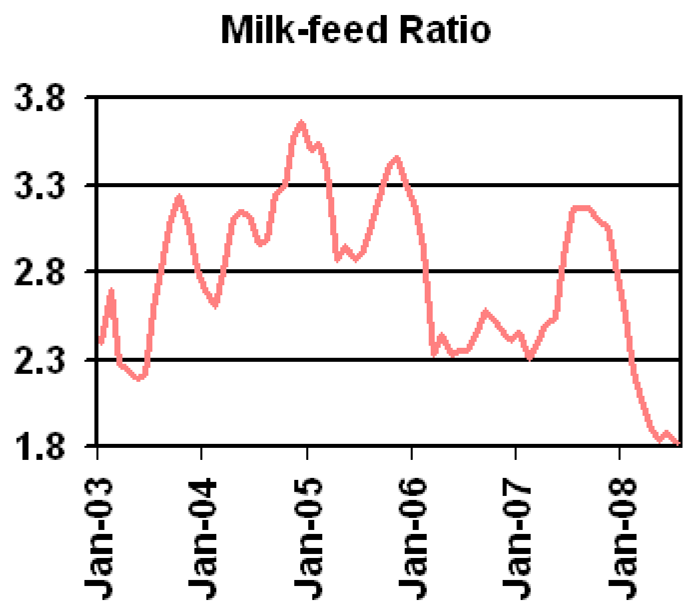
KDM Trading, Inc.
877.695.8538 www.kdmtrading.com
Dan Schindler, Mark Potter & Keith Schnese

The KDM Dairy Report – August 1st, 2008

What's Bullish:

Futures Month	Friday 08/01 Close	Friday 07/25 Close	Change
Aug-08	$18.00	$18.94	($0.94)
Sep-08	$18.02	$19.52	($1.50)
Oct-08	$18.30	$19.50	($1.20)
Nov-08	$18.22	$19.49	($1.27)
Dec-08	$18.18	$19.31	($1.13)
Jan-09	$18.10	$19.12	($1.02)
Feb-09	$18.07	$19.07	($1.00)
Mar-09	$18.11	$19.05	($0.94)
Apr-09	$18.28	$19.08	($0.80)
May-09	$18.30	$19.05	($0.75)
Jun-09	$18.50	$19.15	($0.65)
Jul-09	$18.75	$19.21	($0.46)
Aug-09	$18.92	$19.41	($0.49)
Sep-09	$19.10	$19.54	($0.44)
Oct-09	$19.10	$19.50	($0.40)
Nov-09	$19.05	$19.50	($0.45)
Dec-09	$19.06	$19.45	($0.39)
Aug-Dec	**$18.14**	**$19.35**	**($1.21)**
2009 Avg	**$18.61**	**$19.26**	**($0.65)**

- Commercial Disappearance: Use of milk in all products in May was up 1.4% vs. a year ago, according to USDA stats released this week. Jan-May, use of milk in all products is up 4%. Butter use was up 20.6% in May and up 24% YTD, however, use of American cheese was down 6.5% in May and is now up only 0.3% YTD.
- Ag Prices Report: The July milk-to-feed ratio was published at 1.82, down slightly from a revised 1.88 in June. It's the lowest ratio since tracking began (see chart).
- Milk production in the Northeast holding at a "lighter" level, and supplies are sharply tighter in the Mid-Atlantic, according to Fluid Milk & Cream Review. Extreme heat caused one plant to receive only half the tankers this week vs. last. Florida finally stopped shipping milk out with a rapid decline. Two weeks ago 180 loads left the state; this week, zero.
- In the Midwest, spot loads of manufacturing milk, which were selling at big discounts only a week or so ago, are now commanding a $1.00 premium, according to Fluid Milk & Cream Review. Cheese orders have been better, while cheese yields have declined. Milk intakes are mostly lower as a result of recent hot, humid weather. Cream supplies are tight and churning is light.
- Hay supplies are tight and plants in the Pacific Northwest are not seeing the offerings of cheap, surplus milk that were available a few weeks ago, according to Fluid Milk & Cream Review.
- Dairy Market News reports churning activity across the country is seasonally active, but not generating sufficient volumes of butter for needs. Butter demand is holding steady at good levels, thus inventoried stocks continue to supplement production shortages.
- While block and barrel prices were relatively high before this week's drop, Dairy Market News reports that demand at those price levels seemed to be strong. Interest in low fat cheese in the Northeast is also very positive.
- Current cheddar blocks in the Midwest are reportedly "snug", although barrels are more available, according to Dairy Market News. Mozzarella interest has improved and supplies are tighter. Cheese plant schedules are often lighter as milk receipts have declined noticeably in the past few weeks. Milk supplies will tighten further after supplemental milk shipments to the South resume.
- Western cheese buyers continue to look for current blocks, and any offerings have been generally easy to clear, according to Dairy Market News. Under grade cheese offerings are also clearing in very short time periods.
- Weekly cold storage numbers for the period 07/01 through 07/28 show cheese stocks are down 4% at USDA selected storage centers, or a drop of nearly 4 million lbs. Butter stocks, however, are up 1%.
- Butter stocks at CME-approved warehouses fell by 4.1 million lbs for the week ending 07/26, leaving 96.9 million lbs on hand. Last year at this time butter stocks fell 0.7 million lbs with 149 million lbs on hand.
- International: Annual export numbers for the Australian 07/08 milking season are in, with total exports down Jul-Jun on a tonnage basis by 14.4%, according to DairyAustralia. Butter exports were down 21.9% while cheddar exports were down 8.3%



What's Bearish:

- Cash Market: Blocks plunged 23¼¢ to $1.83½/lb and barrels shed 17¢ to settle at $1.80/lb this week, as sellers took control of the spot market. Buyers put up a fight, grabbing 27 loads of blocks at 27 loads of barrels, but still came up on the short end. Butter was the lone bright spot, gaining 3½¢ to close at $1.57½/lb on no trades.
- Effective September 1st, a new manufacturing make allowance will go into effect, cutting 35¢/cwt from the Class III price formula. The decision was approved by USDA and affects all federal milk orders.
- July Class III was announced at $18.24/cwt, down $2.01 from June.
- International: Dairy Market News reports that stocks of nearly all types of manufactured dairy products in Western Europe are available for domestic and international buyer interest. Sales activity has been slow, and milk production has been bolstered by lush, green pastures from prevalent rainfall.
- International: Some cheddar suppliers in Australia are indicating that domestic retail sales are showing signs of declining, according to Dairy Market News. Consumers are looking at their disposable income and appear to be cutting back. Cheese sales are continuing, but the trend is toward smaller package sizes.
- Central dry whey prices averaged 23½¢ this week, according to Dairy Market News. The market is weak as buyers seem content to wait for lower pricing opportunities. Inventories are building as domestic interest is slow, export sales activity has waned, and more competition is noted from other regions of the world.
- Dairy Market News also calls the nonfat dry milk market weak. Producer inventories are increasing and there are reports of lower offering prices in an effort to stimulate demand.
- Dairy cow slaughter for the week ending 07/19 was 45,800 head, only 700 head more than a year ago.
- Milk production in California has regained much of their recent losses, as weather conditions have moderated, according to Fluid Milk & Cream Review. Evening lows in the 60's have helped cow comfort.

Recommendation:

Last week we said the cheese rally should be sold, but we could not have predicted the meltdown in the cash cheese market this week. On Wednesday, sellers crushed barrels, pushing them all the way down to $1.65 from $1.93, and in the process, set new all-time records for largest single drop in a day at 28¢, and largest spread between blocks and barrels at 32¢. With the world price for cheddar hovering around $2.25/lb, it seemed overdone, and sure enough, on Thursday barrels popped back 15¢ to leave them at $1.80. We had a lot of phone calls this week wondering what was going on. There's certainly some gamesmanship going on among the major players in the cheese pit, but it appears we have a "battle royale" on our hands. Clearly there is cheese available. We're told that early spring and summer cheese buyers were scared to death of "$2.50 cheese" this fall, so were quite happy to buy $1.80 - $2.20 cheese. Now that their warehouses are getting full, they're less willing to take on new product, resulting in excess coming to the cash market. On the other hand, the last two weeks of cheese updates indicate blocks are getting tight around the country and buyers are out looking to own product. The cash market certainly bears that out, as we've had up to 5 different buyers taking on loads of cheese this week. The high weekly volume, a combined 56 loads (1 load = 44,000 lbs) of blocks and barrels, is compelling evidence of this. So, it seems the two sides will rest over the weekend and be ready to duel again next week. Where we go from here is difficult to say. We are disappointed in the dry whey market. While we weren't expecting another run to 79¢ like last year, we did think by this time of summer that 35-40¢ was possible. Instead, prices continue to weaken, and the 17¢ difference from 40¢ (our hope) and 23¢ (current Central whey price) means $1.02/cwt less in the Class III formula. That difference could make or break a producer's cash flow this go-round. We'll also need to watch the international market carefully, as more product availability from Europe and improving conditions in Oceania will bring more competition. Rainfall in New Zealand and Australia going forward will be a key to whether they'll be able to recover from last year's drought. If they don't get the rain, our domestic milk prices will certainly benefit. We're hearing about lots of cash croppers wishing they'd sold more corn and beans at their highs, and will likely sell any new rallies in grains. This could limit gains in row crops, and we bring it up because the same will be true for milk. A lot of producers missed out on selling $20 and $21 milk and would love another shot at it, so we'd expect a lot more sell-side liquidity to show up should we make another run on the cheese price. The new make allowance goes into effect on September 1st. Commit the following to memory: $2.10/lb cheese now equals $19.65/cwt milk, and it could be lower, depending on where dry whey goes. Certainly the market has become much more confusing and it's very difficult to predict even long-term trends. If we stay in the low $18 to upper $17 level for the next 4-6 months, it could set the second half of 2009 up for some major gains. But we could just as easily come storming back in 3-6 weeks as school begins and holiday cheese buying is on people's minds. We would look to sell milk at $19.50 or higher Oct-May. That's close to our $2.10 cheese price and cheese above that level has tended to kill international interest. Buy the best PUT options you can get for 50¢ if you can't bear to sell milk. It will provide a safety net should the market deteriorate further, yet keep you open for higher prices if we have a fall rally.