

The KDM Dairy Report – February 14th, 2014

What's Bullish:

- World Ag Supply & Demand Report: USDA increased their 2014 milk production forecast, but also increased their Class III price forecast due to expectations for strong demand. They now expect Class III to average \$18.70/cwt, up 50¢/cwt from last month's forecast.
- The weekly Dairy Products Sales Report showed 40-lb block cheese averaged \$2.28/lb, up 5.1¢ from last week. 500-lb barrels jumped 6.7¢ to \$2.30/lb. Dry whey increased 0.6¢ to average 62¢/lb, NDM inched 0.5¢ higher to \$2.07/lb and butter gained 4.4¢ to \$1.84/lb.
- Weekly cold storage numbers indicate a drawdown on cheese stocks continues. Cheddar holdings at USDA-selected storage centers declined 1%, or 1.1 million lbs, over the period 02/01 through 02/10. Butter stocks, however, were up 9%, or 822k lbs over the same period.

Futures Month	Class III 02/14	Class III 02/07	Change	Dry Whey 02/14	Dry Whey 02/07	Change	Cheese 02/14	Cheese 02/07	Change
Feb-14	\$23.14	\$22.87	\$0.27	62.95¢	62.73¢	0.23¢	\$2.265	\$2.255	\$0.010
Mar-14	\$21.04	\$20.72	\$0.32	63.95¢	61.50¢	2.45¢	\$2.050	\$2.037	\$0.013
Apr-14	\$19.87	\$19.44	\$0.43	63.00¢	60.00¢	3.00¢	\$1.929	\$1.906	\$0.023
May-14	\$19.23	\$18.81	\$0.42	61.50¢	59.00¢	2.50¢	\$1.866	\$1.857	\$0.009
Jun-14	\$18.98	\$18.78	\$0.20	60.00¢	58.50¢	1.50¢	\$1.860	\$1.850	\$0.010
Jul-14	\$18.81	\$18.82	(\$0.01)	59.00¢	58.00¢	1.00¢	\$1.855	\$1.854	\$0.001
Aug-14	\$18.70	\$18.70	\$0.00	57.95¢	57.70¢	0.25¢	\$1.850	\$1.849	\$0.001
Sep-14	\$18.54	\$18.58	(\$0.04)	56.98¢	57.40¢	(0.42¢)	\$1.845	\$1.840	\$0.005
Oct-14	\$18.35	\$18.27	\$0.08	55.80¢	56.50¢	(0.70¢)	\$1.815	\$1.810	\$0.005
Nov-14	\$18.02	\$17.96	\$0.06	55.50¢	56.00¢	(0.50¢)	\$1.785	\$1.784	\$0.001
Dec-14	\$17.80	\$17.74	\$0.06	55.25¢	56.00¢	(0.75¢)	\$1.766	\$1.767	(\$0.001)
Jan-15	\$17.50	\$17.44	\$0.06	55.00¢	55.00¢	0.00¢	\$1.760	\$1.765	(\$0.005)
12 Mo Avg	\$19.17	\$19.01	\$0.15	58.91¢	58.19¢	0.71¢	\$1.887	\$1.881	\$0.006

- Fluid Milk East: The Mid-Atlantic and Southeast are set to encounter another winter storm blast. The storms are expected to cause wide spread disruptions and major delays, with pick-ups and deliveries, as milk haulers face unsafe icy and snow covered roads. Manufacturing milk supplies have been scaled back, even with some plants already below their expected levels, due to backlog from previous weeks' winter storms. Class I demand has led to increases in intake volumes at most bottling plants, with some plants having as many as 32 loads added. Farm production is increasing across the Southeast but expected to flatten with the increase in cow discomfort level, as episodes of cold winter temperatures take effect. The Northeast is also experiencing winter storms but without major transportation issues. Manufacturing milk supplies in the Northeast are adequate for the Class I demand. Production levels are on the upswing in Florida, but cold weather conditions in the North are increasing the number of seasonal residents into Florida and as a result Class I demand is on the strong side.
- Fluid Milk Central: Milk production is steady to slightly higher, but remains below expectations. Producers noted some cows had frozen teats leading to evaluated somatic cell count levels. Nutrition is a concern as current silage is not providing as much energy to the cows as previous crops. Cows are consuming more feed, with additional feed energy going towards body maintenance to keep warm to combat current low temperatures. Class II product demand picked up this week with notably higher condensed skim interest along with cottage cheese and yogurt. Butter churn operators took on additional cream supplies available this week as they look to fill international and upcoming Easter commitments. Some ice cream manufacturers ramped up production levels.
- Butter: Butter churn operators throughout the U.S. were able to take advantage of heavy cream supplies to maintain or increase churn rates. Lower butter prices have increased domestic demand, while international interest remains active. Many butter manufacturers have light inventories and look to rebuild stocks.
- Dry Whey Northeast: Dry whey is being manufactured at reduced levels. Inventories are adequate, but demand is good, with buyers finding it difficult to purchase dry whey through spot sales.
- Dry Whey Central: Availability is tightening as manufacturers contracted larger volumes this year, reducing availability in the spot market. Recent high cheese prices caused many cheese/dry whey makers to cut back on production rates, forcing many to focus current light inventories on contract commitments only. Domestic demand is steady and international interest is active. End users are experiencing delayed shipping on some orders.
- NDM Northeast: Milk supplies are tight for some manufacturers, as significant volumes of milk are being diverted to bottling plants to meet the increasing Class I demand, due to influences of winter storms. Demand is good.
- CWT has accepted requests for export assistance for 1.645 million lbs of 82% butter and 4.0 million lbs of cheese. The product will be delivered from February through June 2014.
- Grains: Corn, soybeans, meal and wheat all rallied this week. Stronger than expected demand, weather and oversold conditions all helped push prices higher. Chicago meal prices through Aug are all above \$400/ton.
- International: China's milk production fell in 2013 and could fall further in 2014, according to Rabobank Ag analyst Tim Hunt. China's drive to close smaller dairy operations in favor of large-scale operations is causing milk production to fall faster than it can recovery.
- International: Milk powder export demand in the EU is improving as powder production declines in the southern hemisphere. Prices for skim milk powder continued to firm, supported by strong export demand. First quarter SMP production is nearly sold out with spot sales for immediate delivery requiring premiums to complete the sale. Negotiations are ongoing for Q2 with the unusual situation, in some cases, of having prices higher than Q1. Good export interest is coming from Asia and also from the Middle East as those countries are building stocks ahead of Ramadan.
- International: Australian milk production continues to be suppressed by bouts of extreme heat and dry weather. The breaks between the various heat waves have offered some bounce back in production, but the continuing cycle of heat has accelerated production declines. Numerous wild fires have periodically interfered with some milk shipments, due to intense smoke limiting visibility and closing highways. Australia's milk production season to date is -3.0%, compared to last season. Dairy Australia has also summarized exports for the July-December period, showing total export tonnage down 11.8%. Milk powder demand remains good and continues to be the dominate factor in the dairy markets.
- International: Oceania butter continues to draw good export interest. Export activity continues to reflect a two tiered market with higher prices for product destined for Russia, while pricing for the Middle East and North Africa is represented by mid-range and lower range pricing respectively. Available supplies are relatively tight with most manufacturers comfortable with their current inventories as most Q2 sales with repeat customers are on the books. Global demand for milk powders remains strong with supplies tight. Most supplies in the near term are committed. Some buyers are buying hand to mouth, hoping for the possibility of increased supplies and lower prices coming from the northern hemisphere. U.S. milk and SMP production have been below expectations and have not factored greatly into the supply side of the global SMP pricing equation. China's trading activity is slowly coming back into the market following the New Year's holiday. Export interest remains active from Southeast Asia, the Middle East and North Africa. Oceania cheddar cheese prices increased significantly this period as cheese makers needed higher returns to justify production, in lieu of diverting milk volumes to other, more lucrative, dairy product production. Export demand has increased with more interest coming from South Korea, Japan and Russia. Most supplies are committed through Q1 with limited availability in Q2. Cheddar prices averaged a U.S. equivalent \$2.38/lb this week.

What's Bearish:

- Spot Market: Blocks plunged 12¼¢ and barrels shed 14¼¢ to settle at \$2.10½ and \$2.06¼ respectively. Trading was heavy, with 24 loads of blocks and 16 loads of barrels exchanging hands. Butter was down 5¢ to \$1.77/lb on 9 trades, while Grade A NDM managed a ¼¢ gain to \$2.02/lb on 10 trades.
- Dairy cow slaughter for the week ended 02/01 totaled 53,900 head, down 14.7% vs. the same period a year ago. YTD the dairy cull is down 6.6%.
- Fluid Milk West: Milk production conditions in the Southwest region are perfect according to dairy producers. Cows are responding to comfortable temperatures and adequate rations. CA farm milk production continues increasing throughout the state. Dairy cooperatives report the current strong production trend is likely a result of a combination of actions by dairy farmers. These actions include managing dairy rations and keeping some dairy cows a little longer than usual. At current milk prices, some farmers report older cows and others at the usual end of their annual milk production cycle are still covering the cost of their upkeep. Demand from bottlers is steady to slightly lower, depending on location. Milk production in NM is continuing a steady climb, while processors are still receiving outside milk from a few bottling operations, as well as additional pushback from internal fluid accounts. Some milk loads traveled across state lines to find manufacturing capacity. AZ dairy producers report farm milk production is maintaining the upward trend as climate conditions are favorable. Processors report component values are steady to improving as extreme heat is not an issue at present. Bottler demand is seasonally lower. A few cheese operations decreased vats this week in response to weaker demand. Cream interest was lighter compared to last week and sellers note demand from some higher Class end users is slow to emerge.
- Fluid Milk Pacific Northwest: Milk production continues to increase seasonally in the region. Lower feed costs are encouraging dairies to hold onto cows longer and still remain profitable. Milk supplies in the region continue to fall short of manufacturing demand, however.
- Dry Whey West: Higher prices are meeting increasing resistance domestically. The export market is holding steady with reports of lower priced product being offered from the EU. Domestic demand is good, but stocks are adequate for contract fulfillment. Spot loads are also available from resellers.
- NDM Central: The market tone is steady with many buyers in a "wait and see" approach, while others are catching up on loads. Many spot load sales were closer to the bottom of the mostly price series. Production levels are steady to higher as a few manufacturers were able to obtain extra milk supplies. Domestic demand is mixed while export sales are active.
- NDM West: The market is mixed. Farm milk production is steadily increasing in the west, and according to some milk processors, is well above projections for this time of year. Many manufacturers are ahead of projected NDM production because of strong milk intakes. Q1 - Q2 NDM needs remain unfilled for some end users, but during the last 6 - 9 months, many buyers have learned to operate on a just in time basis and are prepared to buy sparingly until price trends reverse.
- Cheese Northeast: Cheese production has slowed, but inventories are increasing with sluggish sales, as cheese buyers take a step back. Export interests are steady, but the market tone is tentative.
- Cheese Midwest: Potential Midwest cheese buyers who until late last week were described as holding back purchases while awaiting anticipated price declines, are now generally still waiting. Many buyers would like to restock inventories, but are patient enough to step back and wait until they have confidence that there is a new price equilibrium. Cheese orders beyond current needs are not very common this week, resulting in some indications of manufacturer inventories building. Midwest milk supplies are called sufficient or good by most cheese manufacturers, even with the lingering, unusually cold weather. Mozzarella manufacturers report that orders are soft. Some manufacturers believe that recent price levels have been hurting the bottom line of mozzarella buyers in particular, also leading to softness in ordering. There is ample availability of blocks in the spot market.
- Cheese West: Cheese production in the West is building with increased milk supplies in much of the region. Cheese stocks in the West are reported to be adequate for most needs.
- International: Current Western Europe milk production continues to increase at volumes well above year ago levels. Mild winter weather, higher milk prices, herd expansion, moderate to lower feed costs and strong global demand for milk powders have all combined to support milk production increases. Production levels in some areas of Europe are approaching or exceeding year ago peak levels. The significant increases in milk production have milk powder manufacturers drying at or near capacity levels. Milk production volumes are projected to increase towards the seasonal peak, in April-May, and will surpass milk powder manufacturing capacities, despite expected increases in drying capacities. Cheese production is expected to cover the additional manufacturing needed to process the additional milk volumes.
- International: New Zealand milk production continues to be well above year ago levels. Weather conditions have been supportive of milk production, especially on the South Island. Some producers have implemented supplemental forage feeding in order to maximize their late season production. Overall, the production season looks to end strong for most producers. The gains in late season production, over last year, are allowing manufacturers to more confidently manage and build stocks for the upcoming carryover period.

Recommendation:

The spot cheese market provided the fireworks again this week. Blocks took a big hit on Monday on no trades, while barrels were sharply lower on Wednesday. However, Wednesday was different, in that we saw buyers step forward and take on a significant amount of both blocks and barrels. Thursday and Friday's spot sessions were much quieter, with no trades or change in price. Perhaps we've found some equilibrium here, but we think more cheese is likely headed to the spot market next week. Fresh cheese is out there and indications are inventories are starting to build a little. That makes us bearish in the short term, and we would recommend hedgers sell March above \$21, even though it's currently trading at about a 50¢ discount to spot prices. Beyond March, however, the picture appears more positive. China is past its New Year celebrations and orders appear to be picking up from them again. With the exception of the West, milk production across the U.S. is struggling to gain traction due to weather and feed issues, while Class I demand is strong, limiting manufacturing milk availability. Powder is still tight across the globe. The Southern hemisphere will be wrapping up its production season in the coming months with limited stocks. Q2 contracting is going on in earnest. CA is dry. Australia is baking. Oceania cheddar is tight. Dry whey futures made a nice move higher this week as it appears to be a cheaper protein source than other powders. Producers are hanging on to cows longer at these profitable levels, but strong beef prices are also encouraging them to replace them with younger stock. Unless the USA can really crank up production, we think prices are going to remain at elevated levels. So what should you do further out? We would look at buying \$21.00 CALL options Apr-Dec at an avg 25¢. This offers no downside protection, but gives you the "courage" to sell your milk if prices keep appreciating over the long term. For example, if we hit \$20.50 or higher in any of these months, pull the trigger and sell your milk. If prices keep moving higher after your sale, great! You will give up some upside before your CALL option kicks in, but no matter how high prices go, you'll be giving up a max of 75¢/cwt, while you participate in the higher prices. Give us a call if you need some help in understanding this strategy. 2014 looks to shaping up to be an incredible year for dairy operations. Make sure you try to capture as much profit margin as possible. The new Farm Bill that was passed has us worrying about overproduction issues in 2015.

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