

A hot point of discussion the past few weeks has been the status of packer margins in both the pork and beef sectors. As you can see in the diagrams at right, while margins have certainly tightened for pork packers, they have fallen off a cliff for beef packers.

As always, readers should note that the margins depicted here are GROSS margins. They do not estimate packers' profits. They estimate the amount of money packers have to pay for plant, equipment, labor, transportation, energy and any other costs. Whatever is left over is net profit. We do not try to estimate packer costs because we have very little data and, based on our knowledge, those costs differ considerably from company to company and plant to plant.

What is surprising in that margins could get this bad this quickly after packers in both species have managed margins so well over the past few years. There have, of course, been many ups and downs — even more than these charts show since we use 4-week moving averages to smooth the data a bit. The raw weekly data is VERY noisy. Why the big declines?

The situation for pork packers is perplexing indeed, primarily due to its timing. Pork margins frequently get tight in the summer (as they did last year) when hog supplies decline. Packers need to maintain throughput to support labor forces, minimize unit costs of plant, equipment, etc., maintain customer relationships, etc. They chase the limited supplies hard, bidding up prices and damaging margins in the short run in order to manage their long-run business.

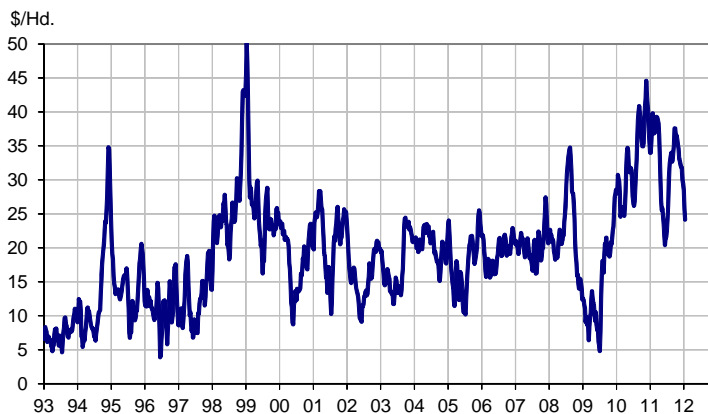
Hogs, though, have hardly in short supply this past fall. Pork packers, as a group, ran near capacity for much of the fall and meat margins (the difference between the cutout value and the cost of the animal) were above \$10/head in late November. See the margin component chart on page 2. Meat margins began declining in December and were negative for the weeks of January 7 and 14, the last two weeks for which data are available. Why have packers continued large slaughter runs (+4% and +2.5% from 2010 levels the past two weeks) at negative meat margins? Is there something coming on the demand side that will reward them for maintaining volume? Are they fighting to maintain market share in spite of short-term losses? All of those would explain this behavior. We think negative meat margins will be reconciled sooner rather than later, though, so expect some pressure on cash hogs unless stronger cutout values appear quickly.

The beef side is, in our opinion, much more of a capacity-driven situation. The beef packing sector has been over-sized relative to cattle numbers for some time. Some reconciliation has occurred over the past few years (Tyson's closure of its Emporia, KS plant being the most notable) but there is still more capacity than can be profitably supported and that situation is going to get MUCH worse over the next 18-24 months. Just how much worse will be answered to some degree by this afternoon's Cattle report.

This margin situation has been brewing for some time as well. The margin component chart on page 2 shows that meat margins for beef packers have been negative for the vast majority of weeks since mid-2010. The situation has become critical since October 1 when the beef margin hit -\$105.89. The low, so far, was Christmas week at -\$123.59.

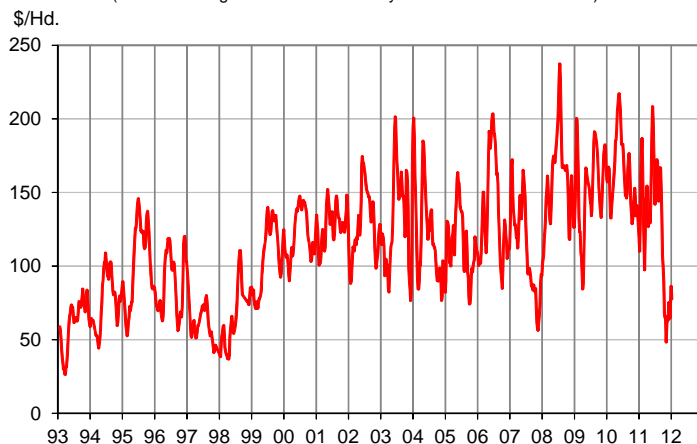
EST'D GROSS PACKER MARGIN - PORK

(4-week average of Cutout Value + By-Product Value - Live Cost)



EST'D GROSS PACKER MARGIN - BEEF

(4-week average of Cutout Value + By-Product Value - Live Cost)



But there are more cattle in feedlots now than last year, you might say. Yes, but that doesn't mean there are more market-ready cattle in yards. Early placements of light-weight cattle began last winter when wheat pastures were short. They continued in a big way last summer when grass pastures failed. The flow of these light-placed cattle to market has been very difficult to predict and we would argue that packers' behavior, slaughter levels late in 2011 (even considering the two snowstorms in the southern plains) and prices are evidence that market-ready supplies are tight. And they will get even tighter.

One bright point for both species — and the saving grace for total packer margins — is the value of by-products. Exports of pork variety meats and a rebound in cattle hide values had by-products at record levels this fall and they should remain high in 2012.

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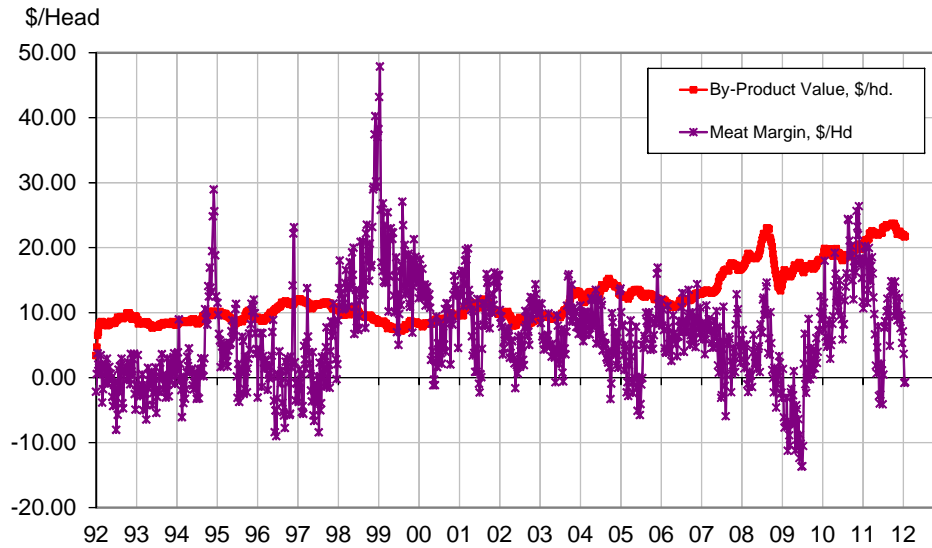


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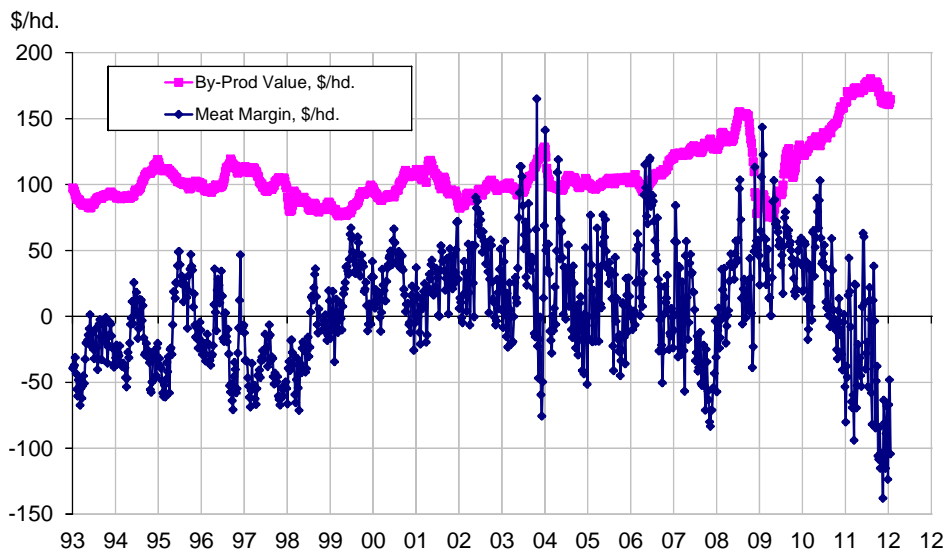
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PORK PACKER MARGIN COMPONENTS



BEEF PACKER MARGIN COMPONENTS



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