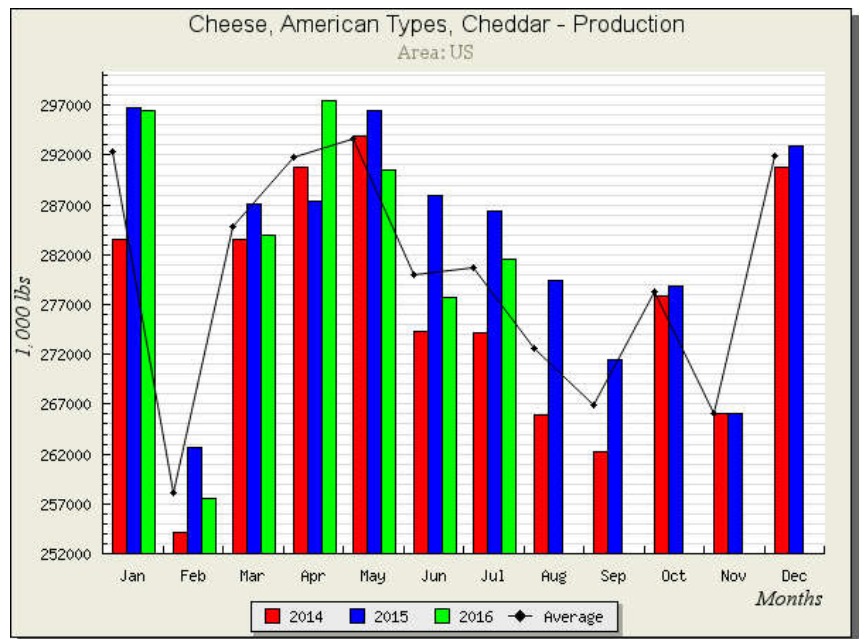


The KDM Dairy Report – September 2nd, 2016

What's Bullish:

- Dairy Products Report: Cheddar cheese output in July was down 1.7% vs. a year ago, according to USDA (see graph below). Total cheese output increased 1.4% as more milk was redirected to produce Italian varieties. Butter output, however, was up 6% vs. last July.
- Weekly cold storage numbers are showing a strong drawdown in both cheese and butter stocks. Holdings at USDA-selected storage centers fell 6% (1.9 million lbs) for butter and 4% (3.9 million lbs) for cheese over the period 08/01 through 08/29.
- Fluid Milk Northeast: Milk production in the region moved slightly lower. Class I demand continues to fill pipelines as remaining schools are set to begin following the upcoming Labor Day period. Milk production in the Mid-Atlantic is steady to lower. Manufacturing is operating at levels 50% below capacity in some instances, as milk receipts continue to decline. Bottling orders are active, prompted by increased customer demand.
- Fluid Milk Southeast: Farm milk declines in the region continue to require incoming milk shipments to support active fluid sales. Sales in the area are steady with add-ons to orders, as heavy milk volumes clear to a number of school networks. Weather conditions remain hot in Florida. Milk production continues to fall off. This week, 95 loads of milk were imported into the state, up from 40 loads last week.
- Fluid Milk Central: Milk production in the region is uneven. Farm level milk production in the southern region is heading incrementally higher. However, in the northern areas of the region, farm level milk production is still trending downward. As Class I demand trends upward seasonally, sales into manufacturing facilities are declining and limited, in many cases, to contractual volumes. Milk marketers and manufacturers note the lack of availability of spot milk loads for Class II and III production. Spot sales are clearing within a narrow price range, \$.50 - \$3.00 over Class.

Class III 09/02	Class III 08/26	Change	Dry Whey 09/02	Dry Whey 08/26	Change	Cheese 09/02	Cheese 08/26	Change
\$16.87	\$16.60	\$0.27	30.900c	30.625c	0.27c	\$1.799	\$1.769	\$0.030
\$16.98	\$16.57	\$0.41	35.500c	34.975c	0.52c	\$1.777	\$1.740	\$0.037
\$16.70	\$16.24	\$0.46	36.300c	36.350c	(0.05c)	\$1.745	\$1.697	\$0.048
\$16.28	\$15.94	\$0.34	37.250c	37.500c	(0.25c)	\$1.697	\$1.663	\$0.034
\$15.96	\$15.78	\$0.18	38.000c	38.875c	(0.88c)	\$1.657	\$1.650	\$0.007
\$15.96	\$15.90	\$0.06	38.250c	38.500c	(0.25c)	\$1.665	\$1.657	\$0.008
\$16.04	\$16.02	\$0.02	38.950c	39.550c	(0.60c)	\$1.667	\$1.669	(\$0.002)
\$16.13	\$16.20	(\$0.07)	38.750c	39.975c	(1.23c)	\$1.685	\$1.684	\$0.001
\$16.30	\$16.36	(\$0.06)	39.000c	39.975c	(0.98c)	\$1.697	\$1.697	\$0.000
\$16.46	\$16.57	(\$0.11)	39.475c	40.000c	(0.52c)	\$1.715	\$1.715	\$0.000
\$16.65	\$16.85	(\$0.20)	39.000c	40.725c	(1.73c)	\$1.741	\$1.740	\$0.001
\$16.74	\$16.90	(\$0.16)	39.250c	40.975c	(1.73c)	\$1.740	\$1.746	(\$0.006)
\$16.42	\$16.33	\$0.10	37.552c	38.169c	(0.62c)	\$1.715	\$1.702	\$0.013



- Butter: Production is ongoing in the Central and West regions, but has slowed significantly for some processors in the East. Nationwide, some churn operators are running production schedules at full capacity to meet the upcoming Q4 needs. However, butter production is intermittent in a few processing plants as cream continues tight in those facilities. Bulk butter microfixing is active in the Central region. Domestic print butter demands from restaurants and many retail outlets are strong.
- Dry Whey Northeast: Prices moved higher this week. Current production is moving through contracts with little available for spot market activity, as milk receipts decline seasonally. As the baking sector expands fall production schedules, the dry whey market is seeing fair to good demand. Inventories are light. The market undertone is firm.
- Dry Whey Central: Inventories are mixed. Stocks of a few specific brands are tight and command stronger prices. Other industry contacts report dry whey is readily available from both manufacturers and the secondary market. Overall, inquiries are steady and dry whey is moving well through regular contracts.
- Dry Whey West: Prices increased during the week. Manufacturers report good demand and the proximity to export markets is providing some strength in the western whey market. Inventories are mixed. A few processors indicate their stocks are committed through the end of the year, while others have greater availability. A few processors say their commitments for higher whey protein concentrations have reduced the amount of whey powder they have been able to make.
- Cheese Northeast: Steady drops in milk supplies are lowering production levels. Domestic cheese sales are good in both wholesale and retail sectors. Processors are set on building cut cheese stocks, for strong fall seasonal contract needs. Inventories, in general, are adequate.
- Cheese Midwest: Milk has gotten a little tighter and spot loads of milk are harder to find. Although a few processors are occasionally buying an extra load of milk, others are more cautious. There is some concern about what the cheese price will do. A few cheese makers have backed off on their production runs. Inventories are long industry-wide for American and Italian cheese, but manufacturers say they are managing their inventories closely and, in some cases, have been able to lower their cheese holdings.
- Cheese West: Output remains active as there are very few obstacles in getting enough milk for most processing needs. Some cheese makers are running full production schedules. Although exports have been sluggish, domestic demand for natural cheese has been good. Retail accounts are

pulling good volumes and cheese is moving well through existing contracts. A few manufacturers report that although cheese supplies are long across the industry, they have been able to draw down their cheese stocks and are regularly turning over their inventories.

- Foreign Cheese: Cheese in the EU remains in shorter supply than desired. June was the first 2016 month where EU cheese production fell below the corresponding month's level for the previous year, according to Eucolait. Manufacturers say that limitations on milk availability for cheese making is what limits cheese production.
- International: Continuing firmer prices in Western Europe for most dairy commodities is encouraging dairy manufacturers. The trend of skim milk powder market demand increasing, coupled with milk drawing away from SMP production, results in need to sell less into intervention. Tighter current cheese inventories reflecting production not able to keep up with demand, was not expected earlier this year, but is now a factor in drawing milk away from SMP production and tightening that market. Overall there is increasing confidence that the EU is moving into a period where higher prices will be sustainable into 2017.
- International: The new milk production season in Australia opened weaker than last year. According to Dairy Australia, July 2016 milk production in Australia was 10.3% below July 2015. Continuing to drag milk production is producers reducing cow numbers. Another factor is that a number of dairy producers responded to recently lowered milk pay prices by "retiring". Looking ahead for the season, general expectations are for the season to yield less milk than last season. Cheese supplies are tightening for some manufacturers. The tighter cheddar supplies are related to higher prices and returns currently available for Mozzarella manufactured in Oceania, with some sales near \$4,000 per metric ton. This has led to a shift in manufacturing preference toward Mozzarella from cheddar.

What's Bearish:

- Spot Market: Blocks finished the week down 6¢ to \$1.68/lb on 1 trade. Barrels fell 4¢ to \$1.64/lb on 32 trades. Grade A NDM gained 2¢ to \$0.87/lb on 12 trades, while butter lost ¼¢ to \$2.05/lb on 12 trades.
- Cold Storage Report: Butter stocks at the end of July were 31% higher than a year ago, according to USDA. American cheese stocks and total cheese stocks were both 10% higher over the same period.
- Livestock Slaughter Report: Dairy cow slaughter in July totaled 213,300 head, down 10.6% vs. a year ago, and the lowest July total since 2011.
- Fluid Milk Northeast: Hot weather saw some relief this week in the Northeast. Evening temperatures dipped down into the 50s in some parts of the area, boosting cow comfort. Milk marketers report a smaller decrease in milk production than in recent weeks. As education institutions go back into session, bottlers report strong orders for single serve containers. Industry contacts report availability of discounted spot loads of milk on the weekends.
- Fluid Milk Southwest: Farm milk production in California is steady to slightly higher. The cooler temperatures are relieving heat stress on cows. Milk volumes into manufacturing are sufficient to meet processing needs. Demand for Class 3 (ice cream) is waning. Arizona, milk output is heading up as temperatures are dropping slowly. With the reopening of schools, manufacturing milk volumes are lower, but sufficient to keep local balancing plants busy. Many processors anticipate a drop in sales during the Labor Day holiday weekend as schools will be closed. Class II sales are steady to lower. Harvesting of good/excellent quality alfalfa hay is active around the state. Lower temperatures in New Mexico are supporting comfort of dairy cows. Therefore, the farm milk output is higher. Bottling sales are steady to lower, as most of the school pipelines are full. Class II sales are lower as demand for ice cream is weakening. Manufacturing milk volumes moving into Class III manufacturing plants are higher this week. Dairy operators' interest for high quality alfalfa is light as supplies are readily available.
- Fluid Milk Pacific Northwest: Milk production is steady to slightly lower but adequate for most processing needs. Bottling demands from school milk programs continue to take good volumes of milk. Milk production is steady in the mountain states of Colorado, Idaho and Utah. After reaching the peak, milk output hasn't trailed off very much. Intakes are in fairly good balance with processing needs. Manufacturers report no problems getting milk.

Recommendation:

Spot cheese prices were down this week, but tempered their decline. By the end of the week, buyers became more aggressive, picking up 15 loads of barrels alone on Friday. With international cheese prices rising closer to parity with the U.S., bidders most likely felt further downside in cheese prices was limited. In addition, while not as tight as in the past several weeks, domestic demand continues to clear large volumes of cheese. Cooler nights are helping aid cow comfort in many of the southern regions, but the Southeast remains hot and humid, continuing to be a milk deficit region. Clearly fresh cheese supplies are more available, as seen in the volumes traded in the spot market. However, we would view the market as more balanced, with good, two-sided trade occurring. That probably means Class III prices will remain fairly steady in the near term. After reaching heights that were probably too high, then plummeting too far, Class III's saw a nice rebound up front. Wheat put in a 10-year low this week, while both corn and soybeans continued to drop in the face of ever improving crop conditions. Cheap feed will make cheap milk. Despite the global milk supply beginning to contract, further weakness in grains will need to be watched. Should Class III futures continue to rally next week, we would place some target orders in for Q4, which settled at an average of \$16.66 today. Enter orders to sell at \$16.90 or higher. Q1 2017 settled at \$15.99 today. Consider lightly selling at \$16.20 or higher. Any sales in Q1 should be protected with call options at some point.

Note: Our offices will be closed on Monday in observance of Labor Day

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