

The KDM Dairy Report – January 10th, 2014

What's Bullish:

- Spot Market: Blocks gained 15¼¢ on no trades to close at \$2.20/lb while barrels screamed 24¢ higher on just two trades to settle at \$2.16/lb. Butter picked up 10½¢ to close at \$1.67½/lb on 7 trades, while Grade A NDM inched ¼¢ higher to \$2.07/lb on 10 trades.
- Fluid Milk Southeast: Class I demand has had a strong bounce back in Florida as most schools and universities are back in session. The increase in fluid demand has created the need for imports with 22 spot loads this week, vs. 50 loads of exports last week. The Southeast region has also seen a significant increase in Class I demand. Milk supplies are barely adequate to cover fluid demand.

| Futures Month | Class III 01/10 | Class III 01/03 | Change | Dry Whey 01/10 | Dry Whey 01/03 | Change | Cheese 01/10 | Cheese 01/03 | Change |
|------------------|-----------------|-----------------|---------------|----------------|----------------|----------------|----------------|----------------|----------------|
| Jan-14 | \$20.50 | \$20.06 | \$0.44 | 60.00¢ | 58.50¢ | 1.50¢ | \$2.018 | \$1.980 | \$0.038 |
| Feb-14 | \$20.21 | \$19.68 | \$0.53 | 60.70¢ | 59.68¢ | 1.03¢ | \$1.985 | \$1.936 | \$0.049 |
| Mar-14 | \$19.22 | \$19.07 | \$0.15 | 60.65¢ | 60.93¢ | (0.27¢) | \$1.880 | \$1.866 | \$0.014 |
| Apr-14 | \$18.70 | \$18.55 | \$0.15 | 61.28¢ | 60.75¢ | 0.52¢ | \$1.820 | \$1.806 | \$0.014 |
| May-14 | \$18.53 | \$18.18 | \$0.35 | 60.03¢ | 59.25¢ | 0.77¢ | \$1.808 | \$1.785 | \$0.023 |
| Jun-14 | \$18.40 | \$17.96 | \$0.44 | 60.20¢ | 58.75¢ | 1.45¢ | \$1.795 | \$1.765 | \$0.030 |
| Jul-14 | \$18.19 | \$17.72 | \$0.47 | 58.00¢ | 57.75¢ | 0.25¢ | \$1.773 | \$1.734 | \$0.039 |
| Aug-14 | \$18.09 | \$17.65 | \$0.44 | 58.00¢ | 57.50¢ | 0.50¢ | \$1.766 | \$1.741 | \$0.025 |
| Sep-14 | \$18.00 | \$17.60 | \$0.40 | 57.00¢ | 57.00¢ | 0.00¢ | \$1.768 | \$1.736 | \$0.032 |
| Oct-14 | \$17.90 | \$17.62 | \$0.28 | 57.00¢ | 56.25¢ | 0.75¢ | \$1.757 | \$1.740 | \$0.017 |
| Nov-14 | \$17.85 | \$17.59 | \$0.26 | 57.00¢ | 57.00¢ | 0.00¢ | \$1.751 | \$1.734 | \$0.017 |
| Dec-14 | \$17.68 | \$17.46 | \$0.22 | 56.30¢ | 56.00¢ | 0.30¢ | \$1.755 | \$1.727 | \$0.028 |
| 12 Mo Avg | \$18.61 | \$18.26 | \$0.34 | 58.85¢ | 58.28¢ | 0.57¢ | \$1.823 | \$1.796 | \$0.027 |

- Manufacturing supplies have been cut below contract minimums. Good butter demand is helping absorb the excess cream supplies within the region.
- Fluid Milk Central: Subzero temperatures and adverse road conditions created many problems in the Central region the past week. Some of the problems included the following: switching of heat sources at plants, frozen pipes at various facilities, compressors going out at farms, and milk truck breakdowns. Those conditions lead to milk production rates at the farm stalling as cows used more feed energy for body warmth, some dumping of milk as trucks could not make it to the farm or plant, and logistic problems at various plants. Spot loads of milk ranged from Class to \$2.00 over Class as supplies were not readily available. Bottling demand is good as school pipelines were refilled. Class II demand has slowed but is expected to pick up as the Super Bowl is nearing.
- Fluid Milk Southwest: Feed and operating costs continue to weigh on profitability for CA operations. In addition, the California Department of Water Resources issued the first Snow Survey of 2014, showing the statewide snowpack water content at about 20% of normal for this time of year. In NM, milk production is steady to slightly higher but interest from bottlers is active, with some orders for additional standby loads placed early in the week. Farm milk production in AZ is maintaining a gradual upward trend. However, bottlers are drawing strongly on milk supplies.
- Butter: Prices strengthened as the week progressed as bulk butter inventories are tight. Butter production is steady to increasing across the regions with focus on 82% production for export and rebuilding bulk butter supplies. Domestic interest is weakening as holiday print orders are done, but export demand is good given the U.S. price advantage over international prices. Processors are working hard to fill demand.
- Butter consumption has hit a 40-year high, according to a report this week by ABC News. Margarine once was viewed as a healthier, lower-calorie alternative to butter. But margarines typically contain trans fats, which research has shown to increase the risk of heart attack. Butter's freedom from trans fats has seen it gain ground on its main rival.
- Dry Whey: In the Northeast, prices for dry whey are firm due to higher spot prices and indices. Production of dry whey is mixed in the region as manufacturing interruptions, resulting from severe winter snow storms, limit volumes at some plants. Demand for dry whey is good with active domestic and export interest. The market undertone is firm. In the Central region, the market tone is firming as some end users are finding it difficult to locate product. The subzero temperatures created some implications for a few manufacturers as they had to switch heat sources, frozen pipes, and periods where dryers were shut down. End users received delayed loads due to trucking issues from the road conditions and temperatures. Demand for dry whey is good domestically, but export interest is sluggish. In the West, dry whey prices are higher for the first full week of the New Year. Firm dairy protein prices and strong export demand is helping to raise the market. Whey production is being limited by lower cheese production and competition from concentrated whey products.
- NDM: The market tone is firm as manufacturers are busy restocking and fulfilling contracts. Domestic demand is good and international interest is active. Various buyers indicate they have been unable to build inventories prior to the end of the year, and F.O.B. spot loads remain tight.
- Cheese Northeast: Winter storms and arctic temperatures limited vat volumes for cheesemakers in some areas. Other plants are running heavy production schedules as inventories are being rebuilt. Demand is good.
- Cheese Midwest: Cheddar interest is hot. Some manufacturers report selling extra loads last week into this week, with inquiries for extra loads into next week as well. A number of plants report that milk production has been steadily increasing on a daily basis for about two weeks - until this week's extremely cold weather. Cheese manufacturers asked to comment noted that they had opted to sell some milk during November rather than make cheese.
- Cheese West: The market tone is firmer overall as tight supplies are limiting spot sales. Production in the West is lower this week with a plant down for scheduled maintenance.
- Cheesepocalypse! In a story widely distributed by the AP this week, Kraft Foods confirmed a Velveeta shortage, just as high demand from the NFL playoffs kicked into gear. Apparently a combination of manufacturing challenges and increased sales are to blame. Last year sales of Velveeta cheese increased 23.7%!
- This week's Global Dairy Trade auction saw the dairy price index decline 0.8% from the prior auction two weeks ago. However, cheddar prices increased 1.9% to a U.S. equivalent \$2.11/lb and butter jumped up 5.1% to a U.S. equivalent \$1.92/lb.
- Exports: According to the Foreign Agricultural Service, exports of butter during November 2013 totaled 19.8 million pounds, a 215% increase from a year ago. Exports of butter and milkfat for January-November 2013 total 180.1 million pounds, up 81% from the same period a year ago.

Exports of cheese and curd for January-November 2013 total 629.3 million pounds, up 19% from the same period a year ago. Cheese and curd exports for the period account for 6.2% of U.S. cheese production. Exports for November 2013 totaled 62.7 million pounds and are 54% higher than a year ago.

What's Bearish:

- Fluid Milk Northeast: Manufacturing milk supplies are heavy coming off the holiday period in the Northeast and Mid-Atlantic regions.
- Fluid Milk Southwest: Farm milk production is strengthening seasonally across the Southwest. Fluid orders are active, with some milk handlers responding to bottlers' orders from outside the Southwest. Dairy processors in CA report farm milk production and pickup volumes are maintaining a slow upward trend.
- Fluid Milk Pacific Northwest: Milk production in the region is showing some improvement as milk totals are finally moving off of seasonal lows. Weather conditions are not causing any difficulties in either moving milk or stressing of dairy cows. UT and ID milk production is mostly steady to increasing slightly.
- Cheese: Higher spot prices this week are putting a damper on export and domestic sales.

Recommendation:

Wowza! Cash cheese took the spotlight this week as suddenly sellers disappeared. On just two trades for the week, barrels raced 24¢ higher while blocks gained 15¼¢ on zero trades. Class III futures exploded higher, though after two days of the spot market stalling, they came off their mid-week peaks. Cheese prices are now at six-year highs and well over \$2/lb, a price that has historically been difficult to maintain. Indeed, USDA updates this week indicate some price resistance out there. We wouldn't be surprised to see buyers catch their breath next week, and for sellers to take the opportunity to sell \$2+ cheese, but the tight supply of fresh cheese and lower manufacturing output is likely to persist for a while, maybe well into Q1. How could \$2 cheese be sustained so long? Domestic milk production has yet to respond much and international demand remains strong. November exports were simply amazing. Cheese shipments reached a record high, NDM/SMP sales topped 45,000 tons of the eighth straight month and total dairy exports were up 29% vs. Nov '12. On a total solids basis, exports were equivalent to about 15.5% of U.S. milk production in November. Current spot prices work out to about \$22.25 Class III. With the Feb Class III contract set to start pricing in a week, if spot cheese prices hold or move higher, the Feb and Mar milk contracts will likely make another leg higher with it. Of course, a setback in prices will shake the market lower as well. We're up in nose-bleed numbers and traders (and hedgers) are understandably nervous in this uncharted paradigm. We wouldn't sell any Q1 milk here, but consider entering the following target orders to get a floor price established: Buy the Feb 19.50 PUT for 15¢ or better, the Mar 18.50 PUT for 20¢ or better and the April 17.75 PUT for 22¢ or better. Hang on for more excitement next week!

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