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The KDM Dairy Report – February 22nd, 2013

What's Bullish:

Futures Month	Class III 02/22	Class III 02/15	Change	Dry Whey 02/22	Dry Whey 02/15	Change	Cheese 02/22	Cheese 02/15	Change
Feb-13	$17.26	$17.23	$0.03	63.75¢	63.98¢	(0.23¢)	$1.662	$1.663	($0.001)
Mar-13	$17.24	$17.30	($0.06)	59.00¢	58.25¢	0.75¢	$1.683	$1.690	($0.007)
Apr-13	$17.27	$17.36	($0.09)	55.50¢	54.75¢	0.75¢	$1.708	$1.722	($0.014)
May-13	$17.59	$17.61	($0.02)	55.18¢	54.00¢	1.18¢	$1.750	$1.750	$0.000
Jun-13	$17.92	$18.02	($0.10)	55.25¢	55.00¢	0.25¢	$1.780	$1.789	($0.009)
Jul-13	$18.34	$18.47	($0.13)	55.00¢	55.00¢	0.00¢	$1.829	$1.829	$0.000
Aug-13	$18.47	$18.54	($0.07)	55.50¢	55.50¢	0.00¢	$1.845	$1.844	$0.001
Sep-13	$18.48	$18.53	($0.05)	54.50¢	54.00¢	0.50¢	$1.845	$1.851	($0.006)
Oct-13	$18.35	$18.40	($0.05)	54.75¢	54.75¢	0.00¢	$1.827	$1.835	($0.008)
Nov-13	$18.12	$18.22	($0.10)	54.75¢	54.50¢	0.25¢	$1.804	$1.814	($0.010)
Dec-13	$18.07	$18.15	($0.08)	54.75¢	54.30¢	0.45¢	$1.796	$1.808	($0.012)
Jan-14	$17.80	$17.95	($0.15)	48.80¢	48.80¢	0.00¢	$1.805	$1.805	$0.000
12 Mo Avg	**$17.91**	**$17.98**	**($0.07)**	**55.56¢**	**55.24¢**	**0.33¢**	**$1.778**	**$1.783**	**($0.005)**

- Despite heavy milk production in the Midwest and Northeast, cheese inventories at USDA selected storage centers are flat through the first 18 days of Feb. Butter stocks are up just 1% over the same period.
- Livestock Slaughter Report: Dairy cow slaughter in Jan totaled 296,900 head, the highest number since the mid-'80s, and a strong 12.5% higher than a year ago.
- Culling continues to be heavy. For the week ended 02/09, 67,000 dairy cows went to slaughter, 4.5% higher than the same period a year ago.
- Fluid Milk South: Class I demand remains strong in Florida with contacts suggesting the warmer than usual winter is prompting seasonal residents to stay longer and dine out more often, resulting in increased fluid milk sales. Milk production continues to increase, but remains below year ago levels. Drought conditions are limiting forage regrowth with 50% of the pastures rated as either poor or very poor.
- Butter Central: Central butter manufacturers have active churning schedules and sales are excellent. Some manufacturers are currently sold out of production they wish to sell and are churning heavily to fulfill sales commitments.
- CWT has accepted requests for export assistance to sell 956,806 lbs of Cheddar and Monterey Jack cheese. The product will be delivered February through August 2013.
- Cheese West: Production is mostly steady and manufacturers report inventories are at manageable levels. Domestic retail demand is mostly steady into various food and club stores. Mozzarella sales for food service accounts are showing some increases.
- International: January milk output in Australia was down 5.5% vs. a year ago, while the current milking season, which had started out very promising, is now down 0.3%. Drought over much of the milking area is being blamed.
- International: With a world-wide slowdown in milk production, there is expanding interest and awareness among U.S. manufacturers in the potential for cheese exports. It is noted that with milk production in Europe, New Zealand and Australia being below last year's overall level at this time, U.S. cheese is increasingly profitable to export and lots of it is being exported. That is making at least some big manufacturers less concerned with the potential market impact of increased milk supplies in coming months.

What's Bearish:

- Spot Market: Blocks declined 4¾¢ on just 2 trades, settling at $1.62¾/lb. Barrels were unchanged with no trades, closing at $1.63. Butter declined 1½¢ to settle at $1.59/lb, with 5 loads exchanging hands.
- Cold Storage Report: American cheese stocks in Jan were unchanged from a year ago, but increased an unusual 7.9 million lbs from Dec. Total cheese stocks were up 1%, or 9.2 million lbs vs. last Jan and up 1% from Dec. Butter stocks rocketed up 35% in a month (Dec to Jan) and were 21% higher than a year ago.
- Milk Production Report: Output in Jan was 0.5% higher than a year ago. This was less than most analysts expected, but cow numbers grew for the 3rd consecutive month (not a good trend), jumping 7,000 head from Dec. With a younger herd and better genetics, milk per cow shot up 13 lbs vs. a year ago.
- Most Class III components were lower in this week's USDA price survey. 40-lb blocks fell 2¢ to average $1.66/lb and 500-lb barrels decreased 1.7¢ to $1.59/lb. Dry whey lost 1.2¢ to average 63.4¢/lb and nonfat dry milk shed 1.5¢ to $1.56/lb. Butter was the lone winner, gaining 4.2¢ to average $1.56/lb.
- Fluid Milk East: Manufacturing milk supplies have increased in the Northeast and Mid-Atlantic regions. Milk production remains strong with good component levels. Class I demand has leveled off and in some cases declined following the recovery from the recent storm. The combination of milk production increases and declines in Class I demand resulted in expanded milk volumes going to auxiliary manufacturing plants in the Southeast. Demand for cream has improved as cream cheese, butter and ice cream makers have expanded production to various degrees ahead of the Passover and Easter holidays, but cream supplies continue to overwhelm demand needs, requiring loads to be shipped out of region at significant discounts in order to find a home. Significant volumes of cream continue to flow to churns.

- Fluid Milk Central: Milk production in the Central region is mostly steady, but fluid sales are level to slightly lower, with a few bottlers pushing back loads this week. A few convenience stores ran bottled milk price specials this week to try to boost sales. Demand from cheese manufacturers is unchanged to lower, with some pushback on loads adding to the volumes marketers must clear. Spot milk load prices continue to trail the Class price for most sales. Cream is readily available, sourced within the Central region as well as from sellers in the East and West. Central churning operations are busy clearing cream into butter inventories.
- Fluid Milk Southwest: Despite the impact of financial restrictions and high feed costs, and the fact that some producers continue to be challenged, with reports of foreclosures and selloffs still being seen, milk output has been steadily building, with volumes above year ago marks. AZ milk production trends are moving higher. Farm level conditions have been favorable for milk growth and the overall trends are still gaining towards the seasonal peak. Processing plants are expanding schedules to handle the available milk supplies.
- Fluid Milk Northwest: Milk production in the Pacific Northwest is reported to be mostly steady. Higher feed costs and resulting ration adjustments are holding production per cow numbers back. Expansion plans for many dairies continue to be on hold at current breakeven levels. UT and ID milk production is reported to be lower than year ago levels. Slightly lower dairy cow numbers and difficult to achieve milk/feed breakevens are slowing any hoped for expansions.
- Butter East: Production continues at increased levels as cream volumes going to churns remain heavy. Production of butter for Passover has increased as manufacturers build inventories ahead of the holiday. Despite the improved demand, most manufacturers continue to expand inventories.
- Butter West: Cream supplies are heavy and much of the available supply is ending up at butter churns. Ice cream manufacturers are expected to enter the cream market more aggressively soon, but are still slow to add to purchases. Butter churns are content to build inventories for later in the year.
- Dry Whey East: Milk flows to cheese plants remain strong, keeping whey production very active and adding to inventories. Some manufacturers have offered loads at discounts in order to reduce supplies. Demand is weak with most end users purchasing for immediate needs only. Export interest has improved, but those buyers are also looking for discounts prior to purchasing. The market undertone remains weak.
- Dry Whey Central: Prices are lower across the range. With inventories building, several manufacturers are lightening inventories with active spot selling as the end of the month approaches.
- Dry Whey West: The market tone is reported to be weak as export markets are closer to the lower end of the price range. Buyers are showing reluctance to purchase above contract needs.
- Nonfat Dry Milk: Milk production increases and declines in Class I demand combined to increase manufacturing milk supplies, which resulted in expanded nonfat dry milk production. Some plants are manufacturing only low heat NDM in order to better handle the heavy milk volumes coming into the plants. Demand remains lackluster with hand to mouth purchases as buyers are unwilling to expand inventories, feeling prices will move lower in the near future. Spot sales are limited with prices significantly below contract levels. Export interest is improving, but prospective buyers are looking for price discounts. The market undertone is weak.
- Cheese East: Milk volumes headed to vats remain heavy with most cheese makers on 6-7 day production schedules. Most cheddar operations are adding to inventories and/or increasing volumes going into aging programs, but mozzarella makers have enjoyed good sales following promotions by some national pizza chains.
- Cheese Midwest: Most cheese manufacturers are operating with full or nearly full schedules, unconstrained by milk supply availability.

Recommendation:

Milk production up, cow numbers up, big gains in cold storage for both cheese and butter, and blocks fell below barrels to invert the spread. This is all pretty negative, especially for the front months, yet Class III futures were only moderately lower for the week. Current spot prices work out to about $16.80 Class III. With Mar starting its calculation period this week, steady to lower spot cheese prices will force Mar futures lower. In the medium to long term, however, there's a growing sense that 2013 could see exports take off even more than in the prior 2 record-setting years. With milk production falling in Europe and Oceania, domestic manufacturers seem less concerned about spring flush this year. The assumption is that improved exports will offset peak milk output. They may be right. Despite the preponderance of bearish reports out this week, Class III yawned it off with mostly single-digit losses for the week. Dry whey futures actually increased, despite very bearish fundamentals currently. These conflicting elements make it difficult to make a valid hedge recommendation. We still think you should sell rallies in Mar/Apr. Beyond that, there's some great opportunity for those hedgers that enjoy a good premium to lock in some 2nd half milk. On the other hand, the use of cheap, out-of-the money PUTs as "disaster insurance" might make sense for some. The July-Dec 16.50 PUT avg is 22¢/mo. For some producers, that floor works out to around $18-19 mailbox, or more. That's not a bad plan, considering you don't have the milk locked in. If prices go higher later, you'll benefit from the rally. On the other hand, if fundamentals stay sour longer than expected (and we all know they can, ie. 2000, 2002, 2003, 2009), you will sleep well at night, knowing you can at least cash flow! Work on a plan. Get something done!