The KDM Dairy Report - October 27th, 2006

Bullish Fundamentals:

Futures Month	Friday 10/27 Close	Friday 10/20 Close	Change	10-yr Average	Top 3rd Price
Oct-06	$12.35	$12.32	$0.03	$13.21	$14.00
Nov-06	$12.53	$12.89	($0.36)	$12.32	$13.34
Dec-06	$12.95	$13.00	($0.05)	$12.44	$13.53
Jan-07	$13.02	$13.15	($0.13)	$12.27	$13.11
Feb-07	$13.01	$13.10	($0.09)	$11.68	$12.37
Mar-07	$13.14	$13.15	($0.01)	$11.82	$12.54
Apr-07	$13.35	$13.25	$0.10	$12.30	$13.51
May-07	$13.38	$13.25	$0.13	$12.32	$13.67
Jun-07	$13.49	$13.35	$0.14	$12.39	$13.49
Jul-07	$13.98	$13.93	$0.05	$12.82	$13.74
Aug-07	$14.20	$14.25	($0.05)	$13.23	$14.17
Sep-07	$14.34	$14.42	($0.08)	$13.79	$14.66
Oct-07	$14.00	$14.20	($0.20)	$13.21	$14.00
Nov-07	$13.88	$13.88	$0.00	$12.32	$13.34
Dec-07	$13.75	$13.64	$0.11	$12.44	$13.53
Jan-08	$13.35	$13.35	$0.00	$12.27	$13.11
Feb-08	$13.10	$13.15	($0.05)	$11.68	$12.37
Mar-08	$12.99	$12.99	$0.00	$11.82	$12.54
Apr-08	$12.90	$12.90	$0.00	$12.30	$13.51
May-08	$12.86	$12.86	$0.00	$12.32	$13.67
Jun-08	$12.95	$12.95	$0.00	$12.39	$13.49
2007 Avg	**$13.63**	**$13.63**	**($0.00)**		
Jan-Jun '08	**$13.03**	**$13.03**	**($0.01)**		

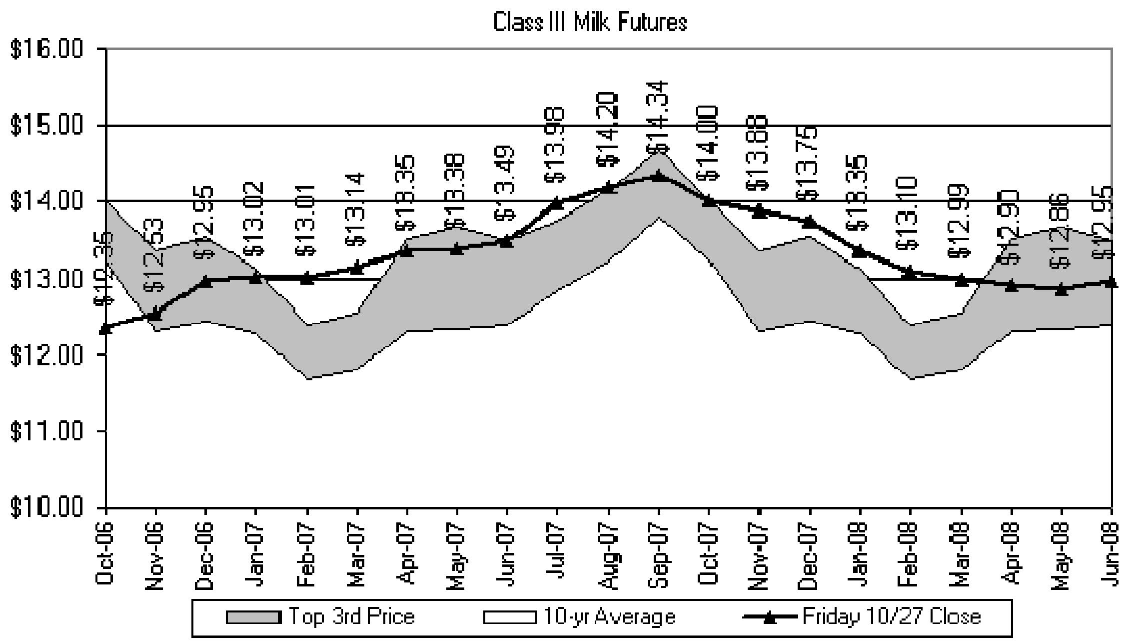
- USDA weekly cold storage numbers show an increasing rate of drawdown in both cheese and butter stocks. For the period 10/01 through 10/23, butter holdings at selected storage centers fell 22%, while cheese stocks were down 3%.
- At CME-approved warehouses, butter stocks fell 7.1 million lbs for the week ending Oct 21st, compared to 3.8 million lbs pulled out during the same week last year.
- In the Midwest, strong demand for condensed skim to replace nonfat dry milk is causing some cheese plants to reduce milk going to the vat, according to Fluid Milk & Cream Review. Class I, II, and III operations are out looking for additional milk supplies and not finding it. They also report that the sharply higher grain and hay prices are causing farmers to evaluate feed stocks and animal numbers, which could lead to increased culling.
- 329 loads of milk were imported into the Southeast part of the country this week, about the same as last week. Fluid Milk & Cream Review reports that some import agreements that would have expired in October have been extended into November due to strong demand. Milk handlers in the region expect imports at these levels will continue until about Thanksgiving. Strong Class I sales continue to pull milk into bottling plants, leaving less than desired levels for manufacturing needs. Production of cream-based holiday items is gearing up, including eggnog, which is improving Class II demand.
- Some California cheese plants are starting to limit production to help rebalance cheese inventories and drying additional loads of milk, according to Fluid Milk & Cream Review. Fluid demand is strong in AZ, with Class I utilization in September up from the previous month. In NM, the milk supply is slightly below what is needed to run fluid and cheese plants at full capacity, and in the Pacific Northwest, some operations are looking for additional milk as more handlers make the decision to send it to the dryer instead of the vat.
- Dairy Market News reports that since peaking 14 weeks ago, butter stocks have declined by an average of 5.9 million lbs per week, a rate far faster than last year, when the average weekly decline was 2.5 million lbs. Strong retail orders from grocery stores as they prepare for the upcoming holidays is cited as a likely cause.
- Supplies of current block cheese are not as readily available as a few weeks ago, according to Dairy Market News. Inventory is lighter due to good demand and plants shifting milk out of cheese production into butter/powder operations for the better financial return.
- Production of nonfat dry milk is higher as plants direct more milk away from Class II and III operations; however, buyers continue to report shortages and delays on their contracts. Much is sold before its actual production date! Brokers and end-users don't expect to see adequate supplies until late December or early 2007.
- "Most plants have nothing to offer." That's the dry whey situation, according to Dairy Market News. Some shipments are running behind and additional supply availability is not anticipated for at least three weeks.
- Commercial Disappearance: Use of Other-than-American cheese was up a strong 6.6% in August, compared to only an average increase of 0.7% Jan-July. Use of butter in August was up 7.3%, nonfat dry milk up 4.7% and use of milk in all products was up a healthy 3.2%.
- International: Milk output in New Zealand is slightly ahead of last season at this time, however, in Australia, the drought that sent grain prices higher is now affecting dairies. In Victoria, which accounts for nearly 80% of Australia's milk output, some reports are indicating that production in the northern half of the region could be down by as much as 20%. In Western Europe, the milk supply is tight as stocks of dairy products are being consumed by the domestic

market, leaving little available for export. Handlers expect prices to remain firm and supplies to be limited for the balance of the winter.

Bearish Fundamentals:

- Cash Market: Sellers maintained control this week, as buyers weren't as aggressive as last week. Blocks fell 4¢ on the week to close at $1.24/lb today, while barrels shed 1¾¢ to settle at $1.24¾/lb. Butter was the biggest loser, dropping 8¢ to $1.27½/lb. 8 loads of blocks, 1 barrel and 8 cars of butter exchanged hands for the week.
- Commercial Disappearance: While showing strong gains in most other dairy food types, American cheese use in August came in at a disappointing 0.9% increase vs. last year.

Recommendation:



Milk is moving away from cheese production and into drying facilities. That's the message we're getting from report after report. It comes down to financial return, and with cheeses prices stuck in a rut, more money can be made turning the milk into powder. It also helps balance cheese inventories by reducing production. The big question is how much impact will this have on the market? Grains continue to march higher so 2007 is shaping up to be quite an expensive year to feed cows. After a sell-off at the beginning of the week, the 2007 contracts marched back to match their annual high from last week at $13.63 average. Prices were up today on strong volume, despite a weak cash cheese session where blocks fell a penny. Commercial end users of milk are looking at the same fundamentals and starting to establish long hedges to cover themselves against higher milk and cheese costs next year. This is providing buoyancy to the market despite the weak cash cheese situation. We believe you should hedge some milk at these levels. There is still a lot of uncertainty about where 2007 will settle out, but at $13.63, many producers can make good money. Sell up to 25-40% of your production, then start looking to buy call options July-Oct to mitigate your upside risk. Be prepared to ride out some volatility. You may have to wait to get those call options until well into the New Year before enough is known about where the market is headed and premiums come down. And there is the risk that the markets just keep heading up and you don't get it done. But that would mean your unsold milk is gaining in value and would be a good thing.

If you ever have any questions on the market, whether you have an account with us or not, we'd be happy to answer any questions you may have. Call us toll free at 1.877.695.8538