, tightening the barrel supply.

Bearish Fundamentals:

- Dairy Products Report: Total cheese output in July was 3.9% higher than last year while American cheese output was 4% higher. The same report in 2005 showed a 4% and 4.2% increase for the two cheese over 2004, making for a 2-year cumulative gain of 7.9% for total cheese and 8.2% for American varieties (see graph).
- August Class III milk was officially announced at $11.06/cwt today, well below its 10-year average of $13.23.
- USDA announced today that they would reconvene the national public hearing on the cheese make allowance September 14th. They have the option of immediately adopting an increase on an interim basis after the meeting, or again delay a final decision until later in the year or early 2007. If an increase was immediately adopted, the Oct-Dec contracts could lose 30-50¢, but being an election year, we don't expect a decision right away.
- With the exception of New Mexico, much of the Southwest and Pacific Northwest are benefiting from near ideal milking conditions, according to Fluid Milk & Cream Review. Solids levels have now come back, while milk production is generally higher than a year ago.
- Tropical Storm Ernesto's recent foray into Florida and the Carolinas caused some schools to close and disrupted milk shipments into the region. 19 fewer loads were imported this week, and interest from Class I handlers was reduced.
- Supplies of both blocks and barrels are available out West, according to Dairy Market News, causing contacts there to question how much strength is really behind recent price increases.

Recommendation:



While the cash market was able to secure gains for the week, it showed signs of weakness as butter came off its high on Wednesday of $1.38 and barrels fell from its Thursday high of $1.33½. As a result, significant premium was taken out of the fall months today, due also to USDA's announcement on the make allowance issue. Trade is likely to be choppy over the next several weeks as seasonal holiday demand and a near term tightness in current cheese collide with generally high inventory numbers and recovering milk production. Ultimately, Class III will follow cheese, which could be stuck in a tight range for awhile. The next milk production report will be released on September 18th. Both cow numbers and milk production should be muted some due to lingering heat in the first part of August, but we wonder if October's report will show a trend back to an increasing herd size? We continue to recommend getting up to 50% coverage in 2007 by the end of September. We could target to sell at $13.05 or higher, or consider a fence strategy as well. Enter an order to buy the 12.25 PUT and sell the 13.75 CALL, Jan-Dec, for a net cost of 4¢ each. This would yield an effective floor of 12.21 with a cap on your milk at 13.71 for a very reasonable cost. The remainder of 2006 is susceptible to a drop in the cheese price. Consider another fence for Oct-Dec, buying the 12.50 PUT and selling the 13.75 CALL for 15¢ each. This would give you an effective floor of 12.35 and cap at 13.60.

Note: We will be closed Monday in observance of Labor Day.