

The KDM Dairy Report – December 2nd, 2016

What's Bullish:

- Spot Market: Grade A NDM jumped 10¼¢ to settle at \$1.00¼/lb on 20 trades, while butter picked up 13¼¢ to close at \$2.18½/lb on 14 trades.
- Outlook for U.S. Ag Trade Report: USDA's quarterly look at U.S. Ag exports saw them raise their dairy expectations by \$500 million, to a projected total of \$5.3 billion. The cite milk output declines in key milk-producing countries leading to higher global prices, to the benefit of U.S. exports.
- Butter stocks at USDA-selected storage centers have fallen 57% (15.6 million lbs) over the period 11/01 through 11/28. Cheese stocks have declined 4% (3.1 million lbs) over the same period.

Futures Month	Class III 12/02	Class III 11/30	Change	Dry Whey 12/02	Dry Whey 11/30	Change	Cheese 12/02	Cheese 11/30	Change
Dec-16	\$17.16	\$16.86	\$0.30	39.350¢	38.450¢	0.90¢	\$1.778	\$1.755	\$0.023
Jan-17	\$16.96	\$16.21	\$0.75	41.850¢	39.500¢	2.35¢	\$1.742	\$1.679	\$0.063
Feb-17	\$16.98	\$16.15	\$0.83	42.025¢	39.900¢	2.13¢	\$1.743	\$1.670	\$0.073
Mar-17	\$16.89	\$16.18	\$0.71	42.025¢	40.000¢	2.03¢	\$1.730	\$1.675	\$0.055
Apr-17	\$16.83	\$16.19	\$0.64	41.875¢	39.550¢	2.33¢	\$1.724	\$1.675	\$0.049
May-17	\$16.89	\$16.28	\$0.61	41.675¢	39.900¢	1.78¢	\$1.732	\$1.684	\$0.048
Jun-17	\$17.17	\$16.45	\$0.72	42.275¢	40.000¢	2.28¢	\$1.749	\$1.699	\$0.050
Jul-17	\$17.55	\$16.67	\$0.88	42.325¢	40.000¢	2.33¢	\$1.782	\$1.723	\$0.059
Aug-17	\$17.60	\$16.85	\$0.75	42.325¢	40.000¢	2.33¢	\$1.800	\$1.739	\$0.061
Sep-17	\$17.68	\$17.03	\$0.65	42.550¢	40.125¢	2.43¢	\$1.801	\$1.755	\$0.046
Oct-17	\$17.43	\$16.97	\$0.46	42.325¢	40.025¢	2.30¢	\$1.785	\$1.750	\$0.035
Nov-17	\$17.29	\$16.91	\$0.38	42.750¢	40.700¢	2.05¢	\$1.758	\$1.745	\$0.013
12 Mo Avg	\$17.20	\$16.56	\$0.64	41.946¢	39.846¢	2.10¢	\$1.760	\$1.712	\$0.048

- Cream East: Demand is active throughout the region, with both Class II and III manufacturers readily taking in available loads on both spot and contract bases. In some areas, cream is in fairly high demand because of continuing cream exports.
- Fluid Milk Central: On-farm milk pick up volumes are trending steadily higher. However, fluid demand has been rebuilding through midweek as retailers reassess stocks on hand and place orders. Also, school districts are reconvening, along with offering the usual single serve milk packages as part of meal plans. Production of some holiday items, such as eggnog or specialty flavored milk, is scheduled to continue through the end of the year. Milk availability on the spot market is limited as processing plants that were closed for a holiday hiatus are once again taking in milk volumes. Cheese manufacturers continue to look for spot milk loads to cover near term production, but some are running into shortages. Eastern brokers report fielding requests for spot milk loads from Central region cheese manufacturers. In addition, a few milk marketers report that orders from Class II manufacturers have blown through the milk supply in the upper Midwest and marketers are extending their searches to fulfill requests. Cream demand is steady to higher within the region and also from manufacturers in the East region. Market participants indicate continuing exports of cream are tightening supplies in both regions.
- Butter Northeast: Butter manufacturing is coping with a seller's market for cream, due to heavy demand. Some large manufacturers in the Northeast have bought all of the cream offered to them this week. Current plans are to continue buying cream at a good clip in coming weeks to keep butter production strong. Some suppliers of cream report that regional cream availability has tightened. Reports of cream buying interest from Canadian dairy manufacturers has further led to a competitive supply demand situation. Unsalted butter supplies are said to be tight and keeping orders filled has become challenging.
- Butter Central: Production remains strong in order to cover the anticipated robust seasonal demand, driven by the year-end holiday. The high volume of orders from retailers is shrinking stock levels at some plants. Some Class II manufacturers are pulling heavy cream intakes. As a result, a few butter churners are seeking additional spot loads of cream. Requests from food service are improving, as the year-end shopping season gets close. At this point, the market tone is firm.
- Butter West: Production remains active as processors work hard to fill end of year commitments. Because domestic butter shoppers note everything is better with butter, retail butter demand is strong. Butter inventories continue to decrease due to the solid demand, but stocks are still larger than last year at this time.
- Dry Whey Northeast: Production of dry whey is steady and in line with cheese production within the region. Some industry contacts suggest inventories are a little tight. Contracting for Q1 is ongoing. The market undertone is stable with some signs of firming.
- Dry Whey Central: Prices moved higher at the bottom of the price range and on both ends of the mostly price series. Industry contacts say the strong U.S. dollar is keeping exports in check, but dry whey is moving well through current agreements. Inventories are comfortable to tight. A few manufacturers say they are trying to hold back on Q4 offers in order to make sure they have enough whey available for 2017 commitments.
- Dry Whey West: Prices are slightly higher at the bottom of both the range and mostly price series. A few manufacturers continue to report committed inventories through the remainder of the year. Industry contacts say dry whey production is generally in balance with the steady pull from domestic customers.
- Cheese Northeast: This week lots of milk was available for cheesemakers. Some manufacturers are working to get ahead of anticipated orders for holiday season cheese. Blocks remain a bit tighter than some buyers prefer.
- Cheese Midwest: Manufacturers indicate that, although there is a good supply of milk available for processing, low-cost spot loads of milk are a little harder to find again. Cheese production is very active. Processors are racing to meet committed holiday shipment deadlines. Retail cheese orders are strong.
- Cheese West: Cheese makers report solid demand for retail and food service cheese. Some buyers are making their final orders and restocking store shelves ahead of the winter holidays. Milk is readily available for processing and cheese production is active. In many cases, the cheese vat is the top choice for where to use milk not going into the bottle. Some industry contacts say branded, cut and wrap cheese is mostly committed through the end of the year. However, barrels and cheese used in processing are long.
- Foreign Cheese: Cut cheese supplies in Western Europe are tight. Holiday demand has been lively. Milk availability is the controlling factor in keeping up with demand. German milk production week after week is still declining. Cheese contract discussions for the first quarter are moving slowly because both buyers and sellers are uncertain about milk supplies and thus, cheese production potential.

- International: Processors are scrambling to secure dairy farm suppliers as production continues to slide across parts of Australia, according to a news article this week. Output in Victoria was down 11.9% in Oct, leaving some processors wondering how they were going to meet three-year commitments to produce cheese and butter. Huge losses during Australia's peak months look set to affect the entire industry. Output in Australia could decline to a level not seen in 20 years.
- An article this week in the South China Morning Post stated that some Chinese dairy companies are so short of cash, that they are renting back their cows as a form a collateral to borrow money.

What's Bearish:

- Spot Market: While NDM and butter were higher, block cheese lost 5¢ to close at \$1.81/lb on 5 trades, while barrels shed 7½¢ to \$1.61½/lb on 25 trades.
- Fluid Milk Northeast: Milk production along the East coast is steadily improving. Manufacturers handled higher volumes over the extended holiday weekend, but noted that some milk volumes are being pulled toward higher class uses as the week advances. Condensed skim availability in the Northeast is above needs in many areas and brokers report some challenges in finding homes for the current volumes. Due to the ample supply, prices shifted lower on the bottom of the Class III spot price range.
- Fluid Milk Southeast: Florida milk handlers noted the flow of milk reversed for the week, with 23 loads heading out of state as the higher milk production trend exceeded local processing capacity. Milk handlers also note pick up volumes on farms are improving as dairy operators opt to hold onto cows while cull prices are low. Components are improving seasonally.
- Fluid Milk Southwest: In California, milk production is up, following seasonal patterns. In addition, some producers are expanding the size of their dairy herd. Milk volumes moving into Class 2 and Class 4b (cheese) are higher, mostly driven by the strong year-end holiday demands. In Arizona, a comfortable climate for the dairy cows is increasing milk yields at the farm level. Milk intakes are in balance with processing needs. In New Mexico, farm milk intakes are slightly higher due to cooler daytime temperatures.
- Fluid Milk Pacific Northwest: Recent cool, wet weather is placing a damper on milk production in some states in the Pacific Northwest. However, in the mountain states of Idaho, Colorado and Utah, milk output is strong. Industry contacts say there is a lot of good quality feed for the region's dairy herds. Manufacturers are seeing no slowdown in milk intakes and there is plenty of milk for processing needs. Some snow is accumulating at higher elevations, a promising sign that there will be water available for next year's irrigation needs.

Recommendation:

Wow! Milk prices absolutely exploded to the upside this week, with an explanation point put on it during Friday's trade, where volume was heavy across the board. Despite spot cheese prices finishing the week lower, it was the sudden resurgence in NDM, hitting a high not seen since Oct'15, and a butter price back over \$2 that really got the ball rolling. The spread between Class III and Class IV had grown to several dollars, but has now shrunk to less than \$1. Even though milk production and cow numbers continue to slowly climb in the U.S., there is still a net global decline in milk output going on, and it has not yet bottomed out. Cheese is tight in Europe and global demand for powder is on the rise. Throw in U.S. holiday demand and something had to happen. And happen it did. Over and over this week, the market would shake off daily declines in spot cheese, only to see Class III's finish higher. Dry whey futures also finished solidly in the green, bumping above 40¢/lb for all but the front month. Our take is that it was a combination of long-hedgers (end users of milk) getting coverage, as well as some spec short covering that caused prices to shoot higher. The 2017 average now sits at \$17.21, up from \$16.56 a week ago (Wed close). For those that took our recommendation to buy 1700 courage calls in in 2017, the strategy worked perfectly. So, where do we go from here? Technically, the market is way over-bought and is susceptible to substantial correction. Indeed, while we posted gains for the day, many contracts up front finished the session 30¢ or so off the high. The market is extremely nervous and will be sensitive to any weakness. Given current fundamentals, however, we expect Class IV to eventually overtake Class III, which is supportive overall. Don't be surprised to see a post-holiday correction as well. If that happens, producers should try to pick up more call options to protect existing hedges to further upside. Those that have done no marketing at all yet in 2017 should consider letting a small percentage of their milk go at this \$17.20+ average. Feed is cheap so this should be a profitable number.

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