

The KDM Dairy Report – December 21st, 2012

What's Bullish:

- Spot Market: Blocks finished the week up 1½¢ on 6 trades to close at \$1.74/lb, while barrels finished the week up 3¢ on 32 trades to settle at \$1.65½/lb. Butter, however, lost 5¾¢ on 9 trades to settle at \$1.53¾/lb.
- Weekly cold storage holdings indicate a seasonal drawdown in both butter and cheese stocks. Over the period 12/01 through 12/17, cheese stocks are down 1% while butter stocks are down 9% at selected USDA storage centers.

Futures Month	Class III 12/21	Class III 12/14	Change	Dry Whey 12/21	Dry Whey 12/14	Change	Cheese 12/21	Cheese 12/14	Change
Dec-12	\$18.57	\$18.59	(\$0.02)	65.13¢	65.23¢	(0.10¢)	\$1.788	\$1.785	\$0.003
Jan-13	\$18.05	\$17.75	\$0.30	61.08¢	61.43¢	(0.35¢)	\$1.766	\$1.733	\$0.033
Feb-13	\$18.25	\$18.25	\$0.00	57.03¢	56.90¢	0.13¢	\$1.788	\$1.805	(\$0.017)
Mar-13	\$18.36	\$18.66	(\$0.30)	57.50¢	55.60¢	1.90¢	\$1.825	\$1.850	(\$0.025)
Apr-13	\$18.39	\$18.70	(\$0.31)	56.00¢	55.50¢	0.50¢	\$1.822	\$1.854	(\$0.032)
May-13	\$18.43	\$18.73	(\$0.30)	55.63¢	54.25¢	1.38¢	\$1.838	\$1.850	(\$0.012)
Jun-13	\$18.51	\$18.71	(\$0.20)	55.50¢	54.25¢	1.25¢	\$1.846	\$1.852	(\$0.006)
Jul-13	\$18.60	\$18.69	(\$0.09)	54.70¢	54.25¢	0.45¢	\$1.864	\$1.868	(\$0.004)
Aug-13	\$18.70	\$18.63	\$0.07	54.63¢	54.50¢	0.13¢	\$1.872	\$1.859	\$0.013
Sep-13	\$18.65	\$18.60	\$0.05	54.95¢	53.50¢	1.45¢	\$1.863	\$1.860	\$0.003
Oct-13	\$18.45	\$18.36	\$0.09	54.50¢	53.50¢	1.00¢	\$1.833	\$1.837	(\$0.004)
Nov-13	\$18.28	\$18.26	\$0.02	54.50¢	53.50¢	1.00¢	\$1.827	\$1.828	(\$0.001)
12 Mo Avg	\$18.21	\$18.49	(\$0.28)	56.76¢	56.03¢	0.73¢	\$1.828	\$1.832	(\$0.004)

- Livestock Slaughter Report: Dairy cow slaughter for the month of November totaled 268,800 head, up 16,000 head from a year ago, or 6.3%.
- Dairy cow slaughter for the week ending 12/08 totaled 67,800 head, up 10.1% from a year ago. YTD, total dairy cow slaughter is up 171,400 head from 2011.
- Fluid Milk East: In Florida, milk exports were unchanged at 70 loads compared to last week as Class I demand held steady. Grain supplies are limited and prices are high, so most producers expect this year's flush to be below last year's levels. In the southeast, milk supplies continue to be nearly in balance with need with only a few loads going to auxiliary manufacturers.
- Fluid Milk West: Milk production in the Southwest is mostly steady but building slightly. However, volumes tend to be well below year ago levels and balancing plants and processors see little trouble handling the milk supplies over the holidays. Lower cheese and butter prices have dairy farmers looking at lower milk prices. This will hurt profitability in the near-term. In New Mexico, lower cow numbers and high feed costs are responsible for production losses. Processors report sufficient milk can be found for current needs, but are watching availability of milk in the second quarter of the year. A large dairy in the region will close soon and cows are being put on the auction block.
- CWT has accepted requests for export assistance to sell 7.547 million lbs of Cheddar and Monterey Jack cheese. The product will be delivered December 2012 through June 2013.
- Cheese Midwest: Strong export sales during the last week have helped some manufacturers clean out their inventory of block cheddar. This was a welcome development during a period of sluggish retail sales and increasing supplies. The week's export transaction accounted for nearly 20% of all the manufacturer's exports for 2012.
- International: Western European milk production levels are trending below a year ago. Output is higher in Germany, but lower for most other countries. Despite higher milk pricing, weather effects and high input costs are constraining milk growth. Dairy product prices are mostly steady to slightly higher.
- International: High-speed costs are also affecting milk output in New Zealand and Australia. Analysts are forecasting zero growth into the New Year for both New Zealand and Australia as the higher costs are stressing margins and supplemental feeding is being lowered to mitigate costs.

What's Bearish:

- Milk Production Report: US milk production in November was up a surprising 1% over last year. In addition, cow numbers increased for the first time in six months, rising 7,000 head. Gains were led by Colorado up 6.5%, Kansas up 6.1%, Wisconsin up 4.7% and Minnesota up 4.5%.
- Cold Storage Report: American cheese stocks in November were down 2% vs. a year ago, and total cheese stocks were down 4%, but the rate of decline was lower than normal. Butter stocks were up 36% vs. Nov '11.
- Prices declined for most Class III components in this week's price survey. 40-lb cheddar blocks averaged a \$1.81/lb, down 5¢ from last week. 500-lb barrels fell 4.6¢ to average \$1.75/lb. Butter lost 4.1¢ to average \$1.59/lb and dry whey decreased 0.9¢ to 65.4¢/lb, but nonfat dry milk inched 0.3¢ higher to \$1.55/lb.
- Rabobank released their Q4 dairy review this week, predicting weaker demand growth and slower price recovery. Consumption has been weaker than anticipated and key buyers have accumulated solid forward coverage. This may delay price recovery until late Q1, and prove less extreme than the forecast three months ago.
- Fluid Milk East: Manufacturing milk supplies continue to increase in the Northeast and Mid-Atlantic regions. Butter fat levels of incoming milk are above year ago levels, sometimes near 4%. Class I demand is expected to decline later in the week, adding to overall manufacturing milk volumes. Florida milk production is beginning to pick up again as cooler weather hits the state. In the Southwest, milk supplies continue to be nearly in balance, but cream supplies are very sloppy with some loads having trouble

finding a home. Butter makers are in no mood to buy extra loads of cream at this point, as they'll know they'll be facing heavy supplies over the holiday period. Demand for cream is weak as orders are filled and ice cream plants are preparing for extended shutdowns.

- Fluid Milk Central: Production of milk on farms is increasing steadily in the central region. Protein, butterfat and nonfat solids test values are also rising. Milk handlers indicate some manufacturers are still looking for processing room during the upcoming extended holiday weekend. Prices for spot loads of milk range five dollars under Class, but may decline further as the weekend approaches. Several balancing plants indicate they are booked to capacity with internal supplies and no additional milk can be processed.
- Butter: A combination of: butter prices declining this week to levels last present during mid-July, cream offerings being heavy and expected to increase, and butterfat tests since July substantially above the last few years, all lead to one result - cream supplies exceed demand. The surplus is expected to increase with the coming holidays. The only real viable outlet for the surplus cream will be the churn. This leads to a situation where manufacturers are averse to building inventories in the face of falling cream prices, while at the same time retail butter orders are dropping as the window for shipping and stocking store shelves before the holidays closes.
- Dry Whey East: Dry whey prices in the Northeast are mixed this week, with some manufacturers having expanded supplies while others remain fairly tight. Production is expected to exceed demand over the holiday period as more milk makes its way to cheese fats. Demand has weakened as end-users have adequate supplies to cover their year and needs. The market undertone has turned steady to weak.
- Dry Whey West: Some pushback has developed on the buying side for Western whey powder. Production of whey is expected to increase over the next three weeks and demand will likely be lackluster due to the holidays. There is generally a weaker undertone developing in the market.
- Nonfat Dry Milk: Nonfat dry milk production is increasing as heavier milk volumes are headed to the dryers due to declining Class II production. Most drying operations are expected to be at or near capacity for much of the holiday period, with inventories building.
- Cheese East: Cheese production continues to increase in the Northeast as milk production builds along the seasonal trend. Holiday orders are all but filled, and as a result, cheese inventories are expanding. Domestic and export demand are expected to decline over the holiday period.
- Cheese Midwest: Cheese production across the U.S. continues at accelerated levels. Milk supplies are steady to increasing in many parts of the country. Coupled with reduced demand from Class I and II due to the holidays, more milk is available for cheese manufacturing. This is expected to be the case for the next two weeks. Midwest plants are reporting discounts to Class III pricing for surplus milk from out of the region.
- Cheese West: Weekly average block prices have declined for 6 consecutive weeks. This has held demand in check as buyers have been placing only minimal orders while they wait for a bottom. Manufacturers are watching inventory levels closely and have no desire to build stocks at this time. Production has been running a bit ahead of last year as protein tests have been strong all fall even with milk supplies in the region less than last year.
- International: In New Zealand, milk production levels are steady, but processing plants are still running on extended schedules to handle the milk supplies. Australian milk output levels have been growing slightly in recent weeks. Buying interest is generally covered over the year-end holidays and through other events like the Chinese New Year. Stocks are well positioned for Q1.

Recommendation:

Despite bearish fundamentals: a Milk Production report showing a surprise increase in milk output and higher cow numbers, a Cold Storage report indicating drawdowns are seasonally lower than normal, and buyers hitting the sidelines for the holidays, both cheddar block and barrel prices rallied in this week's spot market. Barrel buying was particularly strong as 32 loads exchanged hands. Some have suggested the barrel buying was done in order to satisfy a government contract announced earlier in the month. With current spot prices working out to about \$17.50 Class III, the spot market will need to prove itself again next week in order to keep the rally going. We think it's a gift and will be short-lived. With the exception of the Jan contract up 30 for the week, most of the deferred contracts saw heavy losses as producers who had done very little hedging to this point came to the realization that prices may not recover as quickly as earlier thought (per above fundamentals). It appears that price recovery may be pushed back from Q1 into Q2. As we suggested last week, rallies in Q1 contracts should be sold. We would place orders to sell Jan at \$18.30 or higher, Feb at \$18.40 or higher and Mar at \$18.60 or higher. Get some coverage on this spot market strength which may not last that long!

Note: Markets will be open for just a half day on Monday and closed all day on Tuesday. On behalf of all of us at KDM Trading, Inc., we wish you and your families a very Merry Christmas!

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