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The KDM Dairy Report – September 20th, 2013

What's Bullish:

Futures Month	Class III 09/20	Class III 09/13	Change	Dry Whey 09/20	Dry Whey 09/13	Change	Cheese 09/20	Cheese 09/13	Change
Sep-13	$18.14	$18.18	($0.04)	57.60¢	57.70¢	(0.10¢)	$1.793	$1.800	($0.007)
Oct-13	$18.09	$18.19	($0.10)	57.68¢	57.75¢	(0.08¢)	$1.790	$1.801	($0.011)
Nov-13	$17.70	$17.78	($0.08)	57.03¢	57.20¢	(0.18¢)	$1.743	$1.753	($0.010)
Dec-13	$17.07	$17.05	$0.02	57.25¢	57.63¢	(0.38¢)	$1.676	$1.676	$0.000
Jan-14	$16.65	$16.56	$0.09	55.00¢	54.50¢	0.50¢	$1.661	$1.652	$0.009
Feb-14	$16.54	$16.41	$0.13	54.50¢	53.50¢	1.00¢	$1.650	$1.647	$0.003
Mar-14	$16.52	$16.37	$0.15	53.75¢	53.00¢	0.75¢	$1.650	$1.652	($0.002)
Apr-14	$16.47	$16.39	$0.08	52.00¢	52.00¢	0.00¢	$1.660	$1.652	$0.008
May-14	$16.47	$16.39	$0.08	52.00¢	52.00¢	0.00¢	$1.660	$1.655	$0.005
Jun-14	$16.61	$16.67	($0.06)	52.03¢	52.00¢	0.02¢	$1.680	$1.690	($0.010)
Jul-14	$16.95	$16.95	$0.00	51.00¢	49.00¢	2.00¢	$1.738	$1.740	($0.002)
Aug-14	$17.10	$17.07	$0.03	51.00¢	48.25¢	2.75¢	$1.740	$1.745	($0.005)
12 Mo Avg	**$17.03**	**$17.00**	**$0.02**	**54.24¢**	**53.71¢**	**0.53¢**	**$1.703**	**$1.705**	**($0.002)**

- Spot Market: Butter buyers were at it again this week, pushing prices up 7¢ to $1.60/lb and grabbing 67 loads along the way; the highest weekly total since 2004. Grade A NDM gained 1½¢ to settle at $1.84½/lb on a more modest seven trades.
- Over the first 16 days of Sep, cheese stocks at USDA selected storage centers declined 2%, or 2.3 million lbs. Butter stocks over the same period also fell 2%, or 257,000 lbs.
- Fluid Milk East: Manufacturing milk supplies in the Northeast and Mid-Atlantic regions are very tight, due to strong pulls from Class I and lower seasonal milk production. Most balancing plants are able to meet their fluid contract commitments with very little remaining for manufacturing. A majority of crops and pastures are in good to excellent condition in both regions, but there is concern in New England that the reduced forage harvest, due to an exceptionally wet summer, will limit feed supplies this winter. Milk production declines in Florida have slowed as it nears the seasonal low point. Hot weather continues to cover most of the state. Class I demand remains strong and prompted 210 loads to be imported this week, up from 186 last week. Milk production has continued to decline in the Southeast, but has been adequate to cover Class I demand. Manufacturing supplies are being held near contract minimums to ensure bottling plant needs are met. Cream supplies are very tight as demand has significantly increased. Cream cheese manufacturers are in the middle of their heavy production season and are looking for additional loads. Churns are also seeking additional loads as demand for butter has improved. Condensed skim milk supplies are also very tight. Most supplies are moving through contracts with little if any available for the spot market. Class IV production in the East is nearly nonexistent, due to the tight fluid supplies.
- Fluid Milk Central: Active ordering from bottlers is shunting milk away from cheese plants. Some milk marketers indicate with the closure of one bottling plant in southern Wisconsin earlier this year, additional pressure is on other bottlers to fill that void. Despite the recent improvement in farm milk production, many cheese plant managers are still operating below capacity. Some plants are working 5 or 6 days per week instead of the full 7 day schedule. Interest in Class III spot milk loads is active, with potential buyers making active sweeps through areas of the Central region. Anecdotal reports indicate offers of $3.50 over Class were rejected as a cheese plant operator still needed that milk to fill cheese orders.
- Fluid Milk Pacific Northwest: Milk production in the region improved marginally with cooler temperatures, but many processing plants continue to operate on reduced schedules. Milk remains tight as processing demand is currently above supplies. Fall harvest of corn for silage is progressing and yields are said to be very good, but hay supplies are lighter than hoped for due to cooler weather earlier in the year.
- Butter Northeast: Cream supplies have significantly tightened this week, limiting butter production. The tight cream supplies are a result of improved cream demand in combination with lower seasonal milk/cream production and butterfat levels. Some butter makers are seeking additional loads of cream with little success. Others are microfixing supplies to fill orders and, as a result, inventories are being worked lower. Domestic demand for butter continues to be good as retailers expand inventories ahead of the fall and holiday seasons. Butter supplies are relatively tight internationally, prompting increased export orders.
- Butter Central: Tighter cream supplies have limited butter production, forcing some manufacturers to choose between selling current butter production into export, or domestically. The recent upward movement for butter prices on CME trading has motivated some retail buyers, who were expecting to buy butter this fall but were watching prices, to try and place orders ahead of further upward price movement. But they have come away frustrated as some manufacturers have entered into export contracts and continue to fill those contracts. Even with bulk butter selling for up to 8¢ over, greater profit is currently available with export contracts, even after adjusting for 80%/82% factors in manufacturing.
- Butter West: Butter prices in the West have firmed. Increased seasonal demand is reported to be in full swing as retail buyers and club stores continue to look to build inventories. Print butter lines are operating on busy schedules to fill orders. With schools back in session, food service accounts are also adding to the higher demand. Export demand is good. Butter production has slowed as tighter cream supplies are limiting churning. Stocks of bulk butter are in better balance and discounts are tighter.
- Dry Whey West: Whey production is lower as many cheese plants are operating at reduced schedules due to tight milk supplies. Competition from whey protein concentrates is also reducing the amount of whey for drying. Demand for whey is showing some added interest as end users begin to gear up production of fall products.
- NDM East: Prices moved higher as very tight milk supplies in the East have all but eliminated the production of nonfat dry milk in the region. Current inventories are being worked lower as orders are filled. Eastern NDM supplies are filling more domestic demand needs than in past years, which have tightened current supplies. End user demand is increasing as baking manufacturers are looking to expand inventories prior to fall. Some cheese manufacturers are also looking for additional loads for fortification purposes. The market undertone is firm.
- Cheese East: Production has declined as milk supplies are tightening, due to the combination of increased Class I demand and lower seasonal milk production. Demand for cheese is strong with good domestic orders as retailers increase inventories for the college football and NFL seasons. Export demand is good as buyers from around the world are shopping the bountiful supplies in the US at prices below international levels. The active domestic and export markets are working inventories lower.
- Cheese Midwest: Most cheese manufacturers are receiving less milk than during recent weeks. Spot milk is generally not available, even after focused looking for it. Some offers of $3.50 over class for spot milk were declined. The impact on specific manufacturers varies. Some are not

hurting in terms of cheese production for current demand. Nevertheless, those plants would increase cheese production if more milk was available. Other plants have reduced their production schedules, particularly for cheddar, and diverted some milk into Mozzarella plants to enhance production scale economies.

- Cheese West: Cheese production is currently limited by tight milk supplies in the West. Manufacturers report adequate supplies to fill most orders, but extra manufacturing capacity is available. Cheese sales are increasing seasonally, but spot buyers are price sensitive at the higher levels. Export sales are reported to be active.
- CWT has accepted requests for export assistance to sell 3.123 million lbs of butter and 2.3 million lbs of cheese. The product will be delivered September through March 2014.
- International: The Global Dairy Trade auction held on Tuesday resulted in a 0.3% increase in prices across the product index. Butter saw the biggest gain, jumping 5.2% to an average price of $1.77/lb. Cheddar cheese was up 1% to an average price of $1.95/lb.

What's Bearish:

- Spot Market: While butter and NDM were the highlights this week, blocks and barrels both fell 4½¢ on no trades, settling at $1.79½/lb and $1.76¾/lb respectively.
- Milk Production Report: Output in August was up 2.6% vs. a year ago, far above most analyst expectations. Though an increase was expected due to low output in August last year, it was the first time EVER since records started in 1930, that August output was higher than July. Yikes. Gains were led by KS up 8.8%, IA up 8%, FL up 6.9% and AZ up 5.5%. CA was up 2.7% and WI up 1.7%.
- Livestock, Dairy & Poultry Outlook Report: USDA increased their 2014 Class III price forecast 50¢/cwt from last month's estimate, to an average $17.55/cwt. They contend the U.S. will maintain a competitive advantage in world dairy markets, and will thus have higher exports of cheese, butter, and nonfat dry milk. The resulting tighter stocks support the increased milk prices in 2014.
- Livestock Slaughter Report: Commercial dairy cow slaughter in August totaled 266,000 head, down 9,300 head (3.4%) from a year ago.
- Fluid Milk West: CA milk production trends are mostly flat with recent weeks. Current cooler conditions are neutral to the milking herd. Class I demand has begun to stabilize as orders are becoming more consistent across categories. Processing plants are running on projected schedules. AZ milk production is steady to rising slightly. Weather conditions are drier and are having less of an impact on milk cows. The effects of recent rains are easing. Class I sales have evened out. Processing of milk is mostly going well at the present time. A new facility is being ramped up.
- Dry Whey Northeast: Production has declined as less milk is making its way to cheese makers, but domestic demand remains lackluster as buyers are purchasing in volumes needed to cover their current need. Export demand is also viewed as slow and not meeting expectations. Some manufacturers are offering loads at significant discounts in order to better manage their inventories.
- NDM West: Demand remains best into export channels. Regular, domestic account interest is often uneven. Buyers remain cautious, mainly because they are nervous about future pricing. The milk production season in Oceania is beginning and the international worriment is that the current, historically high, pricing levels could be pressured lower as more SMP is offered onto the world market.
- Grains: After a brief boost, led by the Fed's announcement it wouldn't be tapering its bond buy-back program (money printing), grains gave up all of their gains on the week, firmly putting them back on a downward long-term trend and into new lows.

Recommendation:

Hmmmm. It was an interesting week to say the least. Spot cheese was quiet with no trades at all, but still lost 4½¢ on offers. Then butter buyers went crazy again picking up an astonishing 67 loads. The Fed decided not to taper their bond buy-back program, which had been widely expected. This pushed the S&P into new record highs, caused the value of the U.S. dollar to plunge (more money printing) and commodity prices to rally. But on Friday, the House vote to defund Obamacare caused the Dow to plunge 185 points as fiscal uncertainty returned. The U.S. dollar rallied and grains gave up all their gains. In the meantime, USDA released a bearish milk production report. The 2.5% increase was above expectations and we're not going to paint it bullish, but we should remember that last Aug, milk output was down substantially. Longer term, however, this is a bearish report. August output was higher than July's for the first time we have records, going back to 1930. The most likely culprit is higher cow numbers. Since we're not getting updated info on headcount due to sequestration, we can look at the sharp decline in Aug slaughter numbers and make this conclusion. So what do we make of all this? In the short-term, fundamentals are still very bullish. The country is tight manufacturing milk from coast to coast, north to south. While spot cheese prices were lower this week, the sudden and strong interest in butter is going a long way in reducing excess inventory. NDM is tight domestically and globally. The GDT auction this week reflects the ability for powder to continue at sustained high prices, despite a strong start to the new milking season in Oceania. The move higher in spot butter and NDM pushed the Class IV calculation up more than 40¢ to about $20.70/cwt. The drop in spot cheese and decline in dry whey this week puts Class III at about $18.16/cwt. With a spread of more than $2.50/cwt between the classes, it's supportive Class III going forward. The market "feels" ready to pop to the upside at some point. The long-term is still up in the air. Certainly if we keep growing the milk supply and cow numbers like we are currently doing, it won't bode well. But, we're also continuing to hear about the strength in the Chinese bid for product as their output in the 1st half of the year was down several percentage points. With 16%+ of our milk equivalent now going to the export market, Class III prices will live or die on export demand. It appears that so far, demand is going to continue to support the market, or at least keep it from plunging dramatically. But any change in international demand, even going flat, will likely cause milk prices to plunge due to our growing domestic production ability. The first half average for 2014 climbed back 7¢ to settle at $16.54, exactly where it was two weeks ago. Commercial long hedgers appear to be getting more active, which could help this Jan-Jun pack keep moving to the upside. Add a front-month rally and maybe emotion gets us to our $16.70 target we've been touting for the last month. We'd look to get 25% of your output done there. Up front we think up is the path of least resistance, and will stick with our sell targets of: Oct upper $18's, Nov upper $17's to low $18's, Dec mid $17's.