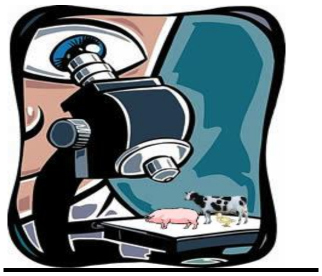


MEAT MARKETS
UNDER A MICROSCOPE

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

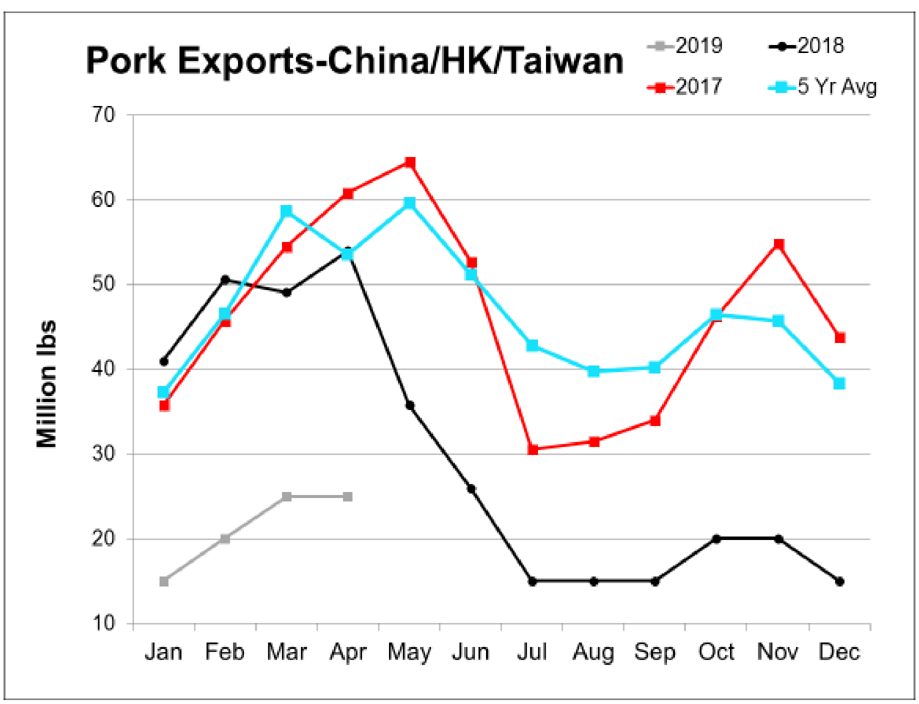
July 16, 2018

Never one to be afraid to make a fool out of myself, I'll show you my month-by-month forecasts of the beef and pork cutout values after having done my best to objectively account for the tariffs that been put on imports of U.S. meat by China and Mexico. As always, I invite your critique. Believe it or not, sometimes I don't know what I'm talking about.

First of all, only the tariffs implemented by China and Mexico are of any consequence. Canada imposed retaliatory tariffs on U.S. products two weeks ago, but that list included nothing involving meat except prepared meals. I am assuming that all tariffs that are in place today will remain in place indefinitely. If one day we wake up to the news that these tariffs are being rescinded, then of course I'll have to erase the blackboard and start over again.

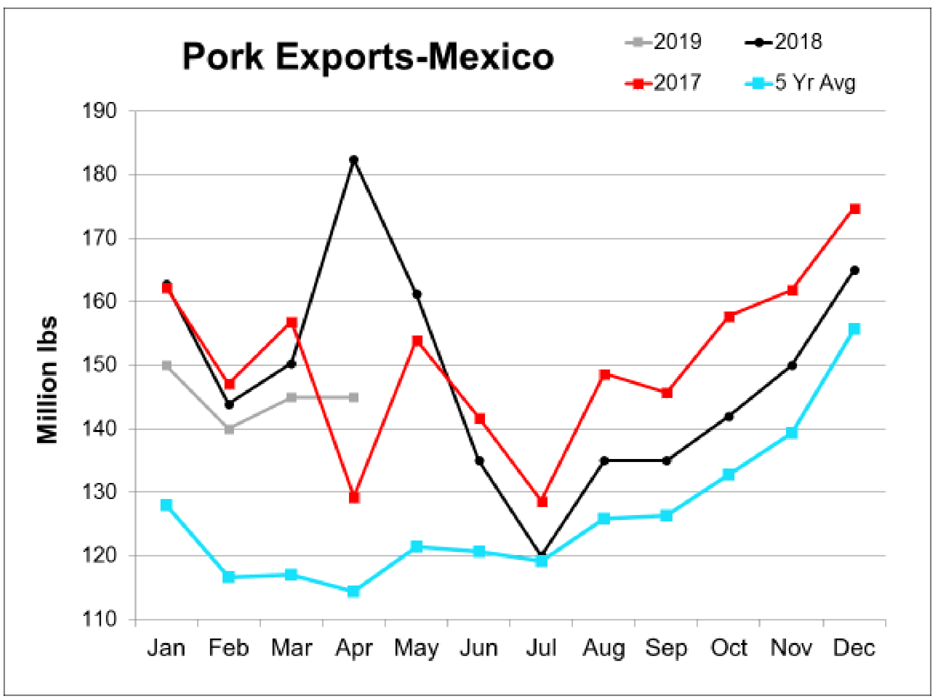
This is going to require a number of charts and graphs, so bear with me.

I'll begin with the subject of pork, because clearly it is in this market that the trade disruptions have the greatest impact.



The first round of tariffs that China imposed on U.S. pork pushed the duty from the standing 12% to 37% in April. It is reasonable to think that this action had something to do with the sizeable drop in shipments during May. [May is the most recent months for which official trade data are available.] The second round here in July pushed the duties up to 72%....pretty onerous.

Accordingly, I assume that shipments to China/Hong Kong/Taiwan combined have quickly dropped to a rate of 15 million pounds per month. I settle on this number because over the past twelve months Hong Kong has taken an average of ten million pounds per month, and Taiwan has bought an average of two million pounds per month. The U.S. Meat Export Federation says that Hong Kong is not affected by the new tariffs. **Thus, a rate of 15 million pounds per month represents a practical floor for the three countries combined**. I am often asked why I roll the three together. The reason is because of the "Grey Market" transshipments of U.S. product through Hong Kong and into China that have occurred in the past; and by the way, I wonder what would prevent that activity from increasing, now that direct shipments to Mainland China are effectively locked out. I include Taiwan in the trifecta simply because the Taiwanese business used to be more substantial and more variable than it is now, and it was easier and more accurate to project exports to the region as a whole. [This is probably a good time to mention that in my forecasts, I try to recognize that a substantial portion of U.S.-to-China pork trade has consisted of byproducts, and the loss of this byproduct business would not really affect the carcass cutout value—only the "drop credit".]



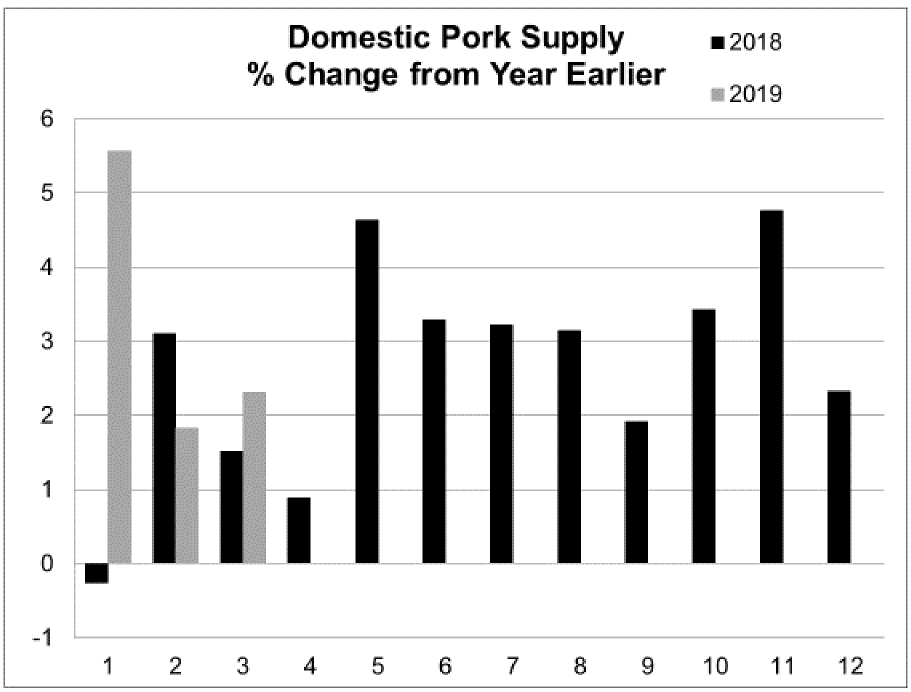
As for Mexico, there is now a 20% tariff on U.S. pork, half of which was applied in June, and half here in July. I am told that hams account for roughly 75% of U.S. pork exports to Mexico….which naturally helps explain why the ham market is struggling to hold above $.50 per pound here in midsummer. In the picture at left it may appear that I am underestimating the slowdown in export business; but in comparison with what the trade volume *would have been*, the difference is substantial indeed. There should still be quite a seasonal increase in the fall, and I'm guessing that volumes will remain above the five-year average. **Keep in mind that while the tariff has added 20% to the price of U.S. hams at the border, domestic market prices over the past two weeks are down 34% from a year earlier.** Looking at it from this angle, my export projections might be too modest.

Noting the increases in pork exports to other destinations, my guess is that total shipments will be down 4-5% from a year earlier this fall and winter, following a 1% *increase* this summer. The figures are shown in the table at the top of the next page.

U.S. Pork Exports (million pounds) & Change from Year Earlier

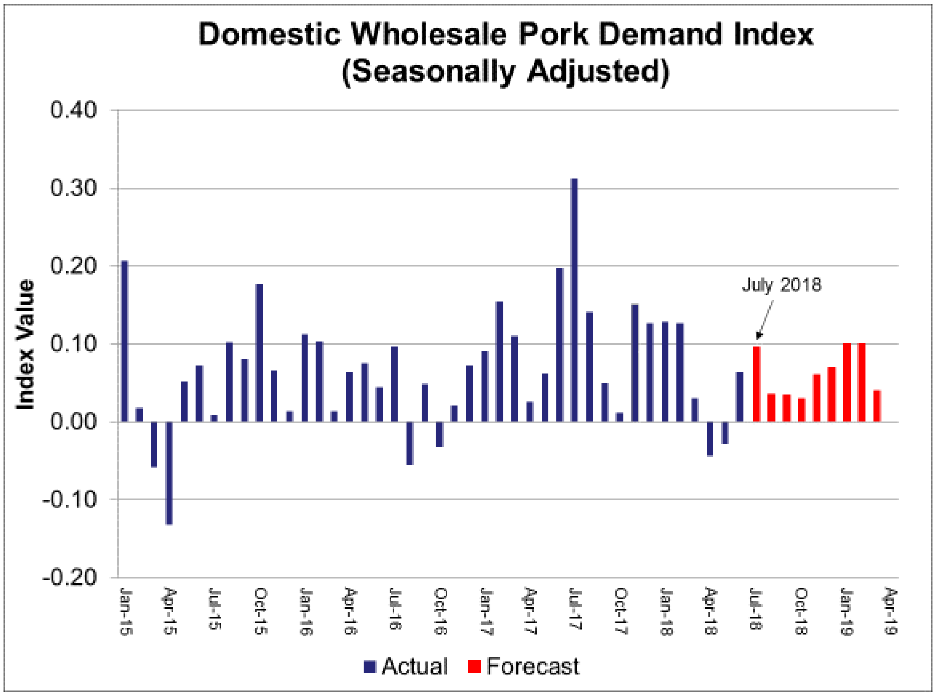
	Q3 '18	% Chg	Q4 '18	% Chg	Q1 '19	% Chg
Mexico	390	-7.8	457	-7.6	435	-4.8
Japan	285	+2.1	325	+1.5	325	+3.4
Canada	139	-1.1	138	+0.4	125	+0.1
Korea	135	+76.4	198	+24.6	220	+4.5
Colombia	77	+75.6	87	+30.9	75	+15.6
China/HK/Taiwan	45	-53.2	55	-62.1	60	-57.4
Australia	45	+10.8	56	-5.8	63	+1.7
Total	1247	+1.4	1477	-4.3	1443	-4.8

Taking USDA's pig crop estimates and farrowing intentions and farrowing intentions at face value; assuming typical seasonal changes in carcass weights; and incorporating these export projections along with stable imports (remember, Canada has done nothing to affect pork trade with the U.S.), **I come up with 2-3% year-over-year increases in domestic pork supplies from now through January. In November the domestic market likely will have to absorb nearly 5% more pork than a year earlier.**

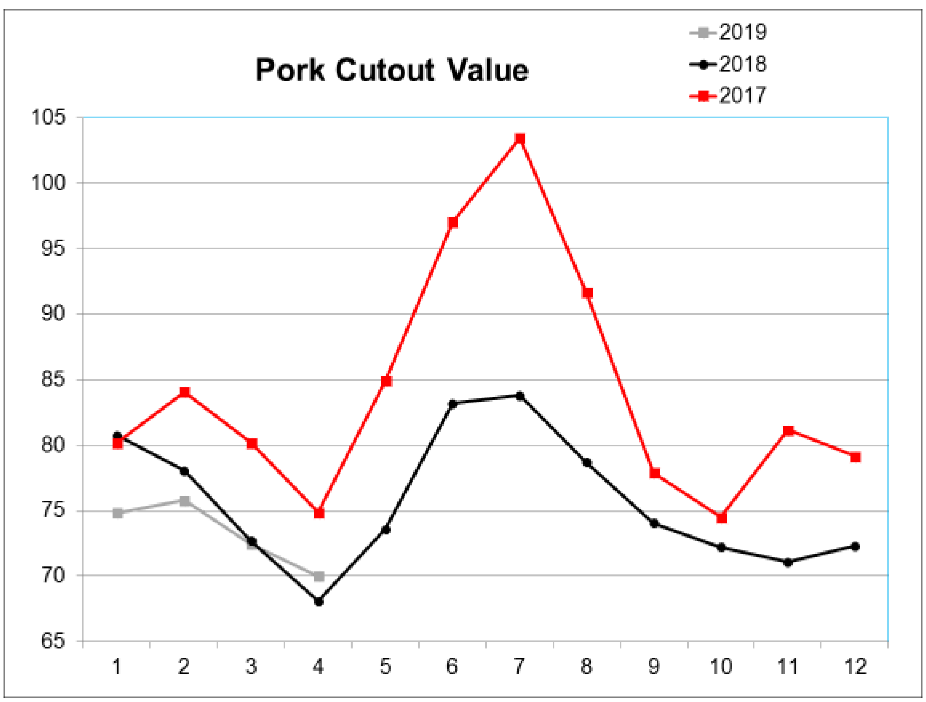


The price at which the additional supply can be moved through the marketing chain is, of course, dependent on demand at the wholesale level. It is a complex and mysterious force in the marketplace, and my Kindergarten-level approach is to use an index which measures supply-price combinations relative to the long-term average for the same month. [I always compare January data with January averages, February data with February averages, etc. in order to remove the seasonal influence and uncover "core-level" demand.]

The first picture on the next page illustrates how demand for pork reached a cyclical low point in April, and—in my humble opinion—it has reached a cyclical peak here in July. My guess is that the next low point will occur in October; but that low will not be as deep as those of last April or the previous October. It is a difficult variable to project, involving a lot of educated guesswork. **One concrete consideration, though is that retail pork prices are currently the lowest in nine months and are declining; and retail margins are wider than they were a t this time a year ago. These conditions are generally supportive of demand at the wholesale level….eventually.**



Applying these demand projections with the supply projections I showed earlier produces the forecast of monthly average pork cutout values shown in the next picture. As an economist, I should dutifully mention that if the demand index value shown above were to remain at .10 instead of dropping to .03 to .04, then my forecasts for the August-October period would be $5 per cwt too low; if the index values were to drop to zero, then my August-October forecasts would be $2-$3 too high. My intuition tells me to err to the bearish side….



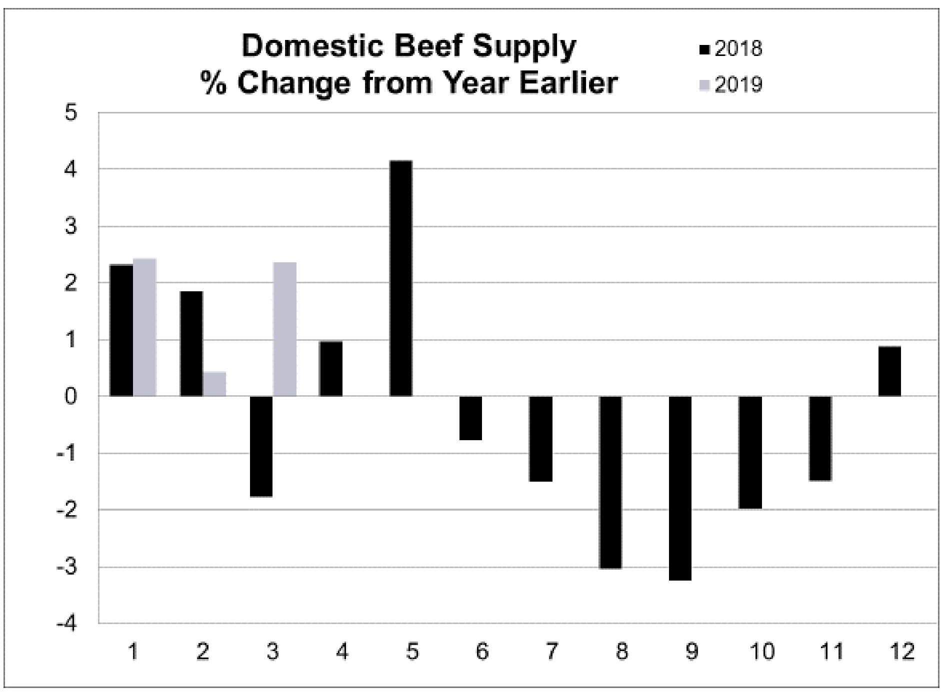
OK, so how about the equivalent picture in the beef market? This will take less time to describe, because there are no trade disruptions for which adjustments are needed (and also because I'm starting to feel guilty about the length of this report). Mexican tariffs apply only to pork, not beef, and China has been buying only insignificant quantities of beef directly from the U.S. (about two million pounds per month). And as in the case of pork, Hong Kong is not applying any punitive tariff. I'll jump straight to the table of export projections by country:

U.S. Beef Exports (million pounds) & Change from Year Earlier

	Q3 '18	% Chg	Q4 '18	% Chg	Q1 '19	% Chg
Japan	238	+1.9	203	+6.6	218	+10.5
Korea	175	+39.1	176	+30.2	148	+9.0
China/HK/Taiwan	137	+15.7	185	+4.1	144	+2.8
Mexico	115	+1.9	113	+1.5	101	+2.8
Canada	85	+8.2	83	+4.4	74	+4.2
Total	835	+11.9	854	+9.3	772	+5.8

It is a much healthier picture than in the pork market. Based on the patterns that have been estabished so far this year, it looks as though each of the top five foreign customers will import more U.S. beef than a year earlier in each of the next three quarters.

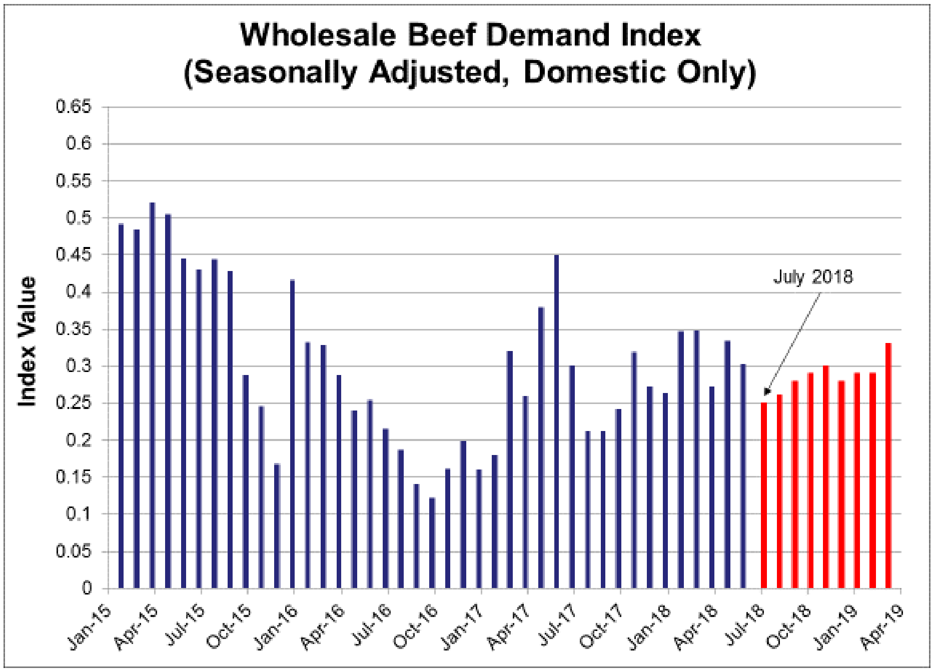
Combined with the upcoming year-over-year declines in fed cattle slaughter from August through November—which I insist are likely, even though many of my colleagues think I'm nuts—the robust export figures present the domestic market with substantially reduced beef supplies through the balance of summer and into the fall. As best I can tell, the year-to-year changes swing back over to the plus side beginning in December.

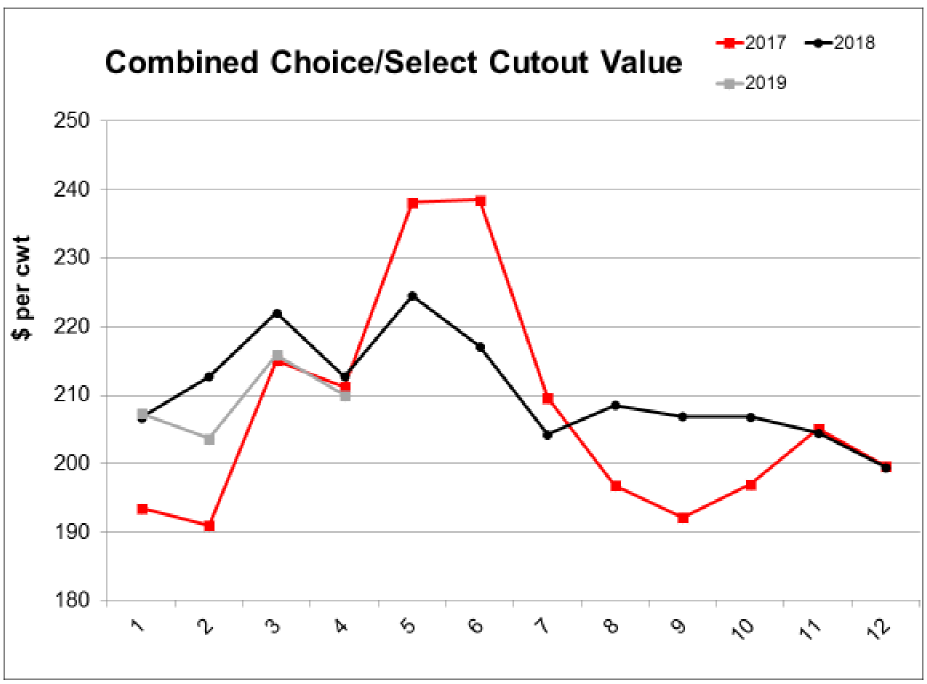


I should point out that the supply picture shown at left reflects a seasonally normal trajectory in carcass weights and a continued 7-9% larger cow slaughter through the second half of 2018.

Almost the mirror image of the situation in the pork market, the wholesale demand index is probably establishing a cyclical low here in July and will move back up into the middle of its recent range over the next several months. Assuming that it is indeed on bottom right now, the next cyclical peak would be due in October or November. Expressed in English, I perceive no compelling reason why wholesale beef demand should veer from its seasonally normal path within the next few months. The situation in retail prices (unchanged from a year ago) and margins (wider than a year ago) is not as bullish of demand at the wholesale level as in pork, but neither is it a bearish picture.

My best guess, then, is that the combined Choice/Select cutout value will find its equilibrium around $209 per cwt in August, September, and October, and then taper off at the end of the year.





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