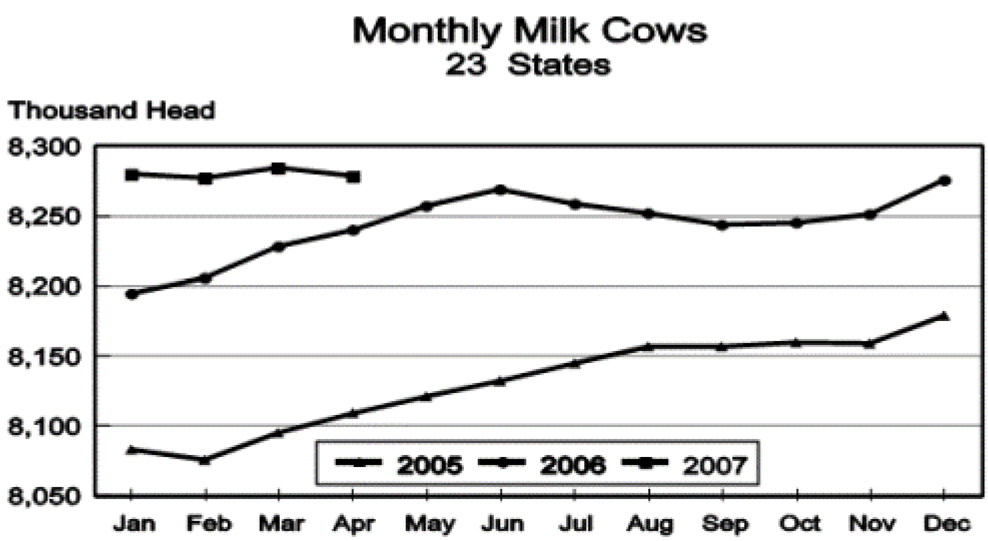
The KDM Dairy Report – May 18th, 2007

Bullish Fundamentals:

Futures Month	Friday 05/18 Close	Friday 05/11 Close	Change	5-yr Average	Top 3rd Price
May-07	$17.50	$17.45	$0.05	$13.14	$14.49
Jun-07	$18.77	$18.75	$0.02	$12.54	$13.63
Jul-07	$18.45	$18.80	($0.35)	$12.25	$13.16
Aug-07	$18.40	$18.85	($0.45)	$12.41	$13.34
Sep-07	$18.42	$18.85	($0.43)	$13.11	$13.99
Oct-07	$18.00	$18.40	($0.40)	$13.19	$13.98
Nov-07	$17.36	$17.75	($0.39)	$12.88	$13.86
Dec-07	$17.08	$17.70	($0.62)	$12.92	$14.01
Jan-08	$16.55	$16.90	($0.35)	$12.50	$13.33
Feb-08	$15.80	$15.85	($0.05)	$12.53	$13.21
Mar-08	$15.65	$15.98	($0.33)	$12.78	$13.50
Apr-08	$15.57	$15.98	($0.41)	$13.09	$14.31
May-08	$15.50	$15.74	($0.24)	$13.14	$14.49
Jun-08	$15.59	$15.83	($0.24)	$12.54	$13.63
Jul-08	$15.59	$15.75	($0.16)	$12.25	$13.16
Aug-08	$15.70	$15.94	($0.24)	$12.41	$13.34
Sep-08	$15.94	$16.08	($0.14)	$13.11	$13.99
Oct-08	$15.40	$15.55	($0.15)	$13.19	$13.98
Nov-08	$15.21	$15.39	($0.18)	$12.88	$13.86
Dec-08	$15.13	$15.19	($0.06)	$12.92	$14.01
May-Dec Avg	**$18.00**	**$18.32**	**($0.32)**		
2008 Avg	**$15.64**	**$15.85**	**($0.21)**		

- Cash Market: Cheese prices rebounded this week and butter was about steady in the spot market. Buyers moved from blocks to barrels, picking up 20 loads to only 1 barrel, and in the process pushed blocks up 1½¢ to reach $1.71/lb today. Barrels gained 3¾¢ to $1.69/lb. Butter was quiet with no trades the entire week, though it settled a ¼¢ higher than last week at $1.49¼/lb.
- Weekly NASS dairy prices were up strong this week, with the exception of dry whey. 40-lb blocks increased 8.8¢ to average $1.56/lb and 500-lb barrels gained 7.3¢, also at $1.56/lb. Butter added 4¢ to average $1.43/lb while nonfat dry milk increased 8.5¢ to $1.64/lb. Dry whey was down slightly, losing 0.9¢ to average 75.8¢/lb.
- The largest dairy cooperative in the Southeast announced this week that as of September 1st, they will no longer market milk from cows treated with rBST. The decision was driven by customer demand, which includes the largest grocery chain in the region, Publix Super Markets. Producers who continue to use rBST will have to pay an additional handling charge, including transportation.
- Weekly dairy cow slaughter for the week ending 05/05 was 47,200 head, higher than the 40,800 that were culled during the same week a year ago. YTD the weekly slaughter is now up 15.7% vs. last year as 123,900 additional head have exited the milking herd.
- Hay stocks are down 29.8% vs. last May, according to statistics cited in Fluid Milk & Cream Review. California milk output continues to come off its peak and Class I demand has remained steady. In Arizona, milk volumes are declining slightly as daytime highs are now topping 100 degrees. Production in New Mexico is off as well, but is attributed more to a limitation of new cows, feed prices, breeding patterns and lingering affects of previous weather. In the Pacific Northwest, milk production is still on the rise, but pastures are not yielding as much feed value as earlier and some early hay fields are being green chopped. Some dairies are looking for additional heifers but are having little luck as prices increase on a weekly basis.
- Prices for Western nonfat dry milk continue to firm, according to Dairy Market News. Any additional offerings quickly trade with good demand from both domestic and foreign accounts. Buyers looking for additional loads are often coming up empty, and contacts indicate they could move more loads to export accounts if the loads were available.

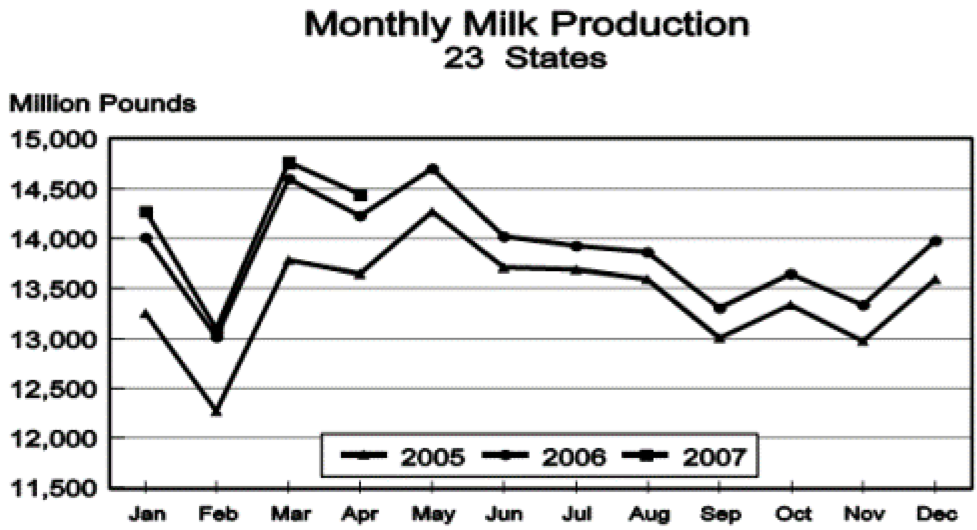


- Dairy Market News reports nonfat dry milk buyers and sellers in the Central region continue to express concern over price and supply during the summer months. Some producers are storing loads for future internal use or contractual sale. Out East, some plants did not schedule any drying for the week due to declines in milk availability.
- Active export trading pushed Western dry whey prices higher this week, according to Dairy Market News. Demand and sales were both higher than last week, and some domestic buyers are short of needs. First quarter exports were 19.4% higher than 2006 levels, and accounted for 44% of total dry whey production during this period.

- Strong domestic and international prices for nonfat dry milk and skim milk powder will allow butter/powder plants to compete aggressively with other class use for milk, according to Dairy Market News. Some buyers are worried about late year milk and cheese availability, so they're trying to build inventory now. Mozzarella remains chronically short of needs, with some orders being shorted due to reduced yields or limited extra milk supplies.
- Dairy Market News reports offerings of current blocks and barrels remains adequate to tight in the Western region. Buyers have not backed off purchasing during the past couple weeks as they need to satisfy both immediate needs and for fall programs.

Bearish Fundamentals:

- Milk Production Report: April milk production in the 23 major states was up 1.6%, according to USDA figures released this afternoon. Production was up 1.3% for all 50 states. This was a little higher than expectation and could lead to further correction on Monday. States with biggest percentage gains were MI up 5.8%, ID up 5.3% and CO up 4.4%. CA increased production by 4.3% and WI was up 2.6%. Milk per cow averaged 1,745 lbs, up 19 lbs from last April. The one supportive element of the report was that the number of milk cows dropped 6,000 head from March to April.



- After the first 14 days in May we're still seeing a moderate build in cheese stocks, according to USDA weekly cold storage numbers. 1.7 million lbs have been added to warehouses for the month; a gain of 1%.
- Butter stocks at CME-approved warehouses increased by 8.6 million lbs for the week ending 05/12, compared to only a 4.5 million lb increase during the same week last year. This was the largest weekly increase since January. Stocks on hand are now only 5.9 million lbs under last year's levels.
- Fluid Milk & Cream Review reports Florida exported 172 loads of Grade A milk this week, compared to 161 last week and only 90 a year ago. Bottlers are looking at reducing bottling schedules as schools start to close over the coming weeks. Demand for cream has not been overly aggressive, while ice cream production has been slow in developing this season.
- Central whey prices continue to be mixed, according to Dairy Market News. Some producers are in balance, but others have loads to clear and are offering them at steady to lower prices.

Recommendation:

The Class III market was even more volatile this week as we saw over a $1 move from intraday low to high in some contract months on Thursday. Today we had a gain in the cash cheese market which resulted in a broad sell-off! Word from the street was that is was profit-taking in advance of today's Milk Production Report. The market is very nervous at these levels and continues to act very emotionally. Expect volatility to increase further. We're seeing some renewed strength in the cheese market as reports indicate current cheese is starting to tighten up. Buyers in this week's spot market seemed anxious to own product and never allowed the block price to drop more than a penny or two before jumping back in and bidding for more. Most of the country is off peak milk production and warmer weather is affecting solids levels. With the continued high cost of nonfat dry milk, cheese plants are not able to fortify the vat so are processing more milk as yields drop. In addition, the ability for the dry whey prices to hold in this week's AMS numbers and even climb higher out West demonstrated that a big correction to the downside is unlikely. International demand is what is supporting both nonfat dry milk and dry whey prices so well at this time, and it doesn't look like that will end soon. Everyone we talk to, from the floor trader in the dairy pit, to other brokers, to dairy producers **expect** to see $20+ milk at some point, and that probably scares us the most. Yes, the potential is there and that is our bias, but when everybody thinks something should happen, any little glitch will send the market tumbling. For that reason, we still feel it's important to take action to protect your income. It will be very difficult, if not impossible, to buy PUT options during a market freefall. Continue to target the July-Dec 16.50 PUTs at 30¢ average for each, or start selling some milk on any month that gets over $19.50. You will never be able to pick the top, and anything over $19 is an amazing price. For 2008, we're growing more concerned that a big jump in prices now will result in lower prices in 2008, especially the last half. Consider selling 25% of your production if 2008 hits an average of $16 (currently $15.64). For Q1 2008 we still like the fence strategy, buying the 15.00 PUT and selling the 17.50 CALL for a net cost of 10¢ each month. This trade results in a floor of 14.90 and a cap on your milk at 17.40 for very minimal cost. Give us a call next week and we'll help you put together a risk management strategy for your operation!