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

The KDM Dairy Report – July 27th, 2012

What's Bullish:

Futures Month	Class III 07/27	Class III 07/20	Change	Dry Whey 07/27	Dry Whey 07/20	Change	Cheese 07/27	Cheese 07/20	Change
Jul-12	$16.67	$16.67	$0.00	50.00¢	50.05¢	(0.05¢)	$1.686	$1.682	$0.004
Aug-12	$17.30	$17.96	($0.66)	53.50¢	54.25¢	(0.75¢)	$1.735	$1.790	($0.055)
Sep-12	$18.35	$19.14	($0.79)	57.50¢	57.50¢	0.00¢	$1.817	$1.885	($0.068)
Oct-12	$18.69	$19.08	($0.39)	58.50¢	58.30¢	0.20¢	$1.833	$1.889	($0.056)
Nov-12	$18.82	$19.04	($0.22)	58.50¢	59.75¢	(1.25¢)	$1.842	$1.875	($0.033)
Dec-12	$18.75	$18.96	($0.21)	58.00¢	58.25¢	(0.25¢)	$1.840	$1.865	($0.025)
Jan-13	$18.29	$18.84	($0.55)	56.00¢	55.28¢	0.73¢	$1.815	$1.844	($0.029)
Feb-13	$17.95	$18.50	($0.55)	56.00¢	55.00¢	1.00¢	$1.792	$1.828	($0.036)
Mar-13	$17.90	$18.30	($0.40)	54.00¢	55.00¢	(1.00¢)	$1.792	$1.825	($0.033)
Apr-13	$17.91	$18.25	($0.34)	53.50¢	53.03¢	0.48¢	$1.820	$1.795	$0.025
May-13	$17.97	$18.25	($0.28)	52.50¢	52.03¢	0.48¢	$1.825	$1.765	$0.060
Jun-13	$18.05	$18.43	($0.38)	53.00¢	51.50¢	1.50¢	$1.835	$1.765	$0.070
12 Mo Avg	**$18.05**	**$18.45**	**($0.40)**	**55.08¢**	**54.99¢**	**0.09¢**	**$1.803**	**$1.817**	**($0.015)**

- 57,000 dairy cows were culled during the week ended 07/14, up 10.5% from a year ago.
- Fluid Milk Southeast: The southern portions the Northeast and also the Mid-Atlantic region have suffered from a prolonged heat wave, which has significantly lowered milk production. Some manufacturing plants are having difficulty meeting their fluid contracts. Crop conditions in both regions are deteriorating quickly with New York reporting 85% of the top soil being very short or short of moisture. Pennsylvania is reporting 63% of its pastures in very poor or poor condition. Milk production in the Southeast region continues to decline. The continuing heat wave has increased milk load rejections due to temperature issues. Good cream demand and declining availability, due to lower butterfat levels and milk production, have combined to increase multiples this week. Ice cream and cream cheese production account for the strongest demand for cream. Retail promotions for ice cream and cream cheese are numerous.
- Fluid Milk Central: Interest in cream is active from several manufacturing lines, including ice cream, frozen specialties, dips, and sour cream. Farm milk butterfat components are trending seasonally lower. A few churn operators indicate butter orders waiting for fulfillment are growing while butterfat intake volumes shrink. Interest in spot milk loads is brisk, but supplies are tight. Various milk handlers indicate competition by plant operators for milk on the farm level is heating up once again. In some cases, plant operators are offering premiums for producer milk, and that tends to create stiff competition among plant managers in areas with limited near-by farm milk sources. Dairy farmers continue to reevaluate herd sizes for successful carryover into spring of 2013. The cost of feed is one part of the equation.
- Fluid Milk West: California milk production is trending lower seasonally on a week-to-week basis, but holding up rather well. Plant receipts are varied. Some locations are up compared to a year ago, whereas others are lower. Milk supplies are adequate for current needs and plant capacity is available. Contacts are stating that feed costs and other financials are playing a bigger role in the current market for dairy producers. The fat and protein levels in the milk are declining seasonally along expected levels. Arizona milk production is trending lower. The milking herds are feeling the impact of the prolonged hot weather, but the biggest factor is the humid conditions. Heat abatement measures are in place to mitigate losses. Cream markets are steady to firm. There is fair to good demand in local and out of region markets. Demand is noted from ice cream and cheese producers.
- Butter: Declines in butter production have been fairly significant as cream supplies have tightened. Current butter production is focused on filling current orders with little being added to inventories. In many instances, butter producers are generally only working with cream supplies from regular and ongoing suppliers, with these suppliers sometimes scrambling to fulfill commitments. Overall, churning schedules are often not keeping pace with demand, thus inventoried stocks are being used to fulfill demand. Retail orders are holding up quite well.
- Dry Whey Northeast: Dry whey prices again moved higher this week. Buyers looking for additional loads have to look outside the region and/or for resale opportunities. Dry whey production is steady at lower seasonal levels, due to the declines in milk production and also because most cheese makers have adequate inventories. Dry whey inventories are held in firm hands. Demand remains good with strong pulls from ice cream makers and whey based health product manufacturers. The market undertone remains firm.
- Dry Whey West: Spot sales from manufacturers are very limited with the bulk of production committed to contracting buyers. The market is firming as ice cream and other users look to build their inventories. Buyers are noting higher whey futures contracts for upcoming months and are looking for additional product to be a physical hedge for future needs. Export whey prices moved higher in trading this week.
- Nonfat Dry Milk: Prices continue to trend higher. The market undertone is firm. Buyer interest is fair to good to domestic and export accounts with concerns about coverage in the short and longer terms. Many buyers are unclear as to what extent the current situations of drought and hot weather are having on the dairy markets and further to what extent the "weather markets" are having on current and future feed input costs. Inventories are held in firm hands as the market has a firm undertone.
- Cheese East: Declines in cheese production have occurred at most plants, due to declines in milk production. Cheese going into aging programs has declined, which is typical for this time of year, and some cheese inventories are being worked lower.

- Cheese Midwest: Manufacturers are holding inventories with confidence, and not terribly eager to discount prices to move inventory. The current weather factors of heat and dry conditions in many areas are only reinforcing the confidence of firms holding cheese, and that the sales climate later in the year appears to favor higher prices rather than lower prices.
- Cheese West: Lower farm milk intakes and lower seasonally expected component levels are causing cheese makers to look to NDM and condensed skim milk to fortify vats. Demand is good at the retail level with buyers taking contract orders and often times inquiring about additional spot orders. Barrel cheese demand is also showing strength as buyers look to add to their inventories. Current cheese inventories are mostly described as good for needs. Export demand has slowed but continued assistance from the CWT program is helping to move international sales.
- International: Bank of New Zealand ag economist Doug Steel predicts the severe drought in the United States is likely to push the prices of two key New Zealand commodities - dairy and beef – higher. World dairy inventory levels currently are high, so the flow-through impact of the drought might not be immediate, but would support 2013 and even 2014 prices.
- International: Tainted milk scandal #3 in 2012 for China. China's Hunan Ava Dairy Co Ltd said on Monday it will recall baby formula sold under its Nanshan Bywise brand after a cancer-causing agent was found in test samples, the latest blow to the country's scandal-ridden milk industry struggling to restore consumer confidence.

What's Bearish:

- Spot Market: Blocks finished the week down 1¼¢ to settle at $1.70½ on 8 trades. Barrels were down 1¢ to $1.68½ on 4 trades. Butter gained 8¢ to close at $1.67 with 21 loads exchanging hands.
- Weekly cold storage numbers indicate both butter and cheese stocks continue to build at USDA selected storage centers. From 07/01 through 07/23, cheese stocks are up 1%, or 1.7 million lbs, while butter stocks are up 3%, or 332,000 lbs.
- Fluid Milk Northeast: Milk production in New England and upstate New York has remained at more than adequate levels for dairy manufacturing, despite the recent spells of hot dry weather.
- Fluid Milk Pacific Northwest: Temperatures have been ideal in most cases for optimum milk production. Short spells of hot weather are being balanced by cool nights. Milk production is at or above year ago levels. With production declines in other parts of the country from hot weather, processors are welcoming the continued production. Rising feed costs, due to drought and heat in the South and Midwest, are rapidly changing breakevens for dairy farmers.
- Dry Whey Central: Dry whey prices are unchanged to fractionally higher. Market participants indicate most dry whey needs can be filled readily. There is some concern by contacts as to why dry whey prices are firming when supply, as evidenced by rapid fulfillment of contract and spot sale orders, is adequate and not deterring sales fulfillment.

Recommendation:

Just two weeks ago we warned in our report about being complacent in a bull market and assuming it would continue to go up. Since then, the spot market has failed to move higher, grains have seen a serious correction and we hear about dairies that were in the thick of the 100+ heat that have rebounded back to pre-heat milk output levels. Aug milk futures are down 92¢ from that report, while Sep is down 53¢. The 2013 contracts average $17.96, down from a high of $18.22. Those Aug 17.50 PUTs purchased last week at 15¢ are now valued at 30¢. My how things can change! We still believe long-term the highs in both milk and grains are not in, but this most recent rally provided opportunities that are no longer available, and it's worth remembering that lesson that we sometimes need to keep learning.

Current spot prices work out to about $17.15 Class III. With the Aug contract well into its pricing period, it's easy to see why it experienced the largest decline the past two weeks. Bulls need to be fed, and the buyers in spot were simply not willing or able to push prices higher. Perhaps they were also aware how out of sync U.S. prices were getting compared to the international market. Overseas players have taken note of the U.S. drought, but for the most part, the world is well supplied with dairy products at the moment, so we just don't expect to see world prices to move sharply higher until later in 2012 and possibly into 2013. U.S. Class IV prices were sharply higher this week as butter continued to rally. Using current spot prices, Class IV works out to about $17.00, nearly closing the gap with Class III. Should Class IV move even higher in the coming weeks, it should support Class III as well. There will be additional incentive to shift milk supplies into butter/powder, and away from cheese production. The long-term outlook still looks very bright, with the correction in the 2013 contracts likely a retracement in a longer bull market. Grains recovered in very volatile trading this week as precipitation triggered aggressive profit-taking, but longer range forecasts predicted dryer and hotter conditions next week. The trade is also trying to grapple with ending stocks and demand that price-rationing hasn't solved yet. The bottom line is we don't expect milk prices to decline much further, and if they do, it is an opportunity for those who have sold milk at lower prices to get some upside coverage on. Give us a call! Feed costs are going to go sky high in 2013, putting break-evens for many dairies around $20/cwt, which will support milk prices for quite some time.

Trading futures and commodities involves substantial risk and may not be suitable for all investors. You should carefully consider whether the risks involved in trading in commodities is suitable for you or your organization in light of your financial condition. While the information we gather and present is deemed to be reliable, it is in no way guaranteed. Neither the opinions expressed on this website nor in "The KDM Dairy Report", shall be construed as an offer to buy or sell any futures or options on futures contracts. In addition, past performance is not necessarily indicative of future results.

© Copyright 2012 - KDM Trading, Inc. All Rights Reserved – www.kdmtrading.com