

The KDM Dairy Report – February 21st, 2014

What's Bullish:

- Spot Market: Blocks gained 5¼¢ for the week to settle at \$2.16¼/lb while barrels jumped 9½¢ to close at \$2.15%. Grade A NDM was up 2¼¢ to settle at \$2.04¼/lb and butter increased 1½¢ to \$1.78½/lb.
- Cold Storage Report: Butter stocks in Jan were down 33% vs. a year ago and American cheese stocks were down 2% vs. last Jan. Total cheese stocks were also down 2%.
- Just as milk prices are improving, fierce competition for hay and limited water supplies to grow other feed crops have dimmed the outlook for California dairy farmers, according to an article this week in Dairy Herd Management. Hay prices are way up as drought has forced beef cattle and sheep operations to feed more hay. Demand for alfalfa from China and the Middle East is also helping drive up the cost. China imported 575,282 metric tons of alfalfa from the U.S. in 2013, up 60% from the year before and nearly eight times as much as in 2009. China will likely continue to import growing volumes of alfalfa and dairy products as long as Chinese incomes continue to rise. While the cost of corn has gone down, other feedstuffs like cottonseed and soybean meal have continued to rise, driving up the cost of production for dairies. Unless the drought breaks soon, many expect a substantial reduction in milk production over the summer.
- The executive vice president of Foremost Farms was quoted in an article this week saying demand is stronger than what they can supply. Cheddar cheese is getting harder to find in stores as production has shifted to hot export commodities like Italian cheeses and skim milk powder, which are in great demand in China and other Asian countries.
- Outlook for Ag Trade Report: USDA increased its dairy export forecast for 2014 and expects it to reach a new record high. Projected dairy exports for FY '14 (Oct. 2013-September 2014) were raised \$400 million from the previous forecast, to \$6.3 billion, as strong global demand continues to support high prices.
- Milk Production Report: Jan milk output in the U.S. was up just 0.9% vs. a year ago, according to USDA. In addition, cow numbers increased only 7,000 head from December.
- Fluid Milk Northeast: Manufacturing milk supplies are mixed in the Northeast and Mid-Atlantic regions. Manufacturers are looking to recover from last week's snow storm. Some balancing plant operators reported milk supplies as still weakened due to the impact of last week's snow storm that sent anticipated loads to bottling plants because of increases in Class I demand.
- Fluid Milk Pacific Northwest: Milk production continues to increase seasonally, but processing facilities are reporting no problems in handling the current milk volumes. Demand for milk continues to outpace supplies for many manufacturers in the region. Dairies have been slow to build herds despite higher milk prices. Higher prices for replacement heifers at recent auctions are slowing expansion, with many dairies keeping lower producing cows longer as a way to keep production up.
- Butter stocks at USDA-selected storage centers are down 21% (2 million lbs) through the first 17 days of Feb. Cheese stocks over the same period are up 1%, however.
- Butter Central: Many butter churn operators are churning heavily, but domestic sales are picking up and there is good international interest. Some butter manufacturers are focused on rebuilding stocks, while others with 82% production capabilities are busy filling export orders. Bulk butter availability continues to be limited with most supplies spoken for in the near term.
- Dry Whey Central: Prices moved higher this week as buyers had to pay premiums to secure what limited supplies were available. The market tone is firm with increased buyer interest to manufacturers and resellers, but some price resistance is present. Dry whey manufacturer production rates are steady to lower, leaving little excess in the spot market. Domestic buyers are taking extra loads when they can get it and export sales are steady to higher. Some end users are reporting to have a few contract loads being delayed for later shipment.
- Dry Whey West: Buyers are expressing concerns over higher prices, but continue to purchase for immediate needs. The market tone is firm as whey protein prices remain a competitive buy compared to competing dairy protein sources.
- NDM East: Inventories are tight. Domestic demand is mixed, but export demand is active.
- CWT has accepted requests for export assistance to sell 848,780 pounds of 82% butter and 4.149 million pounds of Cheddar, Gouda and Monterey Jack cheese. The product will be delivered from February through April 2014.
- International: China's increased demand in 2013 alone equaled the total increase in milk production in the United States, the European Union, Australia and New Zealand combined, according to the National Milk Producers Federation.
- International: The results of a study by Lincoln University showed that Chinese consumers were willing to pay 74% more than the normal price for dairy products, if they came with a food safety certification. Several recent tainted dairy product scares have put a premium on non-domestic dairy products.

Futures Month	Class III 02/21	Class III 02/14	Change	Dry Whey 02/21	Dry Whey 02/14	Change	Cheese 02/21	Cheese 02/14	Change
Feb-14	\$23.19	\$23.14	\$0.05	62.88¢	62.95¢	(0.08¢)	\$2.271	\$2.265	\$0.006
Mar-14	\$21.79	\$21.04	\$0.75	63.50¢	63.95¢	(0.45¢)	\$2.118	\$2.050	\$0.068
Apr-14	\$20.90	\$19.87	\$1.03	63.08¢	63.00¢	0.08¢	\$2.039	\$1.929	\$0.110
May-14	\$20.01	\$19.23	\$0.78	62.98¢	61.50¢	1.48¢	\$1.953	\$1.866	\$0.087
Jun-14	\$19.72	\$18.98	\$0.74	62.50¢	60.00¢	2.50¢	\$1.926	\$1.860	\$0.066
Jul-14	\$19.38	\$18.81	\$0.57	59.23¢	59.00¢	0.23¢	\$1.906	\$1.855	\$0.051
Aug-14	\$19.12	\$18.70	\$0.42	57.75¢	57.95¢	(0.20¢)	\$1.889	\$1.850	\$0.039
Sep-14	\$18.86	\$18.54	\$0.32	56.75¢	56.98¢	(0.23¢)	\$1.865	\$1.845	\$0.020
Oct-14	\$18.60	\$18.35	\$0.25	56.75¢	55.80¢	0.95¢	\$1.849	\$1.815	\$0.034
Nov-14	\$18.34	\$18.02	\$0.32	56.98¢	55.50¢	1.48¢	\$1.808	\$1.785	\$0.023
Dec-14	\$18.00	\$17.80	\$0.20	55.50¢	55.25¢	0.25¢	\$1.778	\$1.766	\$0.012
Jan-15	\$17.60	\$17.50	\$0.10	55.00¢	55.00¢	0.00¢	\$1.760	\$1.760	\$0.000
12 Mo Avg	\$19.63	\$19.17	\$0.46	59.41¢	58.91¢	0.50¢	\$1.930	\$1.887	\$0.043

What's Bearish:

- GDT: Dairy product prices recorded their biggest drop since early November in the latest GDT auction on Tuesday. The GDT Price Index fell 1.2% from the last sale two weeks ago. Milk protein concentrate fell 5.4% and butter slid 3.8%. Cheddar dropped 1.7% to a US-equivalent \$2.20/lb.

- Livestock Slaughter Report: Producers are hanging on to more cows. Dairy cow slaughter in January totaled 270,200 head, down 9% (26,700 head) from Jan '13.
- Dairy cow slaughter for the week ended 02/08 totaled 59,900 head, down 7,100 head or 10.6%. YTD the dairy cull is off 7.2% vs. 2013.
- Fluid Milk Southeast: Milk production is up in the region as distribution improves following snow storms that blasted through the area last week. Bottling sales are reported as flat, while surplus loads are being channeled to other regions. Florida milk production is steady. Warm weather has replaced unusually cool temperatures with expectations cow comfort levels will improve. Class I sales are steady this week as bottlers' level off orders. Export shipments totaled 39 loads. Cream supplies are heavy with extra loads being brokered to manufacturing plants.
- Fluid Milk Central: Milk processors noted milk production levels were improving at the farm. This week more milk supplies started showing up in the spot market with prices going lower, ranging Class to \$1.50 over Class. Recent cutbacks in bottling orders have shifted additional supplies into Class II. Cream supplies are heavy with a few butter churn operators turning away supplies because of production capacity constraints. Some cheese manufacturers are cutting back on production rates and reducing orders to milk processing plants, making extra milk supplies available for Class IV manufacturers.
- Fluid Milk West: Dairy producers in CA report continuing gains in milk production. Processors acknowledge milk intakes are heading higher, and there are some concerns about surpassing state processing capacity in the next few weeks. The milk production trend in NM is firmly established and heading upward. Dairy producers report cow comfort is optimal, with daytime temperatures in the 70- 80 degree range and nighttime readings in the 30-40 degree range. Dairy quality feed is available. Processors report sales into fluid accounts continue to drift lower as temperatures increase. Because of increasing milk intakes, some plant managers were looking for relief from out-of-state manufacturers. However, offers of loads have generally not found any takers. AZ farm milk production is steady to higher. Processors report they are getting requests from out of state sellers to accept farm milk or condensed skim for manufacturing. Within Arizona, demand from Class I, II, and III accounts is lower.
- Butter Northeast: Production is at increased levels, with some churns running six day schedules. Some manufacturers report cream supplies as substantial and exceeding demand. Sellers are searching for buyers to purchase surplus cream loads.
- Dry Whey Northeast: Because of uncertainty, some buyers are making just-in-time purchases as they wait on the market conditions to become clearer. Inventories are sufficient, with heavy stocks reported in some manufacturing channels. Contractual orders are providing the bulk of the trades, with few spot trades. Some buyers are content with purchases of slightly older dry whey being offered below market value through resellers.
- NDM West: Prices are steady to lower on a mixed market. Production of low heat nonfat dry milk is active. A few manufacturers report the strong uptick in milk production is earlier and stronger than anticipated. A few manufacturers are looking for outlets for spot loads of milk or condensed skim as plant processing capacities have been reached. Interest in those spot loads is light to moderate.
- International: Despite a heat wave in Jan, Dairy Australia is reporting that milk production during the month was up 3.1% vs. Jan '13.

Recommendation:

Cheese buyers have been sitting on the sidelines the past couple weeks as they've watched the price for block cheddar fall 26½¢ from a record high \$2.36/lb. The big question was would we fall below \$2/lb? That was answered this week. As soon as bids began reappearing in the \$2.06 - \$2.09 area, buyers sensed a low was in and began getting more aggressive in seeking product. By the end of the week both blocks and barrels were solidly higher. Class III futures responded with big gains through June as the substantial discount between spot prices and futures was tightened. Current spot prices work out to about \$22.28 Class III, so further strength in cash buying next week should keep Class III moving higher, at least in the front months. There are several factors that give us concern, however. Milk production in the Western states is really kicking in to high gear with the warmer weather. CA is facing a drought, but in the near term, weather is perfect. Already, more milk is heading into the vat. Likewise, Florida is back to being a milk export state and the Southeast is starting to see some surplus loads as well. Fluid demand is flat and there is surplus cream everywhere. In the Central region, milk production is starting to increase and will more rapidly as warmer temps arrive. Despite the better returns in Class IV, undoubtedly more milk will be turned into cheese as the overall manufacturing supply increases. Secondly, dairy cull numbers are dropping rapidly. Producers are hanging on to cows longer as a way to grow the herd; and grow it will. Lastly, while we saw a major correction in the spot cheese price, we're already back up to a \$2.16¼ block price. We saw major push-back on price and demand destruction above \$2.30/lb, and our discount to the world is rapidly eroding again. It begs the question how much more upside is left in the spot market, unless we're set to make new highs again. With the added milk supply, we doubt it. Balancing these concerns are a whole plethora of factors, including a modest Milk Production increase, friendly Cold Storage report, minor gain in cow numbers, drought and international demand. Once again, the big questions is – will strength in international demand soak up increases in milk production? Unless we're able to substantially increase production, probably yes. However, while we pass through time to answer this question, expect more volatility in Class III futures as we expect more loads to cheese to eventually show up in the cash market. We've probably carved out a cheese trading range of about \$2.10 - \$2.30. Trade each side of that range appropriately. Producers should consider sales when we get near the upper end of the range, while end users should consider purchases near the lower end of the range. We're just about dead center right now. We still think buying \$21.00 courage CALL options Apr-Dec is a good idea. For those that have already marketed milk, it provides a relief valve and gets you back in the game, while for those still waiting to sell, it serves as a line in the sand where you can pull the trigger on those sales without fear. Finally, at these high prices, you may just want to look at cheap disaster insurance. The May-Oct 17.00 PUT options average 25¢ each. That's six months of protection at a base price that is profitable for operations receiving a positive basis above Class III. Have a great weekend everyone!

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