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

The KDM Dairy Report – July 6th, 2012

What's Bullish:

Futures Month	Class III 07/06	Class III 06/29	Change	Dry Whey 07/06	Dry Whey 06/29	Change	Cheese 07/06	Cheese 06/29	Change
Jul-12	$16.71	$16.87	($0.16)	51.00¢	51.25¢	(0.25¢)	$1.682	$1.702	($0.020)
Aug-12	$17.52	$17.62	($0.10)	54.00¢	53.00¢	1.00¢	$1.755	$1.762	($0.007)
Sep-12	$17.87	$17.73	$0.14	55.00¢	53.70¢	1.30¢	$1.777	$1.770	$0.007
Oct-12	$17.76	$17.62	$0.14	55.25¢	53.75¢	1.50¢	$1.770	$1.760	$0.010
Nov-12	$17.63	$17.32	$0.31	54.50¢	54.50¢	0.00¢	$1.748	$1.733	$0.015
Dec-12	$17.45	$17.24	$0.21	52.75¢	53.50¢	(0.75¢)	$1.738	$1.720	$0.018
Jan-13	$17.25	$17.06	$0.19	50.50¢	46.28¢	4.23¢	$1.730	$1.710	$0.020
Feb-13	$17.05	$16.66	$0.39	43.03¢	42.00¢	1.03¢	$1.705	$1.693	$0.012
Mar-13	$17.00	$16.60	$0.40	42.53¢	41.00¢	1.53¢	$1.702	$1.666	$0.036
Apr-13	$16.80	$16.60	$0.20	40.10¢	38.53¢	1.58¢	$1.705	$1.676	$0.029
May-13	$16.90	$16.60	$0.30	46.00¢	40.25¢	5.75¢	$1.713	$1.713	$0.000
Jun-13	$16.91	$16.82	$0.09	46.00¢	41.25¢	4.75¢	$1.710	$1.710	$0.000
12 Mo Avg	**$17.24**	**$17.06**	**$0.18**	**49.22¢**	**47.42¢**	**1.80¢**	**$1.728**	**$1.718**	**$0.010**

- Dairy Products Report: Cheddar cheese output in May was down 2% vs. a year ago, while total cheese output climbed just 0.4%. Butter output was 4.8% higher than a year ago, but 3.8% lower than in April. Production of dry whey for human consumption declined 5.6% vs. last May while manufacturer stocks at month end were 5.2% lower.
- Most Class III components were higher in this week's dairy price survey. Butter jumped 7.1¢ to average $1.47/lb, 40-lb block cheese increased 1.2¢ to $1.63/lb and 500-lb barrels gained 4.1¢ to average $1.62/lb. However, dry whey lost 1.1¢ to average 48.7¢/lb and nonfat dry milk decreased 1.1¢ to $1.10/lb.
- Fluid Milk East: Milk production declines in the Northeast and Mid-Atlantic regions are accelerating due to hot humid weather. News reports are noting wide areas experienced periods without power and many remained without power. Accounts are noting that retailers that lost power are discarding refrigerated and frozen items. There will be big volumes to restock, but with an uncertain timeframe to get all segments of the chain in place with refrigeration and demand. In Florida, milk production continues to decline at an accelerated pace as cow comfort levels have declined with the onset of heat and humidity following the tropical storm. Grade A milk exports from the state fell by 20 loads vs. last week. Milk production in the Southeast region has seen significant declines due to the heat and humidity. Some bottling plants are adding loads, because delivered loads were running light. Only a few loads are being sent to auxiliary manufacturing plants.
- Fluid Milk Central: Milk supplies are showing the effects of recent record high temperatures. Various plants are reporting drops of up to 10% in milk intakes. This is causing plants to balance production schedules to optimize their efficiencies. The hot weather is expected to reduce milk production for much of the upcoming summer months. Drought conditions of varying degrees in the region are causing concern about feed costs and availability in the Midwest.
- Fluid Milk Southwest: Hot weather conditions are common over most of the milk producing areas of Arizona and New Mexico. In addition, humidity levels are increasing. This is causing seasonal monsoon conditions in Arizona. The overall impact of the weather stress is causing milk production to decline in both states. Fat and protein levels are trending lower. Processing plants are running on reduced schedules as the milk flow declines.
- Dry Whey Northeast: Dry whey production has declined following the declines in cheese production, due to lower milk intakes. Demand for dry whey continues to be good with strong pulls from ice cream and ice cream mix manufacturers. There is the feeling among many in the industry that the current heat wave, covering much of the country, will significantly reduce milk production and eventually reduce dry whey production at a time when demand is increasing. Some buyers are expanding their inventories with the idea that future supplies may run tight and prices will be higher. Resale activity has increased at prices above the range. Though prices declined this week, various market underpinnings are giving the market a firm undertone.
- Nonfat Dry Milk: Nonfat dry milk prices are steady to higher. Record high temperatures in the Midwest are expected to affect milk production over the next few weeks and may limit NDM production. This is resulting in a firm undertone for nonfat dry milk prices. Manufacturers are attempting to build inventories, but current demand is taking a larger percentage of production. Demand for high heat NDM is increasing and plants are scheduling time to meet those needs.
- Cheese East: Cheese production is beginning to decline as hot humid weather is accelerating the seasonal decline in milk production, limiting milk volumes going to cheese plants. Cheese makers are also reporting lower milk components as a result of the heat and humidity. Domestic demand for cheese remains good with numerous retail sales promotions and improved food service demand. Export demand remains fairly good, but there is growing concern that the increased price levels on the CME Group may decrease export interest.
- Cheese Midwest: Milk volumes going to cheese plants this week were holding steady, but cheese makers are becoming concerned about the possible steep declines in milk production due to the current heat wave and the forecast for its continuation over the next 3-5 days. Though milk volumes have not declined as of yet, butterfat levels have declined a full percentage point at some plants in the last couple of weeks.
- Cheese West: Western cheese prices are steady to firm this week. As milk solid levels decrease, plants are increasing usage of dairy powders and skim concentrates to fortify cheese vats. Domestic demand is good into retail outlets.

- Grains: Soybean meal established new all-time highs while corn and beans saw strong increases in response to "the weather event" this week. $7 corn $15 beans and $450/ton meal is the new reality facing dairy farmer cash flow.
- International: European whey stocks are tightening as good internal demand is clearing available volumes. Exports have been active, but have slowed recently. Cheese production is seasonally active, but is trending lower as overall milk volumes decline.

What's Bearish:

- Spot Market: On a quiet, holiday-shortened week, block cheese declined a penny to settle at $1.64/lb on 3 trades. Barrels were unchanged at $1.67½/lb on no trades. Butter increased just ½¢ to $1.53¼/lb with 3 trades for the week.
- Fluid Milk West: California milk production is trending slightly lower on a week-to-week basis. Temperature levels are hot during the day, but are cooling off at night. Producers are able to mitigate most of the stress on the milking herds. There are no processing capacity concerns. Class I demand has slowed and many bottlers ramped up ahead of the holiday to take some additional downtime. Retail and foodservice accounts reflect slower summer demand for fluid milk. Milk production in the Pacific Northwest continues to be above year ago levels. Favorable weather, with temperate days and cool nights, is helping to keep production levels up. Production in the region is past flush but only slowly coming off peak production. Dairy farms are harvesting alfalfa and replenishing feed supplies.
- Dairy Market News reports during April, 4.3 billion pounds of packaged fluid milk products is estimated to have been sold in the United States. This was 2.7% lower than April 2011.
- International: Milk production in Western Europe continues to decline seasonally, but overall volumes are running about 2% ahead of last season at this time. Butter traders are indicating that International buyer interest is limited as European prices are often higher than buyers are willing to pay. Traders and handlers of manufactured dairy products are indicating that buyer interest, both domestically and internationally, is projected to start to ease as the summer vacation season gets underway.
- International: All classes of dairy products declined an average 5.9% in this week's Global Dairy Trade auction. Cheddar cheese fell 0.7% to an average U.S. equivalent price of $1.39/lb.

Recommendation:

The big story this week, of course, was the heat wave that covered (and still covers) much of the Midwest and Eastern parts of the country. Not only were there unprecedented highs, the more telling stat was the high "lows" put in overnight. Many areas remained in the upper 70's to low 80's overnight, with dew points in the 60's and 70's, making it extremely uncomfortable for the cows. The heat has stayed long enough that damage has undoubtedly been done. We are hearing reports from producers that they are down 10-15%, and these are operations with fans, misters, etc. The big unknown now is what kind of rebound will we see when the heat breaks later this weekend, and will there be any longer term affects, such as with breeding. This uncertainty, along with the wild ride higher in grains, caused the Q4 and 2013 contracts to rally. Large bids, most likely by commercial long-hedgers, were seen in the 2013 months. In fact, in today's trade, the two contracts with the highest trade volumes were Feb/Mar 2013. You almost never see that. Grains finished lower today, in what was likely mostly profit taking. Weather forecasts throughout the grain belt continue to predict only small amounts of precipitation. With little movement seen this week in the spot market, the July and Aug contracts finished lower for the week. Spot prices work out to about $16.70 milk, which is right where July is sitting. Cheese made prior to the heat is still available, but 30-60 days from now, the situation could be quite a bit different. The spot market trades only 4-30 day old cheddar, and this specific class of cheese could get quite a bit tighter in the weeks to come, as milk production and component losses begin to take their toll on cheese output. The most negative aspect of the market is that international prices continue to fall. We simply can't compete right now against $1.38/lb cheese, if that indeed is the going rate, according to this week's GDT auction. And this week's Dairy Market News updates indicate export interest is slowing as U.S. prices increase. Despite this growing "negative", we think the damage to milk output has and will be substantial. In addition, Mexico is our largest cheese buyer, and is less susceptible to the weaker euro. The market is never "risk free" however, and we would continue to recommend hedges that allow the possible capture of additional upside. Consider Aug-Dec 16.50 PUT, which settled at an average price of 40¢/mo. Enter GTC orders to buy them for 30-35¢/month. This would yield an effective floor of about $15.70 base price, yet give you 100% upside. We would leave 2013 alone for now. It's breaking into new contract highs, with Q1 averaging $17.10. Have a great weekend and stay cool!