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The KDM Dairy Report – July 13th, 2012

What's Bullish:

Futures Month	Class III 07/13	Class III 07/06	Change	Dry Whey 07/13	Dry Whey 07/06	Change	Cheese 07/13	Cheese 07/06	Change
Jul-12	$16.73	$16.71	$0.02	50.05¢	51.00¢	(0.95¢)	$1.685	$1.682	$0.003
Aug-12	$18.22	$17.52	$0.70	55.00¢	54.00¢	1.00¢	$1.810	$1.755	$0.055
Sep-12	$18.88	$17.87	$1.01	58.00¢	55.00¢	3.00¢	$1.861	$1.777	$0.084
Oct-12	$18.69	$17.76	$0.93	58.50¢	55.25¢	3.25¢	$1.835	$1.770	$0.065
Nov-12	$18.60	$17.63	$0.97	58.50¢	54.50¢	4.00¢	$1.830	$1.748	$0.082
Dec-12	$18.60	$17.45	$1.15	58.50¢	52.75¢	5.75¢	$1.828	$1.738	$0.090
Jan-13	$18.40	$17.25	$1.15	53.53¢	50.50¢	3.03¢	$1.815	$1.730	$0.085
Feb-13	$18.08	$17.05	$1.03	53.00¢	43.03¢	9.98¢	$1.798	$1.705	$0.093
Mar-13	$17.83	$17.00	$0.83	52.50¢	42.53¢	9.98¢	$1.760	$1.702	$0.058
Apr-13	$17.50	$16.80	$0.70	50.00¢	40.10¢	9.90¢	$1.740	$1.705	$0.035
May-13	$17.66	$16.90	$0.76	49.00¢	46.00¢	3.00¢	$1.730	$1.713	$0.017
Jun-13	$17.76	$16.91	$0.85	48.00¢	46.00¢	2.00¢	$1.720	$1.710	$0.010
12 Mo Avg	**$18.08**	**$17.24**	**$0.84**	**53.71¢**	**49.22¢**	**4.49¢**	**$1.784**	**$1.728**	**$0.056**

- Spot Market: Blocks gained 4¢ on aggressive buying of 21 loads to settle at $1.68/lb. Barrels were up ½¢ to $1.68/lb on just 1 trade. Butter increased 1¾¢ to settle at $1.55/lb on just 1 trade, while Grade A NDM jumped 3½¢ to $1.26½/lb on 2 trades.
- World Ag Supply & Demand Report: USDA made their first upward price revision of the year for Class III milk prices in this month's report. Citing higher feed costs and the heat, milk per cow was adjusted lower, as well as the 2013 milk production forecast. USDA now expects Class III to average $16.75/cwt, up 5¢ from last month's report.
- All Class III components were up in this week's NPDSR survey. 40-lb blocks increased 0.8¢ to average $1.64/lb while 500-lb barrels jumped 5.7¢ to $1.68/lb. Butter was up 3.6¢ to average $1.51/lb, dry whey inched 0.6¢ higher to 49.3¢/lb and nonfat dry milk picked up 6.2¢ to average $1.16/lb.
- Dairy cow slaughter for the week ended 06/30 totaled 52,700 head, up 1,400 head from the same period a year ago. YTD the cull is up 51,400 head from 2011.
- Fluid Milk East: Milk production declines continued to accelerate in the Northeast and Mid-Atlantic regions as a result of the recent hot humid weather. Bottling plants in the Mid-Atlantic region have added on loads, due to decreases in load weights. Milk production in Florida is said to be dropping like a rock, due to high temperatures and heat indices lowering cow comfort levels. Producers are continuing to dry off cows and culling their herds as milk production declines. Class I demand is good for this time of year. Milk production in the Southeast region has also declined significantly due to the recent extended bouts of hot and humid weather. Class I plants are adding on loads, because of lighter load weights. Production is nearly balanced with demand with only a few loads going to manufacturing. Some producers are culling deeper into their herds due to limited feed supplies. Demand for cream is very good coming from ice cream and cream cheese makers. It should also be noted that condensed skim supplies going to Greek yogurt production remain strong.
- Fluid Milk Central: The impact of recent hot weather registered this week as milk haulers and milk receiving plant operators report farm milk declines ranging up to 20% compared to the previous week. Milk processors regard this as evidence of the toll taken on cow comfort and milk production in the Central region during the latest bout of high daytime temperatures. In addition, culling activities are expected to increase in the near term as dairy producers evaluate milking cows approaching the end of their annual milk production cycles. Current on-farm feed availability and increasing purchased feed costs will likely impact those culling decisions, especially as the conditions of corn, soybeans and alfalfa fields deteriorate in several areas of the Central region due to moisture deficits. Cropping operations report corn for grain conditions in several areas have deteriorated due to lack of moisture. In some areas, suitability of corn for silage use may also be in question. Third crop alfalfa cuttings are in progress, with yields estimated to be below historical values. Availability of spot loads of milk decreased this week as operations reevaluate use of available farm milk.
- Fluid Milk West: California milk production is being impacted by hot weather conditions over the southern part of the state and into the Central Valley. Temperatures over 110 degrees are stifling the milk flow and processing plants are seeing lower milk receipts. Hot temperatures and increased humidity levels have created monsoon conditions and excessive heat warnings across much of Arizona. Nighttime temperatures are only cooling to the upper 80's, creating more stressful conditions for cows. Milk production rates are declining because of the current conditions. Processing plants are adjusting schedules around milk intakes and some planned maintenance issues. New Mexico milk output is trending lower on a week-to-week basis. The impact of hot weather conditions in recent weeks has affected milk output. Cream markets are firmer as demand has improved across all classes. The impact of hotter weather is also lowering the fat content of incoming milk. On the demand side, buyers are looking for cream to offset local shortages. The hot weather is also spurring on demand for ice cream and plants are working on additional schedules.
- Butter: Churning schedules across the country eased this week as overall cream supplies declined. Lower churning cream supplies are being attributed to a couple of factors; declining milk volumes and butterfat levels along with enhanced Class II demand. Butter producers did indicate that they were surprised to see that holiday cream volumes were not as heavy as projected. Much of the decline is being attributed to hot temperatures across the country, reducing cow comfort and lower milk output. Lighter churning activity this week often did not keep pace with demand, thus many producers and handlers were reaching into inventoried stock to fulfill orders. Butter producers feel that for the next 4 - 6 weeks, churning cream volumes will be lighter and inventoried butter stocks will become more necessary to fill needs. Most statements this week indicate that not many people believe butter prices stand much chance of moving lower this summer with the current conditions.
- Dry Whey East: Production has declined in the region as a labor strike at a major cheese plant in New York limited production. Demand for whey is very good as ice cream production is very active and also due to increased purchases by baking manufacturers. Resale activity this week saw purchase prices above the high end of the range. The decline in milk production in combination with the strike, relatively flat cheese production and good demand gives the dry whey market a firm undertone.
- Dry Whey Central: The market undertone is firming. Discounts to the market were less and dry whey prices gained compared to last week's prices as producers and buyers factor in current milk availability and cheese production. Recent decreases in farm milk production prompted reduced cheese production at several Central region plants. Spot prices of milk are on the rise, due to the seasonal decline in overall farm milk production. Dry whey production is steady to lower throughout most of the region, especially at those cheese operations dependent on

dwindling patron milk supplies. In some situations, orders for cheese loads were canceled by sellers as cheese manufacturers do not expect much of a rebound in farm milk intakes through the balance of the summer.

- Dry Whey West: Prices are steady to firm for Western whey powder this week. Domestic sales are leading prices higher. Exports continue to occur within the range. Offerings of whey powder are on the decline seasonally following milk production lower. Stocks are generally in balance and held with confidence. Buyers are becoming more aggressive in looking for whey as the year progresses. Most are aware that the long run trend of less whey production every year is certainly continuing. Buyers would just as soon have something in the warehouse as not going forward.
- Nonfat Dry Milk: Manufacturers and resellers indicate interest is reemerging and the market tone is firming. Effects from the recent heat wave in the Central region showed up this week in lower farm milk intakes at many plants in the region, ranging up to 20%. Dryers in the region are running below capacity and inventories of high heat NDM are light. Low heat nonfat dry milk inventories are steady, but the sudden drop in farm milk intakes may have manufacturers digging into inventories more quickly than projected.
- Cheese East: Cheese production in the Northeast has been disrupted by a labor strike at a major New York cheese plant. Cheese makers are reporting lower milk components as a result of the recent spells of heat and humidity.
- Cheese Midwest: White water is how a manufacturer described milk delivered to regional cheese plants in recent days. The toll of regional heat and dryness results in cows eating less dry matter and drinking more water, which reduces solids in milk. This leads to more manufacturers fortifying milk used for cheese manufacturing. Cheese manufacturers with other product options are dedicating more if not all milk received to cheese at the expense of other dairy products, to generate the required volume of cheese production. Some manufacturers are now scrambling to fill cheese orders booked during recent months when the concern was more focused on making cheese sales to assure an outlet for milk. A few manufacturers would now prefer somewhat lower contract obligations in terms of the current milk supply and component count. Widespread expectations are that the milk supply will be declining until about October and that expectation is driving the plans of cheese manufacturers. This is expected to reduce the days of operation per week in a number of plants as the weeks progress. Even now, some plants which were running 7 days a week have reduced to 6 days.
- Exports: According to the Foreign Agricultural Service, exports of butter and milkfat for May total 15.9 million pounds, up 1% from last year. Exports of cheese and curd for May totaled 61.6 million pounds, up 43% from last year.
- Grains: USDA was aggressive in their assessment of this year's corn crop, cutting the yield by 20 bu/acre in one month. Soybean yield was cut 3.4 bu/acre, which is still above the historical average for this time of year. Weather forecasts continue to predict little rain, sending contracts to new highs this week.

What's Bearish:

- Cheese West: Milk production and tests in all regions are declining, but so far adequate milk still seems to be available to cheese makers for current production. However, some increase in fortification by cheese manufacturers has been noted. Domestic retail demand is still generally considered to be good, but export demand is slowing. Recent domestic cheese price levels are pricing U.S. manufactured cheese less favorably in the global marketplace compared with cheese manufactured in other parts of the world.
- Over the first 9 days of July, cheese stocks at USDA selected storage centers increased 1%, or 936,000 lbs. Butter stocks increased 2% or 196,000 lbs over the same period.
- Fluid Milk Northwest: Warmer weather has finally begun to hit region, but so far stress is minimal. Milk production is off the peak, but not by that much. Pasture conditions are good for those areas that rely heavily on grazing for summer forage. Plants are running well in the region.

Recommendation:

Beware when the KDM Dairy Report is so bullish-to-bearish lopsided like it has been the past couple weeks! We try to call it as we see it, but our first line reminder is really one of age-old wisdom in the markets. And that is, just when everyone and their neighbor is the most bullish and thinks the market "couldn't possibly go down", it does. While we do think over the long term things look very positive for milk, we expect some violent moves in both directions over the coming weeks. Heat/drought remained the big drivers this week as grains continued to rocket higher. Stories of corn being chopped for hay/silage are becoming more frequent. 3rd cutting of alfalfa will be meager in many parts. Class III futures responded with a strong move higher this week, with $1+ gains and big volume seen well into the 2013 months. Bottom line is the cost of production is going to take a big hike higher. Components and production are falling, and suddenly some cheese plants are scrambling for milk to meet contracts. We all know the milk market takes its cue from the daily spot market at the CME. That is a 4-30 day cheddar that trades. Based on the heat we had last week and into this week, we could see that "young" cheese supply tightening significantly in the days/weeks ahead. Cheese futures acknowledge this with Aug milk futures at $1.80 despite a spot market at $1.68. Likewise, Aug milk futures settled at $18.22, but current spot prices work out to just $17.05. The market "expects" cheese to move higher soon. If it doesn't, the Aug contract in particular will get hit hard. On the flipside, we could see a scenario where we have a blow-off top, meaning cheese gets bid up beyond expectations, say in the $1.90's, only to move violently lower again. This is a possibility. While production did get hit, there are several producers we talked to this week that have bounced back nicely. In addition, we price ourselves further and further away from the international market and we are seeing exports slow down. With so much uncertainty, and after such a strong gain this week, producers should look to protect those gains, in the event of a quick move back down. We'd rather not be capped or sell outright as we still think there is substantial upside potential. We advise shifting to a PUT option only strategy. Load up on the Aug 17.50 PUT for 16¢ and Sep 17.25 PUT for 21¢. Enter target orders for the Oct 17.25 PUT for 25¢, Nov 17.00 PUT for 30¢ and Dec 16.75 PUT for 30¢. There's no excuse NOT to get something done at least for Aug and Sep next week. Protect yourselves from the coming volatility!