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The KDM Dairy Report – January 26th, 2018

SPOT MARKET	1/19	1/26	Change	Trades
Cheddar Blocks	$1.5650	$1.4725	($0.0925)	9
Cheddar Barrels	$1.3450	$1.3200	($0.0250)	20
Butter	$2.1200	$2.1300	$0.0100	12
Grade A NDM	$0.7075	$0.7100	$0.0025	13

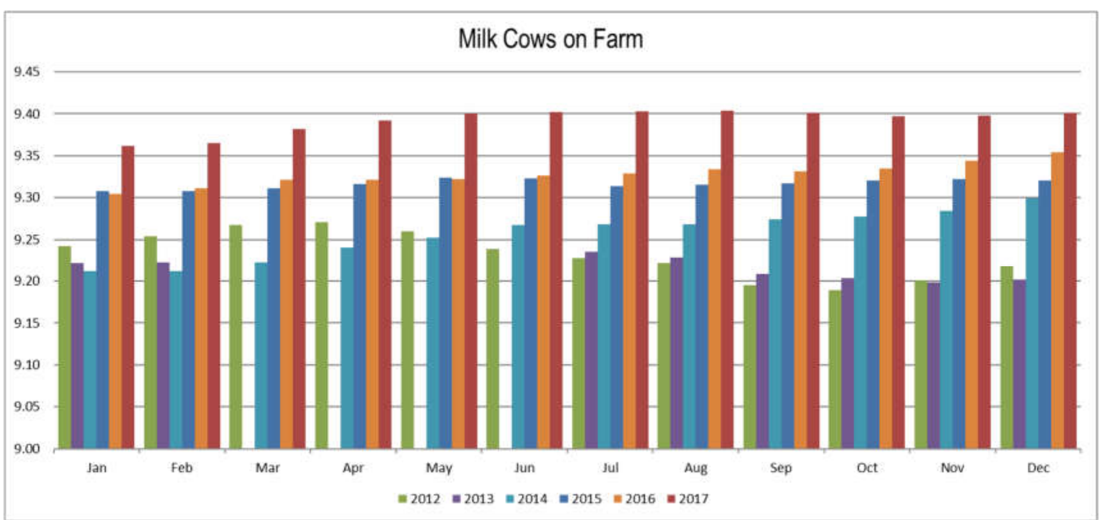
Futures Month	Class III 01/19	Class III 01/26	Change	Dry Whey	Dry Whey 01/26	Change	Cheese 01/19	Cheese 01/26	Change
Jan-18	$13.88	$13.91	$0.03	26.675¢	27.250¢	0.57¢	$1.507	$1.507	$0.000
Feb-18	$13.56	$13.32	($0.24)	25.675¢	26.250¢	0.57¢	$1.480	$1.457	($0.023)
Mar-18	$13.54	$13.44	($0.10)	25.900¢	27.200¢	1.30¢	$1.477	$1.465	($0.012)
Apr-18	$13.71	$13.68	($0.03)	26.075¢	27.300¢	1.23¢	$1.502	$1.487	($0.015)
May-18	$14.07	$14.06	($0.01)	26.750¢	27.900¢	1.15¢	$1.530	$1.522	($0.008)
Jun-18	$14.52	$14.48	($0.04)	27.500¢	28.825¢	1.33¢	$1.581	$1.560	($0.021)
Jul-18	$15.08	$15.02	($0.06)	27.500¢	29.250¢	1.75¢	$1.635	$1.612	($0.023)
Aug-18	$15.52	$15.44	($0.08)	28.000¢	29.275¢	1.28¢	$1.668	$1.652	($0.016)
Sep-18	$15.56	$15.63	$0.07	27.825¢	29.400¢	1.58¢	$1.683	$1.673	($0.010)
Oct-18	$15.72	$15.75	$0.03	28.500¢	29.800¢	1.30¢	$1.695	$1.692	($0.003)
Nov-18	$15.70	$15.68	($0.02)	29.000¢	29.850¢	0.85¢	$1.685	$1.687	$0.002
Dec-18	$15.62	$15.59	($0.03)	29.325¢	30.575¢	1.25¢	$1.672	$1.670	($0.002)
12 Mo Avg	**$14.71**	**$14.67**	**($0.04)**	**27.394¢**	**28.573¢**	**1.18¢**	**$1.593**	**$1.582**	**($0.011)**

What's Bullish:

- Weekly cold storage numbers indicate cheese stocks at USDA-selected warehouses declined 4% (3.4 million lbs) over the period 01/01 through 01/22.
- Dairy cow slaughter for the week ending 01/13 totaled 65,700 head, up 7.9% vs. the same period a year ago. That's the highest weekly total in nearly a year.
- Fluid Milk East: In the Northeast, some industry contacts report seeing production down from the stressful winter conditions and lower feed quality. Southeast milk production is fairly flat this week and market participants report milk produced in the region is somewhat limited. Milk is still being pulled from other regions to support demand.
- Butter Central: Due to the snowstorm early in the week, butter plant managers in areas affected were down on employees and forced to cut back on production. Unsalted butter demand is healthy, and some producers are reporting limited supplies. The butter markets continue to trend slowly downward, but many contacts are not overly concerned. In recent history, as butter prices have ebbed, buying activity has increased. The butter market tone is somewhat stable.
- Dry Whey: Northeast supplies are manageable, as many customers have added to their contracts. Some industry contacts communicate prices are at the floor, indicating prices can stay steady or improve. Central whey output is down slightly, as some cheesemakers are taking on less milk. Some Western contacts report that the whey market is recovering, though supplies remain large.
- NDM: Northeast prices increased this week. Customers with brand specific interests strengthened prices representing the uppermost end of the range. Buyers, in general, appear bewildered by current market dynamics. Nonetheless, buyer demand has increased with speculative buying. Prices in the Central region increased. This week brought a notable directional shift in prices. Multiple factors have propelled prices, and more transactions are now being reported at $.70 and higher. Regional availability, brand specific purchasing and GDT/CME upticks are also providing a bullish bounce. Prices for Western NDM adjusted up on both the range and mostly series. Several buyers/end users think that the current rebound of NDM spot values does not make sense, as large stocks are still available. Conversely, some manufacturers justify the increase in NDM prices mainly due to an improvement in demand from the bakery sector as the spring baking season approaches.
- Foreign Cheese: The European Union cheese market is active. In Germany, semi-hard cheese prices are stabilizing. Supplies are declining, whereas demand is trending higher.
- CWT has accepted 17 requests for export assistance to sell 2.692 million lbs of Cheddar and Monterey Jack cheese and 39,683 lbs of butter to customers in Asia, the Middle East, North Africa and Oceania. The product has been contracted for delivery in the period from January through April 2018.

What's Bearish:

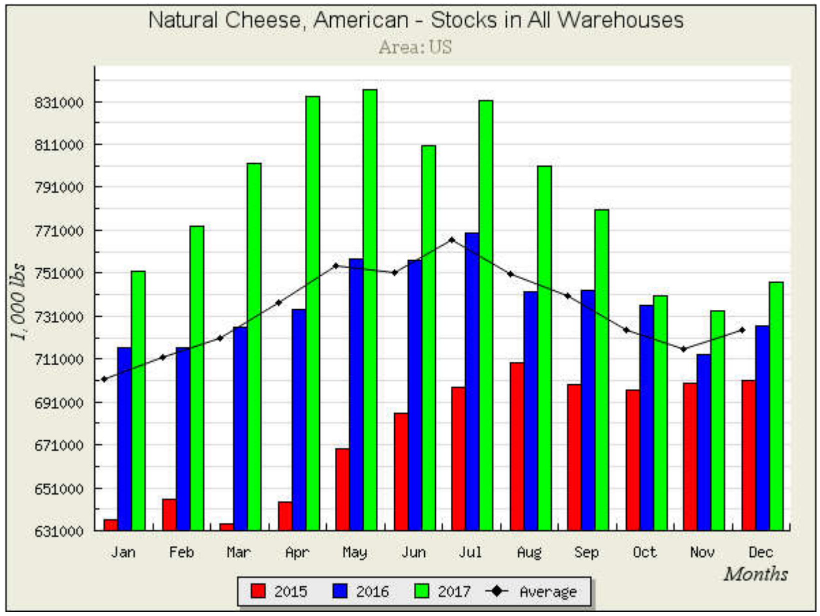
- Milk Production Report: December milk output in the U.S. was up 1.1% vs. Dec '16, while cow numbers increased 2,000 head from Nov. Gains were focused in the West, with CO up 9.2%, TX up 8.1%, and UT up 6.2%. 2017 finished with the milking herd up 47,000 head compared to 2016.
- Cold Storage Report: American cheese stocks at the end of December were 3% higher than the prior year and up 2% vs. Nov (see graph next page). Total cheese stocks were up 7% and 2% respectively. Butter stocks increased 2% vs. Dec '16 and rose 6% vs. Nov '16.



- Livestock Slaughter Report: 247,300 cows were removed from the milking herd in December, down 2.3% (5,700 head) vs. Dec '16.
- Fluid Milk Central: Contacts are scrambling to place milk supplies in the face of multiple challenges. Hauling costs and hindrances are being echoed from one contact to the next. A strong snowstorm slammed much of the Central states and parts of the upper Midwest, creating havoc for suppliers and producers early in the week. Bottling order declines, year over year, are also plaguing milk suppliers who are currently facing declining orders elsewhere. As cheese orders have seasonally slowed, some Class III producers are declining even discounted spot milk offers.
- Fluid Milk Southwest: California current milk output is rising on a weekly basis. Contacts report that finding the trucking necessary for milk hauling is a challenge. In Arizona, processing plants have been receiving heavy supplies of milk and are working harder to balance it. Milk production is continuously

increasing and getting close to the flush levels. In New Mexico, milk production continues its higher trend. Overall, milk supplies are up, and processing plants continue to work at full capacity.

- Fluid Milk Pacific Northwest: Industry contacts report milk is mostly finding a home within the region, but a few loads are moving into neighboring states to find processing space. In the mountain states of Colorado, Idaho and Utah there is still a lot of milk. Industry contacts say there is processing capacity available in Colorado and the southern part of the region, but across Idaho and the northern part of the region, available space in manufacturing facilities is more limited and distressed loads offered at $3 to $4 under Class are not uncommon.
- Butter Northeast: Manufacturing is very active, as substantial volumes of surplus cream are available. Interest from export markets, for now, is modest. However, the market anticipates a projected upsurge in global sales.
- Butter West: Production is active amidst the abundant supplies of cream. Manufacturers are running churns near capacity, but would be happy to sell off a few loads of cream to take the pressure off. Much of the production focus is on filling current orders and making bulk butter to put away into storage. Butter inventories are growing.
- Cheese Northeast: Cheese processors are staying active as milk is clearing into vats. Milk availability is generally steady as milk is moving when it needs to. Cheese spot trading activities are steady to light.



- Cheese Midwest: Some plant managers experiencing seasonal slowdowns are taking time to make updates and repairs in their respective facilities. Other Midwestern cheesemakers are continuing seven-day workweeks, and plan to continue for the foreseeable future. Some discounted spot milk changed hands, and a number of cheese producers reported that offers have yet to decrease. Barrel processors are facing a stark disadvantage right now regarding market prices, and they continue to report fairly slow orders. Cheese inventories vary, but as milk supplies and cheese production have recently been heavy, overall supplies are available.
- Cheese West: Readily available milk is stimulating more cheese production. Cheese supplies remain substantial despite processors' efforts to keep inventories at check. Some contacts suggest that domestic retail sales for cheddar are solid. However, international cheese inquiries are slower for some sellers.

Recommendation:

Spot market volumes were relatively quiet this week, but that didn’t stop blocks from falling 9¼¢. The block/barrel spread, which stood at 22¢ last Friday, is now down to 15¼¢. Barrel demand appears to be slow at this time, so it’s unlikely we’ll see much of a barrel rally. But block demand is better, so we might just camp out near these levels for a while. This week’s Milk Production Report has cow numbers actually increasing slightly. As we head in to the flush period with nearly 50,000 more cows than we did a year ago, we look set to challenge plant capacities yet again. With farm pay prices set to drop about $2/cwt from Dec ’17 to Jan ’18, and going lower from there, it’s about to get much tougher for dairy operations. Current spot prices work out to about $12.90 Class III, with the Feb contract just starting its pricing period. If block prices are eventually pressured lower towards barrels, we’d expect Class III futures to push in to new contract lows. But there are some hopeful signs. International demand appears to be picking up some, which should help exports. On that front, the USD pushed in to lows not seen since 2014, which makes our exports more price-competitive. Dry whey and NDM seem to be close to a floor, with buyers starting to get more aggressive at these attractive prices. Inventories are in better shape as a result. The same is true for butter, with expectations for demand to increase in the near future. EU cheese demand is on the rise while supplies are declining. And then there are the outside markets. Crude oil continues to push in to highs not seen since 2014. After breaking through prior resistance in the low $60’s, the next stop looks to be in the $80’s. Both gold and copper have been trending higher, both crucial in the electronics industry. The stock market keeps making new highs. Soybeans appear set to break a down-trend going back to the highs set in 2012. All this to say, if commodities, as an asset class, begin to gain favor, it will likely help the dairy complex as well. For these reasons, it’s hard to recommend selling up front at current levels. We would rather buy cheap put options up front, in case we really do plunge in to new contract lows. Consider the Feb 13.25 PUT at 13¢, the March 13.25 PUT at 23¢ and the April 13.25 PUT at 25¢. We know these are not profitable levels, but they do stop the bleeding. The second half of the year is a tough one. If you really feel like you need to get protection in place, you can sell it for an average of about $15.50. Then buy 17.00 call options for an average of 19¢ each. If the market makes a strong move up after your hedge, you will miss out on about $1.70 of that move, but above $17.20 you are back in, with unlimited upside. If you’re not sure how this works, give us a call.