

The KDM Dairy Report – October 12th, 2007

Bullish Fundamentals:

- For the first 8 days in October, weekly cold storage numbers show [cheese stocks fell](#) 442,000 lbs.
- Though not far above last year's level, weekly dairy cow slaughter numbers were [nonetheless robust](#). For the week ending 09/29, 51,900 head were culled, compared to 51,200 head during the same week a year ago.
- Fluid Milk & Cream Review reports 441 loads of Grade A milk were shipped into the Southeast region of the country this week, compared to 378 last week and 297 a year ago. [Strong Class I sales](#) are noted, despite a lack of promotions in the grocery aisle.
- Dry whey sales are improving and [inventories are in much better shape](#), according to Dairy Market News. For the first time in months, both Western and Central whey saw slight price increases.
- The cheese market is unsettled, according to Dairy Market News, but they do note that cheese output in the Midwest is lower due to additional Class I demand, and holiday related [orders are beginning to pick up](#) for gift packs.
- Western cheese buyers are back in the market [making heavier purchases](#), according to Dairy Market News. They're taking advantage of better prices, but are also running out of time to get what they need for fall.
- International: Milk production in Europe is below quota levels, according to Dairy Market News. Stocks of dairy end-products remain [lighter than desired](#) and butterfat is still in tight supply.
- International: Milk output in New Zealand is ahead of last year, but below expectations. And Australia's lack of rain continues to plague many dairy regions. Many producers are being limited to about 20% of their water allocation, so pasture growth is becoming a big issue again. Early reports indicate July-Sept production was down as much as 18% vs. last year, though a year ago they had a very positive start to the season. Stocks of dairy products are limited with [basically nothing available](#) for spot or export interest.

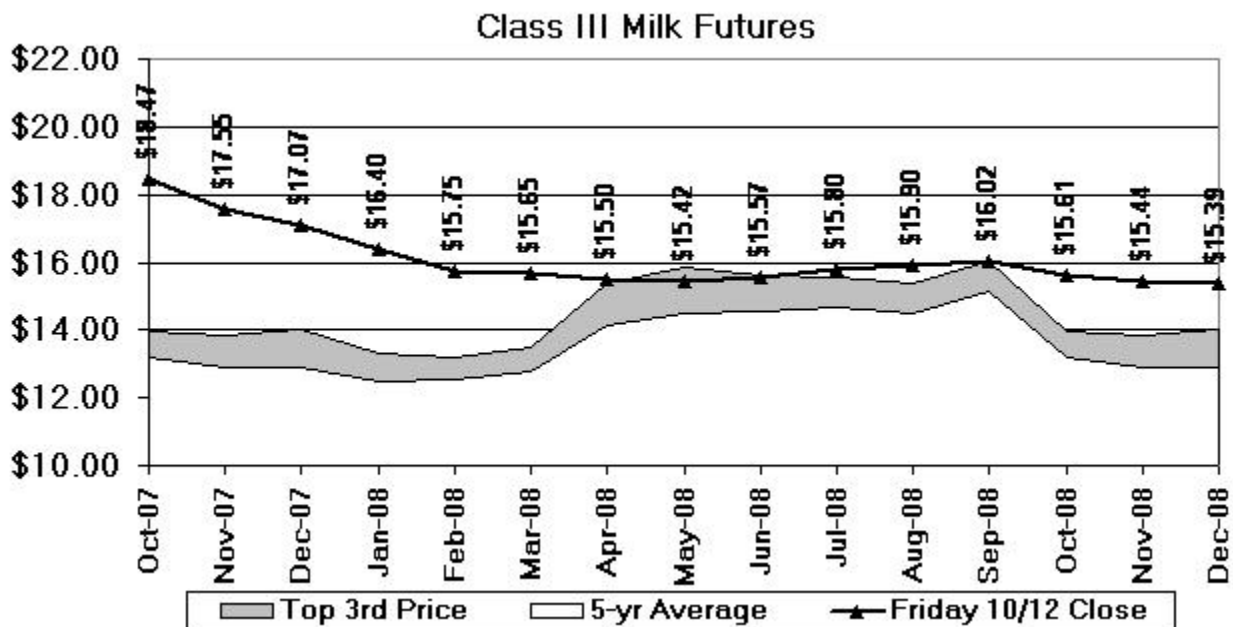
Futures Month	Friday 10/12 Close	Friday 10/05 Close	Change	5-yr Average	Top 3rd Price
Oct-07	\$18.47	\$18.30	\$0.17	\$13.19	\$13.98
Nov-07	\$17.55	\$17.20	\$0.35	\$12.88	\$13.86
Dec-07	\$17.07	\$16.72	\$0.35	\$12.92	\$14.01
Jan-08	\$16.40	\$16.25	\$0.15	\$12.50	\$13.33
Feb-08	\$15.75	\$15.80	(\$0.05)	\$12.53	\$13.21
Mar-08	\$15.65	\$15.79	(\$0.14)	\$12.78	\$13.50
Apr-08	\$15.50	\$15.54	(\$0.04)	\$14.14	\$15.36
May-08	\$15.42	\$15.51	(\$0.09)	\$14.50	\$15.85
Jun-08	\$15.57	\$15.66	(\$0.09)	\$14.54	\$15.63
Jul-08	\$15.80	\$15.88	(\$0.08)	\$14.66	\$15.57
Aug-08	\$15.90	\$15.98	(\$0.08)	\$14.47	\$15.40
Sep-08	\$16.02	\$16.16	(\$0.14)	\$15.14	\$16.02
Oct-08	\$15.61	\$15.75	(\$0.14)	\$13.19	\$13.98
Nov-08	\$15.44	\$15.65	(\$0.21)	\$12.88	\$13.86
Dec-08	\$15.39	\$15.55	(\$0.16)	\$12.92	\$14.01
Oct-Dec Avg	\$17.70	\$17.41	\$0.29		
2008 Avg	\$15.70	\$15.79	(\$0.09)		

Bearish Fundamentals:

- Cash Market: Sellers were the overall winners this week, as the block price lost 3¾¢ to settle at \$1.84¾/lb and barrels shed 2¼¢ to close at \$1.86¾/lb today. Butter crashed through \$1.30, finishing at \$1.28½/lb, down 3¼¢ for the week. Buyers were active, however, picking up 14 loads of blocks, 8 barrels and 17 cars of butter.
- World Ag Supply & Demand Report: USDA [lowered their Class III price forecast](#) for 2008 in response to lower cheese prices and an increase in their 2008 milk production estimate. Despite robust domestic and international demand, USDA lowered their projected 2008 Class III forecast by 80¢, now expecting it to average \$16.05/cwt.
- California's cup runneth over. Milk output remains very strong, [stressing processing capacity](#), according to Fluid Milk & Cream Review. There are reports of milk not being picked up (which we've corroborated with our own contacts in the state), and several plants may implement base plans to limit the amount of milk they will process from their producers.
- NASS numbers this week [took a hit](#) as recent weakness in the cash cheese market finally made its mark on the survey numbers. 40-lb blocks fell 6¢ and barrels dropped 6.7¢, leaving them both at \$1.95/lb. Expect another drop next week as the NASS numbers catch up with cash. How low will butter go? It gave up another 2.4¢ to average \$1.33/lb. Powders were down as well with nonfat dry milk losing 1.1¢ to average \$2.05/lb and dry whey still looking for a bottom, down 1.1¢ at 41.3¢/lb.
- Butter stocks are decreasing, but [at a crawl](#), meaning the total on hand is gaining compared to last year. For the week ending 10/06, 119.4 million lbs of the yellow stuff were sitting in CME-approved warehouses. Last year at this time, only 89.3 million lbs were in storage, leaving today's levels 34% higher.
- We have lots of butter, but let's make more! Churning activity is [strong across the country](#), according to Dairy Market News, and the cash price has dipped to its lowest point since early in the year. Export sales are waning, and some market participants are doubting how much impact additional export sales can have on the market.

Recommendation:

Nothing really happened this week to tell us much of anything, other than that the 2007 contracts were pushed too low last week. Cheese buyers see to be defending \$1.80 cheese, and with 40¢ whey as a bottom, that puts us at \$18 milk. If cheese holds again next



week, we'd expect Nov and Dec to start moving higher. Today we executed a few min-max contracts, buying the Nov 16.50 PUT and selling the 18.50 CALL for a net cost of 5¢. That's not a bad trade on up to a third of your unsold milk. It leaves you with an effective floor (base price) of 16.45 and a cap, or ceiling on your milk at 18.45. In light of recent price action and a milk production report due next Thursday that's most likely going to be negative to neutral, what's not to like about being capped at that level? We did the same thing for Dec, buying the 16.00 PUT and selling the 18.00 CALL for 5¢ net cost. No one knows when holiday buying will stop, so we feel this is a good, solid hedge. If you can't stand being capped, then just buy the PUT options outright and leave yourself 100% open. The Nov 17.00 PUT settled at 21¢ and the Dec 16.26 PUT at 23¢. Buy them and sleep better. We still feel there's not much to do with 2008. Be prepared for more pressure down if producers feel the need to get covered, but in our opinion, with a \$15.70 average right now, the downside risk for 2008 is under \$1.00/cwt. We'd rather ride it out for now since there seems to be more upside risk in 2008 than downside. Comment on grains: Corn was up today despite the biggest overall crop on record, based on USDA's estimate of 13.3 billion bushels. The street was expecting 13.5 or higher. Beans and meal were mixed to higher, as uncertainty about the S. American drop is providing support. We would consider getting part of your protein needs in 2008 booked on dips in the meal market, so keep an eye out for opportunities.

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