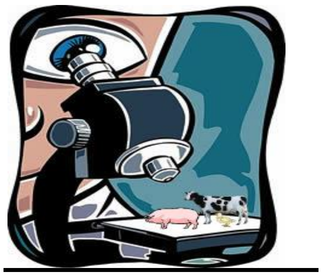


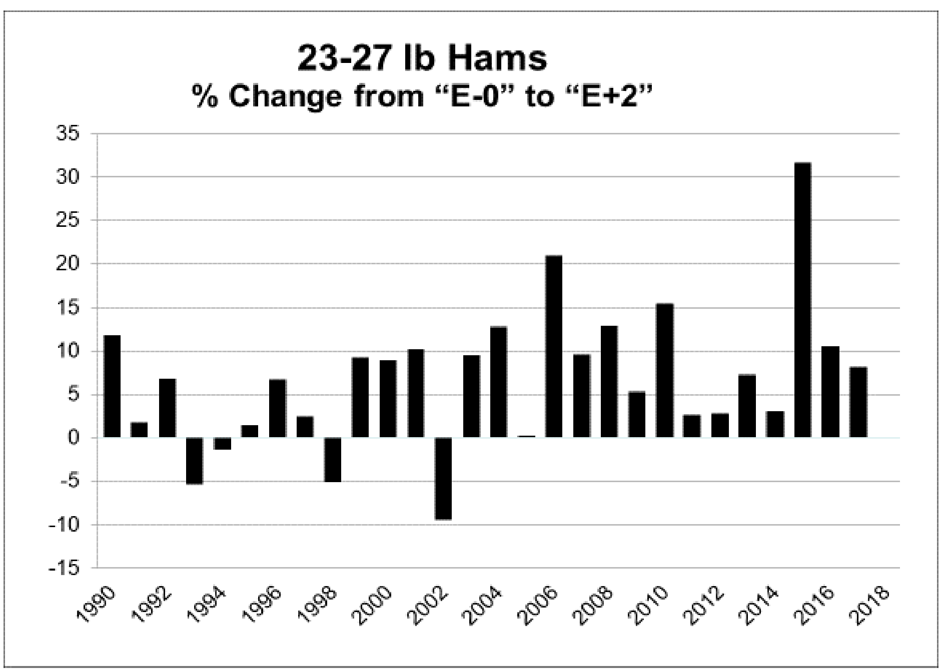
MEAT MARKETS
UNDER A MICROSCOPE

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

March 26, 2018

I realize that I said the same thing at this time last week, but the pork cutout value should be on bottom right here. I mean really, how much downside potential could remain? It always possible that I am overestimating the strength of underlying support at $.50 per pound in the ham market, and at $1.00 per pound in the pork belly market, and at $.80 in the bone-in loin market, and at $1.10 in the (strap-off) boneless loin market, and at $.60 in the lean trim market, and at $.70 in the market for boneless picnics. But these are all prices which have attracted buyers in the past, and I don't know of a reason why they would not do so again. And with the exception of bone-in loins (which are still a nickel away), all are where prices were quoted on Friday.

The Devil's Advocate side of my brain says, "well, yes, but hog slaughter is running 4% above a year earlier". And this is true, but according to USDA's estimate of the fall 2017 pig crop, kills should drop back to an average of 2,360,000 in April, down from 2,413,000 over the past four weeks. Unless demand slows down commensurately, this should result in higher prices.



My expectation is that cutout value will trade essentially sideways in the week ahead, and then turn upward. If this is to happen, then the leadership role must be taken by hams. As you can see in the picture at left, it's pretty rare that ham prices do *not* appreciate between the week of Good Friday and the second week following Easter. Why should this not be the case again this year? Not only should there be strong interest from foreign buyers, but there should also be a pretty fair amount of inventory demand at this price level.

Speaking of foreign buyers, what about the 25% tariff that is to be imposed by China on U.S. pork? Frankly, to echo the dreadfully over-used phrase that is repeated on CNBC and Bloomberg, this does not appear to "move the chains". Mainland China has bought an average of 32 million pounds of U.S. pork per month over the last 12 months, comprising 6.8% of total U.S. pork exports. Live hog exports to China have been negligible. No one knows how volumes will be reduced by the new tariff, and so we are forced to take a guess. What if the volume is reduced by a rather substantial one-fourth? Well, I had been projecting (reasonably, I think, given the currently low Chinese pork prices) that without the new tariff, U.S. shipments to mainland China would have averaged 39 million pounds per month in the second quarter (down 5% from a year earlier) and 20 million pounds in the second quarter (unchanged from a year earlier). In that case, a 25% reduction would amount to about ten million pounds per month in Q2 and five million in Q3. When I take the econometrician's approach and insert these adjusted values into the pricing equation leaving all else unchanged, it reduces the forecasts of cutout values by roughly $.50 per cwt.

There are some other mitigating factors to be considered. For one, the most recent figures I saw showed that U.S. carcass prices were some 30% lower than prices in the European Union (one of the strongest competitors for Chinese pork business, along with Canada and Brazil). Secondly, according to a report issued by the USDA's Foreign Agricultural Service, China's Ministry of Commerce states that it will "…implement the second part of the list [the one pertaining to pork] after further evaluating the impact of the U.S. measures on China….", and that the new tariffs will be implemented "…if China and the United States fail to reach an agreement on trade compensation within a specified time…". Apparently, China's retaliatory measures will be carried out under the framework of the World Trade Organization. The point is that nothing may happen right away.

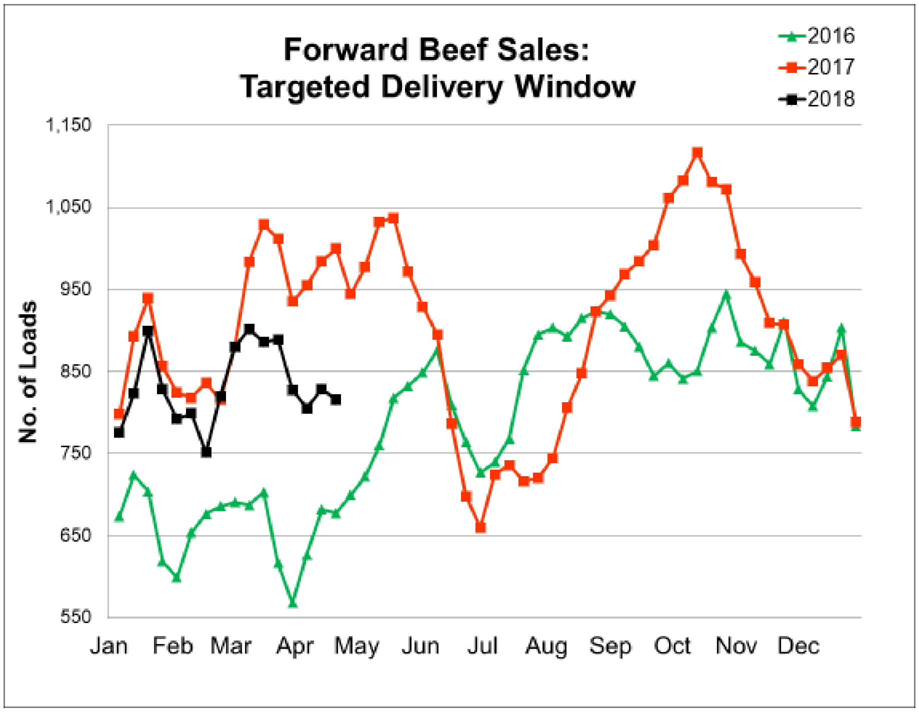
Back to more mundane matters, I would like to point out that if pork belly prices are indeed on bottom, this doesn't necessarily mean that they will reverse course immediately. However, I notice that this market went through a similar springtime "reboot" in each of the last three years. In 2015, the sideways, bottoming-type price action lasted five weeks; in 2016, it lasted four weeks; and in 2017, it lasted just two weeks. With prices averaging $1.04 per pound this past week and $1.08 the week before, I would gauge that this bottoming process is two weeks old. By this obscure standard, we might look for prices to begin moving higher within the next two weeks. By the way, the low weekly average last spring was $1.08.

At the beginning of March, stocks of frozen bellies stood at 47 million pounds vs, just 16 million a year earlier. I have to think that stocks have grown since then. If they accumulate at the same pace as they did in March-April 2017, then they will peak on May 1 at about 65 million pounds vs. 34 million a year earlier. Assuming that USDA's estimate of the winter pig crop was accurate, then per capita pork belly supplies will be 6-7% larger than a year earlier in the critical June/July period… certainly enough to prevent prices from challenging last summer's peak.

The combined Choice/Select beef cutout value has remained within a narrow ($2.92 per cwt) range for more than three weeks. **My guess is that it will break out of this range to the downside, initiating a slide that should begin this week and last for about three weeks**.

It is rather obvious that the nearest major support level on the chart of the combined cutout value lies at $210 per cwt, about $11 below today's quote. It will undoubtedly test that support level somewhere down the road. The question is, will it do so within the next three weeks?

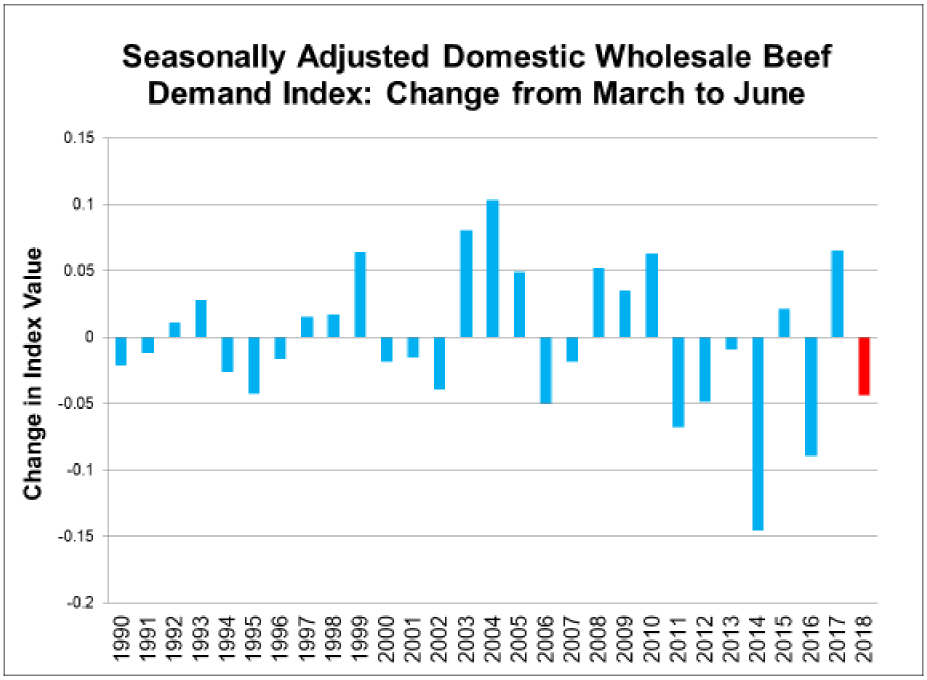
It doesn't seem like such a far-fetched notion. Clearly, it would require a greater-than-average decline during this upcoming period; but then again, it would require no more of a decline than we saw in each of the past two years. If it were to precisely match last year's setback from the third week of March to the second week of April, then it would place the combined cutout value just above $210.



I have learned not to put *too* much stock in these numbers, but the volume of product booked in advance for April delivery is not indicative of aggressive retail feature plans. In the picture at left, each data point represents the average volume of beef booked four to eight weeks prior—including fixed-priced and formula-priced transactions and forward contract sales, both domestic and export. Considering that fed cattle slaughter, in my humble estimation, should average about 5,000 head per week above a year earlier in April, it is not such a good sign that the black line is so far below the red line in the picture above. It suggests that packers will have substantially more meat to sell into the spot market in the weeks ahead (compared with both recent weeks and a year earlier). It also suggests that an explosion in wholesale demand such as we witnessed in May/June 2017 is unlikely to occur again this year….at least, the seeds have not been planted. The final black data point on the chart, by the way, represents the week ending April 21.

Why only a three-week setback in the beef market, and not a major crash (as the futures market seems to be telling us)? First, let me make it clear that what I'm talking about is a low in the middle of April that should hold up until late June, with a recovery in between. I know, it's ridiculous to think that I could pinpoint the pattern this way, but bear with me. I have to try.

There are two considerations that point objectively to a temporary rebound in the cutout value between mid-April and Memorial Day. One is that even when I factor in a heavy rate of steer and heifer slaughter *and* a considerably weaker-than-seasonally-normal change in demand from March to May, I still come up with an average combined cutout value of $218 per cwt in May. Specifically, I am assuming that fed cattle kills will average 520,000 per week in May, compared with this past week's total of 478,000; and I am assuming that there will be a drop in the seasonally adjusted wholesale demand index that borders on the extreme:



Some sort of decline in the index seems to be in order, because of the light forward-booking activity that we just talked about, and because the index has been quite high here in March and is due for a cyclical peak right here.

The second reason to look for a rebound in the cutout value after the middle of April is simply because there is a pretty consistent tendency for it to do so, especially when the price action in the first half of April is weak.

Finally, I would like to point out that as of this afternoon's close, the futures market—assuming that the steep futures-to-cash discount will persist—is discounting a combined cutout value of $113.25 in May and $107.25 in June. I think it's fair to say that expectations are very bearish….and excessively so, in my opinion.

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