



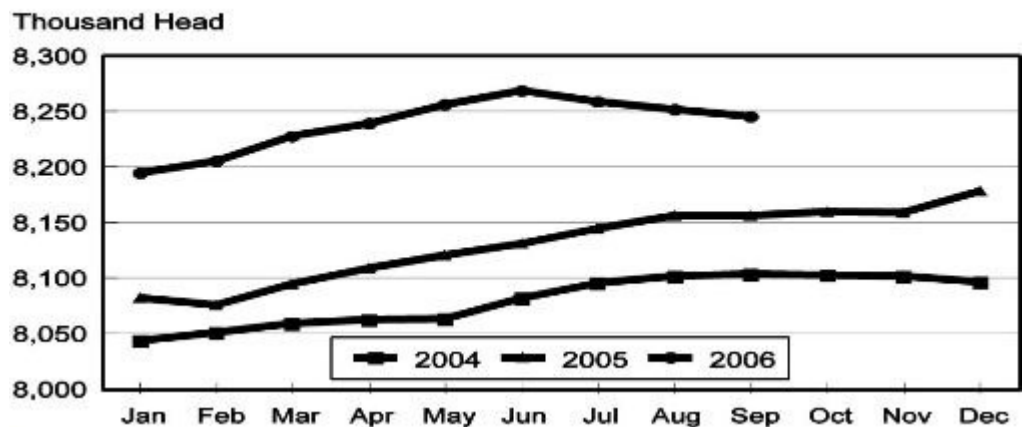
The KDM Dairy Report - October 20th, 2006

Bullish Fundamentals:

- Livestock Slaughter Report: Producers continue to aggressively cull the dairy herd, perhaps to pay bills. 206,400 dairy cows went to slaughter in September, vs. 190,200 last year. YTD, 1,704,100 cows have been culled vs. 2005 YTD total of 1,644,200. After starting the year behind 2005, the cull rate is now [3.6% above last year's rate](#).
- Livestock, Dairy & Poultry Outlook Report: Reforms made in the European Union in 2003 reduced subsidies for producing butter and nonfat dry milk. As a result, more milk has gone into cheese which has had a beneficial affect, according to USDA. Lower cheese prices in Western Europe have increased cheese demand, while supplies of nonfat dry milk and butter have gone down. [Worldwide growth in both cheese consumption and milk protein concentrates](#) is further limiting nonfat dry milk supplies. Furthermore, the drop in value of the U.S. dollar during this time has made U.S.-sourced dairy products a relative value. USDA concludes by saying these fundamental changes favor further significant exports of U.S. nonfat dry milk in the near term.
- Cash market: Block buyers came in force this week, picking up 28 loads and moving the price up 7¾¢ in the process. Blocks settled at \$1.28/lb today. Barrels followed, but gained only a penny to close at \$1.26/lb, with only 3 loads trading. Finally, butter lost a half cent to close at \$1.35½/lb today, with 7 cars exchanging hands.
- Weekly cold storage holdings reported by USDA continue to reflect a [seasonal drawdown](#). For the period 10/01–10/16, butter stocks are down 17% and cheese stocks have declined by 2%.
- Dairy cow slaughter for the week ending 10/07 [remains robust](#). 49,900 head were culled vs. 43,700 during the same period last year.
- Fluid Milk & Cream Review reports some operations have [shifted milk away from cheese](#) to take advantage of "unprecedented" strength in nonfat dry milk prices and demand. Supplies of manufacturing milk remain less than desired and cheese plant operators are having troubles filling orders for non-cheddar varieties. Cheese plants are running on reduced schedules as current cheese prices are a disincentive to produce.
- Milk receipts in the Northeast are [trending lower](#) when they should be going higher, according to Fluid Milk & Cream Review. It's contributing to the tight supply situation found in the entire Eastern region of the country. Florida imported an extra 31 loads of Grade A milk vs. last week, as bottlers continue to ramp up for the influx of winter residents.

Futures Month	Friday 10/20 Close	Friday 10/13 Close	Change	10-yr Average	Top 3rd Price
Oct-06	\$12.32	\$12.30	\$0.02	\$13.21	\$14.00
Nov-06	\$12.89	\$12.27	\$0.62	\$12.32	\$13.34
Dec-06	\$13.00	\$12.40	\$0.60	\$12.44	\$13.53
Jan-07	\$13.15	\$12.50	\$0.65	\$12.27	\$13.11
Feb-07	\$13.10	\$12.42	\$0.68	\$11.68	\$12.37
Mar-07	\$13.15	\$12.44	\$0.71	\$11.82	\$12.54
Apr-07	\$13.25	\$12.52	\$0.73	\$12.30	\$13.51
May-07	\$13.25	\$12.63	\$0.62	\$12.32	\$13.67
Jun-07	\$13.35	\$12.84	\$0.51	\$12.39	\$13.49
Jul-07	\$13.93	\$13.41	\$0.52	\$12.82	\$13.74
Aug-07	\$14.25	\$13.70	\$0.55	\$13.23	\$14.17
Sep-07	\$14.42	\$13.87	\$0.55	\$13.79	\$14.66
Oct-07	\$14.20	\$13.62	\$0.58	\$13.21	\$14.00
Nov-07	\$13.88	\$13.45	\$0.43	\$12.32	\$13.34
Dec-07	\$13.64	\$13.20	\$0.44	\$12.44	\$13.53
Jan-08	\$13.35	\$12.80	\$0.55	\$12.27	\$13.11
Feb-08	\$13.15	\$12.75	\$0.40	\$11.68	\$12.37
Mar-08	\$12.99	\$12.76	\$0.23	\$11.82	\$12.54
Apr-08	\$12.90	\$12.73	\$0.17	\$12.30	\$13.51
May-08	\$12.86	\$12.75	\$0.11	\$12.32	\$13.67
Jun-08	\$12.95	\$12.75	\$0.20	\$12.39	\$13.49
2007 Avg	\$13.63	\$13.05	\$0.58		
Jan-Jun '08	\$13.03	\$12.76	\$0.28		

Monthly Milk Cows
23 States



- Fluid milk demand is strong across the Southwest region of the country, according to Fluid Milk & Cream Review. Bottling plants continue to pull heavily from supplies in CA, AZ and NM. In the Pacific Northwest, concerns are growing over [increasing feed costs](#). The quality of the third cutting hay crop is deteriorating due to rain, and few dairy producers locked in their grain costs when prices were lower in September.
- Despite cheddar block offerings exceeding short-term demand, Dairy Market News reports the cheese market is [cautiously firm](#). Demand for holiday items has improved, and the extreme tightness in NDM supplies has some cheese plants separating extra butterfat out rather than using it to extend yields. Other plants are sending milk away from cheese production due to the very strong interest in NDM and skim solids.
- Dairy Market News reports the dry whey market remains firm. Production is steady to lower as milk is being moved from Class III to Class IV facilities. Supplies are in balance, but most plants have [nothing to offer](#) on a spot basis.
- Exports of dry whey through August were [11.8% higher](#) than a year ago, according to Dairy Market News. China was by far the biggest buyer, at 74.6 million lbs. Western whey producers do not have supplies to fill current orders.
- Butter holdings at CME warehouses [dropped a sharp 7.4 million lbs](#) this week, compared to a 1.4 million lb drawdown last year at this time. Total holdings still exceed last year, but only by about 21 million lbs.
- The NASS price for butter increased 1.2¢ this week to average \$1.29/lb. Nonfat dry milk was up 0.9¢ to 89.4¢/lb and dry whey continued higher, up 0.5¢ to 35.3¢/lb.

Bearish Fundamentals:

- Milk Production Report: September milk production was up [a higher than expected 2%](#) in the 23 major dairy states, and up 1.6% for all 50 states. Gains were led by TX up 10.5%, CO up 7.5% and ID up 6.5%. There were 41,000 more milk cows vs. last year, but on the positive side, cow numbers were down for the third consecutive month, falling 9,000 head from Aug to Sep.
- Cold Storage Report: Butter and cheese stocks in September were all higher than a year ago, according to USDA data released today. Butter holdings were up 42%, American cheese was up 2% and Total Cheese stocks were up 11%. Today's Daily Dairy Report indicates that's the [highest level of cheese inventories](#) going into 4th quarter since the year 2000.
- Dairy Market News reports churning activity is heavier as more cream has been available. Butter handlers feel current production and [inventory will be sufficient](#) to carry them through the yearend holiday period.
- While seeing an increase in other Class III components, NASS [cheese prices fell](#) again this week. Blocks fell 1.4¢ to \$1.25/lb and barrels dropped 3¢ to \$1.27/lb.

Recommendation:

Our final comment last week was, "Volatility in the grain market looks like it could spill over into milk!" Wow, did that ever happen! As outlined last week, we believe there are three primary factors influencing the milk market. 1.) Higher grain prices in 2007 will give those dairies that can grow their own feed a distinct advantage, and anticipation of further financial hardship for Western dairies, most of who did not lock in feed prices, is anticipated by the trade. 2.) The push for BST-free milk nationwide is helping as grocers feature it more prominently at the store and cooperatives push their patrons to abandon its use. 3.) CWT has been collecting 10¢/cwt and has announced another herd buyout in early 2007. Now we'll add a fourth reason, which has not been on the radar of most dairy market analysts, the Global Dairy Market. World supplies of nonfat dry milk, dry whey and MPC's is very tight. As mentioned above, when the EU dropped subsidies for these products, it made U.S.-sourced product much more price competitive. Global prices of dairy products are going up (maybe a lesson we can all learn on the detrimental affect of subsidies!). Perhaps this realization finally found its way to the market today and we were off to the races. More than 2,300 contracts were traded in Class III alone! **Caution: The market is very volatile and emotional right now!** During today's trade, sellers virtually disappeared at one point, leaving more than 50¢ between the bid and ask of some contracts. January briefly traded near limit up at 13.58 and Nov '06 hit 12.98 though we are already in the calculation. Trying to make marketing decisions will be very difficult going forward, as the market may tend to overdo it on both the ups and downs. We did sell into today's rally between 13.48 and 13.50 for the year, yet we ended today at a 13.63 average. Wow! Today's Cold Storage Report may bring some sellers come Monday, and we don't think it's wrong to hedge some of your production here, but be careful. We have consistently recommended hedging between 25-40% of production, and if you have done that, great. We still feel there is further upside possible, so we would now switch to PUT options if you want to cover any further production. That way you can leave your milk open to further upside, and if the prices get too crazy high, you still have the option to sell your milk outright. Give us a call and we can give you a quote of Jan-Dec PUT packs for 2007. Hang on! It looks like volatility will be here for a while, and higher prices are welcome news!

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