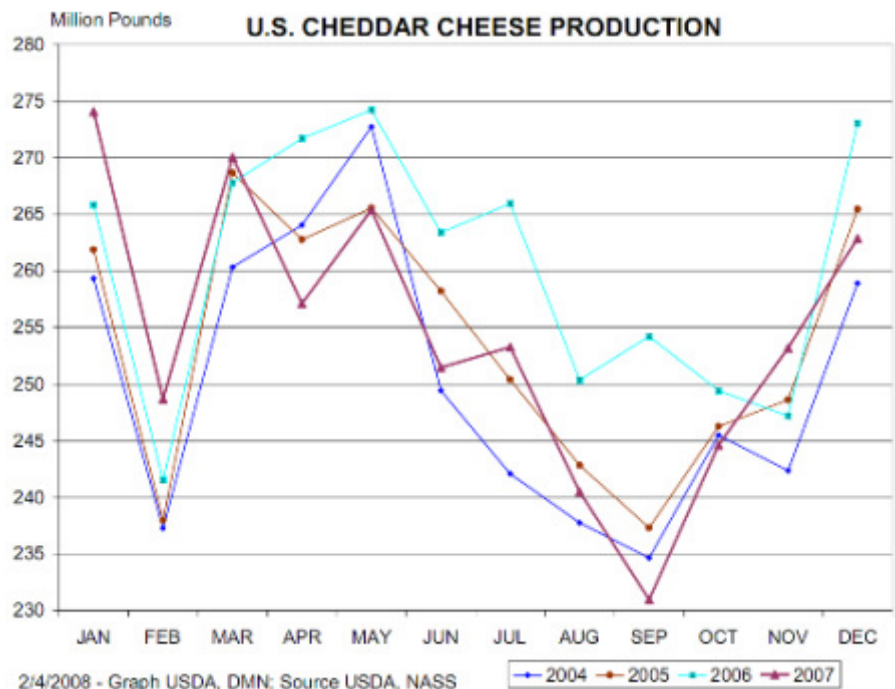


The KDM Dairy Report – February 8th, 2008

Bullish Fundamentals:

- Cash Market: Blocks are knocking on the \$2 door again as they shot up 19¢ for the week to settle at \$1.99/lb. Barrels reluctantly followed, gaining 15¾¢ to close at \$1.93¾/lb. In contrast to the past couple weeks of very high volumes of trades, sellers virtually disappeared, with only 6 blocks and 2 barrels exchanging hands. Butter remained stuck in the low \$1.20's, settling at \$1.22, down ¼¢ on the week. 12 cars exchanged hands.
- Dairy Products Report: While not overly bullish as a whole, the Dairy Products Report showed cheddar cheese output in December was [3.7% below last year's levels](#). That's important, because it's only cheddar that trades in the cash market. Total cheese output was up a modest 1.5%, while butter was up 2.6%.
- Current cheddar [blocks are tight](#) in the Midwest, according to Dairy Market News, and manufacturing milk supplies are being impacted by the push by bottlers and some cheese buyers for products produced only with r-BST free milk. Cheese production is seasonally heavy, but exports are moving natural and white blocks.
- Western cheese buyers continue to make purchases even with prices sharply higher, according to Dairy Market News. It appears buyers have [minimal inventory](#) so are paying up. Under grade cheese offerings are clearing well.
- Cumulative weekly cold storage numbers reveal that during the month of January, cheese stocks at USDA selected storage centers [fell 5%](#).
- Wild weather over much of the Pacific Northwest is adding stress to the milking herd, according to Fluid Milk & Cream Review. Cows are eating more feed and hay to maintain body weight and milk production, further stressing the limited hay offerings available. Prices for hay have jumped sharply higher.
- International: New Zealand ag giant Fonterra, who account for 40% of the international trade in butter, cheese and milk powders, announced this week that they [may restrict new export orders](#) due to the current drought in the country. Record dry weather in January has left much of the North Island with extreme soil moisture deficits. Milk production in Waikato, a major dairying area, is down 27%, with other areas down between 9-21%. The company said they are "booked up" for the rest of the milking season, and advised the new export orders may not be accepted.
- International: Australia dairy exports for the first half of the milking season (Jul-Dec) were [down 20.7%](#), according to Dairy Australia. Whey products were off 44.3%, followed by butter oil down 40.9%.

Futures Month	Friday 02/08 Close	Friday 02/01 Close	Change	5-yr Average	Top 3rd Price
Feb-08	\$17.27	\$17.04	\$0.23	\$12.53	\$13.21
Mar-08	\$17.76	\$17.20	\$0.56	\$12.78	\$13.50
Apr-08	\$16.85	\$16.52	\$0.33	\$14.14	\$15.36
May-08	\$16.36	\$16.10	\$0.26	\$14.50	\$15.85
Jun-08	\$16.32	\$16.10	\$0.22	\$14.54	\$15.63
Jul-08	\$16.47	\$16.34	\$0.13	\$14.66	\$15.57
Aug-08	\$16.55	\$16.49	\$0.06	\$14.47	\$15.40
Sep-08	\$16.72	\$16.70	\$0.02	\$15.14	\$16.02
Oct-08	\$16.47	\$16.36	\$0.11	\$14.78	\$15.58
Nov-08	\$16.36	\$16.27	\$0.09	\$14.75	\$15.73
Dec-08	\$16.33	\$16.25	\$0.08	\$15.09	\$16.18
Jan-09	\$16.20	\$16.14	\$0.06	\$14.40	\$15.24
Feb-09	\$16.15	\$15.95	\$0.20	\$12.53	\$13.21
Mar-09	\$16.19	\$16.05	\$0.14	\$12.78	\$13.50
Apr-09	\$16.15	\$16.05	\$0.10	\$14.14	\$15.36
May-09	\$16.13	\$16.08	\$0.05	\$14.50	\$15.85
Jun-09	\$16.16	\$16.05	\$0.11	\$14.54	\$15.63
Jul-09	\$16.18	\$16.10	\$0.08	\$14.66	\$15.57
Aug-09	\$16.23	\$16.20	\$0.03	\$14.47	\$15.40
Sep-09	\$16.31	\$16.25	\$0.06	\$15.14	\$16.02
Oct-09	\$16.26	\$16.25	\$0.01	\$14.78	\$15.58
Nov-09	\$16.21	\$16.20	\$0.01	\$14.75	\$15.73
Dec-09	\$16.21	\$16.20	\$0.01	\$15.09	\$16.18
Feb-Dec 2008	\$16.68	\$16.49	\$0.19		
2009 Avg	\$16.20	\$16.13	\$0.07		



Bearish Fundamentals:

- World Ag Supply & Demand Report: USDA lowered their Class III forecast from last month due to an expectation for continued growth in cow numbers. USDA predicts the [larger milking herd](#) will more than offset slower growth in output per cow. Finally, weakening international prices are expected to keep dry whey and nonfat dry milk prices under pressure. As a result, USDA dropped their Class III price forecast from last month a rather substantial 75¢/cwt, down to \$15.80/cwt.
- NASS cheese and powder prices were [lower again](#) this week, lagging the cash market by 10-14 days. Cheddar blocks averaged \$1.79/lb, down 11.6¢ from last week, and barrels were fell 9.4¢ to \$1.85/lb. Nonfat dry milk dropped 5.4¢ to average \$1.40/lb, while dry whey continued its plunge, losing 2.4¢ to 32.5¢/lb. Butter remains stuck in a tight range, but was up a fractional 0.3¢ to average \$1.20/lb.
- Butter stocks at CME-approved warehouses [increased by 7.8 million lbs](#) for the week ending 02/02, leaving a total of 102.1 million lbs on hand.
- Central dry whey prices were [mostly lower](#) this week, ranging from 25-26¾¢/lb, according to Dairy Market News. Supplies are balanced to long with production steady.
- Nonfat dry milk [supplies continue to build](#) across the country and prices are weak. Export interest has improved with the lower prices, but production is so heavy that stocks are not declining.
- Milk supplies in the East are [building seasonally](#), according to Fluid Milk & Cream Review. Some Class II plants are gearing up production to relieve some of the processing stress in the area, while balancing plants are busy churning butter, condensing and drying. Florida was again a net exporter of milk this week, sending out 60 loads.
- Fluid Milk & Cream Review reports the weather has improved in California, which could lead to additional milk supplies that are not needed. There is [still plenty of milk](#) in the region to keep plants as full as they want to be.
- Churning activity across the country remains seasonally strong, according to Dairy Market News. Cream is [readily available](#), so producers are increasing production days, while others are running near peak levels. Domestic demand is fair, but new interest from off-shore buyers is resurfacing.

Recommendation:

Let's talk about California for a minute. First, we work with customers in 16 states, including California, and it's our desire to see all dairies thrive, so what follows is purely fundamental observation and how it could impact the market this year. We're taking a look at California, well, because they have by far the nation's largest herd and milk output. In the December milk production report, California accounted for about 20% of the nation's herd and produced 22% of its milk. With a herd size of 1.833 million cows, they had 585,000 more cows than runner-up Wisconsin; or, 46% more. Total output in Dec was 3.446 billion lbs, a full 1.44 billion lbs more than "America's Dairy Land". Since 1997, CA has increased milk output by an average of 4% each year and increased its herd by 3%. What would happen this year and going forward, if California's ability to expand its herd and milk output were stunted? We think we're beginning to see signs of this as: 1.) CA has literally run out of processing capacity for all its milk. Both a cheese plant and drying facility closed this year. With margins tight on cheese, it seems there's little desire to build a new plant in the state. CA has been shipping excess milk out of state but those processors are getting full as well. Over the past couple months, reports of dumping have increased and continue to the present. Other surplus milk is going to animal feeding operations. 2.) We're hearing substantiated rumors of large co-ops implementing a quota system. For example, you might get to ship xx lbs of milk based on 90% of your Aug production. Anything over and you're on your own. 3.) The cost of dumping milk and selling it on the cheap to feed lots and out of state is being shared by all producers in the form of a lower milk check. While Jan Class III (cheese milk) came off the board at \$19.32, the CA 4b price (cheese milk) was announced at \$16.91. With the high cost of feed, lower milk checks and the potential for a quota system, what dairyman is considering major expansion there at this time? 4.) Cull rates are up according to our sources. Producers who were culling 250 head/mo are now at 500 head/mo. 5.) Stricter environmental regulation making it difficult to operate a dairy. 6.) For all the reasons above, producers are leaving CA and setting up operations in other states. Could CA be making a top in both herd size and milk production? We are watching CA output and herd size very closely and will keep you informed.

Cheese sellers disappeared this week, allowing the cash market to move dramatically higher. Futures followed but are now pricing in a discount, not believing the current cheese price will stick. We're hearing about strong orders, tight supply and an increase in the export market, so while we may head lower (or higher) from here, a complete collapse looks less likely. And from what we're hearing about Australia and New Zealand, the U.S. could be setting up for record exports. These are strange times with high milk production and low stocks of cheese, but it is what it is. Buy PUT options up front and leave the last half of 2008 open.

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