

**The KDM Dairy Report – February 7<sup>th</sup>, 2014**

**What's Bullish:**

- Dairy Products Report: Cheddar cheese output in December was down 2.8% vs. a year ago, according to USDA. Total cheese output was up 2.3%, but mostly from Italian varieties with short shelf lives. Butter output fell 6.9% from Dec 2012, while NDM production was down 20.8%.

Futures Month	Class III 02/07	Class III 01/31	Change	Dry Whey 02/07	Dry Whey 01/31	Change	Cheese 02/07	Cheese 01/31	Change
Feb-14	\$22.87	\$23.11	(\$0.24)	62.73¢	62.73¢	0.00¢	\$2.255	\$2.271	(\$0.016)
Mar-14	\$20.72	\$21.47	(\$0.75)	61.50¢	61.50¢	0.00¢	\$2.037	\$2.101	(\$0.064)
Apr-14	\$19.44	\$20.04	(\$0.60)	60.00¢	62.50¢	(2.50¢)	\$1.906	\$1.956	(\$0.050)
May-14	\$18.81	\$19.20	(\$0.39)	59.00¢	60.75¢	(1.75¢)	\$1.857	\$1.875	(\$0.018)
Jun-14	\$18.78	\$18.88	(\$0.10)	58.50¢	61.00¢	(2.50¢)	\$1.850	\$1.850	\$0.000
Jul-14	\$18.82	\$18.73	\$0.09	58.00¢	59.55¢	(1.55¢)	\$1.854	\$1.836	\$0.018
Aug-14	\$18.70	\$18.64	\$0.06	57.70¢	59.00¢	(1.30¢)	\$1.849	\$1.830	\$0.019
Sep-14	\$18.58	\$18.46	\$0.12	57.40¢	58.00¢	(0.60¢)	\$1.840	\$1.812	\$0.028
Oct-14	\$18.27	\$18.17	\$0.10	56.50¢	57.00¢	(0.50¢)	\$1.810	\$1.796	\$0.014
Nov-14	\$17.96	\$17.94	\$0.02	56.00¢	57.00¢	(1.00¢)	\$1.784	\$1.773	\$0.011
Dec-14	\$17.74	\$17.70	\$0.04	56.00¢	56.80¢	(0.80¢)	\$1.767	\$1.753	\$0.014
Jan-15	\$17.44	\$17.46	(\$0.02)	55.00¢	50.00¢	5.00¢	\$1.765	\$1.765	\$0.000
<b>12 Mo Avg</b>	<b>\$19.01</b>	<b>\$19.15</b>	<b>(\$0.14)</b>	<b>58.19¢</b>	<b>58.82¢</b>	<b>(0.63¢)</b>	<b>\$1.881</b>	<b>\$1.885</b>	<b>(\$0.004)</b>

- Fluid Milk East: The Southeast region is experiencing yet another severe winter storm. Milk transports are experiencing delays and logistic problems with bottling plants being shorted loads. This situation is occurring, as many bottlers and manufacturers were playing catch-up after last week's storm. Portions of the Mid-Atlantic and Northeast regions are also experiencing numerous weather related problems, causing interruptions in manufacturing schedules. Class I demand is strong as retailers are experiencing runs on dairy products.
- Fluid Milk Central: Cold weather continues to take a toll on the cows in the region as milk production is flat to marginally higher. Spot milk prices ranged a little more than Class to \$2.25 over Class. Bottling demand was higher earlier in the week as processors prepared for weather forecasts of snow and icy conditions Tuesday into Wednesday. Demand for yogurt has picked up.
- Dairy Market News reports The California Department of Water Resources recently announced that, except for a small amount of 2013 carryover water, customers of the State Water Project may not get water deliveries if the current water shortage persists. Deliveries to agricultural districts that hold water rights in the Sacramento Valley, may be cut by up to 50%. Anecdotal reports indicate some dairy producers in the state are concerned about overall feed availability for the upcoming year. This concern centers on alfalfa/mixed hay, but extends to other feedstuffs that are often used in California dairy rations. Some of these byproduct feedstuffs may be in reduced supply due to the current water shortage.
- Butter Central: The U.S price advantage compared to Oceania and European prices continues to facilitate good export sales as butter manufacturers are busy fulfilling 82% contracts. Butter churn operators are taking any extra cream supplies available, making cream tight in some areas. Some butter makers are faced with the decision of how much production is split between 80% and 82% as Easter demand begins to be filled. The market tone is firm with not much bulk butter available in the spot market.
- Butter West: Prices are steady to weak with a weak undertone to the market, but cream remains tighter than hoped for as orders continue to move print butter into retail channels. Manufacturers report stocks as adequate to tight. Forward sales of butter to retail accounts have slowed some with buyers looking to purchase at lower prices, but export sales continue to be good.
- Dry Whey Central: The combination of higher cheese prices resulting in lower cheese/dry whey production and dry whey manufacturers contracting out higher amounts leaves the market firm with limited product available in the spot market. Domestic interest is increasing and export demand is moderate.
- Dry Whey West: Prices are marginally higher and the market tone is mostly firm. Domestic demand is good as buyers are looking to secure supplies for the first and second quarter. High prices for alternative whey proteins and good export demand for whey are pushing prices upward. Export sales continue to be good despite slower sales to China over their New Year period.
- Cheese Northeast: Production is down, with some cheese makers in the region reducing volumes significantly. Inventories are reported as fairly adequate, as manufacturers look to rebuild stocks and fulfill contractual commitments. The week following Super Bowl weekend is witnessing a decline in domestic demand, but cheese export interest remains active. The market tone is steady to firm.
- International: December milk production in Australia was up 1.4% vs. a year ago, but YTD output still lags last year by 3%, according to Dairy Australia.
- International: This week's Global Dairy Trade auction saw the GDT Price Index bump 0.5% higher than the previous auction two weeks ago. Butter and whole milk powder were the biggest gainers, up 2.6% and 1.4% respectively. Cheddar cheese declined 4.3% to a U.S. equivalent \$2.24/lb.
- International: Demand from China is expected to keep global dairy markets firm into the second quarter, according to an article in the Capital Press this week. So far, the marginal increase in global milk production is easily being absorbed. In the last four months of 2013, China imported a staggering 550,404 tons of milk powder, whey, cheese and butterfat, up 74% from a year earlier and more than Russia, Mexico, Japan, and Algeria combined. China's cost of production is very high, and it doesn't have the arable land to grow feed.
- International: A recent cheese shortage in Britain is putting pressure on processors to source more milk and increase payments to farmers, according to ABC Rural. Demand for imported dairy products in Asia is lifting regional prices around the globe.

**What's Bearish:**

- Spot market: Block cheese lost 13¼¢ on 8 trades to settle at \$2.23¼/lb this week. Barrels gave up 11¼¢ to close at \$2.20¼/lb on just 2 trades. Grade A NDM declined 2¼¢ to settle at \$2.01¼/lb on 8 trades, while butter was down 6¢ to \$1.82/lb on 28 trades.
- Dairy cow slaughter for the week ended 01/25 totaled 60,500 head, down 4,200 head (6.5%) vs. the same period a year ago. YTD the dairy cull is down 14,600 head (4.9%) from 2013.

- Fluid Milk Florida: Class I demand in Florida is good, but not strong enough to clear all the carryover supplies following last week's storm. There were 80 spot loads exported this week, up from 53 last week and just 20 a year ago. Milk production is increasing as weather conditions have improved. Cream supplies are increasing as standardized cream volumes have expanded, giving cream based dairy product manufacturers the opportunity to purchase additional loads. Extra cream supplies are being utilized within the region.
- Fluid Milk Southwest: CA milk handlers report farm milk production is showing continuing strength as on-farm pick-up volumes increase week over week. Class 2 demand is steady to lower into sour cream, dips, and aerated cream. Farm milk production continues to climb in NM. Bottling plants are taking additional loads in some areas as milk demands vary throughout the region.
- Fluid Milk Pacific Northwest: Milk production in the region is building slowly. Class I usage is mostly steady. The increased volumes are being utilized for manufactured products within the region. UT and ID milk production is increasing slowly as well. Manufacturing capacity is still well above current milk supplies.
- Butter Northeast: Production is steady in the region. Supplies are adequate, with some butter makers acquiring extra cream volumes, prompted by increased Class I demand.
- Dry Whey Northeast: Production has declined marginally as some cheese manufacturers have pulled back volumes, but inventories are expanding with the lessening of spot sales. Export demand has declined as some international purchases are being impacted by the Chinese New Year.
- NDM Central: The market tone is weakening as many offers are showing up at lower prices as more manufacturers are able to offer loads in the spot market. Low/medium heat manufacturers are producing at good levels of production. Demand for domestic and export is moderate, but the export market is being closely monitored as it is expected to pick up once some countries reemerge after their holidays. Inventories are adequate.
- NDM West: Prices in the Western region are lower on the bottom of the range and across the mostly price series. A few manufacturers made price adjustments to maintain long-term relationships. Some resellers indicate their customers are pushing back on resale load pricing.
- Cheese Midwest: Reports of increased cheese orders are generally very marginal at best. The consensus has been that orders mostly remain hand to mouth as buyers continue to wait out high cheese prices, expecting them to decline. Super Bowl related cheese orders peaked some weeks ago, and now there are no big demand cheese events ahead for some time. Milk supplies are increasing so when cheese makers decide the time is right to increase production, the milk will be available.
- Cheese West: Participants on both sides of the aisle are becoming increasingly cautious about maintaining current price levels. U.S. prices are now close to international price ranges and demand is showing some resistance. Domestic demand is becoming tentative with buyers looking to avoid large inventories.

#### **Recommendation:**

Record high cheese prices finally felt some push-back this week as a few loads were finally shaken loose in the spot market. While supplies are generally still on the tighter side, buyer push-back is allowing sellers to bring a few loads to the exchange. Most of the damage was done today, and Class III futures responded with a decent sell-off. The big question on everyone's minds now is how low will we go? Even a 30¢ drop from the high leaves us at over \$2 cheese, and once again well below international prices. March futures, both Class III and Cheese, had been pricing a drop in spot prices for quite some time, and current predict a bottom at about \$2.05/lb. It's been so cold in much of the Midwest that single digits above zero now feels downright warm. In the same way, though we've been above \$2 cheese since the 20<sup>th</sup> of December, low \$2 cheese might feel like a great price, despite it being historically very high. As long as international demand remains strong, it just might be part of the new paradigm shift of higher global dairy prices. China just celebrated its New Year, so we now enter a more quiet demand period. However, that might not last that long. Drought in California, heat in Australia and continued lackluster production improvement in much of the Midwest could get end users thinking about their long-term needs sooner, rather than later. In fact, while the front months saw some pressure this week, the last half of 2014 pushed into new record high territory on decent volume, in what appears to be commercial long hedgers getting some coverage. Feb has just one week left in its calculation, with the first three all above \$23/cwt. If we see just minor slides in the spot cheese market next week, today's settlement of \$22.87 is overdone. We wouldn't be surprised to see some buying come in next week. March at \$20.72 has already priced in another 20¢ drop in the spot market, so we wouldn't be sellers up front. Hopefully we gave enough warning in prior weeks to get those PUT options bought – there was plenty of opportunity to do so. And in light of the strength in the back half of the year, we wouldn't sell there either. For those with a bit more risk tolerance, consider selling Mar-Jun PUT options if emotion takes this market lower next week. Premiums for these will likely go higher and will give you an opportunity to use the funds you collect to apply towards buying a PUT option at a higher strike. For example, the April 17.50 PUT settled at 16¢. If its value increases to 30¢ or more sell it. Should the market then recover, you could then enter an order to buy an April 18.75 PUT, currently at 48¢, for 30¢ or less. Give us a call if you'd like help in understanding how this works.

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