KDM Trading, Inc.
877.695.8538 www.kdmtrading.com
Dan Schindler, Mark Potter, Keith Schnese & Nick Potter

The KDM Dairy Report – October 3rd, 2014

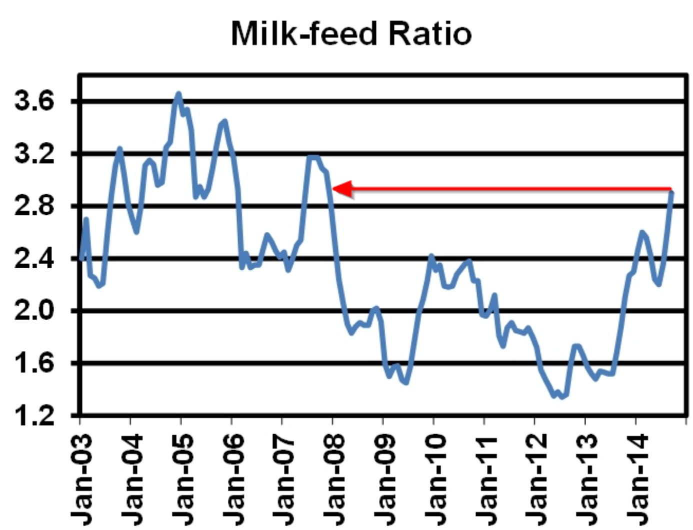
What's Bullish:

Futures Month	Class III 10/03	Class III 09/26	Change	Dry Whey 10/03	Dry Whey 09/26	Change	Cheese 10/03	Cheese 09/26	Change
Oct-14	$24.27	$24.29	($0.02)	65.825¢	64.500¢	1.33¢	$2.327	$2.330	($0.003)
Nov-14	$21.74	$22.03	($0.29)	62.000¢	58.500¢	3.50¢	$2.111	$2.150	($0.039)
Dec-14	$20.10	$20.61	($0.51)	57.000¢	56.000¢	1.00¢	$1.987	$2.036	($0.049)
Jan-15	$18.17	$18.75	($0.58)	51.000¢	51.275¢	(0.27¢)	$1.832	$1.885	($0.053)
Feb-15	$17.72	$17.95	($0.23)	47.000¢	48.500¢	(1.50¢)	$1.815	$1.825	($0.010)
Mar-15	$17.44	$17.76	($0.32)	44.525¢	47.000¢	(2.48¢)	$1.792	$1.810	($0.018)
Apr-15	$17.24	$17.60	($0.36)	44.500¢	46.500¢	(2.00¢)	$1.777	$1.800	($0.023)
May-15	$17.24	$17.51	($0.27)	44.875¢	46.750¢	(1.88¢)	$1.779	$1.797	($0.018)
Jun-15	$17.23	$17.50	($0.27)	43.750¢	46.025¢	(2.28¢)	$1.778	$1.800	($0.022)
Jul-15	$17.35	$17.78	($0.43)	44.000¢	47.000¢	(3.00¢)	$1.794	$1.815	($0.021)
Aug-15	$17.34	$17.90	($0.56)	44.000¢	47.750¢	(3.75¢)	$1.800	$1.820	($0.020)
Sep-15	$17.34	$17.88	($0.54)	44.500¢	48.000¢	(3.50¢)	$1.787	$1.815	($0.028)
12 Mo Avg	**$18.60**	**$18.96**	**($0.37)**	**49.415¢**	**50.650¢**	**(1.24¢)**	**$1.882**	**$1.907**	**($0.025)**

- Dairy Products Report: Cheddar cheese output in Aug was down 1.9% vs. the prior year, while total cheese output saw just a 0.9% increase. Both numbers were well below analyst expectations. Butter output also fell vs. 2013, declining 2.4%. That said, Aug 2013 cheddar output was a bit of an anomaly (on the high side) and 2014 output did exceed the levels of 2010-2012.
- Weekly cold storage numbers indicate butter holdings at USDA-selected storage centers have declined 18% (3.8 million lbs) over the period 09/01 through 09/29. Cheese stocks, however, increased 2% (2.2 million lbs) over the same period.
- Fluid Milk Southeast: Florida milk production is flat. Many counties are under flood warnings as rain has continued for 20 consecutive days. Farmers are unable to get into the fields to plant or harvest, due to muddy conditions. Milk shipments imported into Florida this week totaled 140, 20 more than the previous week.
- Fluid Milk Southwest: NM milk production is steady, but somewhat below expectations. Cow comfort is below normal due to recent rains. Dairy producers indicate dry weather is needed as some holding pens have not dried out. Quality losses are noted for some alfalfa hay bales stored in the open due to recent rains, and subsequent molding. Growers are anxious to harvest irrigated corn fields, but have to wait for dryer weather. Milk loads are finding processing room within the Southwest. With hot, humid weather lingering in parts of AZ, dairy producers report milk production is unchanged. Manufacturing plants are running below capacity, while accepting occasional loads from out of state sellers.
- Fluid Milk Pacific Northwest: Milk production in the region is slowly declining along expected lines. Class I usage is steady. Cream for manufacturing continues to move to various plants for increased production of cream cheese, egg nog and sour cream. Some plants are scheduling maintenance projects as volumes are reduced. UT and ID milk production is declining slowly.
- NDM: Contacts indicate offerings from manufacturers priced under the market are less noticeable in the marketplace as inventories are more comfortable after recent sales transactions. Domestic sales activity is generally light, but offshore sales are increasing, as multi-load volumes are heading to buyers in the Americas and the Middle East.
- Cheese Midwest: The decline in cheese prices last week into this week is leaving Midwest cheese manufacturers and customers more comfortable in terms of prices moving toward a sustainable range. Manufacturers are feeling increasingly confident in manufacturing beyond booked orders and customers are more confident in buying beyond immediate needs. Aging programs are looking toward beginning to accelerate inventory levels. Milk is available to cheese makers at a significant discount below class prices. Managers at cheese plants not operating at capacity are showing interest in buying extra milk. The recent tightness in barrel supplies is easing, with some barrel sales now occurring at flat market. Blocks are available.
- Cheese West: Cheese production is strong in the region, to supply retail demand for the upcoming holidays that remains good. Milk supplies are adequate for those plants hoping to increase production. Cheese makers are cautious about building inventories without solid commitments from buyers. While cheese prices have come off of the record levels, spot sales are slow.
- International: Global milk demand is likely to exceed supply in the next 10 years, according to the latest dairy index released by Tetra Pak. Demand would be driven by population growth, rising prosperity and increased urbanization in emerging markets, including Africa, Asia and Latin America. The expected increase in demand from emerging markets was unlikely to be met by local producers in these emerging markets, opening the door for strong exports from established dairy exporting countries.

What's Bearish:

- Spot Market: Blocks fell 9¢ for the week to settle at $2.15/lb on 9 trades, while barrels gave up 13¢ on 5 trades to close at $2.17/lb. Grade A NDM was unch at $1.39½/lb on just 3 trades, but butter shed 15½¢ on 7 trades to settle at $2.89½/lb.
- This week's Global Dairy Trade auction saw the dairy price index fall another 7.3%. Declines were led by Butter Milk Powder (-11.3%) and Whole Milk Powder (-10%). Cheddar cheese was down 1.2% to a U.S.-equivalent $1.37/lb.
- Ag Prices Report: With falling grain prices and stubbornly high milk prices in Sep, USDA has the preliminary milk-feed ratio for Sep at 2.90, up from 2.61 in Aug, and the highest level since Nov 2007 (see graph).
- Dairy cow slaughter for the week ended 09/20 totaled 56,300 head, down 9.2% (5,700 head) vs. the same period a year ago.
- Fluid Milk Northeast: From the Northeast to the Mid-Atlantic region, farm-level milk production is increasing. Seasonal temperature declines



are contributing to improved cow comfort. Class I demand is steady. Milk volumes to manufacturing are ample.

- Fluid Milk Southeast: Milk production is climbing in the Southeast, as cooler temperatures remain intact. The cancellations of orders by some bottling plants are making it necessary to redistribute milk loads. Surplus shipments are clearing to various dairy manufacturing operations and channeled across regions at a discount. Cream supplies are heavy and readily available. Demand has fallen due to Monday's sharp decline in the CME butter market. Condensed skim milk supplies surged, paralleling increases in milk volumes.
- Fluid Milk Central: Milk supplies are growing as reported spot loads ranged from Class to $2.50 over Class. Bottling sales are mostly flat with the exception of a few areas where heavy promotions pushed orders higher. Cream cheese manufacturers are ramping up production rates. Cream supplies loosened dramatically as current butter and cream prices are causing some buyers to back off unless orders need to be filled.
- Fluid Milk West: Milk production is mostly steady in CA. Milk haulers indicate load volumes stabilized after the most recent declines. Dairy producers have access to ample supplies of good quality feed and forages at manageable prices. Fluid demand is steady, though sales of milk and/or condensed skim into ice cream and related item categories declined as those manufacturers discontinue hot weather specialty items.
- Butter: Orders are good from bakeries, food processors, and private labels, but some sellers are experiencing increased competition in the retail segment as buyers become increasingly price sensitive. Interest for bulk butter is trending lower as less expensive international butter is putting buyers into a wait and see approach on purchases. Butter imports are making their way into the U.S., with some contacts anticipating a huge drop in butter prices.
- Dry Whey: Production in the Northeast is increasing as seasonally strong milk volumes clear to Class III manufacturing. Inventories are growing, giving the market a weak undertone. In the Central region, the undertone is softening as the export market is pressuring some sellers to discount supplies to keep product moving. Domestic interest is light to moderate, production rates are steady to higher and supplies are adequate for current needs. Western dry whey prices were lower this week. Domestic sales are moderate to good, but export sales are competing with lower prices from the European Union. Stocks are generally available from both manufacturers and brokers.
- Cheese Northeast: Cheese production is very active as plants clear heavy intakes of milk, resulting in a few operations employing 7-day production schedules. Inventories are growing with the increase in manufacturing.
- International: Global dairy sector analyst Rabobank issued their latest quarterly report on the global dairy industry, saying that international and regional dairy markets are headed for 12 months of low prices. A strong wave of milk from export regions collided with weaker Chinese buying and a Russian ban on import from key suppliers. They predict a prolonged period of low prices will be required to clear the international market of excess supply.

Recommendation:

Despite a Class III rally on Friday, led by gains in the spot market, the market overall finished in the red. Sep Class III settled at a new all-time record high of $24.60, helping the milk-feed ratio to highs not seen since 2007. The signal has been there for quite some time now to increase production. Feed issues in the Midwest and equity recovery out West has held those gains in check, but it appears that more milk will finally be headed our way in 2015. Producers are expanding. The surge in the US-dollar to multi-year highs will make it all the more difficult for our exports to be price competitive. In fact imports are on the way and already arriving on our shores. There still is good domestic demand in the near term as preparations for the upcoming holidays keep buyers in the mix. That is allowing for an "orderly" decline in cheese prices and butter prices, vs. the absolute free-fall that could have occurred. We still believe rallies should be sold, however. Current spot prices work out to about $22.65 Class III, so the market is predicting further declines with the Nov contract nearly $1 discount. Holiday buying could cause additional pops in the market next week, which hedgers should take advantage of. Consider making additional sales at $22.90 Nov and $20.35 Dec. The 2015 contracts did not benefit by the rally up front and also finished in the red, with the annual average at $17.44 down to a level not seen since April. We would consider selling up to 50% of your milk at $17.50 or better. Then go out and purchase 19.50 call options over the same months for an average 42¢ each. You will be giving up some significant upside, but you will be back in the game should the market turn and move higher. Even more importantly, we would suggest getting sold the 1st half of 2015. The average settled out at 17.51 today. You can snag those same 19.50 calls to protect the upside for 35¢ avg each. Get some coverage in 2015 before that holiday demand ends!