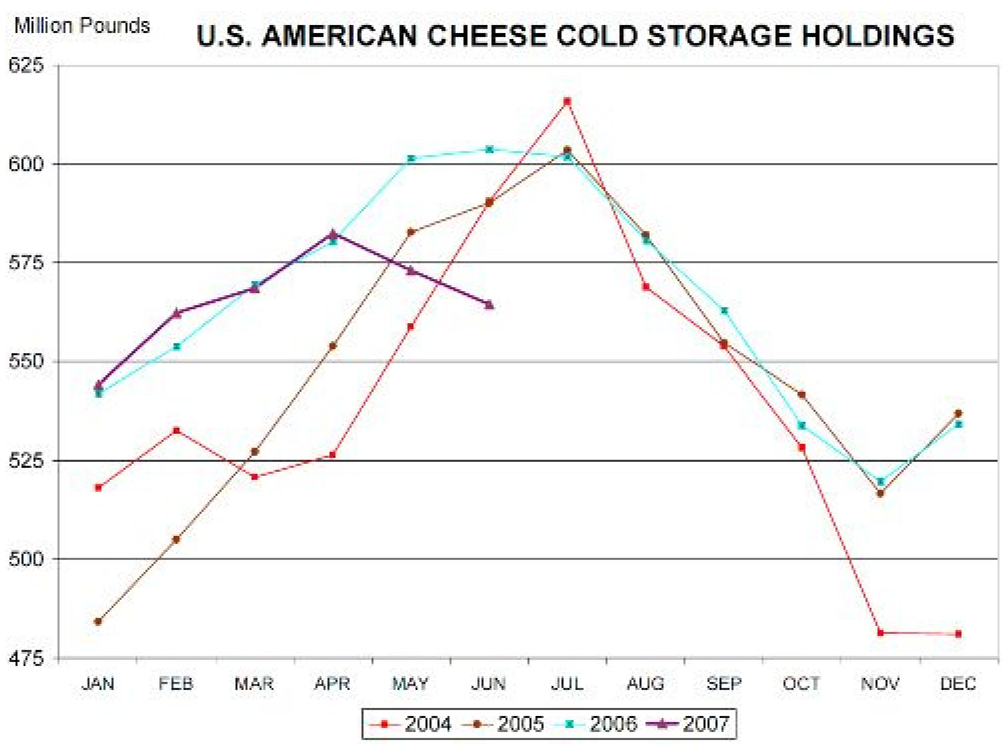
The KDM Dairy Report – July 20th, 2007

Bullish Fundamentals:

Futures Month	Friday 07/20 Close	Friday 07/13 Close	Change	5-yr Average	Top 3rd Price
Jul-07	$21.29	$21.17	$0.12	$12.25	$13.16
Aug-07	$19.10	$18.98	$0.12	$12.41	$13.34
Sep-07	$17.80	$18.84	($1.04)	$13.11	$13.99
Oct-07	$17.30	$18.00	($0.70)	$13.19	$13.98
Nov-07	$16.89	$17.20	($0.31)	$12.88	$13.86
Dec-07	$16.27	$16.85	($0.58)	$12.92	$14.01
Jan-08	$15.48	$15.80	($0.32)	$12.50	$13.33
Feb-08	$15.05	$15.30	($0.25)	$12.53	$13.21
Mar-08	$15.04	$15.25	($0.21)	$12.78	$13.50
Apr-08	$15.03	$15.15	($0.12)	$13.09	$14.31
May-08	$14.96	$14.96	$0.00	$13.14	$14.49
Jun-08	$15.03	$15.15	($0.12)	$12.54	$13.63
Jul-08	$15.16	$15.30	($0.14)	$12.25	$13.16
Aug-08	$15.20	$15.45	($0.25)	$12.41	$13.34
Sep-08	$15.35	$15.58	($0.23)	$13.11	$13.99
Oct-08	$14.88	$15.06	($0.18)	$13.19	$13.98
Nov-08	$14.74	$14.85	($0.11)	$12.88	$13.86
Dec-08	$14.58	$14.61	($0.03)	$12.92	$14.01
Jly-Dec Avg	**$18.11**	**$18.51**	($0.40)		
2008 Avg	**$15.04**	**$15.21**	($0.16)		

- Milk Production Report: While the balance of the report was slightly bearish, June cow numbers for all 50 states were down 10,000 head vs. June 2006, which is a drop of an additional 8,000 head from May. Jan-June milk production is up only 1% for the year, less than the 1.8-2.0% increase usually needed for population/demand growth.
- Cold Storage Report: American cheese stocks in June were down 7% vs. a year ago and down 2% from May, while total cheese stocks were unchanged. Butter stocks were up 5% vs. last year and up 2% vs. May.
- Livestock, Dairy & Poultry Outlook Report: USDA's monthly look at the dairy sector comes with some caution. They site current high milk prices as likely to increase cow numbers, and that could moderate prices slightly in 2008. However, output per cow is expected to rise only 1.4% and tight world supplies along with a weak dollar should keep exports strong. Australia is not expected to increased nonfat dry milk supplies until 2008 at the earliest and low availability from Europe should keep global supplies tight. USDA expects cheese prices to stay high throughout the balance of 2007 and then moderate in 2008. Even so, they predict 2008 Class III milk will range from $16.55 to $17.55 for the year, which is much higher than the current average as of today's close at $15.04.
- Weekly cold storage numbers continue to reflect a 1% drawdown in cheese stocks. For the first 16 days in July, holdings are down 1.6 million lbs.
- Dairy Market News reports that butter makers in the Central region are seeing buyer interest from Europe, looking for butterfat in butter and anhydrous milk fat.
- International: Dairy Market News reports firm prices and limited supply continue to be the case for dairy products in Europe. Milk production is edging lower in the region and hot temperatures are being recorded in most areas. The strong Euro vs. the U.S. dollar have only made prices higher.
- International: European whey prices had weakened, but are now trending higher. Stocks of powder are available but tightening, and buyer interest is gaining momentum, according to Dairy Market News.
- International: Buyer interest remains strong in Oceania, and handlers indicate that all of first half production is committed, with traders now working on second half needs. Prices for dairy products remain firm and are expected to stay that way for the foreseeable futures, according to Dairy Market News.



Bearish Fundamentals:

- Cash Market: Block cheese plummeted 11½¢ for the week and barrels lost 10¢, with most of the loss coming in today's spot session. Blocks now stand at $1.84½/lb while barrels are at $1.83/lb. Butter gained 3¢ to settle at $1.52/lb. 7 loads of blocks, 12 barrels and 10 cars of butter exchanged hands.
- Milk Production Report: In the 23 major dairy states, June milk production was solidly above expectations at 1.2% higher than last year. While cow numbers fell as a nation, the 23 major states added 19,000 head vs. a year ago and were up 2,000 had from May 2007. Milk per cow was up 16 lbs. California came on strong, up 4.1%, and Colorado increased output by 6%, followed by Arizona at 5.9%.
- Livestock Slaughter Report: 7,000 fewer dairy cows went to slaughter during the June vs. the prior year, the first time cull numbers have been lower this year. Year-to-date, dairy cow slaughter is still 12% ahead of 2006, but that could change if producers continue to hang on to cows.
- Cattle Inventory Report: USDA's twice-annual look at U.S. cattle inventory has the number of milk cows unchanged from last year at 9.15 million head, but the number of milk replacement heifers is up 3% to 3.9 million head.
- Dry whey prices are falling in the Central region, and traded between 64-70 cents this week. Dairy Market News reports production is strong and stocks are still building. Buyers sense further drops in price so are purchasing on only a hand-to-mouth basis.
- Demand for dry whey is slower in the Western region as well. Prices are sharply lower as domestic buyers take a wait and see attitude on new purchases. Exports accounted for 50% of total dry whey production for the period Jan-May.
- With the exception of nonfat dry milk, NASS surveyed prices were down across the board. Cheddar blocks dropped 2.5¢ to average $2.00/lb and barrels fell 3.7¢ to $1.98/lb. Butter decreased 2.1¢ to $1.45/lb and dry whey shed 1.8¢ to 73.5¢, but nonfat dry milk was up 0.7¢ to $2.04/lb.
- Weekly dairy cow slaughter numbers continue to trail the aggressive pace set earlier this year when close to 50k animals were culled. For the week ending 07/07, 33,600 animals went to slaughter vs. 34,300 head during the same period last year.
- In the Central region, Fluid Milk & Cream Review reports Class I sales are slow, even for summer, and manufacturing milk interest is spotty. Cheese plants are wary of building inventory at current prices and are not actively pursuing new producers.
- In the Southeast, milk handlers report surprisingly steady milk production for this time of year, with high volumes moving in to balancing plants. Florida shipped out 118 loads of milk this week, compared to importing 16 loads during the same period last year.
- California milk production has rebounded from recent weather related declines, according to Fluid Milk & Cream Review. Nights are comfortable and there is ample availability of quality hay, while more cows are freshening. Culling rates appear to be lower and plants are running full, with milk being moved around to find a home.

Recommendation:

The price drop that the futures market had been predicting for the past few weeks finally happened today as block cheese fell 9¼¢ and barrels lost 9½¢ in the cash session. Class III futures responded predictably lower during the free-fall, but when cheese buyers stepped in and started pushing the price back up, milk futures started moving back towards unchanged for the day after being as far down as 50¢ lower. What's ironic is that for the past two Friday's, cheese has gone up and milk futures have dropped. Today cheese fell, but by the end of the pit-traded session, milk futures were unchanged to up to 44¢ higher in November. Why? Because some of the months were overdone to the downside. When buyers stepped in to purchase $1.84 blocks and $1.83 barrels, it gave the floor some confidence, a support level, that cheese would have a hard time falling below $1.80/lb. We wrote just last week that $1.80 cheese yields about $18.25 milk, but Oct traded as low as $16.70 and Nov went down to $16.35. Too low! Our current cash price works out to about $19.20 milk, so as long as we don't see another 10¢ drop in cheese next week, we'd expect to see Aug hang in there and Sep and beyond start to recover. Navigating the next few weeks could continue to be treacherous, but market extremes to either side provide opportunity. For those that have sold milk previously at lower levels, either buy the contracts back or purchase CALL options which will add value to your contracts if prices continue to recover! For those with PUT options that were purchased before the crash, if you are an aggressive hedger, consider taking your profits now and add $1.00 to $1.50 to your milk check Aug-Oct.