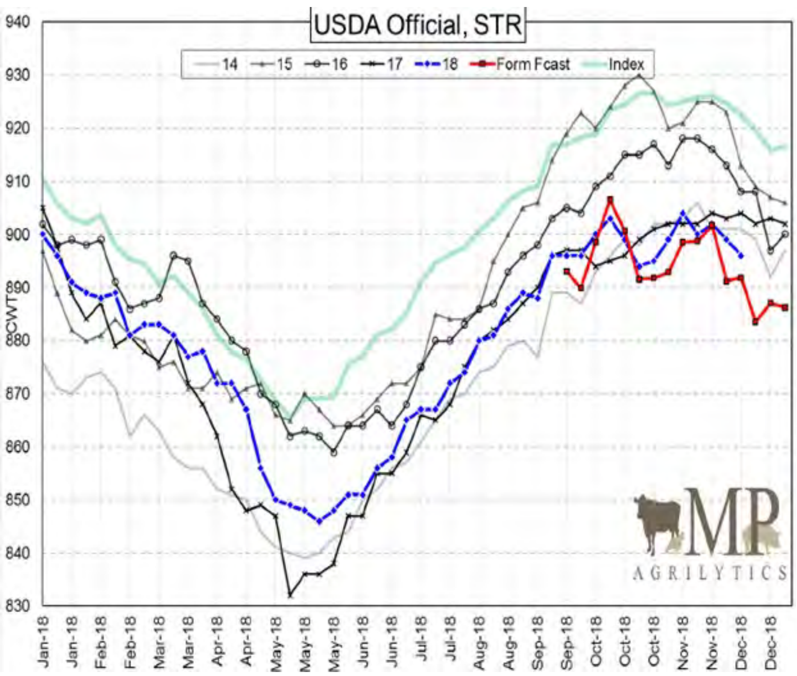
December 2018 Monthly Commentary

Cash cattle prices started the month at $118 and ended at $123 despite a much greater reduction in slaughter rates into the holidays as compared to past years. Winter weather combined with less than expected available supply were supportive to prices. Basis strengthened, consistent with seasonal patterns, with February futures now par with cash at $123. Open interest increased nearly 40,000 contracts during the month, with large increases in April and June adding to the already-large February holdings. Funds will focus on rolling many of their February longs back to the April and June during the first half of January. This rolling may form a temporary market top, but this is not expected to be the ultimate top for 2019. Additional growth in open interest is expected well into the spring and early summer.

	Week Ending 29-Dec		Week Ending 1-Dec
Kansas Cash Trade	123.00	5.00	118.00
Blended Beef Price	211.65	4.72	206.93
February Futures	124.17	3.67	120.50



Weights are falling. It was a very wet fall (record wet) in the northern feeding areas, which has been followed more recently by 2-3 winter storms, leaving behind more precipitation and muddy feedyards. This has hurt performance and yields, which will be difficult to recover. Kansas and Oklahoma were the most recent area affected by snow and ice in spots and up to 3" of rain throughout Oklahoma. Yards are cleaning up now, but cattle weight losses are lingering and more winter weather remains a performance risk over the next 60 to 90 days. Weights are running at/below their recent 5 year lows with a. 20 pound drop in carcass weights representing about a 2% decling in beef production. Should this consistently wet weather pattern persist, it will continue to adversely affect beef production, adding to seasonal support for beef prices heading into the spring months.

Beef prices remain low in relation to levels reached during 2014-15, but closed 2018 well above a year earlier with cattle feeding returns climbing into the black along with packer operating margins. The $200 area appears to be firm floor for beef prices and at a $100/hd packer margin translates into roughly $118 live cattle price. Demand is strong and expected to remain supportive to prices which are expected to follow a trend similar to 2017. If correct, expect a seasonal dip into February ahead of a seasonal surge into the spring. This year will be particularly interesting with several fast food chains are having remarkable success with new quality offerings, driving them into purchasing arrangements beyond the more traditional trim and grind markets. These are new supply chain arrangements and should mean stronger demand, which will become more apparent as fed cattle supplies tighten and weights fall further. Meanwhile, most forecasting experts are still looking at 2018 as their model for pricing--expecting that USDA is still correct in their 2% to 4% larger feedlot inventories coming on the horizon. We disagree and are looking for much stronger prices this spring and early summer. Replicating packer margins near $400/hd like last year, that implies cattle prices at $130. However, if packer margins are $300/hd, that implies cattle prices at $135; at $200/hd, cattle could reach $140 and $100/hd margin translates into a $148 cattle market. This range results in our spring cattle price forecast. Today

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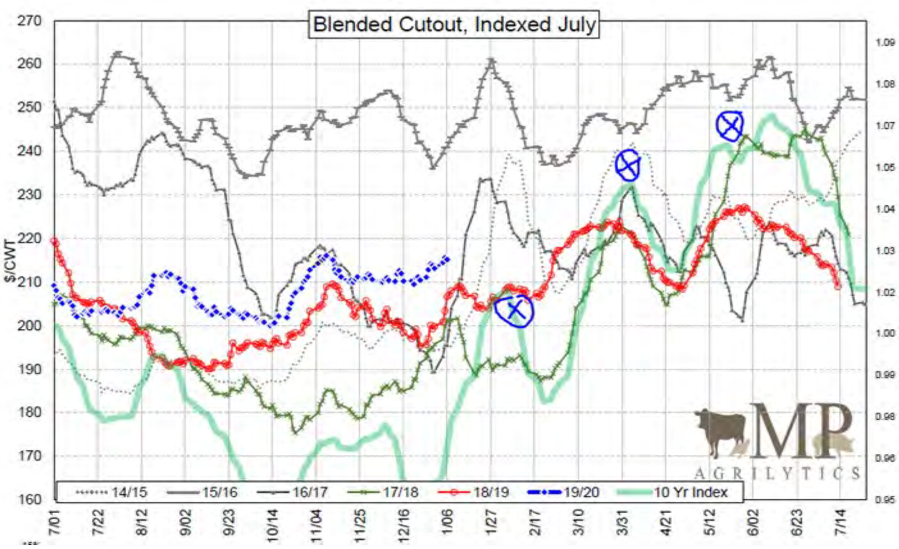
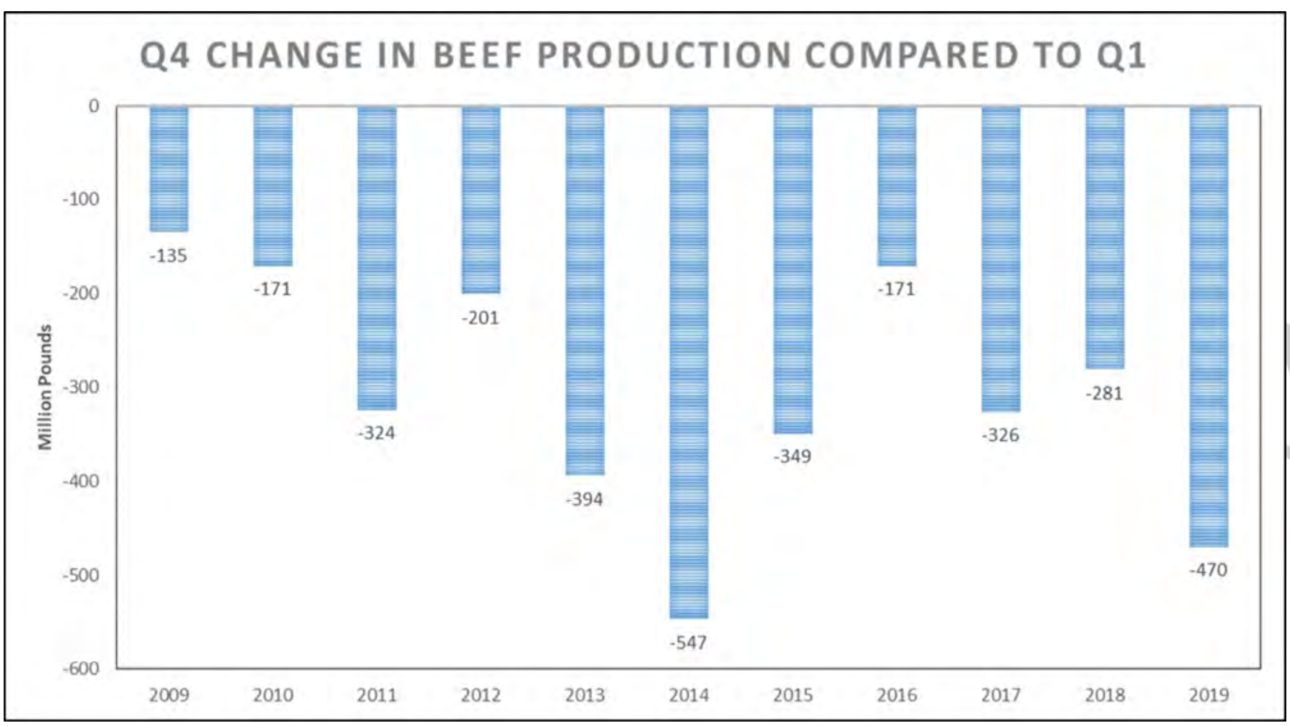
the futures market is reflecting price prospects in the $125-$130 range. A concern is that calves were placed much later this year because of the bad weather and likely means the spring “hole” in supply between yearlings and calves could be greater than normal. This is much different than the 2018 spring supply pattern. This contrasts sharply with many forecasting experts use of last year as their analogous year for 2019 supplies and prices. We expect trim and grinds (hamburger) to be very strong, as well as, middle meat (grilling steaks) demand. And, with lighter carcass weights, 50% fat trim could also move much higher.



Export volumes eroded seasonally into the end of 2018 and should re-engage in early 2019. A much smaller Aussie supply may reduce US imports, shifting the US to a net exporter of beef during the first half of 2019. The temporary truce between President Trump and President Xi is holding as the two sides of this trade war attempt to resolve their differences by March 1. China has been buying US soybeans, rice and pork in the wake of this truce, but progress on other contentious issues are ill-defined as the US negotiating team prepares to travel to Bejing in early January. ASF continues to ravage the Chinese hog industry and prospects for much larger meat exports to China should be supportive to both US beef and pork prices this summer and fall.



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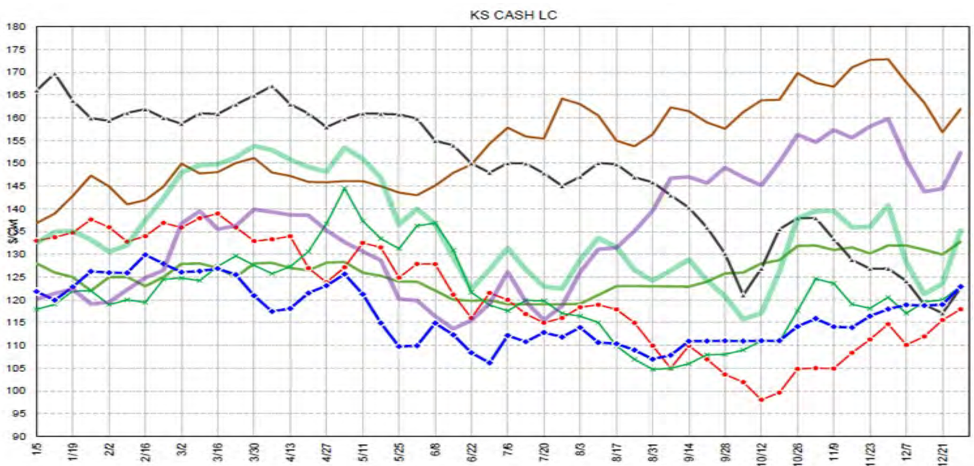
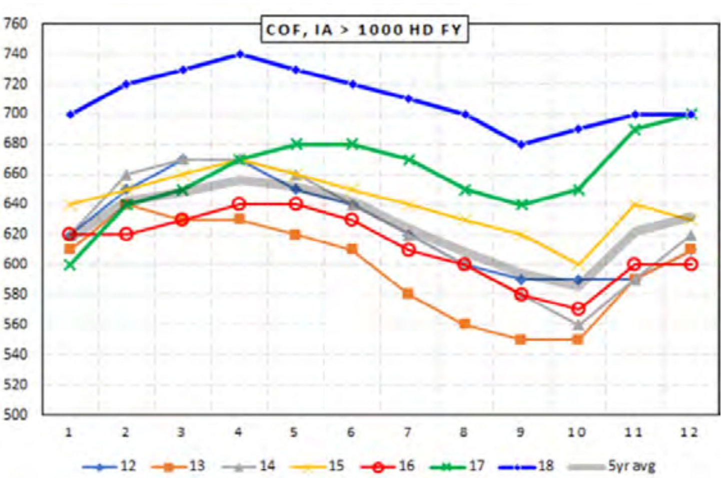
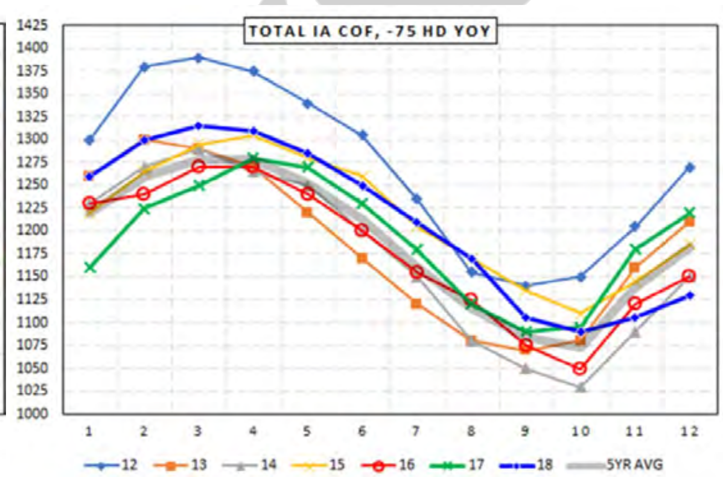
The cash cattle trade should trend higher in the spring, but we are mindful of a potential price correction toward $120-$118 into early February. But, we are more focused on the potential march to the spring highs. April futures over the past five years has moved $20 from contract lows to highs in bearish markets and as much as $40 in bullish markets with the average being roughly $30. This year's contract low was $111, which implies $141 for April futures is reachable. We are quickly moving beyond the time period when cattle can be placed against the April and May time period. As well, weather and muddy feedyards can disrupt performance, pushing cattle away from this period, further into the summer.



One thing I would like to spend some time on this month is the public USDA data that is readily available and used by every market participant to forecast supplies. For clarity this report uses the data for the 1,000 hd and larger feedyards. Unfortunately, the smaller yards can be missed, leading to overestimates and underestimates of the total inventory. The rally that carried to historic highs at $170, likely over estimated supplies by a wide margin and underestimated the subsequent supply ahead of the 2016 drop in prices. This supply variation resulted from changes at the smaller yards. Today we find some interesting data in these same regards. The bigger yards in Iowa have record large inventories. But, when combined with the small yards it's a much different picture. If this data is close to accurate the inventory estimates based exclusively on the larger feedyards may be off by roughly 1.5%. While this is not a big number it can be significant if it occurs during the most inelastic spring demand period. Also, with weights pulling production down roughly 2%, the total beef production short-fall maybe as much as 3.5%. In addition, the 2% larger December 1 feedlot inventory is being buoyed by the far West with a larger volume of Holstein's on feed. Placed on feed at much lighter weights, these cattle will take much longer to become market-ready. So, if the core feeding inventory in the heartland is flat with last year and the USDA feedlot inventory is 1.5% over estimated and weights are down 2%, beef production this spring may be much smaller than suggested by conventional wisdom.





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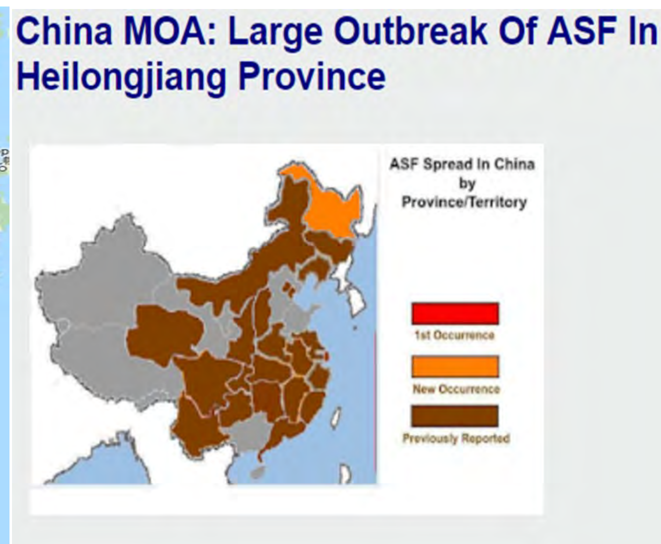
African swine fever (ASF) outbreaks in China continue. This is an epidemic that likely has been under-reported in terms of both infection rate and death loss. We have seen roughly 100 ASF outbreaks from the Chinese Gov't postings across 23 provinces since August 1st. Many of these reports have been in small to medium size herds often numbering lower than 500 head. Over the past month, however, the bigger commercial herds have been hit. Over the past week there have been 2 new cases reported from the NE provinces where the original cases were discovered back in August and September. This suggests the disease is not contained and hints at how tiny the reported outbreak totals might be



compared to actual incidents. These original provinces are where it was supposed to have been found and contained for the most part. ASF is the most deadly disease for pigs known and there is no cure for it yet. Since China has the largest hog herd in the world it will be very hard to fix this problem without further loses in future production as well as needing to import US and European pork. We think the most likely effects of this won't be seen until this summer or fall. However, we are starting to see some very keen interest in hams, suggesting that US hog prices are bottoming. Hog and pork prices should rally from here into the middle of Q1 and eventually well into the summer. If China either buys US pork directly, or indirectly through Canada or Mexico, prices can easily be $75 this spring and $95 this summer. We are starting to engage this market with long calls in April and will look to add long futures or short puts as we see the trade opportunities present.

Thank you to our friends at MP Agrilytics for their data and charts.

Regards,

Scott Shepard

January 4, 2019

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