



The KDM Dairy Report - September 29th, 2006

Bullish Fundamentals:

- USDA released commercial disappearance numbers this week, confirming [strong demand for American-type cheese](#). Use of American cheese in July was up 6.1% vs. July 2005. However, use of other cheese was down 1.9%. Use of nonfat dry milk was up 7.7%, while butter use was down 4%. Finally, use of milk in all products was unchanged from a year ago.
- The seasonal [drawdown continues](#) for both cheese and butter stocks. Holdings at USDA selected storage centers were down 4% for cheese and 19% for butter for the period 09/01 through 09/25.
- Butter stocks at CME-approved warehouses [declined by 6.5 million lbs](#) for the week ending 09/23, compared to a 1.2 million lb drawdown last year. 99.3 million lbs remain on hand vs. 70.0 million lbs in storage last year.
- The dairy cow [slaughter was strong](#) again this week. 49,000 head were culled vs. 42,500 during the same week a year ago.
- Milk is still tight in the Midwest, according to Fluid Milk & Cream Review. Fluid sales had a solid week, and bottler orders were [expected to surge](#) ahead of the Class I price increase for October.
- 345 loads of Grade A milk were imported into the Southeast part of the country this week, vs. 226 loads during the same period last year. Fluid Milk & Cream Review reports the milk supply remains limited, and handlers continue to believe the [situation will not change](#) until after the holidays and even into 2007.
- In the California, robust Class I sales and cheese producer needs appear balanced with the milk supply, leaving little surplus. As a result, butter churns and drying operations are [receiving less milk than desired](#). In Arizona, milk production is down from August, but bottler and cheese operation demands are very strong, keeping supplies tight. New Mexico production is steady, but with strong demand, cheese producers that were planning to operate additional days may not have enough milk.
- Dairy Market News reports the nonfat dry milk market remains tight. Although production has rebounded from summer heat, strong bottler and cheese demand has [left little for dryers](#), leaving some operators idle.
- Western whey producers are [falling behind on shipments](#), according to Dairy Market News. Strong demand and tight foreign supplies appear to be the main factors behind the shortage, and some contacts see little relief in sight.
- International: Dairy Market News reports milk volumes are often [short of needs](#) in Western Europe. Drinking milk demand is strong and competing with strong cheese demand, while butter stocks are limited and prices are increasing. In Australia, the new milking season has begun with the [driest August in many years](#). Rainfall in September has been minimal, causing concerns for milk producers and handlers. A large percentage of this year's milk production has been committed, so traders see little surplus product will be available for spot purchase.
- Cheese buyers continue to have trouble acquiring barrels, mozzarella and provolone, according to Dairy Market News. Some plant operators are [declining new orders](#) and delaying others due to lower production. New block production in the West and Southwest has kept the block supply ample, but barrel capacity has not seen a similar increase, which may lead to continued inverted spreads. Some barrel traders are talking to their users about substituting white blocks or 640's in lieu of barrels.
- Economy: Consumer sentiment in September rose to its [highest level since last April](#), according to the closely watched index. The fall in gasoline prices and near record stock market levels appear to be the main factors behind the rise.

Futures Month	Friday 09/29 Close	Friday 09/22 Close	Change	10-yr Average	Top 3rd Price
Oct-06	\$12.60	\$12.70	(\$0.10)	\$13.21	\$14.00
Nov-06	\$12.55	\$12.60	(\$0.05)	\$12.32	\$13.34
Dec-06	\$12.56	\$12.53	\$0.03	\$12.44	\$13.53
Jan-07	\$12.44	\$12.50	(\$0.06)	\$12.27	\$13.11
Feb-07	\$12.30	\$12.32	(\$0.02)	\$11.68	\$12.37
Mar-07	\$12.33	\$12.40	(\$0.07)	\$11.82	\$12.54
Apr-07	\$12.40	\$12.40	\$0.00	\$12.30	\$13.51
May-07	\$12.45	\$12.46	(\$0.01)	\$12.32	\$13.67
Jun-07	\$12.70	\$12.61	\$0.09	\$12.39	\$13.49
Jul-07	\$13.30	\$13.26	\$0.04	\$12.82	\$13.74
Aug-07	\$13.57	\$13.55	\$0.02	\$13.23	\$14.17
Sep-07	\$13.65	\$13.61	\$0.04	\$13.79	\$14.66
Oct-07	\$13.34	\$13.32	\$0.02	\$13.21	\$14.00
Nov-07	\$13.20	\$13.17	\$0.03	\$12.32	\$13.34
Dec-07	\$12.99	\$12.99	\$0.00	\$12.44	\$13.53
Jan-08	\$12.75	\$12.81	(\$0.06)	\$12.27	\$13.11
Feb-08	\$12.70	\$12.76	(\$0.06)	\$11.68	\$12.37
Mar-08	\$12.76	\$12.76	\$0.00	\$11.82	\$12.54
Apr-08	\$12.70	\$12.70	\$0.00	\$12.30	\$13.51
May-08	\$12.70	\$12.70	\$0.00	\$12.32	\$13.67
Jun-08	\$12.74	\$12.74	\$0.00	\$12.39	\$13.49
2007 Avg	\$12.89	\$12.88	\$0.01		
Jan-Jun '08	\$12.73	\$12.75	(\$0.02)		

Bearish Fundamentals:

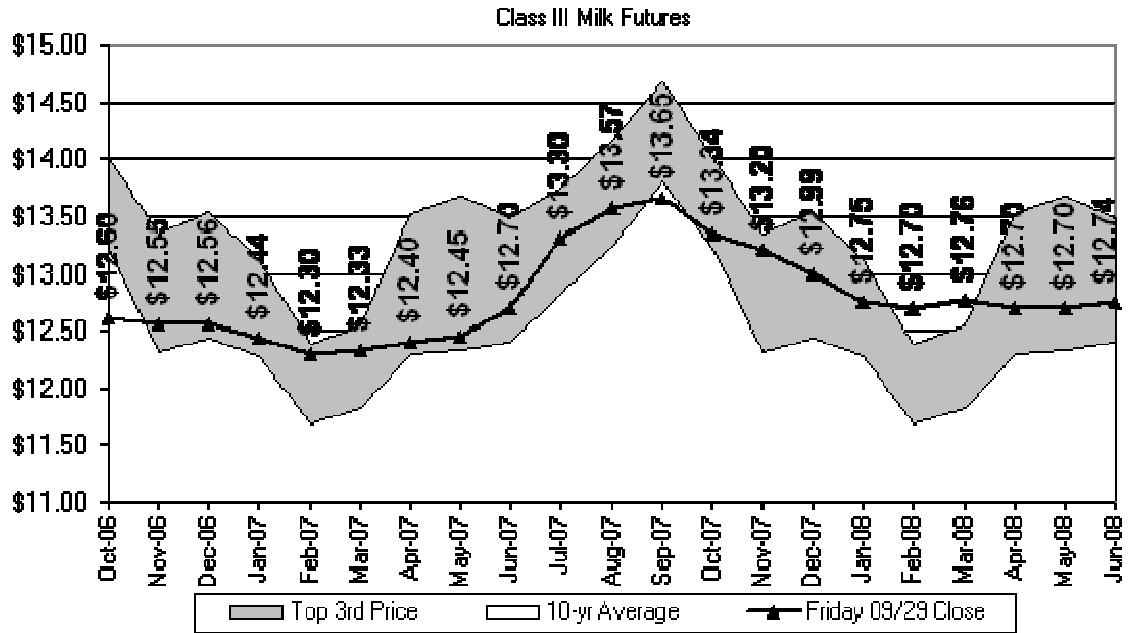
- September Class III milk was [announced at \\$12.29/cwt](#) today, \$1.23/cwt higher than last month, but still well below its 10-yr average of \$13.79/cwt.
- The [milk-feed ratio increased](#) from 2.47 in August to 2.57 in September, according to USDA's monthly Ag Prices Report. If the ration continues to increase, it could be a signal for producers to continue expansion plans due to better profit margins.
- Cash market: Blocks, barrels and butter all lost ground this week, although we might be starting to see a little life in barrels. Blocks dropped 7¢ since last Friday, settling at \$1.26/lb today. Barrels fell 4¢ to \$1.30/lb and butter shed 1½¢ to \$1.30½. In a

bit of a surprise, the rarely traded Grade A nonfat dry milk was bid up 12¢ today to close at \$1.02/lb and Extra Grade was bid up 11¢ to \$1.01/lb.

- Weekly NASS numbers started to [reflect recent weakness](#) in the cash cheese market. 40-lb blocks fell 0.6¢ to average \$1.28/lb while 500-lb barrels were down 1.8¢, also at \$1.28/lb. Butter decreased 1¢ to \$1.29/lb and nonfat dry milk lost 0.1¢ to average 85.7¢/lb. The only bright spot was dry whey, which picked up a strong 1.6¢ to 33.4¢/lb.
- Dairy Market News reports a significant percentage of holiday orders are already in the books, but not yet shipped. Some handlers feel overall food service [orders are lighter than last year's](#) at this time.
- Current [blocks are available](#) in the West for immediate sale, according to Dairy Market News. Traders there feel there is not much that can push the price for current blocks above \$1.35 this fall.
- Economy: Consumer [spending in August dipped](#) 0.1%, according to the U.S. Commerce Dept., the first decline since September 2005. Incomes rose just 0.3%, their smallest increase in nine months.

Recommendation:

Additional block production capacity that has come online this year in the Southwest has kept the block supply ample. However, similar investment in barrel production facilities has not occurred, and barrels are currently tight. The traditional 3¢ block / barrel spread may become rarer as the inverted market we find ourselves in is occurring more frequently. Non-commercial (spec) forces appear to be influencing the nearby months, so choppy, sideways trade looks set to continue for awhile. Milk production



and solids levels are improving, so there's no telling when the barrel supply will loosen. For this reason, we would still try to protect Nov and Dec. Last week we successfully purchased the Oct 12.75 PUT options for 20¢. That gives us an effective floor of 12.55. This week, enter orders to buy the Nov and Dec 12.50 put options for 20¢. It looks like we'll have at least a couple months (Sep,Oct) settle above \$12, but beyond that it's not a sure bet.

Trade activity in the 2007 contracts has been interesting this week with what looked like the appearance of some commercial hedging and spec buying. Dairy end users may be getting a little nervous about what their costs will be next year and are buying upside protection. Speculators continue to focus on the last half of 2007 as we again saw the annual average gain a penny this week to \$12.89, but as you can see from the table above, there is a continuing tilt towards lower prices in the first half of 2007, with higher prices in the second half. We also heard from producers this week who told us at least two different cooperatives were offering \$12.97 contracts for the year. While not a bad price, it tells us their customers are looking to get protected against higher prices. If you can make money at that price, by all means get some coverage. However, we would advise purchasing upside protection with CALL options for the last half of the year. In summary, our outlook on 2007 is mixed. We feel the first quarter is the most vulnerable, so consider a risk reversal for those months, buying the 12.00 PUT and selling the 13.00 CALL for an average of 7¢ each. That will give you an effective floor of 11.93, with a cap or ceiling on your price at 12.93. Or, consider outright sales above 12.60.

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