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The KDM Dairy Report – December 7th, 2012

What's Bullish:

Futures Month	Class III 12/07	Class III 11/30	Change	Dry Whey 12/07	Dry Whey 11/30	Change	Cheese 12/07	Cheese 11/30	Change
Dec-12	$18.51	$18.74	($0.23)	63.75¢	63.25¢	0.50¢	$1.788	$1.820	($0.032)
Jan-13	$18.07	$18.79	($0.72)	58.80¢	60.33¢	(1.53¢)	$1.775	$1.825	($0.050)
Feb-13	$18.07	$18.76	($0.69)	54.50¢	57.48¢	(2.98¢)	$1.801	$1.848	($0.047)
Mar-13	$18.30	$18.78	($0.48)	53.75¢	56.30¢	(2.55¢)	$1.827	$1.863	($0.036)
Apr-13	$18.39	$18.75	($0.36)	54.00¢	56.00¢	(2.00¢)	$1.840	$1.860	($0.020)
May-13	$18.36	$18.70	($0.34)	54.00¢	56.00¢	(2.00¢)	$1.846	$1.851	($0.005)
Jun-13	$18.38	$18.65	($0.27)	53.25¢	56.00¢	(2.75¢)	$1.839	$1.839	$0.000
Jul-13	$18.52	$18.67	($0.15)	53.25¢	54.25¢	(1.00¢)	$1.853	$1.851	$0.002
Aug-13	$18.64	$18.55	$0.09	53.00¢	54.00¢	(1.00¢)	$1.856	$1.850	$0.006
Sep-13	$18.52	$18.46	$0.06	53.00¢	53.75¢	(0.75¢)	$1.845	$1.840	$0.005
Oct-13	$18.33	$18.34	($0.01)	53.50¢	53.75¢	(0.25¢)	$1.826	$1.826	$0.000
Nov-13	$18.15	$18.20	($0.05)	53.00¢	53.50¢	(0.50¢)	$1.810	$1.813	($0.003)
12 Mo Avg	**$18.35**	**$18.62**	**($0.26)**	**54.82¢**	**56.22¢**	**(1.40¢)**	**$1.826**	**$1.841**	**($0.015)**

- Fluid Milk West: CA milk production is slowly building but is behind year ago levels as dairy farmers continue to struggle with profitability issues. Fewer cows and expensive feed has lowered production from last year. Manufacturing capacity is still above current milk supplies. AZ reports milk production is increasing slowly, but supplies are behind a year ago. Class I sales have returned to normal after the Thanksgiving holiday. Favorable weather in NM has boosted milk production slightly. However, supplies are still below year ago levels. Less cows and lower cost rations are holding production back. Milk production in the Pacific Northwest remains right near the seasonal bottom. Financial margin stress is not helping output to move higher very fast this fall/winter. Plants have been handling the milk receipts with no problems.
- CWT has accepted requests for export assistance to sell 1.058 million lbs of butter and 1.285 million lbs of Cheddar and Monterey Jack cheese. The product will be delivered December 2012 through February 2013.
- Dry Whey West: Prices ranged from steady to higher with a continued firm undertone noted. Producer inventories range from light to balanced. Contacts expect sales activity to slow as the end of the year approaches, but they have factored that into their normal plans. Buyers are taking regular volumes from normal suppliers and some have to go outside of the region or to new sources to cover some known needs. Export orders continue to develop.
- International: Milk production in Western European countries generally hit the seasonal low points around mid-November. Milk in total is indicated to be flat to lower in recent months when compared to year ago levels, bringing the cumulative season to date output totals to around 1% higher. Milk prices are high, but input costs are limiting profitability and growth. Dairy farmers have been protesting milk quotas and prices below cost of production.

What's Bearish:

- Spot Market: Blocks finished the week unchanged at $1.76/lb with no trades, but barrels lost 5¼¢ to close at $1.66/lb with 5 trades. Butter decreased a penny to settle at $1.59/lb on active trading of 20 cars.
- Cheese and butter prices continue to tumble in the weekly USDA price survey. Butter plunged 14.6¢ to average $1.71/lb. 40-lb block cheddar decreased 7.7¢ to average $1.92/lb and 500-lb barrels gave up 7.9¢ to $1.84/lb. Further declines are likely in light of current spot weakness. Dry whey bucked the trend, gaining 0.3¢ to average 65.7¢/lb, as did nonfat dry milk up 1.1¢ to $1.53/lb.
- Fluid Milk East: Manufacturing milk supplies in the Northeast and Mid-Atlantic regions are down from last week, but above levels prior to the Thanksgiving holiday. Class I demand has leveled off this week. Milk production in Florida is increasing as seasonally mild temperatures have improved cow comfort levels. Class I demand has marginally declined this week. The increase in the milk supply prompted 40 spot loads to be exported from Florida. These are the first export loads since late July and have occurred 3 weeks earlier than last year. Southeast milk supplies are nearly in balance with demand. Most auxiliary manufacturers are being held to their contract minimums, but Class I demand has leveled off. Cream supplies are having a problem finding a home. Significant discounts are being used to prompt buyers to purchase loads. The excess cream supply is due to a combination of factors, which include, increases in overall milk production, increases in butterfat levels, strong cream volumes coming off increased yogurt production and lower demand from cream based product manufacturers as holiday orders are nearly filled. The consistently declining butter market has put some cream buyers on the sidelines waiting for the market to find a floor.
- Fluid Milk Central: Farm milk production is increasing steadily, following typical November/December trends. Processors indicate the overall trend on components shows a seasonal increase. A few processors commented they are surprised by the current strength in component values because many thought that once dairy farmers began putting drought stricken 2012 feed stocks into rations, milk production and components would falter. So far, that hasn't happened. Spot milk load availability increased substantially this week. The increase in the number of spot milk loads means the prices paid per hundredweight are moving lower. Currently, pricing incentives from sellers have loads clearing at $2.00 - $2.50 under Class. Handlers anticipate milk prices will continue to slide as the two holiday weekends approach.
- Butter: Churning in the West is somewhat above expectations, where cream remains readily available and club store sales are excellent with heavier orders coming in. Central butter production is active, using primarily internal cream. Butter inventories are building seasonally but interest for December is sluggish and generally lower than projected by some manufacturers. Northeast butter production has slowed and butter inventories are level to slightly increasing.
- Cheese: Upper Midwest cheese manufacturers are coping with strong milk flows generating strong cheese production, contrasted with cheese buyers unwilling to commit due to CME prices trending lower. Cheese orders are below production volume at most plants. Some cheese plants report receiving more milk than ever for the end of November into December, which is also generating high yields resulting from outstanding fat and protein content. A theme in many plants is that customers are not ringing the phone off the wall. Concern is also being voiced in plants that will be in production Monday and Tuesday the weeks of Christmas and New Year's Eve, due to not having capacity to divert milk into other products, that the resulting year end production may have a challenging time finding sales. In the Northeast, milk volumes going to cheese vats have increased, due to a combination of marginal milk production increases and a leveling off of Class I demand. In the West, overall cheese

orders for the end of the year holiday period have been rated as fair to good. Ordering started earlier than normal this year, so current orders appear to be a bit slower. The weak prices at the CME Group for most of the past month have buyers generally holding off on making any additional purchases.

- Dry Whey East: Prices continue moving to higher price levels, but inventories are building slightly, as most buyers are purchasing to cover their immediate needs only.
- Dry Whey Central: A few manufacturers indicated they discounted prices to help clear inventories prior to the start of 2013. Central farm milk production is registering small increases from week to week, allowing cheese manufacturers to add a few vats per week of cheese production and send additional condensed whey through the dryers.
- International: New Zealand milk production is retreating slowly from the seasonal peak, yet trends are higher and keeping pace with the 4-5% range above year ago levels for the season. Weather conditions are generally favorable with adequate moisture and moderate temperatures for pasture regrowth. Cow numbers are higher than year ago levels. Forage quality and quantity are in good shape for milk cow needs and generating good milk volumes, fat levels, and milk solids. Processing plants are running on seasonally active schedules to handle the current milk intakes. Australian milk production reports showed output for October running at 1% higher than year ago levels. Processing capacity is adequate to handle current milk supplies. The cheese market is pulling more milk into cheese production to service domestic and active export accounts. Current cheddar averaged $1.81/lb.

Recommendation:

Give credit to the American milk producer and the power of profits. Despite lower cow numbers and feed costs that make profitability challenging in parts of the country, a combination of strong output in the Midwest and weaker demand is resulting in excess cheese and cream supplies across the country. With lead times before Christmas quickly coming to a head, slower orders and additional milk being pumped out over the holidays, we expect little upside in the cheese market in the near term. Current spot prices work out to about $17.50 milk. With January settling at $18.07 today and a block-barrel spread of ten cents, chances are we'll see blocks drop to correct the spread at some point. Jan begins its calculation in about a week, which would put further downward pressure on this contract. Jan futures hit a low of $17.65 today, before recovering, but that low could be a sign of things to come. Dry whey futures came under pressure this week as our weekly price summary above shows red across the board. We would sell any rallies in Jan and Feb. Or, consider buying the Jan 17.75 PUT at 26¢ and the Feb 17.50 PUT at 30¢ to at least get a floor under your milk. These lower prices are likely to set off quite a reaction in the other direction at some point. We fielded several calls this week from both the East and West on how hard this is going to be on producers. The rubber band is getting pulled tighter and at some point will spring back with a more violent move. We hope all producers will be able to weather the next few months, but there will likely be fewer cows in the milking herd and fewer in the dairy biz come the end of Q1. An article out this week referenced several dairies in CA that owed their lenders in the tens to even over 100 million USD. With grains hanging in there and hay still on the short side, these lower milk prices will cure lower milk prices. We expect to see quite a rally in 2013 futures at some point after the holidays / Super Bowl. For that reason, we would not get too aggressive beyond Q1 with your hedging.