

The KDM Dairy Report – December 20th, 2013

What's Bullish:

- Spot Market: Blocks gained 7½¢ on just 2 trades to settle at \$2.00/lb while barrels picked up 12¢ on 2 trades to close at \$1.95/lb. Butter increased 1¼¢ to \$1.58¼/lb on 6 trades and Grade A NDM jumped 3¢ to \$2.11/lb on just 1 trade.
- Milk Production Report: November milk output in the US was up just 0.1% vs. a year ago and down from the prior month. Cow numbers declined 5,000 head from October, and were below year-ago levels for the first time since February. Milk-per-cow increased just 2 lbs, indicating potential ongoing issues with feed quality. Gains were led by KS up 7.5%, UT up 5.8% and CO up 3.4%. CA was up just 0.6% while WI saw a decline of 0.6%.
- Weekly Cold Storage: Cheese stocks at USDA-selected storage centers declined 4%, or 4.5 million lbs, over the period 12/01 through 12/16. Butter stocks were down 1% over the same period.
- Fluid Milk East: The combination of strong Class I and II fluid demand limited manufacturing milk volumes in the Northeast and Mid-Atlantic regions. Florida Class I demand remains strong, with retail sales trending higher, as holiday tourists are flocking to the state to escape winter weather conditions in the North. Class I demand has held up in the Southeast region with minimal volumes going to manufacturing plants.
- Fluid Milk Central: Farm milk production in the region is steady to marginally increasing, but a combination of lower feed quality and recent cold weather has put a damper on production growth. Interest for cultured products is steady to strong as retail stores keep up with increased consumer demand leading up to the holidays. Cream supplies remain tight this week, tighter than years' past, but are anticipated to loosen over the next few weeks.
- Fluid Milk Pacific Northwest: Milk production in the region continues near seasonal lows. Milk production is increasing slowly after cold weather restricted output last week, but the milk supply is currently tight with competition amongst the manufacturing plants in the region. Expansion plans for dairies are slow to materialize due to tight lending practices.
- Butter Northeast: Production is down, as retail sales of Class I fluid milk and Class II cream surged, due to winter weather conditions in the region and normal seasonal demand. Supplies are very tight with inventories being reduced as manufacturers fill end of year commitments. Demand is very strong for domestic and export markets, with orders set for end of year and going into first quarter 2014.
- Butter Central: Production has slowed for most manufacturers, following seasonal trends. Domestic butter demand has dropped off from previous weeks, but export interest is good. Some butter makers reported Q4 sales were the best they have seen in years. Butter inventories are reduced and cream supplies are still hard to come by.
- Butter West: Production remains lighter than hoped for as milk production is at seasonally light volumes. Export demand remains good as U.S. butter prices are lower than much of the international market. Butter stocks are tighter than anticipated in many cases.
- Dry Whey Northeast: Production is active, but supplies are tightening with some producer's stock obligations going well into January. Domestic demand is good, with a majority of product moving through contracts. Export demand remains strong.
- Dry Whey Central: The market has a firming undertone. Some dry whey manufacturers report reduced production levels, while export interest has picked up given the U.S. price advantage over Europe's dry whey prices.
- Dry Whey West: Prices are higher. The market undertone is firm as available supplies have tightened. Cheese production remains seasonally tight due to limited milk supplies. Whey stocks are tight with most of this year's production committed and increasing amounts of Q1 production spoken for. High dairy protein prices have buyers looking for any available supplies. Export demand is good for Q1 sales with firmer prices being noted.
- NDM East: Prices moved higher this week. Supplies are very tight with export sales the primary factor in the decline of stocks. Production has been low, due to good Class I demand, while the market undertone remains firm.
- NDM Central: Domestic demand is strong with little excess product available in the spot market as many manufacturers are in soldout into Q1. International interest is steady to strong.
- NDM West: The market is firm and availability of spot loads is light. Some sellers report delivery of a portion of December contract loads has been delayed until January due to lower than expected production. Reseller inventories are limited. Concerns regarding NDM availability in early 2014 have some buyers reexamining whether to contract NDM. New contracts are locking in NDM at prices that haven't been around since mid to late 2007.
- Cheese Northeast: Cheese production is active, but supplies are being shrunk as cheese makers fill established year end orders. Strong demand in the domestic market parallels cheese exports to various global markets.
- Cheese Midwest: Plants are not anticipating volumes of extra milk for cheese making over the next two holiday weeks commensurate with what has occurred in recent years. Limiting factors mentioned are that Wednesday holidays will lead to less time off for many people, and increased regional drying capacity coupled with strong nonfat dry milk prices is expected to move more milk to dryers than cheese plants.
- At the most recent Global Dairy Trade auction on Tuesday, the price index of all products increased 0.2% from the last auction two weeks ago. Butter led the gains, up 7.9%, while cheddar cheese was up 1.0% to a US-equivalent \$2.07/lb.

Futures Month	Class III 12/20	Class III 12/13	Change	Dry Whey 12/20	Dry Whey 12/13	Change	Cheese 12/20	Cheese 12/13	Change
Dec-13	\$19.03	\$19.02	\$0.01	57.75¢	58.75¢	(1.00¢)	\$1.879	\$1.873	\$0.006
Jan-14	\$19.63	\$18.52	\$1.11	58.50¢	58.75¢	(0.25¢)	\$1.930	\$1.825	\$0.105
Feb-14	\$19.00	\$17.96	\$1.04	61.00¢	59.98¢	1.03¢	\$1.855	\$1.756	\$0.099
Mar-14	\$18.89	\$17.75	\$1.14	60.50¢	60.25¢	0.25¢	\$1.845	\$1.738	\$0.107
Apr-14	\$18.50	\$17.61	\$0.89	60.75¢	59.75¢	1.00¢	\$1.802	\$1.719	\$0.083
May-14	\$18.18	\$17.48	\$0.70	59.50¢	59.15¢	0.35¢	\$1.767	\$1.708	\$0.059
Jun-14	\$17.89	\$17.47	\$0.42	59.00¢	59.25¢	(0.25¢)	\$1.756	\$1.699	\$0.057
Jul-14	\$17.60	\$17.35	\$0.25	58.25¢	58.25¢	0.00¢	\$1.730	\$1.706	\$0.024
Aug-14	\$17.58	\$17.39	\$0.19	57.75¢	57.00¢	0.75¢	\$1.732	\$1.715	\$0.017
Sep-14	\$17.55	\$17.42	\$0.13	57.00¢	57.00¢	0.00¢	\$1.730	\$1.717	\$0.013
Oct-14	\$17.50	\$17.38	\$0.12	56.00¢	55.75¢	0.25¢	\$1.733	\$1.717	\$0.016
Nov-14	\$17.55	\$17.42	\$0.13	56.50¢	56.50¢	0.00¢	\$1.733	\$1.730	\$0.003
12 Mo Avg	\$18.24	\$17.73	\$0.51	58.54¢	58.36¢	0.18¢	\$1.791	\$1.742	\$0.049

- International: Milk production has begun its seasonal upswing in Western Europe, with milk intake volumes up over year ago levels. A number of producers in a number of countries are beyond their production quotas, but supplies are tight for dairy products across the board, making most are willing to pay the levy. The lack of any significant roll back in butter prices, speaks to the strength of export demand with strong sales to Russia. Local demand for butter remains good. Prices for skim milk powder were steady to firm, and appear to be the manufacturers' dairy powder of choice as margins are above whole milk powder. Supplies are very tight in the near term and into the first quarter of 2014. Prices for first quarter sales to Asia and the Middle East were strong.
- International: November milk production in Australia was down 2.9% vs. a year ago, according to Dairy Australia. YTD, milk output is 3.9% lower than the prior milking season. The good weather and margins currently being experienced by dairy producers have brightened the outlook for dairy operations, but there has yet to be seen significant expansion of the dairy herd. Supply availability ranges from tight to very tight across dairy product groups. Russian demand for Australian butter continues to be strong and pushed prices higher. Overall butter supplies are tight, while domestic demand for butter in Australia has been good ahead of the yearend holidays. Very strong demand for SMP, especially from China, has outstripped available supplies and pushed prices higher. Supplies are tight globally with some Oceania manufacturers having fully committed supplies through the first quarter. Oceania cheddar cheese prices moved higher this period as completed negotiations with Japan moved the upper end of the price range higher. The average price for Cheddar reached a US-equivalent of \$2.22/lb. Cheese supplies have tightened in Oceania as some milk volumes have been channeled to whole milk powder production.
- International: Chinese buyers of New Zealand dairy giant's milk powder are trying to diversify their suppliers so they are not reliant on one single source, according to an article this week in the South China Post. This is opening the way for US and European firms to break Fonterra's grip on an infant milk formula market set to double to \$25 billion by 2017.
- International: Milk Specialties' December market report says Chinese demand for dairy continues to be unrelenting. Typically at this time of year, buying slows down as holiday orders are completed, but the realization that high prices may be here to stay has buyers still coming to the market. US manufacturers have turned their focus away from drying NFDN to making SMP in favor of higher world prices. With demand still strong from all major dairy importers, many question whether the forecasted increase in 2014 milk production will be sufficient to replace the dwindling stocks. This suggests that pricing will continue to rise into Q1.
- International: Rural lending specialist Rabobank said it expects world dairy prices to remain at the current elevated levels in 2014 because of ongoing strong demand from China. The increase of export supply since September, as producers have responded to improved margins, has been largely soaked up by China. China continues to buy exceptionally large volumes of product from the international market to supplement falling local milk supply and this is likely to mop up most, if not all, of the increase in exports arising from key surplus regions in the fourth quarter. China's buying has left the rest of the international market with less supply to go round, keeping the market tight. Rabobank believes many of the buyers in regions including South East Asia, the Middle East and North Africa, have used up all the meaningful back-up stocks after a period of prolonged belt-tightening. Rabobank expects a further increase in China's dairy purchases from the world market in 2014.

What's Bearish:

- Livestock Slaughter Report: Dairy cow slaughter for November totaled 249,100 head, down 7.3% vs. a year ago.
- Fluid Milk Southwest: Farm milk production is making a comeback on southwest dairy operations. Cold weather moved out of the region as the polar jet stream shifted to the Northeast, allowing an influx of warmer air. CA milk handlers report more farm loads are being topped off, indicating farm milk production is on the rise. Farm milk production in NM held steady, but AZ milk production benefitted from recent improvements in daytime temperatures. Various Class II and III plant operators report milk supplies are sufficient for production of the last of the holiday-related items.
- International: New Zealand milk production in October was reported by DCANZ at 3,157,000 tons, up 5.4% from October last year and 9.2% higher than two years ago. Weather conditions have held up very well for producers with more than adequate rainfall over recent weeks, making for very good pasture conditions near the midsummer point. The favorable weather and good margins have encouraged producers to extend or expand production where possible, with some sheep and beef farming conversions to dairy. Excellent prices and demand for skim and whole milk powder continue to prompt manufacturers to focus on production of those products, with less fluid milk volumes going to butter and cheddar manufacturing.

Recommendation:

On 11/23 we pondered in our weekly report, "Which side will tip the scales?" international demand or an increase in U.S. milk output. It seems clear, for now, that international demand is winning that battle. While we wouldn't be surprised by a post-holiday correction (we've heard mozzarella is trading at a discount in order to move product), it is likely to be mild. The greater financial return in producing SMP is limiting cheese output around the globe, while gains in milk output east of the Rockies has been slow. It appears both from anecdotal evidence and this week's Milk Production report that feed quality is limiting output gains. And with cow numbers actually trending lower in the U.S. (although we expect that to turn around soon), further increases in milk production will take some time. Tight credit is limiting expansions, while the potential for an increase in interest rates as the Fed tapers its QE program could put highly-leveraged dairies out of business. Feed has gotten cheaper, but it's mainly the corn aspect, while hay and meal remain more expensive. And how long will it take China to rebuild its herd after losing 2 million head? It all adds up in our minds to elevated Class III prices into Q2. With this in mind, we would abandon further sales and switch to PUT-buying mode. The Feb-Jun 17.00 PUT avg is 26¢. Enter orders to buy them at 23¢ avg. If the markets continue to rally, attempt to sell a Feb-Jun CALL option for the same amount. For example, the 21.00 CALLs avg 11¢, but if Class III jumps higher, their value would increase. A producer could enter an order to sell those calls at the same 23¢, and if successful, would "leg" into a fence trade with a 17.00 minimum and 21.00 maximum at net premium cost of zero. Producers who have sold at lower levels should look into buying call options, or bull-call-spreads to capture some upside and enhance their hedges.

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