VOLUME 1, ISSUE 2

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

THE MONTHLY **NOVEMBER 1, 2018**

RED MEAT OUTLOOK: HOGS & PORK

October saw cash hog prices declining, although not as fast as the futures market had projected. As a result, the futures market corrected upward toward the end of the month. The market, as well as most industry analysts, have noticed that the availability of live hogs has fallen well below expectations and that is primarily the reason for the unusually slow decline in cash hog markets. The fourth quarter of the year almost always sees bigger hog kills than what is typical at other times of the year. This is primarily a function of biology. Hogs that are slaughtered in Oct-Dec are conceived in Jan-March (3 months gestation + 6 month feeding period). The cool temperatures during the conception period leads to a higher percentage of pregnancies and thus more hogs to be slaughtered in Q4. The same thing happens in reverse for pigs conceived in the hot months of July, August and September. Reduced conception rates in those months leads to smaller slaughter in April, May and June of the following year. USDA's surveys indicated that the pig crop in the March-May quarter of 2018 was 4.3% larger than the year before, so naturally the market has been looking for 4.3% more hogs to be slaughtered in the Sep-Nov period. That hasn't happened and it's beginning to look like USDA's survey over-estimated the size of the pig crop this spring. As of the end of October, the industry has slaughtered about 800,000 fewer hogs than would be expected based on USDA's pig crop estimate. There were some hurricane-related reductions in slaughter during September as packing plants shuttered for Hurricane Florence, so it wasn't too surprising the Sep-Nov slaughter got off to a slow start. However, it's only logical that those hogs delayed by the hurricane would eventually show up for slaughter. So far that hasn't happened. It is very difficult to delay hog marketing more than 2-3 weeks as the animals will become too heavy and packers will discount the over-weight carcasses. That has left many wondering where those 800,000 hogs have gone. The best explanation is that USDA's survey grossly over-estimated the number of pigs born this spring. We think the actual March-May pig crop may have been up only 2.3%, rather than the 4.3% increase that USDA reported. Slaughter levels have increased seasonally, but the industry is still killing fewer than expected for this time of year. **Table 1** provides a look at how weekly slaughter levels have transpired since September and compares that with what USDA's estimate of the March-May pig crop would have implied.

> Cutout expected to push down to **$70** area by mid December

DOMESTIC PORK DEMAND

We don't mean to imply that kills will be small during the next couple of months--they will not. We currently project at least a couple of weekly kills in November that approach 2.7 million head per week and those would be all-time records. But even that will not be enough to match up with the March-May pig crop estimate, so USDA will likely revise that estimate lower when it releases its next issue of *Hogs and Pigs* on December 21. Rising Q4 slaughter levels will put more pork on the market and that should pressure prices lower. The cutout has been working slowly lower since it made a near-term top shortly after the hurricane in mid-September. Currently, the cutout is holding in the $77-78 range, but the additional production in the next few weeks is expected to push it down to the $70 area by mid-December. The belly primal has been propping the cutout up over the past few weeks. **Figure 1** shows the contribution of each of the major primals to the cutout over the past month and it's clear that the belly primal is the only one that has increased materially since late September. All of the other primals have been lower or unchanged. The problem with having one primal providing most of the support for the cutout is that when that primal starts to fade, the cutout can fall rapidly. The belly market is acting like it is in the process of making a top and could be heading lower relatively soon. When that begins, the decline in the cutout will be much swifter than what we've seen over the past month. **Figure 2** provides a look at our belly primal forecast. Our price forecasts for all of the major primals can be found in **Table 2**. Our recommendation to pork buyers is to remain close bought where possible and wait for lower pork pricing to come later in November.

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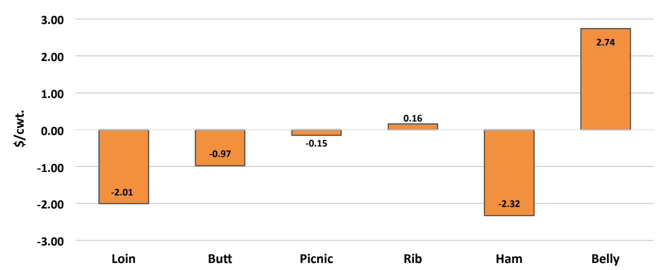
Table 1: 2018 Q4 Hog Slaughter Compared to the March/May Pig Crop

Week Date	9/5/18	9/12/18	9/19/18	9/26/18	10/3/18	10/10/18	10/17/18	10/24/18	10/31/18	11/7/18	11/14/18	11/21/18	11/28/18
Week Number	1	2	3	4	5	6	7	8	9	10	11	12	13
Pig Crop Projected Sltr	2,256	2,554	2,577	2,566	2,589	2,603	2,633	2,595	2,634	2,629	2,655	2,409	2,585
Actual Sltr	2,215	2,315	2,341	2,568	2,503	2,489	2,589	2,569	2,614	2,660	2,690	2,380	2,710
Weekly Over/Under	-41	-239	-236	2	-86	-114	-44	-26	-20	31	35	-29	125
Cumulative Over/Under	-41	-280	-515	-513	-599	-712	-756	-782	-802	-772	-737	-766	-640

Table 2: JSF Hog and Pork Price Forecasts

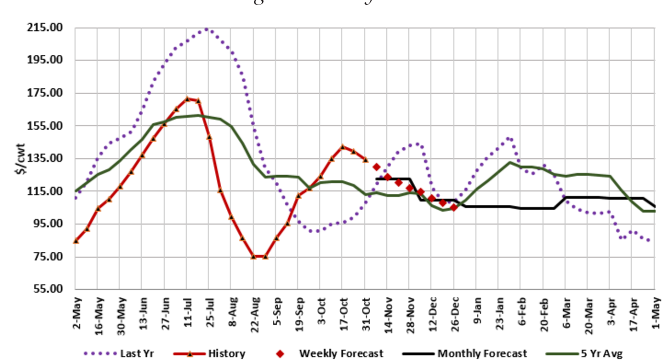
	7-Nov	14-Nov	21-Nov	28-Nov	5-Dec	12-Dec
Pork Cutout	74.7	73.0	72.1	71.7	71.3	70.8
Loin Primal	70.2	68.4	68.5	69.0	69.2	68.5
Butt Primal	87.2	84.6	82.4	81.7	82.0	83.3
Picnic Primal	52.4	53.3	53.0	51.8	50.3	48.7
Rib Primal	117.7	118.2	117.6	117.8	118.8	121.1
Ham Primal	51.4	50.4	50.6	51.1	51.6	52.4
Belly Primal	129.8	123.9	120.1	117.1	114.5	110.6
Lean Hog Index	59.6	55.8	53.6	52.7	53.9	55.5

Figure 1: Primal Impact on Pork Cutout



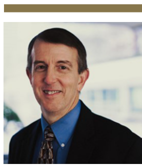
From Sep 28, 2018 to Oct 29, 2018 - Cutout Chg = -2.56

Figure 2: Belly Primal



CONCLUSION

How the falling cutout will affect the price of hogs is a function of the amount of leverage that packers have over producers. Normally, in times when the available hog supply approaches the upper limit on packing capacity (as it will this quarter), packers are able to expand their margins and most often that comes at the expense of hog prices. Pork packing margins have been excellent for several years now and that's a main driver of why new capacity has been added in the last year. Right now, we estimate that packing margins are near $20/hd. Last fall, during the peak kills in Q4, packer margins reached $35/hd. The new capacity might prevent packer margins from getting quite that large this year, but $30/hd margins are a distinct possibility. With the cutout expected to continue lower and margins expected to get larger, this suggests that hog prices should continue on a downward trajectory during November. We currently project the Lean Hog Index near $55 when the Dec futures contract expires in the second week of December. The futures market has recently traded the Dec contract near $59, so clearly there is some disagreement about how low hogs will go this fall. The 2019 futures contracts all look way too high relative to our fundamental forecast, but it is likely that traders in the 2019 issues are building in an ASF "risk premium" in case the disease spreads wildly, forcing China to import large quantities of pork next year and thus raising price levels in the US. We currently put the odds of a major ASF event in 2019 at 20%, but that is not an insignificant risk given the magnitude of the price increase that could materialize if ASF results in the demise of millions of hogs in China and elsewhere.



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