M&R Capital 2016 Outlook

As the market transitions into 2016 there will be many cross currents affecting our trade. Outside market influences and systemic fears surrounding China seem to be invigorating the continuation of the macro commodity bears. However, as it pertains to cattle, many of the leading indicators that pulled cattle down into a historically large decline have stopped and reversed course while other lagging indicators have merely stalled or stopped. One thing we need to be respectful of is the macro traders and the back trading fundamental guys that are caught using 6-month old news and don't forecast new developments. In addition, the trend followers have become a powerful bunch regardless of the fundamental pulse of the cash markets or events coming down the pipe. These are the same characters that pulled prices from $165-$175 when it was not needed and seemingly are doing the opposite thing with trade here from the $120-$130 area. Too many times we seem to be caught in headline news trading or even incorrect news trading. The recent environment has many traders struggling to understand why the exchange even calls it a futures market. With that in mind, this is a recipe for continued volatility and opportunity could surface. These next several months should be an exciting time for our market. We will talk more about that in this newsletter, but before we do we need to be very mindful of a few structural things that will surely dominate the trends and the market for 2016.

1. **Vertical Integration.**
   - Our recent volatility in pricing continues to negatively affect almost every cash market participant of all sizes. It is taking people away from the market and at a minimum changing the way their businesses interact with it. Commercial relationships with producers, retailers, and packers will get stronger and the desire to use the exchanges as a large part of their business needs (basis) will become less necessary. This is how the vertical integration process starts. Basis variability increases and equity positions are affected from such violent flat price trading patterns. Whether that is week to week or month to month, participants simply don't have the financial power to be in the market or they need help from other partners in the business. It will start slow and take a long time but we are at that point where people are looking to change things. This integration will definitely lead to less open interest on the Chicago exchange as we transition out. The basic concept here is that commercials can invest their capital they are using on their exchange positions to instead invest into their business for physical relationships and ownerships that have a real payout and actually add value to their business rather than dwarf it. This helps them better manage risk, something the CME has lost site of in recent years.
2. **High Frequency Traders (HFTs).**
   - The transition of markets being controlled more by short term high frequency trading engines has been a challenging situation. Without question we have to plan on this concept only expanding. The key for the powers that be will be to maintain a level playing field for all market participants. If not this will come at the expense of less fundamental traders and tied to our first bullet point above. Despite aggressive industry efforts to change this development the exchanges have made their focus and direction very clear. CME did, however, announce that as of February 1st they are going to attempt to put a governor on the ability of the HFTs. Until this announcement market participants were unaware that the livestock markets were only markets at the CME in which HFTs were allowed to flood with unlimited orders vs actually trading. We shall be watching to see if this changes the market's heartbeat. Overall, until these issues are resolved the open interest has peaked and will get smaller as the year unfolds.

9047 Poplar Avenue, Suite 101, Germantown, TN 38138

newaccounts@mnrcapital.us • Tel: 901-766-4446 • Fax: 901-766-4406

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3. **Cash Market Price Reporting.**
    - Over the years a growing number of feedlots have marketed their cattle on a formula tied to the 5 area state average (TX, KS, CO, NE, IA). This is changing. Many traders have determined that one geographic area has been setting the price for the entire trade. Over the years the trends in this area have been challenged at best for market pricing leading to mostly willing sellers of cattle $2 to at times $6 under the other states. As a result of these depressed sales efforts traders are now deciding to quit accepting this average price and are starting to become a force in setting that price. We should begin to see volumes grow as a result of these changes in the cash reports.

Here are some bigger picture views on my expectations for 2016. Please keep in mind that the livestock markets are new crop markets pretty much every month so things change with the wind as compared to most annually produced and storable markets.

1. Weather has been wet and muddy all fall for most of the winter in the north. This weather affect will continue to bring weights down as we trend into the summer. Wet and cold is the worst thing for cattle in the feedyard. Futures are not currently trading this fact.
2. Australian production will continue to be less and prices will continue higher. Current prices are 150% of 2015 and 200% of 2014. The liquidation that has been seen over the past couple years has been large. Australian supplies should be down in 2016 and in the years that follow. The larger implications from here will affect the spring and summer as the market is able to work through cold storage supplies. This will delay decision making needs affected from the much smaller imported supply and the inevitable higher prices.
3. Futures contracts at a discounts to cash. Throughout the market's declines from 2014 through 2015 futures premiums to cash dominated the landscape. Looking into 2016 the futures markets are at very large discounts to cash. Discounts are the building blocks for bull markets.
4. There are declining domestic supplies. The US domestic supplies are expected to match if not exceed last years record small supplies through the first half of the year.
5. Demand for grinds is getting a strong bump from the fast food chains' recent changes to their $1 menus as well in retail as prices have come down from nearly $6/lbs. last year to between $3/lbs. and $4/lbs. depending on the item. This compares to wholesales prices that have come down from $3/lbs. all of last year to mostly $2-$2.50/lbs. today.
6. Market structure for COF. The "big" cattle that dominated the flow of supplies in 2015 have been cleaned up and the swap to feeder cattle has changed enough that feeders are encouraged to turn cattle faster. This will mean greater marketing rates month over month, lower trends in weights, and a more manageable supply stream. This should help increase the cattle feeder's leverage in the negotiation process for trade from being a price taker to a price maker.
7. Seasonals could be higher into the spring and early summer
8. Long term structural supply and demand signals are bullish. For years the cattle market spent time struggling with the $120-$130 level. Since breaking that price barrier in 2013 it's no surprise that prices are trying to find long term support in and around these very levels. Long term modeling that hurt demand at $160-$170 is structurally rebuilding demand at this $120-$130 area.

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9. Exports have been declining as prices and the affects of the US Dollar trends for the past 2 years have hurt the US trade flows. Looking forward, world markets have seemed to have done all they are able to do with shifting demand curves which have allowed prices to correct to current levels. Long term affects of population growth and limited supply growth (over time) should begin to increase demand for US products; especially in the wake of the severe liquidation that has occurred in the Australian markets over the past two years.
10. Volatility is high so owning options is very costly. The implication here is that we can utilize this market inefficiency through replacing futures only products with these short options products.
11. As always outside market influences seem to be at an all time high for emotional and bearish influences across all sectors. No one seems to be escaping this year's world issues. However, one important issue is that all previous US and world recessionary crisis have been more a result of high priced crude oil not low priced crude oil. While it is currently popular to accept the idea that the sky is falling, in reality it actually benefits the consumer by keeping some money in their pockets. As you might imagine that is always good for the demand side in the S&D equation.

These are some of the grand things I am looking for as we move into 2016.

We are looking forward to a successful year.

Regards,
Scott Shepard
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