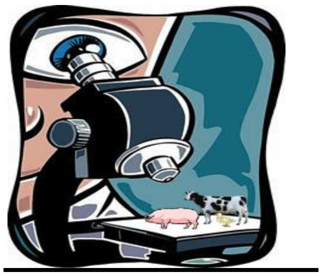
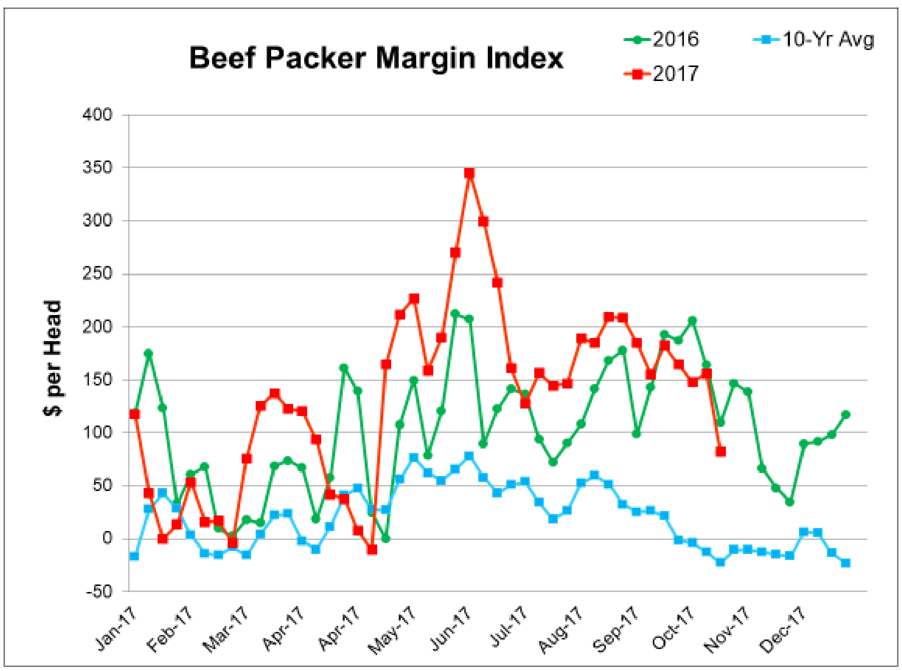


MEAT MARKETS
UNDER A MICROSCOPE

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

October 30, 2017

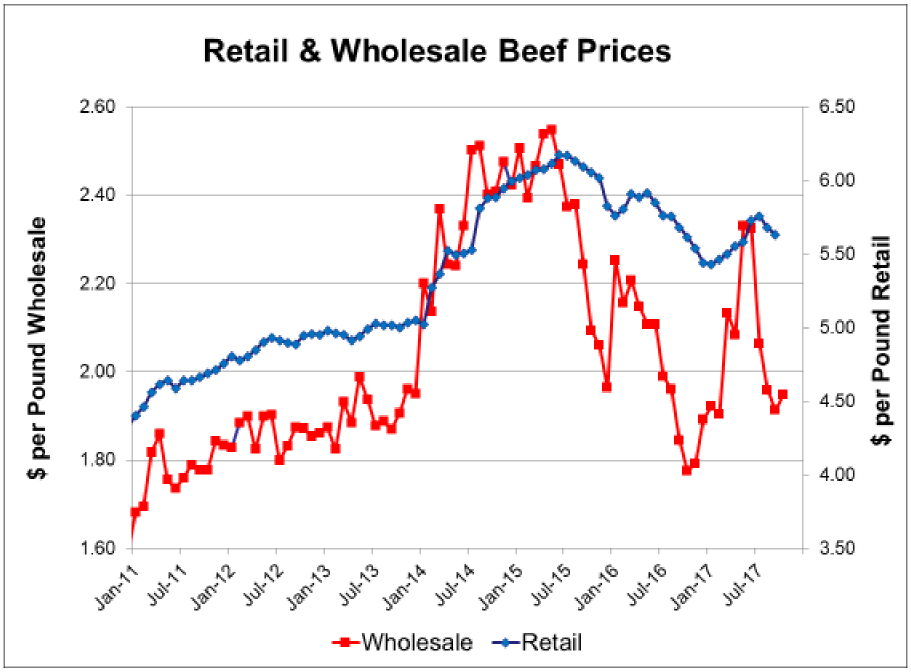
The gradual uptrend in beef cutout values could pick up some steam in the week ahead, due to increased upward pressure from the live cattle market. The Five Area Weighted Average Steer price took a $7 per cwt leap late Friday to about $118, its highest level since the third week of July. This made a big dent in packer margins:



This is not likely to be a one-off "outlier", but instead a signal that packers will have to work harder to manage margins through the balance of the fourth quarter. **Cattle supplies are coming into a "tight spot" within the broader cyclical upswing**. By most statistical indications, front-end supplies are quite current; steer and heifer kills have been vigorous, especially since Labor Day, and steer carcass weights, as of the latest official reading, were 19 pounds lighter than a year ago. There has been virtually no increase in weights since the holiday, whereas they normally put on about nine pounds over this time frame. Moreover, premiums in the December and February futures contracts ($3 and $7.50 per cwt respectively, even on top of this past week's gains in the cash market) should encourage feedlots to hold cattle off the market for higher prices down the road. Low feed costs make it easier for them to do so.

Up to this point, packers have done a disciplined job of refraining from jacking up beef prices upon every uptick in their input costs (and risking a backlash from buyers). But now that margins have taken an eyebrow-raising "hit", I can see how they might be more inclined to raise asking prices and trim production schedules. We'll find out very soon.

One important consideration is that retailers have room to absorb a significant hike in wholesale product costs. Below I show the spread between the combined Choice/Select cutout value (updated through October) and the average retail price of beef as last reported by the Bureau of Labor Statistics in September:



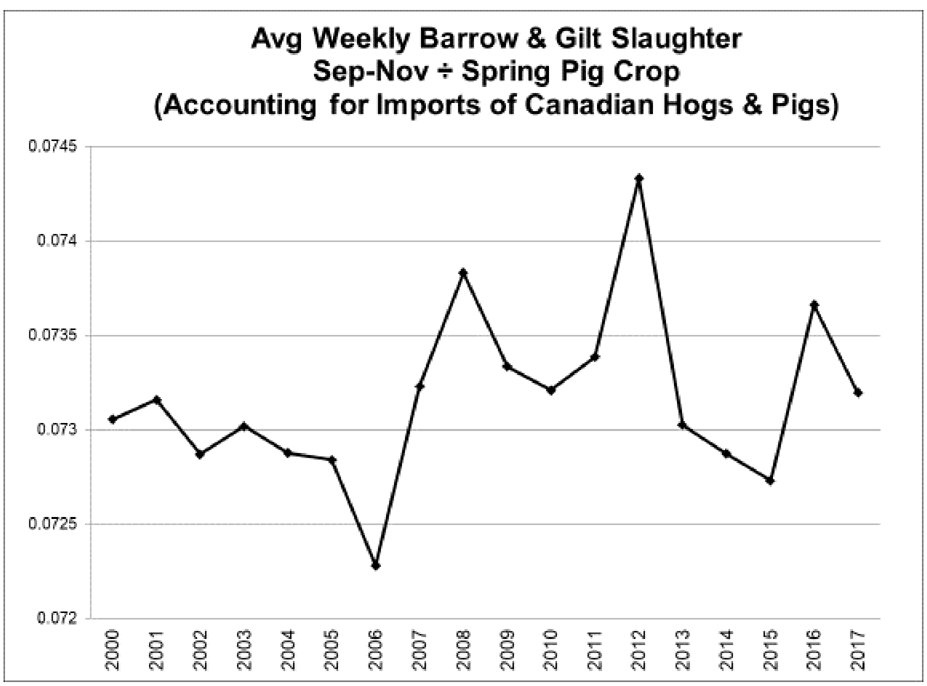
With retail prices apparently moving downward once again, and the economy in a healthy state by most accounts, the prospects of strong holiday beef demand at the wholesale level are quite good. As one astute and seasoned colleague put it a few days ago, supermarkets have been building a "war chest" and are preparing to "blow their brains out" with cheap features—especially ground beef—toward year end. This may be an exaggeration or an oversimplification, but I can't argue with the logic.

At the moment, I am conservatively forecasting that the combined cutout value will hit a temporary wall at its nearest resistance level of $202-204 per cwt ($4-5 above Friday's quote), but I would not be surprised to see it go beyond that sometime in November. I notice that on five occasions since 2000, the combined cutout has advanced 5% or more between now and Thanksgiving; such an increase this time around would carry it to about $207. In order for that to happen, we would have to see the chucks, rounds, briskets, top butts, short loins, and strips collectively hold steady, while rib cuts, tenderloins, ground beef, and trimmings move materially northward. Although such a performance would be exceptional for this time of year, it would not be such a tall order. It has happened before.

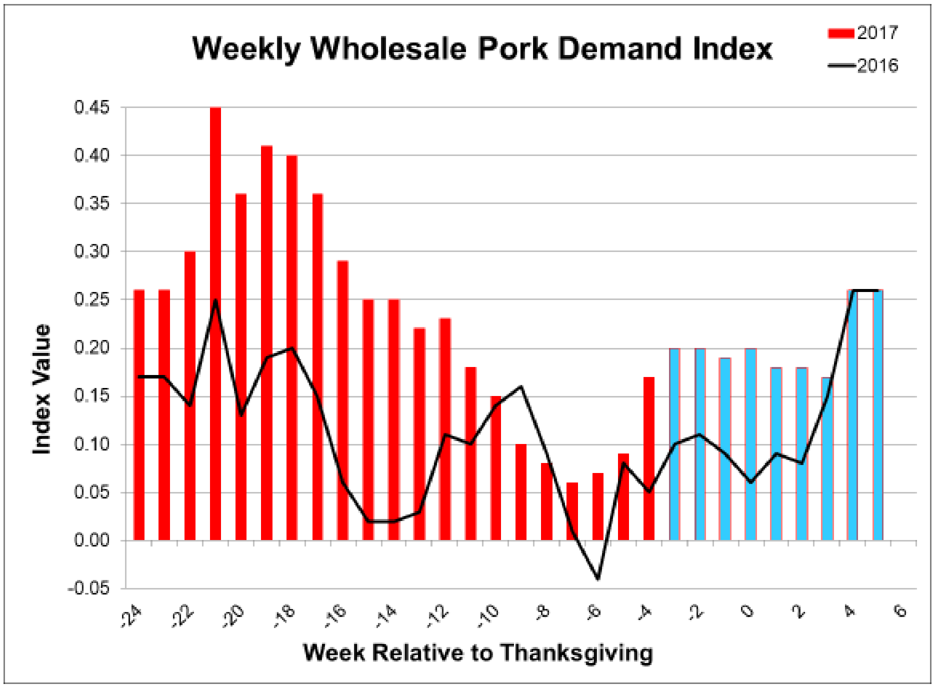
There might be one other bullish factor coming into the market right away, and this one is more fun to talk about….because it involves half-truths, some lies, some exaggerations, some speculation, mysterious covert actions on the part of the United States government, and other such things that keep the Sewing Circle thriving. It involves what USDA refers to as Instrument Enhanced Grading, which, as you probably know, is the use of cameras instead of the Human Eyeball Method to establish carcass quality grades. To make a long story short, the most plausible story I hear is that ever since sometime in June, roughly one half of all major beef plants have been using miscalibrated equipment, resulting in a significant percentage of carcasses receiving a Choice grade that should have fallen in the Select category. Supposedly, the government has just now corrected the "glitch". I could not find anything about it on the Agricultural Marketing Service's website, so this is just hearsay….but I can believe it.

So, let's say that the story *is* essentially true. What impact will it have on the market? Well, obviously, the supply of Choice beef will be reduced, and the supply of Select-grade beef will be boosted. Keep in mind that this is happening at a time when total fed cattle slaughter is being rolled back. And it is happening at a time when Choice ribeyes and tenderloins are typically coming into their most popular demand period of the year. Depending on the actual reduction in the grade-out, these two items could become very scarce in the final two months of the year. Demand for Choice ribeyes and "PSMO's" is pretty inelastic during the holiday season. Remember that Choice boneless ribeyes reached almost $10.50 per pound in June vs. $7.75 currently; Choice tenderloins traded at $10.50 per pound around Thanksgiving in each of the last two years, and above $11.50 in the three years prior, vs. this past week's weighted average quote of $9.99. Choice price increases of this magnitude would outweigh whatever negative impact there would be on Select-grade product, making for a net increase in the combined cutout value.

There has been a lot of Weeping and Gnashing of Teeth (my own teeth included) over the surprising strength in Hog prices and the sharp decline in packer margins, but in the midst of it all, hog slaughter is about where it should be*,* according to USDA's spring pig crop estimate. That *should* mean, therefore, that pork production will take another step upward this week, and maintain that higher level through the second week of December. This past week's kill was 2,526,000; it should average 2,570,000 in November (the holiday week excluded, of course). This is the most objective projection possible, since it places the relationship between September-November hog slaughter and the spring pig crop spot on the 2000-2016 average; and it places the relationship between November slaughter and the September-November total very close to the 2000-2016 average.



Larger production, of course, means lower prices, unless it is offset by stronger demand. Indeed, there was quite an increase in demand this past week, as reflected in the seasonally adjusted wholesale demand index. It was enough to make me change my thinking about the downside potential of the pork cutout value. If demand were to follow a normal seasonal trajectory from this point forward, then the sort of hog slaughter I'm talking about would place the bottom in the cutout value at about $74 per cwt in the week of Thanksgiving—about $3.50 below Friday's quote. I'm guessing, though, that pure momentum will make for a continuation of the stronger-than-normal demand pattern. Below I show you just what I mean by this.



The improvement in demand is clearly a reflection of a markedly counterseasonal increase in the prices of loins and butts. In the past 25 years, bone-in pork loins had never done better than hold steady during the second half of October; this year, they appreciated by 8%. Pork butts exhibited only their fourth significant appreciation since 1990 over the same time frame. I assume that the unusual interest in these two items in the wholesale market was/is associated with active supermarket featuring. I also assume that this activity will fade during the ramp-up into Thanksgiving while production increases, causing prices to set back moderately over the next three weeks. Trimmings and boneless picnics can be expected to lose ground as well, in alignment with the seasonal trend.

The two items for which demand is likely to strengthen enough to offset the increase in production are hams and bellies—the former because of simple holiday strength, and the latter because of heightened freezer demand. I have to expect prices of bellies and heavyweight hams to hold essentially steady between now and Thanksgiving.

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.