

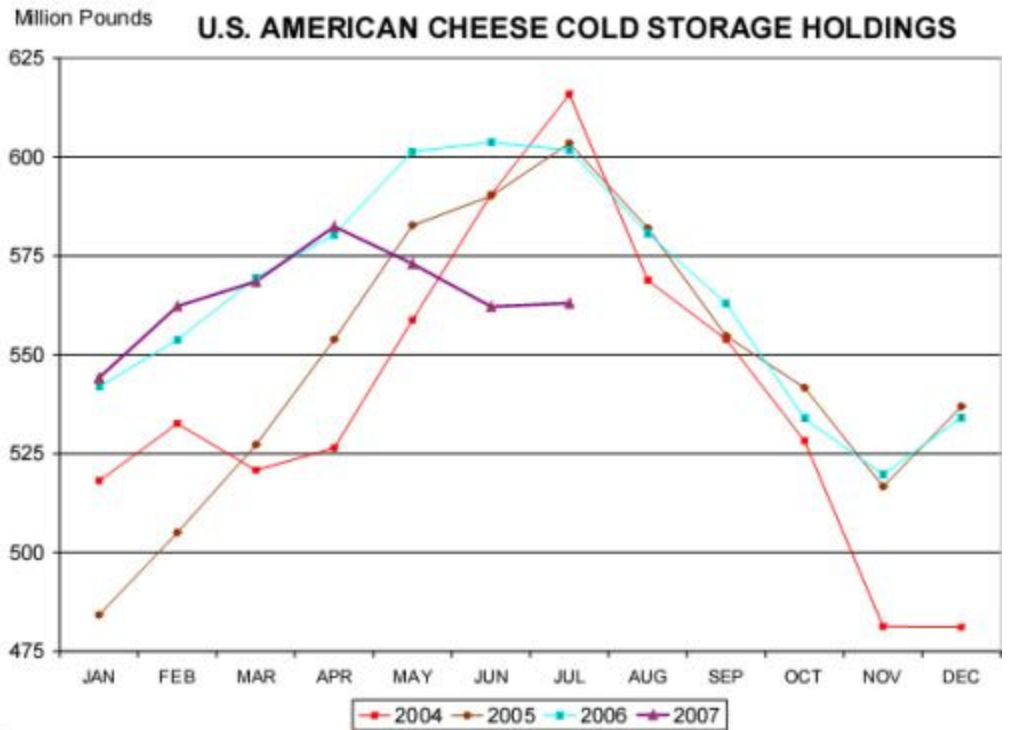


The KDM Dairy Report – August 24th, 2007

Bullish Fundamentals:

- Cold Storage Report: It's apparent cheese makers have been trying to limit production. Stocks of American cheese in July were [down 6% vs. last year](#) (see chart below) and unchanged from the prior month. Total cheese stocks were down 4% vs. a year ago and down 1% from June. But butter stocks were up 5% from last year's levels.
- Cash Market: Cheese prices aren't rocketing higher, but making steady gains nonetheless. Blocks picked up 1¼¢ in the spot market this week, closing at \$1.97¼/lb, and barrels gained 4¼¢ to settle at \$1.93¼/lb. Butter closed at \$1.42¼/lb, also up 4¼¢ for the week. Trading was light. Only 3 loads of blocks, 5 barrels and 8 cars of cheese exchanged hands.
- Livestock Slaughter Report: Despite a slowing trend in weekly dairy cow slaughter numbers, the total number of milk cows culled in July was 180,200 head, 3.2% higher than last July at 174,600 head. Year-to-date, 1.4 million cows have exited the milking herd, [up 10.7% from last year](#).
- Livestock, Dairy & Poultry Outlook Report: USDA's monthly look at several ag sectors includes this headline for dairy; "Global Demand for Dairy Products Could Keep Prices High in 2008 Despite Increased Production". For the balance of 2007, the milk production forecast was unchanged from last month, and could even move lower if feed prices increase and lower than expected use of rBST trims output per cow. For 2008, the milk-feed ratio is expected to be above 3.0, but robust domestic and international demand is predicted to keep prices high, with the current estimate for Class III to [average \\$16.90 for the year](#).
- Weekly cold storage numbers continue to indicate a [drawdown in cheese](#) stocks. For the period 08/01 through 08/20, cheese holdings at select storage centers were down 2%, or 2.3 million lbs.
- The Southeast region of the country imported 550 loads of Grade A milk last week, vs. 357 last week and 413 a year ago, according to Fluid Milk & Cream

Futures Month	Friday 08/24 Close	Friday 08/17 Close	Change	5-yr Average	Top 3rd Price
Aug-07	\$19.83	\$19.82	\$0.01	\$12.41	\$13.34
Sep-07	\$19.76	\$19.36	\$0.40	\$13.11	\$13.99
Oct-07	\$19.04	\$18.38	\$0.66	\$13.19	\$13.98
Nov-07	\$17.92	\$17.41	\$0.51	\$12.88	\$13.86
Dec-07	\$17.30	\$17.09	\$0.21	\$12.92	\$14.01
Jan-08	\$16.16	\$15.85	\$0.31	\$12.50	\$13.33
Feb-08	\$15.60	\$15.42	\$0.18	\$12.53	\$13.21
Mar-08	\$15.53	\$15.45	\$0.08	\$12.78	\$13.50
Apr-08	\$15.41	\$15.37	\$0.04	\$13.09	\$14.31
May-08	\$15.38	\$15.24	\$0.14	\$13.14	\$14.49
Jun-08	\$15.43	\$15.31	\$0.12	\$12.54	\$13.63
Jul-08	\$15.55	\$15.45	\$0.10	\$12.25	\$13.16
Aug-08	\$15.55	\$15.42	\$0.13	\$12.41	\$13.34
Sep-08	\$15.63	\$15.65	(\$0.02)	\$13.11	\$13.99
Oct-08	\$15.28	\$15.26	\$0.02	\$13.19	\$13.98
Nov-08	\$15.02	\$15.05	(\$0.03)	\$12.88	\$13.86
Dec-08	\$14.93	\$14.97	(\$0.04)	\$12.92	\$14.01
Aug-Dec Avg	\$18.77	\$18.41	\$0.36		
2008 Avg	\$15.46	\$15.37	\$0.09		



Review. The [big ramp-up in imports](#) is the result of 100+ daytime highs combined with the need to fulfill Class I needs as bottlers prepare for school openings. Milk handlers have been busy moving milk to deficit areas, pulling from milk suppliers in the upper Midwest, Southwest and Mid-Atlantic regions in order to get enough milk for consumption needs. Milk loads being sent to Class II and III operations are being ratcheted down.

- Fluid Milk & Cream Review reports that massive rainfall in Wisconsin, Minnesota and Iowa has caused disruption in milk hauling. Some loads were dumped and other operations were allowed to hold milk longer than normal, although it was downgraded to Class B. Loss of bridges in areas has resulted in more miles and extra time to pick up milk, and crop loss was extensive. On the demand side, Class I interest is improving as bottlers build working inventory prior to the opening of schools, and that, combined with milk exports to the Southeast, have [lowered supplies available](#) for manufacturing use.
- Heat and humidity are affecting milk output in Arizona and New Mexico, according to Fluid Milk & Cream Review. Many areas of Arizona are setting records for consecutive days above 110 degrees, and in New Mexico, production is trending lower and yields are being negatively affected by lighter fat and protein components.
- In the Pacific Northwest, weather has been good for milking cows, but hay prices are up \$25-30 from last year due to tight supplies. Beef feeders are coming in to the market earlier, which is [increasing the competition](#) for available hay.
- The cheese market is tightening up, according to Dairy Market News. In the Midwest, product is available, but larger orders [take time to acquire](#). A seasonal increase in demand for colby/jack and pepper jack is noted, and increased fluid demand has reduced the manufacturing milk supply.
- In the Northeast, Dairy Market News reports cheese production is tapering off as milk is diverted to Class I deficit areas. Some are anticipating milk loads will [dwindle down to contract minimums](#) soon.

Bearish Fundamentals:

- NASS numbers this week [did nothing](#) to feed to bulls. The weekly surveyed price for 40-lb block cheese averaged \$1.88/lb, down ½¢ from last week, while 500-lb barrels increased by the same amount to \$1.89/lb. Butter lost 3½¢ to \$1.45/lb, but nonfat dry milk gained 1.9¢ to average \$2.07/lb. But dry whey continued its woes, dropping 3¢ to 60.4¢/lb.
- Dairy cow slaughter for the week ending 08/12 went [back to negative](#) levels vs. last year. 43,800 head were culled compared to 47,000 during the same week a year ago.
- California continues to be [awash with milk](#), according to Fluid Milk & Cream Review. Despite increased demand for milk from school lunch programs, processing plants are still working long and hard to handle the supply, yet some is moving out of state to find a home.
- No change in the dry whey market as [supplies remain plentiful](#), according to Dairy Market News. Feed buyers are operating on a hand-to-mouth basis, waiting for a bottom, and those trying to resell excess loads are having difficulty finding buyers.
- The market tone for nonfat dry milk is weak, according to Dairy Market News. At the current high prices, buyers are being cautious and don't want to hold any extra stocks. Cheese makers aren't using additional nonfat dry milk to extend yields as they attempt to control cheese stocks. [Drying remains heavy](#) in California where milk output continues to be strong.
- Butter stocks at CME-approved warehouses dropped by 3 million lbs this week, but that's less than the 8.7 million lbs it dropped last year at this time, and ending stocks are still [above last years levels by 9.7%](#).

Recommendation:

The market appears to be firming as Friday's bearish Milk Production Report resulted in a Monday sell-off, but by the end of the day losses had been pared down. As rational minds realized that part of the big July-to-July increase could be explained by the turnaround in Southwest production, going from a heat wave and big cow deaths in CA last July, to a relatively cool July in '07, fears were eased. And as cheese bidders in the spot market slowly but methodically raised prices and no sellers appeared with a definitive answer, by the end of the week Sep-Feb registered double-digit gains. It was just another reminder how a seemingly decisive report can be forgotten within days. We have to start thinking, however, where the top is for Q4. Getting a whole lot higher than \$20 seems difficult, considering dry whey will probably stick within 40-60¢. \$2 blocks, \$1.97 barrels and 50¢ whey works out to about \$20 milk. With that in mind, consider buying at-the-money PUT options Oct-Dec, paying up to 70¢. That's a lot, but get them done first. Then offer to sell 20.00 CALL options to fund some of the PUT. Call us for more details on this trade! We still think 2008 is undervalued, based on projected demand, the strong Euro vs. the U.S. dollar and the \$1.50 difference between the current average and USDA projections. If you really feel the need to get something done in 2008, then consider buying the 15.00 PUT and selling the 17.00 CALL Jan-Apr on up to 25% of your production, which yields a minimum price at 15.00 and a cap at 17.00.

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