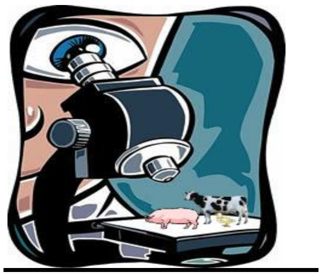


MEAT MARKETS
UNDER A MICROSCOPE

A perspective on the red meat markets by Kevin Bost...sometimes wrong, usually scientific, but always candid

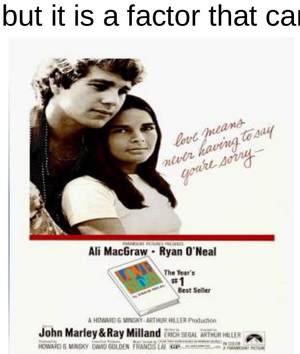
October 12, 2017

Heavy supply and strong demand still characterize the beef market. As best I can tell, this week's fed cattle slaughter is on a pace to equal last week's total (510,000 head), and will be down only modestly from the September rate (excluding the holiday). This, I think, explains the lack of "spark" in cutout values up to this point. I had expected a greater reduction in steer and heifer kills by now.

Owing to my Lutheran roots, it is not my nature to put a positive "spin" on things. But it is my perception that production remains elevated because packers, by virtue of previous forward sales, are committed to delivering a lot of product in the current time frame. Based on forward booking statistics, it does not look as though this condition will change materially until mid-November, at the earliest. Packers have not been keen to raise beef prices on the relatively small spot sales volumes, because they do not want to risk snuffing out demand. What they are doing now is healthy for beef demand in the long run.

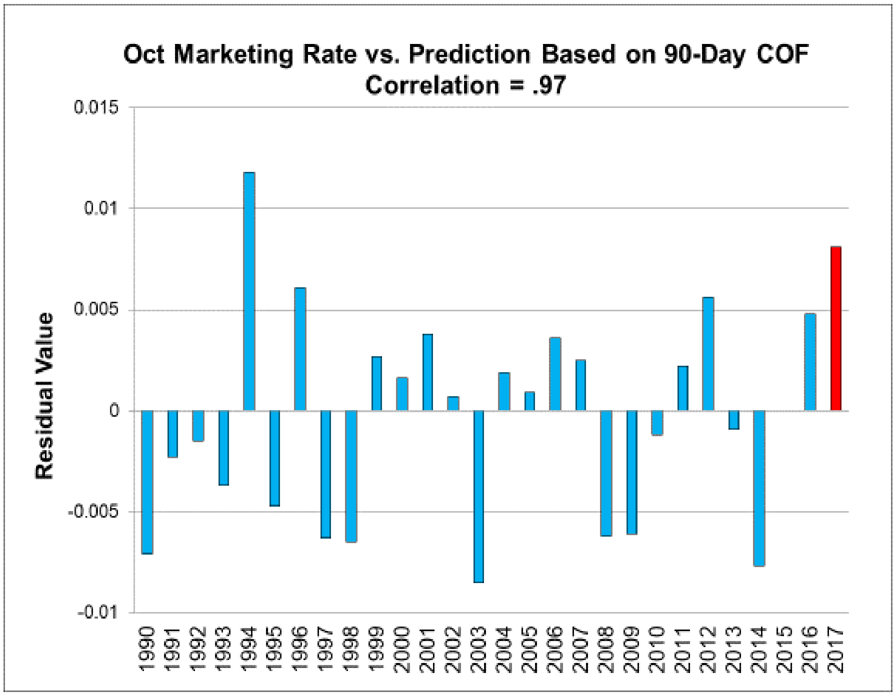
I am willing to adhere to this theory because if the heavy rate of production were the result of backlogged cattle supplies being forced into the "pipeline", then live cattle prices would be falling and carcass weights would be rising more steeply than seasonally normal. Instead, the Five Area Weighted Average Steer price has gained ground in four of the past five weeks, and it looks as though this week's trade will settle out at higher money as well. And, as of the most recent official reading (the week ended September 23), the rate of increase in steer carcass weights was actually a bit slower than the ten-year average….and weights were still running seven pounds under a year earlier. Packer margins, while still excellent by historical standards, have shrunk from their mid-August-to-mid-September readings. Packers are having to work a little harder to procure the necessary cattle supplies.

Fed cattle are being marketed aggressively, judging from slaughter rates relative to the inventory of cattle on feed 90 days or longer. I have dwelled on this subject quite often recently, but it is a factor that cannot be dismissed.



And I'm sorry, but I have to show you once again how marketing rates are matching up with cattle inventories here in October. Remember that there is a 97% (inverse) correlation between the two variables in the month of October, and current marketing rates are coming in far above the regression-predicted value.

Where we're headed, then, is toward a substantial increase in cattle prices in the weeks ahead, such that slaughter/fabrication margins will be more seriously threatened, and production schedules will be reduced.



It is at that point that the combined Choice/Select cutout value will begin a more determined trek toward its nearest discernible resistance level of $203-$204 per cwt vs, this afternoon's quote of $194. That point could be *very* close at hand, if the October futures contract is any indication; prior to today's setback, it had gone up $5 per cwt over the previous five trading days, and now stands $3 above the most recently-establish cash market.

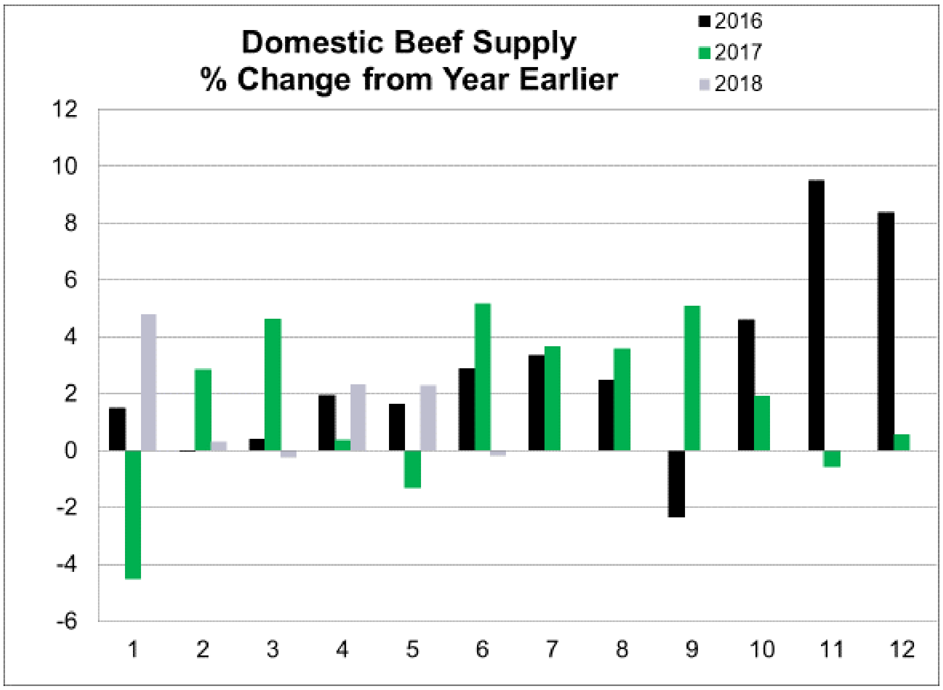
Demand, meanwhile, is performing admirably. It is becoming clear that the monthly wholesale demand index has turned materially upward here in October, confirming that a cyclical low was established in August. If this is indeed the case, then we should expect the upward momentum to continue into November, based on the normal length of the cycle; *it could persist longer if beef prices ascend gradually, instead of taking off like a rocket*. In any case, domestic demand is running well above a year ago right now, and it very likely will remain so throughout the fourth quarter (it will be comparing against some very weak 2016 readings).

Foreign demand for U.S. beef is pretty stout as well. I offer my humble projections for the next three quarters in the table below. A few comments are in order. One is that the sharp increase in the Japanese tariff on U.S. and Canadian beef that went into effect August 1 applied mainly to frozen product; since then, the U.S. has lost Japanese business to Australia in *frozen* beef, but increased its share of fresh beef business. U.S. beef exports to Japan in August rose 10 million pounds from July to August. Another comment is that I read a lot about Korea having a very strong appetite for imported beef in general, due to high prices of domestic product. Thirdly, although my projections reflect the likelihood of some increase in U.S. beef shipments to China/Hong Kong/Vietnam, they do not assume any major blossoming of direct business between U.S. packers and their newly-rediscovered trading pals. Although the Chinese government officially declared a reopening of its borders to U.S. beef in July, I notice that in August, exports to mainland China amount to only 1.1 million pounds. Eventually, though, Chinese demand will become a major bullish factor in the market, due to rapidly rising incomes in that country.

Incorporating the foreign trade variables into the pricing equation, I come up with the Net Domestic Beef Supply projections shown on the next page. They paint a somewhat different picture than production alone.

Beef Exports, Million Pounds:

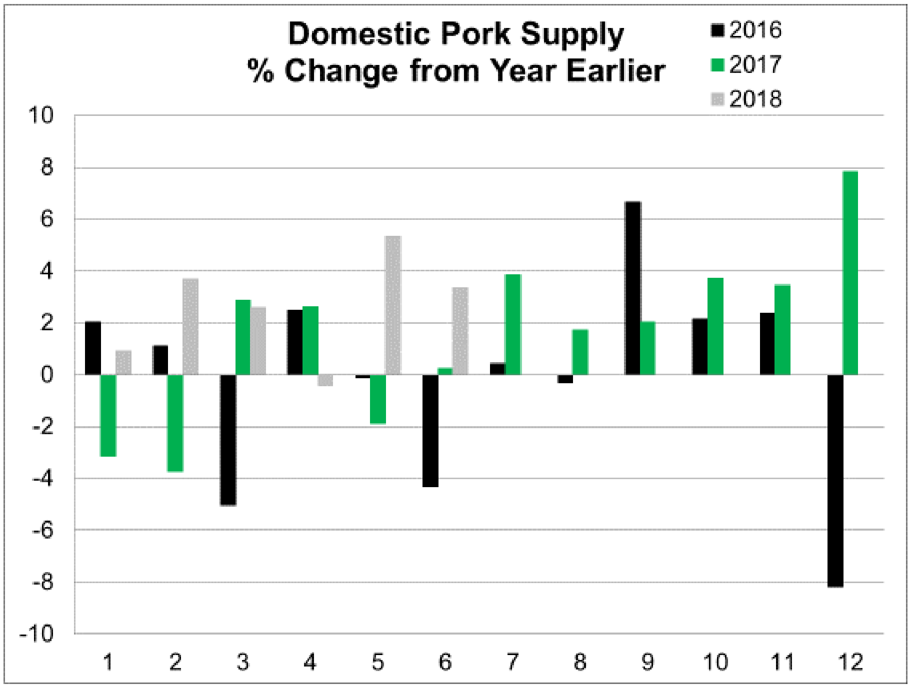
	Q4 '17	% Change	Q1 '18	% Change	Q2 '18	% Change
Japan	168	+4%	194	-3%	218	+7%
China/HK/Taiwan	165	+8	119	+18	130	+12
Korea	152	+4	120	+14	126	+18
Mexico	112	+5	102	+7	105	+5
Canada	87	+3	77	-2	87	+15
Total	764	+4	684	+5	744	+9



I might as well continue with the equivalent perspective on the pork market. **My guesses regarding U.S. pork exports are not quite as "friendly" toward pork prices as they are toward beef.** One Party Pooper is a noticeably subdued demand for U.S. pork from China. While Chinese demand will no doubt strengthen seasonally in the fourth quarter, I read that more stringent environmental regulations are forcing the shutdown of many small pig farms, and therefore a net liquidation of herds. This, in turn, will keep Chinese pork production elevated and reduce the need for imported product. One can never be sure about the veracity of stories emanating from China, but I have no reason to doubt this one. The latest statistics from USDA's Foreign Agricultural Service show that in August, U.S. pork shipments to China were down seven million pounds, or 19%, from a year earlier.

Pork Exports, Million Pounds:

	Q4 '17	% Change	Q1 '18	% Change	Q2 '18	% Change
Japan	295	-4%	310	-3%	315	+2%
Canada	143	+1	130	+5	134	+4
Mexico	506	+2	465	0	445	+5
Korea	137	+10	164	+5	145	+9
Australia	47	+8	57	-6	53	+14
China/HK/Taiwan	101	-22	122	-10	148	-17
Total	1432	-2	1451	+1	1449	+2



Largely because the year-over year changes in exports look like they will be rather small, the outlook for net domestic pork supplies pretty closely mirrors that for pork production. Before you freak out at the huge increase coming in December, I should explain that this is due to the extraordinary amount of down time surrounding the Christmas/New Year holidays last year. I think I covered that subject in a bit too much detail last week, and so I shall not go into further detail today. I should also explain that frozen product flows are included in my calculation of net domestic pork supplies, and her in the fourth quarter, those stock flows will serve to reduce the net supply. There are two primary reasons. One is that there should be a lot more bellies being siphoned away from processing channels and into cold storage than there was during fourth quarter 2016—simply because last fall, there was an unprecedented net *drawdown* of frozen belly stocks. The other reason is that the October 1, 2017 frozen ham inventory, in my humble estimation, was about 10% smaller than a year ago, leaving less product to be drawn out of storage and processed between now and Christmas.

Meat Markets Under a Microscope is published weekly by Procurement Strategies Inc., 99 Gromer Road, Elgin IL 60120. For subscription information, please contact Kevin Bost at (847) 212-7523 (cell) or (224) 227-6281 (office), or visit our website at www.procurementstrategiesinc.com.