

The KDM Dairy Report – October 28th, 2016

What's Bullish:

- Spot Market: Butter rallied 16½¢ for the week to settle at \$1.92½/lb on 38 trades. Blocks gained 8¢ to close at \$1.73/lb with just 5 trades, while barrels picked up 2¾¢ to \$1.59¼/lb on 19 trades. NDM gave up 2½¢ to settle at \$0.85¼/lb with 6 trades.
- A strong, seasonal drawdown was reflected in this week's Cold Storage Holdings update. Cheese stocks at USDA-selected storage centers fell 5% (4.7 million lbs) while butter stocks declined 16% (3.9 million lbs) over the period 10/01 through 10/26.
- Fluid Milk Southeast: Milk output is increasing marginally. Balancing plants are able to fill fluid contracts, but with minimal supplies remaining for manufacturing. Farm milk production in Florida is holding steady, with slight increases in some areas. Components are trending up. However, cream supplies continue to see strong pulls from Class II. Regional availability is somewhat tight. Condensed skim milk supplies are adequate for meeting fluid contracts, although limited supplies remain for manufacturing or spot sales.
- Butter Northeast: Some butter operations in the region are subject to an ease in production as Class II cream procurements peak for holiday processing needs, as those operations rely upon in-house and contracted cream loads. Butter plants continue to grind and micro fix existing bulk supplies to fill orders. This week, reported bulk butter transactions included prices ranging 3 to 5 over the CME Group.
- Butter Central: Farm milk output and components are up and cream is readily available for churning. However, most butter processors are running at full capacity as holiday orders continue to develop. Demand from retailers is strong as the Q4 holidays are very close. Some manufacturers and buyers are settling up contracts agreements for Q1 2017. Some churn operators are trying to lower inventories after microfixing. Spot prices at the CME group are starting to firm again.
- Butter West: Churns are active as butter makers ramp up in advance of holiday demand. Industry contacts say production and sales are strong. Cream supplies are adequate for most processing needs, although cottage cheese, cream cheese sour cream are pulling heavily for available cream. Butter inventories may still be long as compared to last year, but end users suggest there has been a good draw down of available butter stocks.
- Cream West: Demand from Class II/III processors is strong as sour cream and cream cheese production is ramping up ahead of the year-end holidays. Butter churners continue pulling heavy cream supplies.
- Dry Whey Northeast: Spot prices continue to strengthen, while basing points moved contract prices higher. Production is steady to lower as some cheese manufacturers' milk receipts lessened. The dry whey market has few supplies available separate from committed product. Demand is light to moderate, with a firm market undertone.
- Dry Whey Central: Manufacturers report growing interest from buyers to establish contracts for 2017. Demand is decent and dry whey is moving well through existing agreements. Inventories are mixed. A number of manufacturers have tight or committed inventories, but industry contacts suggest dry whey is available from some processors and in the secondary market.
- Dry Whey West: Prices moved higher this week. Specific brands, or whey having characteristics desired by end users are commanding prices at the top of the price range. Industry contacts say demand is decent in domestic and export markets. Some buyers are seeking agreements for Q1 and Q2 of 2017. Manufacturers' inventories remain tight and committed.
- NDM Northeast: Prices saw marginal declines this week, due to f.o.b. spot purchases. However, the region's production rates are steady to lower. Both maintenance programs and limited condensed skim availability push against output rates. Spot load availability is scarce in balancing with little to no drying occurring at some NDM facilities.
- Cheese Northeast: Cheese production continues at a pace comparable to last week. Additional demand for fluids from Class II accounts, for holiday production needs, bear on some plants' milk supplies. Cheese stocks are mostly current with good demand for mozzarella, aged cheddar, and cream cheese.
- Cheese West: Dairy contacts say cheese production is strong and active. However, milk is in pretty good balance with processing needs and gets quickly gobbled up by nearby processors. Cheese makers report good domestic retail demand and a solid pull from food service accounts. Some industry contacts suggest there is still plenty of cheese available, however others report that Western block supplies are much lighter than they were earlier in the season.
- Foreign Cheese: Prices continue to increase in Europe, most strongly for cheddar and mozzarella. Stocks are at a low level. With the European milk supply continuing to decline, there is scant expectation of cheese stocks being rebuilt in coming weeks.
- International: European Union milk production during August was the third consecutive month of 2016 with lower production than year earlier. The top three milk producing countries reported lower milk production for August 2016 than 2015: Germany, -1.8%; France, -2.0%; and United Kingdom -7.1%. The lower production is a factor in manufactured dairy products increasing in price, which will also benefit farm milk prices. Current reports from processors in Germany and France are that milk intakes are moving lower, as expected. Milk production in the Netherlands is also slowing. Butter prices firmed at each end of the price range. This took butter prices to another high for 2016. There are no intervention stocks of butter and private storage stocks are considered normal. Butter stocks are tighter. Declining milk production has some buyers more anxious to secure butter commitments.

Futures Month	Class III 10/28	Class III 10/21	Change	Dry Whey 10/28	Dry Whey 10/21	Change	Cheese 10/28	Cheese 10/21	Change
Oct-16	\$14.78	\$14.73	\$0.05	32.900¢	32.400¢	0.50¢	\$1.577	\$1.577	\$0.000
Nov-16	\$15.69	\$15.46	\$0.23	35.300¢	34.725¢	0.57¢	\$1.657	\$1.639	\$0.018
Dec-16	\$15.57	\$15.21	\$0.36	36.550¢	36.825¢	(0.28¢)	\$1.632	\$1.606	\$0.026
Jan-17	\$15.56	\$15.36	\$0.20	36.500¢	36.275¢	0.23¢	\$1.634	\$1.624	\$0.010
Feb-17	\$15.71	\$15.55	\$0.16	37.025¢	36.300¢	0.73¢	\$1.643	\$1.640	\$0.003
Mar-17	\$15.95	\$15.76	\$0.19	37.000¢	36.325¢	0.67¢	\$1.663	\$1.656	\$0.007
Apr-17	\$16.00	\$15.90	\$0.10	37.100¢	36.525¢	0.58¢	\$1.672	\$1.665	\$0.007
May-17	\$16.10	\$16.00	\$0.10	37.100¢	36.700¢	0.40¢	\$1.681	\$1.681	\$0.000
Jun-17	\$16.26	\$16.20	\$0.06	37.000¢	37.100¢	(0.10¢)	\$1.696	\$1.698	(\$0.002)
Jul-17	\$16.41	\$16.40	\$0.01	37.500¢	37.100¢	0.40¢	\$1.720	\$1.715	\$0.005
Aug-17	\$16.62	\$16.55	\$0.07	38.000¢	37.000¢	1.00¢	\$1.735	\$1.735	\$0.000
Sep-17	\$16.70	\$16.65	\$0.05	38.050¢	37.325¢	0.72¢	\$1.738	\$1.739	(\$0.001)
12 Mo Avg	\$15.95	\$15.81	\$0.13	36.669¢	36.217¢	0.45¢	\$1.671	\$1.665	\$0.006

- International: Milk production expectations for Australia are being revised lower. According to Dairy Australia, September 2016 milk production in Australia was 10.2% below September 2015. Reasons for the lower production include continuing producer dissatisfaction with recent pricing decisions. This has resulted in a number of producers seeking alternate outlets for their milk. Because many other processors are limited by capacity in terms of accepting new milk sources, there has been an increase in culling cows. Wet conditions in Northern Australia and Western Victoria have further impacted milk production. This is already leading to expectations that October milk production will be lower than October last year, leading to revisions of previous predictions of slightly lower October production. Some analysts are pondering 12-month production being lower than volumes for a number of years, historically low milk production.

What's Bearish:

- Through 10/15, the U.S. dairy cow slaughter is behind last year by 40,000 head.
- Fluid Milk Northeast: Milk production in the region is flat. Class I demand is unchanged, while manufacturing milk supplies remain sufficient for processors' needs. Mid-Atlantic farm level production is steady. Class I sales are firm, as Class II sales progress. Manufacturing supplies are adequate as most producers are comfortable with current levels.
- Fluid Milk Central: Milk production has turned upward in many southern areas of the region. Weather conditions have moderated, and cow comfort is on the rise. In the North Central area, dairy operators report generally steady milk production, but protein and butterfat components are recording some increases. Overall Class I demand for milk is stepping lower. Several balancing plant operators indicate they are regularly fielding cancelations on orders. This is leaving some milk available for spot clearing. Commodity cheese producers are generally not looking for additional milk loads. Cream is readily available within the region.
- Fluid Milk Southwest: Milk production in California is seasonally higher in Southern California as the good climate has been conductive to cow comfort. Milk volumes are in balance with processing needs. In Arizona, milk output is trending higher. Milk components continue improving. Milk intakes are in good balance with current processing needs. In New Mexico, milk yields are higher as cooler temperatures are boosting cow comfort. Class I sales are up as some grocery stores are restocking shelves. Class II sales are lower.
- Fluid Milk Pacific Northwest: Milk production in the region is following typical seasonal patterns. It is nearing the bottom of the annual cycle, but manufacturers report having adequate supplies for most processing needs. Pasture and rangeland condition is good or excellent in 25% of Oregon and 48% of Washington. In the mountain states of Colorado, Utah and Idaho, milk production is easing back along seasonal patterns. However, manufacturers report their milk is in good supply and adequate to meet most processing needs. Pasture and rangeland condition is good or excellent in 54% of Colorado, 41% of Utah and 47% of Idaho.
- NDM Central: Prices for low/medium NDM are lower through the mostly series, in an unsettled market. Buyer interest is mostly light to moderate, as reluctance is displayed in making block purchases and contentment with acquiring individual loads. NDM production is expected to rally in the near term, but for now, seasonal Class pulls weigh on milk supplies.
- NDM West: Buyers/end users are putting pressure on manufacturers, holding off on purchases, and taking a wait and see approach, anticipating lower prices. However, processors are optimistic about future prices. Low/medium heat NDM inventories from recent production are readily available. Also, some processors are trying to clear old stocks with some age at prices close to the bottom of the range. Production is ongoing as moderate to heavy condensed skim volumes continue clearing into dryers.
- Cheese Central: With steady milk production and increasing components, cheese yields are improving. Spot loads of milk are available, but many cheese makers are content to use the milk available to them and only buy the milk if they have room and if the price is right. A few manufacturers are noting warehouses seem full as processors ramp up production for the holidays. Contacts think this will resolve itself once seasonal demand overtakes supply. Cheese inventories are a little heavy for barrels but in better balance for blocks. Retail domestic consumer demand is solid, but seasonally slowing for process cheese.
- International: New Zealand milk production during September, as reported by DCANZ, was up 1.1% vs. a year ago. There are increasingly voiced expectations that production in December and January, typically among the highest producing months, will be sufficient to result in seasonal production higher than last season.

Recommendation:

Class III's were solidly higher this week as gains in the spot market propelled futures higher. Block cheese reached its highest level since late August. Butter saw the biggest gain as talks of increasing export interest and holiday competition domestically for cream caught some folks by surprise. Cheese output continues to be strong across the country, but holiday demand is expected to clear a lot of the stocks currently sitting in warehouses. Dry whey prices continue to creep higher, with a firm outlook ahead. Each penny gain in dry whey adds 6¢ to the Class III price, so even a 4¢ increase adds 24¢ to Class III. On the international front, cheese remains tight in the EU with little hope of satisfying demand until milk output begins to pick up after November. And while New Zealand appears to be having a stable start to their new milk production season, Australia is in a shambles. Low milk prices, wet weather and increased culling have put a substantial dent in milk output. Analysts don't believe output will be able to recover, with some predicting a multi-year low. With output also falling in the EU, it sets up a stronger case for substantially increased dairy exports for the U.S. in 2017. Class III 2017 contracts have started to climb. The average last Friday was \$16.16, while today's settlement was \$16.25. It had reached as low as \$16.03 on 9/27. We still think producers should hold off selling 2017 contracts in any great number, and we reiterate our 2-step hedge idea to purchase call options Jan-Apr, followed by resting sell orders near those strike prices. For example, the Jan-Mar 17.00 call options settled at an average 16¢ per month. Buy them, then enter orders to sell or contract with your plant at, say, 16.50/avg. Futures prices would need to rally about \$.75/cwt to hit those targets. If prices rallied further, you would miss out on the upside from 16.50 to 17.00, plus the 16¢ premium paid, but after that, you'd be covered. Call us if you're not sure how this would work and we'd be glad to explain it in further detail.

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