Daily Livestock Report

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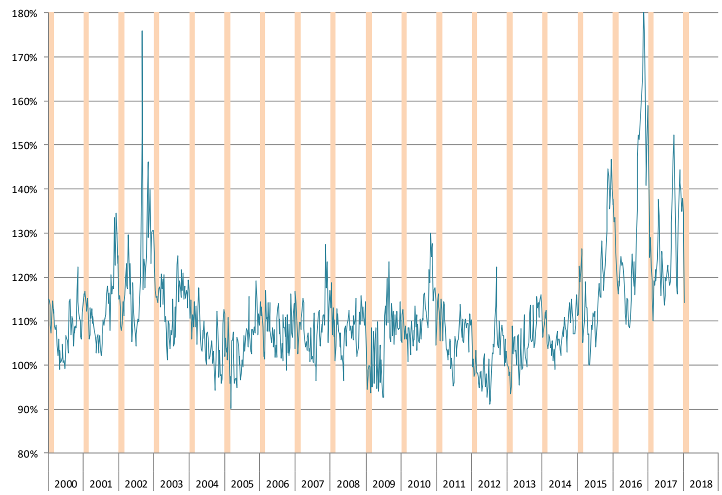
While it is normal for cash hog prices to get some support at the start of the year, the sharp gains in recent days have caught a number of market participants by surprise. Futures have responded by pushing nearby February lean hogs to contract highs (although they appear to have backed off this morning). One way to look at hog values is to examine their relationship to wholesale pork values (pork cutout) and consequently to the processor meat margins. Seasonally hog supplies are the highest in Q4 and pork packers will often bid prices lower, in part because there are more hogs available but also because some of those hogs will need to be processed on Saturday and thus incur higher costs. Hog supplies seasonally decline in January and packers will compete more vigorously to run full shifts during the week. The chart to the right shows a long run ratio of the pork cutout to the IA/MN lean hog carcass price. Keep in mind that the IA/MN price is a base price and thus needs to be adjusted if you want to do an apples to apples comparison with the CME hog index.

What does the ratio tell us? First, it tells us that in most years we expect the ratio to decline from the last week of December to the last week of February. In other words, the packer margin most of the time gets compressed in the first two months of the year. Since 2000, the ratio declined in 15 years, it was flat in one year and it was up only in 2007 and 2013. The average decline in the ratio during this entire period was 10 percentage points. However, in the last two years we have seen a much more dramatic decline in the ratio than in previous years. This ties directly to the capacity constraint issues during Q4 of 2015 and 2016, which significantly inflated packer margins. More processing slack caused margins to compress much more sharply during those two years. At the end of February 2016 the pork cutout ratio to IA/MN lean hogs was 116%, 20 percentage points from what it was at the end of December 2015. In February 2017, the ratio of the cutout to cash lean hogs was 110%, an astounding 49 percentage points compared to the ratio in December 2016. And this brings us to this year. At the end of December 2017 the ratio of the cutout to hogs was 134%, on the high end of the historical range. For the ratio to collapse (which is the historical norm), you either need the pork cutout to increase in value or you need lean hog prices to increase. The pork cutout tends to struggle in the last week of December and early January, largely because ham prices lose ground once Christmas needs are covered. That was again the case this year. Rather, the decline in the ratio has come, as it mostly does, via higher hog prices. What has been astounding is the rate of the decline, with the ratio last night at 114%, 20 percentage points compared to just two weeks ago. One thing that we note is that the meat margin does not go to zero (this would mean a ratio of 100%). The lowest it has been was 105%. With new pork processing plants likely in full operation by the end of February, we would expect the ratio at the end of February to be under what it was last year (110%). If the pork cutout manages to climb to the low 80s, possible given current trend in hams and bellies, this implies cash hog prices in the low 70s, hence futures currently trading at those levels. What bears watching in the next couple of weeks are cutout trends, especially for hams and bellies.

RATIO OF PORK CUTOUT VS. IA/MN LEAN HOG CARCASS PRICE

Weekly. USDA Wt. Avg. $/cwt. Shaded Area is For Jan/Feb.



Ratio of Pork Cutout to IA/MN Lean Hogs at the end of February

Weekly Data. USDA Wt. Avg. Prices. Data from USDA/AMS. Analysis by Steiner Consulting