J.S. FERRARO

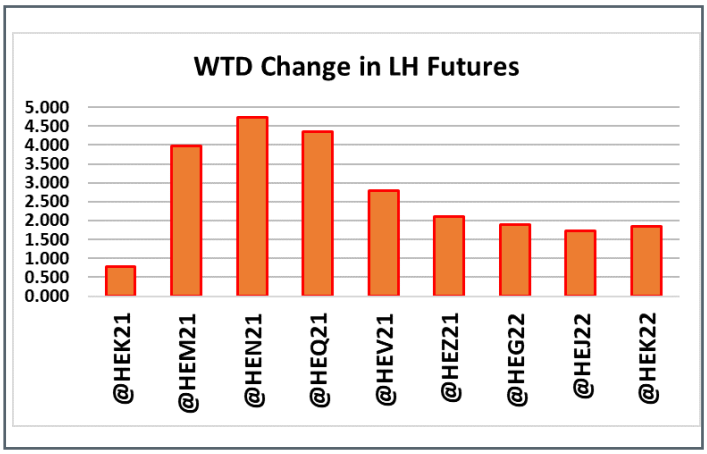
jsferraro.com | 416.306.8788
130 Adelaide Street West, Suite 810 Toronto, Ontario M5H 3P5

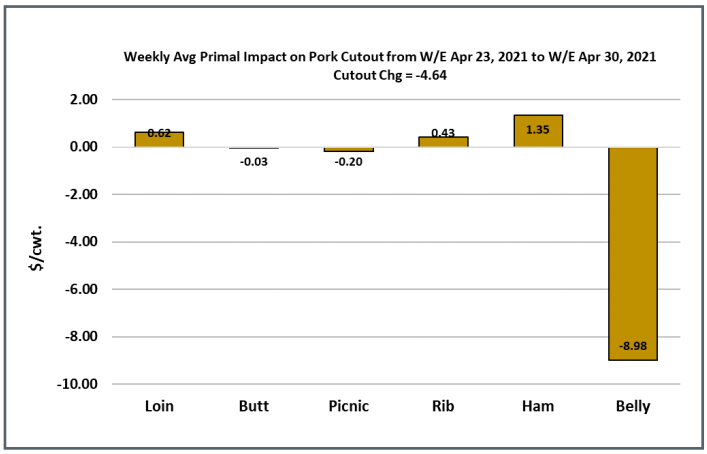
WEEK ENDING APRIL 30, 2021

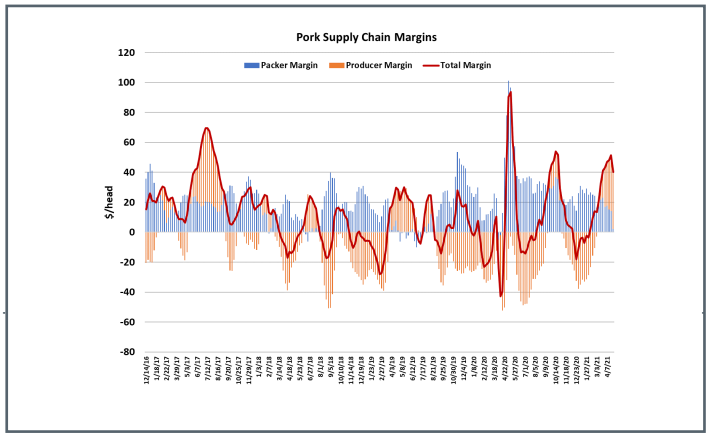
THE PORK WRAP

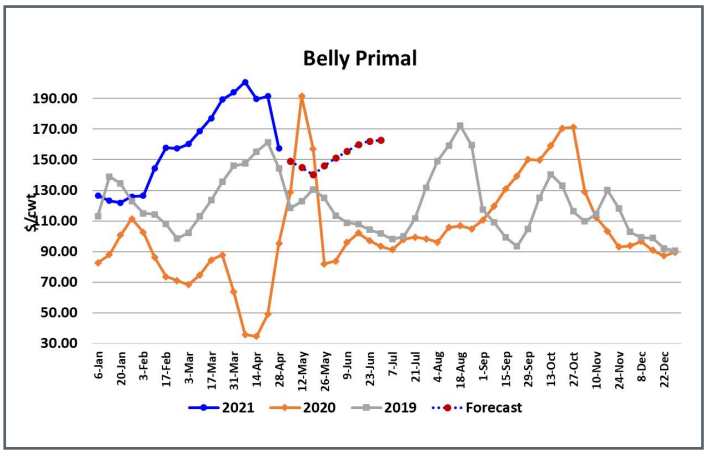
Something changed this week in the hog and pork complex. For once, everything did not move higher. The pork cutout dropped nearly $5 on a weekly average basis. That drop was driven almost exclusively by weakness in the belly primal, which lost $34 this week and is now at its lowest level since early February. While the cutout was pulling back, the negotiated hog market just kept marching higher, with the NDD market up $4.50 on weekly averages. Cutout down, hog prices up, means packer margin compression and boy did that happen this week. Packer margins for last week are calculated to be only $1.58 per head. Margins will likely go negative next week. To illustrate just how unusual this is, the pre-COVID, 5-year average margin for the last week of April is over $11/head. There have only been a very few instances of negative margins over the past five years and most of those have occurred in June or July when hog supplies were very tight. What can packers do to rectify this margin problem? Not much. The normal response would be to scale back on the kill, but kills are already getting small seasonally and packer's per-unit costs would escalate if they purposefully reduced the kill now. Besides, no packers want to tell workers that they must work reduced hours when labor is so tight already. So, packers will just deal with negative margins for a while and hope to make it up when hog supplies begin to increase again after mid-summer. It will hurt more for the packers who are pork-only than for other majors who slaughter both hogs and cattle. Cattle margins this week were over $700/head. The chart below shows that there was very little change in the contribution of the non-belly primals to the cutout this week–most showed very little change. So, it appears that if one wants to know the direction of the cutout, one needs to have a good handle on where the bellies are headed from here. The bellies actually peaked three weeks ago (chart below), but this week featured the most dramatic price decline. I've got the forecast drawn to allow just a few more weeks of small declines in the bellies before they start to work higher again once vacation season gets into full swing after Memorial Day. Last October when the hog and pork markets were on fire, it was the peak in the bellies that marked the beginning of the end in that rally. The cutout essentially followed the bellies lower and eventually all of the other primals capitulated as well. Will that be the case this time? Maybe, but it is hard to know because the situation is so different now. We are in a period of tightening hog supplies, whereas last fall hog supplies were expanding. That made ending the rally a whole lot easier. I do have the cutout working lower from here, but slowly, and there could be brief rallies along the way. I'm keeping the cutout forecast over $100 into early July. The cutout futures are more bullish, keeping it over $100 until October. We must not forget the old adage that the "cure for high prices is high prices" and this won't last forever. With prices staying so elevated for so long, it will likely generate a supply response and give producers reason to expand. The one obstacle to that in the current environment is corn prices in the $7-8/bu range. If they hold there through the summer then producers might be more reluctant to expand and thus the period of high hog and pork prices might last months longer than it would if corn prices were down at a more typical $3-4/bu level. Consumer demand will play a big role as well. Demand for pork has been red hot, but this week the combined packer +producer margin turned decidedly lower (chart below), and this doesn't look like a head-fake type turn.

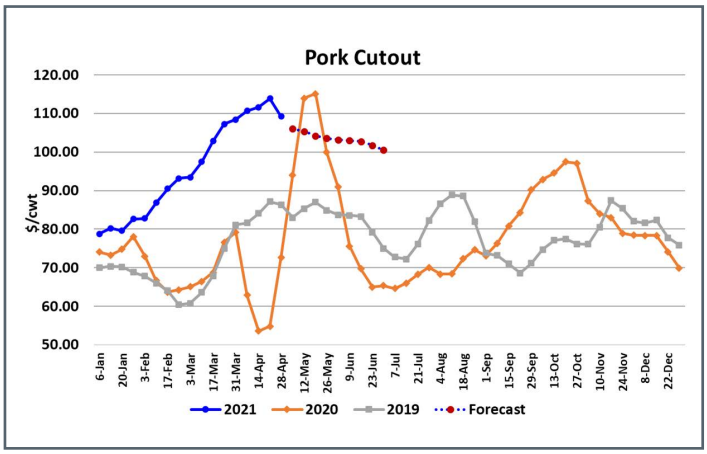
This could be telling us that the demand side for pork is starting to cool. I'd like to see another move down next week to confirm that, but if demand is beginning to cool then the whole complex is in for a lot of changes. The cutout will come down but its likely that hog prices won't decline much and that would mean more pressure on packer margins. Futures would also need to adjust also, since they seem to be projecting this phenomenal demand into eternity. One data point doesn't make a trend, but this week's dip in the cutout and combined margin raise the potential that bigger changes may be on the horizon. Compared to the demand side, the supply side of the market is rather boring. This week's kill came in at 2.45 million head, which was only a smidge higher than what the pig crop projected. We are now three-fourths of the way through the March/May quarter and the cumulative error in the pig crop is a mere 40k head. Good work by USDA on estimating the Sep/Nov pig crop. Barrow and gilt weights held steady at 215 this week, now 10 weeks in a row. Weights should soon start to decline seasonally as warmer weather takes its toll on weight gains. Export demand seems to be sagging a little if the weekly data is to be trusted. High prices tend to do dampen export interest. There have been ongoing rumors that carcasses are leaving the US undetected by the weekly data, but those wouldn't be able to escape the monthly data reports and so far we haven't seen any evidence of a big surge in exports. We will get the official export data for March on Wednesday of next week and will be watching for any larger-than-expected movement, particularly to China. The futures remain very jumpy. There are many traders committed to a very bullish story and think the LHI is going to $130 or better this summer. That alone probably keeps the futures too rich until they get close to expiry and have to converge with the cash market. The LHI only advanced $1.20 this week on an average basis–far less than the $4-5 increase in the negotiated markets. That shows the impact that a falling cutout can have on the LHI. The surge in corn prices this week gave strength to the back of the hog curve. The weekly bar chart below shows just how strong the gains in May corn have been over the last couple of weeks. The corn curve is inverted with the nearby higher than all subsequent contracts. That is the market's way of saying that we need corn now more than we will need it in the future and it incentivizes those producers that own corn to sell it now rather than incur storage costs and sell it for less later. New crop corn is priced almost $2 under old crop at this point, so the market is indicating that by the time fall arrives, any hogs out there will be eating substantially cheaper corn than what is bought to feed them today. The back-of-the hog curve bulls should keep that in mind. Anyway, by now I suspect that most hog operations have hedged their fall corn and thus the risk of further increases in their feeding costs are minimal. Next week it is all eyes on the belly primal and its impact on the cutout. Also, keep an ear out for any packers making noise about cutting the kill to improve their margins. I don't think they would actually do it, but that won't stop them from trying to influence the market by saying they will.

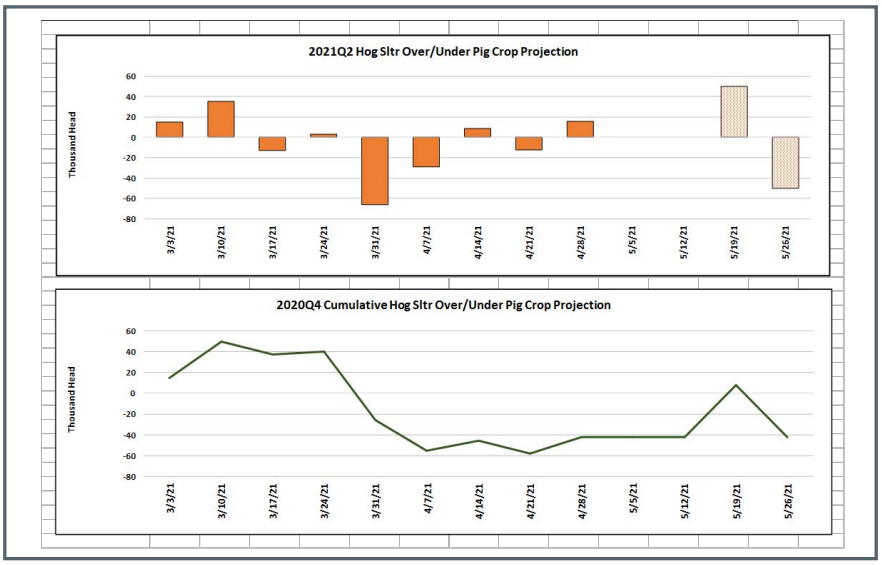












DR. ROB MURPHY BS, MS, PhD Agri Economics,
Executive Vice President, Research & Analysis,
J.S. Ferraro

E: Rob.Murphy@jsferraro.com

Dr. Rob Murphy is an agricultural economist and business leader with over 29 years in the industry. He has a wealth of experience in the North American meat and livestock industries studying, analyzing and predicting market movements.