

The KDM Dairy Report – Feb 3rd, 2012

What's Bullish:

- Cattle Inventory Report: U.S. cattle inventories fell to the lowest since 1952 after a drought in the South prompted ranchers to shrink herds. As of Jan. 1, beef and dairy farmers held 90.77 million head of cattle, down 2.1% from a year earlier. As supply tightens, exports are surging. The U.S. may ship a record 974,000 metric tons (2.15 billion pounds) of beef, excluding variety meats, in 2012, the U.S. Meat Export Federation said. Milk replacement heifers totaled 4.5 million head, down 1% from last Jan, although the total number of milk cows at 9.23 million head was up 1%.

Futures Month	Class III 02/03	Class III 01/27	Change	Dry Whey 02/03	Dry Whey 01/27	Change	Cheese 02/03	Cheese 01/27	Change
Jan-12	\$17.05	\$17.10	(\$0.05)	68.76¢	69.33¢	(0.56¢)	\$1.610	\$1.612	(\$0.002)
Feb-12	\$16.15	\$16.64	(\$0.49)	63.50¢	70.50¢	(7.00¢)	\$1.550	\$1.562	(\$0.012)
Mar-12	\$15.89	\$16.72	(\$0.83)	56.25¢	65.50¢	(9.25¢)	\$1.560	\$1.600	(\$0.040)
Apr-12	\$15.94	\$16.79	(\$0.85)	48.98¢	58.00¢	(9.03¢)	\$1.615	\$1.650	(\$0.035)
May-12	\$16.42	\$16.86	(\$0.44)	46.50¢	53.88¢	(7.38¢)	\$1.664	\$1.685	(\$0.021)
Jun-12	\$16.67	\$17.00	(\$0.33)	46.00¢	52.00¢	(6.00¢)	\$1.705	\$1.700	\$0.005
Jul-12	\$16.95	\$17.14	(\$0.19)	43.50¢	48.50¢	(5.00¢)	\$1.742	\$1.733	\$0.009
Aug-12	\$16.97	\$17.25	(\$0.28)	43.25¢	48.50¢	(5.25¢)	\$1.757	\$1.750	\$0.007
Sep-12	\$17.08	\$17.24	(\$0.16)	45.98¢	48.00¢	(2.03¢)	\$1.757	\$1.749	\$0.008
Oct-12	\$16.97	\$17.10	(\$0.13)	45.98¢	48.00¢	(2.03¢)	\$1.760	\$1.740	\$0.020
Nov-12	\$16.84	\$17.10	(\$0.26)	46.50¢	47.50¢	(1.00¢)	\$1.760	\$1.731	\$0.029
Dec-12	\$16.83	\$17.05	(\$0.22)	45.98¢	47.50¢	(1.53¢)	\$1.760	\$1.725	\$0.035
12 Mo Avg	\$16.65	\$17.00	(\$0.35)	50.10¢	54.77¢	(4.67¢)	\$1.687	\$1.686	\$0.000

- Dairy Market News reports hay supplies in the Western region remain very tight and expensive. Two factors are causing the situation to worsen. The first is that exporters continue to move strong volumes offshore as they have done for much of the year. Further, other regions in the country that are in worse shape, stock wise, are coming in and paying big money to lock up any hay that is still available.
- Cooperatives Working Together (CWT) announced the acceptance of export assistance requests for nearly 11 million lbs of 82% unsalted butter for shipment now through June 2012. CWT also accepted requests for export assistance for 2.8 million lbs of Cheddar, Monterey Jack, and Gouda cheese to Asia, Europe, North Africa and the Middle East.
- International: While cheese demand is forecast to be somewhat limited over next few years, whey demand is expected to be very strong, according to the latest quarterly report by Rabobank. Cheese will be the “underperformer” of the global dairy market, with growth rates lagging behind those of other dairy products, but demand for whey will strongly increase, setting the whey market up for a “structural tightening” in the years ahead. It will be driven in part by growing demand for infant milk formula as more women in emerging markets join the workforce. “With demand for higher-end whey products more generally likely to grow faster than cheese demand (and hence production) in the coming years, whey supply will be highly coveted.”
- International: Dairy product manufacturers and handlers in Oceania are indicating that stocks are basically fully committed and order books are in a strong position.

What's Bearish:

- Dairy Products Report: American cheese output in Dec was up 1.2% vs. Dec '10 while total cheese output increased 2.4% over the same period. Butter production jumped 5.2% over the prior year and was 8.9% higher than in Nov.
- Cash Market: Sellers continued to sell product to cheese buyers. Blocks lost 2½¢ for the week to settle at \$1.48½/lb, with 16 loads exchanging hands. Barrels were unchanged at \$1.49½/lb on 9 trades. Butter lost 6¼¢ to settle at \$1.49¼/lb on 3 trade, and Grade A nonfat dry milk was offered 9¼¢ lower to \$1.35¼/lb with no trades.
- NASS dry whey prices made a precipitous fall in this week's survey, dropping 3.6¢ to average 67.5¢/lb. Butter decreased 0.3¢ to average \$1.59/lb, 40-lb block cheddar lost 0.7¢ to \$1.58/lb and 500-lb barrels gave up 2.7¢ also at \$1.58/lb. Nonfat dry milk was the lone bright spot, increasing 2.8¢ to average \$1.39/lb.
- Weekly cold storage numbers indicate butter stocks jumped 339% in Jan at USDA selected storage centers. Cheese stocks declined 1% over the same period.
- Fluid Milk East: Mild winter weather continues in the Northeast and Mid-Atlantic regions with unseasonably warm temperatures reaching up into New England. The mild weather has prompted increases in milk production, resulting in expanded manufacturing milk supplies. Class I demand remains sluggish. In Florida, Class I demand has declined, resulting in 100 spot loads being exported this week; up from 70 last week. Milk production in the Southeast region is also increasing. Class I demand is lackluster, and the increased milk supplies have necessitated the utilization of auxiliary manufacturing facilities. Cream supplies continue to exceed demand, resulting in lower multiples and heavy volumes going to churns.
- Fluid Milk Central: Farm milk production continues to be above anticipated levels for this time of year. Weather conditions have been extremely favorable to cow comfort levels. Lack of extremely cold weather has boosted production earlier than most handlers had expected. Feed supplies in the Midwest are in good shape and farmers are adding to herds.
- Fluid Milk West: California milk output continues to build across most of the major producing areas of the state. Processors are becoming strategic to be able to handle the milk supplies. Milk production in Arizona is trending higher at levels above a year ago. Farm level conditions for milk cows have been ideal. Plant intakes have been heavy to process incoming milk supplies. In

New Mexico, farm level conditions remain favorable for milk cows and the herd is responding. Milk receipts at local balancing plants are higher and schedules are being increased to handle the milk supply.

- Cheese East: Mild winter weather has brought about increases in milk production, prompting increases in cheese production. Domestic demand has weakened as sales ahead of the Super Bowl are in the books. Inventories are expanding as cheese production increases.
- Cheese Midwest: Cheese production is seasonally strong as milk volumes are readily available to cheese operations. For those operations that are looking for additional milk to maintain full production schedules, procuring that milk is not presenting too much of a problem. In some instances, cheese plants can't take full advantage of all of the milk offerings. Heavy cheese production is often surpassing demand thus inventories continue to build.
- Cheese West: Current production of cheese is stronger than many manufacturers hoped with recent sales activity. Stocks are building at many locations and contacts are somewhat concerned about the timing. Cheese needed for Super Bowl festivities has been shipped for quite a while and things are now quiet on the demand front.
- Butter: Cream supplies continue to exceed demand with the excess volumes going to churns. Butter production remains very active with a number of plants maintaining production near capacity levels. New orders are very limited. End users are holding off purchases or only buying for immediate needs, waiting to see how low prices will fall.
- Dry Whey East: Milk production increases are leading to increased cheese and dry whey production. Falling dry whey futures prices at the CME continue to prompt manufacturers and brokers to consider liquidating some of their current supplies. End users and brokers are viewing the turn in the market as time to hold off purchases to see how far prices may decline. Supplies are moving through contracts with some spot sale activity below contracted prices. Export demand has softened with additional competition coming from Europe. The market undertone continues to be weak.
- Dry Whey Central: Increased offers of spot whey are appearing and are typically below current prices. Reports of large blocks offered to export buyers from outside the region are circulating and have buyers waiting to see if they will see lower pricing. Production of dry whey is good as cheese plants continue to receive increased milk volumes.
- Dry Whey West: Some whey sellers decided that this was a good time to reduce inventory holdings as milk production starts to increase seasonally. To get this done, many relied on export opportunities to move substantial volumes of whey. Prices needed to be reduced to get the volumes sold that allowed them to be more comfortable with inventories at the start of February. Many of these contacts indicate that prices may well rebound in the near future as stock levels become more comfortable for them and the pressure to sell more powder immediately is reduced. Production of powder at this time is heavier than many had assumed due to heavier milk production in the region with quite a bit of it heading to cheese and whey output.
- Nonfat Dry Milk: The market tone is weak. Domestic buying interest has slowed. Offerings of milk and condensed skim are heavy into cheese producers. Export interest is very price sensitive for the current light to moderate demand.
- International: Milk production across Western European countries is steady to trending higher over the past few weeks. Many countries are seeing milk output at levels above a year ago for the similar period. Reports are noting that milk volumes were higher in December versus year earlier for: Germany, France, Austria, Netherlands, and the United Kingdom. More whey powder offerings are being made into export channels as pricing levels are favorable for international buyers.
- International: In New Zealand, weather patterns are quite favorable for good milk production at this time of the annual production cycle. Milk handlers continue to project a 3-4% annual increase over last season, with some milk handlers now adjusting their estimates to a strong 4% plus increase. In Australia, fluctuating weather patterns are not having an overall negative impact on milk output. Milk producers and handlers are indicating that milk volumes are lower, but maintaining levels that are often higher than projected. Australian producers continue to project a 2-3% annual increase when the current fiscal year ends in June.
- International: At the twice monthly Global Dairy Trade auction this week, all dairy contract average prices were lower. Skim milk powder averaged 0.9% less than the previous auction. Anhydrous milk fat was down 6.4%, whole milk powder down 0.8%, milk protein concentrate down 9.6% and cheddar cheese down 2.9%. The cheddar price works out to about \$1.62/lb.

Recommendation:

Timing is everything. A warm winter has brought seasonal milk increases early. Plants are already struggling to handle some of the supply, while demand is at low, post holiday/football levels. Whey futures were sharply lower this week, cheese couldn't rally, so milk futures sold off. While the market caught a bid today and we finished Class III mostly higher, we would see any further rally as a selling opportunity. We're going to be dealing with the flush earlier than normal this year. Inventories are building. Last year Class IV milk led Class III in our Q1 rally. With loads of cream, butter and powder ahead of us, we don't see that happening this time around. Current spot prices work out to about \$16.09 Class IV and \$15.20 Class III. A year ago Class IV was \$3-4/cwt higher than Class III. We think this sets up for some explosive upside later in the year, however. Dry whey is likely to come back strong once temps heat up, hay is tight and financials are getting less attractive by the day. Sell the front months (through June) on rallies, buy call options to protect existing sold positions. Buy call options in the second half of 2012 in advance of selling, if they lose enough premium.

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