



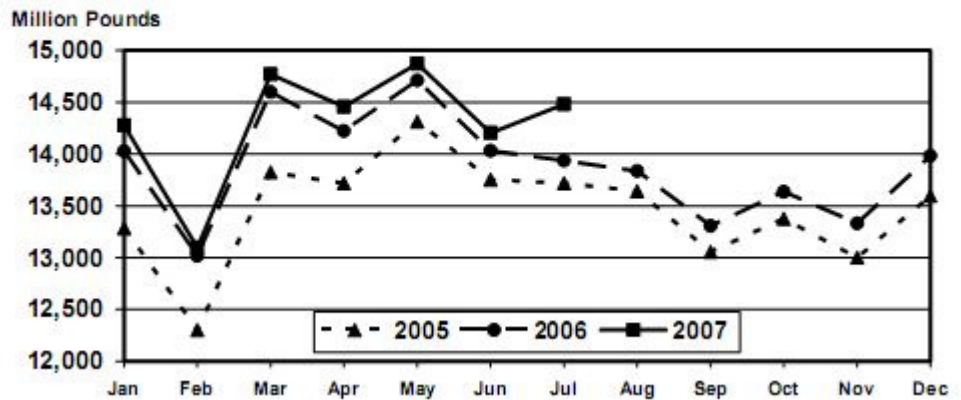
The KDM Dairy Report – August 17th, 2007

Bullish Fundamentals:

- Dairy exports for the first half of 2007 led to a trade surplus, according to the U.S. Foreign Ag Service. U.S. dairy exports totaled \$1.22 billion, up 31.8% from 2006. That resulted in a trade surplus of \$75.5 million, compared to a trade deficit of \$200.2 million during the first half of 2006. Dry whey exports were up 19.3%, butter exports up a whopping 86% and cheese exports up 47%.
- USDA's weekly cold storage stats have [cheese stocks down 1%](#) at selected storage centers for the period 08/01 through 08/13.
- Slaughter numbers seem to be [picking back up](#). For the week ending 08/04, 44,200 head of dairy cows were culled, compared to 42,900 during the same period a year ago.
- What a difference a week makes! Last week 42 loads of Grade A milk were shipped in to the Southeast. This week, 357. Hot, humid weather over the past ten days [has affected cow comfort and milk production](#), according to Fluid Milk & Cream Review. At the same time, demand is up as school pipelines prepare for opening. Manufacturers are being cut back on shipments to barebones levels in order to fill bottling needs, while adequate trucking capacity to move milk has been hard to come by.
- Fluid Milk & Cream Review reports milk is [moving out of the Central region](#) from Wisconsin, Iowa, Minnesota and Michigan, to Missouri, Kentucky and even as far as Florida. The effort to segregate milk based on Posilac use is causing extra miles and expense for farm milk pickups, and components are at summer low levels.
- Milk output in New Mexico continues to be lower than a year ago. Hot weather, [fewer cows](#) in the state and less milk per cow are all contributing to the loss.

Futures Month	Friday 08/17 Close	Friday 08/10 Close	Change	5-yr Average	Top 3rd Price
Aug-07	\$19.82	\$19.83	(\$0.01)	\$12.41	\$13.34
Sep-07	\$19.36	\$19.68	(\$0.32)	\$13.11	\$13.99
Oct-07	\$18.38	\$18.61	(\$0.23)	\$13.19	\$13.98
Nov-07	\$17.41	\$17.68	(\$0.27)	\$12.88	\$13.86
Dec-07	\$17.09	\$17.24	(\$0.15)	\$12.92	\$14.01
Jan-08	\$15.85	\$16.07	(\$0.22)	\$12.50	\$13.33
Feb-08	\$15.42	\$15.77	(\$0.35)	\$12.53	\$13.21
Mar-08	\$15.45	\$15.73	(\$0.28)	\$12.78	\$13.50
Apr-08	\$15.37	\$15.66	(\$0.29)	\$13.09	\$14.31
May-08	\$15.24	\$15.62	(\$0.38)	\$13.14	\$14.49
Jun-08	\$15.31	\$15.62	(\$0.31)	\$12.54	\$13.63
Jul-08	\$15.45	\$15.68	(\$0.23)	\$12.25	\$13.16
Aug-08	\$15.42	\$15.75	(\$0.33)	\$12.41	\$13.34
Sep-08	\$15.65	\$15.86	(\$0.21)	\$13.11	\$13.99
Oct-08	\$15.26	\$15.38	(\$0.12)	\$13.19	\$13.98
Nov-08	\$15.05	\$15.17	(\$0.12)	\$12.88	\$13.86
Dec-08	\$14.97	\$15.07	(\$0.10)	\$12.92	\$14.01
Aug-Dec Avg	\$18.41	\$18.61	(\$0.20)		
2008 Avg	\$15.37	\$15.62	(\$0.24)		

Monthly Milk Production 23 States

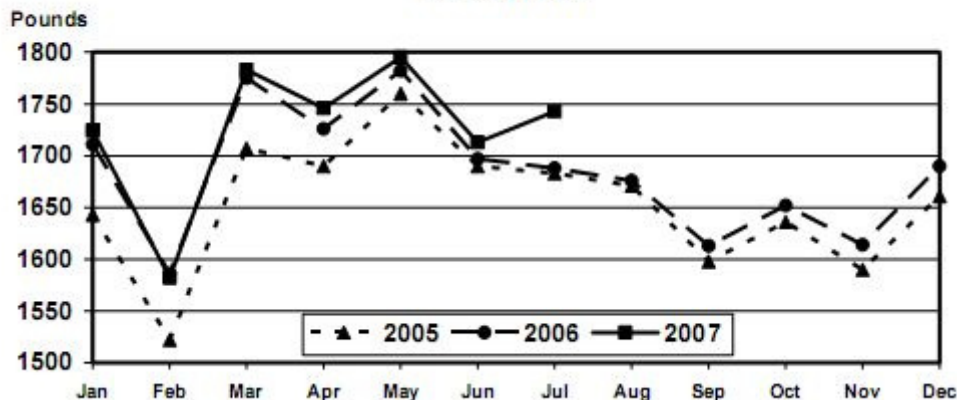


- Alfalfa quality remains an issue, causing dairies to look out of state for additional supplies.
- International: Stock levels of European dairy products continue to be lighter than desired, according to Dairy Market News. The growth of the EU to 27 countries is limiting surplus volumes for international sale. Butterfat, in particular, is in [very tight supply](#), and outside sources are being sought.
- International: The new season of milk production in New Zealand is off to a slow start, while water levels in Australia are still well below last year's levels, according to Dairy Market News. This is putting upward pressure on early season pricing. Stocks of dairy end products remain limited, while [new production is fully committed](#) for the first half of the production season.
- Cheese buyers are being very cautious with their purchase strategies due to the variability in prices, but some are beginning to think that cheese in the [mid \\$1.90's may look like a good buy](#) by the end of August, according to Dairy Market News. Mozzarella interest is picking up as schools ready to open and as the fall pizza season begins.

Bearish Fundamentals:

- Milk Production Report: July milk production in the 23 major states was up a big 3.9%, [far higher than anyone's expectations](#) (see graphs). The increase was primarily driven from a strong increase in milk per cow of 55 lbs above July 2006, and an 50,000 more milk cows than last year. Cow numbers also increased by a strong 14,000 head from June to July. Gains were led by California, up 10.6%, Arizona up 10.4%, Michigan up 7.2% and Colorado up 6.3%. Wisconsin was up 4.1%.
- Cash Market: Blocks were able to inch 2¢ higher on the week to settle at \$1.96/lb but barrels dropped a penny to \$1.89/lb and butter lost a dime, falling to \$1.38/lb. 4 loads of blocks, 3 barrels and 12 cars of butter exchanged hands.
- NASS prices were mixed buy [mostly negative](#) this week. 40-lb blocks managed to increase 0.4¢ to \$1.89/lb, but barrels lost 2.3¢ to average \$1.87/lb and dry whey was 2.2¢ lower to 63.3¢/lb. Nonfat dry milk averaged \$2.05/lb, up 2¢ from last week, but butter fell 1.3¢ to \$1.48/lb.
- International: The European whey market continues to be weak, according to Dairy Market News. Prices are still falling as cheese production is strong and thus [whey volumes are increasing](#). Supplies are surpassing demand.
- Marginal cows are staying in the milking strings longer as California producers continue to capitalize on high milk prices, according to Fluid Milk & Cream Review. Processing plants remain full and milk continues to be moved out of state.
- Although there's been a lot of hype around international interest for butter, reports of actual commercial sales have been [less than anticipated](#), according to Dairy Market News. Most producers feel that sales volumes will not be enough to cause supply shortages, and that heavy cream offerings and fall churning activity should be sufficient to meet both international and domestic demand.
- Dairy Market News reports the domestic dry whey market remains weak, as buyers wait for a bottom and [supplies are still heavy](#).

Monthly Milk per Cow
23 States



Recommendation:

Get ready for more uncertainty. While there appears to be good support in the cheese market, this week saw a dramatic sell-off in the stock market, followed by a bearish milk production report today. Our generally friendly bias towards the milk market has some major assumptions, including continued solid domestic and international demand. We saw a nice recovery in the stock market today, but if the housing/credit crunch cause further major correction, consumers could tighten their purse strings and we could see a drop in demand. That would change the model. But we're not ready to panic yet. Despite the bearish milk production report, international demand is for real! Check out the stats in the first bullet! A cool July allowed California to really crank it up, and the strong milk price gave every incentive to make milk. But since then, the Eastern region of the U.S. has been under a heat crunch in August, and contacts tell us that while spot loads of milk were available everywhere a few weeks ago, suddenly we're short. Also, the action in the cheese market gives us some confidence that we're not burdensome on the supply side of cheese. Schools are getting ready to open and cheese plants are limiting output by sending extra loads to be turned in to nonfat dry milk. We expect Monday to open lower based on the production report, but if the cheese market holds or goes higher, the report will be quickly forgotten. Continue to look for PUT options Oct-Dec. For 2008, we really like the fence strategy, buying the 15.00 PUT and selling the 17.00 CALL Jan-Apr. This yields a minimum price at 15.00 and a cap at 17.00. Jan-Mar have never settled above \$15, so you're establishing a record high floor for very little cost, while keeping a further \$2 in upside should the market stay strong. But even if the market stays strong and you're capped at \$17, how much upside are you risking? Will we have \$25 milk in those months? \$20? We think this is a very solid strategy on up to 30% of your production. Call us if you have further questions.

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