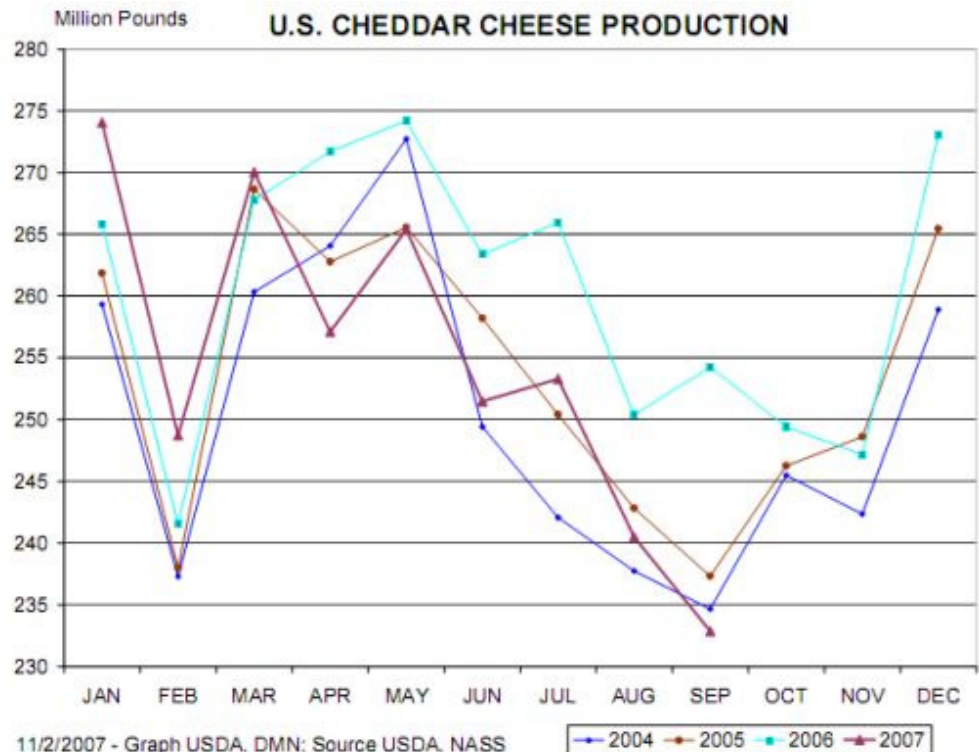


The KDM Dairy Report – November 2nd, 2007

Bullish Fundamentals:

- October Class III milk was announced at \$18.70/cwt today, a [new record high](#) for the month. The previous high was set in 1998 at \$16.04. However, it was down \$1.37/cwt from last month's closing of \$20.07.
- Dairy Products Report: Difficult margins for cheese plants are continuing to result in [lower cheese production](#). Total cheese output for the month of September was 1.4% below a year ago and 2.3% below August. Cheddar cheese output was a significant 8.4% below last year (check out the chart below!) and 3.2% below August. It appears much of the milk has been headed to butter powder operations as butter output was up 7.3% and nonfat dry milk production was up 42.7%. This should be supportive for the cheese market.
- Ag Prices Report: The milk-feed ratio for October came in at 3.05, down from 3.17 in September. While still above 3.0, feed costs have continued to rise since then, suggesting the ratio [could weaken further](#) next month.
- Most NASS Class III components were up in this week's survey, including [another jump for dry whey](#). 40-lb blocks averaged \$1.87/lb, up slightly from last week, while barrels gained 0.3¢ to \$1.90/lb. Dry whey picked up a solid 1.9¢ to average 43.4¢/lb and butter increased 1.2¢ to \$1.29/lb. The lone loser was nonfat dry milk, down 2.2¢ to \$2.04/lb.
- Weekly cold storage number for the period 10/01 through 10/29 show [cheese stocks declined](#) seasonally 1% and butter stocks fell 5%.
- Dairy cow slaughter for the week ending 10/20 reached its [highest weekly total for the year](#), perhaps indicating profitability is becoming more difficult. 56,000 head were culled vs. 51,900 during the same period last year.
- Milk heading to balancing plants in the Northeast part of the country is [running below expectations](#), according to Fluid Milk & Cream Review. Class I sales are steady to slightly higher, while milk production has been occasionally lower. In the Southeast, shipments of Grade A milk into the region were down from last week, but still amounted to 356 loads.
- Dairy Market News reports the butter market is firming as prices have steadily increased this week. New orders from international sources are rumored to be in the works with some projecting exports [might be more active](#) than previously projected.
- Some Western whey producers are indicating they are [sold out](#) for the near term, according to Dairy Market News. Supplies are getting tighter while buyers are aggressively looking for additional supplies for both domestic and international needs.

Futures Month	Friday 11/02 Close	Friday 10/26 Close	Change	5-yr Average	Top 3rd Price
Nov-07	\$18.77	\$18.73	\$0.04	\$12.88	\$13.86
Dec-07	\$17.80	\$17.90	(\$0.10)	\$12.92	\$14.01
Jan-08	\$16.73	\$16.91	(\$0.18)	\$12.50	\$13.33
Feb-08	\$16.21	\$16.37	(\$0.16)	\$12.53	\$13.21
Mar-08	\$16.17	\$16.18	(\$0.01)	\$12.78	\$13.50
Apr-08	\$15.91	\$15.90	\$0.01	\$14.14	\$15.36
May-08	\$15.87	\$15.85	\$0.02	\$14.50	\$15.85
Jun-08	\$15.98	\$15.89	\$0.09	\$14.54	\$15.63
Jul-08	\$16.08	\$15.98	\$0.10	\$14.66	\$15.57
Aug-08	\$16.20	\$16.05	\$0.15	\$14.47	\$15.40
Sep-08	\$16.31	\$16.20	\$0.11	\$15.14	\$16.02
Oct-08	\$15.95	\$15.80	\$0.15	\$14.78	\$15.58
Nov-08	\$15.72	\$15.61	\$0.11	\$12.88	\$13.86
Dec-08	\$15.61	\$15.54	\$0.07	\$12.92	\$14.01
Nov-Dec Avg	\$18.29	\$18.32	(\$0.03)		
2008 Avg	\$16.06	\$16.02	\$0.04		



Legend: 2004 (blue line with circles), 2005 (orange line with squares), 2006 (green line with triangles), 2007 (red line with diamonds)

- Economy: Job growth in October [grew by 166,000](#) according to figures released by the Labor Dept. this week. The number was twice as many as was expected.

Bearish Fundamentals:

- Economy: Consumer confidence hit a [2-year low](#) in October, according to a Reuters article this week. Higher fuel costs and the current housing slump have people worried about the future strength of the economy.
- Economy: Home prices fell at their [fastest pace in 16 years](#), according to a national home price index. Prices are not showing signs of a slowdown or turnaround.
- Cash Market: Block cheese, at \$2.01/lb settled a penny higher than last week, but buyers were much less aggressive at these levels. Barrels also made meager gains, up only ¼¢ to \$1.91¼/lb and fell 1¾¢ today from a high of \$1.93/lb on Thursday. Butter settled at \$1.31½/lb, up 2½¢ for the week. Only 2 loads of blocks, 1 of barrels and 12 cars of butter exchanged hands. Finally, rarely traded cash Grade A nonfat dry milk was offered 7¢ lower with no bids, settling at \$1.93/lb.
- Commercial Disappearance: USDA's update on commercial use of dairy products shows the high prices in summer had a [chilling affect on sales](#) in August. Use of American cheese was down 3.7% vs. August 2008, however other cheese use was up 1.4%. Butter use was down 10.1%, nonfat dry milk use off 13.1% and use of milk in all products down 2.2%.

Recommendation:

The front months are starting to feel a little tired as everyone wonders how long cash cheese can stay above \$2/lb. \$2 cheese this year hasn't lasted much more than 10 consecutive days, and now that we're in the month of November, one has to think the first phase of holiday cheese buying is nearly complete. The Dec-Feb contracts finished down double digits today as trader sentiment changed and profit-taking took control. We feel these months are susceptible to further decline should the cash market stumble, so we are putting out a **Trade Alert**. 1.) Consider selling Nov outright at 18.77. Two of the four weeks in the calculation are in, so if cheese prices hold, Nov will go higher and you will lose on the trade. But as a hedger, this is a good price to be sold. And if the cash market comes down, Nov will react lower. 2.) Buy the Dec 17.25 PUT for 30¢. This yields an effective floor of 16.95 leaving you with 100% upside. Or, buy the PUT and then fund it by selling the 18.50 CALL for 25¢. Your net cost is 5¢, leaving you with a min-max contract and floor price of 17.20 and a cap on your milk at 18.45. 3.) Buy the Jan 16.00 PUT and sell the 17.75 CALL for a net cost of up to 10¢. This will give you a min-max contract with a 15.90 floor and 17.65 cap on your milk. If you were capped at these prices in Dec and Jan, would you be unhappy? For those with a positive premium structure, that is an excellent price for those months. 2008 continues to tug at us both ways. We're concerned about the U.S. economy and what the demand picture will be like. The housing situation could get uglier before it gets better. And cow numbers and milk production continue to trend higher. However, we continue to hear reports about the difficulty in running profitably amid rising commodity costs. Many believe the food vs. fuel battle over grains will be won by food as it prices the energy sector out of profitability. Look at beans which are now trading over \$10/bu though Aug '08. Recent reports of an ethanol glut seem substantiated as the price for ethanol has declined 30% in the past few months, and we've read about several ethanol construction projects either put on hold or tabled altogether. Corn is trading near or above \$4/bu Mar '08 through Dec '10. Hay is expensive and supplies are tight nearly everywhere in the country. Input costs do not appear to be going down significantly for awhile. We're also watching California closely. They appear to have lost some milk processing capacity due to plant closings this year. Milk supplies are still called burdensome, yet they are well off their peak from Mar/Apr. Producers there tell us that a major cheese maker in the state is working towards reducing receipts by 10% and that a major cooperative has lost some ability to send excess milk to other plants. They are not looking for additional patrons or milk. Add to that water shortages/challenges, expensive feed and environmental pressures, and we're hearing that the cost of production is at about the current 2008 average, being that they receive \$1 below class. We have many questions about how CA will be able to significantly increase milk production and cow numbers in 2008, like they have in most years past. Stay tuned! Producers in other Southwest states we work with talk about just getting their balance sheets back to levels of 2 years ago. The vast majority of these producers are not taking on new capital projects or adding substantial numbers of cows, and many are still in "special asset management" class with their banks. For all these reasons, we feel a significant and sustained move lower in prices would not last that long, short of a collapse in the U.S. economy. In the Midwest and NE, however, expansion plans are much more prevalent due to the land advantage of growing their own feed and a positive premium structure. To sum up this long recommendation, we feel in the near term a correction is likely, and will affect the front months, but that ultimately, most of the 2008 contracts will crawl their way back up and extend to higher levels than they are today. For that reason, we continue to focus on protecting Q1 contracts with fence strategies (min-max) and do not feel the urgent need to outright sell 2008 in significant quantities.

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