

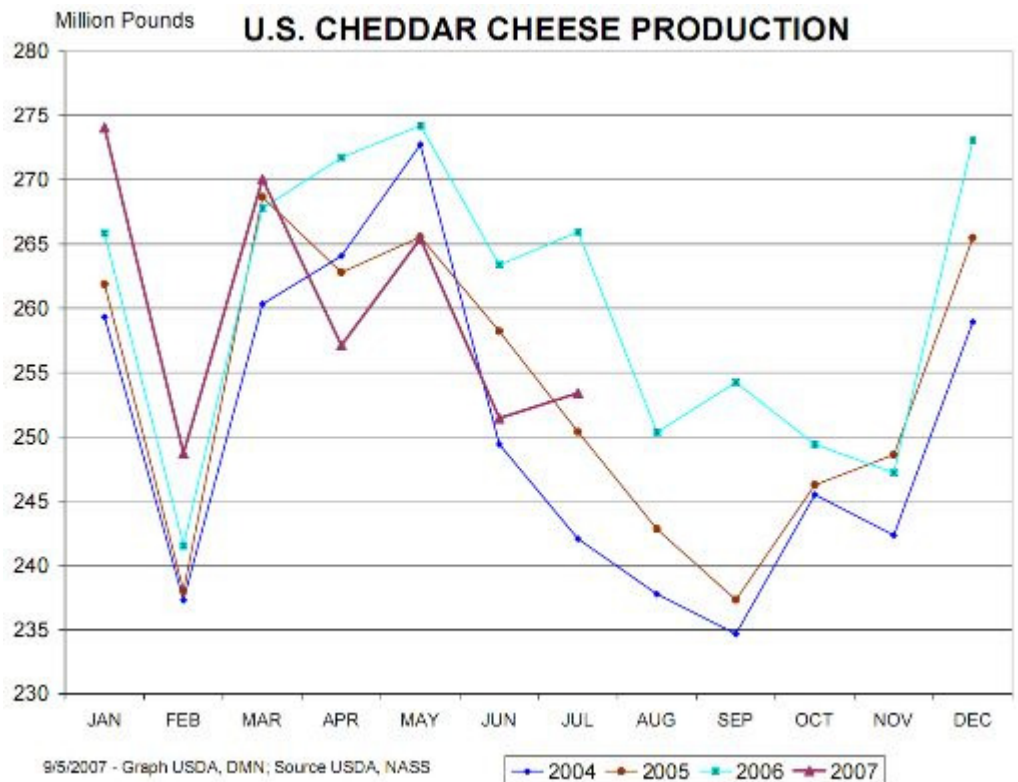


The KDM Dairy Report – September 7th, 2007

Bullish Fundamentals:

- Cash Market: Cheese prices managed to march higher this week, although buyers were forced to make purchases for the first time in two weeks to keep the rally going. Blocks climbed to \$2.14/lb, up 6½¢ from last week, and barrels increased 9¢ to \$2.10/lb, breaking the high in June and reaching the highest prices since 2004. Butter was quiet, losing just ½¢ to \$1.41¾/lb. 7 loads of blocks, 5 barrels and 14 cars of butter exchanged hands.
- Dairy Products Report: Cheddar cheese production in July was [down 4.7%](#) vs. a year ago (see chart) and American cheese output down 1.6%, according to USDA figures released this week. Total cheese production was up 2.6%, but up only 0.6% from the prior month.
- Dairy Market News reports the cheese market is firm, with speculation as to whether we'll set a new all-time record high in 2007. The combination of buyers delaying orders in the hope of lower prices, cheese makers minimizing production, and a lower cheese inventory just as cheese demand improves seasonally is contributing to the view. Current cheese offerings in the Midwest for natural varieties are [tight to short](#) and cheese production is trending lower due to milk moving to fluid accounts.
- NASS cheese prices [continue to rise](#) due to strength in the cash market. 40-lb blocks were up 3.5¢ from last week to average \$1.94/lb, while barrels increased 3¢, also at \$1.94/lb. Butter tacked on 4.2¢ to average \$1.42/lb.
- In the Southeast region of the country, producers are buying hay from the Midwest at up to \$250/ton delivered, according to Fluid Milk & Cream Review. Corn fields are also being chopped early due to poor ear development. Shipments of Grade A milk into the area were 367 loads, down from last week at 602, but close to last year at 389. Milk [production remains below plant capacity](#).
- Demand for manufacturing milk from cheese plants in the Midwest [continues to exceed supply](#), according to Fluid Milk & Cream Review. Good bottler interest for Class I use is limiting availability for Class III use.
- Milk receipts at some California milk processors were [down anywhere from 6-14%](#) from a week ago, according to Fluid Milk & Cream Review. Hot and humid conditions and strong Class I use left some plants with less milk than they would have liked, while ice cream manufacturers were calling for more cream as sales were up during the hot spell. In the

Futures Month	Friday 09/07 Close	Friday 08/31 Close	Change	5-yr Average	Top 3rd Price
Sep-07	\$20.29	\$20.22	\$0.07	\$13.11	\$13.99
Oct-07	\$20.07	\$19.87	\$0.20	\$13.19	\$13.98
Nov-07	\$18.73	\$18.73	\$0.00	\$12.88	\$13.86
Dec-07	\$17.97	\$17.90	\$0.07	\$12.92	\$14.01
Jan-08	\$16.90	\$16.80	\$0.10	\$12.50	\$13.33
Feb-08	\$16.15	\$16.04	\$0.11	\$12.53	\$13.21
Mar-08	\$15.90	\$15.91	(\$0.01)	\$12.78	\$13.50
Apr-08	\$15.70	\$15.71	(\$0.01)	\$13.09	\$14.31
May-08	\$15.65	\$15.60	\$0.05	\$13.14	\$14.49
Jun-08	\$15.65	\$15.62	\$0.03	\$12.54	\$13.63
Jul-08	\$15.70	\$15.73	(\$0.03)	\$12.25	\$13.16
Aug-08	\$15.73	\$15.75	(\$0.02)	\$12.41	\$13.34
Sep-08	\$15.88	\$15.89	(\$0.01)	\$13.11	\$13.99
Oct-08	\$15.44	\$15.41	\$0.03	\$13.19	\$13.98
Nov-08	\$15.23	\$15.20	\$0.03	\$12.88	\$13.86
Dec-08	\$15.10	\$15.04	\$0.06	\$12.92	\$14.01
Sep-Dec Avg	\$19.27	\$19.18	\$0.09		
2008 Avg	\$15.75	\$15.73	\$0.03		



Northwest, plants have additional capacity and milk receipts are down seasonally. Hay is tight and prices continue to firm.

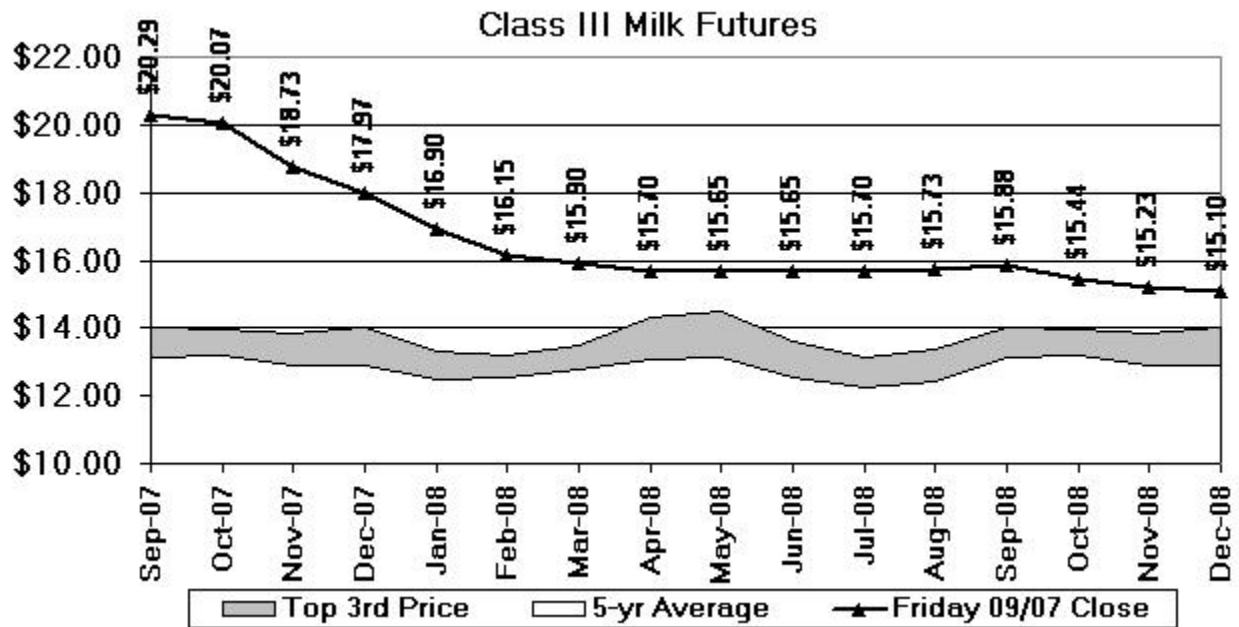
- Dairy Market News reports utilization of nonfat dry milk by cheese plants is light, despite high cheese prices. Cheese makers are attempting to balance cheese output with existing orders, and are [not willing to build or hold inventories](#).

Bearish Fundamentals:

- Ag Prices Report: The milk-feed ratio for August [increased to 3.24](#), up from 3.17 in July and well above last August at 2.48. Generally, when the ratio is above 3.0 it is an indicator of expanded milk production.
- While NASS cheese and butter prices were up, dry whey continued to slide, falling 2.9¢ to average 55¢/lb, and nonfat dry milk lost 2.2¢ to \$2.05/lb.
- July fluid milk [sales were down 1.3%](#) vs. 2006, according to Dairy Market News. Sales of organic whole and reduced fat milk, skim, 1% and buttermilk increased, but sales of flavored whole and reduced fat milk and 2% milk fell.
- Dairy cow slaughter numbers continue to [fall behind](#) year-ago levels. For the week ending 08/25, 47,500 head were culled vs. 48,600 head during the week last year.
- Butter stocks on hand at CME-approved warehouses continue to grow relative to last year. For the week ending 08/25, a little over 3 million lbs of butter were removed, but nearly 8 million lbs were removed during the same period a year ago, leaving [17.8 million more lbs](#) in storage.
- Dairy Market News still calls the whey market “weak”, however some traders think we may be nearing a bottom. The Central price for dry whey averaged between 45¼-50¼¢ this week, [way off the highs](#) earlier this summer in the upper 70¢ range.

Recommendation:

The market was more nervous this week compared to last, as block bidders in the cash market finally shook a few loads free. The question on most minds now is, how much higher and how much resistance will there be above \$2.14 blocks? Class III futures will be quite unwilling to move prices substantially



higher unless buyers remain aggressive in the cheese market. While the supply/demand situation in cheese still looks favorable for continued advances, it may be tougher going from here on out. That’s not to say we’ve reached the peak in either cheese or Class III prices; we have a legitimate shot at breaking the all-time price record of \$2.20/lb, but as a hedger, we think it’s time to get some coverage for Q4 while the market is still rising. Trying to buy PUT options or sell after we’ve reached the peak is 1.) very expensive, and 2.) near impossible. So, for next week, we recommend buying the Oct 19.50 PUT for 35¢, which yields an effective floor of 19.15/cwt. We actually did get several done at that price today before the market faded and they traded as high as 50¢. However, if the market can recover some next week, it should be doable again. Buy the Nov 17.75 PUT for 30¢ and enter a GTC order to buy the Dec 17.50 PUT for 30¢. These PUTs give you a floor, but leave you open to higher prices should the cheese supply stay limited for an extended period! For 2008, we would target to buy the 16.00 PUT and sell the 18.00 CALL, Jan-Mar for a net cost of 10¢ per month. After today’s close, the net cost is 31¢ per month, but we may get there if prices stay strong into October. Again, we would strongly encourage getting PUT coverage for Q4 in the next week or two. Don’t let these prices slip away!!

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