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Livestock Market Situation and Outlook – 2003-04

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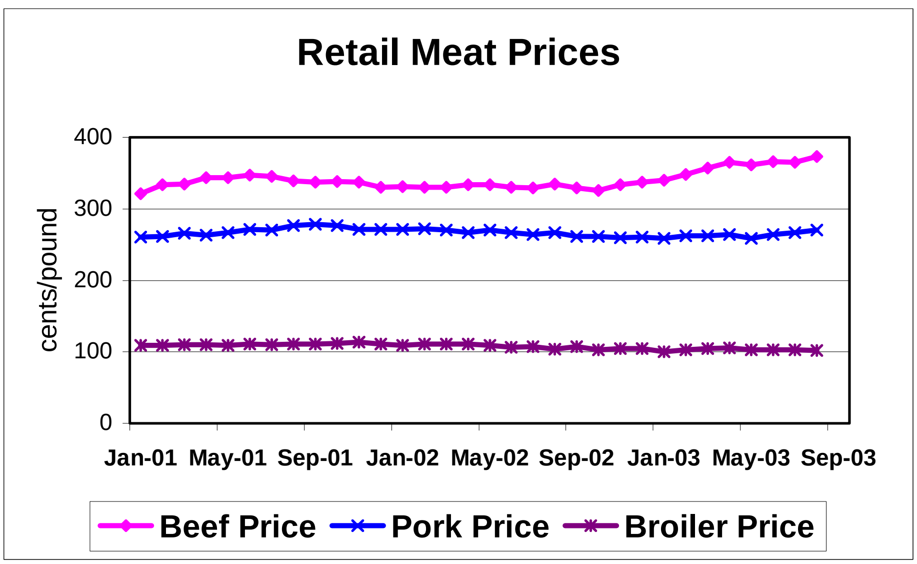
Consumers can expect increasing prices at grocery stores and restaurants for meat products over the next year. Almost everyone in North America has heard about the BSE ("mad cow disease") case in Canada during May. That situation was a catalyst for the U.S. beef market. Supplies had been adequate for demand. But, the immediate elimination of three percent of our supplies of beef and of slaughter cattle caused a fundamental shift in the marketing patterns of feedlots. As price went up, feedlots quickly sent cattle to market because they expected prices to come down in the near future. As a result, cattle went to market at lighter weights and at lower quality grade. The reduction in supply further added to cattle prices. Prices went from $75 per cwt. up to $90 from July to mid September.

These higher cattle prices are being supported by higher wholesale and retail prices. Wholesale beef prices are up 40% from last year's level. Retail prices in August were 17% over the 2002 level. There is anecdotal evidence that retail prices increased 10% in September. It seems that consumer demand – in terms of willingness to pay, remains strong, allowing much of the increased wholesale price to be passed on to consumers. Over the next year, prices are likely to stay at high levels, and consumers are likely to shift at least some of their purchases to other meats, and perhaps reduce total meat consumption. The USDA is predicting a three pound per person drop for 2003 beef consumption, with another 2 pound decline for 2004 – as a result of lower production, NOT due to weak consumer demand.

Modest reductions both pork and chicken supplies expected for the next year mean that consumers will not find an abundant alternative product in the meat case. Since May, retail pork prices have gone up four percent, with chicken prices holding steady.



Tight Slaughter Cattle Supplies will Support a Profitable Feeder Cattle Market

The only way to understand the current beef market is to think in terms of both demand and supply. While most of the data available focus on beef and cattle supplies, demand appears to be just as important as supply in understanding what is driving the market toward the current record high prices levels.

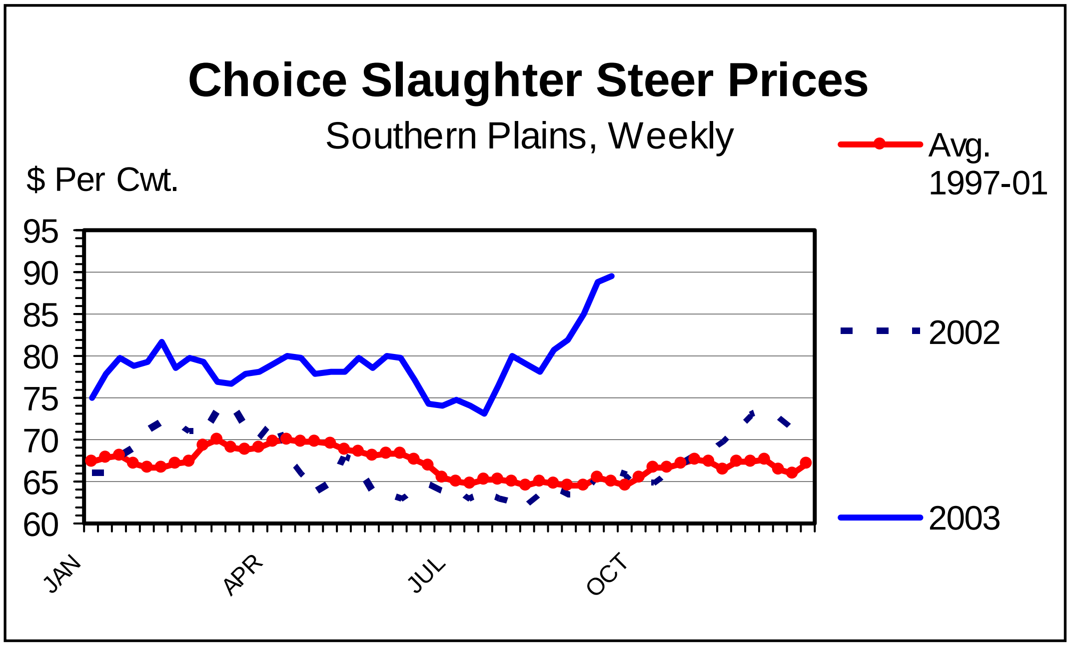
According to analysis of retail prices and product movement (conducted by Dr. Wayne Purcell and the Research Institute of Livestock Pricing at Virginia Tech), demand (that is, the relationship between prices and pounds consumed) was up 4 percent during the second quarter of 2003. Because of delays in the release of retail price information, there is a two month delay in demand data. Still most evidence suggests that demand remains extremely strong. The impact of strong demand is that the quantities of beef that consumers take home are not being greatly affected by the increasing retail prices described in the introduction. Consumers are eating slightly smaller quantities of beef at substantially higher prices.

There is not clear evidence yet on just what is fueling the strong demand. Research has focused on expenditures, but also shows that the development of convenient products and food safety are keys. Many believe that basic attitudes about the role of beef in a healthy diet are changing, but that has yet to be documented.

Trade is an important component of demand. The U.S. exports about 9 percent of its production. Japan, Mexico and South Korea are the number 1, 2, and 3 destinations. Together they account for more than 80 percent of exports. Exports are being distorted by the Japanese “Safeguard” tariff and the Canadian BSE situation. Most forecasts are based on the assumption of “normal” trade flows for 2004.

Snapshot of the Slaughter Cattle Situation – Slaughter cattle prices were below breakeven prices for most of 2002. Feedlots kept placing cattle on expectations of higher prices, which just didn’t materialize. Even though slaughter was only up one percent for the year, production increased by almost 4 percent as average dressed weight hit a record high level of 758 pounds (equivalent to a 1200 live weight at a 63% dressing percentage). Coming into 2003, feedlots were becoming more cautions with their placements and the number of cattle on feed was below year earlier levels.

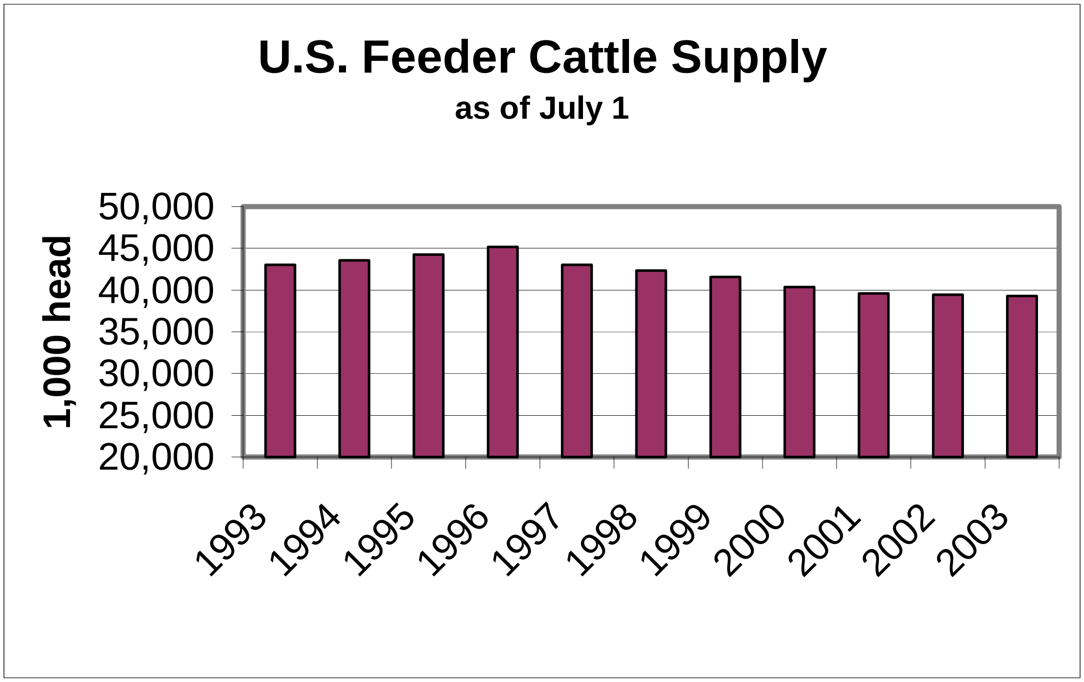
During the summer, the situation began to change dramatically. The Canadian BSE situation was the spark, but is being given too much credit for the record high prices. About 3 percent of the U.S. beef supply comes from Canada. The U.S. also imports about 3% of its slaughter cattle from Canada. The reduction in these beef sources has helped increase cattle prices. But, just as significantly, domestic beef supplies have been declining because of a 20 pound (3 percent) drop in average carcass weights because of marketings being so current. This trend will result in longer term strength in cattle prices, because as cattle go to slaughter there are fewer cattle coming out of the feeder cattle system to replace them. The September USDA Cattle on Feed report indicated that the inventory is down 3 percent, even though placements were up 7 percent. Expectations of profits and drought in the Great Plains encouraged the high level of movement into feedlots.



Source: Livestock Marketing Information Center

Slaughter cattle prices in September will most likely have exceeded the previous record high month (August, 1990 - $77.18/cwt.). Prices are likely to decline, but are still likely to end the year with a fourth quarter average in the low $80s. For 2004, the Canadian situation will be important. Even if the northern U.S. border is not opened to cattle imports from Canada, Canada is likely to push a larger number of cattle through its own facilities and export beef to the U.S. The net effect will be a longer run, but declining impact of BSE in Canada on U.S. markets. Prices for slaughter cattle in 2004 are likely to average in the upper 70s. But, because supplies will be tight, if bad weather significantly hurts the performance of feedlot cattle, prices could easily return to the $90s.

Feeder Cattle are Coming Along for the Ride – Feeder cattle prices have been pulled along by the strong slaughter cattle prices, but may still not be at their tops. There is a strong expectation/worry that the opening of the Canadian border will cause slaughter cattle prices to fall. Futures markets clearly reflect this situation. The October contract is trading in the upper $80s, but the April04 contract price is $78 (as of Sept. 24, 2003) and the June04 contract is at $72. Feedlots are bidding according to the futures prices. If the fundamental factors do keep the market for slaughter cattle in the low $80s, feeder cattle prices will be bid up above the current levels.



This strong demand for feeder cattle is confronting an increasingly tight supply for feeders. The number of feeder cattle estimated outside of feedlots is 13 percent under the level of 1996. This is a consequence of the cattle cycle. The U.S. is in the longest cattle cycle known – and it is likely to be 2 to 3 years before expansion, in terms of a larger cow herd, shows up in inventory reports.

The strong demand and tight supply provide reasons for very profitable prices through 2004. Feeder steer prices (4-5 wt.) are likely to continue to sell around $100/cwt. Steers in the 6-7 wt. class will be roughly $90/cwt. Last winter, because of high expectations for slaughter cattle for February sale, heavy yearlings were selling at about the same prices as calves 200 pounds lighter. This same situation could happen this winter.

The backgrounding enterprise is expected to be profitable if price slides follow normal patterns, which is not very likely this year. Typically a steer calf purchased in October will be sold as a yearling in March with a $13/cwt. negative slide. If so, backgrounding could return $80 to $100 per head over cash expenses. However, if prices follow current futures markets, those yearlings will be sold at breakeven levels.

Long Run Prospects – Because there is no evidence yet of rebuilding the North American cattle herd, most analysts expect tight supply factors to hold feeder cattle prices at high and profitable levels. It appears that the number of cows in the Southeast is increasing, but the drought in the West is holding back expansion beyond the Mississippi. Initial efforts to expand will pull heifers out of the beef chain, leading to even higher short term prices until the calves from those heifers eventually reach the consumer.

In spite of all the good news, the Canadian experience with BSE is a real world reminder that disaster can strike quickly and with broad consequences. Producers, especially those without high levels of equity, may want to use tools such as options, to protect against unlikely but major prices crashes, such as those which hit Canada due to the BSE case.

High prices can be an excuse to slack off on management improvement. However, it can also be a time to use the added income to improve productive efficiency through strategic investments. Such an approach can lower costs and prepare the enterprise for longer term profitability.

Lamb Prices are Strong in a Declining Industry

Increasingly tight supplies are driving lamb prices up. Choice slaughter lambs averaged $72 per cwt. in Texas during 2002, they are likely to average near $90 this year, and are expected to be even slightly higher in 2004.

As of July 1, 2003, the U.S. sheep and lamb inventory was 4 percent below last year's level – following a trend of declining numbers. Drought in the West, along with uncertainty of markets and strong competition from Australia are key reasons for the decline. For the first half of 2003, lamb and mutton production was down about 12 percent.

Imports now make up about 45% of the U.S. consumption. A 9 percent decline in imports has contributed to the higher prices. Drought is not only a problem in the Great Plains region of the U.S. – it is also leading to flock reductions in Australia. As a result, imports will continue to decline and support a strong U.S. lamb market through 2004.

Hogs Prices are Expected to Be at Profitable Levels

The hog industry has made remarkable changes over the past 10 years in structure and productivity. Firms like Smithfield and Tyson have become large processors. The size of production units have changed dramatically. According to the U.S. Pork Industry Structure Study of 2001 (led by the University of Missouri), in 1991, 43 percent of the hogs marketed annually came from operations selling fewer than 2,000 hogs per year, while only 9 percent came from the 50,000 and up head per year operations. By 2000, the smaller category only accounted for 9 percent of the marketings while the largest size category produced 51 percent.

U.S. Pork Industry Structure Study, 2001

U.S. Marketings by Producer Size

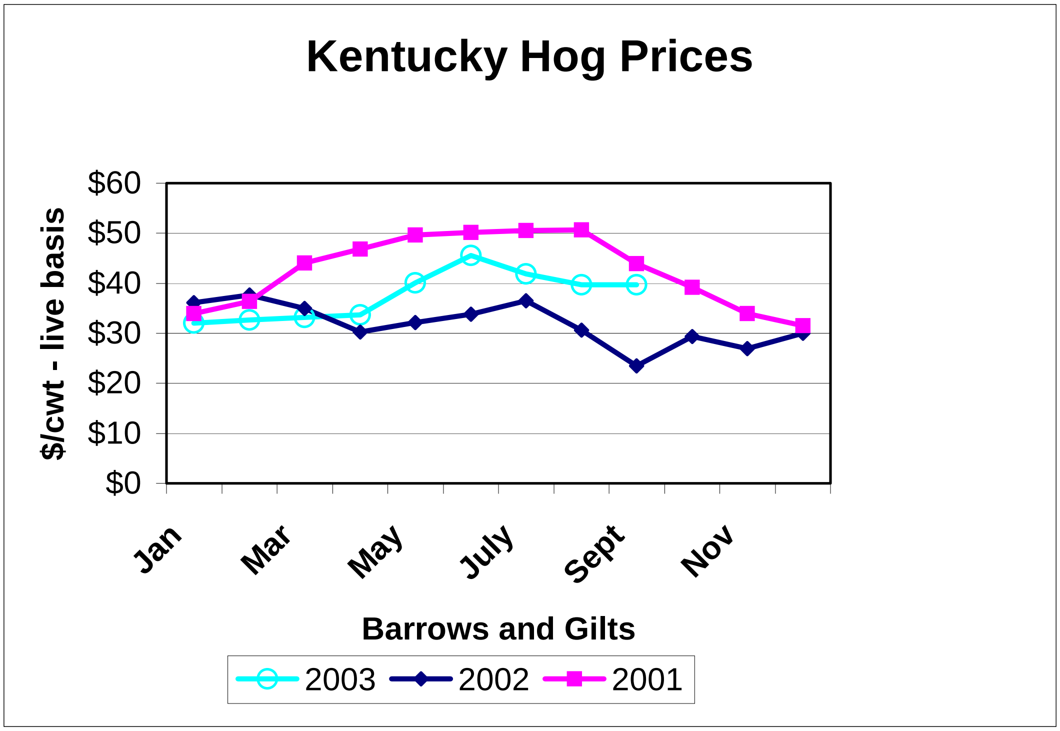
Hogs marketed annually	1988	1991	1994	1997	2000
Under 1,000	32%	23%	17%	5%	2%
1,000-1,999	19	20	17	12	7
2,000-2,999	11	13	12	10	5
3,000-4,999	10	12	12	10	7
5,000-9,999	9	10	12	10	10
10,000-49,999	12	13	13	16	18
50,000 & up	7	9	17	37	51

University of Missouri, Iowa State University, National Pork Board, Pork magazine, PIC, Land O'Lakes, Dekalb Choice Genetics, and Research Institute for Livestock Pricing

Productivity improvements have followed. In the past 20 years, pigs per litter have gone up to 8.7 compared to 7.2 and litters per sow per year have gone from about 1.6 up to more than 2. Finally, carcass weights have risen to 197 pounds compared to 170 in 1980. The result has been a combined annual rate of productivity growth (measured in pounds of pork produced per sow per year) of 4 percent. With demand increasing about 1.5 percent annually, it is obvious that the number of sows (and the number of increasingly large operations) needed to meet consumer demand is declining.

Market hog prices averaged about $35/cwt.during 2002, slightly below the cost of production. The losses led to cuts in the size of the sow herd and lower production. Total pork production for 2003 is expected to be about 19.5 billion pounds, a drop of about 1 percent. The September Hogs and Pigs report gives an indication of production levels for the next year. With a breeding herd down 2 percent, the stage is set for even lower production and a continuation of profitable prices. Fall farrowings (producing the pigs that will be harvested in early 2004 are predicted to be 2 percent under the year earlier level.

Trade, especially with Canada, significantly complicates the situation. The simplest way to describe it is that the net amount of pork (meat) imported from Canada is equal to about 4 percent of U.S production and that the 5.7 million hogs imported from Canada add about 6 percent to U.S slaughter. The bottom line is that about 10% of the U.S. pork industry has Canadian origins. However, about 7 percent of total production is exported to countries other than Canada (Japan and Mexico take two-thirds), significantly balancing the international trade equation.



For 2004, producers should expect prices in the mid $40s, roughly $3 to $5 per cwt. over the cost of production. Seasonally, prices are expected to average in the low $40s into summer and then increase into the mid $40s. Obviously, there is more uncertainty the later in the year, but production may increase pushing prices down near the breakeven point.

Broiler Industry is Adjusting to Lower Exports

In 2001, about 18 percent of broiler meat was exported. Historically, the U.S. consumes large amounts of white (breast) meat and a large amount of dark meat (leg quarters, etc.) is exported. Led by Russia bans in 2002, exports dropped by 17%, putting the equivalent of 3 percent more broiler meat on the domestic market. The result has been flat broiler prices. Still, the USDA estimates that the industry will remain profitable.

Forecasts for the next year are for small increases in broiler production. Increasing demand will help boost prices by 3 to 6 percent over the next year as consumers and the food service industry substitute chicken for increasingly expensive beef. At the same time, exports may increase and add to demand if Mexican trade increases as expected.

Kentucky production is expected to continue expanding, as one of the major processors expands processing capacity and adds 100 to 200 more broiler houses. As a result, production levels in Kentucky may expand more than the national industry.