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The KDM Dairy Report – July 20th, 2012

What's Bullish:

Futures Month	Class III 07/20	Class III 07/13	Change	Dry Whey 07/20	Dry Whey 07/13	Change	Cheese 07/20	Cheese 07/13	Change
Jul-12	$16.67	$16.73	($0.06)	50.05¢	50.05¢	0.00¢	$1.682	$1.685	($0.003)
Aug-12	$17.96	$18.22	($0.26)	54.25¢	55.00¢	(0.75¢)	$1.790	$1.810	($0.020)
Sep-12	$19.14	$18.88	$0.26	57.50¢	58.00¢	(0.50¢)	$1.885	$1.861	$0.024
Oct-12	$19.08	$18.69	$0.39	58.30¢	58.50¢	(0.20¢)	$1.889	$1.835	$0.054
Nov-12	$19.04	$18.60	$0.44	59.75¢	58.50¢	1.25¢	$1.875	$1.830	$0.045
Dec-12	$18.96	$18.60	$0.36	58.25¢	58.50¢	(0.25¢)	$1.865	$1.828	$0.037
Jan-13	$18.84	$18.40	$0.44	55.28¢	53.53¢	1.75¢	$1.844	$1.815	$0.029
Feb-13	$18.50	$18.08	$0.42	55.00¢	53.00¢	2.00¢	$1.828	$1.798	$0.030
Mar-13	$18.30	$17.83	$0.47	55.00¢	52.50¢	2.50¢	$1.825	$1.760	$0.065
Apr-13	$18.25	$17.50	$0.75	53.03¢	50.00¢	3.03¢	$1.795	$1.740	$0.055
May-13	$18.25	$17.66	$0.59	52.03¢	49.00¢	3.03¢	$1.765	$1.730	$0.035
Jun-13	$18.43	$17.76	$0.67	51.50¢	48.00¢	3.50¢	$1.765	$1.720	$0.045
12 Mo Avg	**$18.45**	**$18.08**	**$0.37**	**54.99¢**	**53.71¢**	**1.28¢**	**$1.817**	**$1.784**	**$0.033**

- Spot Market: Blocks gained 3¾¢ for the week to settle at $1.71¾/lb. Barrels added 1½¢ to close at $1.69½/lb. Trading was light with just 2 loads of blocks and 6 loads of barrels exchanging hands. Butter jumped 4¢ to settle at $1.59/lb and NDM leapt 9¢ to $1.36/lb as the Class IV complex came alive.
- Milk Production Report: Milk output in June was up just 0.9% vs. a year ago, and the 5th consecutive month of smaller increases. The total was lower than most analysts' expectations, with July output now expected to show a decline year over year. Cow numbers fell for the second straight month as dairies shed 19,000 head from May to June. Bigger declines expected ahead. Output per cow managed to increase 8lbs/cow, but it was the smallest increase of the year. CA output was up just 0.3%, while WI managed a 2.5% increase.
- Cold Storage Report: Butter stocks in June were 28% higher than a year ago, but they were 55% higher in May. Inventories were reduced by 19 million lbs in June, which is atypical. Usually butter inventories increase during the month.
- Dairy cow slaughter for the week ended 07/07 totaled 44,800 head, up 3,700 head (9%) from the same period last year.
- Livestock Slaughter Report: 229,200 cows exited the milking herd in June, up 10,100 head from June 2011 and the highest June total since 2009.
- Cattle Report: The semi-annual cattle report was released today, with milk replacement heifer numbers down 2% vs. a year ago. Milk cow numbers were unchanged. Total cattle and calves in the U.S. declined by 2% to 97.8 million head, the lowest all-cattle inventory since USDA began tracking in 1973.
- Most Class III components were higher in this week's price survey. Butter increased 3.4¢ to average $1.54/lb, 40-lb cheddar blocks inched 0.2¢ higher to $1.64/lb, 500-lb barrels gained 1.3¢ to $1.69/lb and dry whey increased 0.4¢ to average 49.6¢/lb. Nonfat dry milk was the only loser, decreasing 0.3¢ from last week to average $1.16/lb.
- Fluid Milk East: Hot, dry, humid weather has now reached New England and is stressing crops and limiting hay yields, but has not yet impacted milk production to any major degree. The Mid-Atlantic region is reporting significant declines in manufacturing milk supplies due to declines in milk production, brought about by the continuing adverse weather. Bottling plants in the Mid-Atlantic region continue to add on loads, due to decreases in load weights. Hot humid weather in Florida is degrading cow comfort levels and continuing to lower milk production. Day time high temperatures are in the 90's, while night time lows range from the mid 70's to low 80's. Class I demand was fairly strong this week with no specific reason given for its strength. The combination of lower production and increased demand reduced exports to 39 loads, down 81 loads from last week. This represents the lowest number of spot loads exported this year. Southeast region milk production has declined to a level that is nearly in balance with Class I demand and as a result, manufacturing milk supplies are very limited. An increasing number of loads are being rejected due to high DMC counts and temperatures. Producers continue to cull their dairy herds due to limited feed and hay supplies.
- Fluid Milk Central: Some cooperative representatives indicate dairy producers are currently evaluating feed on hand, possible crop yields, projected feed input costs, financial resources and cows on hand to determine herd size numbers that will allow operations to continue through spring of 2013. For dairy producers who purchase feed, and haven't already arranged for supply contracts, the higher feed input prices must be factored into 2012 - 2013 operating expenses. For milk processors, farm milk intakes are mostly unchanged from the previous week.
- Fluid Milk West: In California, producers are apprehensive as to what impact the rapidly rising grain prices will have on them in the near future and through the winter. Financial stress is occurring now and many believe it could get worse. Hay prices had backed off the peak, but there are signs that they may be increasing again. Milking conditions are not as stressful in Arizona as has been recently noted, but plant operating schedules have declined from peak levels. Cream markets are firm, as less cream is available for churning due to less butterfat in total at the farm level and much higher demand from other cream based products. Some contacts are stating that the summer seems to be happening earlier for most weather related issues. This is helping to improve demand for cream. Milk production levels in the Pacific Northwest are easing back as last week's warm temperatures affected both quantities and composition of milk. Protein and butterfat levels are lower. Dairy farmers are making calculations concerning feed costs as prices for corn are skyrocketing in the Midwest.
- Butter: Hot and often record setting temperatures are causing cows to drink more and eat less, thus causing milk production and components within the milk to decline. Lower butterfat test on incoming milk are contributing to tighter cream supplies for all needs. Class II operations continue to enhance their production schedules following the holiday period of two weeks ago. Strong Class II demand for cream is limiting churning. In instances, although cream is desired for butter production, some operations continue to sell a portion of their cream volumes to higher class usage and better returns. Churning activity that remains is often not keeping pace with demand, thus inventoried stock is being tapped to fulfill orders. Overall butter demand is seasonally good. Retail print ads and in store promotions continue to feature butter for under $2.00 per pound.
- Dry Whey East: Production increased this week, but overall production is on a downward trend following the declines in milk and resulting cheese production. Supplies are fairly tight and held in firm hands. Demand has increased with strong pulls from ice cream makers and whey based health product manufacturers. Resale transactions were numerous this week with prices above the range, giving the market a firm under

tone. Brokers and end users are attempting to expand inventories, feeling that declining milk and cheese production combined with increased demand may move prices higher in the future.

- Dry Whey Central: Some Class III plants indicate cheese orders increased compared to last week as buyers note the trend toward higher prices for cheese. However, milk supplies in the Central region are largely unchanged from the previous week, which marked a 20% decline into some cheese plants compared to late June intakes. Most milk handlers indicate milk pickups on farms are unchanged from the previous week. This has left dry whey production in the Central region mostly steady.
- Dry Whey West: Although the market is showing the steady price, the market tone appears to be firming. Dry whey production is reduced as more of the whey stream is going into concentrated products. Buyers are looking to build their inventories for upcoming needs in case the trend continues. Export prices for U.S. product have firmed and are closer to domestic prices.
- Nonfat Dry Milk: Prices for low/medium heat powder moved sharply higher as demand has increased markedly in the last ten days. Sellers indicate they are getting many more inquiries by phone and e-mail. Buyers are looking at the milk, feed, and weather issues and are trying to get better coverage. NDM producers are in no hurry to sell additional loads of powder at this time. They have seen milk receipts change rapidly in the last week to ten days and are now concerned about contract coverage. There is a firm undertone to the Western NDM market.
- Cheese East: Cheese production overall is declining following the declines in milk production due to the heat and humid conditions covering much of the East. The heat and humidity has also lowered butterfat levels and cheese yields. Cheese production is nearly in balance with current orders with little being added to inventories. Sales have been fairly good for this time of year with good retail promotions and good food service demand.
- Cheese Midwest: The general feeling several weeks ago that cheese markets had "priced in" weather and heat factors, yielded to a renewed and heightened level of unease as the duration and intensity of heat and dryness in vital Midwest crop areas continued, with no relief in sight. Cheese storage facilities are not experiencing expected inventory building for the fall, even with some cheese plants believed not to now have inventory coverage similar to recent years. It is also noted that the historic pattern of inventory building which typically has accompanied CME price increases of the magnitude recently experienced, has not occurred.
- Cheese West: The market is still showing signs of strength as milk volumes are lowering in many parts of the West. Production of cheese in the West is still favored for milk supplies as Class III prices are significantly higher than butter/powder milk prices. Retail sales of cheese remain good at current price levels. Export demand is being aided by assistance from the CWT program. This week the CWT program assisted with 10 million pounds of cheese and butter sales. Stocks of cheese are currently in good balance for needs.
- Grains: New record highs in corn, beans and meal.
- International: Milk production is seasonally declining throughout Western Europe accelerated by adverse weather conditions in some regions. Hot temperatures in areas of Eastern and Southern Europe, coupled with wet conditions in Ireland, the UK and areas of Western Europe are all contributing to cow discomfort and stress. Traders and handlers are indicating that dairy product sales are occurring both internally and internationally, but most are centered within the European community. Stocks of product are available for buyer inquiry, but appear to not be as excessive as in other years at this time of the season.

What's Bearish:

- Weekly cold storage numbers indicate over the first half of July, cheese stocks at USDA selected storage centers increased 2%, or 2.48 million lbs. Butter stocks increased 1%, or 72,000 lbs over the same period.
- Cheese: There is increasing concern with prospects for retail cheese sales during this quarter which began July 1. Cheese buyers are already seeing indications that cheese retail promotions during the third quarter seem to be declining from second quarter levels, both as to volume of ads as well as price aggressiveness. This is attributed to the combined uncertainty resulting from heat, dry weather, and recent CME price strength, leaving less than the normal consensus within the industry of what to expect in coming months. Another factor cited is increasing consumer resistance to higher cheese prices.
- Packaged fluid milk sales in May declined 2.8% compared to a year ago. Total organic fluid milk sales decreased 6.9%.
- International: Milk producers in both New Zealand and Australia are stating that winter conditions have been basically favorable to the milking herd and herd conditioning going into the upcoming season is positive. Milk production projections for the upcoming season remain positive with producers and handlers very optimistic, with output increases from previous years running in the 4-5% range in New Zealand while in the 2% range in Australia.

Recommendation:

August futures finished with a loss for the week as the spot market failed to move up as quickly as the market expected. That said, Sep and beyond were up double-digits for the week as the epic drought of 2012 continued. The Jan-Dec 16.25 x 20.25 fence traded this week at net premium zero. Under normal circumstances, we'd be pretty excited about getting something done there, but with cost of production in many parts of the country approaching $19-20 and the potential for continued and more aggressive losses in cow numbers, we wouldn't want to be capped there. The front months will remain subject to the whim of the daily spot market, but longer term, this market looks very well supported and we wouldn't sell any milk yet in 2013. We would continue to put a floor under the front months in the form of PUTs. We bought the Aug 17.50 PUT this week for 15¢ on a day we rallied; it settled at 18¢ today. We'd look to re-enter that order next week if you don't have any coverage. If cheese sales slow down in the near term, we could see some temporary pressure in the spot market. The Sep 17.50 PUT settled at 19¢. Enter orders next week at 15¢. Get some protection for the unexpected, but let this market ride. Butter and powder are coming alive, which will further support the market. Currently most milk is going to Class III / cheese production due to better returns. But as Class IV prices increase, it could draw milk away from Class III. Bottom line is we don't see much downside in Q4 and beyond. If you sold milk at lower levels and feel like you're getting burned, consider putting on some bull-call-spread trades to capture some of this market. Give is a call next week so we can explain this strategy to you. Have a great weekend!

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