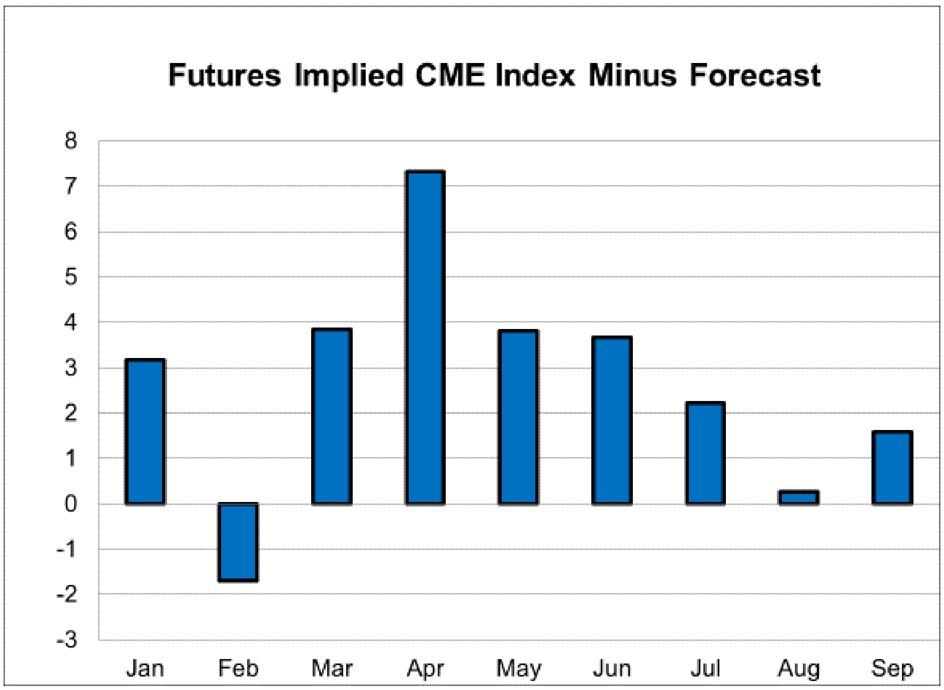
Trading Hogs
…. from a meat market perspective

A commentary by Kevin Bost

December 30, 2017



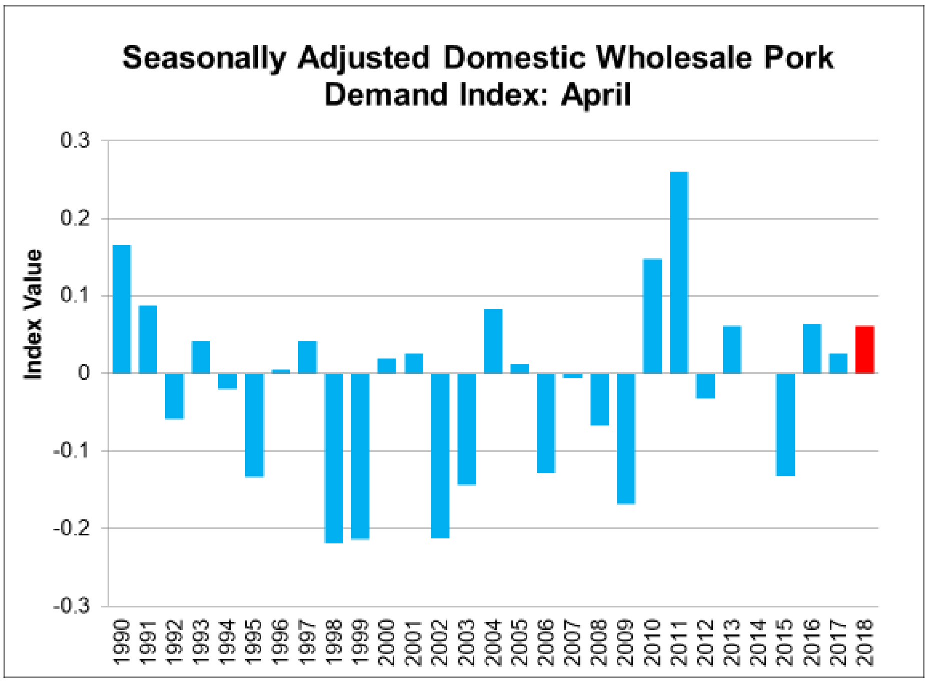
Referring to the picture at left, I am naturally interested in a long February / short April spread. I do not perceive this one as a huge opportunity, but it has some solid fundamental merit. The premium in the April contract over the February contract is not unusually wide for this time of year, but the premium of April futures over the cash hog market *is* (unusually wide, that is), and it is unwarranted, based on what we know today….which why I am also outright short of the April contract. I'll come back to this subject in a minute. But the trend in cash hog prices should be upward between now and February; and since February futures do not appear to be sufficiently undervalued to justify a pure long-side bet, the bull spread might be an acceptable proxy.

The February/April spread has been in a sideways mode for about two months, bounded by $3.50 and $5.00 per cwt (premium to the April). I will place my bet only if it can be done at $4.50-plus….or, *perhaps*, if the April premium drops below $3.50 on a closing basis. I'm not sure about the latter possibility. As best I can tell, the April contract is ultimately worth considerably less than the February contract, and so a close below $3.50 might very well portend a further, significant move.in the same direction. The problem with buying into the spread after a close below $3.50 is that I would have to risk at least 150 points. It would require at least a 300-point profit expectation to keep expected profit and risk in correct proportion. I am *not* highly confident that the spread would move to "even money". I'm still ponering this one.

A short position in the April contract seems to offer the best profit opportunity in the hog market right now. Let's take a look.

First, my projection of an average weekly kill of 2,362,000 in April assumes that USDA correctly counted the fall pig crop. This could always turn out to be an errant assumption, but it is the most dependable information available regarding the hog supply.

In regard to demand, my price forecast includes a "middle-of-the-road" scenario. I'm guessing that the *change* in domestic wholesale pork demand from December to April will be a bit weaker than the 20-year average, but the absolute *level* of demand in the month of April will be among the strongest of the last six years. [In the picture below I exclude 2014 because the index value was so extraordinarily strong (.61) at that time that when it is included, it screws up the rest of the chart.] From this angle, my assumption regrading wholesale pork demand might be viewed as somewhat optimistic.



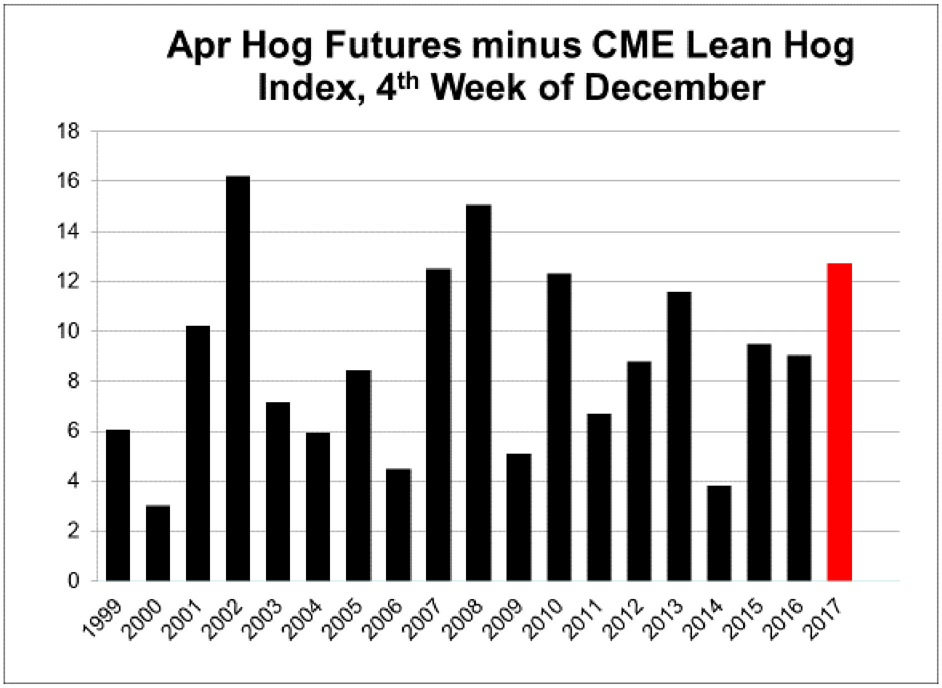
The combination of a 2.36 miilion weekly kill and a wholesale demand index of .06, as represented by the red bar at left, would place the pork cutout value at an average of $75.50 in April. [In case you're wondering, this forecast also incorporates an average carcass weight that is 1.4 pounds heavier than a year earlier, and a 7% year-over-year increase in pork exports at that time.] A natural question is, is it rare for the cutout value to be lower in April than in the preceding December? The answer: no, not really. It has happened six times in the last 15 years.

Finally, the question of packer margins. Much will be revealed about the true impact of expanded slaughter capacity as hog supplies begin to taper off seasonally in January. Until then, my general assumption is that gross packer margins will be well below a year earlier and move back toward their five-year average; specifically, I am factoring in an average of $13 per cwt, compared with $21.12 in December and $17.61 in April 2017.

I consider the demand index and the packer margin as the two least predictable variables in the equation—i.e., if I'm going to be wrong about April hogs being vastly overpriced at Friday's close of $75.65, then it will be because pork demand is much stronger and/or packer margins much tighter than I am anticipating. As we all know, this is entirely possible….but unlikely.

What to do, then? Well, the boundaries are clearly marked: April hogs are bounded by $76 on the high end and $70.50 on the low end. Closes beyond either boundary will be meaningful.

Even though my grandma told me time and time again (I *think* it was my grandma) that triple tops and bottoms will eventually give way, the risk: reward ratio is so favorable in this case that I intend to add to my short position as closely to $76.00 as possible. If the market is able to register two closes above that price, I will step aside.



Forecasts:

	Jan*	Feb	Mar	Apr	May*	Jun
Avg Weekly Hog Sltr	2,422,000	2,377,000	2,373,000	2,362,000	2,323,000	2,278,000
Year Ago	2,361,900	2,327,100	2,326,700	2,285,400	2,250,200	2,183,400
Avg Weekly Barrow & Gilt Sltr	2,355,000	2,310,000	2,305,000	2,295,000	2,255,000	2,210,000
Year Ago	2,297,700	2,262,400	2,260,900	2,220,200	2,185,200	2,117,200
Avg Weekly Sow Sltr	61,000	60,000	61,000	60,000	61,000	61,000
Year Ago	59,900	58,400	58,900	58,100	57,900	58,800
Cutout Value	$76.50	$80.00	$76.50	$75.50	$80.50	$85.50
Year Ago	$80.18	$84.08	$80.20	$74.86	$84.92	$97.04
CME Lean Hog Index	$66.00	$73.50	$70.50	$68.00	$76.00	$80.00
Year Ago	$63.80	$74.16	$71.50	$62.60	$72.28	$86.09

**Slaughter projections exclude holiday-shortened weeks*

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