

**The KDM Dairy Report – January 3<sup>rd</sup>, 2014**

**What's Bullish:**

- Spot Market: Blocks finished the week up 4¼¢ to settle at \$2.04¼/lb but barrels lost 5¢ to close at \$1.92/lb. However, both blocks and barrels rallied on Friday, setting a bullish tone going forward. There were just 2 barrel trades all week, and no block trades. Butter gained 2¢ for the week to settle at \$1.57/lb on 11 trades, while NDM lost 4¼¢ on 10 trades to close at \$2.06¼/lb.
- Cold Storage Report: Butter stocks in November saw the largest monthly drop in 20 years, as holdings fell 33% from October. American cheese stocks saw a more modest 2% decline from October.
- Dairy Products Report: Cheddar cheese output in November was down 3.4% vs. a year ago and down 6.2% from October. Butter output in Nov was down 0.1% and down 2.3% over the same periods. Total cheese output increased 2.4% over last year, helped by a 24% jump in “other cheese types”, but was still down 3.1% from October.
- California is the driest it's been in 136 years, according to an article by Dairyherd. At least 94% of the state is reported in moderate or worse drought, with no relief in sight during the first quarter of 2014. The drought does not bode well for the state's Ag industry. Agricultural customers have been told by the state to expect to receive this year, on average, just 5% of the water they historically request. Last year, customers received 35% of requested supply.
- The coldest arctic outbreak in 20 years is set to hit much of the country this weekend and into next week. Classes at all the state's schools in MN have already been cancelled already by the governor. Dairies from the Midwest to the Northeast will be exposed to the deep freeze, with cows likely expending a lot of energy to keep warm.
- Fluid Milk Central: Colder than normal temperatures and feed quality issues continue to plague milk production rates leaving them stagnant to marginally increasing. Spot load prices on milk picked up a little this week with less than seasonal supplies available. Bottling orders are beginning to pick back up as educational pipelines start to be restocked.
- Fluid Milk West: Processors at butter/powder and cheese operations report milk intakes are receding post-holiday as fluid orders strengthen. CA milk production is unchanged this week. Bottlers are refilling customer outlets as well as resupplying educational institutions for regular operation. A few Western manufacturers indicated availability of spot cream loads was lighter than anticipated in some areas. California spot cream loads were mostly processed in-state.
- Fluid Milk Pacific Northwest: Milk production in the region is mostly unchanged. Milk needed for Class I usage will increase late this week to refill the school milk pipeline. Any surplus milk is being easily handled by manufacturing facilities.
- Butter: Churn operators increased manufacturing rates across the regions as additional cream supplies were available over the holidays. Domestic butter demand has declined somewhat, but international interest is active in the Northeast, picking up in the Central, and good in the West. Inventories continue to be rebuilt throughout the nation after seeing large drawdowns this fall.
- Dry Whey: Inventories in Northeast are fairly tight going into first quarter of 2014. Demand is good as whey remains the lowest priced dairy protein on a per unit basis. In the Central region, some manufacturers are looking to rebuild stocks after cleaning out some inventories over the last few weeks of the year. Demand is steady. In the West, the market tone is steady with some firmness noted. Whey production was up only marginally over the holidays.
- NDM: Supplies remain tight in the Northeast. Domestic demand is variable as most buyers are only buying for immediate needs, but export interest remains active. The market tone is firm in the Central region. NDM inventories are mostly tight, with some manufacturers looking to rebuild stocks. In the West, production has been very active during the last two weeks, but most manufacturers report they have light to nil uncommitted volumes. As December ends, some producers indicate they are behind on contract fulfillment for that month. Bottler demand is reemerging as schools reopen and this is directing some milk volumes away from NDM production.
- Cheese West: Western cheese prices are higher. There is a degree of uncertainty as to market direction this week, but cheese production in the West continues to be limited by tight milk supplies.
- International: China's whole milk powder imports, whose soaring growth in 2013 has been key to supporting dairy prices near record levels, are set to grow nearly as fast in 2014, according to an Agrimony article. China purchased a record-breaking 93,151 metric tons (MT) or 205 million lbs. of whole milk powder (WMP) in November 2013, up 72% from already high import volumes in October 2013 and nearly three times higher than in November 2012. 2014 imports of WMP are forecast to rise another 25%, driven by demand for infant formula and yogurt. At the same time, China's own production is being squeezed by a dearth of capacity, besides domestic milk output growth which is struggling to keep up with consumption expected to rise 6.8% to 38.6m tons next year. Imports of fluid milk itself will grow even faster, by 67% to 300,000 tons, spurred by demand for ultra-high temperature (UHT) treated milk products which are a new trend in first-tier Chinese cities.
- International: A searing heat wave is baking central and northern Australia, piling more misery on drought-hit cattle farmers who have been slaughtering livestock as Australia sweltered through the hottest year on record in 2013. Temperatures have topped 104 degrees in large parts of Australia's key agricultural regions for most of the past week, with the mercury topping 118 degrees in the central west Queensland town of Birdsville. The heat wave is moving east across Australia, prompting health warnings on Friday in some of the country's biggest cities.

Futures Month	Class III 01/03	Class III 12/27	Change	Dry Whey 01/03	Dry Whey 12/27	Change	Cheese 01/03	Cheese 12/27	Change
Jan-14	\$20.06	\$19.48	\$0.58	58.50¢	58.50¢	0.00¢	\$1.980	\$1.920	\$0.060
Feb-14	\$19.68	\$18.78	\$0.90	59.68¢	60.00¢	(0.33¢)	\$1.936	\$1.842	\$0.094
Mar-14	\$19.07	\$18.62	\$0.45	60.93¢	61.00¢	(0.08¢)	\$1.866	\$1.827	\$0.039
Apr-14	\$18.55	\$18.30	\$0.25	60.75¢	60.98¢	(0.23¢)	\$1.806	\$1.792	\$0.014
May-14	\$18.18	\$18.00	\$0.18	59.25¢	59.50¢	(0.25¢)	\$1.785	\$1.761	\$0.024
Jun-14	\$17.96	\$17.85	\$0.11	58.75¢	58.75¢	0.00¢	\$1.765	\$1.745	\$0.020
Jul-14	\$17.72	\$17.63	\$0.09	57.75¢	57.75¢	0.00¢	\$1.734	\$1.736	(\$0.002)
Aug-14	\$17.65	\$17.57	\$0.08	57.50¢	57.75¢	(0.25¢)	\$1.741	\$1.731	\$0.010
Sep-14	\$17.60	\$17.60	\$0.00	57.00¢	56.75¢	0.25¢	\$1.736	\$1.740	(\$0.004)
Oct-14	\$17.62	\$17.57	\$0.05	56.25¢	56.00¢	0.25¢	\$1.740	\$1.741	(\$0.001)
Nov-14	\$17.59	\$17.56	\$0.03	57.00¢	56.50¢	0.50¢	\$1.734	\$1.741	(\$0.007)
Dec-14	\$17.46	\$17.42	\$0.04	56.00¢	56.00¢	0.00¢	\$1.727	\$1.735	(\$0.008)
<b>12 Mo Avg</b>	<b>\$18.26</b>	<b>\$18.03</b>	<b>\$0.23</b>	<b>58.28¢</b>	<b>58.29¢</b>	<b>(0.01¢)</b>	<b>\$1.796</b>	<b>\$1.776</b>	<b>\$0.020</b>

- International: European manufacturing milk supplies are increasing, as producer margins are at levels that encourage milk production and expansion of operations. However, most dairy product supplies are tight going into 2014 with a majority of skim milk and whole milk powder inventories committed through Q1. 82% butterfat averaged a U.S. equivalent \$2.56/lb this week.
- International: Australian milk production for November, according to Dairy Australia, was 2.9% lower than November 2012. July to date totals show Australia down 3.9% with all states below the previous year's production. Dairy product prices have held mostly steady with some underlying firmness seen in skim and whole milk powders. Supplies for most dairy products are tight through the first quarter of 2014. Chinese buyers appear to be on the verge of purchasing Australia's largest privately-owned milk supplier. Other Australian dairy assets have also become targets of possible purchase by Chinese buyers as China looks to expand dairy operations.
- International: Dairy product supplies in New Zealand are viewed as tight with a majority of first quarter production committed. News reports out of China, indicating new regulations imposed by China's Food and Drug Administration may limit domestic milk powder supplies, are giving the dairy markets a firm undertone. The situation in China has increased buying focus on New Zealand's remaining available supplies.

#### What's Bearish:

- Ag Prices Report: The December milk-feed ratio came out to 2.30, the highest level since Sep 2010 and nearly double last Dec at 1.65. Rising milk prices and falling grain prices combined to push the ratio higher.
- Dairy cow slaughter for the week ended 12/21 totaled 61,500 head, down 6,000 head, or 8.9% vs. the same period a year ago. This is the fourth consecutive week of declining cull rates, indicating producers may be hanging on to more cows with improving margins.
- Fluid Milk East: Manufacturing milk volumes have expanded in the Northeast and Mid-Atlantic regions, which is typical over the yearend holidays. Balancing plants are working through the increased volumes with minimal delays. Milk supplies over the holiday period in Florida have brought about the exporting of spot loads. Milder weather has prompted an uptick in milk production. Milk supplies in the Southeast region have also been heavy with most manufacturing plants operating at near capacity levels.
- Cheese Northeast: Cheese production is very active in the region, as cheese makers clear the heavy intake of holiday milk. Inventories are expanding with the increase in production. However, demand is good as cheese makers continue to receive Q1 orders from both domestic and export buyers.
- Cheese Midwest: The market tone is softening with heavy inventories and sluggish sales due to the short holiday week. Many manufacturers took on additional milk supplies last week, but some are cutting back on production levels due to high inventory stocks.
- International: New Zealand milk production continues to pace itself above last year's levels by nearly 6%. The close of the current season should see milk production well above last year's drought stricken finish. The Dairy herd in New Zealand has rebounded from last year's drought with Statistics New Zealand pegging the dairy herd at 6.6 million head, up 27% from 2006.

#### Recommendation:

There was one less trading day this week, with the markets closed on Wednesday for to New Year's, but that didn't slow down the fireworks. A "perfect storm", literally, appears to be brewing in the dairy markets. In addition to the bullish international demand picture, much of the country will be under the deep freeze for the next several days, with some wind chills expected to reach -50 to -60 degrees; seriously dangerous stuff. And while Midwest and Northeast dairies are used to operating in winter environments, this is extreme. The cows will eat a lot of feed but produce less milk as their bodies expend a lot of energy just to stay warm. It's likely that the Central region will continue to struggle building any real milk production increases for the next few weeks. Meanwhile on the other side of the planet, Australia is under the heat lamp, with temps well above 100 degrees. We heard mostly about rough conditions at cattle operations, but believe it is affecting some dairying regions as well. Finally, the drought in California could make running some dairy operations in the state more difficult, if availability of water is restricted. Despite early losses in the spot market and position squaring on Mon and Tue, milk futures came roaring back Thur and Fri as a tight block supply appears to be suggesting the wide block/barrel spread will be corrected with barrels moving higher. Last week's Cold Storage Report and today's Dairy Products Report are both bullish butter and cheese. U.S. butter at \$1.57/lb is a bargain on a world market that is seeking butterfat, priced at \$2.57/lb in the EU. We expect butter prices to continue to gain traction. Likewise, dry whey at roughly 58-60¢/lb is an attractive source of protein when compared to WMP/SMP prices and should see support. Combined with globally tight dairy supplies, some of which are sold out through Q1, it appears Class III futures will end up pricing much higher than just about anyone predicted. Feb Class III settled at \$19.68, up 90¢ for the week, while the Jan-Dec average jumped 23¢ to settle at \$18.26 for the year. Amazing, considering 2013 finished at a \$17.99 average, with many (including us at one point) thinking a wall of milk would arrive in 2014. Coincidentally, the highest annual average on record was 2009, at \$18.37. It's looking more and more likely that record might be smashed! But hang on folks. Before we get too bulled up, remember that prices usually fall when just about everybody is on the band wagon. We're getting pretty close to that now. Hedgers should be protecting these prices. Sell some milk. Buy put options. Get some fences on, but by all means, don't sit on the sidelines, only to watch it go up, and back down. At these levels, the markets will be very nervous, and any indication of demand weakness or production increases may be met, at this point, with limit down moves in the front months. Better to do something now when you can!

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