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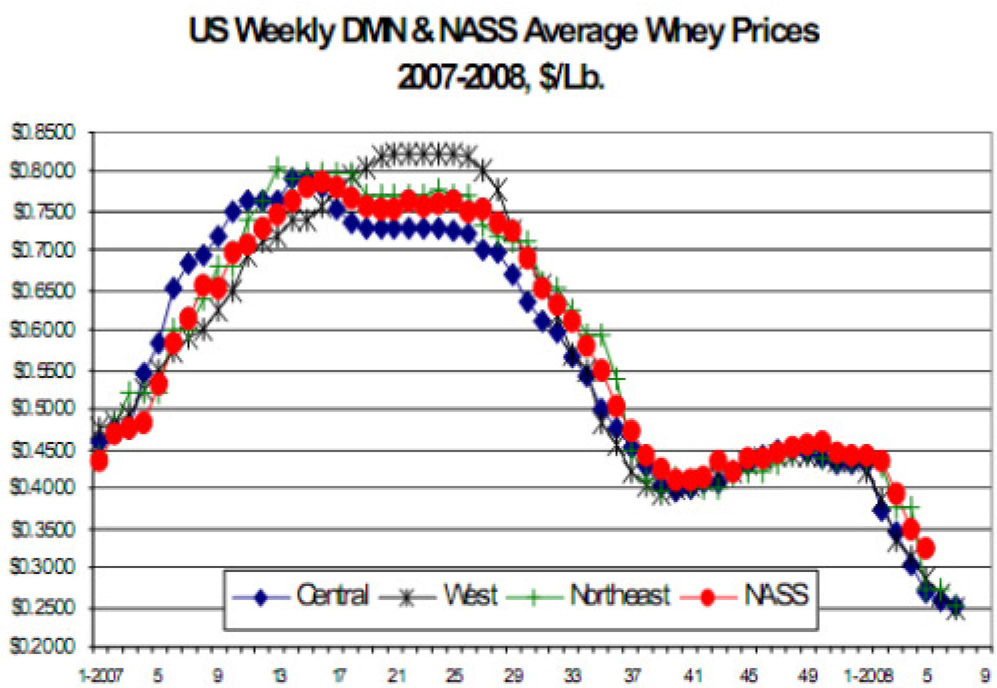
The KDM Dairy Report – February 15th, 2008

Bullish Fundamentals:

- Cash Market: Blocks gained 6¢ in an up and down week to settle at $2.05/lb and barrels increased 5¼¢ to $1.99/lb. Blocks opened Monday at $1.99, lost 4¢ to $1.95 on Tue, then moved back up to $1.99 on Wed before bidders got aggressive on Thur. However, after hitting an intra-session high of $2.11½ on Thursday, sellers appeared and pushed the price back down to $2.05, which is where we finished on Fri. Overall trading was light, with 9 loads of blocks and 6 loads of barrels trading hands. Butter was unchanged for the week at $1.20¼/lb with 7 cars trading hands.
- Weekly cold storage stats for the first 11 days of Feb are showing cheese stocks are down 843,000 lbs, or 1%, at selected storage centers.
- Supplies of current cheddar and many other natural American blocks remain tight in the Midwest, according to Dairy Market News. Export activity and good domestic interest is moving product. Prices for aged Italian varieties are sharply higher as buyers are purchasing larger volumes to make up for lower production in 2007 and limited offerings elsewhere in the world. Cheese production in the region is steady, with plants attempting to limit exposure on uncommitted cheese.
- Dairy Market News reports U.S. exports of cheese and curd for 2007 were up 40% vs. 2006. Cheddar exports were up 210% and totaled 34.5 million lbs.
- Central dry whey prices were steady this week, with some in the industry sensing that a floor is drawing near. Dairy Market News reports inquiries for dry whey are increasing.
- Dairy Market News reports trading activity for dry whey has improved in the Western region as prices have declined. Stronger demand is coming from the export trade and additional domestic sales are noted. Some buyers are stating that supplies and offerings are tighter.
- Inventories of dry whey in the Northeast are at more comfortable levels, according to Dairy Market News. Inventory is being better managed and spot market activity is increasing.
- International: Dairy Market News reports the ongoing drought in the major dairy area of Waikato, in New Zealand, has some producers down to milking just once a day. Culling is active as high summer temps add stress to the animals. Producers are feeding cattle from stored feed, but supplemental feed prices are high. Milk production forecasts are being lowered, which is causing concern among exporters that they will not be able to meet commitments for the current season.
- International: U.S. cheese is being imported into Oceania to

Futures Month	Friday 02/15 Close	Friday 02/08 Close	Change	5-yr Average	Top 3rd Price
Feb-08	$17.17	$17.27	($0.10)	$12.53	$13.21
Mar-08	$17.83	$17.76	$0.07	$12.78	$13.50
Apr-08	$16.88	$16.85	$0.03	$14.14	$15.36
May-08	$16.53	$16.36	$0.17	$14.50	$15.85
Jun-08	$16.48	$16.32	$0.16	$14.54	$15.63
Jul-08	$16.67	$16.47	$0.20	$14.66	$15.57
Aug-08	$16.79	$16.55	$0.24	$14.47	$15.40
Sep-08	$16.97	$16.72	$0.25	$15.14	$16.02
Oct-08	$16.73	$16.47	$0.26	$14.78	$15.58
Nov-08	$16.73	$16.36	$0.37	$14.75	$15.73
Dec-08	$16.73	$16.33	$0.40	$15.09	$16.18
Jan-09	$16.45	$16.20	$0.25	$14.40	$15.24
Feb-09	$16.31	$16.15	$0.16	$12.53	$13.21
Mar-09	$16.31	$16.19	$0.12	$12.78	$13.50
Apr-09	$16.24	$16.15	$0.09	$14.14	$15.36
May-09	$16.22	$16.13	$0.09	$14.50	$15.85
Jun-09	$16.28	$16.16	$0.12	$14.54	$15.63
Jul-09	$16.30	$16.18	$0.12	$14.66	$15.57
Aug-09	$16.35	$16.23	$0.12	$14.47	$15.40
Sep-09	$16.36	$16.31	$0.05	$15.14	$16.02
Oct-09	$16.35	$16.26	$0.09	$14.78	$15.58
Nov-09	$16.30	$16.21	$0.09	$14.75	$15.73
Dec-09	$16.30	$16.21	$0.09	$15.09	$16.18
Feb-Dec 2008	**$16.86**	**$16.68**	**$0.19**		
2009 Avg	**$16.31**	**$16.20**	**$0.12**		



supplement supplies, according to Dairy Market News. Inventories are tight as manufacturers try to cover previous commitments to their best customers.

- International: December cheddar cheese output in Australia was down 11.7% vs. the prior year, according to DairyAustralia. Total cheese output was down 7.4% in the same period.

Bearish Fundamentals:

- Milk Production Report: January milk production in the 23 major states was up 2.4% vs. a year ago, while cow numbers were up 120,000 head. In addition, the milking herd expanded by 15,000 head from Dec to Jan, and milk per cow was up 17 lbs. For all 50 states, milk production was up 1.9%, cow numbers were up 97,000 head and milk per cow was up 15 lbs. The total number of milk cows in the U.S. is now 9.232 million head.
- Livestock, Dairy & Poultry Outlook Report: USDA's monthly look at the domestic ag markets has a forecasted 2.7% increase in milk production in 2008 over 2007. Fueling the higher production is an expected 1% rise in cow numbers, coming from a 3% increase in U.S. heifers expected to calve in 2008. Despite higher feed costs and a solid export market, they reduced their projected Class III annual average by 70¢/cwt from last month to $15.80/cwt.
- Weekly NASS numbers continued to trend lower this week, following recent cash trends. 40-lb cheddar block were down 6.1¢ to average $1.73/lb and 500-lb barrels lost 1.5¢ to $1.84/lb. Powders were sharply lower as well, with dry whey falling 5.2¢ to average 27.3¢/lb and nonfat dry milk off 2.2¢ to $1.38/lb. Butter increased 1.6¢ to $1.21/lb.
- Dry dairy product manufacture is edging close to plant capacity in the Northeast, according to Fluid Milk & Cream Review. Plant managers are working on plans on how to handle the upcoming spring flush.
- Milk supplies in California continue to stress and outpace processing capacity in California, according to Fluid Milk & Cream Review. Production remains at levels well above a year ago, forcing more milk out of state. Arizona is heading towards a new record peak in the next month, and cream supplies in the state are heavy.
- Cheese offerings in the Western region are becoming larger and more common, according to Dairy Market News. Demand has backed off post Super Bowl Sunday and buyers are content to work down stocks while waiting for the next correction in the cheese price.
- Butter production is strong across all regions of the country, according to Dairy Market News. Heavy supplies of milk and cream are forcing churns to run on extended schedules. Most current butter production is destined for storage programs.
- Dairy cow slaughter for the week ending 02/02 dipped back below 50k at 48,800. During the same period last year, 50,800 head were culled.
- International: January milk receipts in France were sharply higher than last year, according to Dairy Market News, and production is increasing seasonally throughout the European Union. Feed supplies are in good supply and the winter weather has not been hard on dairy operations. Cow numbers in Germany were up slightly, the first increase in many years.

Recommendation:

Overall, it was a fairly quiet week in Class III milk, but buyers felt upside risk outweighed downside risk and every month but Feb experienced gains. The Feb-Dec average increased by 19¢, but the last half of 2008 increased the most, up an average of 29¢. Buyers even found value in 2009 contracts, pushing the average up 12¢. They might be telling us something. Dry whey reports from Dairy Market News were the most encouraging in months, with the thought that we may be putting in a bottom (see chart). NASS dry whey numbers will likely continue to head lower near term due to their lag, but if the weekly Central and Western whey prices reverse trend and start moving higher, watch out! Our sources are telling us that international interest for cheese is strong. It appears Australia and New Zealand will have little to no excess product available to export; in fact, Australia is importing U.S. cheese! Finally, while we're still concerned about cow numbers, the 1.9% increase in milk production for January was on the low side of expectations. As cheese has approached and breeched $2 once again in the cash market, buyers have been less aggressive and may now wait for a correction. The cash market appears to oscillate roughly between $1.70 and $2.00, and we may continue to see that for quite some time. In light of the fact we rarely seem to stay above $2 for very long, we would consider selling milk at a $1.95/lb equivalency. Assuming dry whey was to recover from the low 20 cent range to 30-35¢, Class III would come out at about $18.50. March hit a high of $18.19 this week before running out of steam and settling at $17.83. Enter orders to sell Mar and Apr at $18.50 or higher. Or, to stay open to upside, just buy disaster insurance, establishing a floor under your milk with PUT options. Buy the March 17.50 PUT for 25¢, April 16.25 PUT for 25¢ and the May 16.00 PUT for 25¢. Leave the last half of 2008 open. With grain prices still trending higher, we would get coverage on your protein needs on any significant breaks.

NOTE: All U.S. financial markets are closed Monday, February 18th, in observance of President's Day. The KDM offices will also be closed, but re-open Tuesday morning.