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The KDM Dairy Report – Feb 24th, 2012

What's Bullish:

Futures Month	Class III 02/24	Class III 02/17	Change	Dry Whey 02/24	Dry Whey 02/17	Change	Cheese 02/24	Cheese 02/17	Change
Feb-12	$16.08	$16.07	$0.01	64.50¢	64.50¢	0.00¢	$1.544	$1.540	$0.004
Mar-12	$15.28	$15.68	($0.40)	55.50¢	57.50¢	(2.00¢)	$1.519	$1.538	($0.019)
Apr-12	$15.12	$15.63	($0.51)	47.23¢	51.85¢	(4.63¢)	$1.546	$1.570	($0.024)
May-12	$15.15	$15.92	($0.77)	43.75¢	49.25¢	(5.50¢)	$1.570	$1.611	($0.041)
Jun-12	$15.43	$16.10	($0.67)	42.50¢	48.48¢	(5.98¢)	$1.612	$1.643	($0.031)
Jul-12	$15.92	$16.40	($0.48)	41.60¢	47.93¢	(6.33¢)	$1.662	$1.665	($0.003)
Aug-12	$16.10	$16.52	($0.42)	41.75¢	47.25¢	(5.50¢)	$1.676	$1.682	($0.006)
Sep-12	$16.31	$16.53	($0.22)	41.00¢	46.25¢	(5.25¢)	$1.694	$1.695	($0.001)
Oct-12	$16.33	$16.54	($0.21)	40.00¢	44.00¢	(4.00¢)	$1.706	$1.705	$0.001
Nov-12	$16.19	$16.39	($0.20)	40.00¢	45.00¢	(5.00¢)	$1.700	$1.695	$0.005
Dec-12	$16.18	$16.40	($0.22)	40.00¢	45.00¢	(5.00¢)	$1.700	$1.692	$0.008
Jan-13	$16.04	$16.20	($0.16)	40.00¢	40.00¢	0.00¢	$1.692	$1.714	($0.022)
12 Mo Avg	**$15.84**	**$16.20**	**($0.35)**	**44.82¢**	**48.92¢**	**(4.10¢)**	**$1.635**	**$1.646**	**($0.011)**

- Outlook for U.S. Ag Trade Report: USDA raised their dairy products export forecast for 2012 by $400 million, due to stronger than expected exports of cheese, whey, lactose and nonfat dry milk. Strong demand from Asia and Mexico are expected to drive exports in 2012.
- Dairy cow slaughter for the week ending 02/11 totaled 64,100 head, the highest weekly total in a year.
- Hay supplies in the Southeast remain very tight and feed prices are high. Some producers, where feasible, are attempting to graze more cows in lieu of purchasing additional hay and/or feed supplies. Demand for cream is on the increase as cream cheese makers are receiving increased orders for the upcoming holiday. Ice cream and ice cream mix manufacturers have also increased their production schedules.
- Butter Northeast: Butter production is very active with cream readily available and demand for butter increasing. Bulk butter production has slightly declined. Recent bulk, print and export sales have significantly decreased inventories at some plants. Export interest is very good with some plants receiving export queries almost daily.
- Butter Central: Current churning activity has surpassed demand, thus increasing volumes of butter are clearing to inventory. However, current demand for butter is gaining momentum as fairly stable cash price levels are causing buyers to return to the marketplace for current and near term needs. Easter/Passover orders are developing quite well with some feature activity being scheduled during the upcoming holiday period. Food service establishments continue to place fairly good orders as traffic flow through their operations is stronger than projected.
- Butter West: Butter production in the West remains heavy as increased farm milk supplies and increased butterfat volumes are appearing. However, manufacturers report that orders for the Easter holiday are beginning and helping to clear inventories. Increased retail featuring is helping to move print butter at both club and supermarket outlets.
- Cheese East: Inventories continue to increase, but at a lower rate compared to recent weeks as cheddar cheese sales, in some areas, have picked up. Mozzarella sales have also increased to retail outlets and pizza makers. There continues to be good export demand.
- Cheese West: As the cheese prices have stabilized, at least for the short term, there is some increased buying interest from domestic concerns. Some increased featuring at the retail level is helping to move stocks. Export demand is being aided by CWT (Cooperatives Working Together) assistance. Stocks are building but are still described as manageable.
- In a report released this week, Rabobank analysts forecast the combination of soft drinks and dairy beverages will emerge as a megatrend in 2012. Greater consumer demand for health and wellness beverages, rising commodity costs, and growing demand from emerging markets will be key influencers. The thirst for protein drinks, prebiotics and other functional drinks has led to a burst in new product creations.
- Cold Storage Report: American cheese stocks at the end of January were down 4% from last year and flat from Dec.

What's Bearish:

- Cold Storage Report: Butter stocks at the end of January were up a stunning 44% from a year ago and 60% above Dec levels. It was the largest month-to-month gain ever recorded.
- All Class III components were lower in this week's NASS survey. 40-lb cheddar blocks lost 2.7¢ to average $1.50/lb, 500-lb barrels gave up 0.4¢ to $1.53/lb, butter decreased 5.7¢ to $1.44/lb, dry whey inched 0.2¢ lower to 64¢/lb and nonfat dry milk shed 4¢ to average $1.36/lb.
- Weekly cold storage numbers indicate cheese stocks at USDA selected storage centers are up 2.3 million lbs (2%) over the period 02/01 through 02/20. Butter stocks over the same period are up 926,000 lbs (14%).
- Fluid Milk East: Manufacturing milk supplies continue to be unusually heavy for this time of year in the Northeast and Mid-Atlantic regions. The lack of any major winter storms has caused Class I demand to be flat and below year ago levels. Milk production in Florida continues to increase. Class I demand remains sluggish, causing exported spot loads to remain close to last week's total with 131 spot loads exported this week. The Southeast region is also seeing increases in milk production. Nearly all auxiliary manufacturing facilities are receiving milk with some plants near capacity. Milk is being shipped at discounts under Class prices in order to find a home. Numerous plant managers are voicing concerns about the early seasonal rise in milk production

this year and are not sure how they're going to handle increased supplies when the seasonal flush arrives. Class I demand is significantly down from last week with no apparent explanation for the downturn.

- Fluid Milk Central: Farm milk production in the Central region continues to grow weekly as mild weather patterns linger. Regional spot milk load prices reportedly range from flat Class to -$4. Cream in the Central region is readily available.
- Fluid Milk West: California milk production continues to build and the overall level is well over last year's pace. Processors and handlers are feeling the effects of the extra milk, working harder to balance the milk flow. The solids levels of incoming milk are also increasing. Plants are running on longer schedules. Arizona milk production trends continue to build. Milk intakes are taxing the processing capacity of plants in the state, which looks to continue until the farm level supplies decline. Class I demand is flat and unaggressive. New Mexico milk output is higher on a week-to-week basis. Plants are running on extended schedules to process local milk supplies. Favorable weather in the Pacific Northwest is contributing to increased milk flow. Increased cow numbers are adding to milk production as handlers are dealing with above expected volumes for this time of year. Manufacturing facilities are operating on extended schedules to accommodate the increased supplies.
- Dry Whey East: Milk production increases are prompting marginal increases in cheese and dry whey production. Product availability in the Eastern region remains fairly tight with only a few loads becoming available on the spot market as manufacturers remain very comfortable with their current inventories. However, resale loads continue to be offered under market prices as some brokers are rotating inventories. Ice cream and ice cream mix production has increased, which in turn has marginally increased demand for dry whey, but these manufacturers also sense the uncertain undertone of the market and are limiting purchases to their current needs. Brokers have indicated that other dry whey end users have also backed away from purchases above current needs, wanting a clearer picture of the market. Overall demand for dry whey remains sluggish.
- Dry Whey Central: While most contract loads are still shipping regularly, some customers are more reluctant to take contract loads. With cheese production moving higher as a method of clearing both farm milk and condensed skim, dry whey production is climbing.
- Dry Whey West: Western dry whey markets are lower this week. Spot availability is increasing as manufacturers and brokers are offering whey at lower prices. Spot buyers are anticipating lower prices and are buying on an as-needed basis while prices are adjusting. Whey stocks and production are increasing as cheese plants are operating at heavier than usual schedules.
- Nonfat dry milk: The market tone remains weak. Domestic buying interest is uneven and lower than projections. Some buyers are attempting to push back contract loads because they do not have needs or sales. Export interest is light to fair with new interest slow to develop. Drying schedules are heavy and are reflective of the strong milk flow.
- Cheese Midwest: Regional milk supplies remain heavy and some surplus milk sales below class continue to be reported. With the capacity of some cheese manufacturers in the Midwest already nearing limits, some Midwest milk has also been shipped to the Southeast for use in cheese plants operated only part of each year to accommodate heavy milk supplies.

Recommendation:

We finished the week in the red again, in Class III, dry whey and cheese futures. The outlook over the next 2-3 months doesn’t look that promising either. The surge in milk output from the mild winter appears to have been funneled mostly into churns, with massive gains seen in butter stocks, according to the Cold Storage Report, while cheese stocks were flat to slightly lower. While export interest is picking up and domestic promotional/feature activity is increasing, it simply may not be enough to stem the tide of milk our nation’s dairies are producing at the moment. From coast to coast now, processing facilities are being stressed, with many mentions of running on “extended schedules” or “near capacity”. The problem is, we’re probably 3-4 weeks away yet from the peak. Technically, prices are getting oversold, so we’re not sure we’d chase these lower prices. But we are due for a bounce, and would consider selling rallies in Q2. Current spot prices work out to about $14.90 milk, so Mar and Apr could still see some premium taking out of their contracts, especially if dry whey keeps grinding lower and spot cheese stays under pressure. It’s hard to know what to do in the 2nd half. If you’re nimble, consider selling some of you production, with the idea of buying the hedge back and taking profits early. As prices continue to weaken in Q2, we could foresee a situation of “producer panic” where anything with a $16 in front of it suddenly looks good. Yet a lot can happen before July. Crude oil prices are over $100/barrel and corn is consolidating over $6/bu. If the energy sector keeps moving higher, it will naturally pull most commodities with it.