

**The KDM Dairy Report – January 17<sup>th</sup>, 2014**

**What's Bullish:**

- Spot Market: Butter rocketed 17¼¢ higher for the week to settle at \$1.85¼/lb on just 3 trades. Block cheese gained 3¢ to \$2.23/lb on no trades, while barrels were up 4¼¢ to \$2.20¼ on only 3 trades. Grade A NDM picked up 2¼¢ to settle at \$2.09¼/lb on 9 trades.
- Livestock, Dairy & Poultry Outlook Report: USDA increased their 2014 milk production forecast, but also increased their Class III price forecast by 75¢/cwt from last month, to \$18.20/cwt. Robust international demand for cheese, butter and powder was the reason cited.

Futures Month	Class III 01/17	Class III 01/10	Change	Dry Whey 01/17	Dry Whey 01/10	Change	Cheese 01/17	Cheese 01/10	Change
Jan-14	\$20.94	\$20.50	<b>\$0.44</b>	60.38¢	60.00¢	<b>0.38¢</b>	\$2.059	\$2.018	<b>\$0.041</b>
Feb-14	\$21.92	\$20.21	<b>\$1.71</b>	63.75¢	60.70¢	<b>3.05¢</b>	\$2.130	\$1.985	<b>\$0.145</b>
Mar-14	\$20.49	\$19.22	<b>\$1.27</b>	64.00¢	60.65¢	<b>3.35¢</b>	\$1.986	\$1.880	<b>\$0.106</b>
Apr-14	\$19.55	\$18.70	<b>\$0.85</b>	64.00¢	61.28¢	<b>2.73¢</b>	\$1.885	\$1.820	<b>\$0.065</b>
May-14	\$18.99	\$18.53	<b>\$0.46</b>	64.00¢	60.03¢	<b>3.98¢</b>	\$1.833	\$1.808	<b>\$0.025</b>
Jun-14	\$18.74	\$18.40	<b>\$0.34</b>	63.00¢	60.20¢	<b>2.80¢</b>	\$1.813	\$1.795	<b>\$0.018</b>
Jul-14	\$18.40	\$18.19	<b>\$0.21</b>	62.00¢	58.00¢	<b>4.00¢</b>	\$1.795	\$1.773	<b>\$0.022</b>
Aug-14	\$18.30	\$18.09	<b>\$0.21</b>	60.98¢	58.00¢	<b>2.98¢</b>	\$1.783	\$1.766	<b>\$0.017</b>
Sep-14	\$18.20	\$18.00	<b>\$0.20</b>	59.00¢	57.00¢	<b>2.00¢</b>	\$1.784	\$1.768	<b>\$0.016</b>
Oct-14	\$18.00	\$17.90	<b>\$0.10</b>	58.50¢	57.00¢	<b>1.50¢</b>	\$1.770	\$1.757	<b>\$0.013</b>
Nov-14	\$17.86	\$17.85	<b>\$0.01</b>	57.50¢	57.00¢	<b>0.50¢</b>	\$1.765	\$1.751	<b>\$0.014</b>
Dec-14	\$17.75	\$17.68	<b>\$0.07</b>	57.13¢	56.30¢	<b>0.83¢</b>	\$1.752	\$1.755	<b>(\$0.003)</b>
<b>12 Mo Avg</b>	<b>\$19.10</b>	<b>\$18.61</b>	<b>\$0.49</b>	<b>61.19¢</b>	<b>58.85¢</b>	<b>2.34¢</b>	<b>\$1.863</b>	<b>\$1.823</b>	<b>\$0.040</b>

- Fluid Milk East: While Northeastern manufacturing milk volumes remained fairly heavy, supplies declined this week in the Mid-Atlantic region as increased Class I demand reduced milk volumes going to balancing plants. Class I demand is strong in Florida with increased milk volumes being channeled to bottling plants as school and university consumption increases. Imported spot shipments increased this week to 88 loads, up from 22 last week and 43 a year ago. Class I demand has increased significantly in the Southeast as schools reopen and retailers restock following recent storms. The increased demand has reduced milk volumes going to manufacturing plants. Cream supplies are less burdensome this week as Class II demand has significantly increased. Any surplus cream supplies are staying in region as butter makers are more than willing to absorb the excess supplies.
- Fluid Milk Central: Milk production rates in the Central region are coming back as feed quality and temperatures have improved, however, the growth has not been as big as expected for the current time for most areas. The milk supplies have not been as loose as years past at this point. Bottling demand is very good with larger orders and good sales. Ice cream production is starting to pick up some. Ice cream makers are starting to have some concerns about butter prices. Cream demand increased some with most of the demand from butter churn operators. Cream supplies were not quite as plentiful as the last few weeks. Condensed skim is moving rapidly with good demand shown.
- Fluid Milk West: Farm milk production in CA is trending steady to higher, and a few processors report recent upticks in milk intakes surpassed expectations. However, dairy producers are still facing financial challenges in handling upcoming operating costs. Forages are available, but California's 2013 alfalfa/mixture hay harvested acres decreased by 50,000 acres to 900,000 acres; 2013 yields decreased from 2012's 6.9 tons/acre to 6.8. Concerns about water availability, sources, and costs are also rising.
- Butter Northeast: Butter production is reasonably active with some buttermakers rebuilding inventories for the spring. Butter demand is good with adequate buyer interest for both domestic retail and 82% export sales.
- Butter Central: Manufacturers who have the capabilities of producing 82% bulk butter are busy fulfilling international orders. Export sales are good but may take a step back as the U.S. price increases. The market tone is firm to higher. Cream supplies were not as plentiful as last week, reducing churn rates for some butter churn operators. Domestic print sales have held up behind moderate to good demand. Print inventories are adequate while bulk butter stocks are tight. Buyers are not finding any discounts on bulk butter as prices ranged flat to 6¢ over the market.
- Butter West: Manufacturers are reporting tighter than usual inventories for this time of year. Much of the current production is geared towards contract fulfillment of bulk butter for export markets. Print butter demand for domestic use has slowed, but is often above expectations. Cream supplies are increasing slowly, but butter demand and orders continue to clear product at a fast pace.
- Dry Whey Northeast: Prices are higher this week despite the fact that production has increased. Inventories are sufficient for contracted amounts, but good domestic demand is limiting spot sales.
- Dry Whey Central: Prices increased behind higher premiums in F.O.B spot market trading along with various new contract pricing and averages used. The market tone is firm with tight spot load availability as contract volume amounts mostly increased. Production rates are recovering from last week's cold weather, but domestic demand picked up this week with a good push for product.
- Dry Whey West: Prices are higher and the market tone is firm as alternate dairy protein prices continue strong. Whey production is mostly steady as manufacturers balance production to meet projected domestic needs and export sales. Demand for whey is good for available spot offerings, although higher prices have reduced some interest above immediate needs. Dry whey stocks are adequate for needs, but supplies are described as tight in many cases.
- NDM East: Production was mixed with heavier production schedules in the Northeast, while Mid-Atlantic production declined in some areas, due to strong Class I demand reducing manufacturing milk volumes. Domestic demand is hesitant as some buyers feel the market is nearing its peak and are cautious to purchases at current prices. But good global demand for milk powders is adding to nonfat dry milk export interest. The market undertone is steady to firm.
- NDM Central: The market tone is firm with many buyers purchasing with a hand to mouth approach to see what the market does. NDM production rates are steady with some tapering off from increased holiday levels. Supplies are tight.
- NDM West: Prices in the West are unchanged to higher on a firm market. Some market participants anticipate a reversal in market direction in the near term for low/medium heat nonfat dry milk, but others point to continued strength. They cite the following points: decreased production in the Central/East, lower U.S. NDM production through November 2013 compared to 2012 as some manufacturers focus instead on skim milk powder production, recently announced tenders for NDM/SMP, and uncontracted NDM needs for February-March 2014 and beyond.

- Cheese East: Production is increasing along with milk supplies, but it's more a case of manufacturers trying to restock their inventories in anticipation of Super Bowl weekend activities. Inventories are currently light but adequate to the level of meeting contractual commitments. Demand is very good, with increased domestic retail interest and a steady export market. The market tone is firm.
- Cheese Midwest: Last week's significant increase in CME prices has not led to appreciable increased production by Midwest cheese manufacturers. Yes, some plants have notched production up marginally, seeking extra milk and also leading to increased demand for condensed skim used to fortify vats. However, other plants are selling milk in lieu of expanding cheese production and drawing down inventories to meet orders.
- International: Dairy product market activity has increased going into 2014. Demand is good for most products. Though production of SMP has expanded, inventories remain tight with most supplies in Q1 committed, while global demand is very strong. Russian demand for butter, cheddar cheese and whey is providing export opportunities for Eastern manufacturers. Russia has begun to lift its ban on Lithuanian dairy products.
- International: Australian milk production has begun to decline at an accelerated pace as Victoria, South Australia and portions of New South Wales are in the midst of an intense heat wave. Temperatures well over 100 degrees Fahrenheit are lowering cow comfort levels and impacting milk production. The current heat wave has caused numerous fires and once green pastures will soon yellow and wither without additional rains or irrigation. Production of all dairy products has slowed as milk volumes have declined. A majority of available supplies of dairy products for the first quarter are committed with premiums required to secure spot loads in the near term. Export interest remains strong, especially for skim and whole milk powders. China continues to be very active in the various dairy powder markets as they try to offset their domestic milk production shortfalls.
- International: In New Zealand, market activity and trading has increased following the yearend holidays with good interest coming from China and Southeast Asia. Most dairy product manufacturers are attempting to build inventories of dairy products to cover needs over the carryover period, which is typically June, July and August.

#### What's Bearish:

- Weekly cold storage numbers indicate butter stocks at USDA-selected storage centers increased 14% over the period 01/01 through 01/13. Cheese stocks over the same period were unchanged.
- Fluid Milk Southwest: Farm milk production in NM is steady, while sales into Class I slowed as bottlers caught up on restocking in-store coolers. Other fluid account managers pushed back milk loads to handle maintenance issues. Some out-of-state milk loads cleared into NM, seeking manufacturing capacity. AZ milk production is trending higher with the help of comfortable weather. Fluid orders retreated to post-holiday norms.
- Fluid Milk Pacific Northwest: Milk production in the region is increasing along seasonally expected volumes. Moderate winter temperatures and lower feed costs are helping to increase production in the region. Lack of significant snowfall is becoming more of a concern as reservoirs are at reduced levels for next year's irrigation needs. Higher pay prices on milk are encouraging dairies to increase herd size.
- Cheese West: The market tone remains steady to firm this week, but cheese production is mostly steady to higher as milk supplies in the West slowly increase. Some plants with slower sales are willing to turn milk back to manage inventories. The sharply higher prices met with increased resistance as buyers looked to limit spot purchases.
- Cheese: Many manufacturers report that while orders are being filled, retail demand this week is low or slow, with retailers generally buying to fill immediate needs. Many retailers are wary of building inventory at the new higher price basis.
- International: Milk production in Europe is increasing at accelerated levels, due to good milk prices and margins, mild weather, and expanding herds in some countries. Milk production totals for November 2013 showed year over year increases of 3.8% for France and 19.7% for Ireland. For December, the UK realized a 10.7% increase above the previous year. Producers in some countries are going over quota levels and willing to pay the levy rather than reduce production. Prices and demand on the liquid market have weakened following the yearend holidays.
- International: New Zealand milk production continues to show projected increases of 6% or better over last year's drought shortened production season. Since the New Year, a fair amount of rain has covered most of New Zealand, keeping a majority of pastures in good condition.

#### Recommendation:

The spot market was wild again this week as the cheapest fat, butter, caught a bid. With world butter prices trading well north of \$2/lb, U.S. butter is seen as cheap. While we eat a different spec; 80% vs. 82%, fat is fat and in a world that is tight dairy products, it had to come up. Likewise, dry whey has been a bargain protein source, hovering between 55-60¢ for what feels like a year. But on Friday, futures broke solidly above 60¢. With Super Bowl around the corner, from a product ordering standpoint, it appears as if fresh cheese is still in strong demand. But with blocks no pricing north of \$2.20/lb, we are hearing of more pushback on price. There's just no way demand won't be hurt, eventually. The big question is how long can we sustain current levels? Feb Class III futures begin pricing next week and settled at \$21.92 today. But current spot prices work out to about \$22.85, so it is still trading nearly \$1 discount. With this week's gains in spot butter, Class IV has reasserted itself as the Class leader, pricing at about \$23.95. If spot prices hold or go higher next week, Feb, despite tacking on a \$1.71 gain this week, will be forced to go even higher to close the spread. But folks, we're well into nosebleed prices here. The 2014 avg settled at \$19.09 (that is not a typo!). Can you afford to do nothing here? While the front months continue to make new record highs, producers should be looking to lock in some profit at these levels. Protect the front months with cheap PUT options. We got our Feb 19.50 puts for 12¢ this week. Go for the Mar 19.00 and April 18.50 PUTs for 15-20¢ with target orders. Look at putting on a fence (min/max) trade July-Dec. These months will be most vulnerable to higher milk production levels should producers respond to these great margins.

**Note:** Our offices will be closed on Monday in observance of Presidents day. U.S. financial markets will be closed.

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