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J.S. FERRARO & COMPANY | RETAIL READY Foods Inc.

THE MONTHLY

AUGUST 2019

RED MEAT OUTLOOK: HOGS & PORK

The US hog and pork markets made an abrupt turn higher in mid-July, as packers found it more difficult to source the hogs they needed. There were several reasons behind the sharp move higher. First, producers marketed hogs aggressively in June to clear up the May backlog and by the time mid-July arrived, they were current on their marketings again. Second, a searing heat wave moved over the Midwest in early July and that stifled hog growth, pushing carcass weights down rapidly. Finally, the August futures contract was carrying a large premium to the spot market when the July contract expired and that gave producers the financial incentive to slow down marketings in hopes of capturing higher prices later on. Of course, when the cash hog and futures markets turned higher in mid-July, pork buyers scrambled to get coverage and that sent the cutout quickly higher. All of this seems to have run its course now. Hog producers still look relatively current, but the Aug and Oct futures are now trading below the index (see **Figure 1**) and that should provide incentive to bring more hogs to market in the next few weeks. Further, the Midwest heat wave was followed in late July by an unusual cool spell which helped hogs regain weight and become market-ready sooner. The 2020 lean hog futures still contain a sizeable "ASF premium", but the near-term fundamentals point to lower hog and pork prices during August.

> Weekly hog kills expected to **exceed 2.5M head/wk** by the end of August

SUPPLY PICTURE

Hog slaughter during July looks like it was about 6% over last year, but last July's totals were tainted by several plants being down for software upgrades. Packers struggled with poor margins in July and by the end of the month they were constraining the kill in order to improve those margins. The industry is still running ahead of what the Dec/Feb pig crop implied for the Jun/Aug kill, perhaps by about 300,000 head. That raises the risk that August kills will be a little lighter than expected in order to offset the big kills the industry produced in June. Still, the seasonal tendency is toward bigger slaughter numbers from mid-July until December and our forecast has the hog kill moving from about 2.3 million head per week in late July to over 2.5 million head per week in the latter part of August. That should mean greater pork availability and lower pork pricing going forward.

Last month we noted how slow hog carcass weights had been to decline in June. In July however, that problem was rectified as producers got caught up on their marketings and a heat wave in the Midwest slowed down daily gains in hog barns. Carcass weights are still two pounds heavier than last year at this point, but are in the process of putting in their seasonal low and should trend higher from now into December. Our forecast has weights remaining over last year for the next several months. That will add to pork production in the months ahead and help keep price levels constrained. We currently expect August pork production to be up about 3.3% from last year. But September production could be even larger, perhaps as much as 6-7% greater than last year. Now that the Aug and Oct futures are below the spot hog market, producers will have an incentive to keep the hogs moving and that generally points to lower prices. That dynamic was demonstrated in the first few days of August when hog prices turned quickly lower and have been in rapid decline since then.

DEMAND SITUATION

Domestic pork demand in the US has remained rather strong in July, not because consumers were clamoring for pork, but rather because pork processors have sought to keep more raw material around them in light of the uncertainties caused by the ASF situation in China. The number of hams in cold storage at the end of June was almost 15% above last year and the number of bellies was up 6%. It's likely that processors will maintain this stance since the fear of an ASF-induced shortage will continue to loom for many months to come. Cold storage stocks act as a shock absorber in the market. Their presence keeps spot pork prices from going abnormally high (because users can pull from existing stocks) or abnormally low (because users can add to stocks when prices decline). We think that as kills grow this fall and price levels move lower, fearful end users will build cold storage stocks and thus buffer the market from either big price declines or rapid price increases. However, there is a bit of a disconnect between consumer demand for pork (which we think is just *'so-so'*) and demand from processors for supply chain reasons. Retailers have backed away from pork this summer due to the volatility in price levels and the consumer cannot buy what they are not offered. Eventually, this could cause product to back up in the system and a significant downward price correction might be necessary to clear the market. In a situation where there is a looming threat over the market (ASF), the typical price-quantity scatter diagrams are less useful in gauging domestic pork demand because they measure demand at the wholesale level, not the consumer level. The wholesale market is terrified of ASF, but US consumers could care less.

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US pork exports were up 10% in June and that increase was almost solely due to much stronger movement to China. Last summer, China was importing almost no US pork and in June of this year they imported 72 million pounds. So, there is finally evidence of China escalating its purchases of US pork. But the real question is whether or not it will escalate further from here or will it stall around these levels? That's important because these levels of exports, while they may look impressive on a YOY basis, are not nearly enough to absorb all of the extra production that will be coming this fall and winter. And now, President Trump has threatened to impose additional tariffs on Chinese products beginning on September 1, 2019. Surely, China will retaliate with more tariffs on US products, possibly including pork. The trade war appears as though it is going to be long and brutal on both economies. That doesn't bode well for continued big exports to China. Finally, it's worth noting that even futures traders have lost their faith in the China ASF story. In five days last week, the December lean hog futures lost $14. We have been saying all along that the futures market was way too optimistic on the impact that ASF in China would have on US markets. It took a while, but futures traders have finally come around to our way of thinking. **Figure 2** gives the difference between where the futures are currently trading and our estimate of fair value based on extensive analysis of the fundamentals. For those looking for near-term price guidance, **Table 1** provides our price forecasts for the next several weeks.

Futures traders take $14 off the December contract in a mere five days

Figure 1: Lean Hog Index

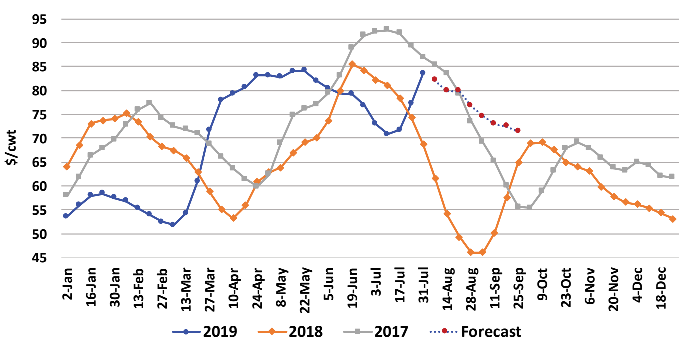

Figure 2: JSF Lean Hog Futures Mis-pricing

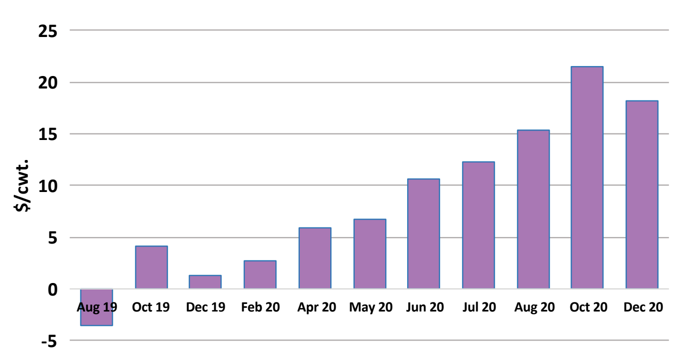

Table 1: JSF Hog and Pork Price Forecasts

	14-Aug	21-Aug	28-Aug	4-Sep	11-Sep	18-Sep
Pork Cutout	87.2	86.4	84.1	83.1	83.5	83.5
Loin Primal	77.0	77.9	78.8	78.9	80.3	81.2
Butt Primal	93.6	92.2	93.0	94.1	94.5	93.0
Picnic Primal	52.2	53.0	53.1	54.2	56.0	57.2
Rib Primal	112.0	115.1	114.3	113.0	114.9	112.0
Ham Primal	79.8	77.2	74.8	73.0	73.1	72.4
Belly Primal	151.0	147.7	135.0	129.8	127.3	127.9
Lean Hog Index	79.8	79.8	76.7	74.7	72.9	72.5

SUMMARY

The US hog and pork complex is currently in a state of disequilibrium. Extreme volatility in the futures market has left hog producers unsure of how to best time their marketings and it has made retailers more reluctant to give pork a prominent spot in their feature advertising. The production pipeline is primed however, and we will see kills grow steadily from this point until early December. Heavier than normal hog carcass weights may also contribute to the pork supply this fall. We see domestic demand at the consumer level as mediocre, but demand at the wholesale level is much better owing to the fact that pork processors are seeking to keep more product around them as a buffer against any ASF-induced surprises. We now have evidence that China has greatly escalated its pork purchases from the US, but those purchases are not nearly large enough to offset the impact of the large production that lies ahead. The futures market has corrected sharply lower recently as traders have finally recognized that the hysteria that surrounded hog futures this spring and summer was largely unwarranted.

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