MEAT MARKETS UNDER A MICROSCOPE

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

August 28, 2018

It's anybody's guess how quickly and how extensively the African Swine Fever will spread through the Chinese pig herd, but the potential threat to the world's pork supply is undeniable. We *do* know that this disease is highly contagious and deadly (to pigs, that is), and my limited understanding is that China's biosecurity systems are *not* highly sophisticated. About the best I can do is to speculate on what would probably happen if this were to become a pandemic.

Obviously, it would severely reduce China's pork supply. The key to the market impact, though, is how the Chinese government, pork producers, and consumers would respond.

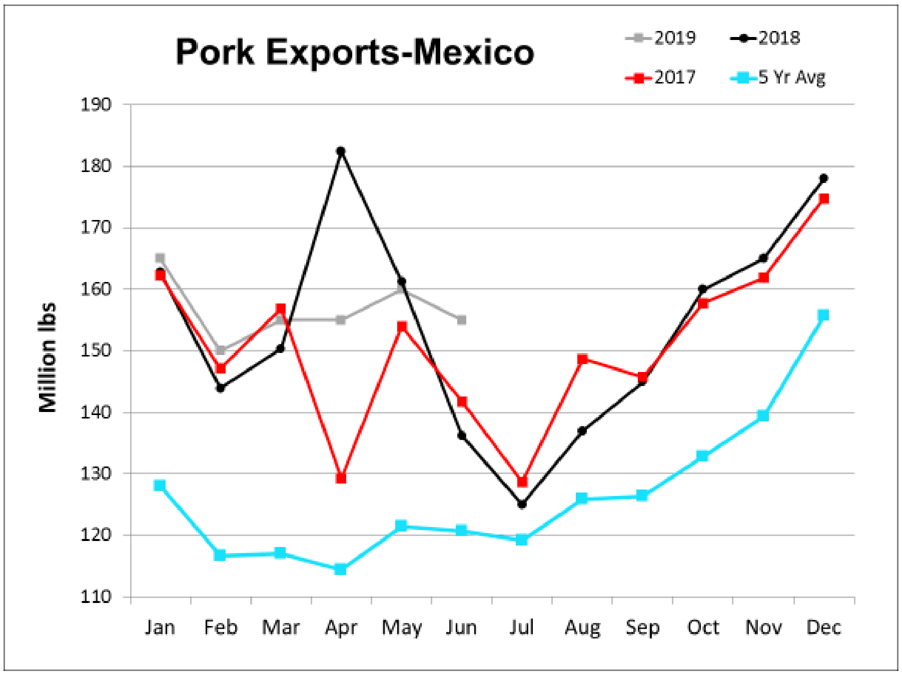
In the initial phase, there might very well be a wave of mistrust among consumers in the safety of the meat—especially in the safety of domestically-produced meat. We're talking, of course, about a vacuum in demand in the short run. The same thing happened after the outbreak of the H1N1 flu virus in Mexico in the spring of 2009; and also in Japan, when the first instance of Bovine Spongiform Encephalopathy was discovered on September 10, 2011. [I remember the date because this story got shoved to the back pages one day later.] In both cases, it took a couple of months for demand to recover. Also to be expected is that producers would sell their animals as promptly as possible, while they are still worth something. However, an article in the South China Morning Post says that affected producers are being significantly compensated by the government, which could mitigate the "rush for the exit". Anyway, it seems that the near-term influence on the Chinese market and demand for imported pork would be bearish.

If the Chinese government wants to prevent consumer-level prices from soaring, then it would seem reasonable for it to facilitate increased imports from other countries. Among potential major suppliers, the U.S. would probably rank near the bottom as long as tariffs keep the landed price as high as it is. And I doesn't seem likely that China will remove or even lower the retaliatory tariffs any time soon.

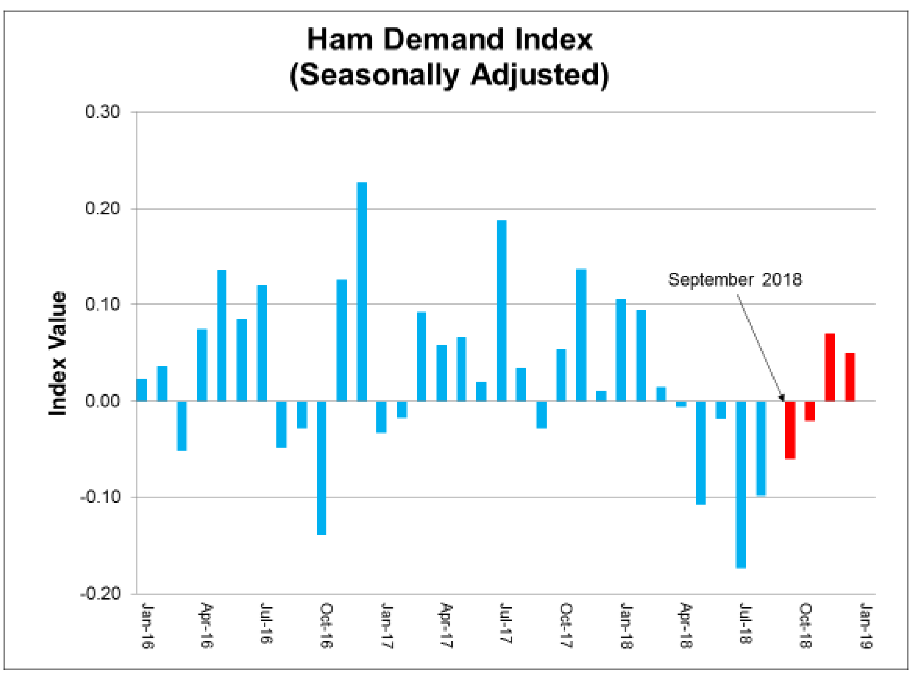
The longer-term impacts on the U.S. market would still be quite bullish, though. We're talking about a potentially massive increase in Chinese pork demand….possibly within months, not years. To the extent that European, South American, and Canadian pork is diverted to China and away from other markets, the U.S. would be a natural candidate to "fill the holes". And somewhere among these considerations is that America's biggest pork producer and processor is owned by a Chinese company.

Altogether, it is enough to keep me away from the short side of the 2019 futures contracts.

Meanwhile, the U.S. and Mexico apparently have struck a new trade deal which, to the layperson (that's me), means that Mexico's 20% duty on imports of U.S. pork will soon disappear. The obvious implications are in the ham market. I am raising my sights for U.S. pork exports to Mexico by 10-15 million pounds per month accordingly. It now looks as though shipments will slightly outpace those of a year earlier in both the fourth and first quarters, whereas some year-over-year reduction would probably have been in order otherwise, based on pre-tariff volumes:



Hams are cheap. You have to go back to 2009, and before that, 2003 to find ham prices this low in the week prior to Labor Day; at this time last year, they were trading at $.71 per pound. I have to think that holiday ham featuring will be noticeably more aggressive this time around because buyers have been—and are still—able to lock up product costs that will accommodate lower retail prices.

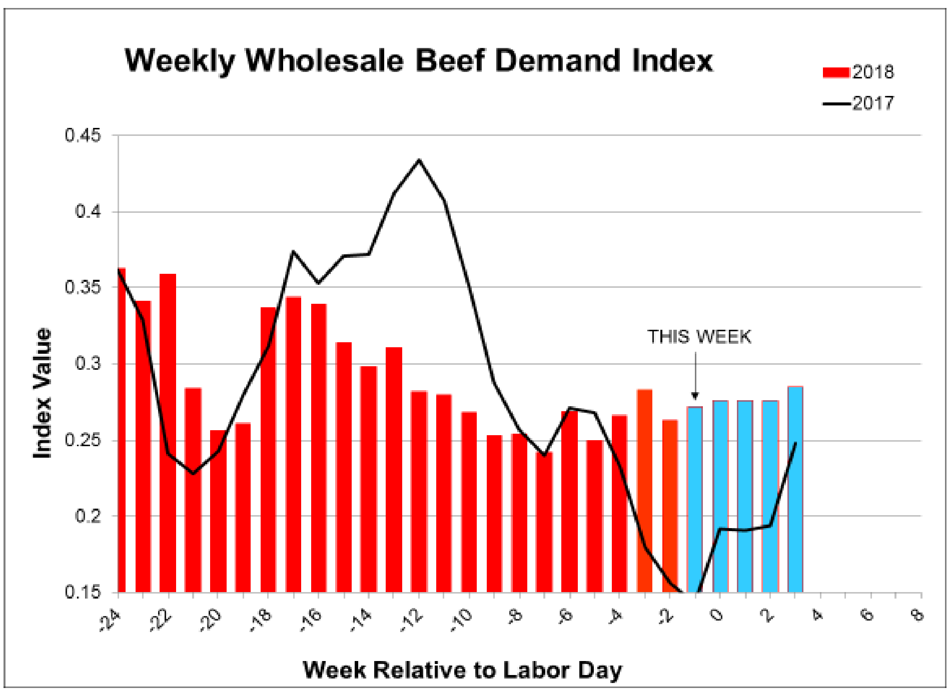


Per capita ham supplies during September-November should be Record large, roughly 2.4% bigger than a year earlier. I say "roughly", because it is indeed a rough measurement, since it does not include projections of ham imports and exports specifically; it incorporates total international pork trade volumes instead. It assumes that there will be 90 million pounds of hams drawn out of the freezer during this period, which compares with 106 million last year and the five-year average of 105 million. It assumes that carcass weights will average about one half pound lighter than a year earlier. And of course, it assumes that hog slaughter will average 4% above a year earlier, as indicated by USDA's spring pig crop estimate.

On the preceding page I show the picture of the seasonally adjusted ham demand index, which has been quite depressed, especially in the last two months. As I mentioned a minute ago, it seems reasonable to expect demand to recover to more typical levels this fall. Why not? If it *does* recover as depicted in the chart, then 23-27 pound hams would average about $.60 per pound in both September and October, and slightly above that in November.

It's a pretty good bet that beef cutout values will turn downward from here and trend lower through the month of September. The ten-year track record shows that the combined Choice/Select cutout value has lost an average of 3.2% from the week prior to Labor Day to the final week of September. From yesterday's quote of $211.92 per cwt, a 3.2% decline would carry it down to about $205. The obvious support level on the chart lies in the neighborhood of $202, an area in which supply and demand found a balance for three weeks from mid-July to early August. This seems a likely place for the next bottom.

Unlike pork, demand for beef at the wholesale level has held up rather well for the past eight weeks and is currently tracking well above a year ago. [As you can see on the chart below, demand fell apart during August 2017 and finally hit bottom in the week prior to Labor Day.]



A decline in the combined cutout value down to $202 is what would happen if the demand index were to follow the relatively flat pattern depicted at left, and if steer and heifer kills proceed at a pace of 505,000-510,000 per week after the holiday. I find no compelling reason to expect demand to materially deviate from this course in either direction.

Forward bookings for September delivery have been pretty healthy—not robust, as they were last year, but solid enough to place packers in a decent "forward-sold" position under the production scenario that I am expecting.

Naturally, the loin cuts (with the exception of tenderloins) and ribeyes are likely to assume primary responsibility for lower cutout values, with trimmings also contributing to the slide.

I'll use the format of *The Daily Racing Form*:

Strips: Choice 0x1's trading 80¢ per pound above a year ago, not particularly cheap from that angle; average decline would place them around $5.25 at end of September; nearest major support around $5.00. Select 0x1's trading 25¢ above a year ago; average decline would place them at $4.50, leaving room for attractive retail price even for a nice looking steak with no flavor in September; but no pertinent support until $4.00.

Short Loins: Choice 0x1's trading 50¢ per pound above a year ago; average decline would place them at $4.70 in late September; this market seems headed for $4.50, the nearest dependable support. Select 0x1's trading just 10¢ above a year ago; average decline would place them at $4.00, which is clearly major support.

Top Butts: Choice product actually a nickel cheaper than a year ago, and the year-over-year discount has been much wider than that up to this point; downward seasonal bias is so consistent that it's hard to bet against, but demand prospects are favorable; average decline would place them at $2.90 per pound in late September; this market appears to have little downside potential. Select product priced about evenly with Choice, but not likely to attract the same attention under $3.00. Average decline would place them at $2.65 in late September; no support until $2.50, which looks rock-solid.

Boneless Ribeyes: This one is pulling away from the pack in terms of demand right now, perhaps because it did not become crazy expensive this summer as it did last year. Choice product trading a full $1.00 per pound above a year ago; average decline would place them at $7.60 in late September, hardly a decline at all; would bet that $7.25 will be traded in September, *maybe* $7.00. Select product is "just" 50¢ above a year ago; average decline would place it at $6.35; solid support at $6.00, which was the bottom in the fall 2017 market.

Flap Meat: Choice product record high for this time of year, $1.60 per pound above a year ago; average decline would place it at $5.05 in late September, but major support at $4.50 seems within reach. Select product trades $1.30 above a year ago; average decline would place it at $4.90; as with Choice, major support lies at $4.50.

Ball Tips: Choice product trading $1.10 per pound above a year ago and record high for this date; average decline would place it at $3.20, but no real support until $2.50, and once it starts in one direction, this market tends to "run". Select product trading $.55 above a year ago; average decline would place it at $2.65 in late September; big support begins at $2.50, but this one spent a lot of time around $2.00 this past spring.

Tri Tips: Virtually no downside potential here. Choice product trades just 15¢ per pound above a year ago and only 10¢ above the fall 2017 low; average price change would place it at $2.20, but doubtful that it will get there. Select product has solid support at $2.00, which is where an average decline would carry it at the end of September.

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.