

The KDM Dairy Report – July 22nd, 2016

What's Bullish:

- Spot Market: Block cheese gained 4¼¢ on just 4 trades to settle at \$1.70¢/lb, while barrel cheese increased 3¢ to close at \$1.77½/lb on 16 trades.
- Livestock Slaughter Report: Dairy cow slaughter for the month of June totaled 223,700 head, up 1% vs. last June.
- Milk Production Report: Output in June was up 1.5%, close to analyst expectations, but cow numbers were virtually unchanged from last month, at 9.3 million head. Cow numbers have been flat to slightly lower for four consecutive months.

| Futures Month | Class III 07/22 | Class III 07/15 | Change | Dry Whey 07/22 | Dry Whey 07/15 | Change | Cheese 07/22 | Cheese 07/15 | Change |
|------------------|-----------------|-----------------|---------------|----------------|----------------|----------------|----------------|----------------|----------------|
| Jul-16 | \$15.27 | \$15.33 | (\$0.06) | 27.500¢ | 27.900¢ | (0.40¢) | \$1.644 | \$1.649 | (\$0.005) |
| Aug-16 | \$16.72 | \$16.46 | \$0.26 | 28.175¢ | 29.500¢ | (1.33¢) | \$1.784 | \$1.750 | \$0.034 |
| Sep-16 | \$16.68 | \$16.49 | \$0.19 | 30.750¢ | 31.500¢ | (0.75¢) | \$1.770 | \$1.742 | \$0.028 |
| Oct-16 | \$16.63 | \$16.52 | \$0.11 | 31.950¢ | 32.275¢ | (0.32¢) | \$1.750 | \$1.740 | \$0.010 |
| Nov-16 | \$16.38 | \$16.40 | (\$0.02) | 33.250¢ | 33.000¢ | 0.25¢ | \$1.717 | \$1.726 | (\$0.009) |
| Dec-16 | \$16.05 | \$16.18 | (\$0.13) | 33.500¢ | 33.725¢ | (0.23¢) | \$1.689 | \$1.706 | (\$0.017) |
| Jan-17 | \$15.94 | \$16.04 | (\$0.10) | 34.000¢ | 34.400¢ | (0.40¢) | \$1.680 | \$1.688 | (\$0.008) |
| Feb-17 | \$16.07 | \$16.10 | (\$0.03) | 35.350¢ | 35.350¢ | 0.00¢ | \$1.683 | \$1.671 | \$0.012 |
| Mar-17 | \$16.16 | \$16.15 | \$0.01 | 35.500¢ | 35.500¢ | 0.00¢ | \$1.698 | \$1.679 | \$0.019 |
| Apr-17 | \$16.16 | \$16.23 | (\$0.07) | 35.550¢ | 35.550¢ | 0.00¢ | \$1.700 | \$1.703 | (\$0.003) |
| May-17 | \$16.31 | \$16.31 | \$0.00 | 35.475¢ | 35.475¢ | 0.00¢ | \$1.716 | \$1.705 | \$0.011 |
| Jun-17 | \$16.45 | \$16.47 | (\$0.02) | 36.000¢ | 36.000¢ | 0.00¢ | \$1.725 | \$1.718 | \$0.007 |
| 12 Mo Avg | \$16.24 | \$16.22 | \$0.01 | 33.083¢ | 33.348¢ | (0.26¢) | \$1.713 | \$1.706 | \$0.007 |

- Fluid Milk Southeast: Hot weather in the region continues to prompt declines in milk production. In Florida, milk production is steady to lower as the state confronts recurring rain, with hot and humid conditions. Sales are currently steady to lower, but demand should increase the first week of August with the start of school. Spot milk shipments out of the area were 50 loads, down 40 loads from last week. Contacts expect import milk shipments to begin in the next 30 days.
- Fluid Milk Central: Milk production continues to drop off in the region. Components are down as well, leaving many milk processors making production adjustments. Spot loads are increasingly difficult to come by. Many milk marketers anticipate this situation will continue to tighten at the end of this week and into the weekend due to the weather forecast predicting the highest temperatures the Central region has faced thus far in the season. Bottlers report steady demand from retail and foodservice outlets. Cream is still readily available, though a few market participants feel the cream market is tightening. Ice cream and frozen dessert manufacturers report strong sales. Some ice cream manufacturers are stepping up production and are pulling more cream into production. Market participants anticipate this market to tighten when the forecasted high temperatures hit.
- Fluid Milk Southwest: Farm milk production is steady to lower in California. The higher temperatures in the Central Valley are taking a toll on cows' comfort. Some dairy operators are drying off cows, which is common for this time of year. Alfalfa hay harvesting continues across the state, but inventories for high quality alfalfa are tight. In Arizona, daytime temperatures are averaging 111 degrees. Consequently, milk yields are lower this week. Sales for ice cream and others Class II dairy products are higher this week. In New Mexico, milk production is trending lower. The warm weather is raising stress in dairy herds. Bottled milk requests from retailers are up this week as some supermarkets are restocking shelves. In addition, demand for flavored fluid milk is active. Orders from food service are steady. Class II sales are up as demand for ice cream continues increasing. Manufacturing milk volumes moving into Class III are down as some processing plants have maintenance/repair work. Condensed skim interest from NDM producers is strong. Western cream supplies continue to be tight. Cream sales into ice cream production are strong.
- Butter: Churning is active across the nation. However, cream supplies are generally tight. At this point, the butter market undertone is firm. Domestic demand from retailers is strong.
- Cheese Central: Cheese production is active, but milk production is tapering off and spot loads of milk are becoming increasingly difficult to come by. Demand for cheese is strong and growing. Several manufacturers report buyers requesting additional loads outside of contracts as well as new buyers looking to make a purchase. Processed cheese sales continue to do well as grilling season is at its peak. Manufacturers of Italian and fresh type cheese report growing inquiries and strong sales. Inventories are mixed. Several weeks of growing sales have aided in inventory relief throughout the Central region.
- Cheese West: Cheese manufacturers and producers are enjoying active and strong production. Plenty of milk is finding its way into cheese vats, even in areas where milk production is seasonally down. However, domestic demand is strong for process cheese and fresh barrels. Some industry contacts are meeting their contractual orders. Buyers are actively seeking out current production, especially for cheese barrels, which are becoming more difficult to find and are sold relatively quickly.
- International: EU milk production during May was 0.2% above last year, a slowing for May compared with the year as a whole. New government efforts to reduce milk production moved forward this week. These measures are to help mitigate the activity of a number of dairy producers to increase production as prices fall, so as to maintain cash flow. In Eastern Europe, Russian imports of many dairy products increased from January-May, 2016, with Belarus being a significant source.
- International: Continuing drought in Central Queensland has left poor pasture availability. The lingering multi-year dryness has led to herd reductions. Many producers are too cash strapped to purchase much hay, which has led to herd reductions as a way to cope with poor pasture availability. In Southern Australia most producers are minimally feeding, constrained by cash flow. Hay is readily available but most buying is hand to mouth. According to Dairy Australia, May 2016 milk production in Australia was 5.5% below May 2015.

What's Bearish:

- Spot Market: While cheese prices were higher, spot butter finished the week down 2¼¢ to settle at \$2.29¢/lb on 19 trades, while Grade A NDM lost 3¢ to \$0.84½/lb on 16 trades.
- Cold Storage Report: Butter stocks at the end of June were up 27% vs. a year ago, while American cheese stocks increased 11%. Total cheese stocks were 10% higher than last year. Nothing surprising, but still bearish.
- Weekly cold storage numbers indicate both cheese and butter stocks are on the rise. Cheese holdings at USDA-selected storage centers are up 2% (2 million lbs) over the period 07/01 through 07/18. Butter holdings over the same period are also up 2% (741,000 lbs).
- Dairy cow slaughter for the week ending 07/09 totaled just 43,900 head, down 16.7% vs. the same period a year ago.

- Fluid Milk Northeast: Manufacturing milk supplies in both the Northeast and Mid-Atlantic regions are steady to heavy. Reductions in Class I demand increased milk supplies to manufacturing plants and have more than offset seasonal declines in milk production.
- Fluid Milk Pacific Northwest: Dairies in the region are enjoying moderate temperatures and good cow comfort. Milk production has rebounded somewhat from the high heat several weeks ago. Milk intakes are in good balance with processing needs. A recently completed facility expansion has increased plant capacity in the region. Milk is readily available in the mountain states of Colorado, Idaho and Utah. Although recent high temperatures may have taken the edge off milk production, plenty of milk is available for processing needs. Some milk continues to move within and from the region as a few cooperatives and manufacturers seek to push off excess milk into neighboring states.
- NDM: Prices are lower at both ends of the price range series while the mostly series holds steady. Sellers motivated to move spot loads of low/medium heat NDM are willing to lower their price point, pulling the price range lower. Demand is mixed. Some market participants feel buyer interest is only present when offers are made at the lower end of the market. Inventories are generally long. Lackluster market interest is leaving some market participants with large stocks on hand. Several manufacturers report building inventories.
- Cheese Northeast: Cheese production is mostly steady as seasonal milk suppliers continue to push active processing. Cheese makers are adding to growing inventories. Domestic demand generally varies, as some manufacturers report a slowdown in sales. Global interest remains sluggish.
- International: New Zealand dairy producers are feeling more positive this milk production season. Many are finding that production outputs are better than they had been expecting. Recent rains have helped replenish water reserves in some areas that had been dry.

Recommendation:

It was block cheese's turn to put in a new high this week, as it hit \$1.70/lb for the first time since Nov 2015. Barrel cheese also reached new heights for the year, as it reached \$1.77½/lb, a level not seen since Nov 2014. Many have asked how cheese prices can be rising at the same time we sit on record amounts of cheese in storage. The answer is that it's the wrong cheese! There is currently very strong domestic demand for fresh barrels, but we have limited production capacity for them. The U.S. hasn't seen a new barrel plant in 10 years. Most of the cheese in storage has some age to it. So, while we are at the height of grilling season, process demand is very strong, meaning barrels are tight. The current heat wave is also adding to the bullish feel. Temps are very warm and humidity is high even in the upper Midwest. Despite fans, misters, etc., production is dropping substantially, from what we're hearing. Schools will be starting up fairly soon in parts of the country, so fluid pipelines will need to be refilled. It probably means the current strength in the market will continue for several more weeks. We're even hearing the \$1.80 cheese is a possibility (we're almost there, actually). But beware! While we still maintain the lows for the year are in, the possibility for a retracement is strong. Nothing goes up forever. Once temperatures begin to cool and process demand slows, we could see cheese take a sharp break back into the \$1.50's, as demand shifts away from process/barrel cheese, and towards the very plentiful aged cheese currently sitting in coolers. Producers should look to add hedges Oct-Mar if Class III prices inch towards \$17/cwt. Or use options to buy PUTs or a fence. Price insurance will get more expensive should we take that sharp break we think may happen. Longer term though, we think that break will be the start of a much longer bull run for dairy. Milk output in the EU is now starting to decline, and cash-strapped operations in Oceania will have a hard time expanding. The U.S. is in an enviable spot to take international market share, and improve it's exports.

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