

Cattle market update – What we need to know

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Abstract

Cattle markets in North America were already showing signs of tight supplies long before the 2011 and then 2012 drought occurred in the US. In many parts of cattle producing areas in the US supplies have been tightened even further as we head into 2013. In Canada, after five years of downsizing post-BSE, the beef herd appears to be poised to see growth through heifer retention. Contrary to the US, western Canada has seen two fairly good years in terms of moisture for grass and forage production – critical to growing the herd. But higher grain prices in 2012 are having impacts on both sides of the border as higher costs have meant cattle feeding losses for much of this year. Margin operators have been caught between fewer cattle supplies/higher cattle prices and record high costs. A key concern in both the cattle feeding and cattle packing industries is that there is too much capacity chasing these fewer cattle supplies. Add to that the global economy, which has been fragile at best, and you get a very volatile environment ranging from: tight supplies = higher prices; all the way to: cautious consumers = competitive protein markets both here and abroad. Record high cattle and beef prices would have historically meant great profits but with today's cost structure (namely grains), it's not quite that simple.

Résumé

Les marchés du bétail en Amérique du Nord affichaient un resserrement de l'offre bien avant 2011 et, ensuite, la sécheresse de 2012 a frappé les États-Unis. Dans de nombreuses parties des régions productrices de bétail, aux États-Unis, les stocks sont encore plus restreints à l'aube de 2013. Au Canada, après les cinq années de restructuration ayant suivi l'épidémie d'encéphalopathie spongiforme bovine (ESB), le cheptel bovin semble en équilibre et prêt à connaître une croissance grâce à l'expansion du cheptel de génisses. Contrairement à ce qui s'est produit aux États-Unis, l'Ouest canadien a connu deux assez bonnes années en ce qui a trait à l'humidité pour la production d'herbe et la production fourragère – essentielles à la croissance d'un troupeau. Mais les prix plus élevés des céréales, en 2012, ont des impacts des deux côtés de la frontière car l'augmentation des coûts a entraîné des pertes au chapitre de l'alimentation des troupeaux pendant la majeure

partie de l'année. Les opérateurs en couverture ont été coincés entre des stocks de bétail à la baisse/des prix à la hausse et des coûts atteignant un sommet record. Un enjeu clé aussi bien pour l'industrie de l'alimentation du bétail que pour celle du conditionnement est que ces deux secteurs se disputent des stocks de bétail en diminution. Ajoutez à cela l'état de l'économie mondiale, qui est pour le moins fragile, et vous obtenez un contexte très volatil dans lequel des stocks restreints = des prix plus élevés; ce qui pousse les consommateurs à la prudence = des marchés des protéines très concurrentiels, au pays comme à l'étranger. Les prix records du bétail et du bœuf auraient antérieurement signifié d'excellents bénéfices, mais compte tenu de la structure actuelle des coûts (notamment pour les céréales), l'équation n'est pas aussi simple.

Introduction/Review of Year to Date

The North American cattle market has entered a period of tighter cattle supplies, beef supply, and along with that has come higher cattle, wholesale, and retail beef prices. In 2011 cattle prices in western Canada were 20-30% higher than 2010, depending on the category, while wholesale prices were only able to gain 10%. Although record high, retail beef prices in Canada were up 6% from 2010. In other words, cattle prices gained on margin while packers and retailers had to give up margin in 2011. And in spite of record pricing, the Canadian exchange rate averaged above par for the year, making new record cattle prices even that much more impressive.

North American Cattle Numbers

The US beef herd faced severe drought conditions in 2011, causing forced liquidation of cows in the most impacted areas. At the same time there was no expansion of the herd. Since more than one-third of the herd was in drought devastated areas, the impacts were substantial. Significantly impacted states were Texas, Oklahoma, New Mexico, Kansas, and Missouri. On January 1, 2012, the US beef cow herd was 3% smaller than 2011, with the number of beef cows on record falling below 30 million head. Drought continued to be a factor in 2012. The percentage of heifers that moved through feedlots averaged 36% in 2011, down from 37% in 2010 but still considered to be large. In order

to move towards expansion in the herd, this percentage will need to drop into the low 30s. As a result of the drought, the largest cow slaughter since 1996 occurred in 2011, totalling 6.7 million cows. A 6% reduction in cow slaughter is expected in 2012 (500,000 head fewer) and further, another 800,000 head reduction in cow slaughter is expected in 2013. The US beef cow herd will be another 3% smaller to start 2013.

The Canadian beef cow herd appears to have stabilized; the January 1, 2012 beef cow numbers were down 1% to 4.2 million head. Total cattle and calf numbers in Canada were up 0.5% after witnessing herd reductions since peaking in 2005. The beef cow herd in Canada is now 20% smaller than the 2005 peak, and the smallest cow herd since 1994. The initial BSE event in 2003 closed export markets, caused prices to collapse, producers to become unprofitable, and then eventually sold cows. Now that the herd is 20% smaller and export markets are slowly re-opening, prices are on the recovery, producers are returning to profitable levels, and now are starting to expand their herds. One indicator of this is that the number of beef heifers kept for breeding was up for the second year in a row, with January 1, 2012 heifer numbers up 4.3% even after the increase in 2011. The heifer:steer slaughter ratio in 2011 was 0.64:1 after peaking in 2008 at 0.76:1, another indicator of more heifers staying in the herd instead of moving into feedlots. Average cow/calf returns were estimated at \$75/head in 2011, with projections of \$100/head in 2012.

Beef Production and Supply

Fed cattle marketings (steers and heifers) fell 14% to 2.9 million head in 2011. This follows on the heels of marketings in excess of 3.5 million head from 1998 to 2006 (other than 2003 due to BSE). Due to the smaller cow herd and calf crop, marketings are not expected to get back to three million head before 2016; the projection for 2012 is 2.75 million head. Fed cattle exports to the US fell 30% in 2011 as more cattle remained in Canada, mostly due to the lower cost of gain in western Canada than in the US. Cow marketings were also down 18% in 2011 to 640,000 head. This follows a record cow slaughter in 2008 of one million head. Cow slaughter is not expected to venture far from 600,000 head for the next couple of years. The price of wholesale cow beef (lean trim) has been record high so far in 2012, which has kept cows coming to town for the strong prices. Overall beef production (fed production plus non-fed production) was down 14% in 2011 to 2.93 billion lb. The forecast for 2012 is down another 5% to 2.78 billion lb. On the contrary, US beef production was up 1% in 2011 due to the drought and large sell-off of cows. 2012 is projected to see tonnage down 2%, with another 2% reduction forecast for 2013. Canadian beef exports in 2011 were

down 17% as smaller supplies and a strong Canadian dollar meant Canadian beef was not as competitive in world markets. But due to tight domestic supplies, Canadian beef imports in 2011 were up 15%. Strong domestic prices will attract more off-shore product in 2012 again. Year to date imports are up 7% in 2012, with non-NAFTA imports up 23%.

Prices and Basis

Feeder steer prices in 2012 have responded to higher grain prices by trending lower since June. Feeder cattle basis levels for western Canadian feeder cattle have been much wider than normal early in 2012, \$2/cwt wider than the three year average, resulting in a \$17/head wider spread from the US market. Feeder cattle exports were small in 2011 with only 76,000 head moving south. So far in 2012, that number is 120,000. The relationship between Canadian and US feed costs continues to ebb and weave, with Canadian costs remaining well below those of the US since the summer of 2010. Calf prices seasonally see their annual price highs heading into grass season (May), and then trend lower into the fall run. The price spread between US and Alberta calf prices had once again returned to "normal"; Alberta prices were considerably lower than US prices since 2003. Fed steer prices have seasonal pricing tendencies with annual highs in the spring (March or April) and annual price lows in the summer/fall. As with feeder cattle basis levels, fed cattle basis levels have been wider than historic levels so far in 2012. Basis has been running \$3/cwt wider than the three year average to date. D1,2 cow prices (cull cows) have a strong seasonal tendency to peak in the spring, and then hit their annual low in November. That trend is expected to hold true in 2012 with annual highs being placed in May/June.

Demand

Canadian beef demand saw a 1.5% increase in 2011 as a result of higher retail beef prices (+6% to \$6.12/lb or \$13.47/kg) plus a slight decrease in per capita consumption. Beef demand has stabilized in recent years. US beef demand was strong in 2011 due to the record beef exports, and wholesale beef demand was considered to be 7% better than in 2010. A more modest 2% improvement in demand is expected in 2012. The soft US economy continues to be a concern for domestic beef demand as well as slowing beef exports compared to last year's pace. In recent years trends towards increased ground beef usage and declining whole muscle cuts has been evident. Price spreads between the cuts are narrowing; for example, end meats and trim prices gained 13-19% in 2011 (over 2010) while middle meats saw less advancement (rib cuts were up 2% while loin cuts were

down 3%). Fast casual dining has also been a segment that continues to see more growth, especially with the gourmet burger. And finally, increased exposure to AAA or Choice beef products has had a positive impact on wholesale pricing.

Price Risk, Industry Structure, Volatility and Pricing Patterns

There continues to be more price volatility in the cattle markets in recent years. In 2011, 40% of the time the weekly price change for fed cattle was \$30/head or more, and 60% of the time it was \$20/head. For an industry that often deals in \$10-20/head margins, these price swings can be frustrating. Trends would suggest that volatility is here to stay and could even be more extreme in 2012. Outside market influences and global impacts are a fact of life for commodities it seems, including cattle. As a result of increased volatility in the marketplace, both sellers of cattle and buyers of beef are doing more forward pricing of their inventory and requirements. The percentage of cattle that are marketed using alternative methods such as grids, formulas, alliances, and forward contracts has grown from 53% in 2005 to 70% in 2011, and the end user is doing the same thing. Today packers forward-sell their beef 63% of the time compared to 50% in 2005.

Market volatility has meant cattle feeders are utilizing risk management with more regularity. This would include futures, options, marketing agreements,

and CPIP (in Alberta). More vertical coordination has occurred as more branded beef programs are developed, meaning more in terms of demand and volume. An example of this type of program is CAB. Excess capacity both at the feedlot level and packing plant level will be addressed as numbers shrink further once cow/calf producers start to retain heifers in their herds. It is fully expected that not all packing plants will survive this consolidation nor will all feedlots. More credit or capital will also be required as prices and inputs move higher. This could be the single largest impact on further consolidation in the industry. Although record prices are expected for 2012 and 2013, so are record high costs and record volatility and risk. Margins and price risk must be managed in this environment.

Conclusions

Prices will be strong for many years, but profitability will depend on one's ability to secure more credit, manage risk, and be disciplined. The business is changing quickly and producers must be able to adapt. Technology will continue to advance the industry on many fronts. The global influence will be positive as Canada and the US produce a premium beef product that many customers around the world are demanding.