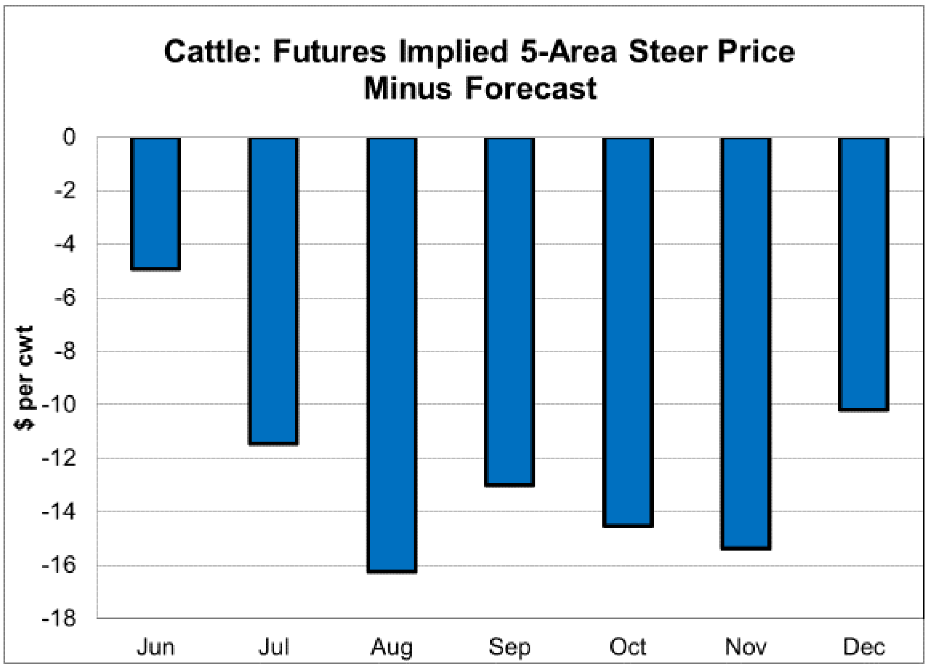
Trading Cattle
…. from a meat market perspective
A commentary by Kevin Bost

May 17, 2018

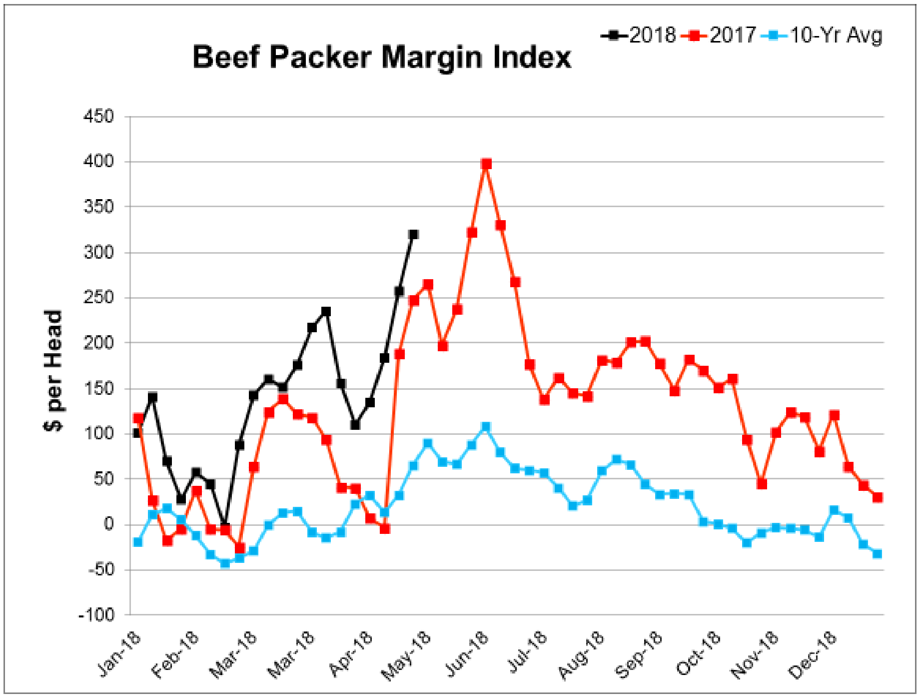


I was stopped out of my long position in August cattle on Tuesday. I was betting that they would not close below $101.72, but they did. My consolation prize is knowing that I adhered to the money management rules that I set for myself when I entered the the trade at $104.00. Somehow, the pat on the back doesn't feel that good.

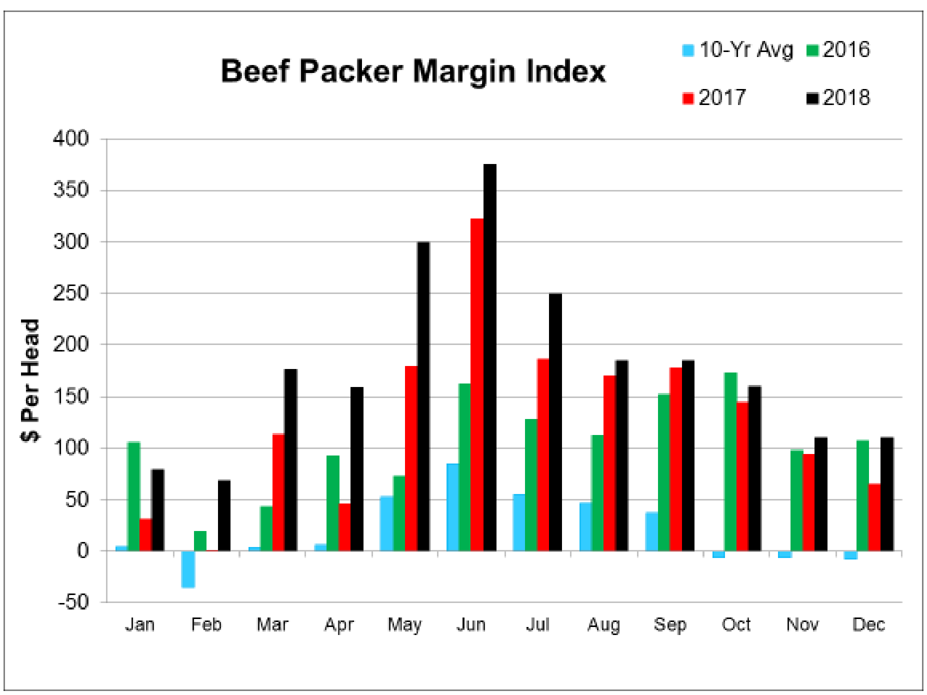
Anyway, my reason for trading August cattle from the long side—summarized in the picture above—remains intact. But the market's inability to hold above such a critical support level could be a signal that my assessment of "ultimate value" may be way too high. And so, I have to check my premises and identify the most likely sources of potential error.

Number one on this list is the packer margin index, which I calculate by taking the combined Choice/Select cutout value; adding the reported hide and offal value; subtracting a constant factor representing slaughter/fabrication costs; and substracting the Five Area Weighted Average Steer price.

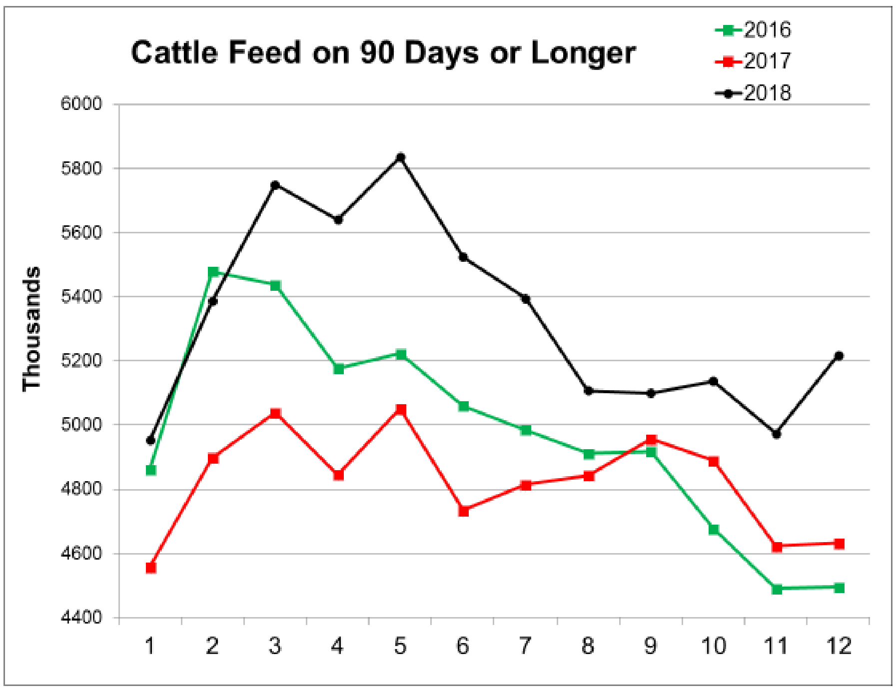
I have been assigning a relatively high value to the packer margin index in the forecast equation, but it is beginning to come in even wider than I had expected. As I show in the first picture on the next page, it looks as though the current week's number will be approximately $320 per head:



Last year, this index reached a peak of $399 in the third week of June, and averaged $323 for the month. In the current environment of anxious feedlot sellers and cattle supplies that challenge the practical slaughter capacity, who's to say that it will not rise above $400 this time around? In my forecast of a $110.00 average cash cattle market in June, I am factoring in a June average margin index of $375; but I have to admit that in reality, I'm just picking a number that looks high in relation to a year earlier. You can judge for yourself:



There seems to be a sound reason to think that whatever the peak in the margin index may be, it will reach its widest point in June and draw much closer to year-earlier levels by August—due to aggressive marketing rates in the meantime, and somewhat tighter front-end cattle supplies. If steer and heifer kills average 535,000 per week in June and 500,000 in July (including the holiday week), then the inventory of cattle on feed 90 days or longer will be only 5% greater than a year earlier on August 1, after being up 17% on June 1. It's enough to make a difference. The notion that the heaviest front-end cattle supplies will hit the market in June is a major reason why I am placing my bets in the August contract. If all else were to remain equal, a decline in packer margins from $375 to $185 would bring about a $14 per cwt increase in cattle prices. To look at it another way, what if the combined cutout value stands at the forecast value of $211 per cwt in August ($15 below yesterday's quote) but the packer margin index is $250 instead of $185? In that case, the cash cattle market would be $112.50 instead of $117.50….still a mile above this morning's trade levels.



The only cause for doubt I have about wholesale beef demand through the summer is that retail beef prices, according to the U.S. Bureau of Labor Statistics, are already matching their July 2017 peaks, after having risen 20¢ per pound, or 3.5% between February and April. I am convinced that one reason for the extraordinary slowdown in wholesale demand from second to third quarter 2017 was the rather sharp increase in retail prices from April to July of that year. It appears that the something similar may be taking place again this year, only it's happening earlier.

All that said, there is a high probability that August futures have discounted far too much in the way of bearish possibilites.

Obviously, there is no remaining support above the contract low of $97.62 in August cattle, and so I have no reason to place another bet appreciably above that level. And on that subject, the close into new contract lows in the October contract yesterday was worthy of attention. At this point, I am waiting for the market to issue another signal that it has bottomed. My entry point may be 300 points from the low at that time, which would mean that I have to risk 300 points once again; but there appears to be enough upside potential to justify that sort of risk.

Forecasts:

	May*	Jun	Jul*	Aug	Sep*	Oct*
Avg Weekly Cattle Sltr	643,000	663,000	622,000	636,000	619,000	626,000
Year Ago	606,400	637,900	603,800	633,800	624,400	629,500
Avg Weekly Steer & Heifer Sltr	518,000	536,000	500,000	506,000	487,000	488,000
Year Ago	490,600	514,200	488,800	511,000	502,100	500,900
Avg Weekly Cow Sltr	114,000	115,000	112,000	118,000	120,000	127,000
Year Ago	104,600	111,000	104,400	111,000	111,200	117,800
Steer Carcass Weights	846	857	870	881	892	898
Year Ago	837.8	854.0	868.5	884.6	896.0	897.8
Avg Weekly Beef Prodn	510	531	502	517	507	514
Year Ago	477.6	509.6	487.6	517.9	515.8	518.4
Avg Cutout Value	$224.50	$221.00	$212.50	$211.00	$206.00	$207.00
Year Ago	$238.12	$238.48	$209.64	$196.81	$192.17	$197.04
5-Area Steers	$117.50	$110.00	$113.50	$117.50	$114.50	$117.00
Year Ago	$136.78	$126.59	$118.41	$110.72	$106.83	$112.08

**Includes holiday-shortened weeks*

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