MEAT MARKETS
UNDER A MICROSCOPE

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

October 13, 2018

The pork cutout value lies only $1.01 per cwt below the pinnacle of its explosive September rally, which was reached two weeks ago. Why is it not backing off? Well, it has not really been tested from the supply side just yet. Over the last five weeks, hog slaughter has averaged 2.5% below a year earlier. Surely the hog supply is bigger than that, isn't it? The biggest kill in that five-week period was 2,558,550 and the last *two* weeks have been near 2,500,000. If USDA's spring pig crop estimate is anywhere close to being accurate, then weekly slaughter will run consistently above 2.6 million from next week until the Christmas holidays begin. Naturally, this will put downward pressure on all pork products.

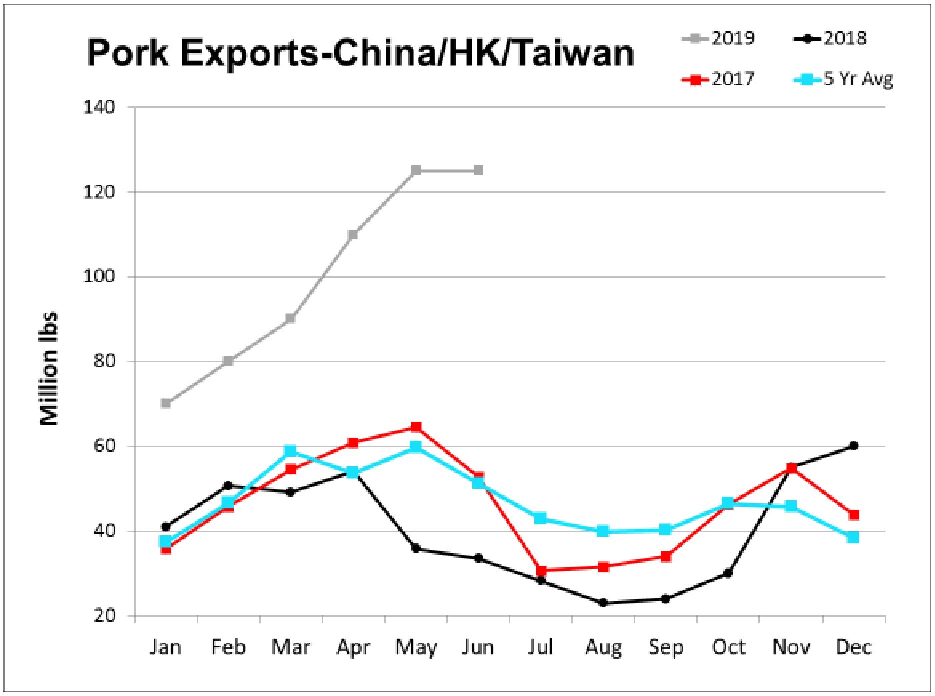
But let's face it: the pace and extent of the upcoming decline in the cutout value will largely be dictated by belly prices. So let's "home in" on that segment of the market.

First of all, it is necessary to make *some* sort of explicit assumption regarding the impact of African Swine Fever on the Chinese pork supply. Up until now, my approach has been to assume that we're *not* looking at a full-blown pandemic here. Adjustments to the forecast would be made as the evidence warranted. But how realistic is that approach, really? Given what we know about the highly toxic and contagious nature of this disease and the not-so-state-of-the-art Chinese biosecurity systems, wouldn't you say that there is a greater than 50/50 that we'll be dealing with a major reduction in Chinese pork production….and therefore, a massive increase in Chinese demand for imported pork? Consequently, I have switched over to the "guilty until proven innocent" approach.

At the top of the next page, I show my humble projections of U.S. pork exports to China/Hong Kong/Taiwan/Vietnam combined. [I treat this conglomerate as a single entity for the purpose of projecting exports, for reasons I shall not delve into right now.] Knowing that this effort can only be a *little* more scientific than throwing darts, I have to try.

While ASF contamination is probably more widespread than official Chinese reports indicate, it is reasonable to expect Chinese imports to ramp up only gradually at first, and then accelerate as the situation becomes dire. The degree of urgency will, presumably, be measured by pork price inflation in China. As for the volumes themselves, I used 2007-2008 as a model year. That was when the "Blue Ear" virus killed enormous numbers of baby pigs and resulted in the highest volume of U.S. pork exports to China on record. What else do we have to work with?

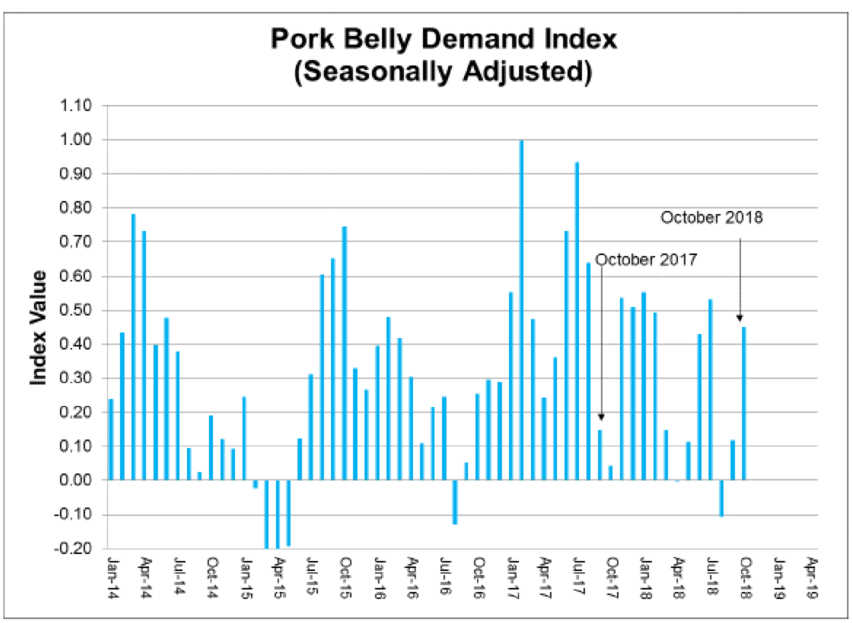
So, then, if exports to China/Hong Kong et al are headed gradually toward 125 million pounds per month, then net domestic (U.S.) pork supplies will fall 1-2% short of a year earlier in the first quarter and will be down 2-3% in the second quarter, despite increased production….



….but the fourth quarter supply probably won't be affected as much, if at all.

Therefore, the fourth quarter outlook for belly prices should be dominated by the usual suspects: hog slaughter, freezer/inventory demand, and demand for bacon from the supermarket sector. I specify the supermarket sector because it is much more volatile than the foodservice sector in terms of wholesale bacon demand, and thus functions as the regulator of product flow in the short run.

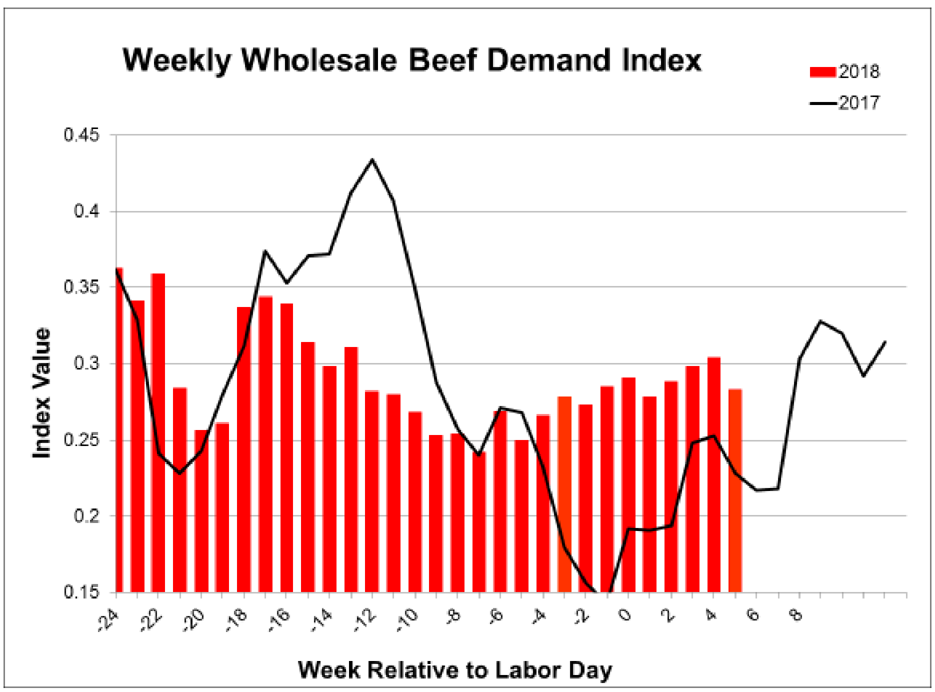
Last fall, belly prices averaged $1.17 per pound and ranged from $.91 in the first week of October to $1.47 in the first week of December, ending the year at $1.10. Why should it not center around $1.17 or so again this time around? Production *should* be up nearly 3.5% and net domestic supplies *should* be up roughly 1.4%.



Pork belly demand here in October is far better than it was a year ago, but you can see from the picture to the left that this was not the case in August and September; and the short-term dynamics are considerably different. I suspect that this is mainly due to the difference in the timing of retail bacon featuring. With belly prices currently standing at $1.42 vs. $.97 on this date a year ago, and having run up about 60¢ per pound over the last six weeks, it's likely that demand for bacon from supermarket chains is due for a rather steep slowdown in November, and maybe December as well. Presumably, that will leave it up to freezer demand to prescribe the floor in the market in the remainder of the fourth quarter. Judging simply from the daily chart, I suspect that inventory demand will be pretty stout in the $1.00-$1.10 per pound range….but not above that level. Premiums in summer 2019 futures prices, and the ability of the market to reach up to $1.70 this past summer should sharpen freezer demand in general. For what it's worth, my guess is that accumulation of frozen belly stocks will amount to about 27 million pounds during the fourth quarter, which would not be big historically but would exceed a year earlier by eight million pounds. All of that year-over-year increase would occur in November and December.

Enough about pork bellies for now. Let's talk about beef.

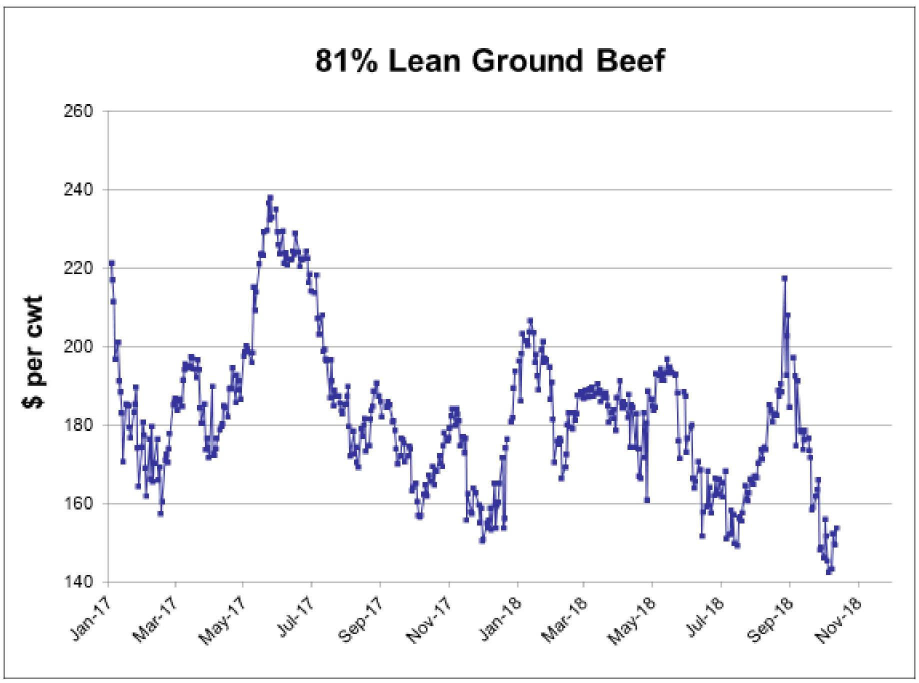
The combined Choice/Select cutout value seemed to have been on course for a bottom in the first week of October and then a pretty stout rally from that point into the end of the month, but it made no headway at all this past week. In fact, one weekly average basis, it lost $1.45 per cwt from the week before. That was only the fourth time in the last 15 years that it lost ground from the first week of October to the second, and so it can be classified as unusual….and it casts doubt on the prospects for the balance of the month, and the entire quarter, for that matter.



Clearly, the short-term demand indicators have stalled—not devastatingly, but significantly. I really don't think this signals the beginning of a downturn in demand—beyond the normal seasonal factors, I mean—because forward booking statistics are indicative of active retail featuring through the first part of November. However, some "lowering of the sights" might be in order for the cutout value in the near term. My best guess is that weekly steer and heifer kills will range from 495,000 to 500,000 in the next three weeks, down slightly from this past week's total of 503,000. If that is to be the case, and if the short-term demand index remains flat, then there will still be a substantial rally….but the rally will fade quickly, and the combined cutout value will drop back to $200 per cwt or slightly lower just prior to Thanksgiving. As one who has been betting money on the long October/short-something-else spread, this is not what I had in mind originally.

My crystal ball had been telling me that the fortunes of the cutout value would be determined by the round cuts, grinds, and trimmings, and this has proven to be true—although I thought that all members of this group would be printing distinctly higher by now. The "50's" did their part, as they have bounced rather smartly from the $.40 per pound mark and appear to be headed for the upper $.50's before they stall out again. But the round cuts and ground beef do not seem to be getting the attention from retailers that I had expected. One plausible theory is that supermarket features have remained focused on middle meats in the post-Labor Day period (perhaps they are selling better than usual because of the strong economy?), and have maintained their wide margins in ground beef to help subsidize this strategy.

In any case, I view the current struggles of the cutout value to be short-lived, especially as they relate to ground beef. One look at the picture below should be enough to tell us that there is a lot of upside potential in the ground beef complex. And why not? It looks as though net domestic beef supplies will be slightly smaller than a year earlier through the balance of the year, and yet ground beef prices in the fourth quarter of 2017 averaged about 12¢ per pound higher than they were quoted on Friday…



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, or visit our website at www.procurementstrategiesinc.com.