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The KDM Dairy Report – October 26th, 2012

What's Bullish:

Futures Month	Class III 10/26	Class III 10/19	Change	Dry Whey 10/26	Dry Whey 10/19	Change	Cheese 10/26	Cheese 10/19	Change
Oct-12	$21.03	$21.04	**($0.01)**	61.98¢	62.00¢	**(0.02¢)**	$2.053	$2.055	**($0.002)**
Nov-12	$21.13	$20.62	**$0.51**	62.60¢	61.50¢	**1.10¢**	$2.059	$2.013	**$0.046**
Dec-12	$20.28	$20.55	**($0.27)**	63.45¢	62.50¢	**0.95¢**	$1.986	$2.014	**($0.028)**
Jan-13	$19.50	$19.98	**($0.48)**	60.00¢	59.03¢	**0.98¢**	$1.912	$1.962	**($0.050)**
Feb-13	$19.26	$19.65	**($0.39)**	59.00¢	58.03¢	**0.98¢**	$1.880	$1.930	**($0.050)**
Mar-13	$18.99	$19.30	**($0.31)**	60.00¢	58.50¢	**1.50¢**	$1.860	$1.890	**($0.030)**
Apr-13	$18.85	$19.02	**($0.17)**	60.00¢	59.50¢	**0.50¢**	$1.855	$1.850	**$0.005**
May-13	$18.66	$18.73	**($0.07)**	59.75¢	59.95¢	**(0.20¢)**	$1.830	$1.825	**$0.005**
Jun-13	$18.60	$18.71	**($0.11)**	59.25¢	59.48¢	**(0.23¢)**	$1.840	$1.831	**$0.009**
Jul-13	$18.57	$18.60	**($0.03)**	57.00¢	58.50¢	**(1.50¢)**	$1.830	$1.829	**$0.001**
Aug-13	$18.50	$18.64	**($0.14)**	56.00¢	57.00¢	**(1.00¢)**	$1.831	$1.831	**$0.000**
Sep-13	$18.50	$18.53	**($0.03)**	54.50¢	54.50¢	**0.00¢**	$1.825	$1.822	**$0.003**
12 Mo Avg	**$19.32**	**$19.45**	**($0.13)**	**59.46¢**	**59.21¢**	**0.25¢**	**$1.897**	**$1.904**	**($0.008)**

- Spot Market: Blocks gained 12¢ for the week on just 6 trades to settle at $2.12/lb. Barrels picked up 16¼¢ on just 2 trades to close at $2.08/lb. Butter increased 1¢ to settle at $1.89/lb with active trading of 18 loads.
- Most Class III components were higher in this week's USDA sales report. 40-lb cheddar blocks jumped 5.7¢ to average $2.09/lb and 500-lb barrels were up 2.8¢ to $2.06/lb. Butter decreased 0.1¢ to average $1.93/lb, but dry whey increased a full penny to 62.6¢/lb and nonfat dry milk gained 1.3¢ to average $1.47/lb.
- Weekly cold storage numbers are showing a drawdown in cheese. Stocks at USDA selected storage centers are down 2%, or 2.37 million lbs, over the period 10/01 through 10/22.
- Weekly dairy cow slaughter numbers are showing sustained, high levels. 63,000 head were culled for the week ended 10/13, up 13.1% vs. a year ago. YTD the cull is now 140,000 head higher than last year.
- International: Milk production trends continue to seasonally decline for most all European regions. In most instances, the production season is over and late season milk volumes are being directed to production of products of best return or most need. Fall weather conditions are contributing to less feed quality and quantity for pasture based production and cows are starting to be housed for the upcoming winter season. Winter feed stocks are often being referred to as not the best from a quality and quantity bases which will challenge many producers. As the milk production season winds down, milk and cream availability is tightening for many products. Holiday cream based items are some of the products that are seeking additional volumes.
- Fluid Milk East: The typical seasonal increases in milk production have been stymied by herd reductions in the Northeast and Mid-Atlantic regions as producers struggle with feed supplies and financial concerns. Milk volumes are adequate to meet fluid demand with manufacturing milk supplies remaining fairly tight. Pasture conditions in both regions are declining seasonally as limited daylight and cooler temperatures restrict regrowth. Milk production in Florida is showing signs of increasing in some areas as cooler, dryer weather is covering much of the state, but good Class I demand prompted 117 spot loads to be imported this week, up from 111 last week. Manufacturing milk supplies remain tight in the Southeast, with most manufacturers being held to their contract minimums. Load rejections due to high aflatoxin levels increased this week. Demand for cream is increasing as production of cream cheese, whipping cream, dips, sour cream, bottled cream and butter are increasing along the seasonal trend. Balancing plants have adequate supplies to cover their fluid contracts, but Class IV production continues to be limited.
- Fluid Milk West: Milk production trends are basically flat in CA. Total output remains below a year ago. The trend is proving hard to reverse as producers work with current milk prices against the high input costs. Processors are able to handle the current milk supplies with limited issues noted.
- Butter: Demand is good to very good as holiday buyers look to fill needs. Retail and club sales are described as very good. Food service needs are also better than year ago volumes.
- Dry Whey East: Prices continued to move higher this week. Cheese and eventual dry whey production moved marginally higher, but current production is moving through contracts with little being added to inventories. The whey supply remains tight in the region. Spot and resale activity continues to be light. The market undertone remains firm.
- Dry Whey Central: Despite increases in availability (see bear point below), the Central dry whey market is also experiencing some increased demand from buyers who generally shop for Western dry whey. Buyers indicate that with limited availability in the West, they are filling immediate dry whey demand from the inventories of Central manufacturers.
- Cheese East: Production in the Northeast has increased marginally as some plants are seeing slight increases in milk volumes. Some plants are comfortable with their current production levels, while others would like to increase production. Cheese orders remain good with most inventories being worked lower. Some cheese makers are attempting to increase cheese going into aging programs, because of lower input costs compared to previous years.
- Cheese West: The market tone is steady as buyers are looking to increase purchases above contracted needs in some cases. Cheese production in the West is running behind desired levels as milk supplies are tight. Cheese plants are filling contracted orders, but are offering little to the spot market.
- Cheese U.S.: Cheese prices continue to fluctuate as the CME Group spot market struggles to find equilibrium. This week saw the market advance significantly on light sales and higher bids. Cheese supplies are tighter than both last month and a year ago. The NASS Cold Storage report showed stocks of natural cheese down 1% from last month and 5% less than last year. Tighter milk supplies and good seasonal demand are combining to move the market higher this week.
- CWT has accepted requests for export assistance to sell 2.262 million pounds of cheddar and Monterey Jack cheese. The product will be delivered October 2012 through March 2013.

What's Bearish:

- Livestock Slaughter Report: Dairy cow slaughter numbers in September were up just 1.6% (4,000 head) compared to last September, however, it was the highest number ever for that month.
- Cheese Midwest: A number of manufacturers presently have cheese backing up, attributed to softer retail demand. For cheese to reach retail stores in time for the beginning of the Christmas to Super Bowl season, the cheese generally must leave manufacturing plants by early November. That date is getting closer. The recent gyrations of CME prices have been viewed as impeding the smooth flow of retail ordering. With CME price movements up and down in a repeating cycle over recent weeks, and with most pricing to retailers based off CME prices, "retailers see price uncertainty" and slow buying, according to a manufacturer. This factor is what most manufacturers believe is a big contributor to cheese backing up at plants this week more than had been anticipated.
- Fluid Milk Central: Farm milk solid components are steady to somewhat higher in the Central region, according to various milk handlers. This is boosting cheese yields throughout the region. A few cheese manufacturers indicate, though, demand for cheese is volatile. Some plants are dealing with numerous order changes throughout the week. A few plant managers noted they have decreased production days in the week to accommodate recent changes in orders, especially linked to Italian type cheeses. Cream spot loads are readily available this week. Manufacturers indicate it is late in the season for ice cream interest and a little too early for strong production of holiday items. Churning is active at many locations. A few operations are offering numerous spot loads of milk per week for an extended duration. Some milk handlers note this is an earlier and larger than usual spot milk availability than seasonal offers that generally occur around holidays to accommodate long weekends.
- Fluid Milk Pacific Northwest: Weather conditions are conducive to increased cow comfort and milk production is beginning to show some increases along seasonal lines. Higher farm milk prices have helped to ease immediate worries by dairies. Feed costs continue to be difficult to manage and maintain profitability, but manufacturing plants are seeing higher than anticipated milk volumes as they await production startup for a new plant in the region.
- Butter: Some butter producers that had been actively churning for potential customers are finding that this need is not as strong as projected and are now holding uncommitted stocks. It is still early, thus they are hopeful that they will be able to clear these stocks before the end of the year.
- Dry Whey Central: The market tone is mixed. Central dry whey loads from manufacturers above contracted volumes are described as readily available. Loads are also available from the trade. Some dry whey spot loads sold as slightly aged are clearing at discounts to the market.
- Nonfat Dry Milk: Demand has softened in the Northeast as ice cream production has significantly slowed. Resale activity has slowed and the market undertone is weak. In the Central region, near term buyer interest beyond contract obligations is light, according to manufacturers and the trade. As the end of some fiscal year bookkeeping approaches, some buyers are less interested in adding additional loads of NDM into inventory.
- International: In recent days, reports of over quota milk volumes were released and 6 countries (Austria, Ireland, The Netherlands, Germany, Cyprus, and Luxembourg) were identified as exceeding their 2011 - 2012 quota levels. Austrian producers surpassed their quota levels by 5%.
- International: The milk production season is at or very near peak levels in both Australia and New Zealand. Manufacturing facilities are all working at or near plant capacities, with minimal problems being reported in processing the milk flow. In Australia, milk volumes generally continue to build towards seasonal peak levels, with milk volumes running as much as 7% stronger in Northern Victoria and overall milk volumes running 2.1% ahead of last year at this time for the first three months of the production year. Australian producers are anticipating a 1-2% growth trend. Cheddar cheese production in Australia is strong with the high milk volumes. Prices averaged $1.79/lb.

Recommendation:

Usually markets celebrate new highs (or lows) as confirmation of direction. **When they don't, be on your guard**. Just last week, Dec, Jan and Feb milk futures made new all-time contract highs, and this week, spot cheese recovered all of last week's losses and then some, pushing into new highs for the year. One would have expected the market to make a strong move higher, but in fact the opposite has occurred. With the exception of Nov milk finishing up 51¢ for the week due to its position of being the front month, all other contracts finished in the red, some solidly. So what's up? We think there are a number of factors curbing enthusiasm. First, cheese in the Midwest went from being "tight" two weeks ago, to "backing up" this week, a flip-flop worthy of politicians, but unusually sudden in the dairy sector. We've heard some talk of cheese coming into the country from Oceania, where cheddar is priced below $1.80/lb, which might have something to do with it. Second, commodities overall are having a hard time as an asset class. Grains are lower, crude oil is lower, gold is lower, etc. so the mentality out there is "sell commodities". Third, one of the reasons for the commodity sell-off is the idea the economy is weakening. Several Dow component companies this week announced weaker-than-expected earnings, and guided 4th quarter profits lower. Globally, the euro nation economies remain weak and there is growing concern over a slowdown in China. Lastly, pre-election jitters! While a big drop in milk prices would result in more dairies going under in the Southwest and West, current prices for dairies in the Midwest and Northeast are VERY profitable. Milk output appears to be surging a bit in the Midwest, and with 70% of it being turned into cheese, more loads could start showing up at the CME in Chicago. Expect some big volatility next week. With spot cheese prices making new highs and some recent strength in dry whey futures, current prices work out to about $21.68 Class III. If cheese prices hold steady next week, Nov and Dec, both trading at a substantial discount, would most likely scream higher. On the other hand, the ominous price action we described above could be an indication that cheese is about ready to break. Flip a coin; we don't know either. As hedgers though, your job is not to try and outguess the market, but to guarantee profitability for your operation. We're nervous and you should be too. We would increase your hedge efforts next week. Buy the Dec 19.50 PUTs for 25¢. Jan-March consider the 18.00 x 20.50 fence at even money. April-Dec, consider selling at an $18.87 average. Get something done!