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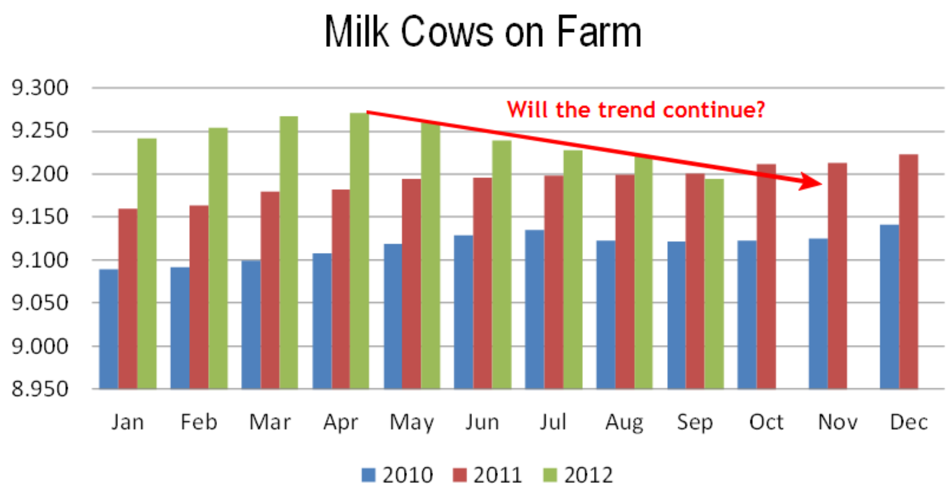
The KDM Dairy Report – October 19th, 2012

What's Bullish:

Futures Month	Class III 10/19	Class III 10/12	Change	Dry Whey 10/19	Dry Whey 10/12	Change	Cheese 10/19	Cheese 10/12	Change
Oct-12	$21.04	$21.14	($0.10)	62.00¢	62.00¢	0.00¢	$2.055	$2.064	($0.009)
Nov-12	$20.62	$21.07	($0.45)	61.50¢	62.75¢	(1.25¢)	$2.013	$2.046	($0.033)
Dec-12	$20.55	$20.80	($0.25)	62.50¢	63.25¢	(0.75¢)	$2.014	$2.022	($0.008)
Jan-13	$19.98	$19.90	$0.08	59.03¢	60.25¢	(1.23¢)	$1.962	$1.944	$0.018
Feb-13	$19.65	$19.35	$0.30	58.03¢	59.00¢	(0.98¢)	$1.930	$1.895	$0.035
Mar-13	$19.30	$19.10	$0.20	58.50¢	59.98¢	(1.48¢)	$1.890	$1.865	$0.025
Apr-13	$19.02	$18.76	$0.26	59.50¢	59.50¢	0.00¢	$1.850	$1.838	$0.012
May-13	$18.73	$18.52	$0.21	59.95¢	59.98¢	(0.02¢)	$1.825	$1.822	$0.003
Jun-13	$18.71	$18.47	$0.24	59.48¢	59.48¢	0.00¢	$1.831	$1.822	$0.009
Jul-13	$18.60	$18.60	$0.00	58.50¢	58.50¢	0.00¢	$1.829	$1.829	$0.000
Aug-13	$18.64	$18.51	$0.13	57.00¢	57.00¢	0.00¢	$1.831	$1.831	$0.000
Sep-13	$18.53	$18.45	$0.08	54.50¢	54.50¢	0.00¢	$1.822	$1.822	$0.000
12 Mo Avg	**$19.45**	**$19.39**	**$0.06**	**59.21¢**	**59.68¢**	**(0.48¢)**	**$1.904**	**$1.900**	**$0.004**



- Milk Production Report: September milk output was down 0.5% in the U.S., the first annual decline since January 2010. Maybe more impressive is the 27,000 head drop in cow numbers from Aug to Sep. The number of milk cows, at 9.195 million head, also dipped below year ago levels for the first time since September 2010. Milk per cow fell 7 lbs vs. 2011. States with the largest percentage declines confirm the hardship in the Southwest, with AZ down 5.4%, TX down 4.7%, NM down 4.5% and CA down 3.9%. Milk per cow in CA fell an astonishing 175 lbs, an indication that feed rations are being pinched.
- Class III components made another strong showing in this week's price survey. 40-lb cheddar blocks jumped 7.4¢ to average $2.03/lb and 500-lb barrels were up 3.8¢ to $2.04/lb. Butter increased 2.5¢ to average $1.93/lb, dry whey nudged 0.5¢ higher to 61.5¢/lb and nonfat dry milk gained 1.8¢ to average $1.46/lb.
- Over the first 15 days of October, cheese stocks at USDA selected storage centers have declined 1.8 million lbs, or 2%. Butter stocks have declined 143,000 lbs, or 1%, over the same period.
- Dairy cow slaughter for the week ended 10/06 totaled 63,400 head, up 11.8% from last year.
- Fluid Milk East: Class I demand in Florida is very strong, with bottlers not being sure what factors are driving the demand. Even the scheduled beginning of eggnog production next week is not believed to be driving demand for milk at present levels. Farm level production dropped by the end of last week to the lowest milk volume since 2009. This is attributed to a combination of feed costs, herd thinning and warmer than normal weather for this time of year, reaching the high 80's during the day. Southeast regional milk supplies are generally steady, but bottling orders are strong. Manufacturing activity is at a low level. Mid Atlantic milk supplies are adequate for bottling demand but are limiting manufacturing. Manufacturing milk volumes are called tight. Northeast milk production is steady to slightly higher. Class I demand is strong, leaving less than desired volumes of milk for cheese manufacturing, especially Mozzarella.
- Fluid Milk West: CA milk production levels are generally holding steady, but remain below a year ago. Handlers continue to move milk around to meet milk supply contracts and internal needs. Farm level costs of production remain high and continue to stress the financials. Feed costs are a major factor. Plants are running on light to moderate schedules. AZ milk production is trending higher, but processing plants are able to handle the milk supplies. The Class I market is pulling more milk and retail features are noted in local store advertising. Milk production in the Pacific Northwest followed expected volumes for the week, though milk supplies are being moved around to fulfill contract obligations. High feed costs and active culling of dairy herds have some manufacturers worrying about milk supplies into the winter and 1Q of next year.
- Butter: Butter producers are taking advantage of available cream volumes as best they can, especially depending on price. At this point, most churning is clearing the doors with inventoried stock filling in the gaps. Butter handlers that have frozen inventoried stock are tempering holdings and micro fixing for upcoming 4th quarter needs. Good retail orders continue to be placed for upcoming holiday needs. Retail promotions are being scheduled to run at varying times during the final two months of the year. Food service orders are also on the positive side as restaurants and food service outlets prepare for holiday shoppers and parties.
- Dry Whey East: Whey supplies are categorized as very tight in the Northeast. There were expectations stated this week that the market will strengthen. Regional cheese manufacturing continues to bump against a lower than desired milk supply as a limiting factor. Most current production is moving through contracts. Buyers of spot loads are generally accumulating inventory on the expectation of increasing prices as well as concern about product availability on spot markets in the near future.
- Cheese Northeast: Milk available to cheese makers in the Northeast remains a bit tight although, there are indications that production in parts of the region is showing signs of increasing. Mozzarella manufacturers would like to make more cheese.
- Cheese Midwest: After the price declines this week, both blocks and barrels remain above prices at this point of each of the last four years. Even so, prior to this week's price adjustments, there was little expectation with any genuine certainty, based on non CME supply and demand factors, that prices would adjust downward so quickly. One large Midwest cheese manufacturer expressed "surprise" at the magnitude of this

week's price adjustment, noting: (1) manufacturer inventories are tight; (2) cheese production is below desired levels; and (3) milk available for Class III use is tight. Other manufacturers in the region echo those observations about the current situation. Manufacturers plan to keep producing cheese with available milk supplies, but few anticipate seeking milk in addition to presently available volumes, by paying class premiums to increase milk supplies.

- CWT has accepted requests for export assistance to sell 2.798 million pounds of Cheddar and Monterey Jack cheese to customers in Asia, Central America and the Middle East. The product will be delivered October 2012 through March 2013.
- Hay Production: According to the October Crop Production report, hay production for 2012 totals 55.6 million tons, down 14.9% from 2011. Area harvested was down 2.1% and yield per acre was down 13.2%. In the Midwest, where the extreme drought impacted hay output, the top three hay production states in the Midwest saw the following: Minnesota 2.9 million tons, down 28.7%; Iowa 2.3 million tons, down 16.8%; Wisconsin 2.2 million tons, down 31.7%.
- International: Soft drink makers like Coke and Pepsi, attempting to integrate dairy into their product line, will face massive sourcing challenges, according to a Rabobank analyst who spoke at InterBev2012 this week in Las Vegas. There are only eight countries in the world that provide milk, that also have a milk surplus. One example cited was Coca-Cola's huge success in China with a drink called Super Milky Pulpy, but supply constraints didn't allow them to source enough milk powder to meet demand.

What's Bearish:

- Spot Market: Blocks lost 10¢ for the week while barrels gave up 14¼¢. Most of the move came on Tuesday, with some questioning the 9¢ drop that day in both blocks and barrels. Trading was moderate for blocks, with 15 loads exchanging hands, while just 2 loads of barrels traded. Butter was also down, losing 5¢ to settle at $1.88/lb.
- Fluid Milk Central: Farm milk intakes are uneven through the Central region. Milk haulers indicate farm milk volumes in the North Central vary from lower to slightly higher. South Central handlers indicate milk intakes are up compared to previous weeks as dairy operations in those areas reach the turnaround point of week on week milk production increases. Availability of spot loads of condensed skim from the Southwest and Mountain regions are increasing seasonally. Cream availability is generally higher in the Central region. North Central ice cream producers indicate their need for cream is lower than in past weeks as the ice cream season winds down.
- Dry Whey Central: Several market participants note increased availability of dry whey loads from resellers this week. These loads readily filled demand in several Central locations. Buyers indicate the resale prices met those of manufacturers or offered some savings. Also, lower market premiums on some manufacturers' spot sales are in place this week. Central buyers translate current pricing and the frequency of spot offers to mean dry whey loads are readily available and manufacturers' and brokers' inventories may be above desired levels for this time of year.
- Dry Whey West: Cheese production continues at a steady pace and dry whey production is in balance with current needs. Some loads of whey are available in the secondary market for those buyers not in a contracted position. Export demand is mostly steady to weak as buyers are reluctant to add significantly to inventories at current prices.
- Nonfat Dry Milk: Current spot sales are under pricing pressure as more offerings are appearing from the manufacturers and additional resale loads are being offered from the first buyers. Offerings are being met with a lighter demand as buyers sense the market undertone is weaker in the short term. Current production levels are trending flat to slightly higher.

Recommendation:

Blocks and barrels took a surprise nosedive this week, catching many off guard. With manufacturing milk tight in most parts of the country and holiday demand just ahead of us, downside appeared limited. It may be that at over $2, some cheese was priced out of the export market and needed a home, or simply that the path of least resistance at the time was down, not up. In the end, the market is always right. After the correction on Tuesday, spot prices declined further, but more slowly. Blocks found strong support at $2.00 as multiple buyers picked up several loads there. Today's Milk Production Report showed the first year-on-year decline in output since January 2010. While the 0.5% decline was below several analysts' expectations, the 27,000 head decline in milk cows was way above expectations. In our opinion, cow numbers is the figure to watch these days (see chart above). Weekly cull numbers have continued to be strong in October, so we think the trend will continue. Feed costs have not come down that much, with the high cost making a big impact on milk per cow, especially the shocking number we saw out of CA. Fewer cows should work out to less milk. This looks good in the long run for milk prices, though we saw this week that anything can happen near term. While the report probably won't make much of an impact on the front months, it may begin to rally the 2013 contracts. You can't turn cow numbers around overnight. This week our Jan-Jun 17.00 x 22.00 fence order filled. For producers being paid $1.50-2.00 or more in premium, this is not a bad way to start your hedge program for 2013 if you have a handle on your inputs. These are very profitable numbers for some producers. The Jan and Feb contracts made new all-time highs this week, and we think more is yet to come. As we wrote last week, an 18.00 x 23.00 fence is more appealing to us. Think about getting in your orders ahead of time. July-Dec avg is $18.40. We still think it's not a bad idea to get a small percentage of your milk sold here.