

February 2010 - Livestock Market Update

Department of Economic Analysis



In this edition:

- The General Economy: Bob Young, Chief Economist
- Livestock Update: John Anderson, Livestock Economist
- Dairy Update: Allison Specht, Dairy & Regulatory Economist

Recommended Readings:

- On February 3rd, EPA finalized a rule implementing changes to the Renewable Fuel Standard (RFS) program. The revised statutory requirements establish new definitions for renewable fuels, specific annual volume standards for cellulosic biofuel, biomass-based diesel, advanced biofuel and total renewable fuel that must be used in transportation fuel: <http://www.epa.gov/otaq/renewablefuels/420f10007.pdf>

Next Market Update:

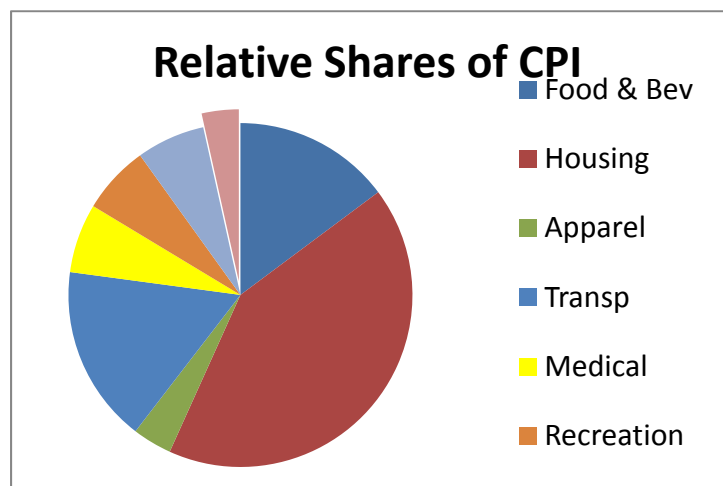
- Crop Market Update: released on March 11, 2010

The General Economy

One question that always seems to come up recently in the Q&A sessions following presentations on the general economy is: 'shouldn't we expect inflation to take off in the next year or so?' That is a story anyone who has been schooled in classical macroeconomics would certainly tell. Over the long-term, the rate of increase in the money supply should give a pretty good indication of the inflation rate. And we have certainly been printing money at a very rapid clip over the last twelve to eighteen months. But like any good economic story there are at least a couple hands.

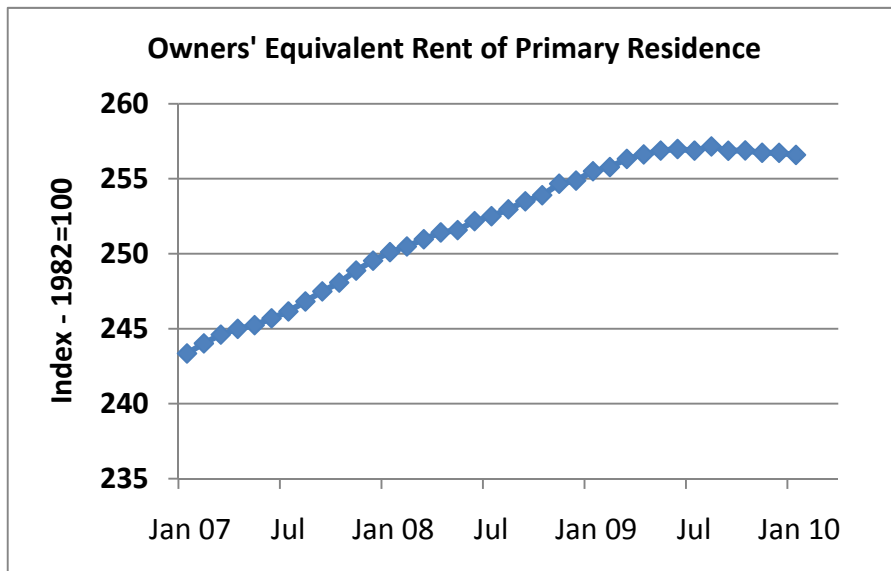
We typically measure inflation by the rate of change in the consumer price index (CPI). Taking that index apart reveals quite a bit of information that may lead one to think that it will be some time before inflation is likely to rear its ugly head.

The overall CPI reflects the price levels of virtually all consumer goods and services. It is developed by weighting the change in prices for the stuff people spend their money on. By far, the largest category is housing. This includes not only rent or its equivalent, but also the energy to heat the house, the



utilities and the furniture. The next largest category is transportation, which includes the cost of automobiles, plane tickets and gasoline. Food, either consumed at home or away from home shows up as the third largest component.

For most things, the prices for these goods and services can be directly observed in the marketplace, like gasoline or a gallon of milk. But for some things, like the rental equivalent of what homeowners would otherwise be paying for their housing, a value is 'imputed' from other factors. This imputed rental value is part of the overall housing category, but by itself accounts for 25 percent of the overall CPI.



It is interesting to see how this value has changed over the last several months. In essence, this term has not changed for three years. Most of us are still making the same house payment, so even though housing prices have moved lower throughout much of the country, imputed expenses for housing probably should be unchanged. Given the state of the housing industry today, it will probably be some time before housing prices move up enough to generate much of an increase from this category.

Capacity utilization in the manufacturing sector has improved somewhat over the last few weeks, moving from 68 percent near the start of the year to 72.6 percent in the last report. While this is moving in the right direction, the capacity use rate bottomed at 76 percent at the depths of the 2002 downturn and averaged closer to 80 percent in 2005 through 2007. Further, numerous reports indicate we have significantly more workers than we have jobs at the moment and that we are likely to remain in that situation for a considerable period in the future.

The last component driving inflation would likely be the value of the dollar. A weakening dollar would contribute to inflation as the cost of imported goods – and we import a lot of goods – would need to rise in dollar terms for the exporters to bring in the same amount of euros or yen. But as bad as things are here, they are worse in many other countries. This is particularly true of the euro-zone at the moment with the problems being faced by Greece. This attracts money back toward the dollar and thus the actual strengthening of the currency that has been underway for the last several weeks. Plus, one has to think that sooner or later interest rates are going to increase, further providing a floor to the dollar relative to other countries.

We have a long way to go before housing prices, wage rates and general price pressure come back to boost general price increases, even in the face of this explosive jump in the supply of money. This may well be a period when those old paradigms just don't hold.

Livestock Update

The fed cattle market has made a good showing so far in February. In the first three weeks of this month, the 5-Area weighted average live steer price reported by USDA Agricultural Marketing Service has improved by over \$6.50 per hundredweight and this week broke the \$90 mark for the first time since late November 2008. Last week's 5-Area price (live basis) worked out to \$91.03. Cash fed cattle prices last week ranged from mostly \$90 in Nebraska and Iowa/Minnesota to mostly \$92 in Texas and Kansas.

The encouraging performance of the fed cattle market over the past month has been a bit of a surprise. A string of moderate year-over-year increases in feedlot placements from mid-summer to early-fall last year suggested that the worst supply pressure of the year in the fed cattle market would come early in 2010, likely coinciding with weak mid-winter demand. There are a couple of reasons why that hasn't happened. First, the weather has been a huge factor in the market this year. Poor feeding weather has sharply reduced finished weights. For the first week of February, the average fed steer dressed weight was 833 pounds. This is more than twenty pounds less than a year ago. In addition, the poor weather has most likely had the effect of spreading out marketings due to the difficulties it has created in getting cattle finished and even, at times, delivered. Second, a substantial portion of the higher placements in July through October last year were in the light weight categories. Marketings of these cattle placed at lighter weights would tend to be more spread out than marketings of heavier cattle, even without this year's weather effect.

The question is: 'where will prices go from here?' A good place to start in evaluating that question is with fed cattle market seasonality. Over the past ten years (2000-2009), the spring peak in fed cattle prices has tended to come in mid-March, followed by a more-or-less steady decline toward a summertime low in late-July. If this year is a "normal" year, then, prices could be another three or four weeks from topping out for the season. Of course, no year is ever average, so any particular year can diverge substantially from normal (i.e., average) seasonal patterns. It is instructive to think about what factors might cause this divergence. For example, as noted earlier, a lot of people expected prices to be relatively weak at this point this year because of the pattern of placements in 2009. Instead, the expected larger cattle numbers have been overridden by the granddaddy of all seasonal forces – that is, the weather – to give us what looks like a pretty standard seasonal price rally.

Moving forward, there is a good case to be made that this year should not be a typical year seasonally; specifically, that prices should continue to move higher right on through the summer (mid-summer at least). Based on past placements, cattle numbers should continue to decline as we move further into the year, offsetting the effect of seasonally heavier finish weights as feeding conditions improve. Historically, small competing meat supplies offer further support from the supply side. Also, as signs of economic recovery become more apparent, this should encourage demand-side improvement in the market, counterbalancing the normal summer slump.

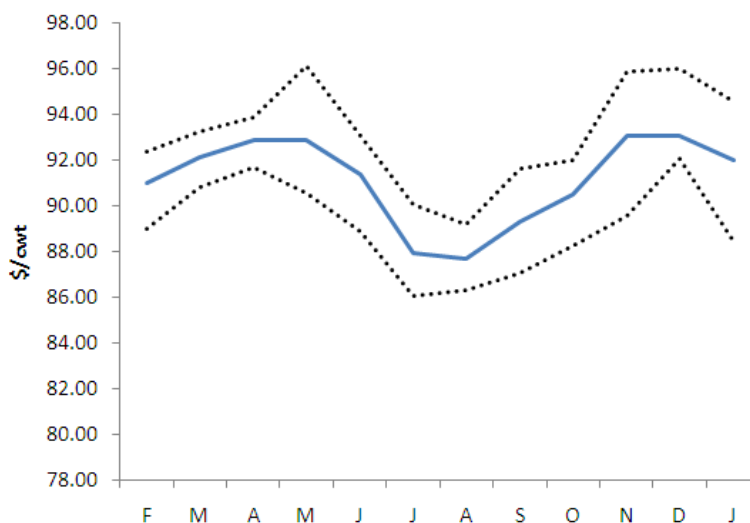
So far, the market is not buying the case for a counter-seasonal move. Figure 1 shows monthly average price expectations based on current Live Cattle futures prices (closing prices for Monday, February 22) and a three-year average of monthly basis for the TX/OK/NM feeding region.

This is awfully close to a typical seasonal pattern in the fed cattle market. Unless demand starts to look exceptional, traders are likely to stick with the market's default position of a mid-spring high followed by a 6-8 percent drop by mid-summer. Right now, the strength of demand is an open question. This month's increase in boxed beef cutouts looks to be mainly a result of push from the supply side not (at least not yet) pull from the demand side.

Cattle on Feed

The February *Cattle on Feed (COF)* report was released last Friday. Table 1 below summarizes key numbers from the report along with pre-report expectations:

Figure 1. TX/OK/NM Fed Cattle Price Forecast based on Live Cattle Futures (February 22, 2010)



Notes: Solid line represents price forecast based on 2007-09 monthly average basis for the TX/OK/NM price reporting region. Dotted lines represent minimum and maximum price forecast based on weakest and strongest 2007-09 basis.

Table 1. February Cattle on Feed Summary

	1,000 head	% of Previous Year	Avg. Pre-Report Estimate*	Range of Estimates*
On Feed February 1	10,989	97.4	96.9	95.7 – 97.6
January Placements	1,825	98.2	95.1	92.6 – 98.5
January Marketings	1,774	102.1	100.9	98.9 – 103.0

Source: Dow-Jones Newswire via LMIC

The market was anticipating a fairly favorable report with lower placements and steady marketings for January contributing to a lower on feed number. The report was kind of a mixed bag in that respect. Being at the high end of pre-report estimates, the placements figure was not as favorable as expected. On the other hand, marketings were more favorable than expected, also on the high side of expectations. The on-feed number was also on the high side of expectations, but that range was pretty tight. The actual on-feed number was only half-a-percent off of the average pre-report estimate.

On balance, the report looked pretty neutral; although if the major concern in the market right now is front-end fed cattle supplies, the large marketings figure should arguably have tilted things a little to the bullish side. Futures traders, at least, were not too inclined to a bullish point of view. Live Cattle and Feeder Cattle futures were down in Monday's trading. Live Cattle contracts beyond the nearby were down only slightly and were more likely showing the effects of an understandable breather after a couple of weeks of very strong gains than reflecting negative sentiment over the *COF*. Feeder Cattle contracts were down more substantially, feeling pressure from corn futures that were enjoying double-digit gains on what looked to be mostly technical trading.

Hog Market Summary

The strong finish to 2009 for hogs carried over briefly into 2010, pushing hog prices right up to, if not slightly over, break-even levels in early January. However, the market stumbled around mid-January, with dressed hog prices declining by over \$5 per hundredweight between the third week of January and the second week of February. Slipping wholesale pork prices simply would not support further hog price gains. In the last couple of weeks, hog prices have rebounded some. Last Friday's national average base price (producer sold hogs, carcass basis) was reported at \$66.42 – over \$3 above the early-February low but still almost \$1.75 off of January's highest daily average base price of \$68.16 (on January 21).

Last week, USDA presented their 2010 projections for the hog market at the annual USDA Agricultural Outlook Forum. One of the more notable points in the hog outlook was the projection for 9 percent growth in pork exports compared to 2009. This is essentially a return to trend line growth in pork exports following the sharp drop in exports from 2008 to 2009. USDA forecasts pork production to decline by 2 percent compared with 2009. The combination of lower production along with improving demand (hopefully in the domestic as well as foreign market) represents considerable fundamental support for the pork sector.

Poultry Market Summary

Broiler prices have held fairly steady over the past month. Higher prices on boneless/skinless breasts have generally offset steady to slightly lower prices on dark meat cuts. This particular discrepancy in the movement of broiler meat prices in recent weeks suggests healthy domestic demand but weak foreign demand. This is certainly what one would expect given the continuing problems with the Russian market. On that point, USDA's poultry market projections from last week's outlook forum are interesting. USDA projects a 15 percent drop in broiler exports in 2010 compared with 2009. This sounds very dramatic, and raises troubling questions about price expectations for 2010. However, the effect of the sharp drop in exports should be mitigated to a large degree by the very slow growth projected for broiler production – just a 1 percent increase in production compared to 2009. This means that 2010 production will remain well below 2008's production of 36.9 billion pounds. For an industry that has spent the past 30 years regularly clocking 3-5 percent growth, 2010's projections appear quite modest and should correspond to a very manageable supply situation despite the sluggish export sector. Unfortunately, for contract producers, this price-supportive supply discipline does not come free. Very small growth in production means very small growth in pounds produced and, therefore, in farm revenues.

Dairy Update

Markets Settle as the New Year Gets Underway

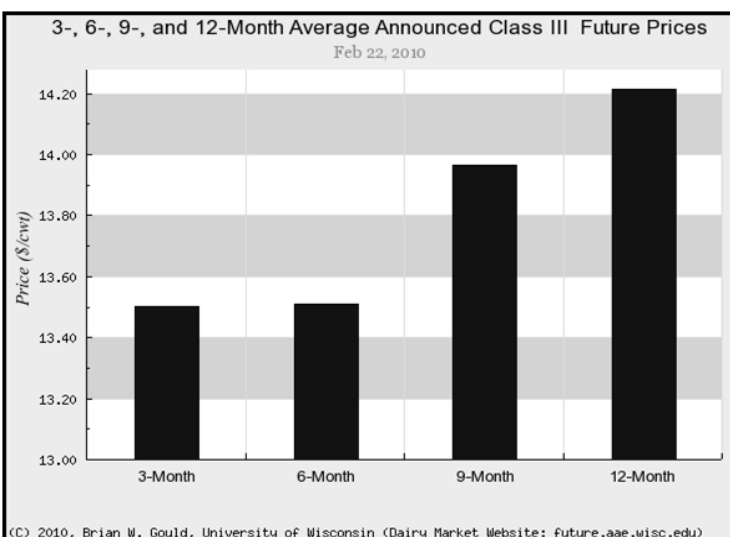
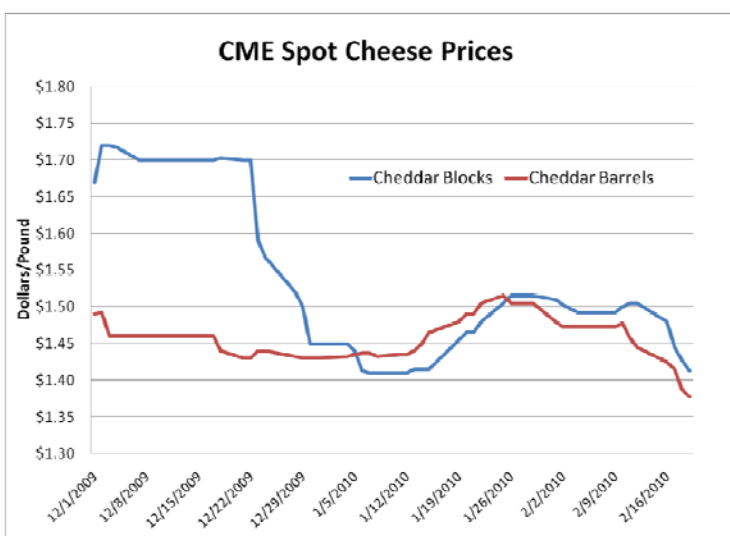
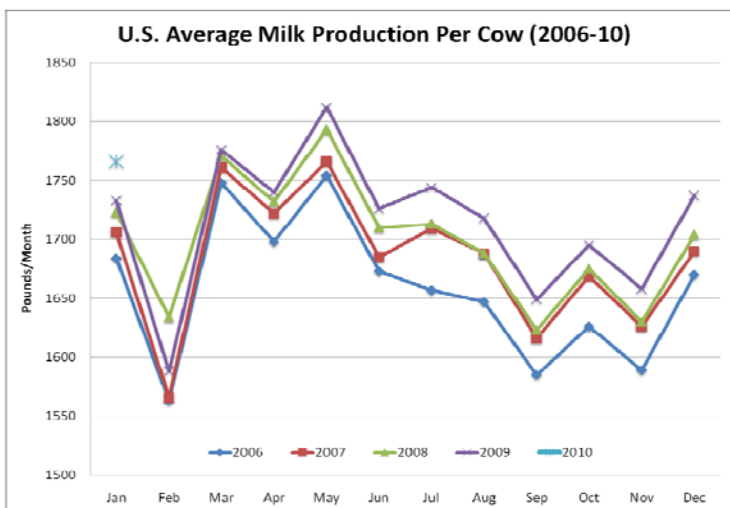
The trend toward rising prices was tempered with reality in February. Milk supplies are still too high to sustain further price recovery. U.S. cow numbers for January were up slightly over December, and January 2010 production per cow was up by 33 pounds over January 2009. The uptick in price, seasonal factors, and somewhat softer input markets drove January milk production higher than in December. However, that production level was only 0.6 percent lower than last January when the U.S. was milking 227,000 more cows. Dairy buyers refilled their inventories in December and January and are reluctant to purchase beyond their short-term needs at the moment. These factors pushed February CME dairy prices down from last month. U.S. and European stocks are also overhanging the market.

Mixed Signals on Production

Despite many analysts' predictions that milk production would continue to fall, January milk production totaled about 16.0 billion pounds, up 265 million pounds from December 2009. This trend is being driven by a seasonal increase and higher production per cow. In January, U.S. monthly production per cow was 1,766 pounds, up 29 pounds from the previous month and 33 pounds versus last January. The national dairy cow inventory grew by 3,000 cows, which is the first increase in cow numbers since December 2008. It is clear that many dairy producers saw the price signal to expand milk production – even if they did not expand their herds. New young replacement cows and decreases in feed costs could contribute to the increase as well. USDA released January 1 dairy heifer inventories and projects an additional 106,000 dairy replacements available. This puts the inventory at just less than 4.52 million, or a 2.5 percent increase over January 1, 2009. About half will make their way into the milking herd this year.

Markets Pull Back

The momentum toward higher prices has reversed. High block prices were driven by holiday purchases, replacing depleted stocks, and concerns among buyers that milk production was going to decline precipitously. The unsustainable block-barrel spread needed to close at some point, and that happened in February. CME cheddar block spot prices flirted around the \$1.50/lb. mark for most of February, while barrels traded close to \$1.47/lb. until last week when the markets nosedived. As of February 22, spot cheddar settlement prices were \$1.395/lb. for blocks and \$1.370/lb. for barrels.



February butter prices have been stable compared to the decline that was seen in January. CME butter spot prices reached \$1.52/lb on January 15 but fell almost 20 cents by the end of the month to \$1.33/lb. February butter prices have traded within a seven cent range – from \$1.31 to \$1.38. CME extra grade non-fat dry milk has traded at \$1.24 for the entire month of February. Large European intervention stocks are pulling down international powder prices across the board.

Class III futures prices have dropped as well. Closing prices on February 22 show a six-month average Class III price of \$13.51. Class III futures prices are not projected to break \$15.00 until October 2010 as of February 22. Based on the downward trend in the markets, the Class I Advanced price for March dropped by fifty cents - from the previous month to \$14.34 from \$14.84. On the bright side, this is \$4.91 above the Advanced Class I mover from March 2009. There will likely be no MILC payment for March, although, NMPF projects a MILC payment could come in April.

Vegas or Bust?

Using risk management tools is not common for dairy producers, unless they are larger operations that utilize large contracts. In a changing trend, some producers who want more control over their milk prices are turning to risk management and the futures market as a way to deal with the volatility in the dairy markets. Dairy producers are probably among the least risk-averse of all agricultural enterprises – most will ride the ups with the downs in hopes of the big payoff. Vegas slots are just as good of a bet these days.

While there is no guarantee that producers who use futures or even forward contracts will come out ahead, they generally know their prices. Knowing your price is worth something these days. For example, producers who sold their milk on CME's Class III futures market could have received between \$15.25 and \$15.50/cwt. for their March '10 milk. That price has since leveled off to \$13.31/cwt. Limitations a)not everyone has access to these tools and b) there is a risk that prices will increase. While futures may not work for everyone, it is an available instrument that some producers are beginning to consider.

