The KDM Dairy Report – July 13th, 2007

Bullish Fundamentals:

Futures Month	Friday 07/13 Close	Friday 07/06 Close	Change	5-yr Average	Top 3rd Price
Jul-07	$21.17	$20.95	$0.22	$12.25	$13.16
Aug-07	$18.98	$19.45	($0.47)	$12.41	$13.34
Sep-07	$18.84	$19.50	($0.66)	$13.11	$13.99
Oct-07	$18.00	$18.12	($0.12)	$13.19	$13.98
Nov-07	$17.20	$16.95	$0.25	$12.88	$13.86
Dec-07	$16.85	$16.60	$0.25	$12.92	$14.01
Jan-08	$15.80	$15.70	$0.10	$12.50	$13.33
Feb-08	$15.30	$15.00	$0.30	$12.53	$13.21
Mar-08	$15.25	$14.90	$0.35	$12.78	$13.50
Apr-08	$15.15	$14.80	$0.35	$13.09	$14.31
May-08	$14.96	$14.76	$0.20	$13.14	$14.49
Jun-08	$15.15	$14.84	$0.31	$12.54	$13.63
Jul-08	$15.30	$15.10	$0.20	$12.25	$13.16
Aug-08	$15.45	$15.14	$0.31	$12.41	$13.34
Sep-08	$15.58	$15.40	$0.18	$13.11	$13.99
Oct-08	$15.06	$14.84	$0.22	$13.19	$13.98
Nov-08	$14.85	$14.74	$0.11	$12.88	$13.86
Dec-08	$14.61	$14.50	$0.11	$12.92	$14.01
Jly-Dec Avg	**$18.51**	**$18.60**	**($0.09)**		
2008 Avg	**$15.21**	**$14.98**	**$0.23**		

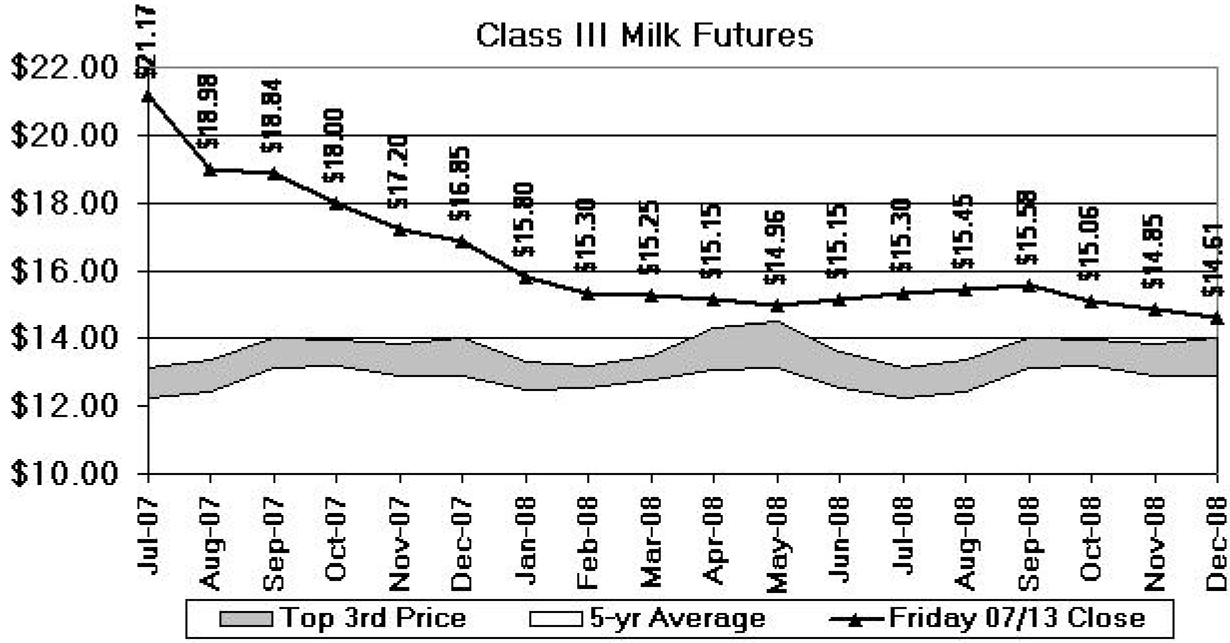
- World Ag Supply & Demand Report: USDA left the milk production forecasts virtually unchanged from last month and continue to stress that dairy prices should remain strong as both domestic and international demand remains firm. As a result, they increased their price forecasts for both Class III milk and cheese. For 2008, USDA expects Class III to average &17.05/cwt, up 50¢ from last month's forecast of $16.45. Cheese is expected to average $1.60/lb, up from last month's estimate of $1.535/lb.
- NASS survey numbers continue to support the futures market. For the week ending July 7th, 40-lb cheddar blocks and 500-lb barrels averaged $2.02/lb, a 0.4¢ increase for blocks and 0.1¢ gain for barrels. Butter was up 0.2¢ to $1.47/lb while nonfat dry milk set a new NASS high of $2.03/lb, up 3.5¢ from last week. Dry whey was the lone loser, but only down 0.1¢ to 74.7¢/lb.
- Weekly cold storage statistics are showing a 1% drop in cheese stocks for the first 9 days of July. That represents a decrease of 1.4 million lbs.
- Some schools are set to re-open during the second week of August in the Southeast, so some bottlers are preparing to fill the pipeline, according to Fluid Milk & Cream Review.
- Heat is affecting milk production in the Pacific Northwest, according to Fluid Milk & Cream Review. Temps over 100 degrees were common with nighttime readings also very high. Hay supplies remain tight in the region and prices are very firm.
- Total butter stocks at CME-approved warehouses continue to lag behind last year by about 10 million lbs. For the week ending 07/07, stocks increased 701,000 lbs, but that was less than half the increase a year ago of 1.6 million lbs.
- Dairy Market News reports that although buyers have been reluctant to purchase cheese above $2, not a lot of cheese has been purchased for fall programs. Buyers are waiting to see if the price softens further, but with the potential for more summer heat issues in the West, cheese sellers are becoming more optimistic about future market trends.

Bearish Fundamentals:

- Cash Market: After making gains last week, cheese was unable to push any higher and feels tired. Blocks lost a ½¢ for the week, settling at $1.96/lb, while barrels gained a ½¢ to close at $1.93/lb. Butter managed to increase 3½¢ to $1.49/lb. 4 loads of blocks, 0 barrels and 4 cars of butter exchanged hands.
- Milk production in Florida has stayed surprisingly strong despite summer temperatures, according to Fluid Milk & Cream Review. 131 loads of milk were exported this week, but last year at this time they were in a milk deficit situation, importing 14 loads.
- Dairy Market News reports May fluid milk sales were down 0.9% vs. last May.
- Because of sufficient milk production in the Southeast, handlers in the Central region of the country do not expect so ship any milk in that direction until August, according to Fluid Milk & Cream Review. Class I sales are very light, and bottlers expect fluid sales to remain sluggish until prices decline significantly. Cheese plant inventories have been increasing with operators reluctant to build more.
- Fluid Milk & Cream Review reports there is plenty of extra milk in California. Milk receipts dropped briefly by as much as 7% during the recent heat wave, but have now rebounded, to the extent that some processors were even looking to move additional milk outside of the state.
- The whey market is continuing to show signs of weakness as there are more reports of stocks building. Domestic and international buyers are waiting until there is a more definite direction before placing long-term orders. Demand from Asian markets has decreased in recent weeks.

- Dairy Market News reports the cheese market as "sluggish", which normally indicates weakness. Buyers are purchasing only for immediate fill-in needs, [not wanting to build inventory] or put cheese into storage at current price levels.

Recommendation:



Trading at more than a $2 discount to July, one would have expected August to rally quite strongly after blocks were bid up 2½¢ today in the cash cheese market. But instead, it settled 7¢ lower for the day. The market continues to feel tired, with virtually everyone expecting cheese to drop in the near future to about the $1.80/lb level. In fact, the market has predicted just that with the substantial discount Aug and Sep futures are currently trading. If cheese doesn't drop soon, however, August futures will start to rally in a hurry as it begins to price under NASS numbers next week. We think the market is correct, however, and continue to have a negative bias in the short-term. Just look at the evidence above, which conforms to anecdotal reports from our contacts in the industry. Buyers are waiting to see how low cheese prices will go before jumping back in, and while not burdensome, cheese supplies appear to be building. As we explained last week, however, we would be more comfortable defending a drop in the short-term with PUT options. Selling at these levels may not be the best strategy, unless you can buy your contracts back. We say this, because punching in the numbers for $1.80 cheese and 50¢ whey still yields about $18.25 milk. How much downside are you protecting by selling Aug at today's close of $18.98? We would continue to recommend buying an at-the-money PUT which will increase in value sooner if prices drop. Buy the 19.00 Aug PUT for 60¢ and the Sep 18.75 PUT for 70¢. If prices drop in the near term, exit the hedge early and take a profit, which you can add to your milk check where ever these months settle. Remember, buying a 19.00 PUT for 60¢ yields an effective floor of $18.40. That's not much higher than our predicted potential low of $18.25, and by the time we get to the end of August, the option is likely to settle without value. Do the same for Sep. For those that have already sold milk at substantially lower prices, you may have an opportunity over the next few weeks to pick up some attractive CALL options Sep-Dec. See this potential correction as an opportunity and get some coverage as the long-term outlook remains quite good. We would leave 2008 alone. Considering long-term demand and the potential for substantially higher soybean meal costs (Dec meal settled at $265.50/ton) adding to input expenses, the current average of $15.21 is not yet attractive enough to start your hedge program. As we've mentioned in earlier reports, we'd like to see at least a $16.00 average before considering any hedges. With USDA predicting 2008 to average $17.05 (not that they've ever been very accurate in the past), it may spur some commercial long hedgers to enter the market for coverage.

We are continuing to visit farms in WI and MN! Let us know if you'd like an on-farm visit! Call 877.695.8538 to set up an appointment!