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The KDM Dairy Report – October 12th, 2012

What's Bullish:

Futures Month	Class III 10/12	Class III 10/05	Change	Dry Whey 10/12	Dry Whey 10/05	Change	Cheese 10/12	Cheese 10/05	Change
Oct-12	$21.14	$20.90	$0.24	62.00¢	62.00¢	0.00¢	$2.064	$2.045	$0.019
Nov-12	$21.07	$20.99	$0.08	62.75¢	63.50¢	(0.75¢)	$2.046	$2.055	($0.009)
Dec-12	$20.80	$20.32	$0.48	63.25¢	63.00¢	0.25¢	$2.022	$1.972	$0.050
Jan-13	$19.90	$19.57	$0.33	60.25¢	60.50¢	(0.25¢)	$1.944	$1.904	$0.040
Feb-13	$19.35	$19.11	$0.24	59.00¢	59.00¢	0.00¢	$1.895	$1.866	$0.029
Mar-13	$19.10	$18.83	$0.27	59.98¢	59.00¢	0.98¢	$1.865	$1.825	$0.040
Apr-13	$18.76	$18.57	$0.19	59.50¢	58.65¢	0.85¢	$1.838	$1.813	$0.025
May-13	$18.52	$18.43	$0.09	59.98¢	58.50¢	1.48¢	$1.822	$1.813	$0.009
Jun-13	$18.47	$18.37	$0.10	59.48¢	59.00¢	0.48¢	$1.822	$1.815	$0.007
Jul-13	$18.60	$18.60	$0.00	58.50¢	58.00¢	0.50¢	$1.829	$1.829	$0.000
Aug-13	$18.51	$18.55	($0.04)	57.00¢	56.50¢	0.50¢	$1.831	$1.839	($0.008)
Sep-13	$18.45	$18.45	$0.00	54.50¢	54.00¢	0.50¢	$1.822	$1.822	$0.000
12 Mo Avg	**$19.39**	**$19.22**	**$0.16**	**59.68¢**	**59.30¢**	**0.38¢**	**$1.900**	**$1.883**	**$0.017**

- Spot Market: Blocks and barrels closed unchanged for the week, settling at $2.10 and $2.06 respectively. Just 3 loads of blocks and no barrels exchanged hands, as sellers didn't really pressure the market. Butter rebounded from last Friday's drop, moving back up 7¢ to settle at $1.93/lb on 13 trades.
- World Ag Supply & Demand Report: USDA revised their 2013 Class III price forecast up $1.00/cwt from last month. They now expect it to average $18.20/cwt, citing recent strength in dairy product demand extending into 2013.
- All Class III components were higher in this week's price survey. 40-lb block cheese gained 6.8¢ to average $1.96/lb while 500-lb barrels jumped 9.0¢ to $2.00/lb. Butter increased 2.9¢ to average $1.91/lb, dry whey was 0.4¢ higher to 61.1¢/lb and nonfat dry milk inched up 0.1¢ to average $1.44/lb.
- Dairy cow slaughter for the week ended 09/29 was the second highest total of the year. 64,500 head were culled, up 9.3% vs. a year ago. YTD the cull is up 126,200 head vs. 2011.
- A Bloomberg article this week says U.S. milk production is headed for its biggest contraction in 12 years. One analyst is predicting the effects of the drought and high feed costs could push milk prices to a record $25/cwt by June. Dairies in the top-producing state of California are filing for bankruptcy, and cows are being slaughtered at the fastest rate in 25 years. The global dairy market is facing a scarcity of supply in the next 12 months as output slows in the U.S. and Europe and demand keeps expanding. Surplus milk available for shipment from the seven biggest exporting regions will decline for the first time in four years, and there is little excess inventory. The U.S. dairy herd will shrink 1.1 percent to 9.11 million head in 2013, the smallest since 2005, according to the USDA.
- Fluid Milk East: Milk production is steady to slightly higher in the Northeast and Mid-Atlantic regions, but Class I demand remains strong and is limiting the manufacturing milk supply. Most balancing plant managers report that milk supplies are adequate to cover fluid contracts with limited excess supplies. Warm days and nights in Florida have checked milk production increases and in some areas lowered production. Class I demand remains very strong and may yet increase further when seasonal residents return in the coming weeks. The limited milk production increases and good Class I demand prompted 115 spot loads to be imported this week, up from 98 last week. In the Southeast, Class I demand is steady and kept the number of import loads to 25 this week. Manufacturing milk supplies are being kept to their contract minimums. Condensed skim milk supplies have tightened this week. Some balancing plants had barely adequate supplies to cover their fluid contracts and as a result, Class IV production is very limited.
- Fluid Milk Central: Milk production in the Central region is following expected levels. Farm milk volumes are near seasonal lows. While milk handlers expect volumes to begin to improve, the turnaround has been slow to materialize. Component trends are also slow to improve. Poor quality feeds are being blamed in some cases.
- Fluid Milk West: CA milk production is mainly steady with recent weeks. There continue to be impacts being seen because of financial and feeding considerations. Cow slaughter numbers are higher than historical levels. Slaughter cow prices are high and interest in buying marginal cows is limited with higher costs of inputs making profitability more challenging even with top end cows. Borrowing to purchase cows is more intricate than in past years. Processing plants are running at seasonal low levels. AZ milk output continues to move higher on a weekly basis, though limits on production remain on the feed and financial side of the equation. NM milk production is trending steady, but processing plants are running on reduced, seasonal schedules. Milk production in the Pacific Northwest is nearing seasonal lows. Fall weather is conducive to increased milk production, but milk supplies remain mostly steady. Class I needs are steady with schools in session, further tightening manufacturing supplies. Costs of feed are serious concerns to dairies as they try to maintain profitability.
- Dry Whey East: Cheese and dry whey production are steady and below levels most manufacturers' desire, due to the tight manufacturing milk supply. Current production is moving through contracts with little being added to inventories. Spot market and resale activity in the East remains very light. Demand has softened as seasonal production transitions from ice cream to baking products, but export interest remains improved compared to recent weeks. The market undertone is steady to firm.
- NDM East: Manufacturing milk supplies remain tight in the East, limiting milk volumes moving through dryers. Current production is moving through contracts. Most inventories are being worked lower, due to the limited production schedules. Some plant managers continue to be concerned about their ability to meet their future commitments.
- Cheese East: Cheese makers are attempting to increase production of mozzarella and provolone following good orders from food service, pizza manufacturers and retail outlets. Current production is filling orders with only marginal additions to inventories.
- Cheese Midwest: Cheese production is in good general balance with sales. Orders are being met and if extra cheese can be occasionally manufactured, continuing buyers are ready customers. Little motivation exists to look for additional milk.
- Cheese West: The market is mostly steady to firm overall as supplies are adequate for contracted demand with additional supplies harder to acquire. Demand remains very good into retail avenues. Buyers are filling holiday orders for specialty cheeses along with traditional varieties for retail needs. Supplies are adequate, although tight in some instances as cheese plants in the West are finding milk harder to source.

- CWT has accepted requests for export assistance to sell 1.056 million pounds of Cheddar and Monterey Jack cheese. The product will be delivered October 2012 through April 2013.
- Grains: Thursday's much-anticipated crop report did revise soybean yields higher as expected, but also revised usage up substantially. All eyes are now on South America as tight ending stocks appear to be headed towards more price rationing.
- International: Western European milk production levels are trending seasonally lower. Milk deliveries into processing facilities are also tending to be declining. According to trade sources, milk output is lower versus a year ago in Germany, France, Netherlands and Ireland. Recent wet weather conditions have a lingering effect on pasturing and cropping. Some countries are noting declines in fat and protein levels of milk receipts, attributed to changing feeding patterns on dairies. Cost of production issues are a concern with farm milk pricing steady to incrementally higher.
- International: In both New Zealand and Australia, manufacturing facilities are all up and running. Stock levels of manufactured dairy products are basically fully committed at this time. Traders and handlers do indicate that they continue to receive new inquiries from potential buyers, but often are not able to fulfill the inquiry. Oceania cheese markets and prices are firm. Traders and handlers are stating that cheese sales have been and continue to be strong. Much of first half production has been committed and discussions for second half needs are occurring.

What's Bearish:

- Butter: Cream supplies were readily available following last Friday's steep price decline in butter. Heavy volumes of cream went to the churn and added to butter inventories. Demand for butter has improved, but is lagging behind last year's levels. Some butter makers have more than adequate inventories and are hesitant to add to current supplies.
- Dry Whey Central: Prices are higher across the range but buyers and sellers alike are feeling that the market has neared a plateau. Increased spot availability from brokers has limited movement upward. Whey production is increasing slowly as cheese plants are busy meeting holiday commitments. Current whey stocks are adequate to fill most needs.
- Dry Whey West: Increased availability of whey from resellers has tempered price increases. Spot market buyers are finding product through brokers.
- NDM Central: Buyers were able to source loads at lower prices than previous week's. Production of NDM remains mostly steady as cheese demand continues to outbid butter/powder buyers for available milk supplies. Many end users are holding sufficient supplies as to not be forced into the spot market.
- NDM West: The market undertone is unsettled. Buyers have moved from needing to secure product to having become more price sensitive. More offerings are coming from the resale market and from buyers who have made index based purchases. Export interest is often slow to gain new business. Pricing points are relatively high when compared to products out of the Oceania region.
- International: Milk production in New Zealand is at or very near peak levels in many regions. Milk producers and handlers are indicating that a strong finish to the previous season, good cow conditioning, and a favorable start to the current season are all contributing factors to a positive season thus far. Milk handlers are projecting that milk output will probably not be as strong as last season, but will be in the 3 - 4% increase range from two years ago. The Australian milk production season is well underway and will peak in about three weeks. Producers and handlers are continuing to project a positive season with most anticipating a 1 - 2% increase over two years ago with some reaching to the 3% level. Milk handlers are hopeful that peak levels will be able to be maintained for an extended period of time.
- International: Aussie butter exports Jul-Aug are up 136.5% vs. a year ago, according to Dairy Australia. Total dairy exports are up 8.9% over the same period. Cheddar exports, however, declined 3.6%.

Recommendation:

Spot cheese prices seem to be in balance as neither buyers nor sellers seemed to be in any hurry to move prices one way or another. Just three block trades were recorded for the week. Manufacturing milk continues to be tight in the East and West, with the Midwest tilting even to a slight excess. Overall though, being that holiday demand is just beginning to ramp up, there appears to be little downside for the spot market in the near term. That said, anything can happen at any time. If you need downside protection at all for Nov and Dec, it's silly not to buy some cheap PUT options to do the job. With 2012 winding to a close, more eyes are beginning to focus on 2013, as they should. Typically, Q4 of any year brings out additional commercial interest in the next year, as companies work on their budgets. These are usually end-users of milk and are long hedgers. Be watching the 2013 contracts for additional trade volume in the near future, as they have been pretty quiet so far. Probably the most bullish factor going for dairy right now is cow numbers. This week's slaughter total reinforces the idea that despite $21 milk ahead, high feed costs continue to take their toll. The Bloomberg article mentioned above could be right, and if we are indeed facing the biggest milk production contraction in 12 years, prices should be well supported for some time to come. The question though, is how long? We remain bullish through the first half of the year and thus don't sense any urgency to get significant coverage. We have a few orders out there for 17.00 x 22.00 fences (min/max), but think contract highs in these months are still to come. We'd be a lot more interested in an 18.00 x 23.00 fence or something similar. What does catch our eye though is the second half of 2013. Let's just say the next 9 months produce $20 or more milk. How long can the market bear this and won't that be a strong enough signal, eventually, for some producers to begin adding cows? July-Dec 2013 averages $18.30. If you operate in an area where you receive $1.50 or more premium and you have your feed covered (because you grow it), you may want to flat out sell up to 25% of your milk here. Sure, prices could go higher, but how often to you get the chance to lock in $20 mailbox that far out? In terms of hedging priority, we believe getting some coverage in the second half of 2013 at these prices is of HIGHER importance than getting covered in the first half of the year. The risk for lower milk prices, in our opinion, is greater beyond June. It may not make sense for your operation to do this, but for some, it may be a great business decision to lock in a very profitable margin. Think about it over the weekend.