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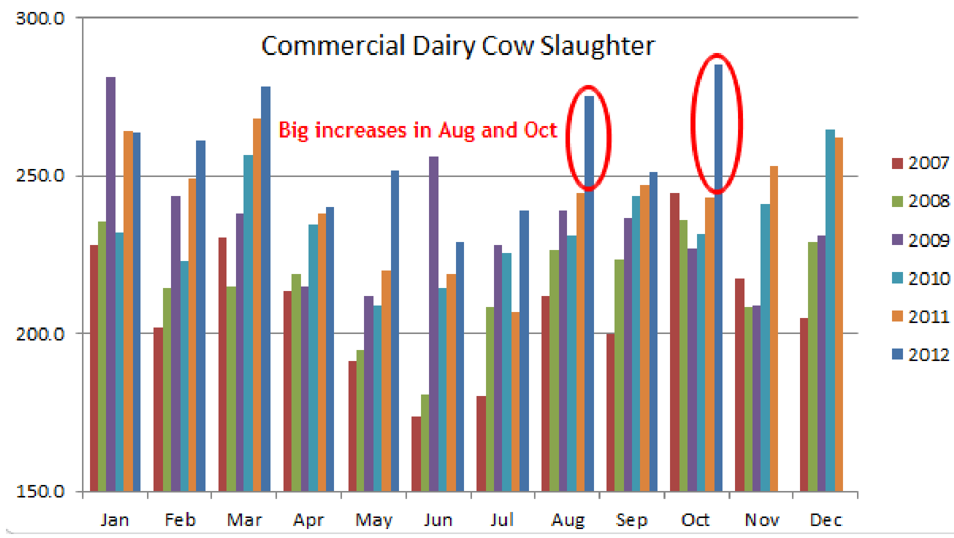
The KDM Dairy Report – November 30th, 2012

What's Bullish:

Futures Month	Class III 11/30	Class III 11/16	Change	Dry Whey 11/30	Dry Whey 11/16	Change	Cheese 11/30	Cheese 11/16	Change
Nov-12	$20.80	$20.74	$0.06	64.50¢	63.70¢	0.80¢	$2.013	$2.009	$0.004
Dec-12	$18.74	$19.04	($0.30)	63.25¢	61.75¢	1.50¢	$1.820	$1.866	($0.046)
Jan-13	$18.79	$18.56	$0.23	60.33¢	58.50¢	1.83¢	$1.825	$1.829	($0.004)
Feb-13	$18.76	$18.33	$0.43	57.48¢	56.20¢	1.28¢	$1.848	$1.813	$0.035
Mar-13	$18.78	$18.45	$0.33	56.30¢	55.75¢	0.55¢	$1.863	$1.831	$0.032
Apr-13	$18.75	$18.60	$0.15	56.00¢	55.20¢	0.80¢	$1.860	$1.838	$0.022
May-13	$18.70	$18.55	$0.15	56.00¢	55.03¢	0.98¢	$1.851	$1.826	$0.025
Jun-13	$18.65	$18.50	$0.15	56.00¢	54.50¢	1.50¢	$1.839	$1.825	$0.014
Jul-13	$18.67	$18.53	$0.14	54.25¢	55.25¢	(1.00¢)	$1.851	$1.840	$0.011
Aug-13	$18.55	$18.50	$0.05	54.00¢	54.50¢	(0.50¢)	$1.850	$1.838	$0.012
Sep-13	$18.46	$18.46	$0.00	53.75¢	54.00¢	(0.25¢)	$1.840	$1.828	$0.012
Oct-13	$18.34	$18.20	$0.14	53.75¢	54.00¢	(0.25¢)	$1.826	$1.814	$0.012
12 Mo Avg	**$18.83**	**$18.71**	**$0.13**	**57.13¢**	**56.53¢**	**0.60¢**	**$1.857**	**$1.846**	**$0.011**



- USDA released their cost-of-production estimate for milk this week, and for the first time since they began tracking, it rose above $20/cwt. October total operating costs came in at $20.56/cwt, up from $19.89/cwt in September.
- Dairy cow slaughter for the week ended 11/17 was up 6.35% vs. a year ago. 65,300 head were culled compared to 61,400 head last year. YTD 158,400 more cows have been removed from the herd than in 2011.
- Livestock Slaughter Report: 285,400 dairy cows were culled from the herd in October, up an amazing 42,600 head (or 17.5%) from last year and the highest Oct total since 1996 (see graph).
- Cold Storage Report: American cheese stocks in October were down 6% vs. a year ago and down 4% from September. Total cheese stocks declined by the same percentages. Butter stocks were up 11% vs. last October but down 26% from September.
- Weekly cold storage numbers indicate a healthy drawdown so far in Nov. For the period 11/01 through 11/26, butter stocks at USDA selected storage centers are down 50%, or 5.3 million lbs. Cheese stocks are down 5%, or 6.4 million lbs.
- Fluid Milk East: Manufacturing milk supplies were very heavy over the holiday period in the Northeast and Mid-Atlantic regions, but below year ago levels. Plant managers were able to handle the increased supplies with minimal delays. Class I demand has increased significantly coming out of the holiday weekend, lowering manufacturing milk supplies, but manufacturing volumes remain above preholiday levels. Florida's milk production continues to increase as cooler weather has covered most of the state, but production is down compared to a year ago as producers have had to limit grains in their feed rations, due to their high cost. Class I demand has bounced back following the holiday and is stronger than anticipated. Southeast milk supplies are much more manageable this week due to improved Class I demand with only a few loads going to auxiliary milk manufacturing plants. Demand for cream has increased coming out of the holiday weekend, with strong pulls from cream cheese manufacturers with some surprisingly good pulls from ice cream makers.
- Fluid Milk West: CA milk production is following the pace of the past several weeks with overall volumes lagging year ago levels. Weather conditions remain favorable for milk output growth, but the impact of high costs of production lingers across the state. Fluid milk sales have returned to pre-holiday levels. AZ milk output trends are building higher, yet remain below a year ago. The typical constraints on milk production remain in play as input costs remain high. NM milk production is trending higher on a week to week basis, but the overall output trails year ago levels. Declines in cow numbers, recent farm closures, and the drops in output per cow, continue to depress the overall milk supplies. No issues were noted over the extended holiday weekend with quotes around about "the best handling over Thanksgiving in years." Milk production in the Pacific Northwest is following expected trends. Volumes are at less than year ago levels due to fewer cows and production per cow is below last year's level. The lower volumes made handling of milk over the holiday weekend a non-event.
- Butter East: Cream supplies were very heavy over the holiday period with some churns operating at near capacity levels, but demand for butter remains good as holiday sales continue strong and are expected to remain strong for the next two weeks. Most butter inventories saw significant declines prior to the Thanksgiving holiday and are now being maintained at their current levels. Recent declines in butter prices have sparked some renewed export interest.
- Butter West: Demand for butter remains very good with retail and club stores refilling their shelves after the holiday weekend. As the price has moved lower, buyers are beginning to look for additional loads above current needs. Current stocks are at comfortable levels without moving to lower prices.
- Dry Whey East: Demand has increased following the holiday as manufacturers resume regular production schedules. Buyers looking for additional loads have to look in other regions, due to the tight supplies. The market undertone remains firm.
- Dry Whey Central: Projected 2013 dry whey volumes for several manufacturers are close to being fully committed and the expectation is that a minimum of loads will clear via the 2013 spot market.

- Cheese East: Manufacturing milk supplies increased over the long holiday weekend, which increased milk volumes going to cheese vats. However, domestic demand remains good as holiday orders continue strong. Weekly average price declines on the CME Group over the past three weeks have sparked some additional export interest.
- Cheese Midwest: Demand for cheese remains good for most varieties with good interest coming from pizza makers. Pepper Jack cheese is also moving well, which is typical for this time of year. Recent price declines on CME Group have prompted an increased movement of cheese into aging programs.
- Cheese West: Advance buying is slow as buyers gauge when the market will stabilize, but retail sales over the holiday were good. Cheese production is reduced as available milk supplies are tight in the West. Export sales are seeing increased demand as the price moves lower.
- Commercial Disappearance: Use of American cheese in Sep was up 2.2% vs. a year ago and increased 7.3% for Q3. Other-than-American cheese use increased 0.6% and 3.2% respectively. Commercial use of butter was down 6.8% in Sep but up 1.1% for Q3 vs. 2011.

What's Bearish:

- Spot Market: For the week, blocks fell 6½¢, all on Friday, to settle at $1.76/lb. Barrels gave up 3¼¢ to close at $1.71¼/lb. Six loads of blocks and two loads of barrels exchanged hands. Butter shed 8¢ to close at $1.60/lb on 13 trades.
- Milk Production Report: Despite cow numbers dropping another 6,000 head from Sep to Oct and total cow numbers down 25,000 head from a year ago, October milk production in the U.S. was down just 0.1%, helped by a gain in milk per cow. Milk production was down 5.9% in NM, down 5% in TX, down 4.5% in AZ and down 3.5% in CA. But output jumped 5.9% in CO, up 5.1% in KS and up 4.7% in WI.
- Cheese prices took a tumble in this week's dairy products price survey, following weakness in the spot market. 40-lb cheddar blocks averaged $1.99/lb, down 6.2¢ from a week ago, while 500-lb barrels fell 11.3¢ to $1.92/lb. Butter declined 2.2¢ to average $1.86/lb, but dry whey picked up 0.6¢ to 5.4¢/lb and NDM increased 0.3¢ to average $1.52/lb.
- Fluid Milk Central: Farm milk production in the Central region is trending steady to higher, following usual seasonal patterns. Milk components are steady to increasing. With some uncertainty built into cheese prices at this time, a few cheese manufacturers are occasionally offering out spot milk loads to place a ceiling on cheese inventory buildup. Also, various cheese manufacturers indicate current commodity cheese prices offer tight margins over cheese milk prices. For that reason, some cheese makers realigning production schedules to produce just enough cheese to cover contracts. Interest is light in most areas for the spot milk loads. A few sales were facilitated by offering discounts on milk prices. Milk handlers and processors report they are already receiving inquiries from operators of cheese and other types of production facilities looking for processing room for milk loads during the holidays at the end of the year.
- Butter Central: Churning schedules over the Thanksgiving holiday weekend were heavier. Many producers anticipate that the cash price will continue to decline as yearend butter orders are placed and filled. Many feel that they do not want to generate firm priced inventories that may not clear for an extended period of time.
- Cheese Midwest: Barrel prices have taken the brunt of the price declines on the CME Group with some buyers holding off purchases to see if prices will go lower. This situation has brought about an increase in barrel cheese inventories at some plants. Cheese makers have commented on the improved quality of milk coming into plants with higher butterfat and protein levels, which increases their yields.

Recommendation:

With a holiday last week, the typical drop in fluid demand resulted in extra manufacturing milk supplies. With the resumption of "normal", those excess supplies are being quickly utilized with the resumption of strong Class I demand. The spot market, however, reflected buyers still looking for a bottom as they didn't put up much fight. Current spot prices work out to about $17.90 Class III, the first time we've cracked the $18 level since August. Being in the midst of its pricing month, December futures took the brunt of the pain. The supply situation remains largely the same overall. Milk is about in balance in the East, plentiful in the Midwest and tight in the West. We're hearing reports of substantial improvements in components, allowing cheese manufactures to achieve greater yields with less milk. The demand side, however, is still a question. As prices have come down, demand has increased, especially on the export side. Domestic demand is still strong as Christmas and New Year's orders are still in the mix, but we wonder what demand will look like in another 2-3 weeks, when lead times for these holidays are too short. Certainly these lower milk prices are not making it any easier for those dairies that are struggling financially, but we could see prices stay about the same for our Q1 contracts, or even lower, if there is a seasonal post-holiday drop in demand. Long term, Q2 and beyond could rocket higher if we continue to aggressively cull dairy cows and grain prices remain strong. Finally, the macro-geo-political arena is a mess, with "fiscal cliff" negotiations going poorly. All this is creating more uncertainty. So, what do you do with all the uncertainty as a hedger? #1. If you have already made sales of your milk at higher prices, use this current downturn to put on upside protection for later in the year. Consider this 3-way trade: Sell the 16.50 PUT, buy the 19.00 CALL and sell the 22.00 CALL Apr-Dec for a net cost of 28¢/mo. Or do just July-Dec for net cost of 20¢/month. While you have risk should prices go below 16.50, on the flipside, if you've sold milk in the $18's and prices rally in Q2 and beyond, you will open that contract up to a cap at $22.00. #2. For milk you have not yet marketed, consider this 3-way trade: Sell the 16.50 PUT, buy the 18.00 PUT and sell the 22.00 CALL, Apr-Dec for an average cost of 28¢/month. This strategy gives you a high effective floor at $17.78 (18.00 – 28¢ premium) and covers you down to 16.50, at which point you would receive the market price. But should the market strengthen, it also allows you to rally to $22.00, which would be forcing it to reach new record highs, but you would be capped there. For a producer receiving $1.50 or more in premium pay, this is an attractive way to guarantee profitability in 2013 on a percentage of your milk. If you are unsure how these more complex options strategies work, please give us a call and we'll walk you through it.