



The KDM Dairy Report – August 10th, 2007

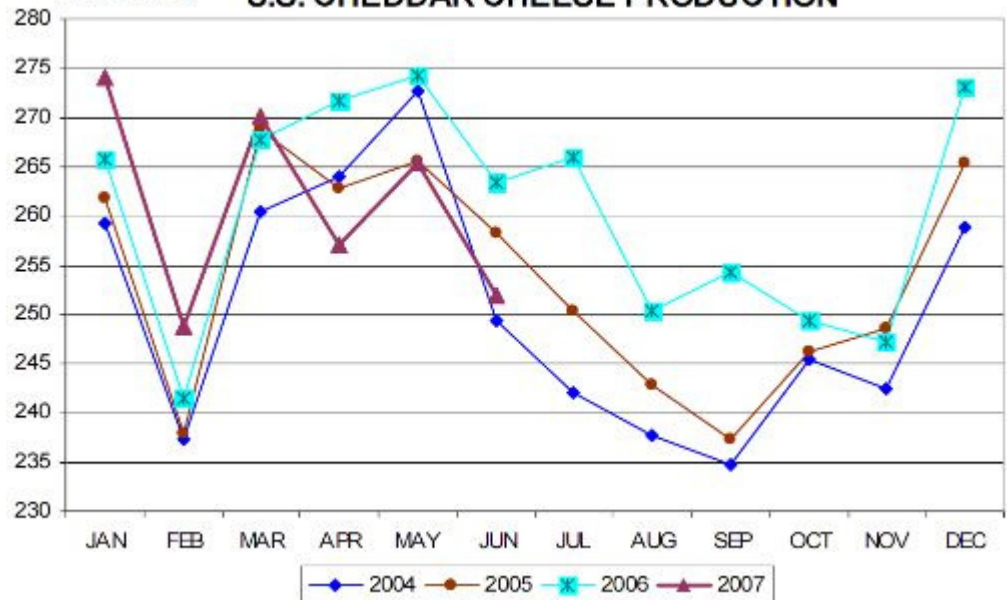
Bullish Fundamentals:

- Dairy Products Report: Total cheese output in June was down vs. a year ago for the first time since 2005, according to USDA figures released last Friday. The 790 million lbs manufactured was 0.8% below June 2006 and 3.7% less than the previous month. American cheese output was [down an even stronger 4.6%](#) compared to June 2006 and down an identical 4.6% vs. May. Butter production was up 9.3% vs. a year ago, while nonfat dry milk output was up 2.1% and dry whey up 1.9%.
- World Ag Supply & Demand Report: USDA's monthly look the ag markets is [mostly supportive](#) for dairy. Firm demand for dairy products, along with strong international prices is expected to continue to support U.S. prices. A tight supply of alfalfa and lower rBST use is forecast to limit growth in milk per cow. However, high replacement heifer supply and a weakening whey market caused them to slightly lower the Class III price forecast for 2008 down 15¢ from last month to \$16.90/cwt.
- Cash Market: Both blocks and barrels continued to make gains in the spot market. Blocks were up 3¾¢ from last week to settle at \$1.94/lb and barrels gained the same amount to close at \$1.90/lb. Butter lost 2¼¢, settling at \$1.48/lb. Buyers were active again, purchasing 9 loads of blocks, 8 barrels and 6 cars of butter.
- The heat wave out East combined with a shortage of hay is having a [negative affect on milk production](#), according to Fluid Milk & Cream Review. A net 34 loads of milk were shipped in to the region as heat indices above 100 degrees during the day and nights above 70 took their toll. Some producers are being forced to buy hay from other states at \$200/ton as pasture growth is stunted. At the same time, bottling demand is starting to pick up as school begins to open in the region.
- Manufacturing [milk interest is picking up](#) in the Central region, according to Fluid Milk & Cream Review. But milk receipts are starting to drop due to recent warmer temps, and components are lower as well. Some corn is being chopped early in Wisconsin due to drought loss, and tighter hay supplies are forcing prices sharply higher.
- Milk output is trending lower in New Mexico due to hot and humid conditions, according to Fluid Milk & Cream Review. In addition, less milk is now available for manufacturing as Class I needs are pulling milk out of state and in to the Southeast.
- The cheese market is showing some sign of firming, as buyers start to focus on fall and school products, according to Dairy Market News. Orders for natural cheese [have improved](#) in the Midwest region, while out West, cheese offerings

Futures Month	Friday 08/10 Close	Friday 08/03 Close	Change	5-yr Average	Top 3rd Price
Aug-07	\$19.83	\$19.99	(\$0.16)	\$12.41	\$13.34
Sep-07	\$19.68	\$19.40	\$0.28	\$13.11	\$13.99
Oct-07	\$18.61	\$18.35	\$0.26	\$13.19	\$13.98
Nov-07	\$17.68	\$17.80	(\$0.12)	\$12.88	\$13.86
Dec-07	\$17.24	\$17.09	\$0.15	\$12.92	\$14.01
Jan-08	\$16.07	\$16.10	(\$0.03)	\$12.50	\$13.33
Feb-08	\$15.77	\$15.63	\$0.14	\$12.53	\$13.21
Mar-08	\$15.73	\$15.65	\$0.08	\$12.78	\$13.50
Apr-08	\$15.66	\$15.57	\$0.09	\$13.09	\$14.31
May-08	\$15.62	\$15.48	\$0.14	\$13.14	\$14.49
Jun-08	\$15.62	\$15.48	\$0.14	\$12.54	\$13.63
Jul-08	\$15.68	\$15.55	\$0.13	\$12.25	\$13.16
Aug-08	\$15.75	\$15.65	\$0.10	\$12.41	\$13.34
Sep-08	\$15.86	\$15.78	\$0.08	\$13.11	\$13.99
Oct-08	\$15.38	\$15.32	\$0.06	\$13.19	\$13.98
Nov-08	\$15.17	\$15.09	\$0.08	\$12.88	\$13.86
Dec-08	\$15.07	\$14.99	\$0.08	\$12.92	\$14.01
Aug-Dec Avg	\$18.61	\$18.53	\$0.08		
2008 Avg	\$15.62	\$15.52	\$0.09		

Million Pounds

U.S. CHEDDAR CHEESE PRODUCTION



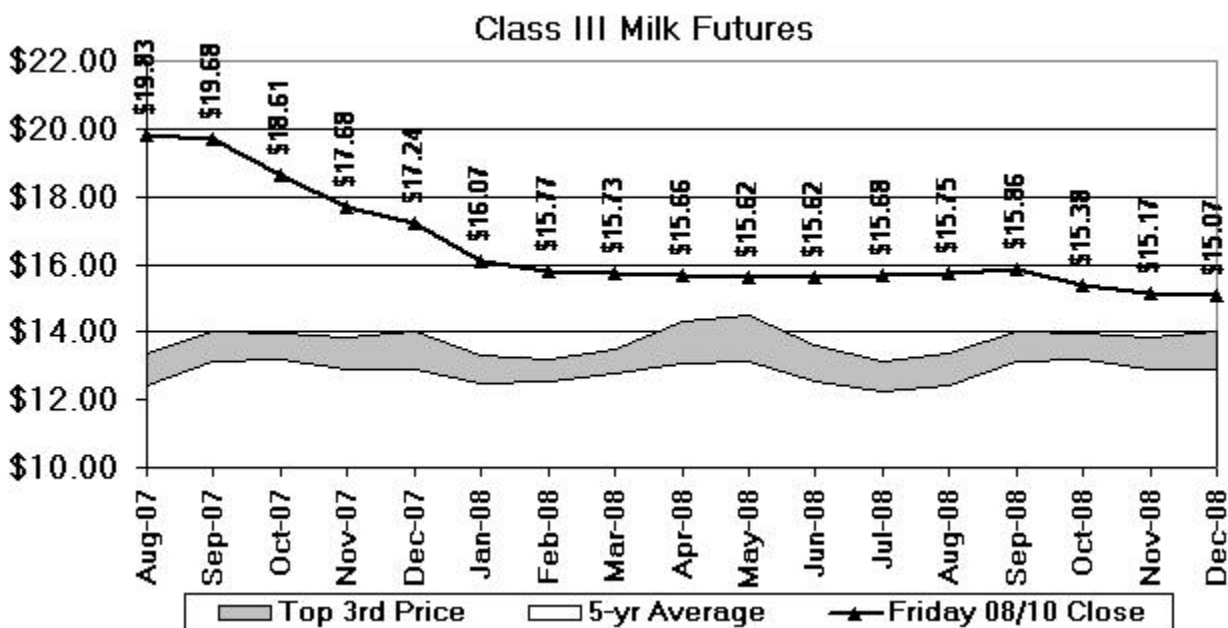
are adequate but not heavy, possibly due to cheese plants limiting production in light of current cheese and milk prices. Buyers are tentative about owning cheese in early August above \$1.90/lb, but that [they know they need more](#).

Bearish Fundamentals:

- NASS surveyed cheese prices [continue to fall](#). Blocks lost 5.8¢ to average at \$1.89/lb and barrels shed 3.9¢ to \$1.90/lb. Butter increased 1.5¢ to \$1.49/lb and nonfat dry milk gained 2.2¢ to average \$2.03/lb, but dry whey lost 3.6¢ to 65.4¢/lb.
- 4.3 billion lbs of packaged fluid milk was sold in the U.S. in June, according to Dairy Market News, but the total was [down 0.8%](#) compared to June 2006.
- Dairy cow slaughter numbers [remain unremarkable](#), basically keeping pace with last year. 42,000 head were culled during the week ending 07/28, compared to 43,200 for the same period last year.
- Heavy milk production in California continues to be the theme this week, as high milk prices, favorable weather and ample feed encourage output. Fluid Milk & Cream Review reports processors are still [struggling to handle the milk](#) and are running at capacity.
- Dairy Market News reports cream offerings are [heavier than anticipated](#) for this time of year, while churning is more active than usual. Butter producers are expressing confidence that despite increased international interest, they don't foresee prices moving significantly from now through the end of the year.
- Dry whey production remains heavy, especially feed-grade, according to Dairy Market News. But decreased feed-grade demand and a [slow down in exports](#) are causing further erosion in prices.

Recommendation:

Each week that goes by without a major correction in the cheese market brings us closer to fall/holiday/school buying, with most buyers' needs still not covered. However, any major push higher, say to the \$2 level is likely to find resistance.



We may just stay near these levels for the next few weeks, which would be supportive for the Q4 contracts still trading at a discount to cash prices. While violent moves up or down is very possible, at this point we think there is more risk to the upside in the remaining 2007 months than down. But that doesn't mean you should go unprotected; we might be wrong! Continue to target PUT options Sep-Dec. Bid 25¢ for the Sep 19.00 PUT and 30¢ for the Oct 17.75 PUT. Wait for cheaper options in Nov and Dec on a rally later this summer or early fall. We continue to recommend holding off on outright sales in 2008 until we get above a \$16 average, but for large dairies, we would consider a min-max strategy, buying the Jan-Apr 15.00 PUT and selling the 17.00 CALL for a net cost of 5¢ on up to 25% of your production. That establishes a record-high floor for minimal cost, while yielding \$2 upside if the markets stay strong. What's not to like with that? Call us if you have questions!

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