

The KDM Dairy Report – Jan 27th, 2012

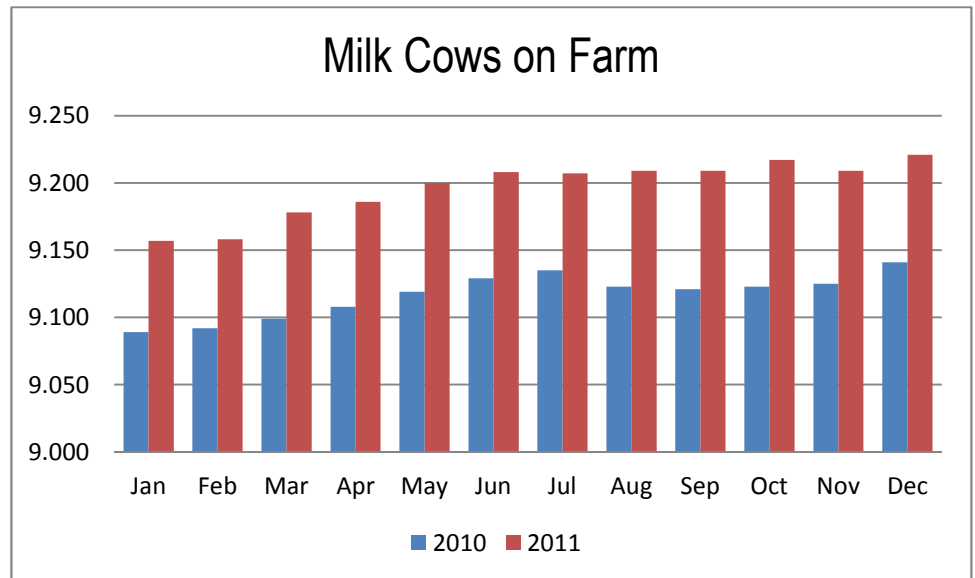
What's Bullish:

- Class III components were mostly higher in this week's NASS survey. 40-lb blocks increased 1.8¢ to average \$1.59/lb, but barrels were down 0.3¢ to \$1.61/lb. Butter went up a penny to average \$1.59/lb and dry whey marched 0.9¢ higher to reach 71.1¢/lb, but nonfat dry milk lost 5¢ to average \$1.37/lb.
- Dairy Market News reports drought conditions have spread to all areas of Florida. Hay supplies are running short in some areas and recent freezing temperatures have limited winter forage growth. Near 90% of pastures are rated as fair, poor or very poor.
- Grains: March corn has rallied more than 40¢/bu since the Jan crop report plummet, while Mar beans are up about 70¢/bu over the same period.

Futures Month	Class III 01/27	Class III 01/20	Change	Dry Whey 01/27	Dry Whey 01/20	Change	Cheese 01/27	Cheese 01/20	Change
Jan-12	\$17.10	\$17.10	\$0.00	69.33¢	68.75¢	0.58¢	\$1.612	\$1.612	\$0.000
Feb-12	\$16.64	\$16.41	\$0.23	70.50¢	70.75¢	(0.25¢)	\$1.562	\$1.539	\$0.023
Mar-12	\$16.72	\$16.69	\$0.03	65.50¢	68.75¢	(3.25¢)	\$1.600	\$1.575	\$0.025
Apr-12	\$16.79	\$16.71	\$0.08	58.00¢	63.70¢	(5.70¢)	\$1.650	\$1.605	\$0.045
May-12	\$16.86	\$16.78	\$0.08	53.88¢	59.50¢	(5.63¢)	\$1.685	\$1.643	\$0.042
Jun-12	\$17.00	\$17.15	(\$0.15)	52.00¢	55.50¢	(3.50¢)	\$1.700	\$1.703	(\$0.003)
Jul-12	\$17.14	\$17.24	(\$0.10)	48.50¢	51.50¢	(3.00¢)	\$1.733	\$1.749	(\$0.016)
Aug-12	\$17.25	\$17.26	(\$0.01)	48.50¢	50.50¢	(2.00¢)	\$1.750	\$1.747	\$0.003
Sep-12	\$17.24	\$17.23	\$0.01	48.00¢	49.00¢	(1.00¢)	\$1.749	\$1.749	\$0.000
Oct-12	\$17.10	\$17.14	(\$0.04)	48.00¢	48.00¢	0.00¢	\$1.740	\$1.740	\$0.000
Nov-12	\$17.10	\$17.12	(\$0.02)	47.50¢	48.00¢	(0.50¢)	\$1.731	\$1.740	(\$0.009)
Dec-12	\$17.05	\$17.15	(\$0.10)	47.50¢	48.00¢	(0.50¢)	\$1.725	\$1.745	(\$0.020)
12 Mo Avg	\$17.00	\$17.00	\$0.00	54.77¢	56.83¢	(2.06¢)	\$1.686	\$1.679	\$0.008

What's Bearish:

- Milk Production Report: Output in December increased 2.5%, well above analyst expectations, and the largest year-over-year increase in 2011. Cow numbers increased 12,000 head from Nov while milk per cow jumped 29 lbs to 1,796. On an annual basis, milk production in 2011 was up 1.8% vs. 2010 and cow numbers increased 80,000 head.
- Cash Market: Blocks managed to gain ½¢ from last week to close at \$1.51/lb. Barrels lost ¼¢ to settle at \$1.49½/lb. Sellers retained control as they offloaded 8 loads of blocks and 25 loads of barrels. Butter gave up 2¢ to settle at \$1.55/lb on just 1 trade.



- Through the first 23 days of January, butter stocks at USDA selected storage centers are up 288%, or 4.35 million lbs. Cheese stocks are unchanged.
- Fluid Milk East: Manufacturing milk supplies are increasing in the Northeast and Mid-Atlantic regions. The increases have occurred due to increased milk production attributed to the mild winter weather and a decline in Class I demand. Cream volumes to churns are maintaining butter production at near capacity levels. Cream supply increases are attributed to increased milk production, good butterfat levels, and additional cream from increased yogurt production. Milk production in the Southeast region is increasing. Class I demand has leveled off in most areas with some push backs in others. Increased milk supplies have to be relocated for processing. Cream supplies have quickly exceeded demand needs, resulting in lower multiples and shipments of cream to the Midwest.
- Fluid Milk Central: Farm milk production is improving steadily in the Central region. Some milk handlers indicate on a month to month basis, milk receipts are up 1-4%. Dairy operators in the upper Midwest report feed inventories are holding up well as winter weather conditions so far have been moderate and haven't stressed cows for extended periods. Central cream availability is improving. Eastern and Western cream spot loads are also moving to Central facilities as processing facilities in the regions of origin reach capacity. Condensed skim loads from the East and West are augmenting supplies in the Central, with some cheese plants increasing cheese manufacturing on the strength of those spot loads.
- Fluid Milk West: California milk production continues to build higher on a weekly basis. The NASS December milk production estimates were 3.8% higher than a year earlier in the state and trade contacts are stating that the January 2012 indications are even higher than that. Milk receipts are increasing and, while there are not capacity issues, the volumes are creating more stress than was projected for this period. Several cheese producers under milk supply contracts are pushing back milk loads and this

milk is moving into butter/powder operations. Arizona milk production is moving higher. Weather conditions have been seasonal and milk cows are making a lot of milk. Plants are receiving more milk and are working harder to balance the milk supply. New Mexico milk output trends continue along steady to slightly higher levels. Milk supplies are above year ago levels and processors are running balancing plants at a higher pace than projected. Western cream markets remain weak and pricing levels are trending lower. Demand for cream is lackluster.

- Butter: Churning activity across the country is strong as cream supplies are plentiful and clearing from one region to another to find processing capacity. Butter producers are gearing up production schedules and often, churns are running at capacity levels. With churning as active as it is, production is greatly surpassing demand, thus clearances to inventory are heavy. Butter demand is fair at best as many buyers are hesitant to procure too heavily in a down price cycle.
- Dry Whey Central: Prices are steady, but spot load availability from manufacturers and resellers is increasing modestly. Most sales activity is still contract based, but spot load buyers remark they are able to consider multiple spot offers of whey, something that wasn't available in recent weeks. As some end users reassess dry whey inventories, a few dry whey contract loads were pushed back and reoffered to the industry. Also, some spot loads of dry whey packaged for the export market are reportedly being offered to the domestic market, with price considerations. Buyer interest is more guarded than in recent weeks.
- Dry Whey West: Prices are fractionally higher this week, but the current price is fueling some uneasiness amongst manufacturers and brokers as to how long these prices can be sustained. International whey prices are below domestic pricing. Contacts indicate that there are unconfirmed reports of block offers of whey that have traders nervous concerning pricing strategies.
- Dry Whey East: Prices continued to move higher, but production is increasing as milk production and manufacturing milk supply increases have prompted higher cheese output. Dry whey futures prices for the second quarter, priced 10+ cents below the current market, are prompting manufacturers and brokers to consider liquidation of some of their current inventories. End users and brokers are receiving increased offers from various suppliers, but sales have not yet been confirmed. Supplies are moving through contracts, but spot sales and resale activity are light as prospective buyers are resisting current market prices. Export demand is also softening with greater competition coming from Europe. The market undertone is weak as supplies increase and demand is softening.
- Nonfat Dry Milk: The market tone for nonfat dry milk is weaker. Buying interest has slowed as purchasers assess the impact of current market price declines. Production has been strong as milk supplies are heavy.
- Cheese East: Cheese production is increasing following the increase in milk supplies. Cheese demand and sales ahead of the NFL playoffs and Super Bowl have been below manufacturer's expectations. Cheese inventories are expanding as production increases.
- Cheese Midwest: Sharply lower CME cash cheese prices last week impacted orders. The impact in some plants was described as "devastating" as some buyers opted to step back and assess the sudden price decline. Some buyers are believed to be waiting until early February to increase ordering and build retail inventory levels. This is expected to see increasing numbers of retail cheese promotions in February, and possibly March. Some manufacturers with assured milk supplies at a level exceeding current cheese sales requirements, have continued steady cheese manufacturing to build inventory levels, expecting a sales increase in the near future.
- Cheese West: Prices are weak as buyers are content to wait before placing additional orders. Milk for manufacturing is available with some cheese plants choosing to turn down some loads. Mozzarella demand has turned lighter and production adjustments have been made by producers. Cheddar stocks are manageable, but demand is moderate for extra orders.

Recommendation:

Not a lot of positive news this week to say the least, and we think it forebodes more price weakness in the near term. Milk out West is starting to build towards its peak, butter churns are running near capacity, cheese sales are slow to moderate and dry whey prices continue to be pressured (see price grid above). What is impressive, is how well Class III futures have held up considering the above, and a bearish Milk Production Report that came out on Monday. We get the argument that our cheese prices are well below international levels and will be defended, but if demand for all dairy products doesn't pickup, the wave of milk that appears to be forming may prove to be too much. The mild winter being experienced in the Midwest and Northeast is also helping production, while farms are efficiently using feed as the cows just don't need to eat as much in the warmer weather. Current spot prices work out to about \$16.00 Class III. With March settling at \$16.72 and only two weeks until it begins pricing, cheese will need to continue to go up to justify the premium. We could be wrong, but we just can't see that happening. As we highlighted last week, dry whey looks vulnerable here, and even a 10¢ drop in price would take Class III to about \$15.50 even at current cheese prices. If you need to get more coverage, we would get more aggressive and simply sell milk Mar-Jun (avg \$16.84). Get up to 75% covered. This weak patch could last longer than anyone thinks. For July-Dec, get 25% covered with the 16.00 x 18.50 fence strategy. Pay up to 5¢/mo. The market has been lulling a lot of people to sleep; time to get your hedge hats back on and get going before it's too late!

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