



The KDM Dairy Report - October 13th, 2006

Bullish Fundamentals:

- World Ag Supply & Demand Report: USDA raised their Class III forecast for 2007 due to the [strength in whey prices](#), which they say will offset weaker cheese prices. Robust domestic and international demand is expected to keep supplies tight well in to the new year.
- For the first nine days of October, USDA weekly cold storage numbers show a [1% decrease in cheese stocks](#) and 8% drop in butter stocks
- Dairy cow slaughter for the week ending 09/30 was a [strong 51,200 head](#), 6,900 more than a year ago at this time.
- Butter use is ramping up again. Stocks at CME-approved warehouses were [down 6 million lbs](#) for the week ending 10/07, compared to a 4 million lb drawdown last year.
- Fluid Milk & Cream Review reports the milk supply remains tight in the Midwest, with spot buy interest exceeding limited offerings. Specialty cheese [sales are strong](#) and the cream supply is expected to tighten with the introduction of holiday dips and eggnog.
- Milk production in New Mexico is trending [lower as cooperatives implement BST-free programs](#), writes Fluid Milk & Cream Review. Bottlers are paying premiums for the BST-free milk which is driven by consumer demand. In Idaho, some larger operations are putting up "For Sale" signs as financial stress is increasing in the region.
- Dry whey remains very tight across the entire U.S., according to Dairy Market news. Export and domestic buyers are competing to obtain product and neither are receiving it in a timely fashion. With European whey prices running from 45-50¢, any U.S. [offerings are quickly absorbed](#).
- International: [Global dairy supplies are tight](#), according to Dairy Market News. Production in Western Europe is only adequate to fill domestic demand, with strong cheese sales highlighted. A drought in Eastern Europe is hitting feed supplies. In New Zealand and Australia, milk production is slightly above last year, but supplies of dairy products for export are minimal. Australia has been particularly dry, which could lead to additional herd culling.
- Weekly NASS average prices this week were a mixed bag, but [leaned positive](#). 40-lb blocks were down a steep 2.6¢ to average \$1.26/lb, but barrels improved 0.9¢ to \$1.30/lb. Butter decreased 0.9¢ to average \$1.28/lb, but nonfat dry milk was up 0.5¢ to 88.5¢/lb and whey continued to climb higher, up 0.5¢ to 34.7¢/lb.
- Feed costs: The grain markets have been wild the past couple weeks. Drought in Australia has more than halved their wheat crop pushing US wheat futures to 10-yr highs. On the demand side, corn and soybean exports are extremely strong, while harvest yields have been revised slightly lower. All this means feed costs are way up. We're already hearing reports of cheaper but lower energy substitutions being put in the feed mix, and this is resulting in lower milk production.
- Economy: The stock market hit [record highs](#) this week due to tame inflation data and lower energy costs. The closely watched Consumer Sentiment Index for October was up from September and [higher than expectations](#).

Futures Month	Friday 10/13 Close	Friday 10/06 Close	Change	10-yr Average	Top 3rd Price
Oct-06	\$12.30	\$12.37	(\$0.07)	\$13.21	\$14.00
Nov-06	\$12.27	\$12.38	(\$0.11)	\$12.32	\$13.34
Dec-06	\$12.40	\$12.40	\$0.00	\$12.44	\$13.53
Jan-07	\$12.50	\$12.40	\$0.10	\$12.27	\$13.11
Feb-07	\$12.42	\$12.23	\$0.19	\$11.68	\$12.37
Mar-07	\$12.44	\$12.26	\$0.18	\$11.82	\$12.54
Apr-07	\$12.52	\$12.37	\$0.15	\$12.30	\$13.51
May-07	\$12.63	\$12.45	\$0.18	\$12.32	\$13.67
Jun-07	\$12.84	\$12.70	\$0.14	\$12.39	\$13.49
Jul-07	\$13.41	\$13.30	\$0.11	\$12.82	\$13.74
Aug-07	\$13.70	\$13.60	\$0.10	\$13.23	\$14.17
Sep-07	\$13.87	\$13.70	\$0.17	\$13.79	\$14.66
Oct-07	\$13.62	\$13.44	\$0.18	\$13.21	\$14.00
Nov-07	\$13.45	\$13.19	\$0.26	\$12.32	\$13.34
Dec-07	\$13.20	\$13.03	\$0.17	\$12.44	\$13.53
Jan-08	\$12.80	\$12.80	\$0.00	\$12.27	\$13.11
Feb-08	\$12.75	\$12.75	\$0.00	\$11.68	\$12.37
Mar-08	\$12.76	\$12.76	\$0.00	\$11.82	\$12.54
Apr-08	\$12.73	\$12.70	\$0.03	\$12.30	\$13.51
May-08	\$12.75	\$12.70	\$0.05	\$12.32	\$13.67
Jun-08	\$12.75	\$12.74	\$0.01	\$12.39	\$13.49
2007 Avg	\$13.05	\$12.89	\$0.16		
Jan-Jun '08	\$12.76	\$12.74	\$0.02		

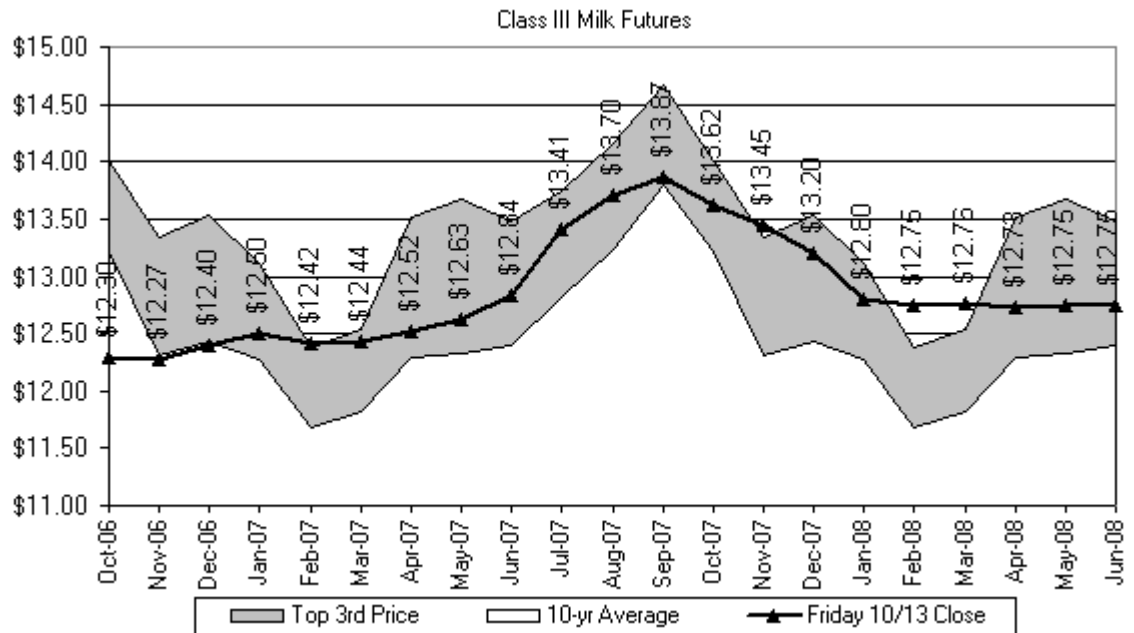
Bearish Fundamentals:

- A [drop in fluid orders](#) resulted in 70 fewer loads of Grade A milk being imported into the Southeast this week, according to Fluid Milk & Cream Review. Milk is generally not available for manufacture, however, increased volumes of cream are finding their way to Class II facilities.
- Fluid Milk & Cream Review reports milk production in California is steady, but lower bottler demand is allowing more milk to flow to cheese plants and dryers.
- Butter [demand is fair at best](#), according to Dairy Market News. There has been little feature activity to stimulate sales, and food service sales are lagging. Butter production is increasing as more reasonably priced cream is now available.

- Western current blocks are readily available, according to Dairy Market News. They also report [barrels are less tight](#) than three weeks ago, as some end users are beginning to buy more blocks for making process cheese.
- Cash Market: While showing signs it's awakening, both blocks and barrels lost ground this week in the spot market. Blocks fell 1¢ to settle at \$1.20¼/lb today and barrels were down 2¼¢ to \$1.22¼/lb. Butter was the lone gainer, moving 2¾¢ higher to settle at \$1.36/lb. Perhaps value is being seen at this price as buyers purchased 12 loads of blocks (9 today), 4 loads of barrels and 23 cars of butter for the week.

Recommendation:

What a week in grain! December corn settled at 3.15½, November beans at 5.92 and December wheat at 526. When was the last time you saw both wheat and beans with a 5 for the first number! Beans are undervalued relative to corn and wheat and are at the beginning of a normal seasonal rally. When 50% of the crop is harvested, beans historically rally into first week in December.



Milk contracts rallied today bringing the

yearly average for 2007 to \$13.05/cwt, a 16¢ gain for the week. But with current cheese trading at \$1.20 and Whey at 36¢, Class III calculates to near \$12.00/cwt. Several factors are contributing to the bullish outlook for milk.

1. Grain and alfalfa prices are high, creating a milk-feed ratio blow 2.5. Historically, the milking herd shrinks when the ratio is below 2.5, and the recent increase in the dairy cow cull rate appears to bear that out.
2. BST-free milk is becoming more popular, mostly in the East and West fluid markets. Some have already started, and several other large cooperatives are on the verge of accepting only BST-free milk.
3. CWT continues to collect 10¢/cwt from participating producers. Expectations are for another herd buyout in 2007.

Usually these down price cycles in dairy last longer than 8 months, but with the current cost associated with milk production increasing, today's unfavorable operating margins may force producers into liquidation sooner rather than later.

So, buy 12.00 put options December to May, paying 20¢ premium. This will leave your options open for the last half of the year, and all your milk open to further upside if the current rally has legs.

Sell up to 40% of your milk production at a \$13.05 average for 2007, and then buy 1500 calls for August, September and October. Buy enough calls to cover 50% of all the milk sold. Spending 30¢ on the calls this will reduce your average sell price to 12.90, but will open up half of your contracted milk above 15.00 in those months.

Volatility in the grain market looks like it could spill over into milk! Call us and we'll help you put together a marketing plan now for your 2007 production!

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