



The KDM Dairy Report - December 22nd, 2006

Bullish Fundamentals:

- Livestock Slaughter Report: November dairy cow slaughter was the most per day since December 2003 and totaled 219,000 head, a 5.1% increase over last November. Year-to-date, 2.142 million head have been culled, which is [running 4.3% higher than last year](#) at this time.
- Livestock, Dairy & Poultry Outlook Report: USDA's monthly look at the dairy sector [projects higher milk prices next year](#) due to only a slight 0.6% increase in milk production and continued strong demand. They expect higher feed prices to keep the milk-feed ratio low, while strong cheese demand will push the average price to \$1.31½ to \$1.39½ per pound. While we'll have ample stocks of butter, global supplies of dairy products are tight, which is expected to continue through the first half of 2007. This should keep U.S. exports strong and will help to keep domestic dry product inventory in short supply. USDA projects 2007 Class III milk to average \$13.15/cwt, a 30¢ increase on their estimate from last month.
- Weekly cow slaughter numbers continue to indicate in [increase in the dairy cull](#). For the week ending December 9th, 53,200 head were removed from the milking herd vs. 48,000 head during the same period last year.
- Producers continue to experience increasing financial pressure from higher feed and hay costs, according to Fluid Milk & Cream Review. Reducing feed rations may [impact production per cow](#) this winter. Hay supplies remain tight, and even with firm prices, could lose acres next year to higher value crops like corn.
- The nonfat dry milk market remains firm, according to Dairy Market News. Heavy buyer anxiety over price and supply of nonfat dry milk in 2007 has been fueled by some producers [not giving any supply guarantees](#) for the coming year. Those that were shorted loads in 2006 don't anticipate receipt of those supplies by the end of the year or in 2007. When possible, buyers are switching to condensed skim, which could limit the amount of nonfat dry milk produced next year.
- Dry whey contracts for 2007 are [commanding much higher premiums](#) over last year, according to Dairy Market News. Sales for 2007 into the export market are already being signed at prices significantly above the top end of the current price range. Production has begun to increase as more milk becomes available, but much of that will go to fulfill 2006 contracts. Domestic buyers continue to search for additional loads but are often going unsatisfied.
- International: USDA reports milk output in Western Europe is not as high as in years past and quota levels may not be attained. A resumption of powder demand has been seen, with buyers realizing there is little to none available and paying up for it. Finally, the [subsidy for whole milk powder was reduced](#) by 100 Euros at last week's European Dairy Management Committee.
- International: Conditions in New Zealand fare better than in Australia, with milk production up ½-1% over last season. However, the drought in Australia has those grazing operations seeing production continuing to decline, due to poor pasture and crop conditions and competition for expensive water supplies. Recent revisions to milk production for the 2006-07 year now [project a 10% decline](#) vs. last year. As a result, dairy end-products are tight in the region and manufacturers and traders have closed the books on new orders.
- Cold Storage Report: A mixed bag on this report. Stocks of American cheese in November were down 1% vs. last year and down 3% vs. October, in a smaller than usual seasonal decline. Meanwhile, butter [stocks plummeted a record 36%](#) from October to November, while remaining 47% above last year's levels. Finally, total cheese stocks were down 3% from last month, but up 7% from last year.

Futures Month	Friday 12/22 Close	Friday 12/15 Close	Change	5-yr Average	Top 3rd Price
Dec-06	\$13.47	\$13.52	(\$0.05)	\$12.58	\$13.68
Jan-07	\$13.10	\$13.15	(\$0.05)	\$12.16	\$13.00
Feb-07	\$13.17	\$13.30	(\$0.13)	\$12.02	\$12.70
Mar-07	\$13.30	\$13.45	(\$0.15)	\$11.89	\$12.61
Apr-07	\$13.60	\$13.71	(\$0.11)	\$13.09	\$14.31
May-07	\$13.85	\$13.90	(\$0.05)	\$13.14	\$14.49
Jun-07	\$14.00	\$14.02	(\$0.02)	\$12.54	\$13.63
Jul-07	\$14.30	\$14.31	(\$0.01)	\$12.25	\$13.16
Aug-07	\$14.50	\$14.57	(\$0.07)	\$12.41	\$13.34
Sep-07	\$14.64	\$14.71	(\$0.07)	\$13.11	\$13.99
Oct-07	\$14.31	\$14.31	\$0.00	\$13.19	\$13.98
Nov-07	\$14.12	\$14.10	\$0.02	\$12.88	\$13.86
Dec-07	\$13.90	\$13.90	\$0.00	\$12.58	\$13.68
Jan-08	\$13.80	\$13.75	\$0.05	\$12.16	\$13.00
Feb-08	\$13.80	\$13.70	\$0.10	\$12.02	\$12.70
Mar-08	\$13.80	\$13.70	\$0.10	\$11.89	\$12.61
Apr-08	\$13.80	\$13.70	\$0.10	\$13.09	\$14.31
May-08	\$13.80	\$13.75	\$0.05	\$13.14	\$14.49
Jun-08	\$13.80	\$13.75	\$0.05	\$12.54	\$13.63
2007 Avg	\$13.90	\$13.95	(\$0.05)		
Jan-Jun '08	\$13.80	\$13.73	\$0.07		

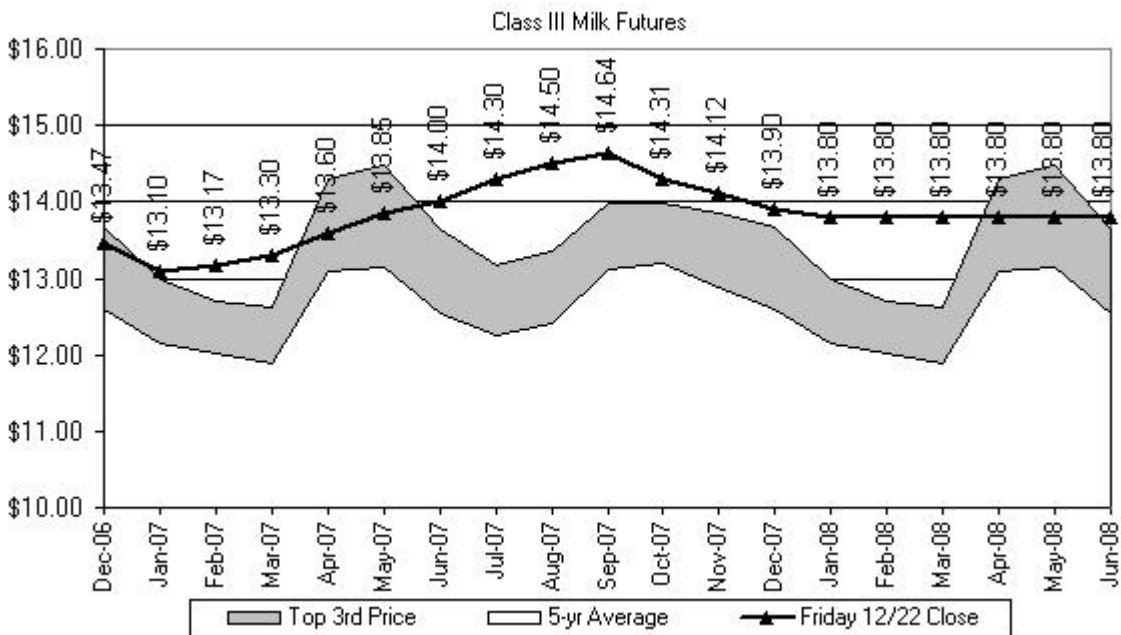
Bearish Fundamentals:

- Milk Production Report: November [milk production was up 2.5%](#) vs. last year in the 23 major producing states, production per cow was up 24 lbs per cow and the number of milk cows increased 81,000 head. Even more concerning, cow numbers have increased 3,000 head since October, marking the second straight monthly increase in cow numbers. For all 50 states, production was up 2%, led by gains in TX up 9.6%, CO up 8.4%, MI up 6.3% and ID up 5.6%. The "big two", CA was up 2.4% and WI up 1.7%.
- Average cheese prices in the weekly NASS survey [took a big tumble](#) this week. 40-lb blocks fell 4.2¢ to \$1.34/lb and 500-lb barrels shed 6.5¢ to \$1.32/lb. Butter was lower as well, declining 0.4¢ to average \$1.24/lb while nonfat dry milk lost 1.3¢ to \$1.02/lb. The lone bright spot was dry whey, which was up 0.9¢ to 41¢/lb.

- Weekly cold storage stats released by USDA show [cheese holdings have increased](#) 2% over the first 18 days of December, which represents an additional 2 million lbs.
- Fluid Milk & Cream review reports milk receipts in the Midwest continue to increase slightly, and manufacturers are expected to get a [boost in supply](#) over the Christmas and New Year's holidays as Class I demand dwindles during school break. Cream supplies are readily available and churning is active.
- Production of nonfat dry milk and butter will be strong in the Southeast over the weekend, according to Fluid Milk & Cream Review. Balancing plants, which have been largely idle up until now, will take advantage of the drop in fluid sales from school closures, and plan on [running for six days straight](#). Only 86 loads of Grade A milk made their way into the area this week, vs. 203 last week.
- Butter handlers anticipate a drop in price now that holiday orders have been placed and shipped. Churning activity is on the increase as cream becomes more available, and inventories are starting to build as [demand is not keeping pace with production](#). In addition, butter producers want a lower cash price as their inventories build and inventory values are established prior to year-end.

Recommendation:

It was a week of abundant reports but quiet, holiday trading. It appears that cheese is in balance at the moment, with both sides comfortable on price. No doubt about it, November's milk production report was bearish, at least for the near term. The trend in this country is more milk from fewer cows, so a 3,000 head increase is not the direction we want to be going if one is hoping for higher prices next year. For that reason, we continue to believe the first quarter is vulnerable to further price erosion. Last week we recommended getting PUT options



bought, and we were successful in getting 13.25 PUTs for Jan and Feb at an average price of 25¢. The price has gone up a little since then, but we would continue to go after them on a significant percentage of your production. It results in nearly a \$13.00 floor for your base price, while leaving you open to 100% upside.

Sell up to 40% of your production in Apr-May at current prices, with the intention of buying CALL options to protect the upside. With grain prices on deferred months near or at record levels, we are still supportive of July-Dec and would not sell more than 25% of your production in those months. We continue to recommend getting your input costs covered on any meaningful dip in the grain market. Price action the last two days shows how quickly they can recover. Finally, we've changed our graph and chart from a 10-year historical view to a 5-year view. The cost of production has changed dramatically from when oil was less than \$20/barrel, so we feel the 5-year view provides more realistic "average" and "top-third" prices.

NOTE: Our offices will be closed on Monday in observance of Christmas Day. On behalf of KDM Trading, Inc., we want to wish you and yours a very Merry and Blessed Christmas!



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