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The KDM Dairy Report – August 2nd, 2013

What's Bullish:

Futures Month	Class III 08/02	Class III 07/26	Change	Dry Whey 08/02	Dry Whey 07/26	Change	Cheese 08/02	Cheese 07/26	Change
Aug-13	$17.89	$17.88	$0.01	58.25¢	58.50¢	(0.25¢)	$1.760	$1.758	$0.002
Sep-13	$18.42	$18.38	$0.04	58.60¢	58.75¢	(0.15¢)	$1.817	$1.805	$0.012
Oct-13	$18.41	$18.40	$0.01	58.25¢	58.75¢	(0.50¢)	$1.817	$1.803	$0.014
Nov-13	$17.75	$17.94	($0.19)	58.50¢	58.60¢	(0.10¢)	$1.750	$1.764	($0.014)
Dec-13	$17.20	$17.33	($0.13)	57.75¢	58.00¢	(0.25¢)	$1.689	$1.705	($0.016)
Jan-14	$16.49	$16.74	($0.25)	54.50¢	54.50¢	0.00¢	$1.649	$1.670	($0.021)
Feb-14	$16.39	$16.64	($0.25)	54.00¢	54.00¢	0.00¢	$1.640	$1.672	($0.032)
Mar-14	$16.41	$16.78	($0.37)	53.50¢	53.25¢	0.25¢	$1.642	$1.686	($0.044)
Apr-14	$16.42	$16.78	($0.36)	52.00¢	52.00¢	0.00¢	$1.656	$1.715	($0.059)
May-14	$16.58	$16.90	($0.32)	51.00¢	50.75¢	0.25¢	$1.682	$1.721	($0.039)
Jun-14	$16.80	$17.13	($0.33)	49.75¢	49.50¢	0.25¢	$1.705	$1.740	($0.035)
Jul-14	$16.96	$17.31	($0.35)	49.98¢	52.00¢	(2.03¢)	$1.740	$1.780	($0.040)
12 Mo Avg	**$17.14**	**$17.35**	**($0.21)**	**54.67¢**	**54.88¢**	**(0.21¢)**	**$1.712**	**$1.735**	**($0.023)**

- Dairy Products Report: American cheese output in June was up a less-than-expected 1.2% vs. a year ago, and declined 6.2% from May. Cheddar cheese output was down 0.1% and down 8% respectively. Total cheese output was up 1.4% vs. last June but down 3.9% from May. Butter output was 2.7% higher than June 2012, but 13.8% lower than in May. Finally, total dry whey output fell 5.2% vs. a year ago while NDM output was sharply lower, down 22.5% over the same period.
- Cheese stocks at USDA selected storage centers are down 2%, or 2.7 million lbs, over the period 07/01 through 07/29, according to the Weekly Cold Storage Holdings report.
- Most Class III components were higher in this week's National Dairy Products Sales Report: Butter increased 1¢ to average $1.45/lb and NDM was up 1.2¢ to $1.75/lb. Dry whey decreased 0.3¢ to average 57.9¢/lb, but 40-lb cheddar blocks gained 0.8¢ to $1.69/lb and 500-lb barrels picked up 2¢ to average $1.71/lb.
- Spot Market: Blocks gained 1¼¢ on 6 trades to settle at $1.77½/lb and barrels were up 1¼¢ to close at $1.77¼/lb on 2 trades. Grade A NDM was steady at $1.73/lb with no trades, and butter gained a penny to settle at $1.44/lb on 5 trades.
- Fluid Milk East: Cooler temperatures have replaced the recent spell of heat and humidity, increasing cow comfort levels, but any bounce back in milk production has been marginal at best in the Northeast and Mid-Atlantic regions. Manufacturing milk supplies are tight with most balancing plants channeling most or all of their supplies to meet their fluid commitments. Second cutting hay harvest continues to lag behind year ago levels by 10-15%. Frequent rains this past week in the Northeast have limited field work activities. Declines in Florida milk production were marginal last week as cooler weather increased cow comfort levels, but Class I demand held about steady with last week and looks to increase in the near term as schools will begin to stair step their way back into the fall term in a week or two. There were no spot loads of milk exported for the second consecutive week. Milk supplies in the Southeast region are nearly in balance with demand and as a result manufacturing supplies are close to contract minimums. Class I plants are beginning to gear up for the upcoming school year as some states in the region will have schools starting up as early as next week. Cream supplies are tight as butterfat levels are reaching their seasonal low point. The decreases in supplies and good cream demand have combined to push cream multiples to 1.60. Some contracted supplies continue to be shorted or delayed for later delivery. Condensed skim supplies are falling short of meeting demand even at higher prices as most balancing plants focus on covering their contract commitments. Some balancing plants are considering offering more loads on the spot market, because their supplies are being reduced at a rate to where it's more cost effective to sell the fluid than dry limited supplies. A major yogurt manufacturer in the Northeast was awarded a government contract for nearly 200,000 pounds of high protein yogurt for various school lunch programs.
- Fluid Milk Southwest: Milk production in CA has come back somewhat as weather conditions have moderated, but temps are expected to start climbing above average again in the next several days. Some milk producers continue to struggle financially and that is not expected to change anytime soon. Milk is moving to plants that offer the best return in the state as there is room in production schedules. AZ milk output is not bouncing back very much even though conditions are more moderate. Humidity levels will begin to increase later this week again stressing the milking herd. Most schools in the state will be back in session next week which will draw more milk away from manufacturing plants. Tests on incoming milk continue to decline. Cream markets continue to firm. Cream supplies are less available as milk production and milkfat content continue to decline across the region. Ice cream production is building, but not to expected levels.
- Fluid Milk Pacific Northwest: Milk production in the region is recovering from recent high temperatures, but continues to decline seasonally. Dairies are evaluating anticipated feed supplies and costs of purchased feedstuffs as they make decisions about herd size adjustments. UT and ID milk supplies are reduced due to unusually hot weather across the region. This is resulting in some plants reducing production schedules. Processing capacity continues to exceed milk production in the region. Dairies are being encouraged to increase production, but some are hesitant to make that commitment.
- Dry Whey West: The tone of the market is currently steady. Whey production continues to lag behind year ago levels, but product is available from both manufacturers and brokers. Hot weather and lower component levels are reducing available supplies of whey to manufacturers. Export prices are in line with domestic prices and much of the Western production is filling good export demand.
- Butter Northeast: Cream has become increasingly tight, due to declines in milk production and lower butterfat levels. Those declines have substantially reduced butter production in the region. Domestic demand can be best described as average, while export interest remains good.
- CWT has accepted requests for export assistance to sell 947,988 lbs of butter and 1.206 million lbs of Cheddar and Monterey Jack cheese. The product will be delivered July through December 2013.
- NDM East: Production of nonfat dry milk has seen substantial declines as lower milk production, combined with increased condensed skim demand has limited milk volumes going to dryers. Milk volumes are low enough at some plants that plant managers are opting to sell their limited fluid supplies in lieu of drying. Domestic demand is about steady with last week. Export interest continues to be good. The declining milk volumes and limited production schedules are providing the market with a firm undertone.
- NDM Central: The NDM market has a firm undertone overall. Contracted loads are being delivered on a timely basis and spot offerings are adequate for needs, but good export interest is reported to be helping to limit NDM supplies from being burdensome.
- NDM West: Production is lower across the region due to declining seasonal milk supplies. The weather has moderated some, but little bounce back in milk supplies is noted. Many contacts are thinking that the market will continue to have a firm undertone until milk output in Oceania begins in earnest. Most are thinking this might happen in November, or it could be even later due to very light pipeline stocks. Domestic demand is fair, but export sales remain strong. Resale and spot offerings are light. Finding 1-2 loads is not a problem, finding larger volumes is a problem. Much higher SMP production than last year continues to limit NDM production and stocks. Some producers are noticing an upturn in demand as summer begins to shift to fall. Prices

for the California Weighted Average Price for the week ending July 19 were $1.7085 for NDM. This is the first time since January of 2008 that the price has been above $1.70. The strength continued this week, moving the price to $1.7219.

- Cheese Northeast: Concerns over future milk supplies have counter balanced the heavy cold storage numbers with most cheese makers continuing to make cheese on 5-6 day production schedules and willing to expand inventories, especially in aging programs. Some cheese makers have a less bearish outlook on the market, anticipating tighter milk supplies will forecast higher prices for cheese and prompt increased sales. Export interest for cheese remains good and continues to be supported by export assistance programs.
- Cheese Central: A number of larger cheesemakers with contracted milk supplies report that milk supplies are up from a week ago, but that process cheese sales are strong while natural cheese sales are off a little. Overall, most manufacturers are comfortable with the current cheesemaking situation. A different situation is reported by some smaller and more specialty cheese plants. In various locations, there are reports of canceling or delaying delivery of a portion of existing cheese orders, due to lower milk volume and components. Spot milk is available to these plants to maintain production to fill orders, but it was a business decision not to pay $2.00 or $3.00 over Class to obtain spot milk to fill all of the orders. Just as football training camps begin seasonal activity, there are increasing reports from cheese manufacturers about buyers beginning to more actively consider inventory needs for the last quarter of 2013 and the first of 2014. Many are finding plenty of cheese in inventory overall but for now, a shortage of discounted product.

What's Bearish:

- Dairy cow slaughter for the week ended 07/20 totaled 55,600 head, down 7.8% vs. the same period last year. YTD slaughter numbers are still ahead of last year, but now by only 43,000 head.
- Fluid Milk Central: The recent hot weather in the Midwest was reported to have lowered milk volumes by 10% at some plants, but cooler days and nights have cattle back at the feed bunk and milk supplies have rebounded. Component levels are still at reduced levels and affecting yields at processors plants, however.
- Butter Central: The butter supply (inventory) is at the forefront of many butter manufacturers' thinking. One manufacturer said that markets are locked in a struggle with heavy inventories, characterized by the manufacturer as the largest butter inventory since 1993. One factor mentioned is increasing volumes of cream generated by increasing production of Greek Yogurt. Butter prices remaining at a lower level may help sales but retailers can buy only so much and many are already well stocked. Thus, especially with the magnitude of butter inventories, there is no generally expressed expectation that domestic sales alone in the near future can significantly absorb sufficient butter to remove the general bearish feeling about markets.
- Butter West: Butter markets are lower as last week's Cold Storage stocks report continues to weigh on prices. Current price levels are encouraging buyers to fill immediate needs and take a wait and see attitude towards building their inventories.
- Dry Whey East: Current production continues to outpace demand with numerous manufacturers continuing to expand inventories. Domestic demand remains sluggish with product moving primarily through contracts. Export interest continues to be fairly good. The supply situation is weighing on the market and providing for a weak undertone.
- Dry Whey Central: Whey supplies are adequate to heavy in the central region. While hot weather has slowed milk and cheese production, manufacturers and brokers have sufficient inventories to fill contract and spot needs. Buyers are filling immediate needs and are cautious concerning additional purchases.
- International: Production in Germany and Ireland is trending lower, but current receipts are higher than year ago levels. The reversal of the impact of poor conditions is welcomed as processors have more milk to manufacture. Milk production in France has stayed higher and at levels just short of a year ago. Across Europe, higher farm milk prices and more reasonable feed cost have been welcomed.
- International: New Zealand milk output is seasonally light. Pastures and cropping conditions are in good shape. Cows are reported to be in fair to good stature entering the new production season with the milk beginning to build in August. Milk prices are favorable for milk producers as they plan and finance ahead. Milk growth is being forecast from flat to slightly higher for the new production year. Australian milk production trends are bottoming out at the low point of the cycle, but winter conditions are overall mild. Higher milk prices are a positive sign for dairy producers. Feed supplies are currently hard to find and are pricy, but the decline in the AU dollar versus the US dollar is a positive for the agricultural sector.

Recommendation:

Grains continued to lose ground this week, and while the spot market was higher, volume was light and gains were minimal. There is a wide variety of opinion out there, but to sum it up, we have manufacturing milk getting tighter across the country, countered by high inventory levels. Interestingly, this week's Dairy Products Report shows that NDM output in June was down 2.58% from a year ago, but manufacturers' end-of-month stocks were 60% higher than a year ago. The only way one can have significantly higher stocks while output declines is due to a substantial drop in demand. And perhaps that's where all the bullish points are being negated. We're all pretty good at getting a handle on supply. Cow numbers, output per cow, feed quality, cull numbers, weather; all these things affect supply. What we're not as good at is measuring demand. Milk has been stuck in a tight range now for eight straight months. Since Dec 2012, the high has been $18.66 with a low of $16.93, a range of just $1.73. Although unusual, milk being stuck in a range is not unprecedented. From Jan 2005 through Jan 2006 (13 months), milk settlements ranged from a low of $13.35 to a high of $14.70, a longer and much tighter spread of just $1.35. And if you exclude the blip of $16.14 in Dec of 2014, from Jul 2014 through Jan 2006, 18 of 19 months ranged from a high of $14.89 to the low of $13.35, a spread of just $1.54. Until we see an uptick in demand, it appears that we'll continue to be range-bound for the balance of the year. Or, further declines in demand and more erosion in grain prices could actually lead us to a bear market. It appears to us however, that $17 is close to a bottom, while $19 is about the top. Within the current situation, we can't imagine cheese heading above, or much above $1.90/lb. It would kill demand. We would target sales, then, when the market rallies to near these levels. Enter target orders to sell Sep and Oct at $18.90 or higher. Sep hit $18.81 and Oct hit $18.79 just yesterday, so these are reasonable levels. Target Nov at $18.35-$18.50 and Dec at $18.00. The 2014 contracts were hit hard again, with the first half average now down to $16.52 after being over $17 as recently as 07/26. At this point, we wouldn't chase prices lower.