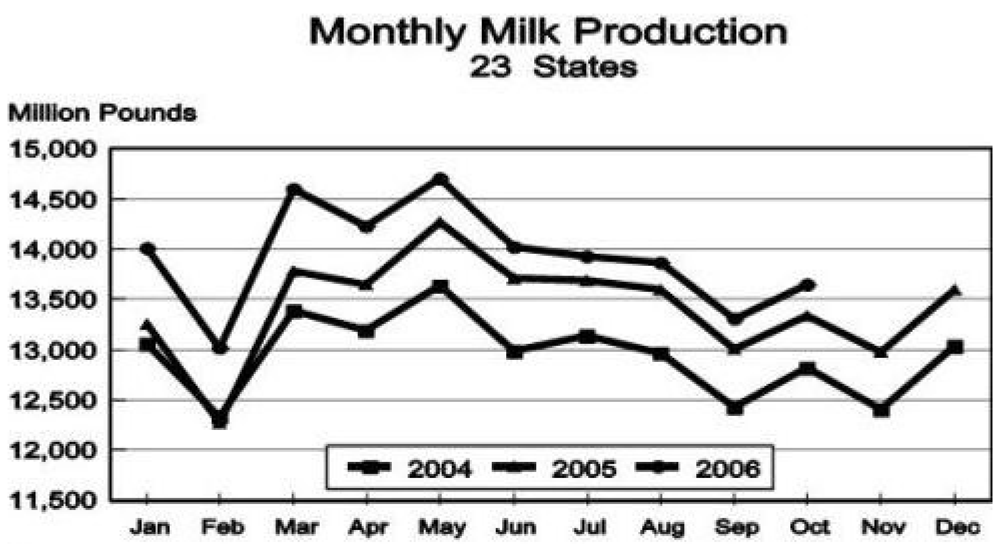

# The KDM Dairy Report - November 17th, 2006

## Bullish Fundamentals:

| Futures Month | Friday 11/17 Close | Friday 11/10 Close | Change | 10-yr Average | Top 3rd Price |
|---|---|---|---|---|---|
| Nov-06 | $12.87 | $12.75 | $0.12 | $12.32 | $13.34 |
| Dec-06 | $13.87 | $13.87 | $0.00 | $12.44 | $13.53 |
| Jan-07 | $13.79 | $14.02 | ($0.23) | $12.27 | $13.11 |
| Feb-07 | $13.79 | $14.02 | ($0.23) | $11.68 | $12.37 |
| Mar-07 | $13.89 | $14.02 | ($0.13) | $11.82 | $12.54 |
| Apr-07 | $13.93 | $14.10 | ($0.17) | $12.30 | $13.51 |
| May-07 | $13.97 | $14.20 | ($0.23) | $12.32 | $13.67 |
| Jun-07 | $14.11 | $14.30 | ($0.19) | $12.39 | $13.49 |
| Jul-07 | $14.30 | $14.60 | ($0.30) | $12.82 | $13.74 |
| Aug-07 | $14.51 | $14.75 | ($0.24) | $13.23 | $14.17 |
| Sep-07 | $14.60 | $14.80 | ($0.20) | $13.79 | $14.68 |
| Oct-07 | $14.01 | $14.34 | ($0.33) | $13.19 | $13.98 |
| Nov-07 | $14.00 | $14.25 | ($0.25) | $12.32 | $13.34 |
| Dec-07 | $13.96 | $13.99 | ($0.03) | $12.44 | $13.53 |
| Jan-08 | $13.52 | $13.60 | ($0.08) | $12.27 | $13.11 |
| Feb-08 | $13.45 | $13.45 | $0.00 | $11.68 | $12.37 |
| Mar-08 | $13.45 | $13.45 | $0.00 | $11.82 | $12.54 |
| Apr-08 | $13.45 | $13.45 | $0.00 | $12.30 | $13.51 |
| May-08 | $13.30 | $13.22 | $0.08 | $12.32 | $13.67 |
| Jun-08 | $13.30 | $13.30 | $0.00 | $12.39 | $13.49 |
| 2007 Avg | $14.07 | $14.28 | ($0.21) | | |
| Jan-Jun '08 | $13.41 | $13.41 | $0.00 | | |

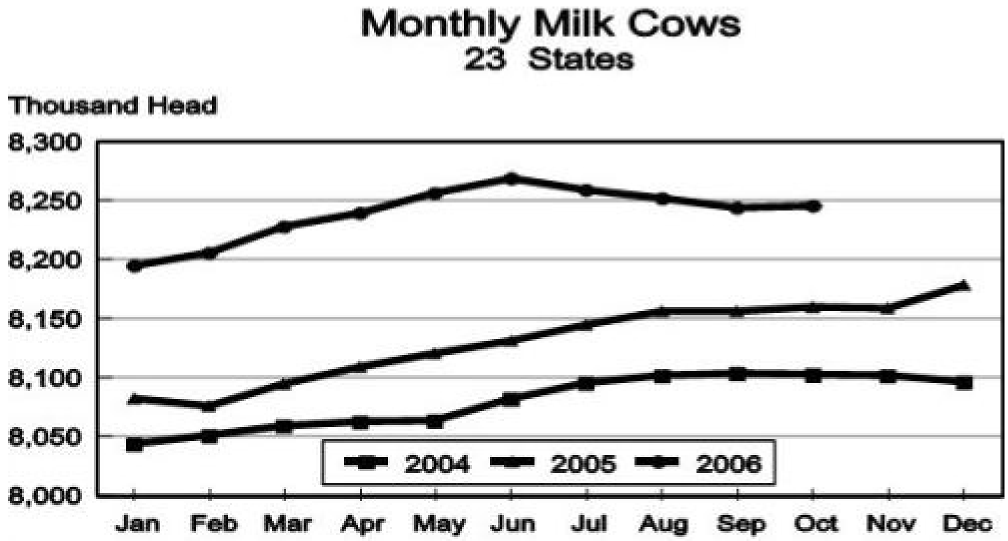
- Cash Market: A prominent barrel buyer continued to lead the spot cheese market as he picked up 22 loads this week. Barrels increased 4¢ vs. a week ago to settle at $1.44/lb today. Blocks followed, gaining 2¾¢ to $1.42¾, but only 9 loads exchanged hands. Butter lost 3¼¢ to finish at $1.29¾ with 27 cars traded.
- NASS surveyed prices made solid gains this week. 40-lb blocks increased 2.3¢ to average $1.25/lb and 500-lb barrels gained 2.8¢ to $1.29/lb. Butter was up 0.4¢ to $1.26/lb, nonfat dry milk up 2¢ to 97.9¢/lb and dry whey set a new record, up 1.8¢ to average 38.3¢/lb.
- Livestock, Dairy & Poultry Outlook Report: USDA released their latest comments on the dairy industry with the following headline: "Moderate Milk Production Increases and Robust Demand Point to Higher Prices in 2007". USDA now expects less than a 1% increase in milk production in 2007 due to a drop in cow numbers and rising feed prices, which will keep the milk-feed price ratio low. They also predict strong demand for cheese will result in an average price between $1.30½ - $1.39½ per pound, and whey supplies could tighten further as milk continues to move to powder production. Finally, a weaker U.S. dollar in 2007 will aid in keeping dairy exports strong, as foreign buyers will see U.S. products as value priced.
- Weekly cold storage numbers for the first two weeks of November reflect a continued seasonal drawdown. Butter stocks are down 3% while cheese stocks are 1% lower since the first of the month.
- Dairy cow slaughter for the week ending 11/04 was 1,200 head higher than last year at this time. 53,400 head were culled vs. 52,200 a year ago.
- Fluid Milk & Cream Review reports Midwest bottlers had their biggest production volume in weeks trying to keep up with regular and school accounts. Strong eggnog, dip and sour cream production is fostering excellent demand for Class II as well. Milk supplies are very tight with buyers looking for supplemental loads going unfilled. Cheese plant operators are having a difficult time competing with bottlers and Class IV buyers, and are running on light schedules.




- In the Northeast, milk handlers indicate demand is very strong and competition for available milk is aggressive. The tight milk situation, which usually abates after Thanksgiving, looks like it won't ease for quite some time, according to Fluid Milk & Cream Review.
- Most Western producers are going into the winter feeding season without having their grain needs locked up, according to Fluid Milk & Cream Review. This is causing concern amongst dairy producers on what their costs will be.
- In the Pacific Northwest, most manufacturers have their cheese output committed into the future, and occasionally, milk continues to be shifted from cheese to butter/powder operations.
- Dairy Market News reports some Western cheese plants are curtailing production by 1-2 days per week to free up more milk for drying.
- Feed demand for dry whey is strong due to the lack of available dairy protein sources in the market, according to Dairy Market News. The mostly price in the Central region of the country ranged between 40¾-41¾¢/lb this week.

- Whey exports for the first nine months of the year were up a strong 15.9%, according to Dairy Market News. Exports accounted for 45% of total U.S. whey production during this time. The top 5 destinations were China, Canada, Korea, Japan and Thailand. Despite continued strong export and domestic demand, whey production is lighter in the Western region of the country because of less cheese being made at a number of locations.
- Same story out East. Dairy Market News reports whey production is down there as well, due to limited cheese production. Some whey end-users are being forced to reduce the amount of whey in their formulations since supplies cannot be obtained.
- Dairy Market News reports butter orders for December delivery are strong. Many retailers and food service buyers are expecting butter needs to be as strong as or stronger than last year.
- Many Midwest cutting operations are running 6-7 day schedules in order to meet demand, according to Dairy Market News. Mozzarella and provolone supplies remain tight as plants are unable to best use the fat in milk by adding nonfat dry milk.
- Current (under 30 day's age) cheese is tight out West, according to Dairy Market News, although it may be just for the short-term. Cheese output is below expectations and under grade cheese is clearing easily.

## Bearish Fundamentals:




- Milk Production Report: October milk production was up 2.3% in the 23 major producing states and up 1.7% for all 50 states. Cow numbers increased month-to-month for the first time since June, up 2,000 head from September, and milk per cow was up 19 lbs vs. last year. Production gains were led by TX up 9.1%, CO up 8.6%, ID up 6.3%, and MI up 6.1%. CA was up 2.3% and WI was up 0.7%. On a positive note, last month's production was revised 6 million lbs lower.
- Fluid Milk & Cream Review reports only 116 loads of fluid milk were imported into Florida this week, a result of increasing production in the state. This is the lightest volume of milk imported since July, and handlers believe future imports will decline as local supply will come into balance with demand.
- Milk production and demand are in balance in AZ and NM, and cheese plants are resuming full production schedules, according to Fluid Milk & Cream Review.
- The increased loads of milk being sent to dryers from cheese plants and other operations are starting to ease the tight nonfat dry milk market, according to Dairy Market News. Some buyers indicate increased delivery of their contracted orders which were previously delayed, while shipments from New Zealand and Chile to U.S. buyers were reported.

## Recommendation:

The milk market continues to be volatile in its struggle with current valuation, especially in the front months. There's a perception that the current barrel buyer may only be there for a limited time, so the street is anxious to push prices lower. They did so at the beginning of the week, but when the barrel buyer continued to bid the price higher in order to obtain needed product, the markets rebounded mid week. Today, despite cash cheese pushing a penny higher, the front months again sold off in anticipation of near-term weakness. They may be right; however, we feel the market needs to be looked at with both short and long-term lenses, so grab your bifocals.

In the near term, the current barrel buyer may indeed pull away, but nobody knows when. That leaves a lot of downside risk for the front few months. Defend them by buying put options or selling into a rally if cheese pushes higher next week. Today we bought the December '06 13.50 put for 10¢. That yields a $13.40 floor with continued upside if markets keep moving higher. After today's sell off, it settled at 14¢, so we at least got a bargain today. Enter orders on Monday to buy the same put option for 10-12¢. Consider selling a portion of your milk Jan-Mar at 13.95 or higher.

Long-term, bullish fundamentals that we've discussed over the past few months remain in play. Sure, our production report showed an increase and cow numbers were up, which was a surprise. We might see additional selling on the open Monday morning, but eyes will quickly focus once again on the cash cheese market and long-term fundamentals. Higher production today doesn't necessarily mean more production in March. However, as we said last week, the higher prices rise now, the more likely it will encourage production and farm expansion, which could leave the last quarter of '07 and even the 2008 contracts vulnerable.

**Note:** Markets will be closed on Thursday and Friday of next week for the Thanksgiving Holiday.