MEAT MARKETS
UNDER A MICROSCOPE

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

March 20, 2019

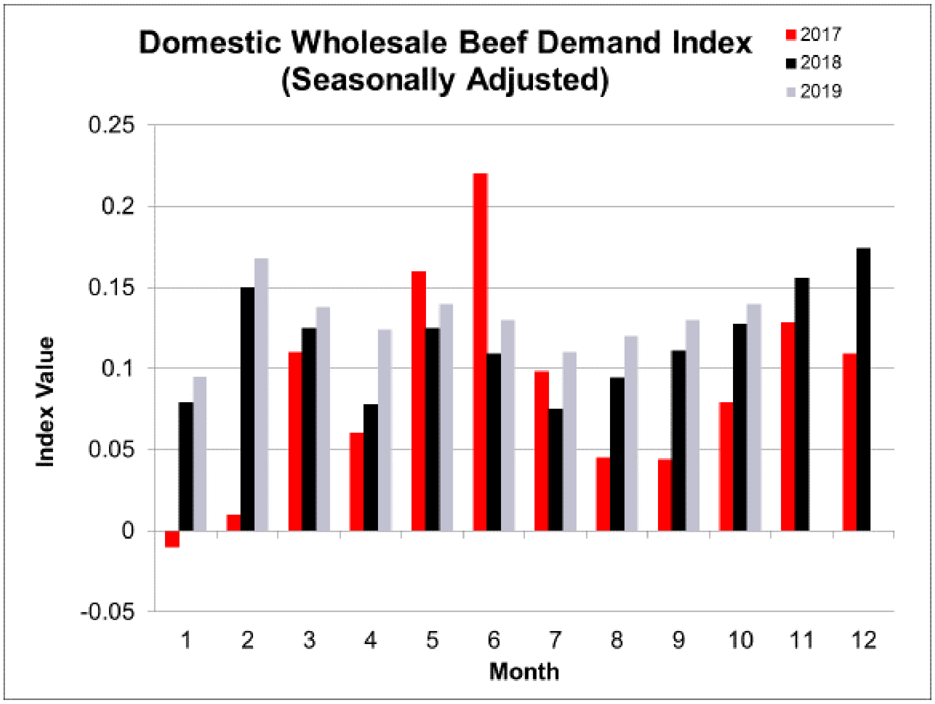
The combined Choice/Select cutout value has extended its rally this week, but I still think we can call this a top. So far, it has not delivered any genuine surprises; I had been guessing that the high for this first seasonal leg up would be in the neighborhood of $228 per cwt, and the current quote is $227.74. Had I known that steer and heifer kills would be so light in the first half of March (467,000), I probably would have forecast a somewhat higher peak. Also, this rally is now almost five weeks old, and the average duration is between four and five weeks. Middle meats have traded mainly sideways over the past week; and if there were to be any "dynamite in the wood pile" right now, it would be found in the rib and loin cuts.

But at the moment, my focus is on the shoulder clods, knuckles and bottom round flats. The end meats in general have recently received more attention in supermarket features than I had anticipated, which I ascribe to the fact that there was no January rally this time around; in other words, their seasonal advance got off to a late start. But let's face it: these items are soon to fall out of favor. Major support levels are quite a way down from current quotes: knuckles $2.25 per pound; flats $2.00; and clods $2.10. To reach these targets by the middle of April, there would have to be a greater-than-usual decline over the upcoming three-week period….but this notion seems acceptable, considering that they are starting out from a higher peak. Knuckles are currently priced about 25¢ per pound above a year ago; flats are up 35¢; clods are up only about a nickel. We cannot attribute the year-over-year premiums to the strong economy, because as recently as January they all traded substantially below a year earlier. Anyway, if the support levels listed above are reached, then this group would subtract about $3 per cwt from the combined cutout value.

Based on historical track records and current price status, we can probably also expect material setbacks in briskets, round eyes, and ground beef. The grinds do not show an historical bias in either direction between now and mid-April, but prices are very close to two-and-a-half-year highs.

The chart of the combined cutout value indicates that if there is to be a three to four-week downturn as I suspect, then the most likely destination would be in the neighborhood of $216 per cwt, around which the market hovered through the first three weeks of February. Obviously, in order to facilitate a $12 drop in cutout values, there would have to be some weakness in other cuts apart from those I just listed. It's difficult to identify the specific products with the highest probability of fitting into this category; but it's even more difficult to identify those which are likely to appreciate between now and mid-April. Fat (50% lean) trimmings are one of the few.

In regard to demand, I cannot help but notice that the seasonally adjusted wholesale demand index has exceeded a year earlier by about the same amount in each of the first three months of 2019. [The reading for March is a projection, of course, but it's going to be pretty close.] I am assuming that the year-over-year difference will be wider in April, because it will be comparing with a distinctly weak performance in 2018; and because forward bookings for first half April delivery were much more active than they were last year:

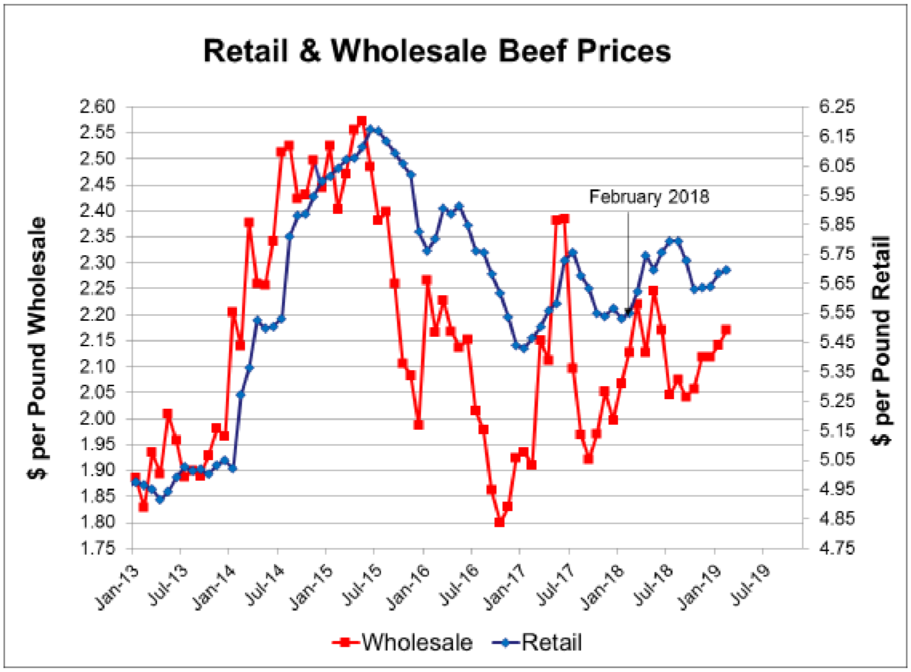


But beyond April, why should we not expect the year-over-year differential to be about the same as it was in the first quarter? And why should we think that the pattern in demand veer away from its seasonally normal course? Generally speaking, short term spikes in wholesale demand occur when precipitated by a period of surprisingly weak wholesale prices. Obviously, that is not going to be the case heading into April; and it will not be the case in May or June either, unless the decline in prices during April is steeper than I am forecasting.

Under the assumptions that steer and heifer slaughter will be running a slight 0.4% above a year earlier in the second quarter; that total beef production will also be up less than 1%; and that second quarter U.S. beef exports will be up 2%, resulting in a slightly reduced domestic beef supply; the demand projections in the picture above would bring about monthly average cutout values of $221 per cwt in April; $228-229 in May; and $223 in June. This is clearly a minority opinion (what else is new?). If packer margins remain close to a year earlier (as they have been so far here in March), then the futures market is pricing April-June combined cutout values at $231, $247, and $241 respectively. One of us is *way* off-base.

Of course, with the pork cutout value having leaped $11.55 per cwt over the past ten trading days, and with the futures market forecasting a further *$22* increase by June, people are naturally wondering if the high pork prices will drive beef demand upward--including Chinese demand for U.S. beef. It is a legitimate question. My humble opinion: if taken to the extreme, yes. But it will not happen quickly. **Keep in mind that just two weeks ago, the ratio of the pork cutout value to the beef cutout was the second lowest on record for this time of year; and even now, they are still far below the ten-year average.** It would take a while for any sort of meaningful substitution to take place. And in regard to China, U.S. beef will probably be pretty far back in the cue, behind Australia, New Zealand, and South America.

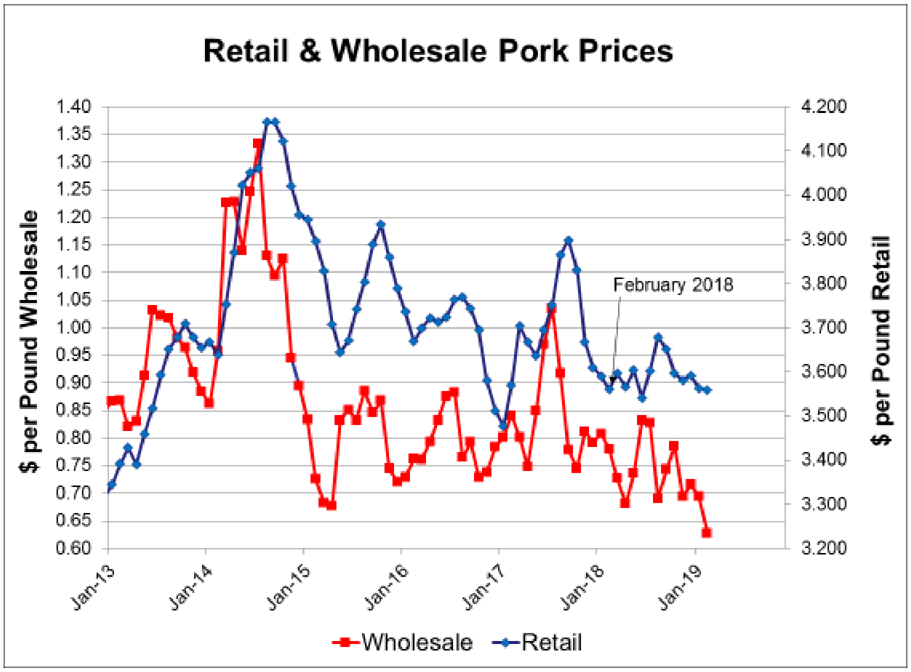
Among the more mundane conditions that will create a “headwind” for beef demand at the wholesale level is the fact that retail beef prices are considerably higher than a year ago. The simple average of the categories labeled “All Uncooked Ground Beef”, “All Uncooked Beef Steaks” and “All Uncooked Beef Roasts” by the U.S. Bureau of Labor Statistics stood 15¢ per pound (2.6%) above a year earlier in February. On top of that, the spread between wholesale and retail prices is narrower than a year ago. I interpret this to mean that retailers probably will not absorb seasonally higher product costs without raising retail prices. Remember that promoting beef less aggressively is a means of raising retail prices. Strong economy or no, rising retail prices tend to slow down the movement of product through the “pipeline”.



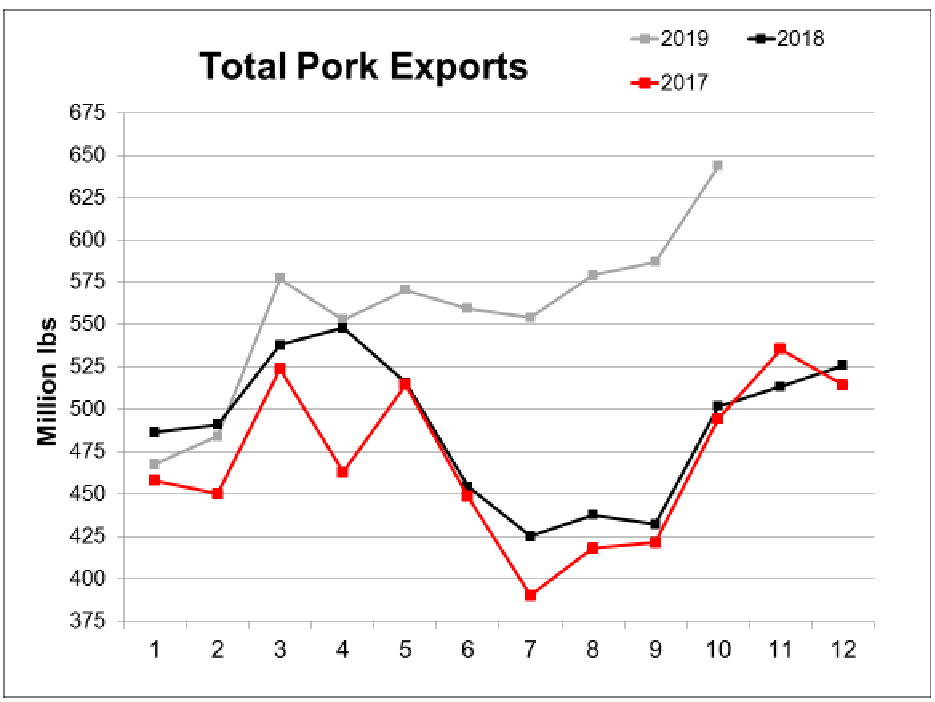
The opposite situation exists in the pork market. Retail pork prices are merely trending sideways, but the wholesale-to-retail price spread is extraordinarily wide….implying that retailers have quite a bit of room to absorb higher product costs without changing consumer-level prices. This condition is, of course, bullish of wholesale demand.

It is easy to forget how hard the pork market struggled through January and February to build demand, and that this is one reason why the pork market has suddenly “caught fire”. I think the price change has been so dramatic because we are witnessing a powerful confluence of three separate developments: one being the response to low wholesale prices that I just mentioned; the second being the actual purchase of a large quantity of U.S. pork by China; and the third being that all this has happened just as production heads into its seasonal decline. The bulk of the latter influence still lies ahead. It looks as though this week’s kill will be near 2,590,000, and my best guess--based on USDA’s existing estimate of the fall 2018 pig crop--is that it will drop to 2,400,000 within three weeks.

Trying to pick a top in the pork cutout value at this point is futile. It is difficult enough to project when the burst of domestic wholesale demand will have run its course--the last time this happened, which was last October, it took one month. It is next to impossible, though, to know how much pork will be exported from the U.S. in the months ahead. I have my own guesses, of course. Because of my unfortunately-chosen field of profession, I am required to make the effort.



My precarious forecast of total U.S. pork exports is shown in the picture below. I am guessing that Chinese imports of U.S. pork will expand consistently, from a pace of 40 million pounds per month at the beginning of the year (this includes Hong Kong and Taiwan) to 120 million by June and 160 million by October. I am also assuming that the Mexican tariff on U.S. pork (20%) will have disappeared by the end of June. Finally, I am considering the impacts that the Chinese business might have on exports to other destinations. I show a list of year-over-year changes in exports for all major customers on the next page.



In case you're wondering how I can suggest a basically sideways trend in total exports between now and August while exports to the "Chinese Block" grow exponentially, it is because export business to a number of major destinations is highly seasonal; in a typical year, U.S. pork exports would decline from early spring to summer. This year, they won't.

U.S. Pork Exports, Change from Year Earlier

	Q2	Q3
China/HK/Taiwan	+155%	+459%
Japan	-7%	-9%
Canada	+3%	-2%
Mexico	-14%	+10%
Korea	+5%	+9%
Australia	+31%	+14%
Columbia	+25%	+18%
Total	+11%	+33%

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