Cows in Control

Special Report – Cattle Feeder Report
April 24, 2021

Ryan Copithorne 4/24/21 Special Report

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A look at cattle feeding profits looking ahead

This is a critical point in time for cattle feeders as this is the time of year when cattle prices seasonally drop. We have seen tremendous appreciation in many commodities, with grains and pork leading the charge higher. Will fat cattle follow higher in this inflationary environment or will they follow seasonal trends lower? This is what we will address in this special cattle feeders report.

Corn and barley prices

Let's start with corn prices. Corn has broken out of a very long sideways base and is headed to old highs with very little resistance to stop it from getting there at this point. The blue box indicates $7.50-$8.00/bu corn in the US or $8.00-8.60/bu barley in Canada is feasible.

If we are in a commodity inflation cycle like the 1970's or even the 2000-2014 period, there is potential for prices go much higher than that, but we will focus on recent highs for now.

Grain prices very often rally in the spring months to encourage farmers to grow more, and then top out in June when seeding intentions are known. Highlighted above (blue circles) are the June tops in 2008 and 2011 amid the full bull run in corn from 2006-2012.

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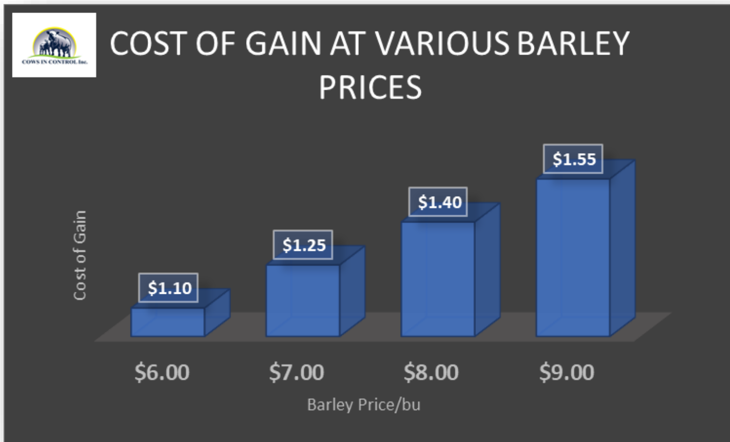
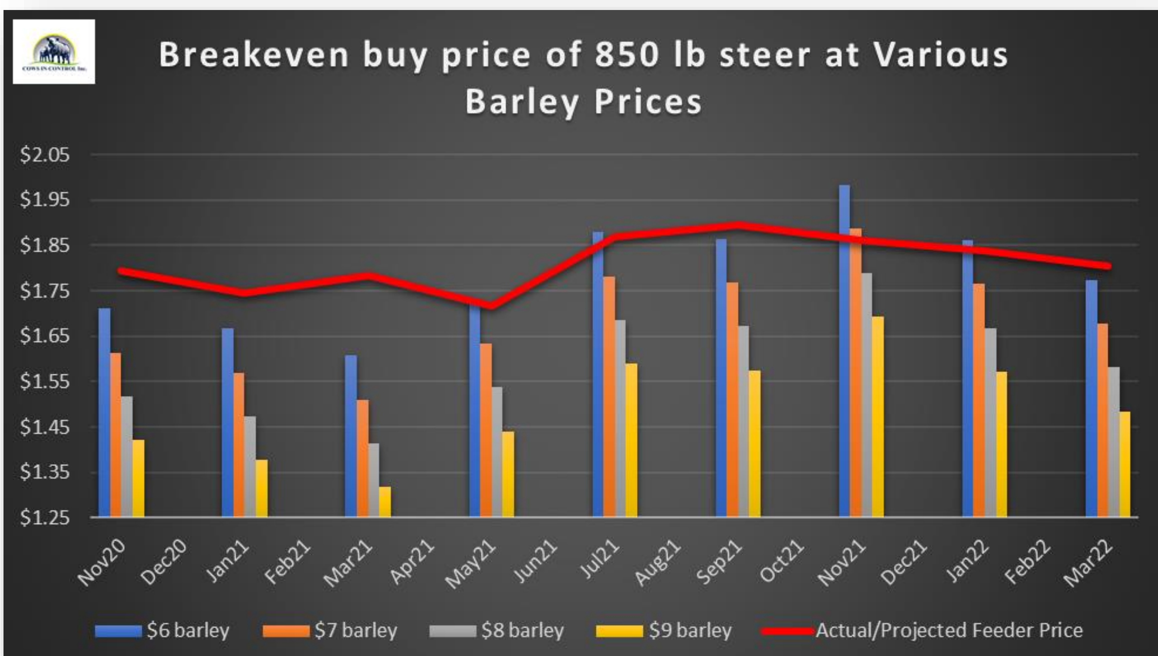


Using the above costs of gain, the price you can afford to pay for feeders at various barley prices is below. You can see that the red line, which is the actual futures projected price, is pricing barley around $6/bu. That may explain the recent sell off in feeder futures as corn has started to rally again. Look how far down the buy price is at $8 and $9 barley! Either feeder prices will fall or fat prices must rise, or everyone is underwater!



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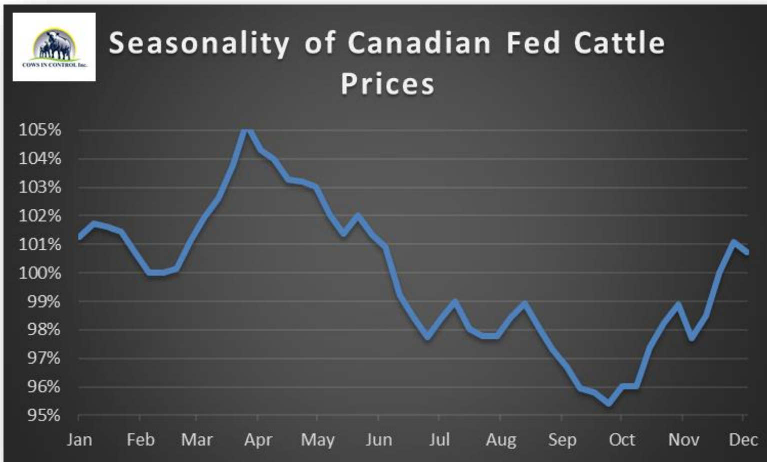
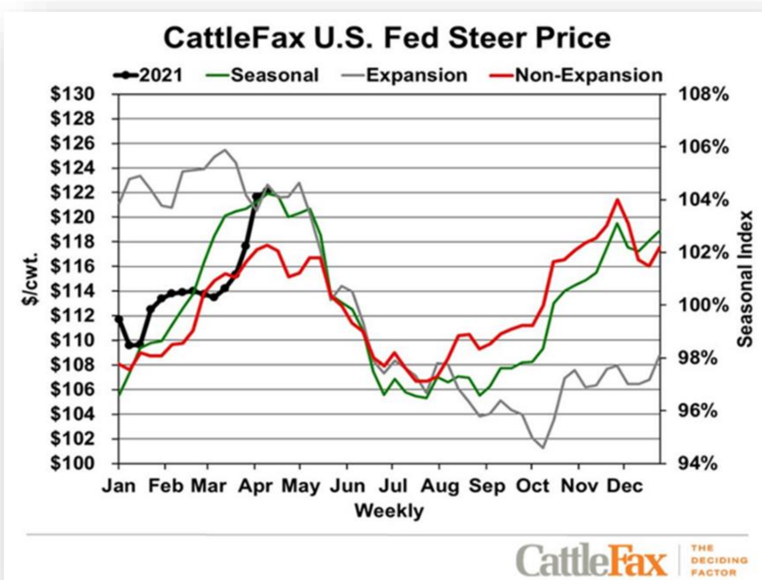
Seasonality

This is the traditional seasonality of fed prices in Canada, peaking in March/April and sliding into the fall months.



This corresponds with US seasonality…



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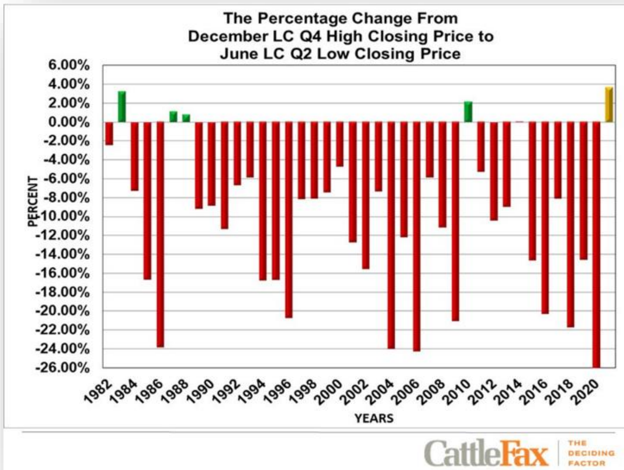
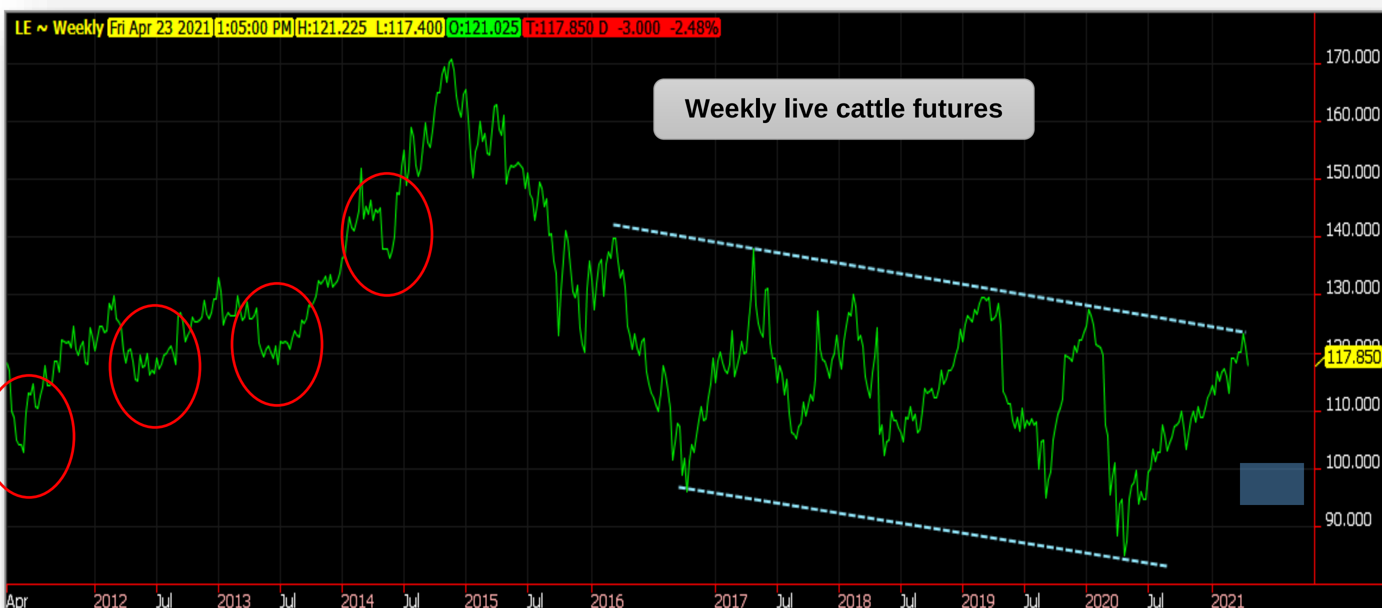
Cattlefax recently put out this graphic demonstrating the usual price change from December into June live cattle futures expiry dates. The average drop is around 11% from December into June. December live cattle futures closed around 110, which would indicate a June futures price of around 98 if this historical pattern were to be realized. Prices dropped 35 out of 39 years, pretty reliable. (Coincidentally, the few years they rallied were stock market rally years).



Below we see the price trajectory for June indicated with the blue box if we do see the drop.



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On the previous graph, we circled the June lows in the 2009-2014 bull run to demonstrate that even in a bull market, the fat market still pulls back into June from the spring highs due to seasonality despite being in a rising market longer term.

This paints a not too rosy picture for June futures at this point. Here is a closer look at the June live cattle futures chart with the indicated price drop level (blue box)…

We are in the midst of a monster grain rally, feeding breakevens are falling apart, is this bearish picture for fat cattle possible? -- Yes, it is always possible. History is telling us this is the trajectory. This is why we hedge. Does it have to go that way – no.

We have some bullish factors that need to be considered into this discussion to counter this bearish case. For starters, lets walk through some previous grain rallies and look at their impact on live cattle prices.

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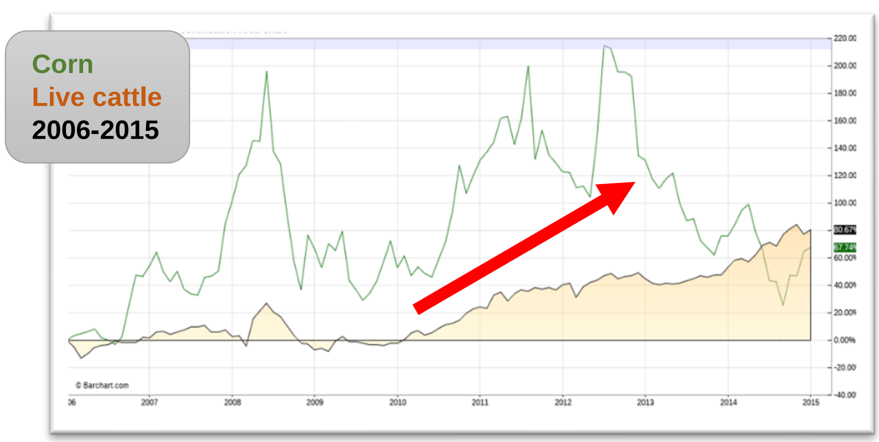
Cattle prices in previous grain rallies

In the 1970's, we had a major cattle price rally. Fat cattle prices rose 135% during that decade or more than doubled. There was an initial surge in 1973, a few years pause and then a final blow off rally in 1977 to 1980.

When we overlay the price of corn during that period. The initial surge in cattle prices was due to weak grain prices. In the 1973/74 grain rally, cattle paused for a few years until the grains cooled off. Note: while grain prices were blowing off, cattle prices stagnated.

By 1977, both grains and cattle rallied in sync due to high inflation at the time that lifted all commodities higher (red arrow above). ***This was an inflation led rally in cattle having nothing to do with grain price impact on cattle prices.***

Fast forward to the 2006-2015 period. There was an explosive grain rally in 2008 much like the 1973 rally with the "Food for fuel" policy of using corn to make ethanol for gasoline. When the world figured out you can only use about 10-15% of ethanol in the blend, the price of corn collapsed. Note again: cattle basically stayed flat during that period when grains blew off.



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When the 2008 Great Financial Crisis happened, and the government started Quantitative Easing and baling out banks, it created a lot of money growth which resulted in inflation from 2009 to 2014. This created an inflation rally like we saw in the late 1970's (red arrow previous chart) which lifted both cattle and grains together. ***Again we saw cattle stay flat during the initial grain blow off and then rally significantly when inflation pulled both grains and cattle together in 2009-2015.***

2015 to today saw a great unwinding of the commodity run, that was until Covid 19, March 2020…

Massive global government monetary stimulus post-Covid coupled with China's rebuilding of its swine herd after African Swine Fever (ASF) losses have caused grain prices to take off once again.

The conclusion we need to assess is whether this will be a grain-only blow off like 1973 and 2008 where grain rallied and cattle stayed flat or is it an inflation rally due to money flooding the system that will lift all boats, grain and cattle together.

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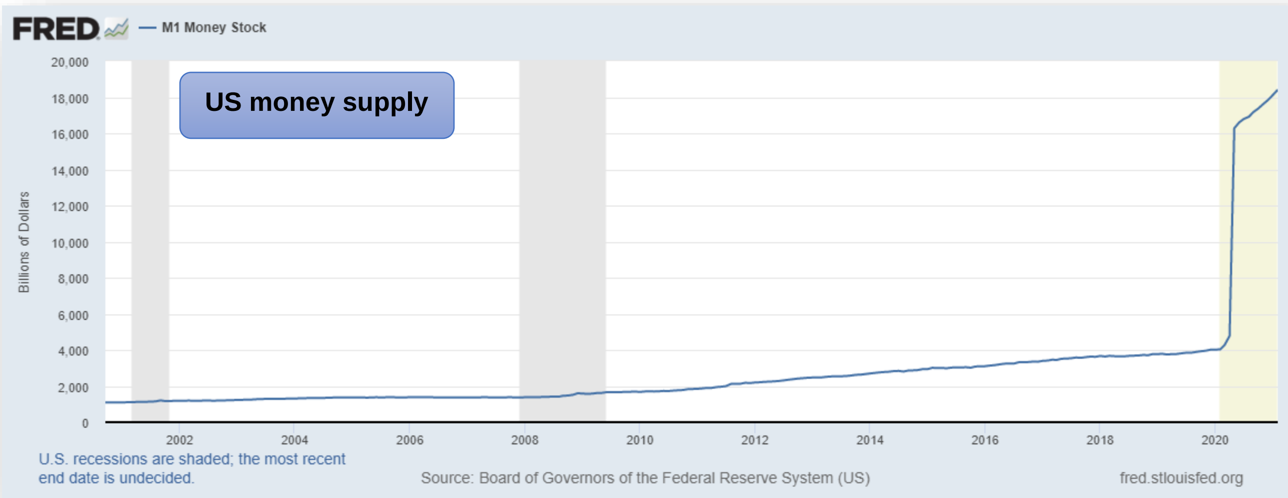
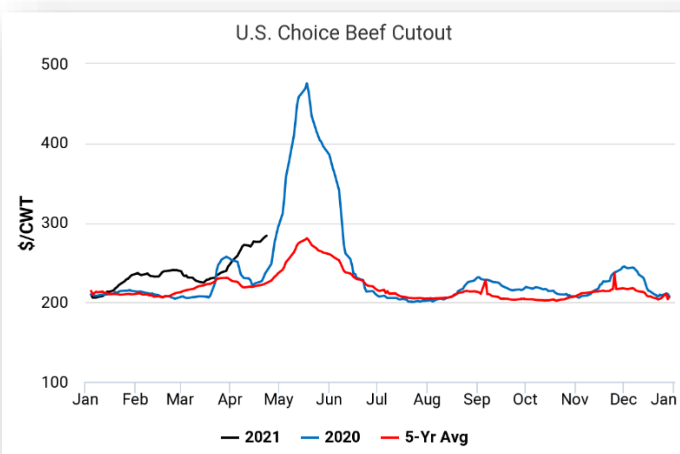
The bull case for live cattle

In regard to inflation, this next graph is almost all we need to say. The government response to Covid 19 was unprecedented in terms of money printing.



Though this money printing was designed to offset losses due to Covid, the rally in commodities, stocks, housing and just about the price of everything indicates that the massive increase in the money supply is going to be inflationary. This bodes well for the inflation case for cattle prices to rise.

Beef cutout prices are indicating there is inflation from the consumer side…



US beef cutouts are the highest in history for this time of year, well above 5-year averages. Packers are pocketing $600+/head margins. Can live cattle fall in price while cutouts are pointed higher like this?

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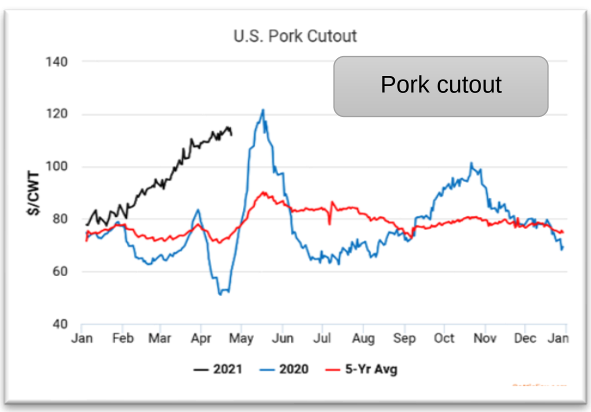
Let's do the math: With cutouts at $284/cwt, if we use a 63% yield and give the packer a traditional 15% operating margin that equates to a ***live price of around $152 ($1.91/lb in Canada).*** Current futures are around $117 ($1.46/lb CDN). Hmm.

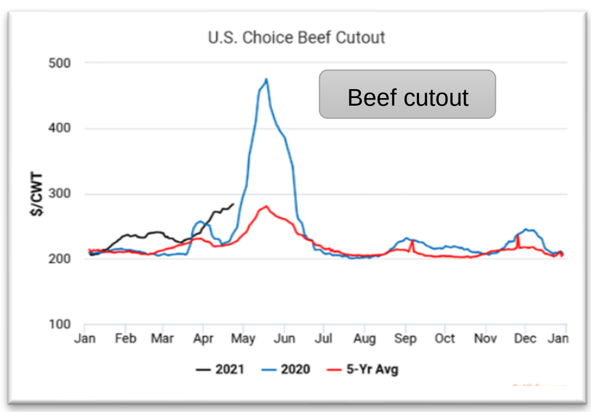
Choice cutout:	882 lb carcass x $284/cwt =	$2505 sale price for packer
Purchase animal:	1400 lbs x $1.17/lb =	$1638 buy price for packer
Operating margin for packer:		$ 867/animal
Less kill cost (roughly 15% of live animal):		$ 245/animal
Packer profit:		**$ 622/animal**

If we look at it another way, in February 2020 before Covid, a fat animal was 92% of the value of the choice cutout carcass. Today it is 65%. If we brought that ratio up to even 85% to account for some added costs for the packer due to Covid, live cattle would be $1.53/lb ($1.91/lb in Canada), similar to the above calculations.

Once the packer loses the leverage of all the backlogged cattle, do you think live cattle prices can stay suppressed like this?

Let's do another analysis. Pork to beef cutout and live cattle: lean hogs





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Looking at the 5 year average of Beef:pork cutout, even though beef cutout is at record highs, it is still significantly lagging pork for this time of year. This means beef cutout though high, still has room to move higher if it is to keep up with pork.

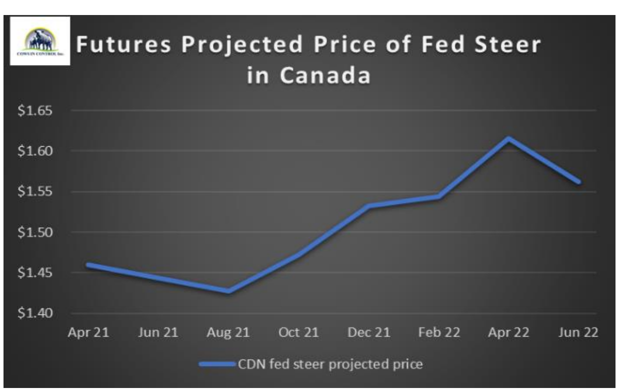
	Price April 2021	5 year Average	Gain in price
Pork cutout	112	74	**51%**
Beef cutout	283	221	**28%**
Beef:pork ratio	**2.53**	**2.99**	

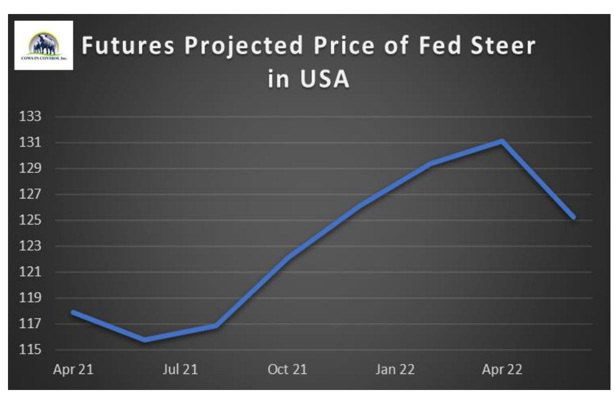
If we used the 2.99 beef:pork ratio, Choice beef cutout would be $334/cwt putting live cattle futures in the high 170's! Possible?

Now, we must remember there is a herd restocking of pork in China due to ASF artificially pushing pork prices higher, so this ratio may be temporarily out of whack. However, meat is substitutable, so the ratios must come back in line over time which would be bullish beef.

Forward Prices

Let's see what futures are saying feeder and fat prices look like going forward…





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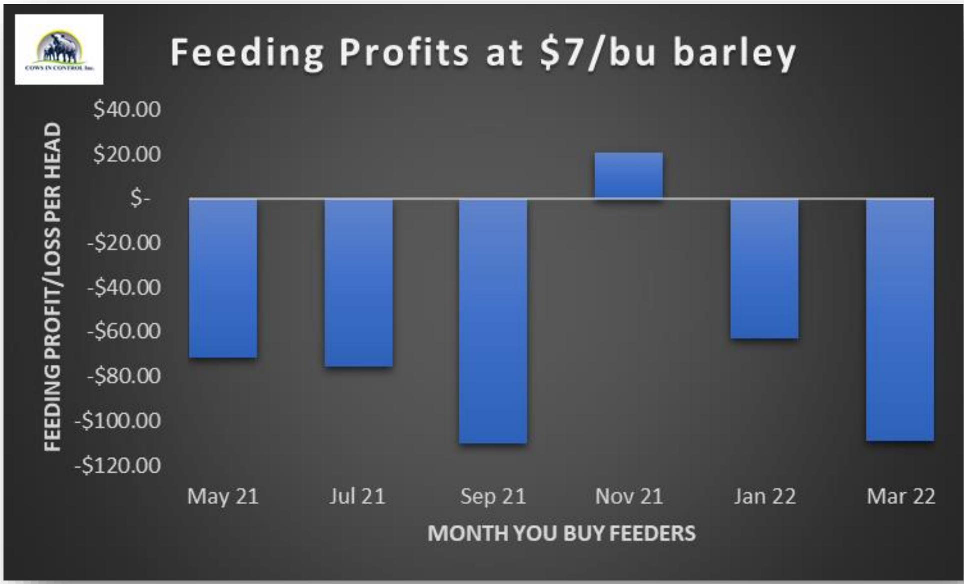
Based on futures projected feeder prices and fat prices, and using $7/bu barley or $1.25/lb cost of gain, these are the expected returns for the 850 lb steers you lay into your feedlot in the coming months…



Note: By using home grown feeds and timing your hedges we can likely improve the profitability of these predicted profits

Risks that can worsen or jeopardize your returns going forward

1. **Rising grain prices** – as cost of grains rises, your cost of gains increase
2. **Live cattle futures fall** – reducing your end sale price for your fats
3. **Feeder cattle futures rise** – increasing your buy in cost for feeders
4. **Packer leverage increases** – when there are a surplus of fat cattle available relative to packer needs, the packer can drop the price they pay.
5. **A rising Canadian dollar** – a rising Loonie softens Canadian fat prices
6. **Basis deterioration** – basis is the price of Canadian cattle versus US cattle. If Canadian basis falls, it lowers the price you receive

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Cows in Control risk reduction methods

1. **Rising grain prices:**
   - Hedging using corn futures is the easiest way to hedge grain price risk. Cows in Control can help you design these hedges. If we think corn prices may go to $7.50/bu or barley to $8.50/bu, we could buy December $5.50 corn call options that are around $0.50/bu that protect you from rising corn/barley prices until next December. Each call option is 5000 bushels or the amount of grain to feed 60 head of feeders
   - Custom feeding vs. feeding your own cattle allows you to charge out full grain prices with a markup rather than taking the risk of rising feed costs. Cows in Control can circulate to cow/calf clients any of your custom feeding opportunities.
   - Growing your own feed is the best way to hedge rising grain costs
   - Forward contract grain with farmers or elevators

2. **Live cattle futures fall:**
   - Cows in Control can tailor hedge plans for you pen-by-pen to protect your sale price using futures or options. Give us a call and we will recommend a hedge strategy for your cattle
   - Forward price contract with the plant – only contract 85-90% of your total numbers in case you fall short of delivery numbers. Cows in Control can help you analyze your forward contract bids.

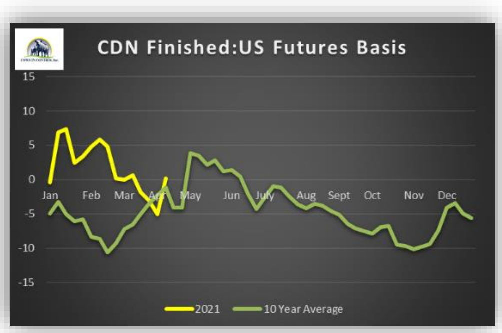
3. **Feeder cattle futures rise:**
   - Cows in Control can build buy hedges as well as sell hedges using futures and options. Give us a call if you intend on buying feeders in the future and want to cap the upside on the price you expect to pay.

   - If you are looking for feeders to buy in future months, give us a call to see if we have clients that may be selling that may be interested in forward selling.

4. **Packer leverage increases:**
    - Though there is not too much we can do to counter packer leverage, what we can do is analyze cattle on feed reports to find marketing holes for you to try to fill. For example, a low monthly placement number could create opportunity 6 months down the road for fat cattle. Cows in Control follows cattle on feed reports quite closely.

5. **Rising Canadian Dollar:**
    - Cows in Control actively tracks the Canadian dollar and can recommend strategies for hedging this risk with Canadian dollar futures or options. We are buying September 81 cent call options currently for example as a simple, cheap way to hedge currency risk. For around $1000 Canadian, we can protect the currency risk on around 60 head of fat cattle. Every cent that the Loonie rises is around 2 cents/lb negative impact on your Canadian fat cattle prices. For a cent/lb cost to fix the currency, you can protect $28/head for each cent the Loonie rises.
    - You can also do forward “swaps” with your bank or a currency exchange company where for a fee they will fix your forward currency based on a dollar amount that you want to protect in the future. In the end they are using futures and options like we use and charge you a margin for that, but it may be worth it to have piece of mind having someone else do this for you.

6. **Basis deterioration:**
    - Canadian basis has been unusually high relative to prior years due to excess feeding capacity in Canada, shrinking herd numbers in Canada, and growth in the packing space in the past few years. Fed basis is very volatile and sometimes it makes sense to get a “basis contract” with your packer where they will often allow you to forward price your basis. A basis contract is similar to a forward price contract in that you are required to deliver cattle against it, but gives you the flexibility to hedge basis risk only and set the forward sale price at a later date. Cows in Control can help you negotiate those basis contracts.
    - Cows in Control follows basis closely and can help you determine what forward basis will be on feeders and fat cattle



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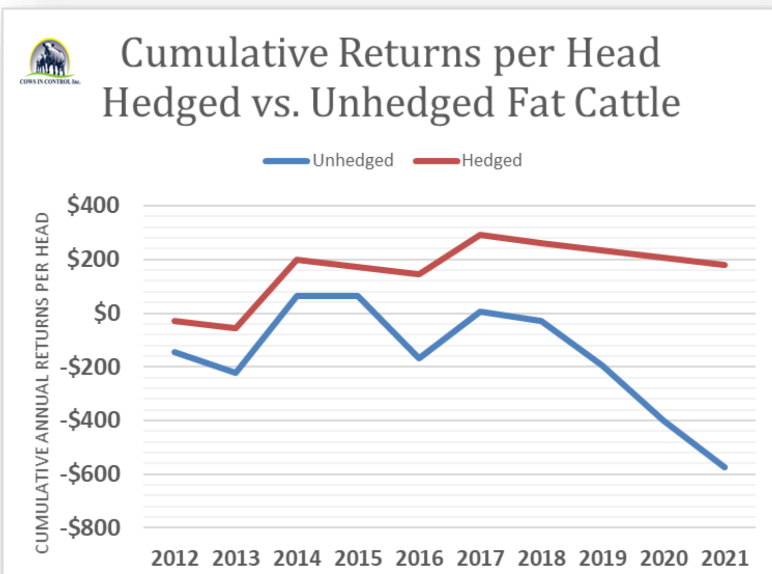
Summary and conclusions

1. We believe this to be an inflationary rally in grains in cattle that will bring both cattle and grains to much higher levels over time, but this does not eliminate the need to hedge
2. Seasonally from now until June is a weak period for fat cattle that should be hedged
3. We believe in hedging fat cattle no matter what direction you think the market is going and whether you are hedging at a loss, breakeven or profit. Protect your downside no matter what. We can always move hedges up if the price rises or build hedges that allow you upside with limited downside risk for not much money.
4. We always carry a minimum 50% hedge on every pen of cattle no matter our feel on market direction, and add to the hedge levels as market conditions dictate.
5. We believe in hedging cattle, feed costs, currency and basis and have strategies for each.
6. Hedging your purchase cost of feeders is as important as hedging your sale price on your fats.
7. Hedging is not about making money on your hedges, it is about covering losses on your live cattle. It is like an insurance expense. If you look at the Canadian feeding profits and losses over the past 9 years, and if all you did was cut your losses, look at the difference in cumulative returns versus the feedlot who didn't hedge.



Canadian Annual Feedlot Returns per Head	
2012	-$146
2013	-$75
2014	$284
2015	-$0
2016	-$231
2017	$175
2018	-$35
2019	-$165
2020	-$205
2021	-$174

Take care out there,

Ryan Copithorne
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