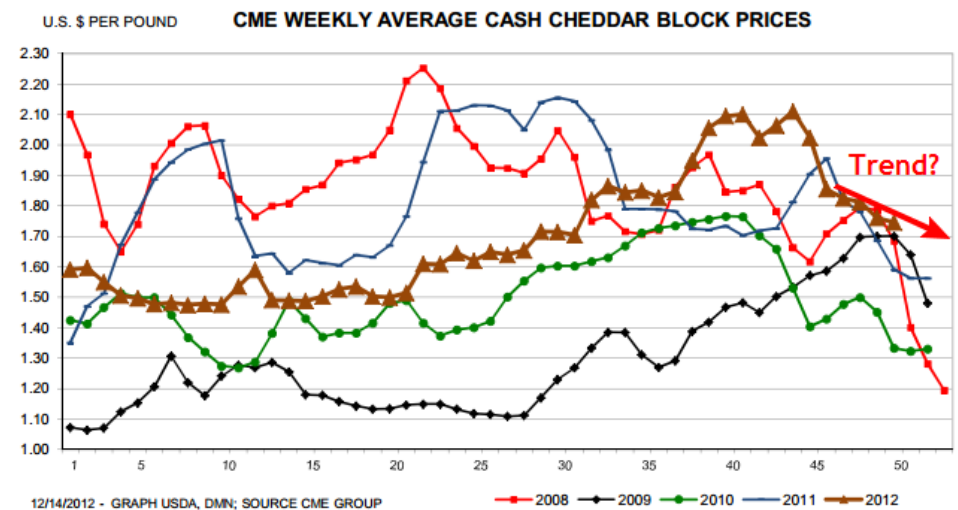


The KDM Dairy Report – December 14th, 2012

What's Bullish:

- World Ag Supply & Demand Report: USDA expects cheese and whey solids exports to increase in 2013. As a result, they increased their 2013 Class III price forecast a dime to \$18.40/cwt.
- Dairy cow slaughter for the week ended 12/01 totaled 65,100 head, up 6.7% vs. 2011.
- Butter stocks at USDA selected storage centers fell 9% over the period 12/01 through 12/10. Cheese stocks, however, increased 1%.
- Fluid Milk East: Hot, muggy weather returned to Florida, lowering cow comfort levels and limiting milk production increases. Class I demand has increased as more seasonal residents are returning to their homes.
- Fluid Milk West: CA milk production is holding mostly steady on a week-to-week basis at total volumes around 5% lower than a year ago at this time. No issues are expected for handling the milk supplies over the yearend. There are some more dairies that are closing and additional cows that are leaving the milk production scene. Feed and other input costs remain high and continue to affect the bottom line for the dairies in the state. Milk supplies in the Pacific Northwest are at expected levels for this time of year. High feed costs remain a barrier to expansion plans for dairies.
- Dry Whey West: The market tone remains firm and export prices are mostly steady. Spot sales of whey are limited.
- CWT has accepted requests for export assistance to export 2.068 million lbs of Cheddar, Gouda and Monterey Jack cheese, to customers in Asia, the Middle East and North Africa. The product will be delivered December 2012 through May 2013.

Futures Month	Class III 12/14	Class III 12/07	Change	Dry Whey 12/14	Dry Whey 12/07	Change	Cheese 12/14	Cheese 12/07	Change
Dec-12	\$18.59	\$18.51	\$0.08	65.23¢	63.75¢	1.47¢	\$1.785	\$1.788	(\$0.003)
Jan-13	\$17.75	\$18.07	(\$0.32)	61.43¢	58.80¢	2.63¢	\$1.733	\$1.775	(\$0.042)
Feb-13	\$18.25	\$18.07	\$0.18	56.90¢	54.50¢	2.40¢	\$1.805	\$1.801	\$0.004
Mar-13	\$18.66	\$18.30	\$0.36	55.60¢	53.75¢	1.85¢	\$1.850	\$1.827	\$0.023
Apr-13	\$18.70	\$18.39	\$0.31	55.50¢	54.00¢	1.50¢	\$1.854	\$1.840	\$0.014
May-13	\$18.73	\$18.36	\$0.37	54.25¢	54.00¢	0.25¢	\$1.850	\$1.846	\$0.004
Jun-13	\$18.71	\$18.38	\$0.33	54.25¢	53.25¢	1.00¢	\$1.852	\$1.839	\$0.013
Jul-13	\$18.69	\$18.52	\$0.17	54.25¢	53.25¢	1.00¢	\$1.868	\$1.853	\$0.015
Aug-13	\$18.63	\$18.64	(\$0.01)	54.50¢	53.00¢	1.50¢	\$1.859	\$1.856	\$0.003
Sep-13	\$18.60	\$18.52	\$0.08	53.50¢	53.00¢	0.50¢	\$1.860	\$1.845	\$0.015
Oct-13	\$18.36	\$18.33	\$0.03	53.50¢	53.50¢	0.00¢	\$1.837	\$1.826	\$0.011
Nov-13	\$18.26	\$18.15	\$0.11	53.50¢	53.00¢	0.50¢	\$1.828	\$1.810	\$0.018
12 Mo Avg	\$18.49	\$18.35	\$0.14	56.03¢	54.82¢	1.22¢	\$1.832	\$1.826	\$0.006



What's Bearish:

- Spot Market: Blocks and barrels lost 3½¢ each to maintain their 10¢ spread. Blocks settled at \$1.72½/lb on just 2 trades for the week, while barrels closed at \$1.62½/lb on 7 trades. Butter gained ½¢ to settle at \$1.59/lb on 7 trades.
- Fluid Milk East: Manufacturing milk supplies are increasing in the Northeast and Mid-Atlantic regions. The increase in the milk supply is mostly attributable to the slowdown in various dairy product production schedules, now that most holiday orders have been filled. Southeast milk supplies are nearly in balance with needs. Class I demand has leveled off this week. Cream supplies are readily available and quickly exceed demand. Increased volumes are moving to churns and price discounts are being applied in order to place excess loads. Numerous loads are being shipped outside the region, at significant discounts. Demand for cream is weak as many cream based product schedules are slowing down, now that most holiday orders have been filled.
- Fluid Milk Central: Milk handlers state farm milk volumes on many milk pickup routes are increasing on a farm to farm basis. In some cases herd expansion through recent acquisitions yielded 15-20% milk production increases for individual dairy producers. Sales of spot loads of milk bogged down this week. Milk handlers indicate few cheese manufacturers are showing interest in processing additional milk this week, due to the current disadvantageous relationships among milk pay prices, cheese yields, and commodity cheese prices. Also, some Central operations are bringing in UF milk from the southeast region under contract arrangements and do not need additional spot loads of milk to meet production targets. Spot milk prices remain in the neighborhood of \$2.00 to \$2.50 under Class.
- Fluid Milk West: AZ milk production is holding steady. Total intakes are running a couple percentage points ahead of the same week a year ago. Processing plants are running on longer schedules to process milk from other facilities that are taking down days. Class I needs have been slower. Cream prices and markets are weaker. Demand has slowed from higher class item

producers and more cream is available to the churns. Butter producers have some reluctance to make butter at current prices and are pushing back for lower multiples on cream sales.

- Butter: Production is active throughout the country as cream use for ice cream, sour cream, dips, and other holiday related items declines seasonally. Domestic demand is tapering off as most stores have stocked up for holiday shopping.
- Dry Whey East: The dry whey price range widened this week with the low end of the range declining. Dry whey production has increased following the increases in cheese production. Demand has weakened as end users have adequate supplies to cover their yearend production schedules and are not inclined to expand inventories at current prices. Manufacturers are current with contract deliveries and production levels are expanding inventories.
- Dry Whey Central: Lower priced dry whey loads from one or two manufacturers were plentiful this week and cleared readily to end users. A few resellers are reportedly offering dry whey loads to the market with some price discounts to help clear inventories as the end of the year approaches.
- Cheese East: Milk volumes going to cheese vats continue to be at increased levels, prompting an increase in cheese production. Inventories are building as most holiday orders are filled. Some cheese makers are increasing the volumes of cheese going into aging programs.
- Cheese Midwest: There is lots of milk going to cheese plants this week. The surprise is that there is even more milk than had been expected. That reality is expected to increase leading to Christmas week and New Year's week. A number of plants are already tentatively planning expanded schedules to accommodate expected holiday milk volumes, especially with a number of other manufacturing facilities, such as nonfat dry milk plants, already actively operating. Some manufacturers also expect this situation to result in manufacturing milk being available priced below class prices. With most cheese plants reporting that farm milk production available to them is much higher than had been expected, the result is higher cheese production and extra cheese availability. Some manufacturers describe the overall cheese situation as listless.
- Cheese West: Cheese production levels are mostly steady in the West. Milk production is steady, with better than expected component levels helping to maintain cheese production. Demand is reported to be good, but end of year buying is fading. Buyers are waiting to see where the market will find equilibrium. Export interest is increasing with the lower prices, but buyers are still cautious.
- During October, 4.7 billion pounds of packaged fluid milk products is estimated to have been sold in the United States. This was 0.6% lower than October 2011.

Recommendation:

With Jan futures beginning to price next week and spot prices working out to about \$17.40, the market worked to take more premium out of this contract, which finished 32¢ lower for the week. Curiously, all other contracts except Aug finished higher and dry whey futures put in a solid week. Deferred butter contracts also saw gains. With most holiday orders completed and a burgeoning milk supply in the Midwest, the market seems content to punish Jan in the near term, but looks like it's expecting a pretty quick reversal. We're not saying that won't happen, but we're not entirely convinced yet either. Oh, there will be a pretty fierce correction to the upside at some point, but it may not happen until later in Q1 or possibly Q2, in our opinion. Milk is still on the tight side in the West and about in balance in the East. These are high population areas that need to service large Class I needs. The Midwest, on the other hand, has much lower Class I needs, resulting in 70%+ of raw milk being converted into cheese. The Midwest cheese update this week was downright bearish, at least in the short term. With a 10¢ spread still being seen between blocks and barrels, combined with the heavy cheese output in the Midwest, we're leaning more towards a spread correction with blocks moving lower. As scary as it is to consider, that could mean Jan futures slip below the \$17 handle and into the \$16's. Yikes! But the silver lining to all that is at those prices, it will do some real damage to the milk supply and a spike in culling. Prices that low won't be sustainable for long. Jan hit a high of \$18.45 this week, before falling under further pressure. We would still sell any rallies above \$18.20. Feb high this week was \$18.36. We would look to sell above \$18.50. April futures had a bit of a breakout to the upside, settling at the high of the week. We would consider marketing some milk at \$18.99 or higher. Beyond Q1, we would hold off on doing anything but cheap disaster insurance in the form of put options.

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