



The KDM Dairy Report - January 26th, 2007

Bullish Fundamentals:

- Cash Market: The cash market came alive this week as buyers sensed a bottom was put in and got aggressive on the bidding. For the week, blocks gained 6¢ to close at \$1.34¾ and barrels jumped 5¾¢ to reach \$1.36½. Butter reluctantly followed, settling at \$1.27/lb, up 4½¢ for the week. 8 loads of blocks, 6 barrels and 21 cars of butter exchanged hands, with today's trade seeing 10 bids for blocks and 12 bids for barrels going unfilled.
- Livestock Slaughter Report: Dairy cow slaughter for the month of December was [up a full 6%](#) vs. December 2005, according to USDA numbers released today. 211,600 head were culled vs. 199,600 head last year. For the year, 4.5% more dairy cows were removed from the herd than in 2005.
- Dairy cow slaughter for the week ending 01/13 was 54,200 head, starting 2007 off at a [faster rate than last year](#), when 50,000 head were culled during the same period.
- NASS surveyed prices for all Class III components were up this week. 40-lb blocks averaged \$1.33/lb, up 1.1¢ and 500-lb barrels were also \$1.33/lb, up 2¢. Butter scratched out a 0.9¢ increase to reach \$1.20/lb, but nonfat dry milk was [up a strong 4.5¢](#) to average \$1.09/lb while dry whey continued to climb higher, up 0.6¢ to 47.6¢/lb.
- Milk supplies for manufacturing are lower than planned in the Northeast, while [fluid sales are strong](#) in the Southeast, according to Fluid Milk & Cream Review. This is curtailing some plant activities and continuing the need to import milk into the region. 21 loads were shipped into Florida.
- Fluid Milk & Cream Review reports, "There is [not enough dairy hay](#) to go around..." in the Pacific Northwest. With months until any new crop hay is available, a number of dairies are not covered on their supplies. Financial stress is increasing just as producers begin visiting with bankers over budgets and operating loans.
- The nonfat dry milk market remains steady to firm, according to Dairy Market News. Production is active to meet demand from current contracts, to catch up on past due contracted loads and to fill spot interest. Stocks are often light and [export interest remains good](#) with world prices still above current U.S. prices.\
- Western whey prices were sharply higher again this week, according to Dairy Market News. Despite aggressive price hikes by producers, foreign buyers are willing to pay for it, leaving domestic buyers struggling to compete and find the powder they need. Though this time of year usually sees a slowdown in sales, Mexican buyers are [returning to the market in a big way](#) and making up for any temporary drop in demand.
- In the Midwest, dry whey supplies remain tight, with the mostly price getting as high as 60¢/lb! Some buyers are [willing to pay](#) these prices just to maintain productivity of their operations.
- Barrel cheese [interest has been good](#), leading to an inverted block/barrel price, according to Dairy Market News. Super Bowl orders have left the plants, but some last minute orders are still being finished.
- Dairy Market News reports Western block cheese is readily available, but [barrels are on the tight side](#). Demand is quite good for this time of the year, with undergrade offerings of cheese clearing very easily.
- Cold Storage Report: American cheese stocks in December were [down 3% from last year](#), according to USDA numbers released this week, and butter stocks were down 2% vs. the prior month. While Total Cheese stocks were 4% higher than last December, it's down from last month's report which had stocks up 7%.
- Livestock, Dairy & Poultry Outlook Report: USDA's monthly look at the dairy industry contained mostly positive news. They expect [higher dairy product prices](#) in 2007 due to low unemployment, robust job creation, rising wages and only a

Futures Month	Friday 01/26 Close	Friday 01/19 Close	Change	5-yr Average	Top 3rd Price
Jan-07	\$13.56	\$13.49	\$0.07	\$12.16	\$13.00
Feb-07	\$14.22	\$13.70	\$0.52	\$12.02	\$12.70
Mar-07	\$14.50	\$13.85	\$0.65	\$11.89	\$12.61
Apr-07	\$14.95	\$14.05	\$0.90	\$13.09	\$14.31
May-07	\$15.15	\$14.46	\$0.69	\$13.14	\$14.49
Jun-07	\$15.20	\$14.59	\$0.61	\$12.54	\$13.63
Jul-07	\$15.45	\$14.82	\$0.63	\$12.25	\$13.16
Aug-07	\$15.75	\$15.05	\$0.70	\$12.41	\$13.34
Sep-07	\$15.84	\$15.25	\$0.59	\$13.11	\$13.99
Oct-07	\$15.45	\$14.88	\$0.57	\$13.19	\$13.98
Nov-07	\$15.17	\$14.70	\$0.47	\$12.88	\$13.86
Dec-07	\$14.95	\$14.40	\$0.55	\$12.92	\$14.01
Jan-08	\$14.63	\$14.15	\$0.48	\$12.16	\$13.00
Feb-08	\$14.55	\$14.15	\$0.40	\$12.02	\$12.70
Mar-08	\$14.54	\$14.15	\$0.39	\$11.89	\$12.61
Apr-08	\$14.40	\$14.11	\$0.29	\$13.09	\$14.31
May-08	\$14.44	\$14.10	\$0.34	\$13.14	\$14.49
Jun-08	\$14.40	\$14.18	\$0.22	\$12.54	\$13.63
Jul-08	\$14.50	\$14.25	\$0.25	\$12.25	\$13.16
Aug-08	\$14.58	\$14.27	\$0.31	\$12.41	\$13.34
Sep-08	\$14.66	\$14.32	\$0.34	\$13.11	\$13.99
Oct-08	\$14.49	\$14.15	\$0.34	\$13.19	\$13.98
Nov-08	\$14.25	\$14.00	\$0.25	\$12.88	\$13.86
Dec-08	\$14.20	\$14.00	\$0.20	\$12.92	\$14.01
2007 Avg	\$15.02	\$14.44	\$0.58		
2008 Avg	\$14.49	\$14.14	\$0.35		

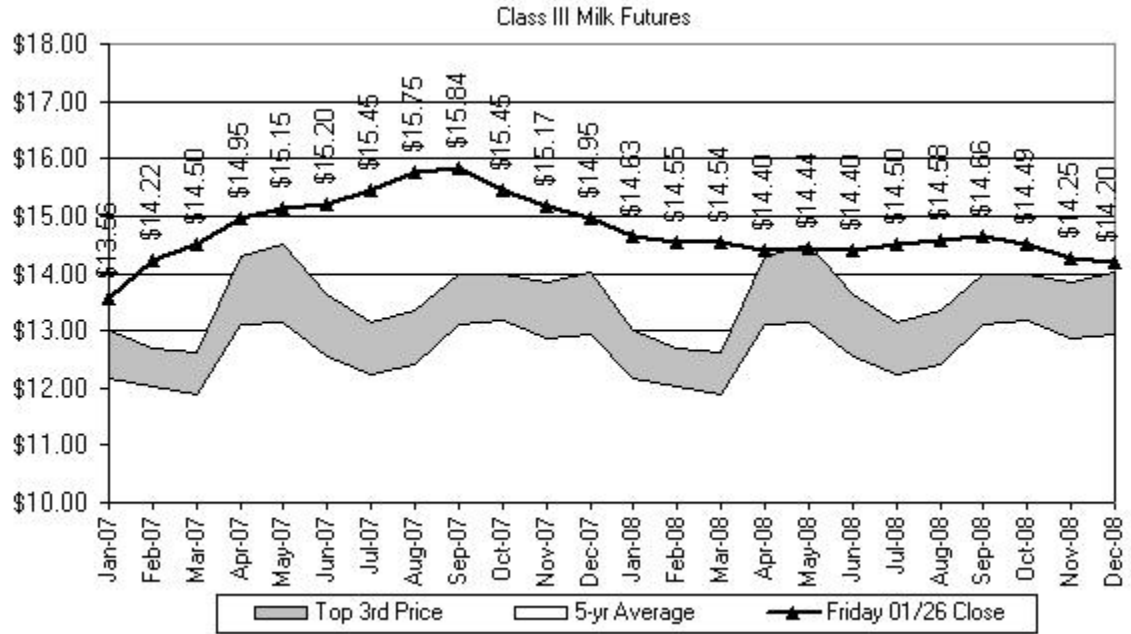
limited increase in milk production. Lower exportable supplies of nonfat dry milk in Australia and the European Union are expected to strengthen U.S. exports and keep prices on the rise. Finally, USDA expects the dairy herd to decline modestly this year, from 9.115 million head in 2006 to 9.040 million head by the end of 2007.

Bearish Fundamentals:

- Butter stocks at CME-approved warehouses [increased 11.3 million lbs](#) for the week ending January 20th, giving us 79.7 million lbs on hand. That compares to last year at this time when we had only 49.3 million lbs in storage.
- Milk production in California is up several percentage points from a year ago, according to Fluid Milk & Cream Review. More cows are being added to the milking herd and milk per cow is slightly higher. The recent cold weather snap appears not to have affected production or processors.
- Dairy Market News reports butter stocks have grown 35.2 million lbs in the past four weeks; the [biggest increase ever](#) for this time of the year. Churns are operating on heavier schedules than they expected as heavy cream offerings continue due to the high nonfat dry milk price.

Recommendation:

We're all catching our breath here after this week's very impressive run higher. Caller after caller asks, "What's driving prices so high... not that I'm complaining!!" Well, the short answer is it's everything we've been writing about week after week. rBST – last week Starbucks and the Safeway grocery chain announced they would no longer sell milk treated with rBST, and we're hearing rumblings about more cooperatives making the



switch as well. The movement keeps gaining momentum. Nonfat dry milk and dry whey keep hitting new highs – if whey hits 60¢/lb, it only takes \$1.45/lb cheese to hit \$15.70 Class III milk. Will that happen? No one knows but the uncertainty is demanding a premium in the market. Grains – corn staying above \$4/bu on the CBOT with solid support for beans and meal. A Southwest producer we spoke with today mentioned even Jan '08 which settled at \$14.68 today is not necessarily a great price, depending on what his input costs will be. Exports – so far they remain very strong since the world price for powder/protein is still higher and the U.S. dollar has weakened relative to other currencies. Strong domestic demand – fluid milk consumption is up 1.6% for the first 11 months of 2006 along with good cheese demand. Finally, the higher cull rate along with a potential CWT herd buyout in 2007, could start moving cow numbers lower.

So what do you do with all this? Keep it simple; we're sticking with our plain, boring recommendation. Sell up to 25% of your production at these (near record) levels, and buy PUT options to cover unsold milk. Enter orders to buy the 14.00 PUT option, Feb-Dec at an average price of 25¢ each. They currently average 26.7¢ so it is a very reasonable target. This would yield an effective floor of \$13.75 yet leave you open to higher prices. Buying put options also results in some interesting secondary choices. If the markets keep climbing, you can choose to roll the put options up to a higher level. For example, if 15.00 puts come down in price, you would sell your 14.00 puts and collect whatever premium was left, and use that to buy the 15.00 puts which would result in a \$1 higher floor. As the market keeps going higher, reward your operation by acquiring ever higher levels of floor price protection. Or, if prices get crazy high, you can simply choose to sell the milk outright and be done. We can't stress enough, however, that at these prices, **you need to be doing something!** At \$15.02 and \$14.49 average respectively, both 2007 AND 2008 are currently trading above the second highest annual average of all time. **Get something done next week!**

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