



## The KDM Dairy Report - January 5<sup>th</sup>, 2007

### Bullish Fundamentals:

- The December Class III price was announced today at \$13.47/cwt, 63¢/cwt higher than November and the highest closing price in 15 months.
- Dairy Products Report: We're making more cheese than last year, but not by much, and [output for other dairy end products was down substantially](#), according to USDA figures released today. American cheese production in November was 1% higher than a year ago but down 1.6% from October. Cheddar output was 1.4% higher than 2005 and 0.5% higher than last month. Total cheese production was 3.1% higher than November 2005 and 1.3% less than October. Finally, butter output was 4.3% higher than a year ago, but 2.5% below the prior month. Despite the increases, both the cheese and butter output numbers were well below expectation. In the dry products areas, dry whey production was down 0.2% from last year and manufacturers ending stocks were down a strong 14.2%. November production of nonfat dry milk for human consumption was down 11%.
- Cash market: Buyers came in force during Thursday's session, bidding barrels up 6¢. For the week, barrels finished up 5½¢ to close at \$1.34½/lb and blocks settled at \$1.34/lb, up 1¢. Butter remained unchanged at \$1.20/lb. 2 loads of blocks, 3 barrels and 1 car of butter exchanged hands.
- Fluid Milk & Cream Review reports plants in the Northeast easily handled milk over the holiday period, and now that Class I demand is growing as schools reopen, some plants will again [cease their drying operations](#) due to lack of milk availability.
- High grain and hay prices are having more of an impact on milk production in the Pacific Northwest than the rash of storms, according to Fluid Milk & Cream Review. Producers remain concerned how much impact the higher input costs will have on production per cow this winter.
- Despite increased production over the holiday period, nonfat dry milk [supplies remain short of demand](#), according to Dairy Market News. End users continue to switch to condensed skim as an alternative, but inventories are light. Dryers out East were hoping to continue operating for the next few weeks, but instead, some have been forced to idle plants already this week.
- Dairy Market News reports dry [whey prices continue to move sharply higher](#) on strong demand from both exporters and domestic buyers. Shipments are being delayed and interest is going unsatisfied. Output was higher over the holidays, but production levels for the first quarter are in question. Handlers report that they are not seeing any real competition from other areas of the world with whey supplies, while the depressed value of the dollar relative to other currencies has made our exports very attractive. The mostly price for Western whey hit 46-49¢ per lb this week.
- International: Traders in Western Europe expect prices for dairy products to remain firm for at least the first half of the year, unless the supply situation changes. Stocks of [dairy products remain fully committed](#) due to increasing domestic demand and a quota milk production system.
- International: Milk production in New Zealand has been revised from a 2-3% increase over last year, down to only ½-1% increase. Cold, wet conditions due to El Nino weather patterns could further reduce projections. In Australia, the devastating drought has reports now projecting an [11% decrease in milk production](#), the lowest in a decade. With production in both countries not reaching expected levels, stocks of manufactured dairy products are limited. Most traders feel that they will not have any additional volumes for international buyer interest, and [export earnings are expected to drop](#) by more than 24%.
- Economy: 167,000 jobs were added in December, according to the Labor Department, a number far higher than the 127,000 analysts had predicted. For all of 2006, the unemployment rate dropped to a [six-year low](#) of 4.6%.

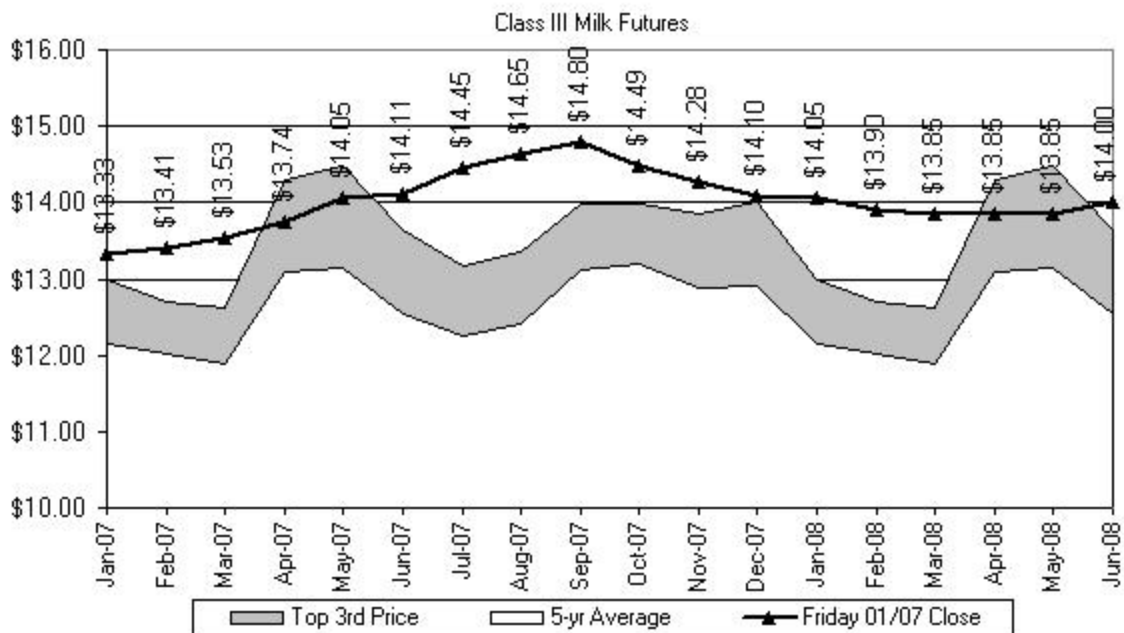
Futures Month	Friday 01/07 Close	Friday 12/29 Close	Change	5-yr Average	Top 3rd Price
Jan-07	\$13.33	\$13.20	\$0.13	\$12.16	\$13.00
Feb-07	\$13.41	\$13.32	\$0.09	\$12.02	\$12.70
Mar-07	\$13.53	\$13.42	\$0.11	\$11.89	\$12.61
Apr-07	\$13.74	\$13.71	\$0.03	\$13.09	\$14.31
May-07	\$14.05	\$13.93	\$0.12	\$13.14	\$14.49
Jun-07	\$14.11	\$14.09	\$0.02	\$12.54	\$13.63
Jul-07	\$14.45	\$14.45	\$0.00	\$12.25	\$13.16
Aug-07	\$14.65	\$14.65	\$0.00	\$12.41	\$13.34
Sep-07	\$14.80	\$14.78	\$0.02	\$13.11	\$13.99
Oct-07	\$14.49	\$14.39	\$0.10	\$13.19	\$13.98
Nov-07	\$14.28	\$14.21	\$0.07	\$12.88	\$13.86
Dec-07	\$14.10	\$14.04	\$0.06	\$12.92	\$14.01
Jan-08	\$14.05	\$14.00	\$0.05	\$12.16	\$13.00
Feb-08	\$13.90	\$13.90	\$0.00	\$12.02	\$12.70
Mar-08	\$13.85	\$13.85	\$0.00	\$11.89	\$12.61
Apr-08	\$13.85	\$13.85	\$0.00	\$13.09	\$14.31
May-08	\$13.85	\$13.85	\$0.00	\$13.14	\$14.49
Jun-08	\$14.00	\$14.00	\$0.00	\$12.54	\$13.63
<b>2007 Avg</b>	<b>\$14.08</b>	<b>\$14.02</b>	<b>\$0.06</b>		
<b>Jan-Jun '08</b>	<b>\$13.92</b>	<b>\$13.91</b>	<b>\$0.01</b>		

## Bearish Fundamentals:

- For the year, 2006 averaged a lowly \$11.89/cwt, the lowest annual average since 2003 at \$11.42.
- Weekly cold storage stats show [cheese holdings increased](#) 1% for the month of December, while butter stocks increased 2%.
- Friday's NASS numbers [did little](#) to encourage milk prices. Both blocks and barrels came in at \$1.30/lb, reflecting a decrease of 0.9¢ for blocks and 0.3¢ increase for barrels. Butter lost 3.1¢ to average \$1.21/lb and nonfat dry milk was down 3.3¢ to \$1.01/lb. Dry whey was the lone bright spot, tacking on 0.2¢ to reach 41.6¢/lb.
- Fluid Milk & Cream Review reports the weather has been unseasonably mild in the upper Midwest, promoting ideal milking conditions. Milk volumes were very heavy over the Christmas/New Year's period, with [plant capacities maxed out](#) at several locations. It wasn't until midweek that the situation became more balanced.
- Milk output in California is [trending 2-3% higher](#) than last year, according to Fluid Milk & Cream Review, and in Arizona, weather conditions have been good for cow comfort, with both production and component levels up.
- Butter stocks are [back on the rise](#). 8.3 million lbs were added to CME-approved warehouses during the week ending December 30<sup>th</sup>, compared to a gain of only 3.5 million lbs during the same period last year.
- Western cheese buyers indicated overall [sales were not as robust](#) as they had hoped, according to Dairy Market News. Cheese production and demand appear to be in balance.

## Recommendation:

If you've been reading our comments for even the past couple months, you know dairy end-products are tight across the globe. Could we be headed for a tight situation in the U.S. too? Sure, our last two milk production reports were bearish, but today's Dairy Products Report seems to indicate our own domestic production is starting to fall. We're also hearing from industry contacts that cheese buying has begun early this year



and that supplies could tighten up soon. The market appears to recognize this as 1.) it shook off the bearish production reports and make allowance news to climb back up over a \$14 average for the year, and 2.) barrel bidders were aggressive on Thursday. Reports from California producers reflect concern that while milk production is growing in the state now, come March, we could see a substantial drop due to the effects of cows not getting bred during the July heat wave. We're not suggesting we won't see any price weakness going forward; we're certainly off the \$14 highs we saw for Q1 contracts in mid-November, but we are seeing new contract highs in the second half of 2007, which leads us to stick with our same recommendation since late summer. Sell no more than 25% of your 2007 production outright. You could even lean towards a PUT option only strategy which provides a floor but leaves your milk open to higher prices. Target to buy the Jan-Mar 13.50 PUT for 25¢ average (currently 26.3¢), then buy the Apr-Sep 13.25 PUT for 25¢ average or the 13.50 PUT for 30¢ average. Through this method you can establish a floor for your base price well over \$13/cwt, while leaving 100% of your hedged milk open to higher prices. Leave Q4 open for now, until premiums for PUT options come down.

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