

December 2011 - Livestock Market Update

Department of Economic Analysis



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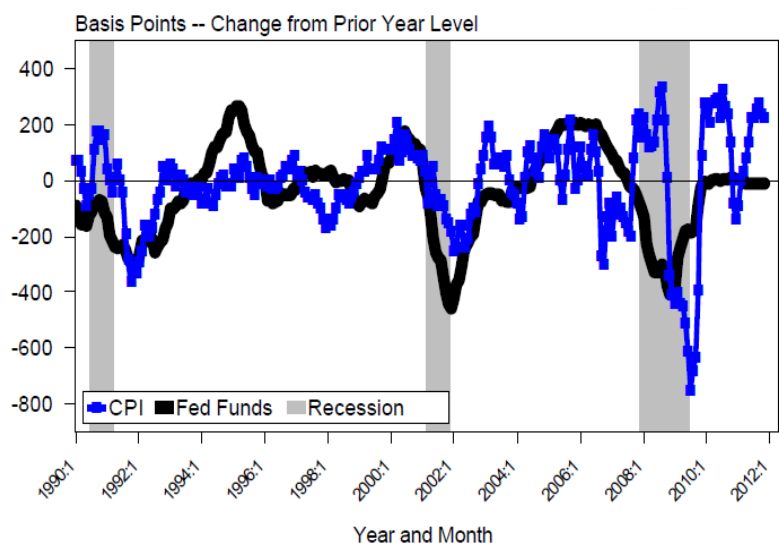
The General Economy: “Building Forces – Inflation and Interest Rates”

For the last few years, whenever I get a question about what one should expect of interest rates, the response has always been ‘they are going to go up.’ Pretty safe forecast with Fed rates for short term paper near enough to zero as to effectively be nil. And yet the market has been willing to take some of the long bond rates down 140 basis points from where they were last year. How clever does that forecast of interest rates only being able to go up from here sound now?

So with that as a caveat, when asked again where one thinks interest rates will go from here, I’d still say that they have to go up. And the forces to drive that are just continuing to build to the point that when the time finally does come, don’t be surprised if they move up with a vengeance.

To make this point, look at the historical behavior of inflation as measured by year-over-year changes in the CPI. Historically the Fed Funds rate tends to move up when inflation moves up. If you think about it, if inflation is moving up and the Fed Funds rate isn’t, it means people are losing ground compared to inflation when they are buying Treasury notes. And yet, here we’ve been for much of the last four years with inflation running well ahead of the interest rate paid on Federal funds.

You might let that happen with your money for a while, but sooner or later...



Flight to quality – to the United States and away from the European Union – certainly drove a lot of that behavior this past year. Germany has soaked up a lot of the funds flowing out of Greece, Italy and some of the other countries that are considered less solid, but the sheer volume of money needs a market as big as the United States. As low as our interest rates have been, at least they haven't had the risk associated with the real potential of a debt default (debt ceiling debates notwithstanding) or a currency going away. In short, they're better than just holding cash.

But four years is a long time to go when you're paying somebody to hold your money for you. One has to think that sooner or later that money is going to find a home outside of our borders and, in order to keep money here, interest rates are going to have to move up. Recognizing we can – and do – move trillions of dollars every day in international markets, those rates could show significant movement in just a few days in response. That could become a very wild ride.

When will it happen? The technical term is 'haven't got a clue.' But the forces are certainly there. What should you do with that information? Be real careful about borrowing money with variable rates attached. Be really, really careful about signing balloon notes that might come due in the next five years. You could find yourself on the wrong side of an ugly situation.

Livestock Update: "2011 – Year in Review"

The final Market Update of the year presents a fine opportunity to look back over 2011 and evaluate the major events of the year. There were, as is the case every year, plenty of major news stories in 2011: the horrific tsunami in Japan, the ongoing European debt crisis (complete with lots of broken windows and burning cars in Greece), the Arab spring, the killing of Bin Laden. But what I am most interested in are the stories of relevance to the livestock and poultry industries. There were also quite a few of these and I will lay out what I think were the most important ones in the next couple of pages. This will not necessarily be an exhaustive list of notable news; I obviously run the risk of leaving out something that one of you out there thinks is important. You are more than welcome to give me a call or shoot an email to straighten me out. I would appreciate the feedback.

Record Meat/Livestock Prices

I think that the behavior of livestock and meat prices was the most significant story for the livestock industry in 2011. This may sound like so general a topic as to constitute a complete cop-out on my part, but anytime the general news media take note of agricultural markets, as they did from time to time with meat prices this year, it is a notable event. In reality, there are several different dimensions to the story of this year's livestock and meat prices; the first and most obvious one – and the only one that really much broke into the public's consciousness – was the simple observation that prices in 2011 were really high by any historic standard. Prices at all levels in the beef and pork sectors – retail, wholesale, and farm – notched new records this year. This is illustrated in Figure 1, which shows retail pork and beef prices reported monthly by USDA Economic Research Service.

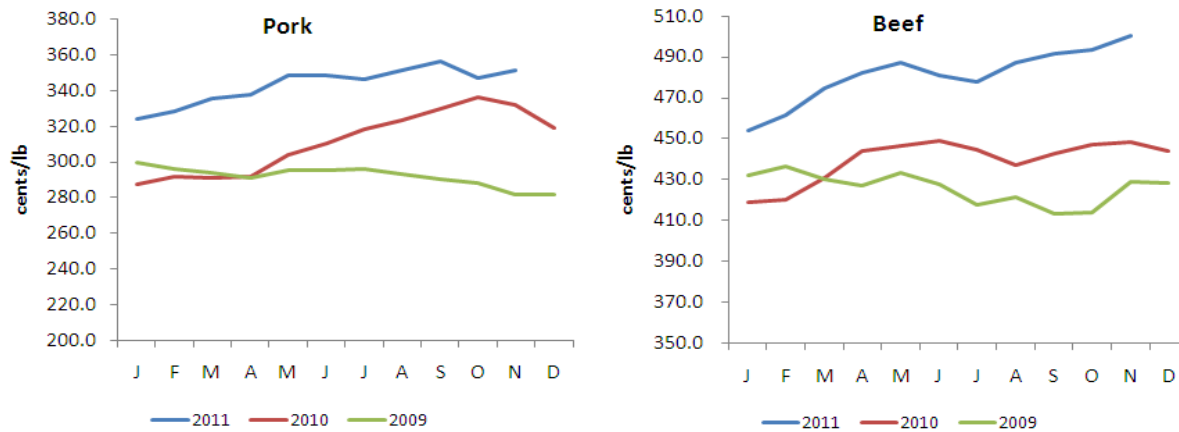


Figure 1. Monthly Pork and Beef (Choice) Retail Prices: January 2009–November 2011
 Source: USDA Economic Research Service.

Retail Choice beef prices broke through the \$5 per pound milestone for the first time ever in November this year. Similarly, retail pork prices surpassed \$3.50 per pound for the first time in August, reaching a high for the year (so far, we don't have December data yet) of just over \$3.56 in September. These higher meat prices did garner some media attention – mostly in the context of the broader issue of food price inflation – earlier in the year. The food price inflation story appears to have pretty much run its course. In the first half of 2011, the Consumer Price Index (CPI) was indicating a historically high level of food price increase (in the vicinity of 5% to 6% annual inflation) across a broad set of food items. By the end of the year, though, food prices had largely leveled off, as was generally expected. For October and November, the CPI food price index posted its smallest gains of the year. In fact, in November, the food-away-from-home index actually dropped month-to-month.

While pork prices have dipped some in recent months, beef prices have continued to edge higher. With declining production in 2012, almost a lead pipe cinch, beef prices are not likely to retreat much – barring some kind of adverse demand shock. It is much less likely, though, that high beef prices will be accompanied by the kind of broader-based food price increases that we saw in the first part of 2011. Therefore, I don't expect it to really be that much of a story in the coming year.

Aside from the level of prices this year, we also saw some rather interesting price relationships. This was not really something that captured anybody's attention outside of the livestock world, but it may point to some significant trends moving forward. The first notable price change was the behavior of broiler prices relative to pork and beef prices. Broiler prices struggled to gain traction really through all of 2011. In fact, broiler prices have not done much of anything in the last couple of years while pork and beef prices have broken all previous records. Figure 2 shows broiler, beef, and pork price changes since January 2010.

Despite serious efforts to reduce production, broiler prices have remained mostly on the defensive. Beef and pork prices have been much better than year-ago levels despite close to steady beef production and slightly higher pork production. Typically in a weak economy like we have had for most of 2011, we would expect broiler demand to be strong and beef demand to be weak with pork somewhere in between. That is really not what we have seen this year and that is what makes the situation notable.

Another notable feature of this year's price relationships has been the consistently wide spread between Choice and Select beef. The spread began increasing rapidly in late summer and spent much of the fall around the \$18 mark. It remains in that ballpark even now. The possible reasons for this unusually wide spread have been widely discussed within the industry. In the most general terms, the supply of Choice beef is pretty tight relative to the amount that buyers would like to have, thus leading to the wider-than-normal spread. But this says nothing about why the supply/demand balance on Choice beef has shifted. There are several reasons for that. On the supply side, high feed prices make it more costly to get cattle that actually have the genetic potential to grade Choice to actually achieve that grade. Thus, with the relatively high feed prices that we have had in 2011, the spread has to be wider to induce feeders to push cattle to that higher-cost endpoint. On the demand side, Wal-Mart has been fairly vocal about its decision to move toward selling higher quality meats in its stores. Wal-Mart is certainly a big enough buyer to affect the market. Also, the large volume of cull cow slaughter brought about by the Southern Plains drought has perhaps also stimulated demand for trim to blend with the large production of lean/processing beef. This would help support a bit higher price for Choice product.

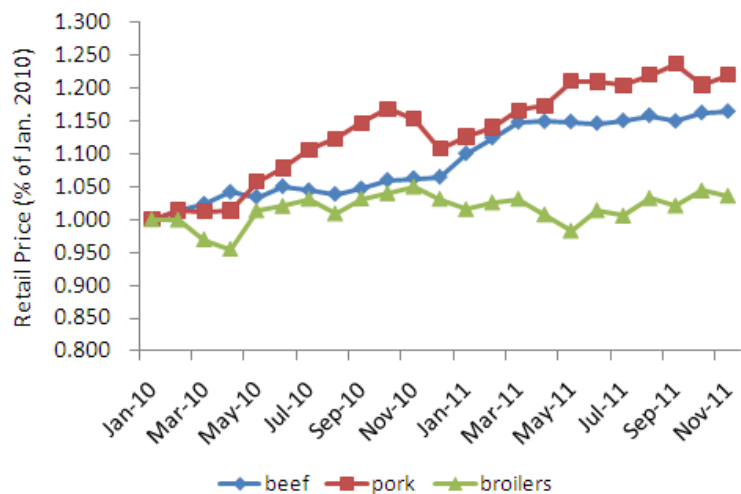


Figure 2. Monthly Broiler, Pork, and Beef Retail Prices as a Percent of January 2010 Price Level
 Data Source: USDA Economic Research Service.

Southern Plains Drought

The second major livestock story of 2011 is surely the Southern Plains drought. This is arguably the top story, but I list it second because I think the biggest effects of the drought – from a livestock market perspective – may be yet to come. I reserve the right to call it the biggest story of 2012. David Anderson (no relation) with Texas AgriLife Extension estimates that Texas cow numbers are down by 600,000 head in 2011 due to the drought. That's a big number. To put that in context, roughly 2% of the entire nation's cow herd has been displaced as a result of the Southern Plains drought. That is not to say that all of those cows are gone forever. It is difficult to get a reliable read on how many of those cattle went to slaughter and how many were moved out-of-state to someplace with more favorable pasture conditions. That will be one of the big questions that we look to the January 1 inventory report to answer.

Looking ahead to 2012, the effects of this year's severe drought will continue to play out in the market. Certainly cow numbers will be down – as said, it remains to be seen exactly how much. Supplies of feeder cattle outside feedlots have also been drawn down by early placement of calves that had nowhere else to go. Next year's calf crop may be down due to reduced fertility from heat and drought stress; though I suspect those will be localized effects that largely wash out in the aggregate numbers. Once pastures recover, the process of rebuilding from the drought will impact demand for females. If that process begins in 2012, with already-depleted feeder cattle numbers, the replacement heifer market will likely go places that it has never gone before.

Meat Exports

The third major story of 2011 is the remarkable success of beef and pork exports. On a value basis, according to the U.S. Meat Export Federation, beef and pork exports reached a record level over the first ten months of the year. On a quantity basis, beef and pork exports are also expected to post new records in 2011. The continued recovery of exports to Korea and Japan has been vital to the success of the beef industry in achieving export growth this year. Moving ahead to 2012, prospects for strong exports are encouraging. The anticipated move by Japan to allow beef from cattle up to 30 months of age should aid export growth to that country. The real question will be how much more growth in exports can be supported with the relatively low level of production projected for 2012. Right now, USDA projects a nearly 5% decline in beef production in 2012 versus 2011. Will export customers continue to bid product away from domestic consumers in that even-tighter-supply environment? Alternatively, to achieve something closer to a win-win situation for everyone, how much more accurate can exporters get at matching retail end products to their highest-valued market, foreign or domestic, thus optimizing carcass value and satisfying the maximum number of consumers? That process is every bit as complicated as it sounds; but it appears to have worked well in 2011.

Broiler Industry Restructuring

In the first section on this year's prices, I noted the difficulties that the broiler industry has had in sustaining any kind of price strength this year. With disappointing end-product prices and high costs of production, 2011 has been a tough year in the broiler industry. While few outside the broiler industry seem to have noticed, the industry has undergone some fairly wrenching adjustments in the past year, including a number of plant closings, sizeable layoffs, acquisitions, and bankruptcies. By my very informal count, at least five of the top 20 integrators announced significant plant closings or layoffs this year. Two filed bankruptcy in 2011: Allen Family Foods and Cagle's (hard on the heels of Townsend's bankruptcy near the end of 2010). One was bought out: OK Foods, Inc. acquired by the Mexican firm Industrias Bachocos. Recent wholesale price data suggest that production cutbacks have begun to have some effect on prices. It is probably too early for much optimism; certainly all signs at this point indicate a bit further decline in production in 2012. Still, there is some reason to hope that the market will be a little more kind to the broiler industry and to broiler producers in 2012 than it has been in 2011.