

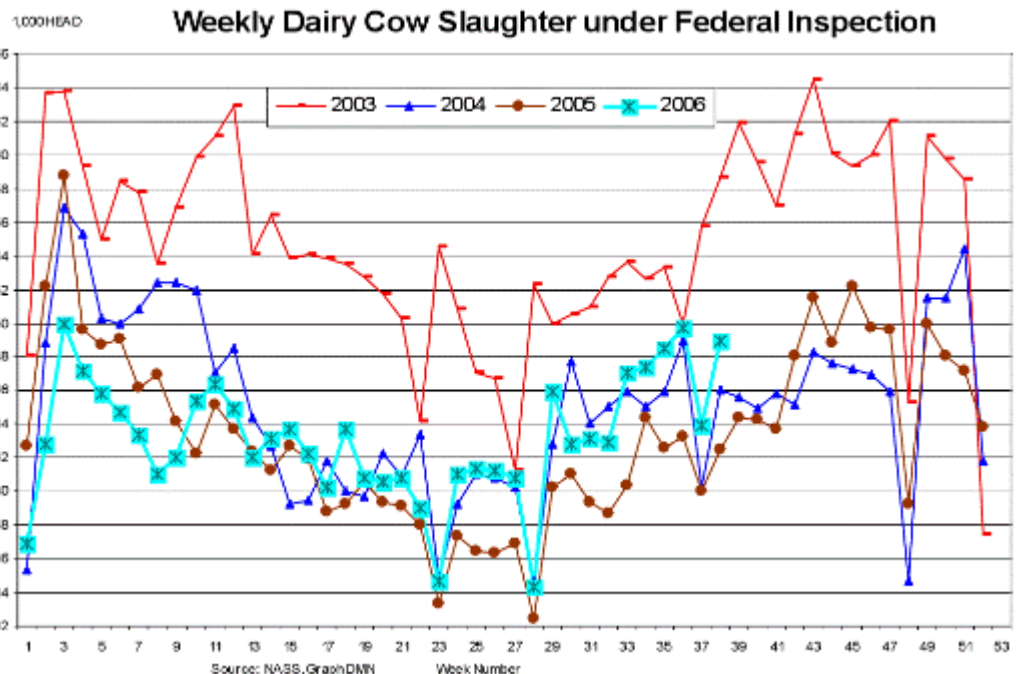


The KDM Dairy Report - October 6th, 2006

Bullish Fundamentals:

- Dry whey continues to make [strong gains](#) as this week's NASS survey reveals. The price increased 0.9¢ to 34.3¢/lb, closing in on 35¢ which is at the high side of expectations. A move through 35¢ will be supportive of Class III prices. Cheese prices also increased in the survey, with blocks up 0.4¢ to \$1.29/lb and barrels up 0.5¢ also at \$1.29/lb. Finally, nonfat dry milk increased 2.3¢ to average 87.9¢/lb.
- Dairy Products Report: August cheddar cheese output was [5.4% below July](#), but 3.1% above a year ago. Butter production was 5.7% below July and 4.3% below last August. Total cheese output was 2.5% higher than July and 3.9% above August 2005. While this could be interpreted as bearish, it could also mean that demand, which we know is strong, is asking for and getting the extra cheese. The fact that cheddar output is 5.4% below last month is important in that it's cheddar cheese that is traded on the cash cheese market at the CME, which gives important direction to milk futures.
- Weekly cold storage numbers show a [5% drop in cheese stocks](#) during the month of September. Butter stocks were down an even more impressive 24%.
- Dairy cow slaughter for the week ending 09/23 [hit 50,100](#), compared to only 44,400 during the same week last year (see graph below).
- In the Midwest, strong Class I sales are keeping the [milk supply tight](#) for manufacturing purposes, according to Fluid Milk & Cream Review. Very little surplus milk is available in the spot market, and is priced \$2.50 to \$3.20 over class.
- Strong bottling interest in the Southeast is leaving limited supplies of milk available for manufacture, according to Fluid Milk & Cream Review. Regional promotions as well as the start of the annual migration south by northern home-dwellers is resulting in [stronger fluid milk sales](#). 367 loads of Grade A milk were imported into the region this week vs. 270 loads last year at this time.
- Dairy Market News report nonfat dry milk prices continue to rise. Production is below plant capacity in many areas due to [strong milk demand](#) by bottlers and cheese plants.
- Dry whey prices continue to move higher, according to Dairy Market News. Both domestic demand and [strong exports](#) are contributing to the price increases, with world dry whey prices making the U.S. a viable option.

Futures Month	Friday 10/06 Close	Friday 09/29 Close	Change	10-yr Average	Top 3rd Price
Oct-06	\$12.37	\$12.60	(\$0.23)	\$13.21	\$14.00
Nov-06	\$12.38	\$12.55	(\$0.17)	\$12.32	\$13.34
Dec-06	\$12.40	\$12.56	(\$0.16)	\$12.44	\$13.53
Jan-07	\$12.40	\$12.44	(\$0.04)	\$12.27	\$13.11
Feb-07	\$12.23	\$12.30	(\$0.07)	\$11.68	\$12.37
Mar-07	\$12.26	\$12.33	(\$0.07)	\$11.82	\$12.54
Apr-07	\$12.37	\$12.40	(\$0.03)	\$12.30	\$13.51
May-07	\$12.45	\$12.45	\$0.00	\$12.32	\$13.67
Jun-07	\$12.70	\$12.70	\$0.00	\$12.39	\$13.49
Jul-07	\$13.30	\$13.30	\$0.00	\$12.82	\$13.74
Aug-07	\$13.60	\$13.57	\$0.03	\$13.23	\$14.17
Sep-07	\$13.70	\$13.65	\$0.05	\$13.79	\$14.66
Oct-07	\$13.44	\$13.34	\$0.10	\$13.21	\$14.00
Nov-07	\$13.19	\$13.20	(\$0.01)	\$12.32	\$13.34
Dec-07	\$13.03	\$12.99	\$0.04	\$12.44	\$13.53
Jan-08	\$12.80	\$12.75	\$0.05	\$12.27	\$13.11
Feb-08	\$12.75	\$12.70	\$0.05	\$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	\$12.89	\$0.00		
Jan-Jun '08	\$12.74	\$12.73	\$0.02		



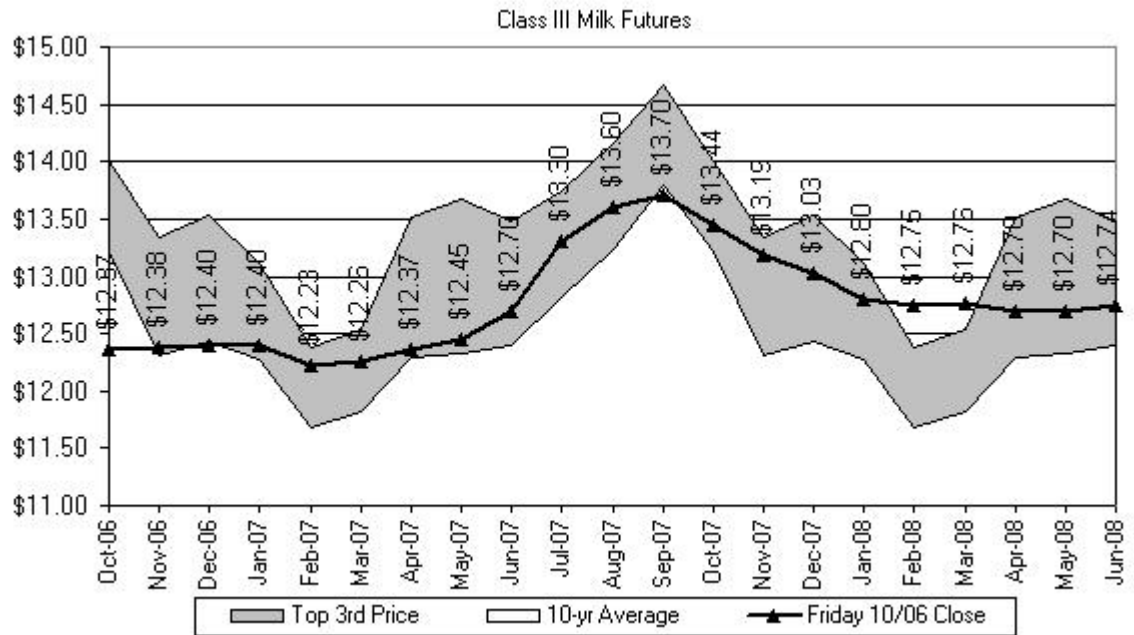
- Cash market: While cheese and butter have been flailing, the rarely traded spot nonfat dry milk market has shot higher. Grade A NDM has rocketed up 34¢ to \$1.24/lb since last Friday, in what most believe is a tactic to free up sales. While nonfat dry milk does not affect the Class III price, it does support a stronger dry whey price.

Bearish Fundamentals:

- Cash market: Back down we go. Blocks came under pressure this week and shed 4¾¢ to close at \$1.21¼/lb today. The price remains inverted to barrels, which closed at \$1.24½/lb, down 5½¢ for the week. Butter managed to increase, gaining 2¾¢ to settle at \$1.33¼/lb. 4 loads of blocks, 5 barrels and 19 cars of butter exchanged hands.
- Butter producers expect cream [supplies to increase](#) and prices to drop as milk production increases and fat content moves higher. Dairy Market News reports butter production in the West has been building as a result.
- The [cheese market is weak](#), according to Dairy Market News. There is a lack of consistent demand for some varieties, while mozzarella supplies remain tight. Buyers need to make holiday orders soon to have product by November, but are waiting to take advantage of lower prices. Barrel cheese is still limited, but other supplies appear adequate for demand.
- Milk production in California is steady to slightly higher, according to Fluid Milk & Cream Review. Cheese plants are [getting a good share of the milk](#), with churning operations and dryers left in want. In other areas of the Southwest and Pacific Northwest, milk supplies are in balance with needs and plants are running on schedule.

Recommendation:

Choppy sideways trade on light volume, with a bias to the downside continued to describe Class III futures again this week. Demand remains strong, but while we won't rule out the possibility of another cheese rally later this fall, there doesn't appear to be supply issues either. Cheese seems determined to trade between \$1.20 and \$1.30 per pound, with every advance near the high end squashed by commercial sellers. The market is seeking



direction, and not finding it, with the result being continued losses in the front months. No one knows where the market is headed near term. Situations like these make it tough to make a "sell" decision due to fear that as soon as you've sold, the market will head back up! That is why we have been recommending using PUT options to get a floor under your milk for the balance of the year, and that advice remains unchanged. The Oct 12.75 PUT options we bought for 20¢ less than two weeks ago closed today at 39¢, nearly double in value. This week we purchased several Nov 12.50 PUT options for 25¢ and they settled today at 28¢. Today we bought Dec 12.25 PUT options for 26¢. Now we have a floor under that milk and if a fall rally does occur, 100% of our milk participates. Next week enter orders to buy the Nov 12.50 PUT for 25¢ and the Dec 12.25 PUT for 25¢.

The 2007 average remained unchanged from last Friday at \$12.89. However, we continue to observe the "tilt" affect with further declines in the first half countered by gains in the second half. The "trade" believes that's when price recovery will occur and are establishing long positions in advance of a potential rally. Reports continue to filter in from our producers of forward contracts offered by cooperatives ranging from \$12.90 to \$12.97. Our recommendation remains unchanged for 2007; sell up to 25% of your production at \$12.90 or higher. For first quarter looks vulnerable to today's fundamentals. 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.

Trading futures and commodities involves substantial risk and may not be suitable for all investors. You should carefully consider whether the risks involved in trading in commodities is suitable for you or your organization in light of your financial condition. While the information we gather and present is deemed to be reliable, it is in no way guaranteed. Neither the opinions expressed on this website nor in "The KDM Dairy Report", shall be construed as an offer to buy or sell any futures or options on futures contracts. In addition, past performance is not necessarily indicative of future results.