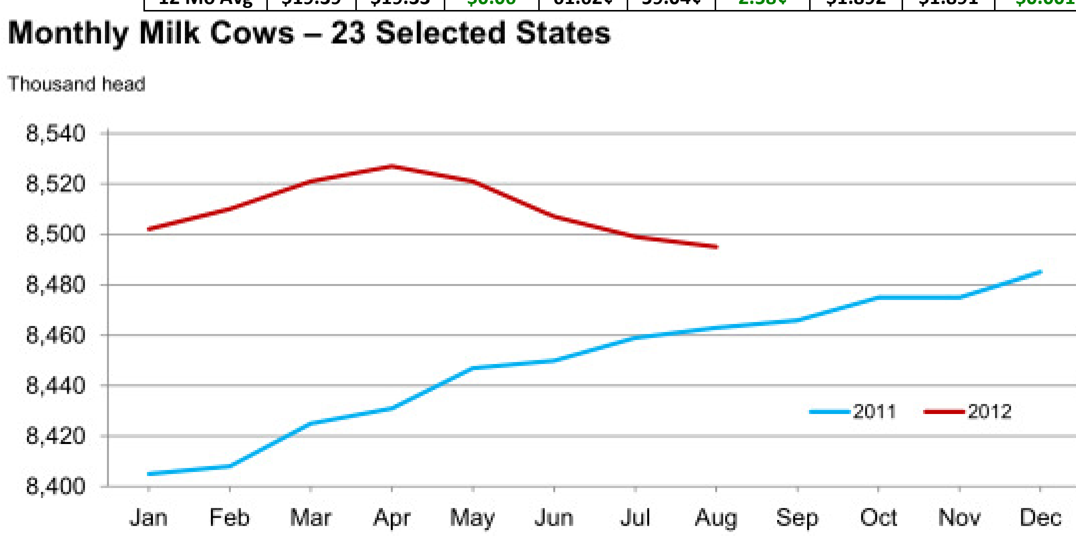
KDM Trading, Inc.
877.695.8538 www.kdmtrading.com
Dan Schindler, Mark Potter, Keith Schnese & Nick Potter

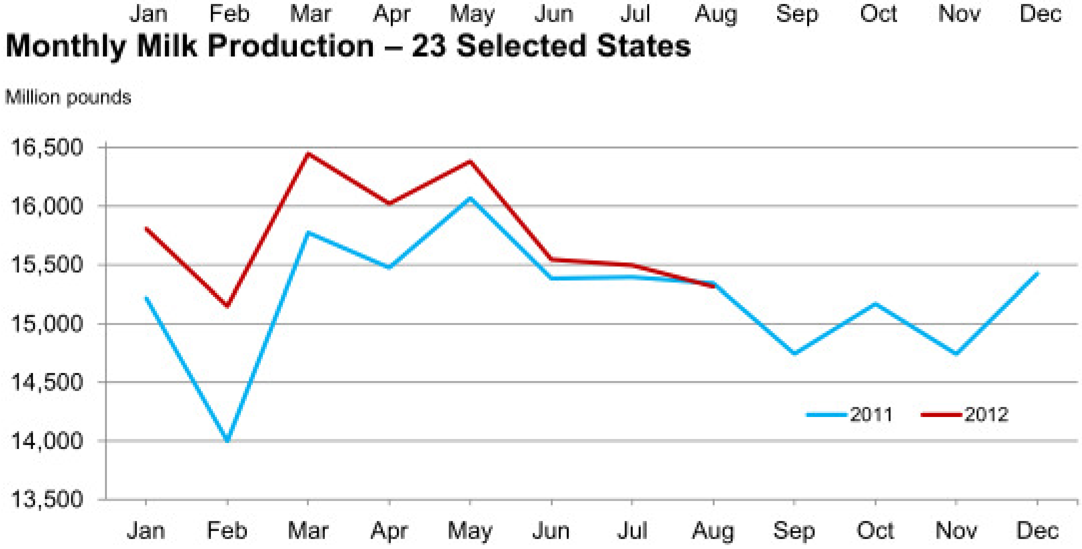
The KDM Dairy Report – September 21st, 2012

What's Bullish:

Futures Month	Class III 09/21	Class III 09/14	Change	Dry Whey 09/21	Dry Whey 09/14	Change	Cheese 09/21	Cheese 09/14	Change
Sep-12	$18.93	$18.87	$0.06	57.75¢	57.00¢	0.75¢	$1.867	$1.865	$0.002
Oct-12	$20.21	$19.97	$0.24	62.50¢	61.00¢	1.50¢	$1.967	$1.940	$0.027
Nov-12	$20.49	$20.39	$0.10	65.00¢	62.03¢	2.98¢	$1.982	$1.964	$0.018
Dec-12	$19.97	$20.21	($0.24)	67.00¢	64.00¢	3.00¢	$1.920	$1.943	($0.023)
Jan-13	$19.70	$19.84	($0.14)	63.00¢	60.00¢	3.00¢	$1.915	$1.920	($0.005)
Feb-13	$19.32	$19.39	($0.07)	62.50¢	61.00¢	1.50¢	$1.887	$1.899	($0.012)
Mar-13	$19.17	$19.14	$0.03	62.00¢	57.00¢	5.00¢	$1.865	$1.876	($0.011)
Apr-13	$18.96	$18.95	$0.01	62.00¢	58.00¢	4.00¢	$1.845	$1.870	($0.025)
May-13	$19.00	$18.90	$0.10	63.18¢	58.50¢	4.68¢	$1.860	$1.850	$0.010
Jun-13	$18.98	$18.74	$0.24	59.50¢	58.50¢	1.00¢	$1.875	$1.849	$0.026
Jul-13	$19.10	$18.90	$0.20	58.00¢	56.75¢	1.25¢	$1.860	$1.859	$0.001
Aug-13	$18.87	$18.64	$0.23	57.00¢	54.75¢	2.25¢	$1.855	$1.855	$0.000
12 Mo Avg	**$19.39**	**$19.33**	**$0.06**	**61.62¢**	**59.04¢**	**2.58¢**	**$1.892**	**$1.891**	**$0.001**

- Spot Market: Blocks gained 14½¢ to settle at $2.00/lb while barrels picked up 14¾¢ to close at $1.96/lb this week. Bidders were aggressive and grabbed 22 loads of blocks and 8 loads of barrels. Butter gained 4¢ for the week on just 1 trade to settle at $1.89/lb.
- Milk Production Report: Milk output in August declined by 0.3%, the first year-over-year decline since Jan, 2010. Cow numbers fell by 6,000 head from July and are now just 20,000 head higher than a year ago. Milk per cow fell 9 lbs vs. last Aug. Major production losses were seen in Western states: CA down 5.8% with milk per cow down 125 lbs. AZ down 3.8%, WA down 3.3%, NM down 2.9% and TX down 1.9%.
- Livestock Slaughter Report: Dairy cow slaughter in August reached a new record high at 275,300 head, up 12.6% vs. a year ago. Jan-Aug the cull is up 128,200 head vs. 2011.
- Dairy cow slaughter for the week ended 09/08 totaled 55,900 head, up 14,1% vs. the same period a year ago.





- Fluid Milk East: Strong pulls from Class I and II plants continue to limit manufacturing milk supplies in the Northeast and Mid-Atlantic regions. In the Southeast, Class I demand remains very strong, prompting 185 spot loads to be imported, vs. 143 last week and just 38 a year ago. Compounding the tight supply problem is the increased number of loads being rejected due to aflatoxin. Most bottling plants are being held to their contracted volumes, even though additional loads have been requested. Demand for cream is gradually increasing with strong pulls from cream cheese makers. Condensed skim milk supplies are very tight in the East as manufacturing milk supplies have been reduced due to the combination of strong Class I demand and increased yogurt production. Some manufacturers looking for additional loads have to go out of region and pay premiums to fill their needs. The tight manufacturing milk supplies continue to concern balancing plant managers and their ability to meet their future nonfat dry milk commitments.
- Fluid Milk Central: Some milk processors within the region report finding milk loads for Class I and II is surprisingly difficult, even with the price incentives attached to those Classes. Finding sufficient loads of milk often requires moving beyond usual suppliers. Central milk loads are clearing into the South/Southeast to help meet fluid demand in that area. Cooperatives with multiple end products indicate plants are operating below capacity. Standing orders for end products as well as milk transportation costs are affecting how farm milk is being allocated among plants. Interest in condensed skim milk is active and various manufacturers indicate demand exceeds availability for the week.

- Fluid Milk West: The most recent milk production report confirms what people knew - CA milk output is running well below year ago levels because of the various weather, financial and feeding factors. Milk production in the Pacific Northwest is below year ago levels. A combination of fewer cows and less production per cow, have milk handlers with tighter supplies going into manufacturing plants. Available supplies are being moved into plants with best returns and other plants are seeing some reduced schedules. UT and ID milk supplies are also reduced. Idaho milk supplies are below year ago levels as dairy farms have reduced cow numbers through harder culling of lower producing animals. Feed costs remain high and dairies are not willing to expand until milk prices can cover the cost of production. Farm lenders are cautious about extending loans to dairies that are experiencing financial difficulties.
- Dry Whey East: Production declined again this week as strong Class I demand limited manufacturing milk supplies and a cheese plant restricted production due to maintenance projects. Current production is moving through contracts with little being added to inventories. Supplies are becoming tight and, as a result, there were no spot sales or resale activity reported within the region this week. Buyers looking outside the region for additional loads have had limited success. The market undertone continues to be firm.
- Dry Whey Central: Prices are higher on a firm market. Milk availability within the region is tight at several locations. Most cheese plant operators indicate their plants are operating below capacity, as has been the case in the last few weeks. Also, compared to just a week or two ago, weekly cheese production is lower. Dry whey inventories at manufacturers are light to moderate as contract fulfillment is drawing steadily on current holdings.
- Dry Whey West: Prices are higher, following a trend that began in mid-June. The market remains firm, while demand for whey is increasing with seasonal interests beginning to prepare for upcoming holidays. Buyers without contracts in place are looking to brokers to fill spot needs. Export demand is good as prices for both domestic and export markets are similar.
- Cheese East: Production declined this week due to a combination of limited manufacturing milk supplies, because of strong Class I demand, and a plant restricting production for a maintenance project. Demand for mozzarella continues to be very good with good orders from food service and pizza makers. Export interest has improved compared to recent weeks.
- Cheese Midwest: Production has slowed as the milk supplies coming into plants have declined. CWT has accepted requests for export assistance to sell 3.320 million lbs of Cheddar and Monterey Jack cheese. The product will be delivered September 2012 through February 2013.
- Cheese West: Buyers are often looking for additional cheese deliveries when possible to try to stay ahead of price increases. Retail and food service sales are good. Additional demand is coming from seasonal buyers for the upcoming holidays. Cheese production schedules are busy, but not to capacity in many cases. Higher prices for milk solids are tempering usage in the cheese vats. Stocks are currently adequate to short to meet trade needs.
- International: Rabobank analysts predict food prices will exceed the all-time high set last year. Droughts in the U.S., South America and Russia are pushing up animal feed costs, spurring meat and dairy farmers to cut herds. Grain and oilseed prices should remain at elevated levels for at least the next 12 months to ration demand and encourage crop farmers to boost planting. The impact of higher grain and oilseed prices will be significant for the animal protein and dairy sectors as they are likely to be squeezed by higher feed costs. The full effect of this commodity price rally and the subsequent lower meat and milk output will be a multi-year rebuilding of herds, which will sustain high price levels.

What's Bearish:

- Butter: Cream continues to be readily available as standardized cream from bottling plants adds to cream supplies. Some butter makers have been opportunity buyers on the spot market as they look to increase inventories ahead of the holiday season. Current production is filling orders and adding to inventories.
- Grains: At least for now, harvest pressure, better than expected bean yields and a slowdown in export sales has put a halt on grain prices. November beans lost $1.75/bu since the first of the month while Dec corn is about 90¢/bu off its highs.

Recommendation:

Milk continues to be very tight in the East and is showing more signs of tightening in the West, where cow numbers are dropping the quickest. The Midwest seems to have decent output, but milk is being syphoned off to meet fluid demand in the Southeast. The net result is that cheese production across the country is being constrained by tighter milk supplies and higher costs for milk solids. At the same time, demand for cheese is increasing as buyers are looking to fill their holiday needs before further price increases. Retail and service sales are good, while demand for mozzarella is very good due to strong orders from pizza makers. The demand was seen in the spot market this week where bidders aggressively went after product. We hit and held at the psychologically important $2.00 cheese number for blocks. However, a major name-brand seller showed up in the spot trade today, after being largely absent this week, perhaps sending a message that "higher-than-$2-cheese" is not desirable at this time. Of the 22 loads of blocks that traded this week, 11 were let go on Friday. A correction ensued with Nov futures hitting a high of $20.90 in the early part of the spot call, and then quickly making a sharp move down to $20.46 for the low, with nearly all contracts finishing in the red. It shows just how nervous the markets are towards and how ready they are to sell off. This should be warning producers to take some risk management action. Despite how bullish fundamentals still appear, once the direction turns, it gets harder, if not impossible, to put together a decent hedge plan. Dairies should be working on that now. Why not just buy PUT options and then let the market do its thing? At least you'll have a floor price. Enter orders to buy the Oct 19.75 PUT for 15¢, the Nov 19.75 PUT for 30¢ and the Dec 19.25 PUT for 40¢. If the market eventually takes off further, you can leg into a fence by selling out-of-the-money CALL options in the same months. For example, the Nov 23.75 CALL is worth about 7¢ right now, but if the markets make a strong move higher this fall, you may be able to sell it for 20¢ or more, making the net cost of your 19.75 PUT 10¢ or less.

Grains: After making new record highs in both corn and beans, we are in the middle of a harvest sell-off. However, commercials still have an enormous sales commitment and there remains concern that once the harvest is in, supplies may be too short to meet demand. Next technical support for Dec corn is at about 7.18/bu and for Nov beans at about 15.80. Should we approach those numbers, dairies should consider hedging/booking a substantial portion of their feed into 2013, as higher prices may follow.