

The KDM Dairy Report – January 24th, 2014

What's Bullish:

- Spot Market: Blocks moved 8¢ higher to a new record \$2.31/lb on just 2 trades, while barrels gained 7¼¢ to \$2.27½/lb on no trades. Butter increased 3¼¢ to \$1.89/lb on big volume of 24 trades, but Grade A NDM lost 4¼¢ to \$2.05/lb, also on large volume of 25 trades.
- Cold Storage Report: Butter stocks in December were down 27% vs. a year ago and down 8% from Nov. Usually butter stocks build from Nov to Dec. American cheese stocks were down 3% vs. last year, while total cheese stocks were off 1%.
- Milk Production Report: December milk output in the U.S. was flat vs. a year ago, according to USDA, and cow numbers were down 12,000 head vs. last Dec. Milk per cow was also unchanged. Increases were noted in the western states with UT up 6.7%, CO up 4.4%, KS up 4.1%, while CA notched a 1.6% gain. However, states in the Midwest were lower, with IL down 7.7%, MO down 6.1%, OH down 3.5%, MN down 2.5% and WI down 1.9%. Total milk cows did increase 2,000 head for the first time in 4 months, however, perhaps indicating a build in herd size has begun.

| Futures Month | Class III 01/24 | Class III 01/17 | Change | Dry Whey 01/24 | Dry Whey 01/17 | Change | Cheese 01/24 | Cheese 01/17 | Change |
|------------------|-----------------|-----------------|---------------|----------------|----------------|----------------|----------------|----------------|----------------|
| Jan-14 | \$21.05 | \$20.94 | \$0.11 | 59.70¢ | 60.38¢ | (0.67¢) | \$2.072 | \$2.059 | \$0.013 |
| Feb-14 | \$22.45 | \$21.92 | \$0.53 | 62.70¢ | 63.75¢ | (1.05¢) | \$2.190 | \$2.130 | \$0.060 |
| Mar-14 | \$20.47 | \$20.49 | (\$0.02) | 63.10¢ | 64.00¢ | (0.90¢) | \$1.982 | \$1.986 | (\$0.004) |
| Apr-14 | \$19.44 | \$19.55 | (\$0.11) | 63.00¢ | 64.00¢ | (1.00¢) | \$1.880 | \$1.885 | (\$0.005) |
| May-14 | \$19.06 | \$18.99 | \$0.07 | 62.00¢ | 64.00¢ | (2.00¢) | \$1.853 | \$1.833 | \$0.020 |
| Jun-14 | \$18.75 | \$18.74 | \$0.01 | 61.25¢ | 63.00¢ | (1.75¢) | \$1.830 | \$1.813 | \$0.017 |
| Jul-14 | \$18.47 | \$18.40 | \$0.07 | 59.75¢ | 62.00¢ | (2.25¢) | \$1.822 | \$1.795 | \$0.027 |
| Aug-14 | \$18.32 | \$18.30 | \$0.02 | 59.00¢ | 60.98¢ | (1.98¢) | \$1.800 | \$1.783 | \$0.017 |
| Sep-14 | \$18.29 | \$18.20 | \$0.09 | 58.00¢ | 59.00¢ | (1.00¢) | \$1.800 | \$1.784 | \$0.016 |
| Oct-14 | \$18.03 | \$18.00 | \$0.03 | 57.50¢ | 58.50¢ | (1.00¢) | \$1.782 | \$1.770 | \$0.012 |
| Nov-14 | \$17.85 | \$17.86 | (\$0.01) | 57.25¢ | 57.50¢ | (0.25¢) | \$1.765 | \$1.765 | \$0.000 |
| Dec-14 | \$17.62 | \$17.75 | (\$0.13) | 57.13¢ | 57.13¢ | 0.00¢ | \$1.743 | \$1.752 | (\$0.009) |
| 12 Mo Avg | \$19.15 | \$19.10 | \$0.05 | 60.03¢ | 61.19¢ | (1.15¢) | \$1.877 | \$1.863 | \$0.014 |

- Fluid Milk Northeast: A winter storm covering the Mid-Atlantic and the coastal regions of the Northeast prompted increases in Class I demand and lowered manufacturing milk supplies in both regions. Dairy product retail sales have increased as consumers stock up in preparation for the extreme cold air mass that is forecast to move into both regions.
- Fluid Milk Central: Central milk production levels increased minimally this week, the extreme cold weather has kept rates below forecast levels. Many farm producers have been busy working with their nutritionists to figure out ways of improving rations to make up for forage quality deficiencies. Spot loads of milk are tough to come by and range from \$0.50 to \$2.00 over Class when secured. Bottling sales are good, exceeding some processors' expectations. Class II demand is improved as retail stores stock up for seasonal Super Bowl products. Butter makers are churning at higher levels, resulting in tighter than normal seasonal cream supplies. Condensed skim demand is very good with bakeries and candy industries building inventories and some cheese manufacturers taking on extra supplies.
- Butter Northeast: Production is active, with substantial cream supplies supporting heavy churning in the region. Current orders are being filled as most buttermakers look to rebuild inventories. Domestic demand is good, comparably, export of 82% unsalted butter remains active. The market undertone is firm.
- Butter Central: Butter makers in the region are doing their best to keep up with strong export sales and good domestic print orders. The market tone is firm with little excess butter available. Butter production rates remain high as many churn operators are running near full capacity. Production of 82% is the main focal point for many butter manufacturers. A few butter makers are worried the higher prices may reduce domestic consumption rates. Print butter inventories are low and bulk butter suppliers are limited.
- Butter West: The market remains strong with tighter than expected inventories. Cream supplies are increasing seasonally, but are often below expectations. Good export demand continues to pull production away from the building of inventories.
- Dry Whey Northeast: Prices moved higher for the third consecutive week. Production is mostly steady with recent weeks, but the severe winter weather this week did cause some periodic interruptions in cheese/dry whey production. Demand activity is best for export, while domestic buyers are a little more cautious.
- Dry Whey Midwest: The market tone is getting firmer as supplies are becoming harder to find and no discounts have been available. Dry whey production levels are steady, but some manufacturers are worried that the higher cheese prices may result in reduced production rates. Dry whey manufacturers and resellers are receiving additional inquiries for product domestically and international demand is good. Many manufacturers are in sold out positions.
- Dry Whey West: Prices are mostly steady to higher with a firm undertone. Whey production is increasing seasonally with higher cheese output, but domestic demand is good and export interest and overall high protein prices have firmed international demand.
- NDM East: Nonfat dry milk production volumes are affected at some plants by the funneling of milk supplies to Class I operations, as consumer dairy retail purchases increase in response to winter weather conditions. Nonfat dry milk inventories are tight, with some manufacturers shipping loads immediately upon clearance. Demand is active for export markets, moderate for domestic accounts. The market tone is steady to firm.
- Cheese Northeast: Cheese production schedules are steady while inventories are suitable for current orders as most manufacturers replenish their stocks. Demand for cheese is uneven, but the market tone remains firm.
- Cheese Midwest: Continuing cheese price increases at the CME to unusually high levels, coupled with price strength for butter and nonfat dry milk, leave little precedent to guide manufacturers or buyers. In almost every dimension of the markets, there are parties doing contrary things. Cheese plant operators are both buying spot loads of milk to increase production while others sell milk from contracted supplies to reduce production. Sales to retailers are described by some plants as good, but weak by others. Export sales are strong for some plants, weak for others. Some manufacturers with export orders are surprised at the strength of Mozzarella exports. There seems to be some strength in buyers looking for bulk cheese.

- Cheese West: Tighter than expected supplies have cheese manufacturers filling contracted orders with little to offer to the spot market. Good export sales into the first quarter of 2014 are keeping inventories from building in some cases.
- Cheese US: Cheese production is mixed across the country as record high cheese prices have buyers and sellers trying to develop new strategies. While milk supplies are increasing seasonally, the increases are not moving solely to cheese manufacturers. Class IV interest continues to pull milk away from cheese plants. The higher prices have reduced some domestic cheese demand. Very good export sales, often made last year and being delivered in the first quarter of 2014, are keeping supplies of cheese tight.
- Glanbia, the largest cheese producer in the U.S., is cutting about 50 employees in Idaho due to a drop in their milk supply, according to a news article this week.
- International: The surge in China's demand for dairy is set to continue in 2014, according to Rabobank analysts. China's attempt to phase out small-scale farming units with 100 cows or less and convert to larger-scale production operations is expected to continue to limit the domestic supply. Rabobank estimates it could take more than three years for this process to complete.
- International: Milk powder supplies are still not keeping up with the needs of Hong Kong residents, according to an article this week in the South China Morning Post. Shortages of infant milk powder are still plaguing many areas of the city a year after an export limit was introduced, with popular brands unavailable in 90% of stores in some districts. The root of the problem is the lack of supply from infant formula manufacturers.
- International: This week's Global Dairy Trade auction saw the GDT Price Index increase 1.4% to a new record high. The biggest gainers were butter, up 10.8% to a US-equivalent \$2.11/lb and Cheddar cheese, up 10.4% to a US-equivalent \$2.33/lb.

What's Bearish:

- Weekly cold storage numbers indicate butter stocks at USDA-selected storage centers have jumped 34%, or 2.6 million lbs, over the period 01/01 through 01/20. Cheese stocks are up 4%, or 4 million lbs over the same period.
- Dairy cow slaughter for the week ended 01/11 totaled 59,400 head, down 18% vs. the same period a year ago.
- Livestock Slaughter Report: 256,700 head of dairy cows were removed from the milking herd in December, down 0.81% vs. a year ago.
- Fluid Milk Southeast: Class I demand has leveled off in Florida and reduced imported spot loads to 43 this week. Florida weather conditions are good and increasing cow comfort levels, prompting an uptick in milk production. Southeast milk supplies are more than adequate to meet fluid demand. Manufacturing milk volumes have seen some marginal increases. Cream supplies are adequate to cover needs with butter manufacturers happy to receive any additional loads.
- Fluid Milk West: Farm milk production in CA continues to trend higher. Manufacturing plants within the state are processing milk intakes on a timely basis, even as intakes make weekly volume gains. Some milk handlers relate the recent farm milk increases to herd growth as well as seasonality. Milk processors in NM report intakes are stepping higher from week to week, buoyed by comfortable temperatures and low humidity. Manufacturing plant operators from cheese and butter/powder facilities report intakes are building steadily as farm milk production increases and demand from Class I declines. AZ farm milk production is climbing steadily. With lighter demand coming from bottlers, and despite the higher demand from Class II, many processors are experiencing improving availability of manufacturing milk.
- Fluid Milk Pacific Northwest: Milk production in the region is increasing along seasonally expected lines. With good demand for processed dairy products, manufacturers are anxious for any increased production. Temperatures in the region are favorable. UT and ID milk production is increasing as mild winter weather has had little adverse effects on dairies. Lower feed costs have helped to improve profitability for dairies. High cull cow prices are another positive factor. Milk processing capacity in the region is well above current production levels. Processors are hoping dairies will increase herd sizes as a way to further increase milk volumes.
- NDM Central: The market tone is firm, but seeing some hesitations from buyers as they are unsure what the market will do. Production levels of low/medium heat NDM are steady. Demand for domestic product is moderate, but not as aggressive as previous weeks. International interest is good and has expectations of picking up some strength as a few countries come back to the market. Some manufacturers have improved working low/medium heat inventories with others in sold out positions.
- NDM West: The NDM market is steady to firm, but a few resellers report North American spot market demand slacked off at the end of last week. NDM manufacturers report the seasonal declines in bottling demand and the upticks in milk production are sending higher milk volumes through the dryers. A few brokers report receiving resale offers at close to the current market from other brokers, which may indicate those with holdings beyond near term needs may be trying to rebalance inventories.

Recommendation:

After starting the week strong, Class III futures finished the week mix. The GDT auction got things going with both butter and cheddar cheese up big, but after spot cheese eclipsed the previous all-time high, the market appeared a lot more tentative and nervous. Milk production is seeing slow but steady gains in the West, but is flat in the Midwest. And the gains out West aren't going straight to cheese, but to dryers as well. In the near term, international demand is not letting up, keeping fresh cheese on the tighter side. The biggest pizza delivery day of the year is soon approaching as well. We think prices can stay here for a while, but at these prices the market will remain nervous. Our cheese prices have lost their competitive advantage vs. the rest of the world, and while they may be justified, buyers aren't too happy about them. Cheese plants too have concerns about losing market share to "house" brands as consumers become more sensitive to price. Some plants are reducing cheese output, not wanting to get stuck with high-priced inventory, while others are increasing output, apparently able to move product at these levels. Despite strong beef prices, culling is down. With replacement heifers on the tight side, producers may be attempting to increase their herds by hanging on to their animas longer with these good margins. Hedgers should continue to protect the front months with cheap PUT options. Buy the March 19.00 PUT at 24¢ and the April 18.00 PUT at 28¢. Consider flat out selling May over \$19.00. Ask yourself if we're still going to be over \$1.90 cheese in May. Perhaps. Perhaps not. June hit a high of \$19.00 on Friday. We'd sell that too if it recovers. Expect more wild price swings both up and down next week. Spot prices work out to about \$23.55. With one week under its belt at \$23+, should spot prices continue to hold or go higher, Feb Class III futures, currently trading at nearly \$1 discount, will be forced higher.

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