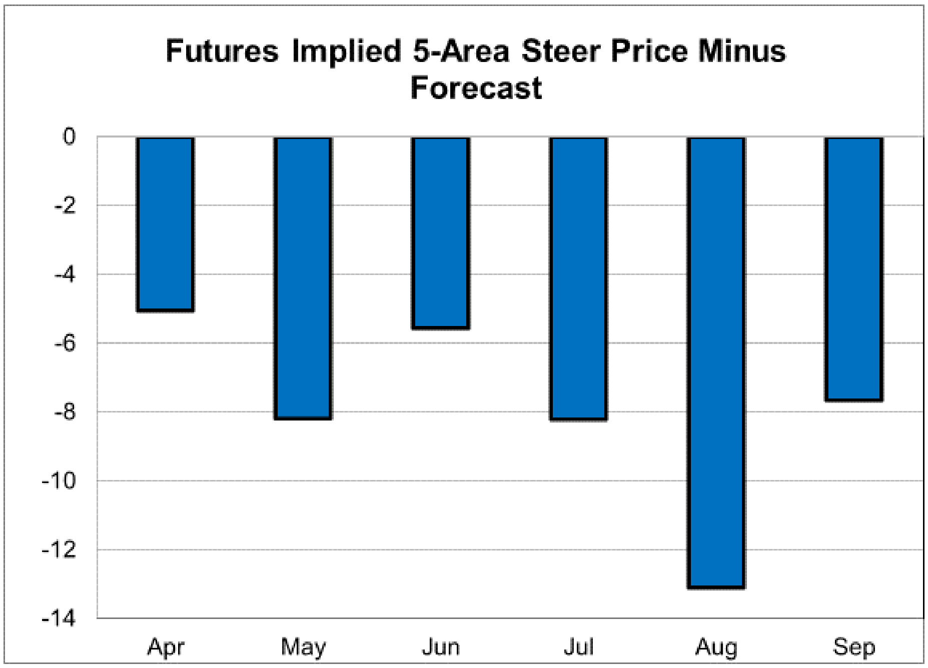
Trading Cattle
…. from a meat market perspective
A commentary by Kevin Bost

March 27, 2018

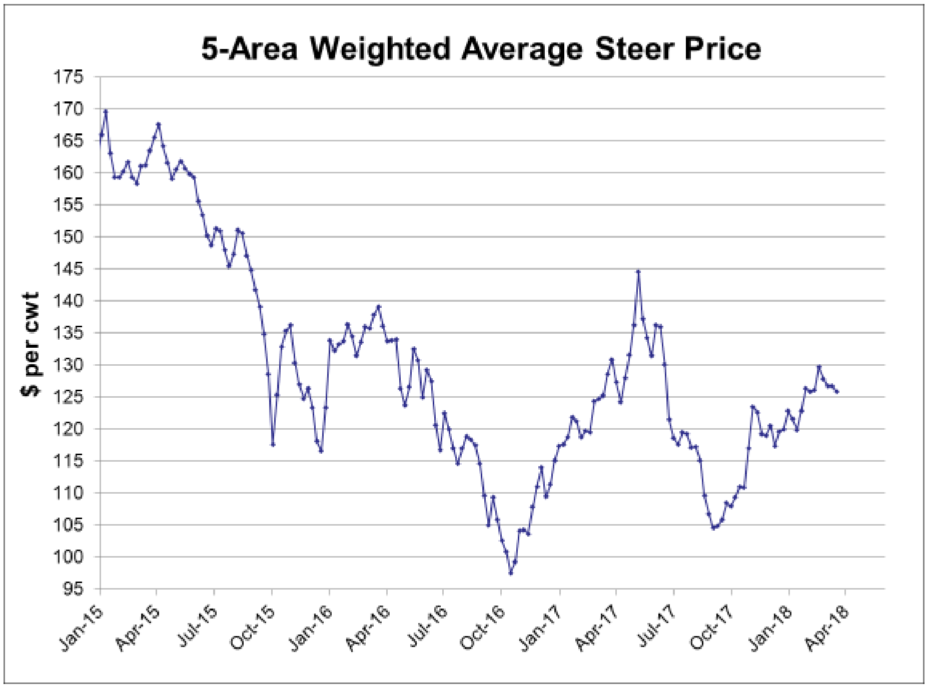


Currently I hold no position in the cattle market. I had intended to place a long-side bet on the August contract, and I still find plenty of reason to do so (it should be obvious from the picture at left). What is holding me back is that the big seasonal increase in fed cattle supplies—well-advretised as it may be—still looms ahead, and the beef market is just now beginning to turn downward after a three-week consolidation. We can guess, but we don't know how far cash prices will have to come down in order to balance demand with the larger supply. It's hard on my nerves to hold a long position when I am waking up to negative news every day.

Does this mean that I won't buy anything until June? Not necessarily. But there is a decent possibilty that cutout values will forge some sort of recovery in the second half of April, and that cash cattle prices will find temporary support above $117.50 per cwt. A look at the first chart on the next page should explain why this price is significant. With the futures discounts as deep as they are, any sign of strength or even stability in the cash market could elicit a strong (bullish) response on the board—perhaps enough to provide technical confirmation of a bottom.

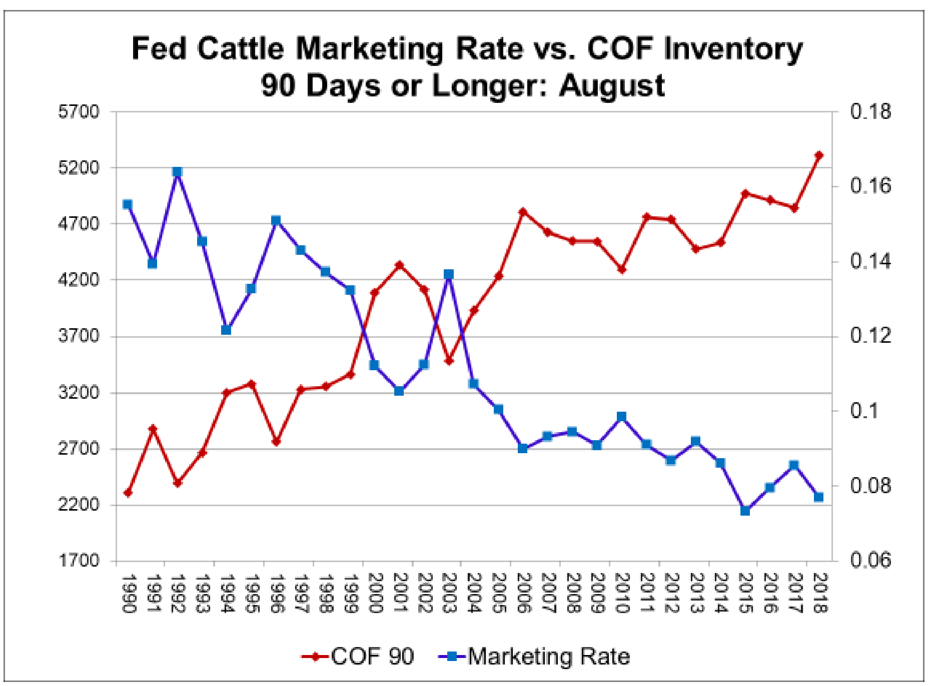
If the August contract is as vastly undervalued as it appears, then I can certainly afford to wait for it to complete a convincing bottoming formation before I place a bet; there would still be a lot of money left on the table.

OK, so once again: what tells me that the August contract may be worth $118? To begin with, it looks as though placements will be roughly 10% below a year ago here in March, and that they will remain below a year earlier in April and May. This is based on the notion that cattle were pulled off wheat pasture prematurely, due to severe drought in the Southern Plains. "Front-end"



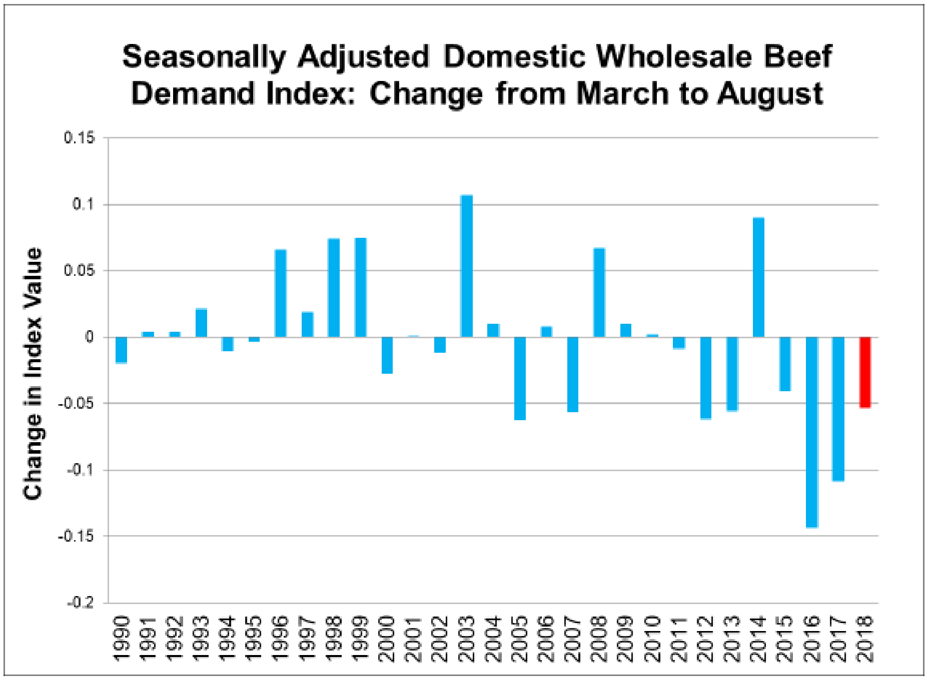
cattle supplies, therefore, should be on their way downward by August. This would be especially true if marketings are aggressive throught the spring and early summer. And this seems a likely prospect, given the widespread anticipation of a steep drop in cattle prices. By the way, it could well be that because of aggressive marketing rates, carcass weights would decline more rapidly than usual, and more more rapidly than my forecast assumes.

In the next picture I plot the inventory of cattle on feed 90 days or longer on August 1 against the August marketing rate. There is a strong, inverse correlation between the two.

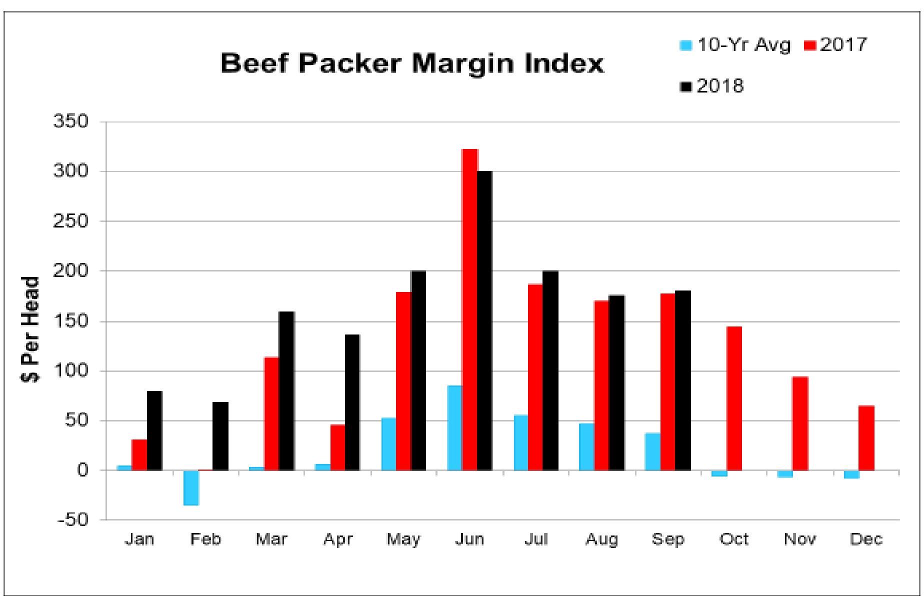


From this angle, my assumed marketing rate in August appears pretty aggressive; and yet, this would result in steer and heifer kills that are actually about 1% *below* a year earlier. I wonder if by August, marketing rates will begin to slow down as price expectations shift (?).

With fed cattle slaughter running in the neighborhood of 505,000 per week in August—and even with steer carcasses 16 pounds heavier than a year earlier—a considerably weaker-than-seasonally-normal change in demand between March and August, as shown in the next picture, would result in a combined Choice/Select cutout value of about $210 per cwt in August. A decline matching last year's plunge would result in a cutout value of about $202.



On, then, to the packer margin. This is probably the source of greatest uncertainty in the price outlook. My best guess is that the spot packer margin index (shown in the final picture) will average $175 per head, which compares with the current month's average of $160 and is slightly greater than a year earlier. I would judge something in the $225 range as being the upper end of sensibility. A margin index of $175 applied to a combined cutout of $210 yields a Five Area Weighted Average Steer price of $118 per cwt; at the more bearish end of the spectrum, the combination of a $202 cutout value and a $225 packer margin index would yield about $109.50… which is near the point from which the precipitous sell-off of the past two weeks began.



Finally, I am open to the idea of buying lightly into weakness in the meantime, as long as the stop-loss is tight and in correct proportion to the near-term profit potential. With a near-term objective of $107.50, that point may be at the contract low of $102.80.

Forecasts:

	Apr	May*	Jun	Jul*	Aug	Sep*
Avg Weekly Cattle Sltr	614,000	647,000	657,000	624,000	636,000	626,000
Year Ago	599,600	606,400	637,900	603,800	633,800	624,400
Avg Weekly Steer & Heifer Sltr	486,000	520,000	528,000	499,000	505,000	494,000
Year Ago	481,100	490,600	514,200	488,800	511,000	502,100
Avg Weekly Cow Sltr	117,000	116,000	116,000	115,000	120,000	121,000
Year Ago	107,700	104,600	111,000	104,400	111,000	111,200
Steer Carcass Weights	868	861	874	889	901	913
Year Ago	849.0	837.8	854.0	868.5	884.6	896.0
Avg Weekly Beef Prodn	498	520	535	513	527	523
Year Ago	478.6	477.6	509.6	487.6	517.9	515.8
Avg Cutout Value	$214.75	$218.00	$216.00	$207.50	$210.50	$203.50
Year Ago	$211.23	$238.12	$238.48	$209.64	$196.81	$192.17
5-Area Steers	$122.50	$121.50	$112.50	$115.00	$118.50	$114.00
Year Ago	$130.04	$136.78	$126.59	$118.41	$110.72	$106.83

**Includes holiday-shortened weeks*

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