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The KDM Dairy Report – Jun 15th, 2012

What's Bullish:

Futures Month	Class III 06/15	Class III 06/08	Change	Dry Whey 06/15	Dry Whey 06/08	Change	Cheese 06/15	Cheese 06/08	Change
Jun-12	$15.61	$15.55	$0.06	50.00¢	51.50¢	(1.50¢)	$1.570	$1.557	$0.013
Jul-12	$16.18	$16.45	($0.27)	51.30¢	52.78¢	(1.48¢)	$1.610	$1.635	($0.025)
Aug-12	$16.60	$16.60	$0.00	52.03¢	52.50¢	(0.48¢)	$1.648	$1.667	($0.019)
Sep-12	$16.85	$16.69	$0.16	52.00¢	52.00¢	0.00¢	$1.674	$1.675	($0.001)
Oct-12	$16.81	$16.60	$0.21	52.50¢	51.00¢	1.50¢	$1.686	$1.677	$0.009
Nov-12	$16.55	$16.47	$0.08	51.38¢	50.48¢	0.90¢	$1.686	$1.685	$0.001
Dec-12	$16.55	$16.35	$0.20	50.90¢	48.00¢	2.90¢	$1.676	$1.673	$0.003
Jan-13	$16.44	$16.15	$0.29	45.00¢	43.00¢	2.00¢	$1.686	$1.670	$0.016
Feb-13	$16.20	$15.84	$0.36	42.00¢	40.00¢	2.00¢	$1.671	$1.665	$0.006
Mar-13	$16.05	$15.85	$0.20	39.50¢	39.50¢	0.00¢	$1.665	$1.665	$0.000
Apr-13	$16.10	$15.91	$0.19	38.50¢	38.50¢	0.00¢	$1.675	$1.680	($0.005)
May-13	$16.25	$16.16	$0.09	40.00¢	38.00¢	2.00¢	$1.713	$1.713	$0.000
12 Mo Avg	**$16.35**	**$16.22**	**$0.13**	**47.09¢**	**46.44¢**	**0.65¢**	**$1.663**	**$1.664**	**($0.000)**

- Spot Market: Cash butter picked up 12¼¢ for the week on 7 trades, settling at $1.54/lb. Bidders were not able to shake loose any product until Friday's session.
- Most Class III components were higher in this week's National Dairy Product Sales Report. 40-lb cheddar blocks increased 3.6¢ from last Wed to average $1.55/lb, while 500-lb barrels were up 3.1¢ to $1.53/lb. Butter increased 0.5¢ to average $1.37/lb and nonfat dry milk inched 0.7¢ higher to $1.10/lb, but dry whey decreased 1.3¢ to average 50.3¢/lb.
- Dairy cow slaughter for the week ended 06/02 totaled 49,900 head, up 5,700 (12.9%) head from a year ago.
- Fluid Milk East: Milk production in the Northeast region continues to decline marginally with corresponding declines in manufacturing milk supplies. The Mid-Atlantic region has experienced declines in production along the seasonal trend. Florida's milk production is rapidly declining as heat and humidity are lowering cow comfort levels. Because of reduced milk production, Class I plants have increased the number of sources they pull from to cover their needs. Recent rains have provided some relief from the dire drought conditions, but aquifers and lakes remain low and more rain is needed. Hay and feed supplies remain tight due to this year's drought. Producers are actively culling their herds as milk production per cow declines, taking advantage of the good cull cow prices and to conform to the newly implemented somatic cell count regulations. Heat and humidity have also accelerated milk production declines in the Southeast with very little need for auxiliary manufacturing. Increased ice cream production has improved cream demand, and cream cheese production has also increased, prompted by good foodservice and retail orders.
- Fluid Milk Central: Spot milk demand from Class III plants continues to outpace availability in several areas of the Central region. As farm milk intakes from patron suppliers trend lower, some cheese plant managers are turning to the spot market for milk. Spot milk prices range from $.50-$1.00 over Class for the week. Some cheese producers are turning to NDM for vat fortification as availability of Central condensed skim and spot milk loads have diminished.
- Fluid Milk West: Milk production in California is down several percentage points compared to last week. Hotter weather conditions have prevailed over much of the Central Valley and the key production areas. Heat abatement measures are in place to make cows more comfortable. Processors are generally welcoming the lower receipts and the reprieve from the seasonally high output levels. Utilization in some cheese plants has been lower due to both maintenance and inventory considerations. Arizona milk output is trending lower. Processing plants are running on lighter schedules and making a more diverse product mix. The impact of hot temperatures is affecting both milk volumes and components. The length of the hot weather is the biggest contributing factor. Class I demand is flat. New Mexico milk production is steady to slightly lower from a week ago. Weather conditions have been hotter, yet have not impacted the milking herd to any great extent. Western cream markets are firming. Demand for cream has improved from ice cream accounts and interest is fair to good from butter manufacturers.
- Butter: Many butter producers and handlers are surprised at the continued strength in butter prices, but then also indicate that this milk production season and demand trends are much different than previous seasons. An overall nonevent winter and unseasonably warm March temperatures were positive factors for a good start to the current milk production season. Good milk flow through manufacturing facilities this spring has provided plentiful milk volumes through butter/powder operations. Favorable weather patterns have also accelerated Class II product demand, especially ice cream and mix sales. Typically, ice cream production does not really kick in until after Memorial Day, but this year, operations were more active prior to the holiday than in recent years. With this trend occurring, cream demand is already more competitive. Volumes of cream remain sufficient to generally maintain near capacity levels for most butter operations, but the surplus volumes available earlier this spring are gone. Retail orders are good, stimulated by feature activities. This week's National Dairy Retail Report showed butter promotions more than doubling nationally, compared to the report two weeks ago. Food service orders are also good as the summer vacation season gets underway.
- Nonfat Dry Milk: Prices continue to move higher this week. The market tone is firming off the most recent market low. Several producers are increasing their spot offering prices to both test the market and not "give away the store" to buyers seeking coverage. There are buyers who missed making purchases at recent low prices who are looking for powder. The resale market is being held tight and those prices are moving higher. Drying schedules are steady to lower, reflecting lower milk receipts and

declines in solids levels. Some producers are making more SMP and MPC. Stock levels are at moderate levels. Many holdings have been committed for nearby weeks.

- Cheese East: Cheese production remains fairly steady overall, with some plant managers unwilling to expand production until their inventories are worked lower. Demand for cheese has improved with good foodservice and export orders. Shredding operations have been increasingly busy, due in part to retail promotions.
- Cheese Midwest: A cheese manufacturer commented that sales are "not great great, but are good". There is a developing sentiment that recent CME price strength in blocks is being driven by anticipation of future cheddar demand later in the year. Some supporting evidence of that this week is inquiries from trading companies seeking spot loads of cheddar blocks from manufacturers intended to be held until later this year. The manufacturers approached are unable to provide the spot cheese until early July due to strong ordering from regular customers. Cheese storage facilities report hearing increasing discussion from prospective buyers worried about the impact of dry conditions on milk production in the Upper Midwest should the conditions continue. Cheese retail advertising volume reported in the National Dairy Retail Report has increased in ad numbers by 16.0% above volume two weeks ago, which was 9.7% above two weeks before that.
- Cheese West: Prices are mostly steady with a firm undertone for block cheese. Barrel demand is mostly steady as supplies are adequate. Production schedules at cheese plants are slowing as milk supplies appear to have passed the peak Spring flush. Plant managers are keeping an eye on inventories and have reduced production in some cases. Mozzarella producers are especially conscious of reduced orders. Export demand has been helpful in moving cheese out of the country.
- International: A Reuters story this week reports China's biggest milk producer (by revenue) has recalled baby formula tainted with high levels of mercury, in the latest safety scare for the country's dairy sector. In response, Mongolia Yili Industrial Group Co. saw their shares decline by their 10% daily limit. The scandal is seen as a big blow to its brand and shows the industry is still struggling with food safety issues, a full four years after tainted milk powder was blamed for the deaths of at least six children. The recall, which began Wednesday, applied to baby formula produced between last November and May. It's been suggested that recent strength in butter/powder prices in Chicago are a response to potential stronger exports to China, as the local population switches to the safety of imported dairy products.

What's Bearish:

- Spot Market: After reaching a high this week of $1.70/lb, blocks were pushed back down to $1.61½/lb, unchanged from last Friday. Barrels closed at $1.57¼/lb, up 5¢ for the week. Just 5 loads of blocks and 5 loads of barrels exchanged hands.
- Dry Whey East: Prices continue to work lower in light market activity. Spot market buyers continue to purchase hand to mouth with the idea of lower prices in the future. Some contract buyers also think prices may move lower and are delaying their regularly scheduled deliveries. Domestic demand remains flat, but export interest has increased as brokers are receiving more price inquires. Production of dry whey is steady at reduced levels as some cheese makers have limited their production until they're able to work their cheese inventories lower. The market undertone remains weak.
- Dry Whey Central: Prices shifted lower this week, following price decreases on index based contracts as well as spot export sales that required price incentives to cover transportation. Various market participants indicate dry whey demand is on pause once again while market information is reassessed. A few end users report the production dates for some delivered dry whey contract loads are now retreating instead of advancing in the calendar year.
- Dry Whey West: Domestic prices continue to show weakness as pricing indices tied to contracts are adjusting lower. Export markets are mostly steady this week with good demand. Whey production is slowing as less milk is going into cheese plants. Manufacture of dry whey is also competing with concentrated whey protein products for the available whey stream. Supplies of whey are reported to be adequate for current demand.

Recommendation:

We saw a fairly volatile market this week as blocks in the spot market made a new high for 2012 at $1.70, only to be shoved back down by Friday. Suddenly butter is strong and dry whey is weak, flip-flopping sentiment from just a week ago. Milk production is still fairly strong, but definitely on the decline now from coast to coast. Some parts of the country are hot, but we're not seeing anything to make a dramatic difference on the whole. Demand seems to be pretty good, both domestic and export, with more export potential possible if the latest tainted milk issue in China grows into something bigger. The euro is starting to fight back against the USD as the potential for another round of quantitative easing by the Fed is a growing possibility. Major elections in Greece over the weekend could cause ripple effects into commodities, depending on the outcome. We expect more volatility next week, but also think upside risk is greater than downside from here. This week we got a July-Dec 15.00 floor with 19.00 cap done at even (net premium of zero cost). This order had been working for a long time and is a fantastic hedge if you can cash flow at a 15.00 base price. Consider an option spread strategy like this one to get yourself some coverage in the last half of the year!