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The KDM Dairy Report – January 11th, 2013

What's Bullish:

Futures Month	Class III 01/11	Class III 01/04	Change	Dry Whey 01/11	Dry Whey 01/04	Change	Cheese 01/11	Cheese 01/04	Change
Jan-13	$18.06	$18.03	$0.03	63.10¢	62.90¢	0.20¢	$1.752	$1.750	$0.002
Feb-13	$17.61	$18.40	($0.79)	57.28¢	59.50¢	(2.23¢)	$1.730	$1.812	($0.082)
Mar-13	$17.70	$18.41	($0.71)	53.60¢	58.00¢	(4.40¢)	$1.771	$1.820	($0.049)
Apr-13	$18.00	$18.45	($0.45)	53.75¢	56.08¢	(2.33¢)	$1.800	$1.830	($0.030)
May-13	$18.27	$18.46	($0.19)	53.75¢	56.00¢	(2.25¢)	$1.822	$1.830	($0.008)
Jun-13	$18.50	$18.62	($0.12)	54.50¢	56.25¢	(1.75¢)	$1.842	$1.850	($0.008)
Jul-13	$18.65	$18.70	($0.05)	54.50¢	55.00¢	(0.50¢)	$1.857	$1.857	$0.000
Aug-13	$18.64	$18.66	($0.02)	54.50¢	55.00¢	(0.50¢)	$1.860	$1.861	($0.001)
Sep-13	$18.46	$18.53	($0.07)	53.78¢	54.98¢	(1.20¢)	$1.845	$1.851	($0.006)
Oct-13	$18.33	$18.34	($0.01)	53.75¢	54.50¢	(0.75¢)	$1.827	$1.838	($0.011)
Nov-13	$18.25	$18.27	($0.02)	54.30¢	54.30¢	0.00¢	$1.820	$1.820	$0.000
Dec-13	$18.20	$18.15	$0.05	53.75¢	54.30¢	(0.55¢)	$1.795	$1.795	$0.000
12 Mo Avg	**$18.21**	**$18.42**	**($0.21)**	**55.05¢**	**56.40¢**	**(1.35¢)**	**$1.810**	**$1.826**	**($0.016)**

- World Dairy Situation Report: USDA's Foreign Ag Service reports currently, global dairy markets are in a stable phase with prices fluctuating within a narrow range. However, for 2013, the forecast pegs milk production to grow by less than 1% in Oceania and to remain virtually flat in the U.S. as high feed prices have taken a toll on the financial health of dairy farmers. In the EU, milk production is forecast to grow by less than 1%.
- Fluid Milk East: Unloading delays experienced over the past two weeks are no longer occurring, because Class I demand is strong as bottling plants are refilling pipelines and resuming full production schedules. Class I demand has come back stronger than expected in Florida. Highs in the mid 80's and lows in the high 60's are lowering cow comfort levels and milk production. Producers continue with supplemental hay feeding as many pastures are slow to regrow, due to dry conditions. The combination of strong Class I demand and a down turn in milk production resulted in only 57 spot loads being exported, down from 188 just last week. Southeast milk supplies are nearly in balance with demand with very few loads being diverted to auxiliary manufacturing plants. Class I demand has returned to pre-holiday levels.
- Fluid Milk West: CA milk production trends are typically higher on a week-to-week basis with overall volumes trending below year ago levels. The effects of high input costs still remain strong concerns across the state. Despite milk pricing levels being more favorable, the overall environment is still affecting a majority of dairy producers. Industry sources indicate the producers are selling more cows and others are leaving the trade. Processing plants are working on reduced schedules as yearend milk supplies are worked through and other fluid handlers and smaller processors have resumed taking normal needs. With the milk supply smaller than in recent years and plants having few issues, the holiday milk volumes were processed smoothly. NM milk production is still trailing the same time a year ago. Class I interest is slowly building. Milk production in the Pacific NW is mostly steady. There is increased manufacturing demand from new facilities. High feed costs, good prices for cull cattle and moderate replacement heifer prices are all factors in determining future herd size.
- Cheese: Domestic demand has improved as promotions are beginning to increase ahead of the football playoffs leading up to the Super Bowl. Export interest has increased with the 30 day contract extension that averted a Longshoremen's strike on the East and Gulf coasts. CWT has accepted 10 requests for export assistance to sell 1.358 million lbs of Cheddar and Monterey Jack cheese, for delivery January through July 2013.
- Grains: USDA pegged corn exports down 200 million bu but feed use up 300 million bu, leaving ending stocks down 45 million bu. That fueled a moderate rally in corn futures on Friday and indicates we may need significantly more feed rationing during the remainder of the current marketing year.

What's Bearish:

- Spot Market: Blocks declined 4¢ with just one trade on the week, settling at $1.72/lb. Barrels finished 4¾¢ lower to close at $1.67¼/lb on more active trading of 13 loads. Butter declined 4½¢ to settle at $1.45½ with 6 trades for the week.
- Most Class III components were lower again in USDA's weekly survey. Butter fell 2.3¢ to average $1.53/lb and dry whey decreased 1¢ to 64.8¢/lb. 40-lb block cheddar averaged $1.75/lb, down 1.8¢ from last week, and 500-lb barrels inched 0.1¢ lower to $1.70/lb.
- Fluid Milk East: Manufacturing milk supplies remain fairly heavy in the Northeast and Mid-Atlantic regions. Milk production is picking up slowly with good component levels. Cream supplies continue to be heavy while demand for remains weak, with a majority of the supply headed to churns. Declines in the butter market this week have softened demand even further as some buyers hold off purchases, expecting lower prices next week.
- Fluid Milk Central: Dairy cooperative managers, milk marketers and balancing plant operators state farm milk intakes in the North Central area continue to build steadily, well ahead of expectations at most locations. Cow comfort has been manageable in most areas and feed stocks are apparently adequate to support increasing milk production as well as gains in milk components. Cream supplies remain ample within the region. Some Western spot cream loads cleared into the Central region this week to find processing room.
- Butter: Churning is active and is often described as above demand. Cream offerings remain heavy and CME prices over the week are lower. Butter is going into inventory - sometimes manufacturer's inventory and sometimes into buyer's inventory.

- Dry Whey East: Production is increasing as milk volumes going to cheese vats have increased following the holidays, adding to supplies. Some whey manufacturers have discounted spot sales in order to better manage their inventories. Demand has weakened as many buyers are only purchasing for immediate needs or holding off purchases altogether in hopes that expanding inventory levels will lower prices. Export interests are looking for significant price discounts prior to purchasing. Some resale activity has been noted in the high $0.50's to low $0.60's, giving the market a weak undertone.
- Dry Whey Central: Prices are mostly lower for the week, and the market tone is weaker. Market participants indicate the availability of spot loads of dry whey from Central manufacturers increased sharply this week, with some offers clearing at markedly lower prices compared to last week. Dry whey inventories at several Central manufacturers are above near term contract fulfillment needs, and represents active cheese and dry whey production during December.
- Dry Whey West: Western dry whey prices are steady to lower. Export prices are trading at the lower end of range. Increased production along with slow end-of-year trading, have increased available supplies. Demand for whey is moderate with some brokers reporting increased inventories.
- Cheese East: Milk volumes going to cheese plants remain fairly heavy with some plants running production 7 days a week. Current production is filling orders and adding to inventories with some plants moving increased volumes of cheese into their aging programs.
- Cheese Midwest: Milk is readily available to cheese makers, some at below Class pricing. There is enough confidence in near future milk supplies that some manufacturers are now working on orders for export cheese that will be shipped soon. These export sales are also being pursued by cheese manufacturers because domestic cheese orders are more "sluggish" than had been expected, possibly because retailers are not fully confident about downside market risk.
- Cheese West: Increased supplies of cheese are blamed for a turnaround in cheese prices. After two weeks of firmer prices, the market moved lower by midweek. Barrel supplies are said to be long and buyers are looking for lower prices to motivate sales. The West produced 41.7% of all the cheese in the U.S. in November.

Recommendation:

Schools are back in session and Class I demand is rebounding helping to reduce the abundance of manufacturing milk over the holidays. However, there still appears to be plenty of cheese to go around, especially in barrels. During this week's spot sessions, it was barrels primarily being offered lower that caused weakness in the cash market. While buyers stepped in eventually, it felt more like their purpose was to implement a "gradual landing" in order to avert a price plunge. Futures prices were sharply lower, with Feb and Mar Class III each losing more than 70¢ on the week. Increasing supplies of dry whey put pressure on whey futures as well, with solid losses in the front months. Excess cream around the country is pressuring butter futures as production is outstripping demand, leading to more product being moved into inventory. Milk supplies continue to be abundant in the Midwest and Northeast. We see little change in fundamentals in the near to medium term, with excess cheese and sluggish domestic demand limiting any real upside. Longer term, however, we expect a sharp reversal. Producers in the West continue to suffer from negative cash flow, which will only get worse with Jan-Feb paychecks. Domestic dairy prices are now much more competitive on the world market and export interest is on the rise. It remains to be seen where grain prices will go, but for the short term, corn has found support and is back over $7/bu. And if USDA is correct with a near 0% worldwide increase in 2013 milk production, any increase in demand (which we think will happen) could send milk prices higher. While our economy continues to limp along, Asian economies are faring somewhat better and demand for dairy products appears to be strong. Just this week a story broke about a surge in sales of one of Australia's most popular brands of infant formula. Due to the lack of confidence in the safety of their domestic brands, Chinese consumers have made a run on the product, buying in bulk and carrying it home, to the extent that barren shelves in the baby aisle have been noted at leading retail outlets. With about 16 million births a year, China is one of the world's largest markets for baby food and infant formula, representing around 23 percent of the $41 billion global market. But, until the supply/demand picture is righted, we expect continued weakness for Q1. Current spot cheese prices calculate out to about $17.35 Class III. With Feb futures beginning its pricing period next week and Mar just behind (and both pricing a premium), we would still look to sell rallies in these months. Consider sales in Feb at $17.90 or higher and $18.25 or higher for Mar. We would still look to purchase CALL options in Q2, with the idea to sell in to them later. Consider the Apr-Jun 20.00 calls at an average of 24¢/mo. If you get them, enter orders to sell your milk at $19.25. Should your sell orders be filled, you'll have a floor price at $19.25 with unlimited upside above $20.25 (giving up a dollar upside on the move). We would still leave the 2nd half of 2013 alone.