

The KDM Dairy Report – March 21st, 2014

What's Bullish:

- Spot Market: Blocks gained 6½¢ for the week to settle at \$2.42¾ on no trades, while barrels closed 4¼¢ higher to \$2.31 on 8 trades. Butter picked up 4¢ to settle at \$1.92 on just 2 trades and Grade A NDM was up 1¢ to \$2.05 on 4 trades.
- Milk Production Report: February milk output was up just 1.1% vs. a year ago, while more significantly, cow numbers were flat vs. Jan at 9.211 million head. The production increase was due to a 21 lb jump in milk per cow. Once again, gains were mainly in the West, with CA up 5.3%, but down in the Midwest, with WI off 2.0%.

Futures Month	Class III 03/21	Class III 03/14	Change	Dry Whey 03/21	Dry Whey 03/14	Change	Cheese 03/21	Cheese 03/14	Change
Mar-14	\$23.29	\$23.29	\$0.00	65.10¢	65.00¢	0.10¢	\$2.270	\$2.265	\$0.005
Apr-14	\$23.53	\$22.37	\$1.16	65.75¢	64.25¢	1.50¢	\$2.283	\$2.174	\$0.109
May-14	\$21.74	\$20.76	\$0.98	65.10¢	62.85¢	2.25¢	\$2.099	\$2.023	\$0.076
Jun-14	\$20.87	\$20.26	\$0.61	63.50¢	62.98¢	0.52¢	\$2.028	\$1.968	\$0.060
Jul-14	\$20.60	\$20.05	\$0.55	60.68¢	60.18¢	0.50¢	\$2.024	\$1.951	\$0.073
Aug-14	\$20.29	\$19.83	\$0.46	60.00¢	60.00¢	0.00¢	\$1.995	\$1.940	\$0.055
Sep-14	\$19.92	\$19.50	\$0.42	58.58¢	58.43¢	0.15¢	\$1.963	\$1.910	\$0.053
Oct-14	\$19.50	\$19.19	\$0.31	57.70¢	57.65¢	0.05¢	\$1.915	\$1.886	\$0.029
Nov-14	\$19.05	\$18.87	\$0.18	57.30¢	57.28¢	0.02¢	\$1.866	\$1.858	\$0.008
Dec-14	\$18.67	\$18.52	\$0.15	57.18¢	57.18¢	0.00¢	\$1.830	\$1.829	\$0.001
Jan-15	\$18.35	\$18.15	\$0.20	56.05¢	54.75¢	1.30¢	\$1.800	\$1.772	\$0.028
Feb-15	\$18.05	\$17.81	\$0.24	54.00¢	50.03¢	3.98¢	\$1.800	\$1.772	\$0.028
12 Mo Avg	\$20.32	\$19.88	\$0.44	60.08¢	59.21¢	0.86¢	\$1.989	\$1.946	\$0.044

- Cold Storage Report: Stocks of American cheese were 5% below year-ago levels and were flat vs. Jan. Same story for Total natural cheese stocks which were down 6% vs. last Feb and flat vs. Jan. Cheese stocks historically are building Jan-June, but not so far this year. Butter stocks in Feb were down 31% vs. 2013 but up 20% from Jan.
- Wow. Weekly cold storage numbers are showing just how strong demand is for cheese. During a month when we are usually building stocks, holdings at USDA-selected storage centers have declined 6% (5.56 million lbs) over the first 17 days of March. Butter stocks, on the other hand, are up 20% (2.96 million lbs).
- Rabobank released their quarterly dairy report this week which was largely bullish for dairy. The global increase in milk supply from Q4 2013 into Q1 2014 was more than matched by another extraordinary increase in China's purchases. They expect an easing in pricing by mid/late Q2, but it will be limited by constraints on suppliers, the need to replenish depleted inventory and ongoing growth in demand. Rabobank forecasts Class III milk to average \$20.67 in Q2, \$19.90 in Q3 and \$18.66 in Q4.
- CWT continues to help move product out of the country. This week they accepted 10 requests for export assistance to sell 220,462 lbs of Cheddar cheese, 2.535 million lbs of 82% butter and 1.268 million lbs of whole milk powder to customers in Africa, Central America, Europe, the Middle East and North Africa. The product will be delivered March through June 2014.
- Cream East: Supplies are either in close balance with demand or short for some manufacturers. Strong pulls on cream supplies are coming from seasonal Class II demand and export churn volumes. Spot transactions are somewhat tight, with a few buyers securing additional loads from sellers in other regions.
- Fluid Milk Central: Milk production is steady to marginally higher, but below expectations mainly contributed to lower feed quality. Many farms in the southern part of the region are slightly behind the seasonal planting schedule due to colder temperatures and lack of moisture in some areas.
- Fluid Milk West: Milk production in CA is trending steady after an early start to the flush. Dairy industry reps are now more certain that the peak of the flush has arrived and will be followed by production declines. Class I demand is sluggish, but there is some increased demand from frozen goods taking additional volumes of condensed skim. Dry conditions persist throughout the state, with almost all water reservoirs ranging from 38% - 98% of historical averages. Currently, dairy operators are working off of stored feed inventories, but there is some uncertainty about feed availability and pricing once fresh feed is needed.
- Butter: U.S. butter prices continue to have a comparative advantage over most international market prices, keeping U.S. export orders active. Contract fulfillment of previously sold export sales along with new contracts are keeping butter inventories tight. The market tone is mostly firm as supplies are light to moderate and overall demand is improving.
- Dry Whey: Prices rose this week in the Northeast as inventories are tight in the region. Spot loads are limited and the market undertone is firm. Prices were also higher in the Central region as good demand and tight supplies support the market. Manufacturers are busy fulfilling commitments, making it difficult for some buyers to find supplies. The Western market is also firm as prices continued to show strength this week. Demand for whey is good with contract sales comprising most of available production. Spot sales are becoming increasingly difficult to source as supplies are tight. Export sales are reported to be steady with good demand.
- Cheese Northeast: Production is mostly steady and milk supplies are sufficient for cheese plants current needs. However, cheese demand is very good with active sales in both domestic and international markets.
- Cheese Midwest: The Midwest cheese market is strong, both in terms of prices and sales. Cheese manufacturers are working to meet strong demand with increased production schedules and by using additional nonfat dry milk and condensed skim to help boost cheese output. Spot loads of milk are available for those looking, but the \$2.00 over class price is higher than many cheese manufacturers believe is economically sensible, leaving most to rely on existing contracted and patron milk.

- Cheese West: Demand remains good for cheese in the face of the higher prices. Increased export sales are keeping cheese stocks tight despite seasonal increases in milk supplies. Cheese production is increasing slowly, but demand is still outstripping current supplies. Block demand is strong as both export and domestic buyers are looking for additional product. Barrel demand is steady with fewer problems sourcing additional stocks.

What's Bearish:

- Dairy cow slaughter numbers continue to lag year ago levels. For the week ended 03/08, 59,600 head were culled, down 10.1% vs. the same period in 2013.
- Livestock Slaughter Report: USDA's monthly look at the cull also shows a slowdown. 236,600 head were removed from the milking herd in Feb, a sharp 8.8% (22,800 head) decline vs. a year ago. YTD the 2014 dairy cull is behind 2013 by 50,000 head.
- In the latest GDT auction event on Tuesday, the dairy price index fell 5.2% from the last auction two weeks ago, its lowest level in nine months. AMF was down 10.7% and WMP declined 5.8%. Cheddar cheese gave up 4.1% to a U.S. equivalent \$2.11/lb.
- Fluid Milk Northeast: The Northeast and Mid-Atlantic regions are seeing increases in milk production. Manufacturing milk supplies are reported as ample, prompted by higher production volumes and slowing Class I demand. Seasonal demand for yogurt is falling off in parts of the region.
- Fluid Milk Southeast: Milk production is up as the region moves farther into spring flush. Overall, Class I milk demand is fair with bottling orders marginally decreasing. Florida is experiencing heavy rain, so this is some concern over cow stress and harvesting hay, but Class I demand is falling below anticipated levels due to schools in the region taking spring break earlier than in the past. Exports increased this week to 98 loads, up from 70 last week and 54 a year ago.
- Fluid Milk Southwest: Farm milk production in NM is still trending higher, although the rate of increase from week to week is flattening. Weather is not a hindrance to milk production at this time. Daytime temperatures are comfortable, hovering in the mid 50's to low 60's. AZ milk processors report milk intakes are steady to higher. Daytime and nighttime temperatures are aiding cow comfort. Fluid milk orders are declining seasonally, but sales of milk loads into ice cream and yogurt are increasing steadily. Most requests to move out-of-state milk into a few Arizona plants are being pushed off until after the peak of the flush.
- Fluid Milk Pacific Northwest: Milk production in the region is trending higher. Favorable weather conditions are contributing to increased cow comfort levels and that is helping improve production. Increased milk pay prices from the good manufacturing demand have dairies looking to make decisions concerning future expansion of their herds.
- During January, 4.4 billion lbs of packaged fluid milk products is estimated to have been sold in the United States. This was 0.8% lower than January 2013. Estimated sales of total conventional fluid milk products decreased 1.5% from January 2013.

Recommendation:

Demand is King.....so far, and we wish we knew him better! We tend to get regular, fairly current supply data (USDA, DMN, etc.), but our (and most everyone else's) pulse on the demand side of the equation is far less certain. We believe it's this lack of current demand data that has caught everyone (and we include ourselves here) off guard by the sustainability and ferocity of the current bull market in dairy. We are well into March but we only recently received our Jan export numbers, which showed another strong uptick in cheese exports. Now our Cold Storage report indicates Feb cheese stocks 5-6% below last Feb and flat vs. Jan, while our Milk Production report has our dairy herd in Feb unchanged from Jan. Weekly cold storage numbers already have cheese stocks down 6% through 03/17, almost assuring we'll see another drawdown when the Mar Cold Storage report is released a month from now. The obvious conclusion from all of this, and affirmed in Rabobank's quarterly report, is that so far, demand is outstripping supply; even an increasing supply. And this is why we set a new record high for cheddar blocks this week in the spot market. Fresh blocks continue to be tight as the gains this week were all bids and no sales. Barrels appear to be more readily available, but will most likely follow blocks higher, which we think will happen next week. CA output is at the peak and will now start to trend lower. The state that accounts for nearly 20% of the nation's milk output is in severe drought and feed costs, hay in particular, are rapidly rising. The Midwest is warming up but is still struggling with poor feed issues and the effects of a brutal winter. Ice cream demand is building in the South, as is the grilling season. Domestic milk production is going to head higher, but will it satisfy growing demand? Australia and New Zealand are nearing the end of their production seasons and will soon dry off their cows. Output in Western Europe is surging, but they are constrained by processor capacity. Domestically, there appears to have been little ability (or desire at current cheese prices) for aging programs to be building inventory. The most likely scenario is that prices stay strong here well into Q2. We're not saying we can't retrace from record high prices. We have the most expensive cheese in the world at the moment. But it also seems unlikely that cheese heads below \$2 any time soon. We willed our 18.50 x 22.00 May-Oct fence this week. This is great insurance for hedgers. Going forward, however, we think producers should switch to a PUT-only plan. No one knows when these prices will correct, but the funny thing about demand (and Kings, for that matter), is that they can change their minds in an instant (at least for the short term). Buyers have demonstrated in the past the ability to just stop buying past a certain price point. Supply, on the other hand, is not so lucky. The milk supply takes months for it to change momentum. And it's for this reason we still think hedgers should be active in this market, obtaining protection. Consider entering the following target orders: May 20.00 PUT at 20¢, June 19.25 PUT at 25¢, July 19.00 PUT at 25¢, Aug 18.75 PUT at 30¢.

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