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

THE MONTHLY

# RED MEAT OUTLOOK: HOGS & PORK

MARCH 2019

Cash hog prices struggled during February, with the Lean Hog Index dropping a little over $5/cwt. The pork cutout also came under pressure, losing about $7.50/cwt over the course of the month. Last month we highlighted the supply and demand challenges that were facing the industry and those challenges only got more severe during February. Slaughter levels continued to exceed expectations and, at the same time, pork demand fell precipitously. Both packers and hog producers felt the financial impact of this confluence of events. Packer margins began February around $15/hd on average and finished up the month closer to $10/hd. Producers saw their margin move from about -$25/hd down to -$35/hd at month's end. This pushed the combined packer-producer margin sharply lower and confirmed the existence of the "demand air pocket" that we discussed last month. This left industry observers struggling to explain what was driving the sudden collapse in demand for pork. Much of it is originating with the US consumer and we think that perhaps the consumer's preferences are shifting away from processed meat items toward more fresh product at retail. Since pork is more heavily processed than beef, the change in consumer attitudes has been detrimental to pork demand while boosting beef demand. A good example of this shift can be found in the picnic primal. Picnics are frequently further processed into sausage and other items. The value of the picnic primal last week was 34% lower than it was in the same week last year.

> Slaughter levels **exceed expectations** while pork demand **falls**

## SUPPLY PICTURE

Since the beginning of the year weekly hog slaughter has averaged almost 4% above the same period in 2018 (**Figure 1**). This has been somewhat of a surprise since the prior pig crops reported by USDA would have suggested that hog kills should have been considerably lower than that. Thus, it is looking like USDA's survey may have under-estimated the size of the Jun-Aug pig crop that came to slaughter in Dec-Feb. At the same time, there have been several incidents of severe weather in the Upper Midwest where many of the pork packing plants are located. That weather caused packers to have to reduce production on some days as the severe cold and ice made it difficult to get workers and hogs to the plants and move pork out of the plants. Those disruptions never lasted more than a couple of days, but they had the effect of delaying hog marketings and resulted in hog weights rising. In analyst parlance, we say that producers "fell behind" in their marketings and thus the supply of hogs became a bit "backed-up." When that happens, it increases the packer leverage in the spot hog market because producers feel a sense of urgency to market as many hogs as they can and are more easily convinced to accept whatever price packers are willing to offer. This helps to explain why hog prices have been so weak lately.

This delay in hog marketings is further confirmed by hog carcass weights. When we de-trend and de-seasonalize hog carcass weights we see that the component not explained by trend or season has risen steadily since the first of the year. The solution to the problem is for packers to step up the kills and clear the backlog. Normally, they must be incentivized to do this by bigger-than-normal margins. Unfortunately, with demand suffering at the consumer level, packer margins declined during February and packers recognized that the demand structure of the market was not strong enough to clear large quantities of additional pork without collapsing margins further. This means that slaughter levels were not large enough to clear the pipeline and so we enter into March with a bigger-than-expected supply of market ready hogs and declining hog prices as a result. One might ask, *"How does the industry get out of this mess?"* The answer lies on the demand side of the market since not much can be done about near-term supplies. Those pigs have already been born and fed and there is really no way to alter hog supplies in the short run. If demand were to improve however, that would lift the cutout, improve packer margins, and provide the incentive to bring the supply chain to a more-normal state of marketing currentness.



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## DEMAND SITUATION

Last month we talked about the combined packer-producer margin and how it served as a gauge of overall domestic pork demand. That combined margin was solidly negative at the beginning of February and declined further as the month wore on. This provided additional confirmation of a *"demand air pocket"* for pork. Pork demand tends to cycle in a pretty regular pattern. It will get strong for a while until pork prices become rich relative to other proteins and then, as retailers adjust their feature plans, it will trend lower for a while. At some point, pork becomes cheap relative to other proteins and that causes a shift toward pork features and helps demand cycle higher. While the cycle is normal, what is concerning is it appears that, since early 2018, the tops in the demand cycle have been lower than the ones before and the valleys have been deeper. This suggests that over a longer period of time, domestic pork demand has been steadily eroding. We think this is possibly explained by a shift in consumer preferences away from processed meat items, which tends to affect pork more than other animal protein sources. **Figure 2** shows this long-term demand erosion in the context of the combined margin. The dotted black lines indicate a shift in early 2018 from uptrend to downtrend.

> Sharp **increase** in US **pork exports** to China amid ASF outbreak

The good news is that it appears the current deep cycle is nearing a bottom. The combined packer-producer margin turned slightly higher last week and may be an indication that pork has now gotten cheap enough relative to beef and chicken that it is finally spurring some increased buying interest. That is good news for the entire supply chain and should be a sign that soon both pork and hog prices will get some support. How fast this happens is still an open question, but it does look to be headed in the right direction. However, just because the short-term demand cycle has turned higher that doesn't mean that domestic pork demand is in the clear. From a longer-run perspective, if consumer preferences are shifting away from pork, then the top in this short-term demand cycle will likely be lower than it would have been in years past and the next downturn will likely produce a deeper valley than what we have recently come through. That should be very concerning for an industry that has greatly expanded its processing capacity in the last few years.

A big reason behind the expansion in pork packing capacity and hog numbers in recent years has been the export market. The US has found it easy to expand its shipments of pork to other countries and the new capacity was designed to fill the needs of the international markets. It is critical that demand from overseas markets grow in the next few years in order to efficiently utilize the added capacity. Unfortunately, macroeconomic data from around the world suggests that many countries outside of the US are experiencing an economic slowdown and that could crimp US pork exports in the coming months. One encouraging development on the export front has been a recent surge in purchases of US pork by China. As China struggles with a growing outbreak of African Swine Fever (ASF) among its vast hog herd, it appears to have turned to the US to source disease-free pork. USDA's weekly export shipments have recently shown a sharp increase in tonnage moving to China, even in spite of the 50% tariffs that have been levied by China on US pork as part of its retaliation for President Trump's imposition of tariffs on Chinese goods. We will need to watch this closely over the next few months. So far, the exports to China have not been enough to offset weak domestic demand and some erosion in exports to other Asian destinations, but there is the potential for a significant positive price impact in the US if China gets more aggressive in sourcing pork from the US as we head into spring and summer.

## SUMMARY

The US pork market continues to be well supplied. Kills have been larger-than-expected, but weather disruptions have caused hog producers to fall behind on their marketings somewhat. Hog and pork supplies should trend seasonally lower into spring, but will remain well above last year's level. There are concerns about the long-run health of domestic US pork demand as it appears that consumer preferences may be shifting away from pork. The shorter-term demand cycle appears to have bottomed and should be improving into March and April. China has recently increased its imports of US pork and that has the potential to be a strong positive influence on US pork pricing if it continues. Price levels in the hog and pork complex are likely to be higher at the beginning of April than they are here at the beginning of March. **Table 1** contains our weekly price forecasts for the major pork primals and cash hogs.

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*Figure 1: Estimated FI Total Slaughter*

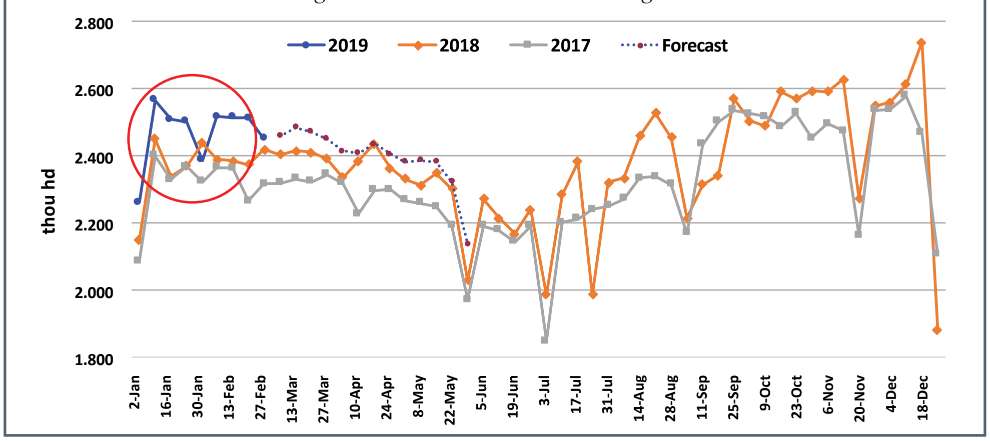


*Figure 2: Pork Supply Chain Margins*

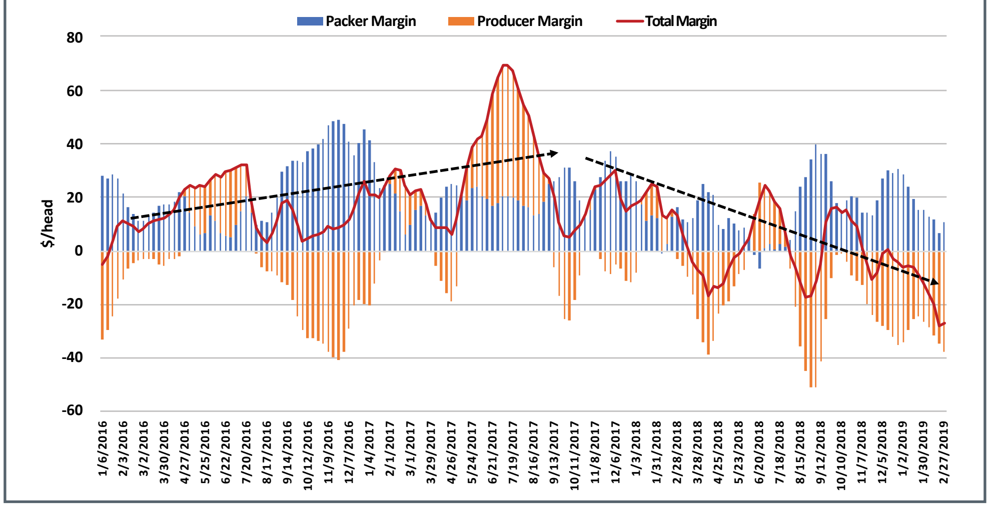


*Table 1: JSF Hog and Pork Price Forecasts*

| | 13-Mar | 20-Mar | 27-Mar | 3-Apr | 10-Apr | 17-Apr |
|---|---|---|---|---|---|---|
| **Pork Cutout** | 63.0 | 63.2 | 64.2 | 65.0 | 65.4 | 65.4 |
| **Loin Primal** | 62.3 | 62.7 | 63.4 | 65.0 | 67.0 | 68.1 |
| **Butt Primal** | 69.0 | 71.2 | 72.5 | 75.0 | 75.4 | 74.3 |
| **Picnic Primal** | 34.7 | 36.2 | 36.9 | 37.2 | 38.8 | 40.4 |
| **Rib Primal** | 116.4 | 118.0 | 123.0 | 124.3 | 126.0 | 126.3 |
| **Ham Primal** | 45.5 | 44.6 | 44.8 | 46.0 | 47.1 | 48.2 |
| **Belly Primal** | 105.2 | 104.1 | 106.3 | 104.0 | 100.0 | 95.7 |
| **Lean Hog Index** | 54.0 | 54.9 | 56.3 | 57.3 | 58.0 | 58.3 |

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