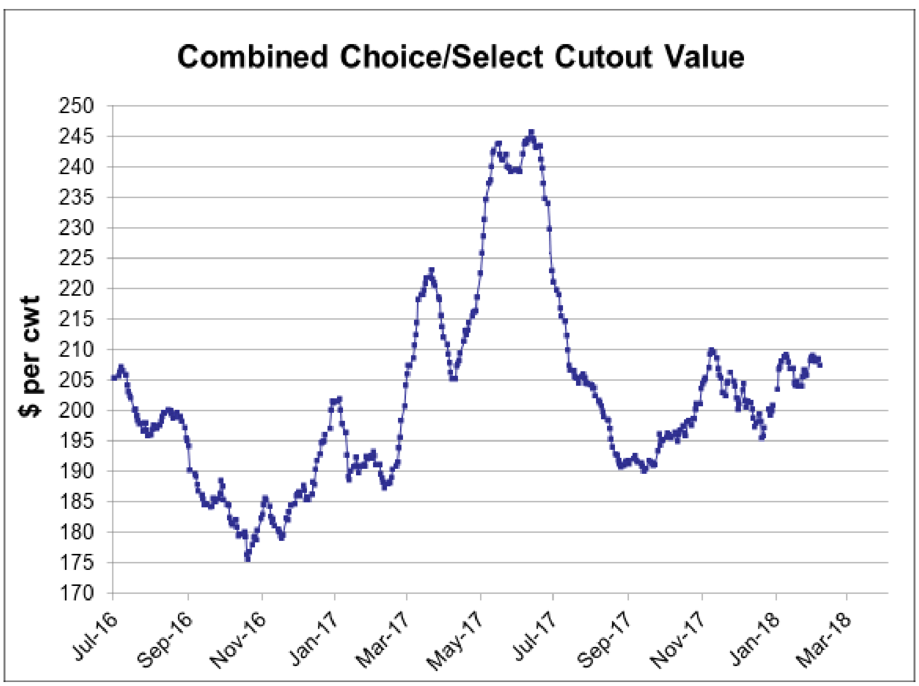
MEAT MARKETS
UNDER A MICROSCOPE

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

February 7, 2018

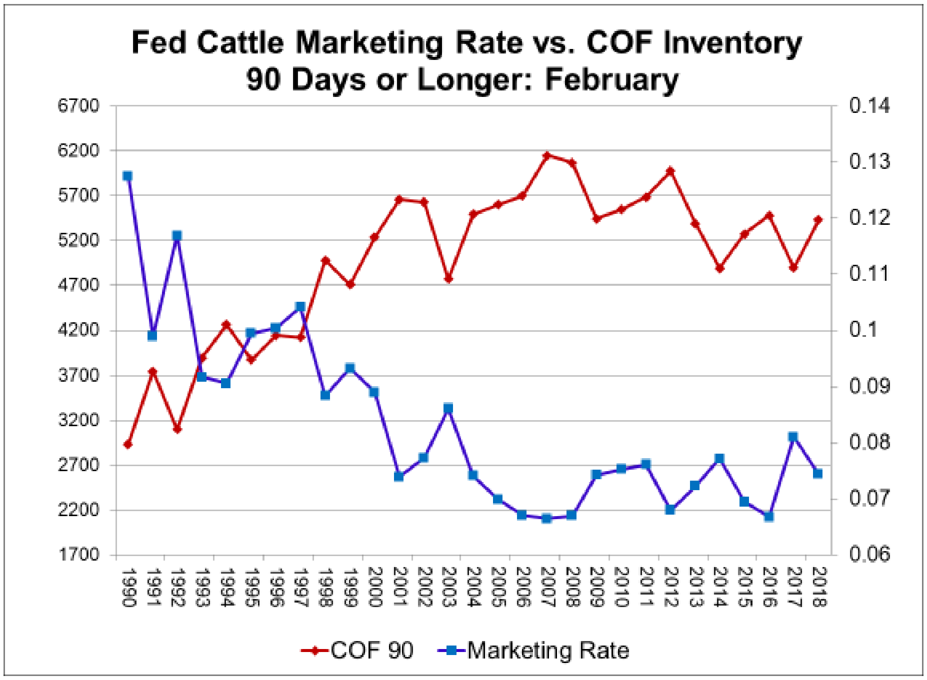
While the combined Choice/Select cutout value still looks as though it has made a temporary top, I am surprised that it has not retreated materially from that high. After all, the market has a pretty consistent tendency to drop over the two-week period just ended; this time around, though, it showed a rare 2% gain during that span. My initial inclination was to examine past years in which the market did something similar during this time frame and see what happened afterward…. so I did, and I came up empty-handed. There is no correlation between the direction of cutout values in the second half of January and the path they follow during February. Oh well.



Always a last resort, I am forced to use brain cells and logic to try to understand what has happened and identify the most likely complexion of the market at the end of the month.

Let's start with the supply side of the equation. Based on the February 1 inventory of cattle on feed 90 days or longer (which was up 11% from a year ago), and a "middle-of-the-road" marketing rate, I am expecting fed cattle slaughter to average around 467,000 per week over the next four weeks. On the next page I show you what I mean by "middle-of-the-road".

The most recent official measurement of carcass weights was taken in the third week of January. If we take the average weights of the second and third weeks of January and project forward along the ten-year average trajectory, then steer carcasses in February are indicated to be five pounds above a year earlier, at 886 pounds. Of course, there are soundly-based arguments why weights would fall either more quickly or slowly than the average, but this is the most objective approach I can think of.



Combining slaughter and carcass weights, it appears that fed beef production should decline about 0.6% from January to February; the average decline over the last 20 years is 1.1%.

And on average, the combined cutout value has declined 1.8% from January to February. Obviously, if production and prices decline concurrently, then demand declines from January to February—not always, of course, but typically. Should this year be any different?

A 1.8% decline in cutout values from the January average of $206.72 would result in a February average of $203. But the reduction in fed beef production should be somewhat smaller than average this time around, and so it would be reasonable to expect prices to fall more than 1.8%, right? **In fact, if the change in demand were to exactly match the 20-year average, then the combined cutout value would average just below $200.50 in February**. Remember, a precisely average change in demand would be signified by a seasonally adjusted demand index that is perfectly flat—i.e., the same in February as it was in January. This is, essentially, what I am anticipating.

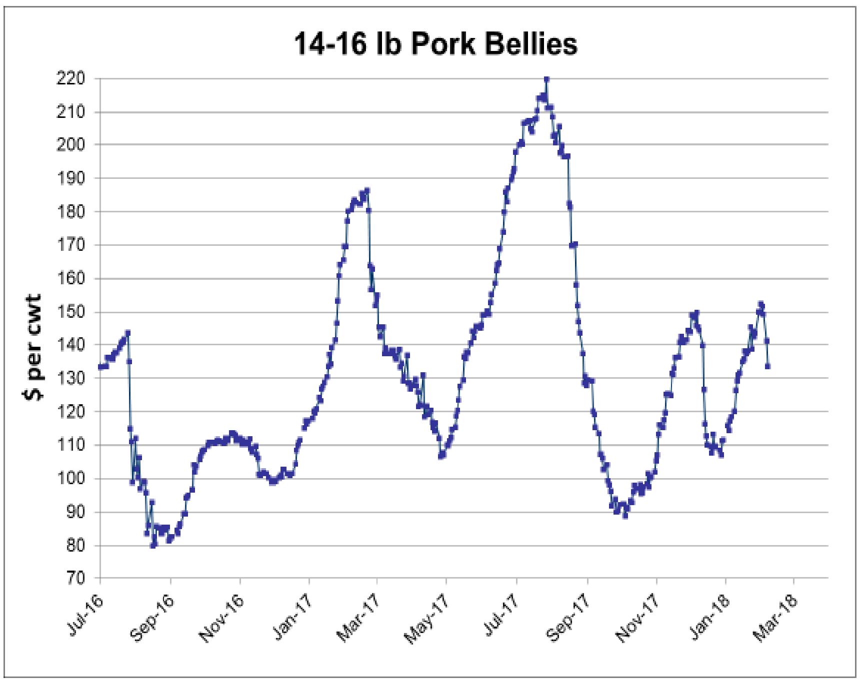
I point to the somewhat subdued forward booking activity for deliveries within the next three weeks as evidence that the change in demand from January to February will not be any stronger than usual. And so, logic tells me that the combined cutout value should average around $201 over the next four weeks (including this week), some $6.50 below yesterday's quote. Thijs, in turn, implies that the next major low should be somewhere in the neighborhood of $196 per cwt, which was the December 20 low.

I notice that the oddity of the strength in cutout values in the second half of January was mostly attributed to the resilience of the end meat complex. The correlation between the change in chuck and round cut prices and the change in the total cutout value during this time frame is 85%, compared with 61% for Choice middle meats and 43% for trimmings/grinds. Not surprisingly, the change in cutout values between now and the end of the month is most closely correlated with the change in end meat prices…. along with “thin meats”—comprising briskets, flap meat, ball tips, tri tips, flank steaks, skirts, and cap meat.

What, then, are the prospects for end meat prices over the next over the next three to four weeks? Well, I notice that shoulder clods, chuck rolls, knuckles, and bottom round flats are all trading in major resistance zones, while inside rounds and round eyes are situated midway between major support and resistance levels. Chuck rolls appear to be particularly vulnerable to a sizeable break, since they currently trade nearly 70¢ per pound higher than they did on this date a year ago, and about 40¢ above the nearest major support level ($2.65 per pound).

Thus, my corrupted brain cells tell me that the combined cutout value is headed downward in the near term…. a short window time-wise, but a substantial setback price-wise. Let’s move on.

I think it is safe to say that the pork belly market has established a major high and therefore, so has the pork cutout value. I hate to harp incessantly on belly prices, but let’s not kid ourselves—the bellies will dictate the behavior of the cutout value.

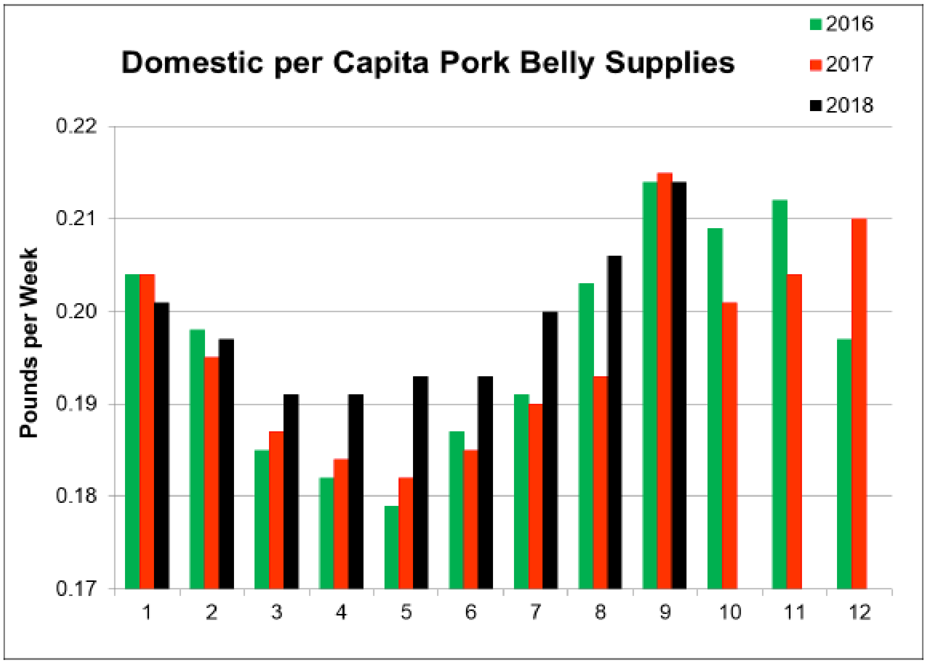



”It was the bellies that did it!”

My perception is that pork belly and wholesale bacon prices had to “reboot” in order to generate sufficient demand for the second and third quarters to avoid a serious supply/demand imbalance. In other words, if prices had remained at $1.50 per pound all the way through April, bacon processors would not have sold enough product for late spring and summertime deliveries to absorb the supply.

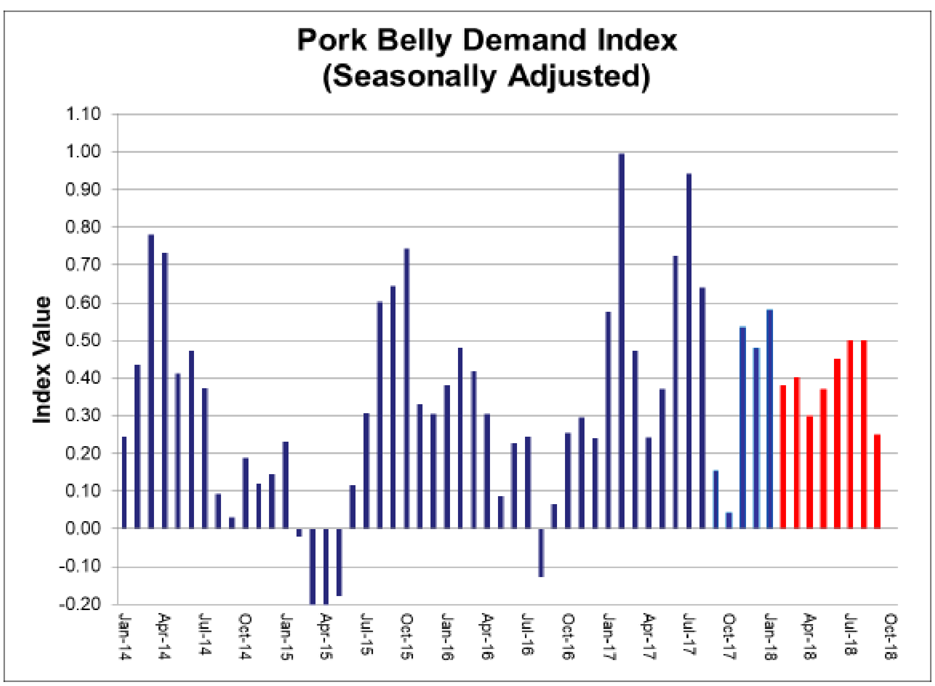
So, then, how far down do prices have to go, and how long must they remain suppressed, in order to “do the job”? I’ll begin with the simple observation that the chart above shows no discernible support above $1.10 per pound. This has been a pretty significant price level over the last couple of years, wouldn’t you say? And it’s not so far away, considering that prices have lost about 20¢ per pound in the last two days.

Assuming that USDA's indications of the fall and winter pig crops are reasonably accurate, it looks as though per capita domestic belly supplies will be up about 5% from a year earlier in the second quarter and up 4% in the third quarter:

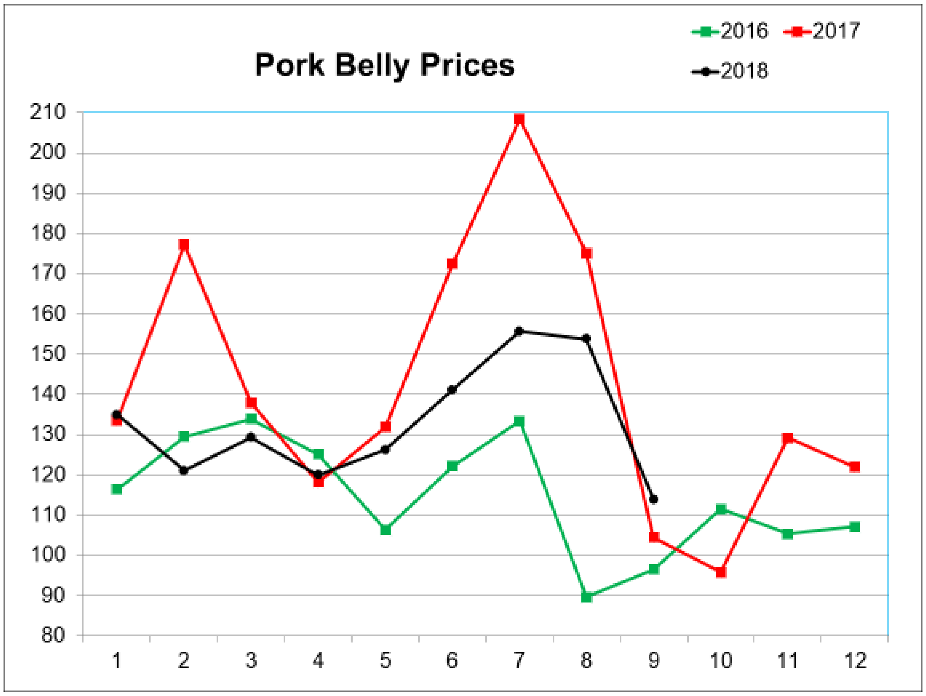


In addition to an accurate count of the fall and winter pig crops, these projections incorporate the assumptions that freezer stocks will grow by about 20 million pounds (a moderate pace) between now and their May peak; and that pork bellies will account for roughly 15% of total U.S. pork exports. [We can talk about this assumption later.]

Now for the demand side of the equation. My basic assumptions are that pork belly demand will show a rather sharp drop here in February, as this market struggles to find its new support level; and that the spikes in demand that occurred in February 2017 and again in June/July were the result of a genuine shortage of frozen supplies and will not be repeated.



Finally, the combination of these supply and demand pictures result in the price forecasts that I show on the next page. They are clearly lower than a year earlier in June, July, and August. I should know better than to put my neck (or a more private part of my anatomy) on the chopping block, but as you know by now, I am never afraid to make a fool of myself….



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