



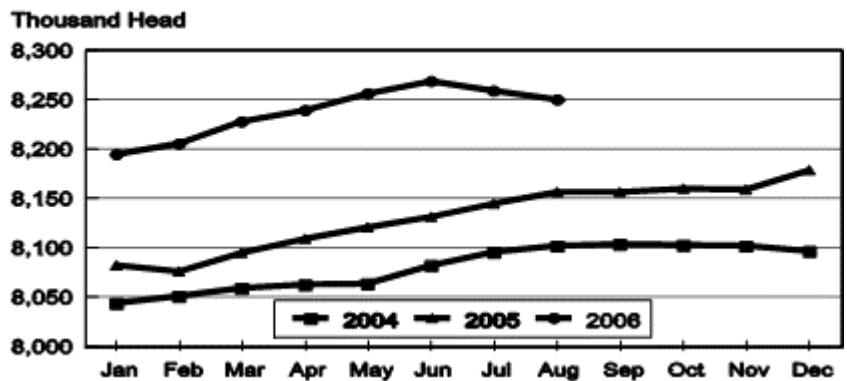
## The KDM Dairy Report - September 22<sup>nd</sup>, 2006

### Bullish Fundamentals:

- Cash Market: Barrel bidding led the way as cash cheese prices made quite a recovery. Barrels gained 6¾¢ for the week, closing at \$1.34/lb today. Blocks reluctantly followed, unwilling to allow the spread to get too far out of hand. Blocks tacked on 5¾¢ to settle at \$1.33/lb. Butter was able to increase a more modest 1¢ to finish at \$1.32/lb. 8 loads of blocks, only 3 loads of barrel and 11 cars of butter exchanged hands.
- Livestock Slaughter Report: Dairy cow slaughter in August was a [strong 13.7% higher](#) than last year, according to USDA's monthly report. 216,500 head were culled vs. 190,400 last August. After starting the year with a slow cull rate, the Jan-Aug dairy cull is now 3% higher than last year, with 1.498 million head exiting the herd, compared to 1.454 million head in 2005.
- Cold Storage Report: Commercial American cheese stocks were below year ago levels for the first [time in 13 months](#), according to Thursday's Daily Dairy Report. August stocks were 1% below last year and 4% down from July. Total cheese stocks were up 5% from a year ago, but down 5% from last month. Butter stocks were 24% above last year but 19% below July.
- Milk Production Report: The only bullish data from this week's milk production report was that the number of milk cows fell for the second month in a row. The number of head fell by 9,000 from July to August for the 23 top milk producing states, and 10,000 head lower for all 50 states.
- Livestock, Dairy & Poultry Outlook Report: USDA predicts dairy [prices will trend higher](#) this fall, according to their report released Monday. Cheese inventories are high, but strong demand is expected to draw down stocks. However, they still predict Class III to average only \$12.16 for the fourth quarter.
- NASS surveyed prices for cheese and dry [components were up this week](#). 40-lb blocks increased 2.4¢ to \$1.29/lb and barrels were up 0.1¢ to \$1.30/lb. Nonfat dry milk gained 0.6¢ to 85.7¢/lb and dry whey continued its climb, up 0.3¢ to 31.8¢/lb. Each penny increase in dry whey adds 6¢ to Class III.
- A typical [seasonal drawdown continues](#) for both cheese and butter. Weekly cold storage numbers from USDA report a 2% drop in cheese stocks and 9% drop in butter stocks for the first 18 days of September.
- The weekly dairy cow cull continues to [outpace last year](#). 43,900 head went to slaughter last week vs. 40,000 head during the same period a year ago.
- Solid Class I sales has resulted in a [continued tight supply](#) situation for manufacturing milk in the Central region, according to Fluid Milk & Cream Review. Spot manufacturing milk prices range from \$2-3 over class.
- Fluid Milk & Cream Review reports that in the Southeast, demand for milk continues to outpace supply, with 319 loads of Grade A milk shipped into the region last week. In the Northeast, milk handlers indicate [supplies are "tighter than tight"](#), with strong Class I demand consuming any incremental production gains. As a result, there is little milk left for manufacturing and drying schedules, with some driers not operating for days at a time. Some contacts do not think the supply situation will be balanced until Thanksgiving or into 2007.

Futures Month	Friday 09/22 Close	Friday 09/15 Close	Change	10-yr Average	Top 3rd Price
Sep-06	\$12.25	\$12.22	\$0.03	\$13.78	\$14.67
Oct-06	\$12.70	\$12.37	\$0.33	\$13.21	\$14.00
Nov-06	\$12.60	\$12.47	\$0.13	\$12.32	\$13.34
Dec-06	\$12.53	\$12.45	\$0.08	\$12.44	\$13.53
Jan-07	\$12.50	\$12.45	\$0.05	\$12.27	\$13.11
Feb-07	\$12.32	\$12.35	(\$0.03)	\$11.68	\$12.37
Mar-07	\$12.40	\$12.34	\$0.06	\$11.82	\$12.54
Apr-07	\$12.40	\$12.40	\$0.00	\$12.30	\$13.51
May-07	\$12.46	\$12.40	\$0.06	\$12.32	\$13.67
Jun-07	\$12.61	\$12.60	\$0.01	\$12.39	\$13.49
Jul-07	\$13.26	\$13.25	\$0.01	\$12.82	\$13.74
Aug-07	\$13.55	\$13.54	\$0.01	\$13.23	\$14.17
Sep-07	\$13.61	\$13.55	\$0.06	\$13.78	\$14.67
Oct-07	\$13.32	\$13.31	\$0.01	\$13.21	\$14.00
Nov-07	\$13.17	\$13.14	\$0.03	\$12.32	\$13.34
Dec-07	\$12.99	\$12.95	\$0.04	\$12.44	\$13.53
<b>2007 Avg</b>	<b>\$12.88</b>	<b>\$12.86</b>	<b>\$0.03</b>		

Monthly Milk Cows  
23 States

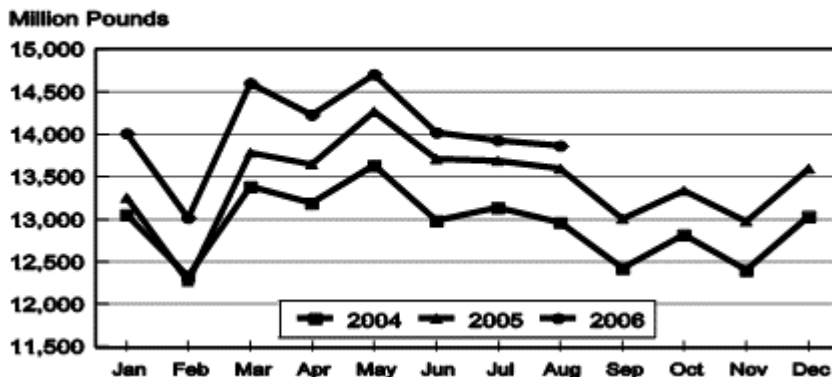


- Cheese plants throughout the Southwest are [calling for more milk](#), according to Fluid Milk & Cream Review. Production has been steady to improving in CA, NM and AZ, but cheese producers are having a hard time keeping up with current demand for cheese.
- Butter stocks continue to be drawn out of CME warehouses at a [more aggressive pace](#) than last year. For the week ending 09/16, a net 6.9 million lbs were pulled vs. only 3.04 million lbs during the same week last year. Remaining stocks are still above last year, but only by 30 million lbs.
- Dairy Market News reports dry whey prices are higher on a firm market. Buyers are [unable to get product](#) direct from the manufacturer so are forced to go to resellers at higher prices. Whey producers expect prices to head higher due to current shortages.
- Western whey powder prices continue to rise, according to Dairy Market News. Sellers state they are unable to meet improved domestic and export interest, and are starting to fall [behind on scheduled deliveries](#).

#### Bearish Fundamentals:

- Milk Production Report: Most dairy analysts did not expect to see more than a 1% increase in milk production for August, but that's exactly what they got. August [production was up 1.6%](#) vs. last year in the 23 major states, and USDA even revised July production up 6 million lbs! Production per cow increased 9 lbs per cow as well. Production for all 50 states was up 1.5%. On a percentage basis, production gains were led by CO, up 7.7%, TX up 7.3%, ID up 6.8% and NM up 6.6%. CA was up 4.1% despite heat at the beginning of the month, while WI fell 0.9%, despite higher cow numbers, due to a drop in production per cow.
- Midwest butter producers don't see much in the line of price increases this fall, according to Dairy Market News. Cream [supplies are more available](#) than in the past several weeks, so churning schedules are more active. Butter destined for year end and Thanksgiving needs will be shipped within the next few weeks, and food service orders have been fair at best.

Monthly Milk Production  
23 States



#### Recommendation:

There appears to be a "disconnect" in the market that is hard to reconcile. For the second week running, there are far more bullish fundamentals to our report, yet it seems premature to say we're out of the woods. For example, milk production was surprisingly strong in August, yet information we've gathered indicates we're tight in many parts of the country, with cheese plants begging for more milk?! What gives? Here's another; no one has any money, but replacement animals are still commanding \$1,800+ per head! It appears that demand for cheese must be strong, and that fluid demand is pulling milk away from manufacturers. Barrels look to be the most snug, as buyers were unsuccessful in securing any loads today after bidding the price up 3½¢. We would anticipate further strength in the cash market next week, but it could snap back at any time, as the major commercial buyers and sellers are strangely silent. Take advantage of yet another opportunity to hedge Oct-Dec with PUT options! With the current cash price working out to about \$12.90 milk, Q4 is trading at a significant discount. If cheese holds, Q4 will go higher. Enter orders to buy the Oct 12.75 PUT for 20¢ (traded at 23¢ today), which would give you an effective floor of 12.55 with unlimited upside. Also enter orders to buy the Nov and Dec 12.50 PUT for 20¢. Later, if prices continue to rally, you can sell a CALL option above the market to help defray the cost of the PUT. If options aren't your thing, target outright sales for Oct above 13.00, Nov above 12.90 and Dec above 12.75.

We are getting increasingly friendly to 2007. The slaughter report was a big plus. If it wasn't just a two-month anomaly due to the heat this summer and cow numbers continue to decline the rest of the year, 2007 will be well supported. As we mentioned last week, the last half of the year could especially appreciate in value. For that reason, we would not book more than 25% of your milk for the year. First quarter could be vulnerable to today's fundamentals, but if we continue to rally this fall, Q1 could come along for the ride. Target to sell Q1 at 12.70 or higher.

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