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

THE MONTHLY

DECEMBER 2018

RED MEAT OUTLOOK: HOGS & PORK

The cash hog market continued to work lower throughout November, as is typical for this time of year. The problem for packers however, was that the cutout fell faster and thus compressed their margin. Packer margins fell from about $20/hd at the end of October to about $13/hd near the end of November. That margin compression is perhaps the biggest mystery in the pork complex right now. Normally, as available hog supplies increase, packers gain leverage and are able to expand their margin at the expense of producers but that didn't happen this year. Some have pointed to the fact that this year there were two new large packing plants in operation that weren't fully functional last fall and so packers may have had to compete more vigorously for the available hog supply. **Figure 1** shows how pork packer margins have tracked this year relative to the previous two years. It's obvious how much more depressed margins have been this fall. Our thinking is that margins were affected by lighter-than-expected hog availability.

> Barrow and gilt slaughter
> **only up 1.6%** in Sept. - Nov.

SUPPLY PICTURE

Earlier in the year, the USDA told us that the March/May pig crop was up 4.3%. But when we got to September/November, when those hogs became market ready, we only saw barrow and gilt slaughter up 1.6%. Packers were expecting more hogs and probably geared up to slaughter more hogs. When they didn't show up as expected, packers had to bid more aggressively on those that were available in order to fill their kill schedules. Now that all of the data for the September/November quarter is in, we estimate that the actual kill was over one million hogs less than what the March/May pig crop indicated. That's a very substantial miss on the USDA's part and they will no doubt revise the March/May pig crop downward when the next *Hogs and Pigs* report is released on December 20, 2018.

With a miss that significant, it does make us wonder if we can trust the reported June/August pig crop, which was up 2.5%. We will be watching slaughter levels closely during the December/February quarter for signs that the June/August pig crop numbers were also off.

Slaughter during December is expected to run between 2.55 and 2.65 million head per week in the non-holiday weeks. The holidays will trim slaughter back some and when January arrives we could see kills drop back to around 2.45 million head per week. Carcass weights have not been much of an issue. **Figure 2** shows this year's average carcass weights compared to last year. Currently they are dead on with last year and they seem to be following a normal seasonal pattern toward a peak sometime in December. So, there is nothing in the carcass weight data that makes us think that hogs are backing up in the system.

DEMAND SITUATION

Domestic demand has been a bit lethargic lately. We chalk that up to the strong economy and consumers trading up to beef from pork and poultry. International demand however, has been fantastic. Weekly pork exports have averaged 6.4% over last year's really big numbers since September. South Korea has shown exceptionally strong year-over-year numbers for pork exports from the US **(Figure 3)**. The US has a free trade agreement with South Korea and that is giving the US a competitive advantage into that market. In the most recent data, US pork exports to South Korea were up 39% from the same period last year. Other big destinations, such as Japan and Mexico, are tracking much closer to last year, but last year was a very good year for Q4 exports so those countries continue to perform well. There have been additional reports of African Swine Fever (ASF) outbreaks in China recently, but so far there hasn't been a significant culling of animals as a result. The futures market is very jumpy about ASF and every credible news story seems to send the market higher. The 2019 contracts have a lot of "ASF premium" built in and so producers would be wise to hedge some proportion of production at these levels.

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Figure 1: Estimated Pork Packer Net Margin

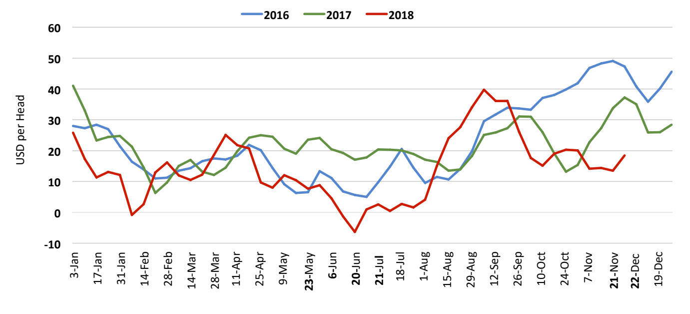


Figure 2: Weekly Barrow & Gilt Carcass Weights

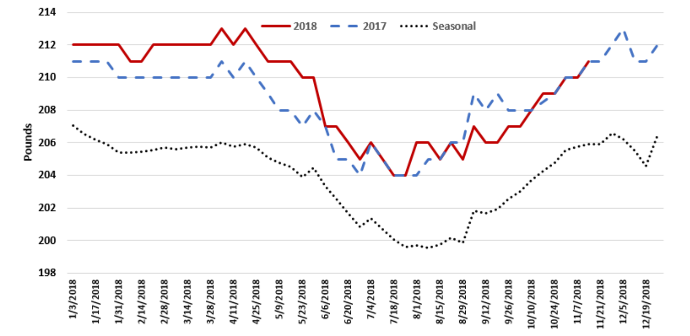


Figure 3: Weekly Pork Exports to S. Korea

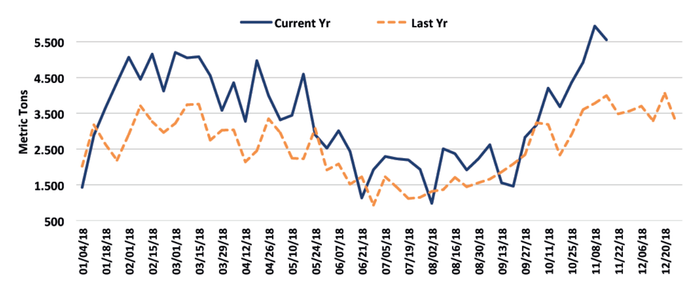


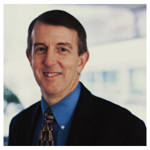
Table 1: JSF Hog and Pork Price Forecasts

	5-Dec	12-Dec	19-Dec	26-Dec	2-Jan	9-Jan
Pork Cutout	70.0	69.5	68.6	67.8	67.3	66.9
Loin Primal	63.8	65.2	66.2	66.9	67.5	68.0
Butt Primal	85.0	83.7	83.0	82.1	80.6	78.2
Picnic Primal	45.1	44.9	45.8	46.2	44.4	43.0
Rib Primal	116.6	118.0	119.0	121.2	121.0	122.2
Ham Primal	52.8	50.3	48.7	47.3	47.6	48.3
Belly Primal	115.7	114.9	109.6	105.3	103.0	101.1
Lean Hog Index	57.9	55.7	54.8	55.0	54.7	55.5

It's possible that if ASF runs rampant in China and mass cullings take place, that hogs could trade over $100 next summer as China would be forced to ramp up its imports to cover the shortfall. But let's not forget there is also a demand component to ASF as well. Even though the disease can't be transmitted to humans, when consumers hear that ASF is spreading they will naturally shy away from pork. It is entirely possible that any supply shortfall as a result of ASF will be countered by depressed demand for pork in China. All of these unknowns surrounding the ASF situation in China helps add to the anxiety of futures traders and makes the market very sensitive to any new information. The pork cutout declined a little over six dollars during November and about half of that was related to the bellies and the other half to the loins and butts. The decline in the bellies was expected given how elevated belly prices became in October. Currently, we are forecasting belly prices to remain below last year until early spring. The loins have been problematic all year long and it only seems to be getting worse here at the end of the year. We expect the cutout to trade between $65 and $70 during December with more risk to the down-side than to the upside. Pork will be plentiful and consumer demand for it right now doesn't seem strong enough to help lift prices higher.

CONCLUSION

We are now seeing the largest hog kills of the year, but those kills are well below what earlier *Hogs and Pigs* reports indicated. Packer margins should be at their highest levels during November and December, but this year they have been substantially below normal. Domestic demand is lethargic but export demand remains very good, particularly from South Korea. Look for the cutout to struggle during December under the weight of big kills and seasonally large production. Loins and hams are attractive buys. Cash hogs should have a little more downside risk as well, but will probably make a bottom and turn higher by mid-December. ASF will continue to keep the futures market very unsettled, but in reality ASF is not likely to become a major market factor until the second half of 2019.



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