



## The KDM Dairy Report - December 1<sup>st</sup>, 2006

### Bullish Fundamentals:

- Dairy Products Report: While other varieties of cheese saw significant production gains, cheddar cheese (the kind that trades on the cash CME market) was up only 0.7% in Oct vs. last year, and down 3.1% from September. Also significant, production of cheddar cheese in CA was down 11.9% from last year, and down 8.4% in WI.
- Commercial Disappearance: Although use of milk in all products was down (see below), American cheese use in September was [up a solid 3.5%](#) in September, and 3.4% in the 3<sup>rd</sup> quarter.
- Cheese prices took a [big jump](#) in this week's NASS survey. Cheddar blocks were up 6.1¢ to average \$1.35/lb, while barrels increased 6.2¢ to \$1.39/lb.
- Cold storage holdings at USDA centers for the period 11/01 – 11/27 reflect a [strong 16% drop](#) in butter stocks and 3% decline in cheese stocks.
- For the week ending 11/18, dairy cow slaughter numbered 52,500 head vs. 49,200 culled during the same week last year.
- Livestock Slaughter Report: 218,400 dairy cows were culled during the month of October, according to USDA figures, a [9.2% increase](#) over last October. YTD, 1.922 million head have been removed from the milking herd, up 4.25% from last year.
- Ag Prices Report: Despite recent increases in the milk price, grains prices have increased faster, resulting in a milk-to-feed price ratio of 2.34 for November, according to USDA. That's [down from 2.53 in October](#) and 3.45 in Nov 2005. A ratio below 3.0 generally favors reduced milk production.
- Minimal extra volumes of milk were available over Thanksgiving weekend in the Midwest, according to Fluid Milk & Cream Review. Plant receipts have been little changed in recent weeks so overall [supplies remain tight](#). Strong cream interest picked up right after the weekend as plants prepare dips and sour cream for year-end celebrations.
- Fluid Milk & Cream Review reported that milk [supplies were easily handled](#) over Thanksgiving weekend in California. Good demand for milk is seen from both processors and bottlers. Weather in the Pacific Northwest was the big story last week. 14 inches of rain fell in parts of Oregon, and there were reports of up to a 50% drop in milk production at some dairies. Very little dairy quality hay is left for sale in Idaho, and the run-up in grain prices has forced some producers to purchase only short-term needs.
- Despite heavier volumes of milk making it to dryers over the holiday weekend, nonfat dry milk [supplies remain short of demand](#), according to Dairy Market News. Buyers are competing for 2007 contracts, but producers are contracting conservatively, while end users continue to be shorted on expected loads.
- Dry whey supplies also remain short of needs, according to Dairy Market News. Most plants have nothing to offer on a spot basis, and resellers are commanding prices in excess of 50¢/lb. Buyers negotiating 2007 contracts are trying to resist significant price increases over last year, but [those in dire need are conceding](#).
- Dairy Market News reports dry whey demand is excellent in the Western region, with offerings short of needs for both domestic and export buyers. Delays in shipment are becoming common, forcing buyers to scramble to find supplies. Whey production is below projected levels [due to lagging cheese output](#), and producers now think it may not be until sometime in 2007 before they catch up.
- Foreign Exchange: The U.S. dollar has fallen substantially in value relative to other currencies in a long term trend, and more dramatically since early October. The British Pound is trading near a 10-year high against the dollar, while the Euro continues to make gains week-to-week. While it becomes more expensive for us to purchase imported goods, it does make our exports far more attractive and value-priced. Grain exports continue to be strong, and the outlook for dairy exports in 2007 continues to look very promising.

Futures Month	Friday 12/01 Close	Wed 11/22 Close	Change	10-yr Average	Top 3rd Price
Dec-06	\$13.35	\$13.70	(\$0.35)	\$12.44	\$13.53
Jan-07	\$13.03	\$13.47	(\$0.44)	\$12.27	\$13.11
Feb-07	\$13.10	\$13.40	(\$0.30)	\$11.68	\$12.37
Mar-07	\$13.13	\$13.40	(\$0.27)	\$11.82	\$12.54
Apr-07	\$13.38	\$13.70	(\$0.32)	\$12.30	\$13.51
May-07	\$13.51	\$13.71	(\$0.20)	\$12.32	\$13.67
Jun-07	\$13.67	\$13.83	(\$0.16)	\$12.39	\$13.49
Jul-07	\$14.03	\$14.04	(\$0.01)	\$12.82	\$13.74
Aug-07	\$14.33	\$14.36	(\$0.03)	\$13.23	\$14.17
Sep-07	\$14.38	\$14.44	(\$0.06)	\$13.79	\$14.68
Oct-07	\$14.07	\$14.04	\$0.03	\$13.19	\$13.98
Nov-07	\$13.92	\$14.00	(\$0.08)	\$12.32	\$13.30
Dec-07	\$13.86	\$13.96	(\$0.10)	\$12.44	\$13.53
Jan-08	\$13.50	\$13.50	\$0.00	\$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	\$13.45	\$13.30	\$0.15	\$12.32	\$13.67
Jun-08	\$13.45	\$13.30	\$0.15	\$12.39	\$13.49
<b>2007 Avg</b>	<b>\$13.70</b>	<b>\$13.86</b>	<b>(\$0.16)</b>		
<b>Jan-Jun '08</b>	<b>\$13.46</b>	<b>\$13.41</b>	<b>\$0.05</b>		

### Bearish Fundamentals:

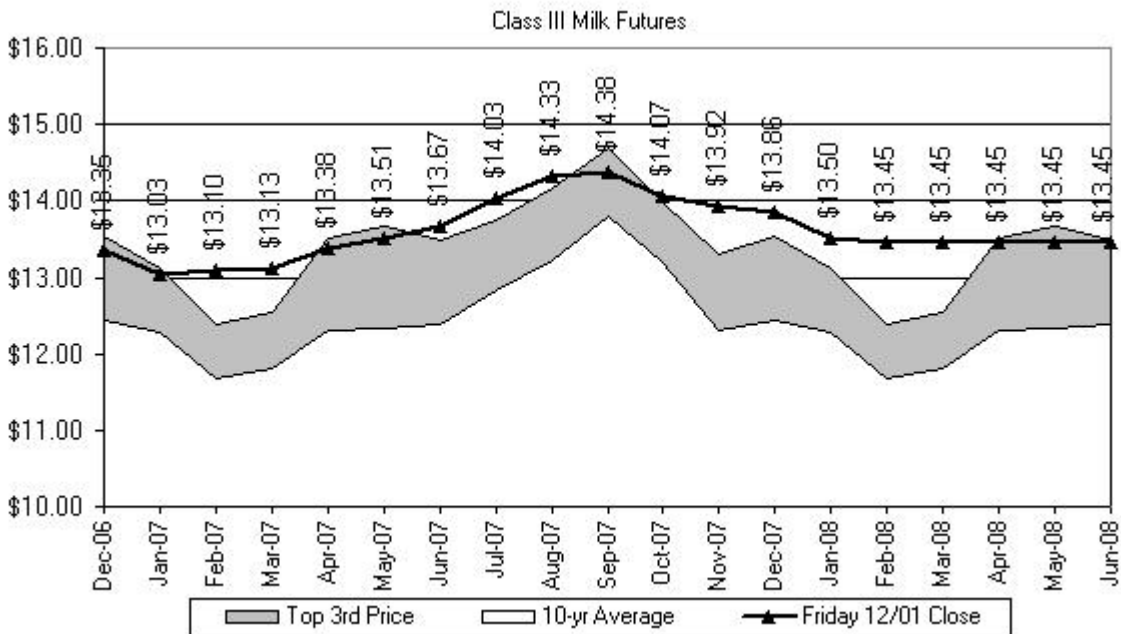
- Cash Market: As we predicted might happen, aggressive cheese buying fell to the wayside this week. Sellers had the upper hand all week with unfilled offers remaining in most sessions. Blocks fell 6¼¢ from the Wednesday before Thanksgiving, settling at \$1.32/lb today. Barrels landed hardest, shedding 12¾¢ to close at \$1.30/lb. Butter was nearly steady, losing only ¼¢ to \$1.27¾/lb. 16 loads of blocks, 10 barrels and 11 cars of butter exchanged hands.
- Commercial Disappearance: Use of milk in all products in September was [down a surprising 4.5%](#), according to USDA figures. That's the first decrease since Feb. 2005. The negative number brought 3<sup>rd</sup> quarter use down 0.3%. Butter use was down 18.8% in

September, while utilization of nonfat dry milk was off more than 25% (due really to lack of availability). Finally, other-than-American cheese use in Sep was down 3.2%.

- Dairy Products Report: Total cheese output in October was [up a strong 5.2%](#) vs. last year, and 2% higher than September, according to USDA numbers released today. Gains were led in American production, up 2.8%, and mozzarella, up 8.1%. Butter output was 8.5% higher than last year and 13.9% above September.
- Florida saw a sharp decrease in shipments of Grade A milk to the state last week. Only 60 loads were imported, vs. 107 last week. Fluid Milk & Cream review notes [production is on the rise](#) at a steady pace in the region, as well as in the Mid-Atlantic states.
- While cheese prices were up, other NASS components fell. Butter declined 1.5¢ to \$1.27/lb, nonfat dry milk lost 0.2¢ to average \$1.00/lb and in a bit of a surprise, dry whey fell 1.9¢ to 37.7¢/lb.

**Recommendation:**

You'll recall from our report two weeks ago that both a short and long term perspective were needed in this market. We are currently in that short term phase where holiday cheese buyers have taken a break to access inventories after the Thanksgiving weekend. We've also heard about some promotions that ended in November as well, and this may be why the aggressive cheese buying we saw over the past few weeks dissipated this week. As producers watched the cheese price fall, new interest in forward contracting milk



was sparked, and along with speculative selling, pushed mainly the first half contracts down substantially (see above). Also note the relative support in the last half of the year. Competition for corn is fierce between exports, feedlots and ethanol plants. The lower value of the dollar makes our products (including dairy) that much cheaper for foreigners to purchase, so until more is known about planting intentions and the seed is safely in the ground, we wouldn't expect a big correction to the downside in grain prices. They may in fact continue rising. The higher feed cost is substantial, with the milk-feed ratio set to go even lower over the coming months as milk prices struggle to move higher, while grain prices continue to be well supported. In short, we expect further weakness in the cheese market over the coming 1-2 weeks. If you have sold or contracted milk for the first half of 2007, the next two weeks will be a prime opportunity to purchase call options to protect those hedges against a price recovery. Will there be a recovery? We think so. Switching to our long term perspective, remember we are nearly into a new year. If the cheese price continues to fall, buyers will be looking at their 2007 needs and will buy value-priced cheese. That will provide some downside protection. But more importantly, much higher feed costs over the coming months are going to make it very difficult for some operations to survive. And the cheap dollar and tight global dairy supplies should keep demand strong enough to warrant higher milk prices in 2007. If you have not hedged any milk in 2007, target to buy call options Jan-Mar during this current weak phase. Enter orders to buy the Jan 13.25 call for 15¢ (currently 26¢), the Feb 13.50 call for 15¢ (currently 28¢) and the March 13.50 call for 20¢ (currently 37¢). If successful, you can then sell or contract your milk on a price recovery near those strike prices, with no worry about a cap on your milk. Basically, you're pre-buying insurance. Call us if you have any questions and we'll help you through an example strategy. Long term, we would hold off selling more than 25% of your production beyond June.

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