

**The KDM Dairy Report – September 19<sup>th</sup>, 2014**

**What's Bullish:**

- Spot Market: Blocks increased 10¢ during the week to settle at \$2.45/lb on no trades. Barrels were almost as impressive, picking up 9½¢ to close at \$2.45/lb on a single trade. Grade A NDM continued to carve out a bottom, increasing 3½¢ to \$1.37½/lb as buyers picked up 20 loads. Finally, butter made a new record high, gaining 6¢ to settle at \$3.06/lb on 31 trades.
- Milk Production Report: August milk production was up 2.5% in the U.S., well below most analyst expectations. Probably the bigger surprise was cow numbers declining 1,000 head from July, in spite of the low culling trend. The dairy herd is, however, still 47,000 head larger than last year. In addition, USDA revised July milk output down 0.1%, or 1 million lbs, from last month's report.
- Fluid Milk Southeast: Milk production in the region was seasonally strong this week, but that was offset by strong demand as bottling orders increased. Florida's milk production is steady. Hot temperatures prevail throughout, with the southernmost part experiencing heavy rainfall as Tropical Storm Polo passes through the region. Contacts expect the effects of the storm to cause a drop in milk production. Import milk into the state totaled 92 loads this week. Cream supplies are tight. Demand is good as some butter makers look for additional supplies in the spot market.
- Fluid Milk Southwest: Milk production is stepping higher on some operations in NM; however, frequent rain storms there are transforming dry lots into muddy holding areas. Those conditions are negatively impacting milk quality. Milk and/or condensed skim loads are finding processing room within the region. Sales into Class I increased slightly as other regions reach toward the Southwest to fill weekly needs. AZ milk production edged lower this week as cow comfort declines due to frequent rain storms moving through the state. Cream availability is tight, with processors focusing on contract fulfillment. Cream loads continue to clear readily into butter making operations in the West as print butter manufacturers indicate their stocks on hand are currently below Q4 needs. Sales into cream cheese/sour cream production facilities continue to divert butterfat away from the churns. Cream brokers note the upcoming price release for October/November Class 3 butterfat is driving some of the buying now.
- Fluid Milk Pacific Northwest: Milk production in the region continues to decline seasonally, with overall volumes above year ago levels due to increased dairy cow numbers.
- Butter Northeast: Inventories are tight with limited growth, as available orders primarily drive production volumes. Most butter sales tend to target approaching holiday needs. Domestic demand is good with steady interest at the retail level.
- Butter Central: Demand in the region is matching current record prices. However, raw material availability is lacking in comparison to requested butter orders across the market segments of retail, food service and ingredient. Butter manufacturers are generally producing at steady to higher rates, but cream cheese manufacturers' increased demand for cream and willingness to pay premiums to secure supplies has pulled cream away from the churn.
- Butter West: Production in the region is being geared to fulfill retail demand for the upcoming holidays. Bulk butter production is slowing as more butter moves to the print lines. Butter stocks continue to be tight. Current high prices have cut into some of the demand, but orders continue to surpass supplies.
- Nonfat dry milk: Some market participants are optimistic that the bottom of the nonfat market has been found for the time being. Many large volume sales were reported, including some new export orders going out, most notably into Mexico.
- Cheese West: Production is strong as manufacturers take advantage of strong retail demand and increasingly higher prices. Cheese plants are running at full schedules at those plants with sufficient orders to clear production in a timely manner. Milk supplies are available to increase production and manufacturers are also fortifying vats with nonfat dry milk and skim milk solids. Export demand is light, yet plants are struggling to fill the domestic demand.

Futures Month	Class III 09/19	Class III 09/12	Change	Dry Whey 09/19	Dry Whey 09/12	Change	Cheese 09/19	Cheese 09/12	Change
Sep-14	\$24.54	\$24.52	\$0.02	67.000¢	67.000¢	0.00¢	\$2.340	\$2.333	\$0.007
Oct-14	\$24.70	\$23.35	\$1.35	62.500¢	64.000¢	(1.50¢)	\$2.385	\$2.241	\$0.144
Nov-14	\$22.63	\$20.67	\$1.96	59.975¢	60.000¢	(0.02¢)	\$2.203	\$2.009	\$0.194
Dec-14	\$21.06	\$19.45	\$1.61	56.750¢	56.000¢	0.75¢	\$2.075	\$1.915	\$0.160
Jan-15	\$18.96	\$18.13	\$0.83	51.500¢	51.950¢	(0.45¢)	\$1.898	\$1.822	\$0.076
Feb-15	\$17.95	\$17.71	\$0.24	48.550¢	49.000¢	(0.45¢)	\$1.825	\$1.797	\$0.028
Mar-15	\$17.54	\$17.51	\$0.03	47.225¢	48.000¢	(0.77¢)	\$1.791	\$1.779	\$0.012
Apr-15	\$17.47	\$17.52	(\$0.05)	47.000¢	48.000¢	(1.00¢)	\$1.782	\$1.784	(\$0.002)
May-15	\$17.45	\$17.54	(\$0.09)	46.725¢	48.000¢	(1.28¢)	\$1.782	\$1.781	\$0.001
Jun-15	\$17.52	\$17.57	(\$0.05)	47.000¢	48.000¢	(1.00¢)	\$1.787	\$1.790	(\$0.003)
Jul-15	\$17.78	\$17.75	\$0.03	48.250¢	49.000¢	(0.75¢)	\$1.805	\$1.808	(\$0.003)
Aug-15	\$17.85	\$17.74	\$0.11	48.325¢	49.000¢	(0.67¢)	\$1.809	\$1.807	\$0.002
12 Mo Avg	\$19.62	\$19.12	\$0.50	52.567¢	53.163¢	(0.60¢)	\$1.957	\$1.906	\$0.051

**What's Bearish:**

- Weekly cold storage numbers indicate cheese stocks at USDA-selected storage centers have increased 4% (3.4 million lbs) over the period 09/01 through 09/15. Yikes!
- Dairy cow slaughter for the week ended 09/06 totaled just 51,300 head, down 5,200 head (-9.2%) vs. the same period a year ago. YTD, 221,000 fewer head have been culled. Yikes!
- Fluid Milk Northeast: Milk production in the Northeast and Mid-Atlantic regions is steady. Some balancing plants are comfortable with available milk supply levels. Extra milk volumes are available with loads clearing at discounts to Class III and IV manufacturers.
- Fluid Milk Central: Milk production is tapering off seasonally, but above last year levels. Milk supplies are mostly balanced with demand, but bottlers note sales are leveling off as the tourist season comes to a close and schools are back into normal classroom routines. Current record butter fat prices and seasonal declines in sales have caused many ice cream makers to scale back production dramatically. Class II demand is slightly weaker.
- Fluid Milk West: Milk haulers report pickups at Northern California dairies are benefiting from cooler weather, as milk volumes are increasing incrementally. Central and Southern dairies indicate recent hot spells are having a net negative impact on milk production as dairy cows eat less

and drink more water, but feed remains available at affordable prices compared to recent years. Fluid milk sales are steady, but balancing plant operators indicate steady to lighter demand from ice cream/frozen dessert accounts as the season advances.

- Butter: Ingredient buyers are aware of lower priced international butter, notably from Australia and New Zealand. Some of those buyers are making import purchases to satisfy current needs. According to FAS, quota imports of butter for January-July 2014 were up 79% from the same period in 2013. July 2014 quota imports of butter were up 111% from last July. Manufacturers are also cautious about building stocks above immediate demand. With international prices well below the U.S., butter producers are worried about lower priced imports slowing demand after the holiday orders are completed.
- Dry Whey Northeast: Prices declined slightly this week. Production is flat to somewhat higher, while stocks are steadily building. Buyers are hesitant, giving the market a weak undertone.
- Dry Whey Central: Cheaper global prices and whey being the highest dairy protein cost on a per pound basis is pressuring prices down. Spot loads traded at discounts this week. The undertone is softening.
- Dry Whey West: Prices were mostly lower this week as increasingly lower export prices weaken the market. Increased offerings of whey into international markets from the E.U. are being blamed for much of the downward pressure. Whey production is high as cheese plants continue to run heavy schedules to fill holiday cheese buying needs. Demand for whey is steady with spot buyers looking for lower prices.
- Cheese Northeast: Discounted milk supplies are prompting steady to higher cheese production. Demand is good, with inventory levels balanced to satisfy near term customer requirements, but the market undertone is unsettled.
- Cheese Midwest: U.S. cheese prices have risen to a level leading to some recent cheese export orders being returned to domestic sales. Manufacturers are cautious about the implications of building inventory levels at current price levels. Cheese buyers are also wary about stocking inventory too far ahead of current needs at current prices. Cheese orders have declined for some manufacturers. Cheddar aging typically picks up in the fall but current price levels have slowed activity in this regard. However, mozzarella orders remain strong, driven by pizza manufacturing needs.
- This week's GDT auction saw the dairy price index unchanged, but cheddar cheese fell 6.5% to a U.S. equivalent \$1.39½lb. Yikes!
- International: The UK dairy herd has expanded for the first time this century, according to a news article this week. Higher returns and the imminent removal of production quotas has fueled the surge.

#### **Recommendation:**

Friday's surprise Milk Production Report may cause prices to rally when trading opens Sunday evening, but we'd consider it an opportunity to sell. Despite the spot market moving in to new record territory for both cheese and butter, there is an obvious reluctance in this market to move much higher. The first "cracks" in the armor may be appearing as rumors of previously exported U.S. cheese returning as import were verified. Cheese sales in the Midwest are slowing with the record high price. Current supplies are still tight, but every market has a breaking point. As hedgers, you can't wait until the market turns. It will freefall and there will be no opportunity to get covered. Q4 rallied an amazing \$1.64 this week to average \$22.82. Q1 2015 sits at \$18.13 avg. Jan-Jun 2015 is at \$17.79 avg and all of 2015 is at \$17.85 avg. With growing milk output in Oceania and the end to production quotas in the EU, we believe the supply is coming. The current massive spread between U.S. cheese and butter prices with the rest of the world simply is not sustainable. It will close. And hard. \$10 beans are gone while corn flirts below \$3.50/bu. Feed will be cheap. Current spot prices work out to an amazing \$25.45/cwt, so Oct/Nov Class III could still benefit from strength in the spot market. However, we still believe it's only a matter of time before this market corrects. In short, our advice to producers is to:

# SELL!