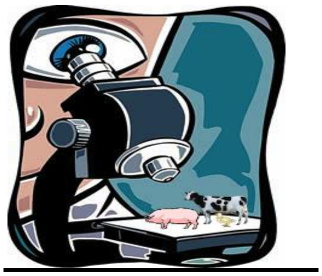
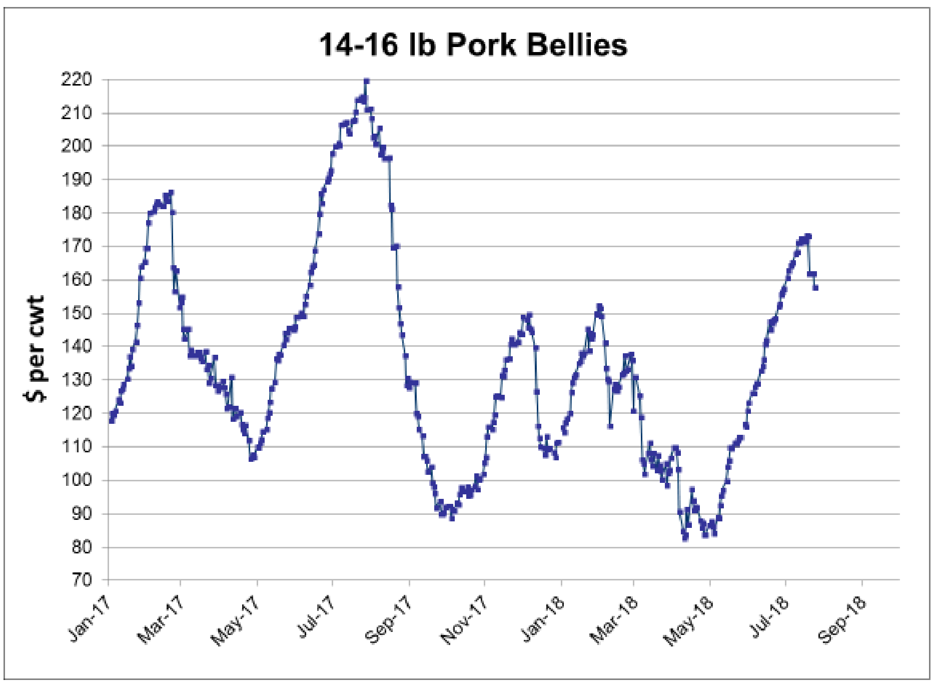


MEAT MARKETS
UNDER A MICROSCOPE

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

July 24, 2018

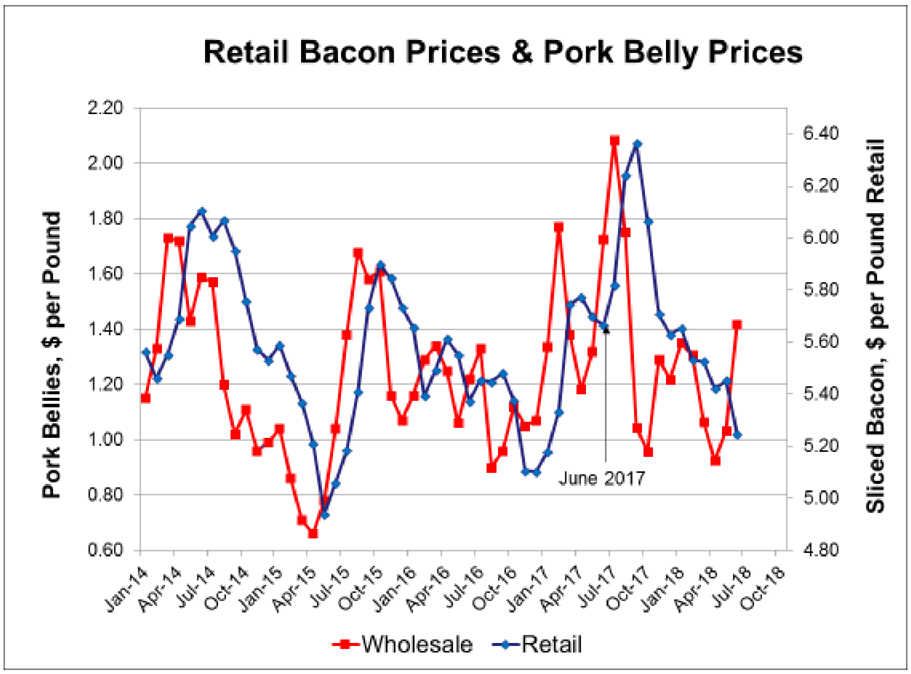


I'll go out on a limb here and say that the pork belly market has topped out. It did so 23¢ per pound above the mark I had guessed before the season started, most likely because of two factors: the lighter-than-expected production in June, and the fairly prominent bacon featuring that emerged as a result of relatively cheap price offerings in the spring.

The nearest support level on the chart above obviously lies in the neighborhood of $1.50 per pound, which could temporarily "catch" the market in the near term. But I do not detect any meaningful support above $1.10. Most likely, even this support will give way sometime this fall.

I arrive at this conclusion semi-scientifically. One simple but valid way to look at it is that in each of the last two years the market traded at or below $.90 per pound sometime in September, and this year's fourth quarter belly supply will be bigger than both—by 2-3%, in my humble estimation. But what are the demand prospects?

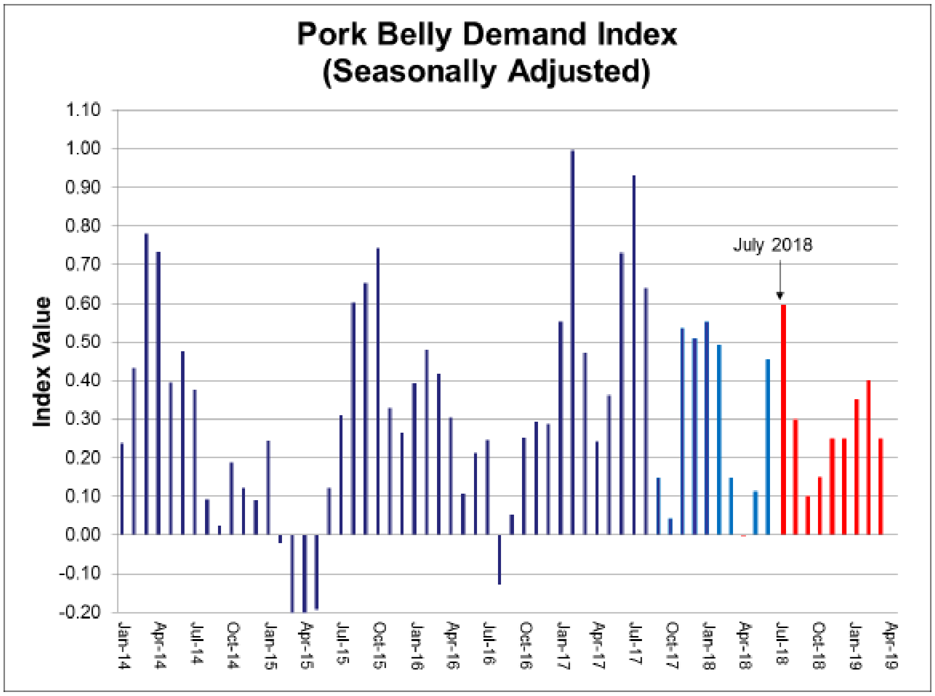
The direction of retail prices is bullish of pork belly demand into and through the fall—not wildly so, but distinctly. As I show in the next graph, retail packaged bacon prices (as reported by the U.S. Bureau of Labor Statistics) are the lowest they have been in a year and a half, and they are trending downward. Low retail prices, if they persist—and I can't think of a good reason why they would not—should sustain the rate of product movement through the "pipeline". Meanwhile, the implied retail margin is a bit on the narrow side even for this time of year, but it is much wider than it was at this time last year. Margins will widen seasonally in August and September, making room for retail promotions in both supermarkets and restaurant chains.

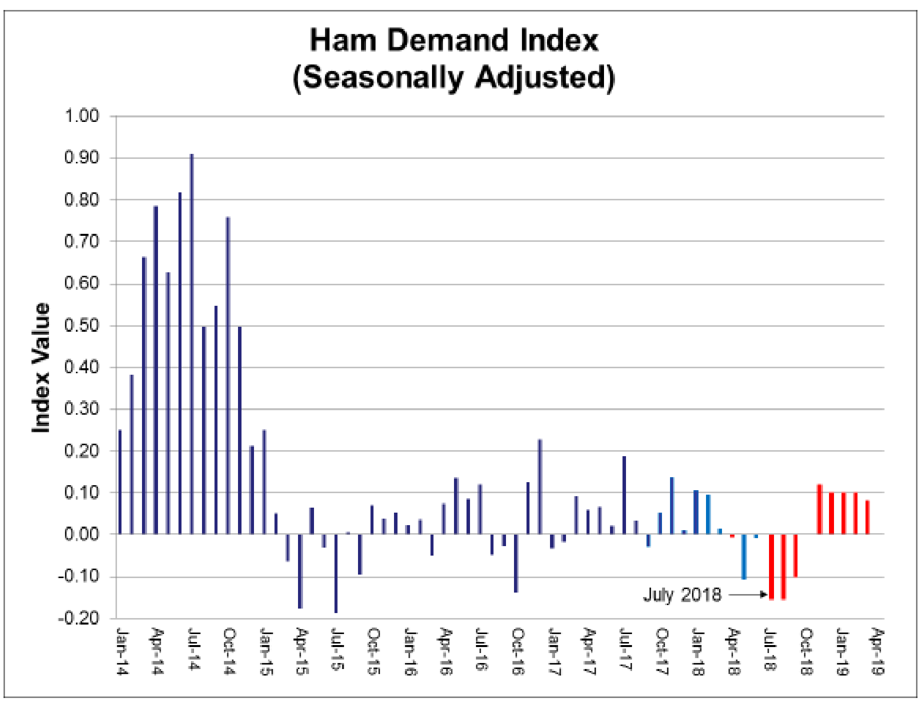


The seasonally adjusted wholesale demand index for bellies shows that "core-level" demand—seasonal considerations excluded—has jumped dramatically from depressed levels in April and May. It also may be indicating that demand has reached a cyclical peak, and is due for a downturn. It's obvious that this index is volatile, which does not make it any easier to project. [And the reason it is volatile is because belly demand is highly *inelastic* in the short term.] But I think it's reasonable to anticipate such a decline in the index, not only from a cyclical perspective but also because it would place the index value at approximately the same level as the last three years during September. And so, my assumption is that demand will reach a cyclical low in September and will be followed by a recovery into midrange territory during the fourth quarter. This picture is shown on the next page.

When I match these demand projections with a 2-3% larger supply, I arrive at a price forecast of $.97 per pound in September, and near $1.00 in October through December. August should be a month of transition, averaging $1.25-$1.30 but finishing the month considerably lower than that.

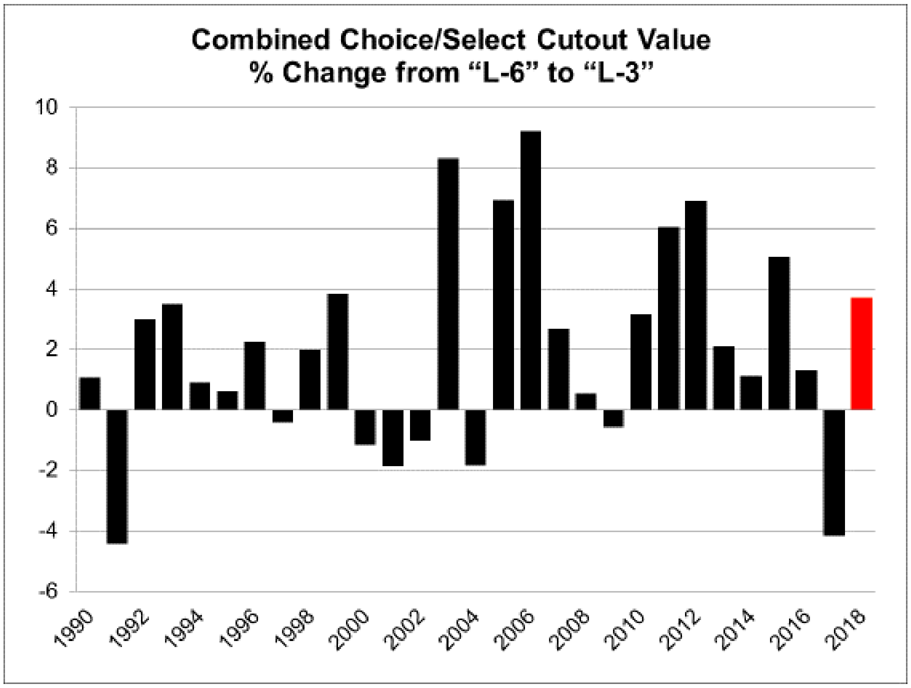
Taking the same approach toward the ham market, I first should explain my assumptions. One is that the tariffs that are currently being imposed by Mexico and China will remain in place through the fall. My intuition tells me that something will happen to make the Mexican tariff go away before then….but what do *I* know about trade politics? If anything changes on that front, then I will make adjustments accordingly. The second critical assumption—which no one seems to be talking about at this point—is that the surprisingly low ham prices that have prevailed ever since Easter will be reflected in retail prices and wind up boosting domestic demand. Demand at the wholesale level is probably at its nadir right now, since it is in the initial stages of a supply shock that the greatest toll is taken on demand. Finally, I should point out that while the slower pace of exports to Mexico would boost domestic supplies, freezer stock flows should reduce them. The buildup of inventories during the second quarter was remarkably small considering the price levels, presumably because less frozen product was needed to fill export orders. My guess is that October 1 stocks will be about 10% lower than a year earlier, leaving less frozen product to be pushed into the supply chain during the fourth quarter. And this impact would be heightened if the Mexican tariff were rescinded, since inventory demand would increase.





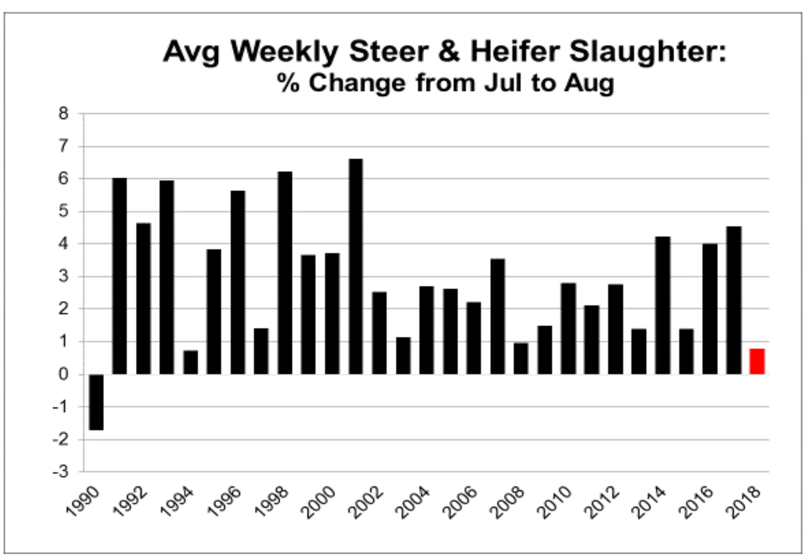
If domestic wholesale demand does indeed recover to more typical levels by the fourth quarter, then even if the Mexican tariff remains intact, there is a decent chance that the ham market is registering its low for the rest of the pre-Christmas period right here in July. I come up with average prices of $.57 per pound for 23-27 lb product in September; $.61 in October; and $.64 in November.

In the World of Beef, the combined Choice/Select cutout value looks very much as though it is bottoming out pretty much "on schedule", right around $203 per cwt. The next development should be a rally of $8-$10 in magnitude and about three weeks in duration. There would be nothing unusual about this, as I show below. In case you don't already know, "L-6" refers to the sixth week prior to Labor Day, the week in which we are now.



The 3.7% appreciation plotted for 2018 would place the average cutout value at $211 per cwt in the week ending August 18. I do not perceive anything in the works that would cause a "failure to launch".

Judging from the volume of beef booked for deferred delivery four to eight weeks prior, packers should be pretty "well-sold" through the third week of August, leaving relatively little to move in the spot market for the next three weeks. [The forward-booking statistics are not so robust for late August and the first half of September.] This conclusion depends, of course, on the rate of production. But I must say, the notion that fed cattle slaughter will drop below a year earlier in August seems more realistic now than it did a month ago.



Assuming fairly aggressive marketing rates, my best guess is that steer and heifer kills will average 500,000 next month; last week's total was 505,000, so we're practically "there". An August rate of 500,000 per week would be 2% below a year ago, and it would also be an unusually small increase from July. [Slaughter normally increases from July to August only because of the 4th of July holiday.] Packer margins are declining, and bargaining power seems to be shifting toward the cattle feeder (vs. the packer), conditions that support the notion of restrained production schedules in August. Anyway, the supply side of the ledger should be moderately bullish of beef prices—not only in August, but into the fall as well. That is another subject for another time.

Under this sort of supply scenario, it would take nothing more than a typical seasonal change in demand to produce an $8-$10 in the combined cutout. Without going down the entire menu, let it suffice to say that *all* major beef products except for strips/short loins, bottom sirloin cuts, and 50% lean trimmings show a distinct seasonal upward bias over the upcoming three-week period. Even the tenderloins have been more often up than down between now and the middle of August.

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, or visit our website at www.procurementstrategiesinc.com.