

**The KDM Dairy Report – September 7<sup>th</sup>, 2012**

**What's Bullish:**

- Dairy Products Report: Cheddar cheese output was up just 0.8% in July vs. a year ago, and down 0.6% from June. Total cheese output was up 2.3% and down 2.3% over the same periods. Butter output fell 2% from July '11 and dropped 3.4% from June.
- Most Class III components were higher in this week's price survey. 40-lb block cheese increased 3.5¢ to average \$1.85/lb, but 500-lb barrels were down 0.1¢ to \$1.83/lb. Butter gained 1.1¢ to average \$1.77/lb, nonfat dry milk was up 3¢ to \$1.33/lb and dry whey gained 1.2¢ to average 56¢/lb.
- Dairy cow slaughter continues to be robust. 60,000 head were culled during the week ended 08/25, up 9.9% vs. a year ago. YTD the cull is up 98,000 head from 2011.
- In California, Texas and Idaho dairy country, anti-lender sentiment is high amid shrinking credit lines. Nationally, dairy customers are the most stressed of all the Farm Credit System's agricultural customers, says Bill York, CEO of AgriBank, based in St. Paul, Minn.
- An article in the Idaho Statesman this week discusses how Idaho ranchers and dairy operations are paying more for feed, pushing them to break-even or slightly below. Some dairy farms can't get bank approval to buy feed on contract, which is usually cheaper than buying on the open market. As a result, some dairies can't afford the optimum feed for their herds, resulting in lowered milk production, often with less butterfat and protein.
- Fluid Milk East: Class I demand is very strong coming out of the holiday weekend in the Northeast and Mid-Atlantic regions, significantly limiting manufacturing milk supplies. Overall crop conditions in both regions are described as fair to good, but yields are lower than normal, due to inadequate rainfall throughout the growing season. Milk production in Florida remains at/or near the seasonal low point as day time high temperatures continue to be in the 90's. Class I demand remains strong. A total of 92 spot loads of milk were imported into the Southeast this week, up from 83 last week and just 20 a year ago. Demand for cream is increasing as numerous cream based manufacturers return to full production schedules after the holiday. Cream cheese production is very active and some butter plants have become opportunity buyers of cream as they look to increase inventories for the Thanksgiving and yearend holidays. Condensed skim milk supplies have become very tight, due to the strong pulls from Class I plants. Supplies are moving through contracts with very little being offered on the spot market. Demand for condensed skim remains good with interest from ice cream, cream cheese and cheese makers. Some balancing plant managers continue to be concerned about their future milk supplies and their ability to meet their nonfat dry milk commitments.
- Fluid Milk West: Processing plants in CA handled the milk supply with relative ease over the holiday weekend and the overall conditions were a nonevent. School milk needs have returned and taking additional fluid milk supplies. Cheese plant needs have been steady and pulling expected volumes. NM milk output has been generally flat at levels tracking below a year ago at this time. Processing plants are running on reduced schedules. Milk shipments out of region continue for contracted volumes. On farm conditions remain stressed with higher milk prices not able to offset higher input costs. Milk production in the Pacific Northwest continues to slow following typical seasonal patterns. Milk handlers reported no difficulties over the holiday weekend and said it was more like a typical week. UT and ID milk supplies are well off of peak production but along expected lines. Feed costs are weighing heavily on dairy farmers as they make fall plans. Expansion plans are on hold in many cases until break evens are in a better light.
- The CWT program has awarded export assistance for 352,740 lbs of butter and 44,082 lbs of anhydrous milk fat for delivery now through December. They have also accepted requests for export assistance to sell 734,139 lbs of Cheddar and Monterey Jack cheese, with delivery over the same period.
- Dry Whey Northeast: Cheese and dry whey production have been limited this week due to the strong Class I demand reducing manufacturing milk supplies. Current production is moving through contracts with little being added to inventories or being made available to the spot market. Demand for dry whey remains good with good pulls from ice cream and baking manufacturers. The market undertone remains very firm.
- Dry Whey West: Prices remain firm with most sales being contract committed. Occasional spot loads from manufacturers are available, but are not readily available. Demand for whey is increasing as buyers look to increase their holdings.
- NDM East: Spot sales and sales based on price indices pushed nonfat dry milk prices higher this week. Strong Class I demand coming out of the Labor Day holiday weekend has significantly reduced manufacturing milk supplies and the production of nonfat dry milk. The decline in production has tightened available supplies. Demand for nonfat dry milk is increasing with good demand coming from cheese makers, ice cream and baking product manufacturers. The combination of good demand and limited product availability has resulted in spot prices considerably above contract pricing. Prospective buyers looking for additional loads are looking out of region. The market undertone remains very firm.
- NDM Central: Prices are mostly higher on a continuing firm market as buyers seek out Q4 needs. Some demand that is traditionally served through Eastern or Western stocks has migrated to the Central region and provided improved selling opportunities for manufacturers. Brokers and traders indicate the strength of the current NDM has become apparent to more of their clients who thought it may be a short term rally. These buyers are now reentering the market to obtain inputs for the fourth quarter and adding to the market strength.

Futures Month	Class III 09/07	Class III 08/31	Change	Dry Whey 09/07	Dry Whey 08/31	Change	Cheese 09/07	Cheese 08/31	Change
Sep-12	\$18.85	\$18.89	(\$0.04)	57.03¢	56.75¢	0.27¢	\$1.851	\$1.865	(\$0.014)
Oct-12	\$19.45	\$19.76	(\$0.31)	59.75¢	60.50¢	(0.75¢)	\$1.901	\$1.925	(\$0.024)
Nov-12	\$19.71	\$19.90	(\$0.19)	60.50¢	61.00¢	(0.50¢)	\$1.910	\$1.944	(\$0.034)
Dec-12	\$19.71	\$19.88	(\$0.17)	62.70¢	62.73¢	(0.02¢)	\$1.910	\$1.937	(\$0.027)
Jan-13	\$19.61	\$19.77	(\$0.16)	60.00¢	60.00¢	0.00¢	\$1.933	\$1.943	(\$0.010)
Feb-13	\$19.20	\$19.37	(\$0.17)	58.50¢	58.50¢	0.00¢	\$1.898	\$1.918	(\$0.020)
Mar-13	\$19.10	\$19.20	(\$0.10)	57.00¢	57.00¢	0.00¢	\$1.901	\$1.917	(\$0.016)
Apr-13	\$18.98	\$19.12	(\$0.14)	57.45¢	57.45¢	0.00¢	\$1.887	\$1.903	(\$0.016)
May-13	\$18.83	\$18.87	(\$0.04)	58.00¢	58.00¢	0.00¢	\$1.875	\$1.875	\$0.000
Jun-13	\$18.65	\$18.65	\$0.00	58.00¢	58.00¢	0.00¢	\$1.849	\$1.849	\$0.000
Jul-13	\$18.75	\$18.80	(\$0.05)	57.00¢	57.00¢	0.00¢	\$1.859	\$1.859	\$0.000
Aug-13	\$18.57	\$18.55	\$0.02	55.00¢	55.00¢	0.00¢	\$1.855	\$1.855	\$0.000
<b>12 Mo Avg</b>	<b>\$19.12</b>	<b>\$19.23</b>	<b>(\$0.11)</b>	<b>58.41¢</b>	<b>58.49¢</b>	<b>(0.08¢)</b>	<b>\$1.886</b>	<b>\$1.899</b>	<b>(\$0.013)</b>

- NDM West: Prices are mixed, but the market tone remains firm. The lack of offerings to test/maintain the top end of the market was apparent this week as producers/sellers often are stretching loads to be able to fill contracted volumes. Production remains light with many dryers down in the region. Producers' stocks are tight and held with confidence.
- Cheese East: Mozzarella makers are attempting to increase production, prompted by good pizza maker and food service orders. Some areas are experiencing fairly tight milk supplies, due to strong Class I pulls, which is hampering efforts to expand mozzarella production. Domestic demand for cheese remains good, export interest has lessened as prices have increased.
- Cheese Midwest: A number of plants report that retailers seem to be increasing cheese ordering. The belief is that these retailers are attempting to stay ahead of prices they expect to trend upward as the year progresses. Pizza manufacturers are also committing to increased orders for Italian varieties of cheese, apparently due to concluding that price increases are more likely than not. Food Service orders are also increasing.
- International: Most product classes were sharply higher in this week's Global Dairy Trade auction, held on Tuesday. The index of all products increased 6% from the last auction 2 weeks ago, with cheddar cheese prices increasing 5.3%. AMF was up 11.8% and MPC70 jumped 15.5%.
- International: An article in BusinessWeek quotes the president of Cargill Animal Protein saying that despite the economic slowdown in China, consumption of meat, milk and eggs is in a mega up-trend. Slower economic growth has hurt commodities from copper to iron ore, but sustained export demand from grains to other food items has persisted.

#### What's Bearish:

- Spot Market: Blocks managed a 1¢ gain for the week, settling at \$1.83/lb, but fell a penny in Friday's spot market. Barrels finished ¼¢ lower for the week at \$1.77½/lb. Trading was moderate with 11 loads of blocks and 4 loads of barrels exchanging hands. Butter was up 2½¢ for the week on 11 trades to close at \$1.86½/lb, but gave up a ½¢ in today's spot market. NDM was steady at \$1.70/lb with no trades.
- Fluid Milk Central: The extended holiday weekend provided extra farm milk volumes for several manufacturing plants this week as some plants shut down additional days and others ran extra hours or added a day to production schedules to clear intakes. The additional spot loads of milk that surfaced cleared readily, with rising interest from cream cheese manufacturers.
- Dry Whey Central: Manufacturers' supplies of dry whey in the Central region are described as comfortable this week. Cheese production has reclaimed a portion of the milk from recent upticks in farm milk pickups. Dry whey production is steady to modestly higher at some locations.
- Butter: Churning schedules during the past week, especially over the Labor Day weekend, have generally been stronger as holiday cream supplies were available to butter churns from coast to coast. Current churning was sufficient to meet fresh butter needs, with some producers able to enhance inventories with surplus production. Standardized cream volumes continue to build as bottling programs for school lunch needs are in full swing now that the holiday is past and most all students have returned to the classroom.
- Cheese West: Prices are mixed as buyers and sellers are content this week to wait with extra purchases. The market is trying to find a balance between price and demand. Domestic demand is mostly steady. Cheese production is above year ago levels in the West, but manufacturers report supplies are not burdensome. Export demand is weaker as U.S. prices are above international prices in many cases.
- An article in the Milwaukee Journal-Sentinel this week says U.S. milk sales have reached their lowest levels in decades. More than half of U.S. adults no longer consume milk, putting consumption near a 30-year low. Shifting consumer habits and a flood of new beverages in the marketplace, including sports drinks and bottled teas, have taken a toll on beverage milk sales.

#### Recommendation:

Just two weeks ago we strongly urged producers to pay up and buy PUT options for Q4, despite the overwhelmingly bullish outlook. Since then, Oct has fallen 61¢, Nov is off 27¢ and Dec is down 24¢. What's happened? In short, a bull market needs to be fed, and it's not right now. The spot market has lacked conviction as buyers appear unwilling to push prices past the mid \$1.80's, while sellers have been more aggressive in letting go of product at these levels. Despite schools now in full session across the country and the dire financial situations of dairies we're hearing about every day, the bottom line is that even farms that go under or others that auction off their animals will continue to milk their herds with old crop feed in the meantime. We could be 3-4 months out from the real impact of the drought. Talk from other industry players includes reports of cheese and butter coming in to the country at favorable prices compared to the domestic market. The bottom line is this; longer term we remain bullish, but anything can happen, and has, in the near term. October looks particularly vulnerable as we wait for the herd size and milk production to decline. We would defend this month, despite the drop it has already taken. Buy the Oct 19.25 PUT at 35¢ or better. If Oct drops, so will Nov and Dec. Target the Nov 18.50 PUT at 30¢ and the Dec 18.00 PUT at 25¢. We would also consider selling Oct outright if, with your component pay, you have a good profit market there. By all means, don't sit idly by as an observer. Take action while you can!

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