

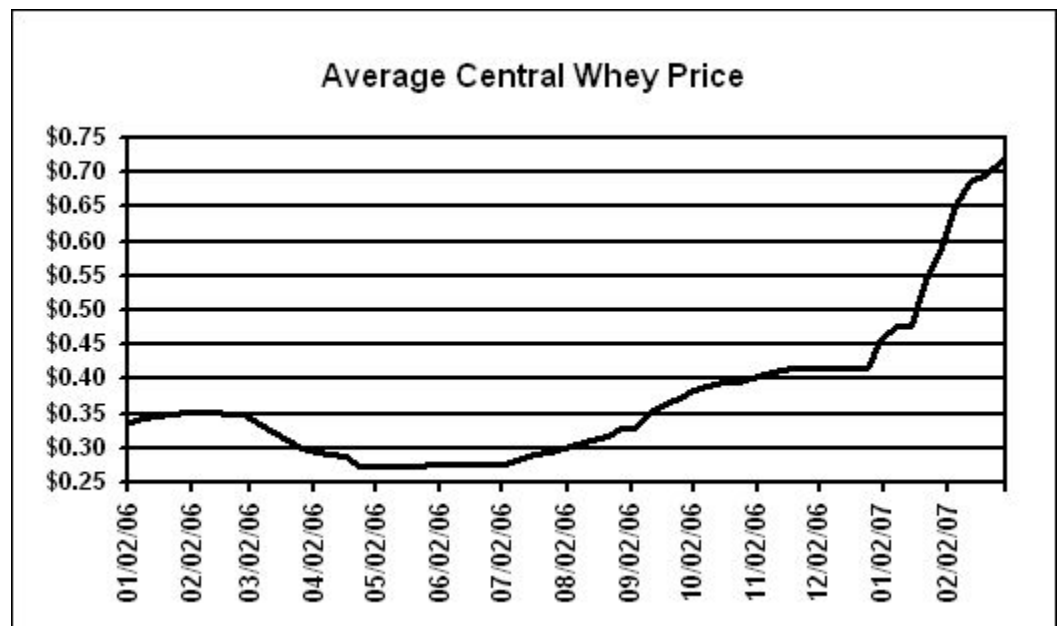


The KDM Dairy Report - March 2nd, 2007

Bullish Fundamentals:

- February Class III settlement was announced today at \$14.14/cwt, the highest close since October 2005.
- Cash Market: Barrels appear to be tighter than blocks, and buyers want them. A total of 39 loads of barrels traded this week, though we finished the week where we were last Friday, at \$1.35/lb. Blocks traded 7 times and lost 2½¢ to settle at \$1.34½/lb, but butter was surprisingly strong given inventories, gaining 10½¢ to \$1.31½/lb. 12 cars of butter exchanged hands.
- Ag Prices Report: Despite rising milk prices, the milk-feed ratio in February fell to 2.32, from 2.42 in January and 2.93 in 2006. That's the [lowest since June, 2003](#).
- Commercial Disappearance: 2006 was a good year for dairy product consumption. USDA's updated disappearance numbers released this week show use of all dairy products during calendar year 2006 up 4 billion lbs (2.2%) from 2005. Individually, butter use was up 4.5%, American cheese use up 5.1% and fluid milk consumption up 1%.
- [Dry whey soared](#) another 4.1¢ in this week's NASS survey to reach 65.5¢/lb, and nonfat dry milk increased 3.5¢ to average \$1.14/lb. However, block cheese decreased 0.5¢ to \$1.32/lb, barrels lost 2.8¢ to \$1.33/lb and butter shed 1.1¢ to \$1.20/lb.
- Weekly cold storage stats continue to show a [4% drop](#) in cheddar cheese stocks for the period 02/01 through 02/26. A total of 5.2 million lbs have been removed from selected storage centers.
- Dairy cow slaughter for 2007 [remains robust](#). For the week ending 02/17, 49,900 head were removed from the milking herd vs. 41,000 during the same week last year.
- Winter storms in the Midwest led to increased purchases of food staples as consumers stocked up before the bad weather hit, according to Fluid Milk & Cream Review. Also, cream [interest is improving](#) as Lenten/spring orders are being prepared and cream cheese output picks up.
- Class I sales in Florida are very strong, leaving the milk supply in balance. For the week, Florida had [zero exports](#) of Grade A milk, vs. 60 loads last week and 96 loads last year.
- It will be three months before new crop hay is available in the Pacific Northwest, according to Fluid Milk & Cream Review. Supplies are very tight, costly and quality is declining. Conditions are wet from heavy snow at low elevations,

Futures Month	Friday 03/02 Close	Friday 02/23 Close	Change	5-yr Average	Top 3rd Price
Mar-07	\$14.54	\$14.62	(\$0.08)	\$11.89	\$12.61
Apr-07	\$14.35	\$14.72	(\$0.37)	\$13.09	\$14.31
May-07	\$14.50	\$14.90	(\$0.40)	\$13.14	\$14.49
Jun-07	\$14.50	\$14.95	(\$0.45)	\$12.54	\$13.63
Jul-07	\$15.00	\$15.45	(\$0.45)	\$12.25	\$13.16
Aug-07	\$15.31	\$15.68	(\$0.37)	\$12.41	\$13.34
Sep-07	\$15.52	\$15.80	(\$0.28)	\$13.11	\$13.99
Oct-07	\$15.40	\$15.50	(\$0.10)	\$13.19	\$13.98
Nov-07	\$15.05	\$15.16	(\$0.11)	\$12.88	\$13.86
Dec-07	\$14.82	\$14.85	(\$0.03)	\$12.92	\$14.01
Jan-08	\$14.80	\$14.80	\$0.00	\$12.50	\$13.33
Feb-08	\$14.78	\$14.75	\$0.03	\$12.53	\$13.21
Mar-08	\$14.77	\$14.77	\$0.00	\$11.89	\$12.61
Apr-08	\$14.82	\$14.82	\$0.00	\$13.09	\$14.31
May-08	\$14.78	\$14.75	\$0.03	\$13.14	\$14.49
Jun-08	\$14.89	\$14.90	(\$0.01)	\$12.54	\$13.63
Jul-08	\$15.05	\$15.05	\$0.00	\$12.25	\$13.16
Aug-08	\$15.10	\$15.10	\$0.00	\$12.41	\$13.34
Sep-08	\$15.15	\$15.20	(\$0.05)	\$13.11	\$13.99
Oct-08	\$14.95	\$14.95	\$0.00	\$13.19	\$13.98
Nov-08	\$14.66	\$14.66	\$0.00	\$12.88	\$13.86
Dec-08	\$14.55	\$14.55	\$0.00	\$12.92	\$14.01
Feb-Dec Avg	\$14.90	\$15.16	(\$0.26)		
2008 Avg	\$14.86	\$14.86	\$0.00		



which appears to be delaying the spring flush. USDA contacts commented that a number of producers are considering bidding aggressively in the CWT herd buyout program.

- International: The powder markets in Western Europe are tight, as in the U.S. Buys are [unable to acquire desired volumes](#), and few expect the tight supply and high prices to change before fall, at the earliest. In Eastern Europe, declining cow numbers and output per cow has export supplies dwindling rapidly.
- International: Milk production in Australia is still forecast to be down 10% for the entire milking season, according to Dairy Market News. Some rain has improved pastures, but a wet fall is needed to replenish water supplies. February is the hottest month in the region. That and the lack of rain in New Zealand is limiting pasture re-growth and may affect late season feed supplies. Strong international demand for powder [will not be covered](#) by the region, leaving buyers to look elsewhere.
- Cheese plants in the Midwest continue to import condensed skim from the West to fortify the vat, due to the high cost and [limited supply](#) of nonfat dry milk.
- Some snack food companies are removing dry whey in their formulations due to the high cost and undependable supply, according to Dairy Market News. Strong demand keeps [moving the price higher](#), however, as this week in the Central region, the mostly price averaged 69-74½¢/lb.

Bearish Fundamentals:

- Dairy Products Report: We [made a lot of cheese](#) and butter in January, according to USDA's monthly dairy products report. January butter output was up 2.5% vs. a year ago and 10% higher than December. Cheddar cheese output was 3% higher than last year but down 0.1% vs. December, and Total cheese output was 6.7% higher than January of 2005, but 0.8% less than December.
- Fluid Milk & Cream Review reports processors in California continue to struggle with the [abundant milk supply](#) as milk intakes climb ever higher. Milk is being moved around to find available processing space.
- Cheese buyers are [delaying orders](#) in anticipation of lower prices next week, according to Dairy Market News. Current cheese is generally available to meet needs.
- While weekly cold storage inventories of cheese were down 4% in this week's report (see above), butter stocks are up 7% over the same period.
- For the week ending February 24th, 110 million lbs of butter were on hand at CME-approved warehouses, vs. 95.6 million lbs during the same period a year ago.
- Despite growing inventories, butter imports in January were [up 18%](#) from a year ago, according to Dairy Market News. 65.4% of the total came from New Zealand.

Recommendation:

The tug of war between cheese sellers and buyers continued this week with neither side gaining ground. Bears point out the current large milk and cheese supply, while the bulls counter with the long-term outlook and current powder shortage. The strength in the dry whey price has added nearly \$2/cwt to Class III in the last month alone, with the average dry whey price in the Central region of the country going up 30¢ since January (see chart above). Today's Dairy Products report is bearish, to the extent that we made a lot more cheese than we did last year at this time, but more cheese output may be a response to more demand and filling of warehouses for future sales. However, 6.7% more total cheese is a lot of extra demand! Looking at our weekly price summary, it appears both the bears and bulls are right, in the sense that we seem to be weak on the front months and well supported in the back months. In our February 9th report we started recommending getting up to 50% sold on the front months due to the sloppy cheese situation, and we still stand by that. The market could continue to rally next week if cash cheese buyers get the upper hand, but it still appears there is plenty of cheese for sale. Sell April and May on rallies. Bids to participate in the 4th round of the CWT herd retirement program are due tomorrow. We believe there will be strong interest in the program. We continue to hear reports of financially stressed dairies, particularly those that buy a majority of their feed. Typical is a dairy expansion that needs 3,000 cows to utilize the new facility, but is only 2/3 full with no money to buy cows. Even with \$15 milk on the CME, they are not able to cash-flow. Banks are struggling with how to deal with their non-performing dairy loan portfolios. The CWT program is one solution, and because of this, right or wrong, we feel banks will be putting a lot of pressure on these operations to submit bids. With that said, we still have a positive bias on the back months, so limit sales and use PUT options June through December to get a floor price under your milk. 14.00 PUT options for those months average 30¢ each. Enter orders to buy them at 25¢, which would yield an effective base price of \$13.75, yet leave your upside open for higher prices.

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