



## The KDM Dairy Report - December 15<sup>th</sup>, 2006

### Bullish Fundamentals:

- World Ag Supply & Demand Report: Despite recent gains in the milk price, USDA expects growth in milk production in 2007 to slow due to a weaker milk-feed ratio. They note that [tight world supplies of dairy products](#) in 2007 are likely to support higher product prices for everything except butter, and raised their price forecasts from last month. Class III milk is now expected to average \$13.15/cwt, a 30¢ increase from last month's guess.
- Cash market: Blocks were stable this week holding at \$1.32/lb, while barrels managed a penny gain to close at \$1.29/lb. Butter also found some support, moving ½¢ higher to \$1.25½/lb. 5 loads of blocks, 6 of barrel and 13 cars of butter exchanged hands in light trading.
- Weekly dairy [slaughter numbers were strong](#) this week. For the week ending 12/02, 53,100 head were culled vs. 49,600 during the same period last year.
- Heifer prices were down sharply at Wisconsin cattle sales this week, according to Fluid Milk & Cream Review. Higher feed costs and lower margins could be to blame. Elsewhere in the region, Class I demand remains good with little problems expected for clearing milk when schools let out. In the southern states, demand for BST-free milk is strong, while [milk receipts remain tight](#) and have not shown much season increase.

Futures Month	Friday 12/15 Close	Friday 12/08 Close	Change	10-yr Average	Top 3rd Price
Dec-06	\$13.52	\$13.72	(\$0.20)	\$12.44	\$13.53
Jan-07	\$13.15	\$13.05	\$0.10	\$12.27	\$13.11
Feb-07	\$13.30	\$13.16	\$0.14	\$11.68	\$12.37
Mar-07	\$13.45	\$13.33	\$0.12	\$11.82	\$12.54
Apr-07	\$13.71	\$13.58	\$0.13	\$12.30	\$13.51
May-07	\$13.90	\$13.80	\$0.10	\$12.32	\$13.67
Jun-07	\$14.02	\$13.95	\$0.07	\$12.39	\$13.49
Jul-07	\$14.31	\$14.22	\$0.09	\$12.82	\$13.74
Aug-07	\$14.57	\$14.43	\$0.14	\$13.23	\$14.17
Sep-07	\$14.71	\$14.58	\$0.13	\$13.79	\$14.68
Oct-07	\$14.31	\$14.25	\$0.06	\$13.19	\$13.98
Nov-07	\$14.10	\$14.10	\$0.00	\$12.32	\$13.30
Dec-07	\$13.90	\$13.96	(\$0.06)	\$12.44	\$13.53
Jan-08	\$13.75	\$13.60	\$0.15	\$12.27	\$13.11
Feb-08	\$13.70	\$13.45	\$0.25	\$11.68	\$12.37
Mar-08	\$13.70	\$13.45	\$0.25	\$11.82	\$12.54
Apr-08	\$13.70	\$13.45	\$0.25	\$12.30	\$13.51
May-08	\$13.75	\$13.45	\$0.30	\$12.32	\$13.67
Jun-08	\$13.75	\$13.45	\$0.30	\$12.39	\$13.49
<b>2007 Avg</b>	<b>\$13.95</b>	<b>\$13.87</b>	<b>\$0.08</b>		
<b>Jan-Jun '08</b>	<b>\$13.73</b>	<b>\$13.48</b>	<b>\$0.25</b>		

- Fluid Milk & Cream Review reports fluid demand is strong in Arizona. Plants have additional capacity to handle milk but little is being offered. In New Mexico, [milk supplies remain tight](#) and some plants are running on limited schedules. Milk is not leaving the state as there is no surplus.
- Class I demand is strong in the Eastern states and continues to [divert more milk than anticipated](#) from lower class uses, according to Dairy Market News. That is keeping nonfat dry milk prices firm as dryers can only produce minimal amounts.
- Dairy Market News reports shipments of Grade A milk into Florida nearly doubled this week, rising from 62 loads to 126 due to robust Class I sales. Processors are [receiving lower milk volumes](#) than expected, as transfers to lower class uses like butter/powder operations are minimal. Some drying facilities remain idle.
- The nonfat dry milk market remains firm, according to Dairy Market News. Offerings continue to be [short of needs](#) and producers are still behind on past orders. Exports Jan-Oct were 3.5% higher than last year, despite lower availability, indicating strong overseas interest remains.
- Exports for dry whey were even more [impressive, up 19%](#) from last year during the same period, according to Dairy Market News. That occurred in spite of lower production from less cheese output. Offerings are not currently sufficient to meet both export and domestic demand, keeping the market very firm.
- Average mailbox prices in September, which settled at \$12.29 on the CME, were \$11.41 for NM and \$11.44 for CA, according to Dairy Market News. That compares to \$13.30 for WI, \$13.18 for MN and \$12.85 for NY, and demonstrates why the West needs a higher Class III price to break-even on their operations.

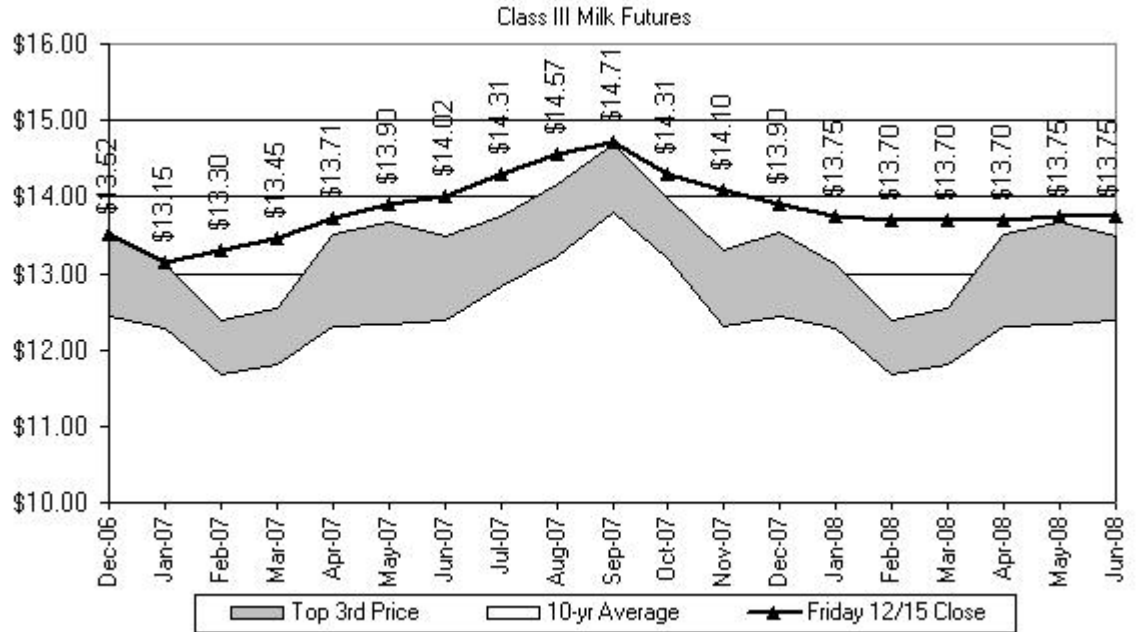
### Bearish Fundamentals:

- NASS prices for most Class III components turned the other direction and [headed lower](#) this week. The average price for 40-lb blocks was \$1.38/lb, down 0.7¢ from last week's survey. 500-lb barrels fell 2.7¢ to \$1.39/lb and butter decreased 2.6¢ to average \$1.24/lb. Dry whey was down slightly, but still over the 40¢ line at 40.1¢/lb, while nonfat dry milk was the lone component to increase, pushing 1.2¢ higher to \$1.03/lb.
- Butter stocks at CME-approved warehouses increased 2.2 million lbs for the week ending 12/09, [marking a reversal](#) of several months of draw downs. The last weekly increase was in July, and is a few weeks ahead of normal.

- Dairy Market News reports butter stocks are in good balance with demand and will be sufficient to meet end-of-year needs. In addition, [availability of cream is increasing](#) as Class II production winds down.
- Milk production in California is trending higher, with gains in fat and protein levels, according to Fluid Milk & Cream Review. Weather has been favorable for milking. Ditto in Arizona, where fat tests are above levels that are normally recorded for this time of year.
- A few Western cheese makers have been [offering additional product](#) for the first time in quite awhile, according to Dairy Market News. Supply and demand appear to be more in balance, which has not been the base for the past couple months, when things were tighter.

**Recommendation:**

We don't expect the cheese market to move a whole lot in the next couple weeks as we appear to be in balance. The important thing to note, however, is that it stopped going down. That gives traders some confidence and lends support to Class III futures. Producer selling was fairly prevalent at the \$14 average for 2007, as those who missed the previous average high of \$14.21 set their sights a little lower. We finished the week at a



finished the week at a \$13.95 average, well off the lows we put in a few weeks ago. The 2008 contracts began to see some activity as bidders pushed them double-digits higher on very light volume. This week we heard about a couple large cooperatives offering \$1.40+ cheese contracts for 1-3 years. It appears to indicate they have customers who want to lock in the cost of their cheese needs, some of them quite long-range, and fear potentially higher prices. This seems to tie in with what we've been saying for a while now; global dairy supply is tight and input costs are high. Long-range corn analysts are predicting a real tug-of-war for corn next year between ethanol plants and dairies/feedlots. One article mentioned 12 new ethanol plants coming on-line soon in northern IA and southern MN, and how they may capture corn typically bound for the Pacific Northwest and California feedlots. Even if corn attracts 4-5 million more acres, if we don't achieve a trend yield next year, we could see rationing and higher prices. As we mentioned last week, if you haven't contracted your feed needs yet, you may want to look at doing it sooner rather than later to take advantage of recent lows. In our opinion, the risk for further upside in the grains is greater than for much lower prices.

Milk in the near term should be somewhat range-bound. While cheese has stopped going down for the moment, supply looks a little looser, and this could spill over into lower prices in the first quarter of 2008. For that reason we would buy some protection in the form of 13.25 PUT options, currently at an average price of 26¢. Go out and get them. You'll have a \$12.99 effective floor in place with 100% upside potential if the market comes around early.

Longer term, we are still supportive of the market and would not sell more than 25% of your 2007 production at current prices.

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