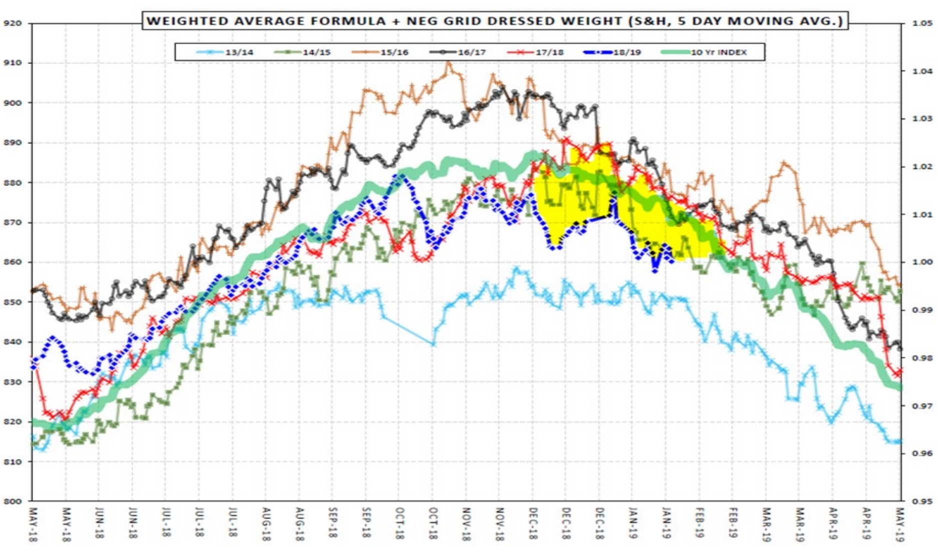
M & R Capital LLC

January 2019 Monthly Commentary

Cash cattle prices began the year at $123 and closed January at $124, despite a continuing industry discussion surrounding kill reductions into mid-February. This is not the first time in recent weeks that temporary kill cutbacks were intended to break prices, but to no avail. The next question is whether kills will be cut further—or add them back? If gearing back up for normal hours for mid-February into March, that should lead to increased packer competition for tightening live supplies compared to recent weeks. This should raise prices heading into late winter and spring. Beef prices inched higher during the course of the month and the blended cutout averaged 3-4% above a year earlier despite the larger fed cattle slaughter. Many items (end cuts and grinds) are at levels which may stimulate forward buying interest from end users. The items that have been performing exceptionally well are the middle meats (or steak items), which have been record high for early winter and are a testament to strong demand for beef. This has been a surprise for this time of year as February is typically one of the worst demand months of the year for middles. So if prices are doing this well heading into mid-winter, what might we see in the coming spring and summer when demand is more inelastic? Funds have been adding to longs, as well as rolling them back to the summer months while commercial hedgers have been very heavy sellers (maybe record shorts). However, because of the government shut down, this data won't be released until they can catch up, perhaps in late February and early March. Weights continue to decline and will erode further into this spring and summer. Winter feeding conditions and feedlot performance in some areas has been the worst in several years. The weight-reducing effects and tightening front-end supplies of fed cattle often are most acutely apparent in late winter and early spring as beef demand strengthens seasonally. In summary, if cash prices hold in $122-$125 area in the midst of a seasonally weak demand period what might they be this summer when demand is more inelastic? Basis has been weak and is expected to remain weaker than the shorts would appreciate.

	Week Ending 1-Feb		Week Ending 31-Dec
Kansas Cash Trade	124.00	1.00	123.00
Blended Beef Price	213.71	2.06	211.65
April Futures	126.28	0.50	125.78



Weights are still falling. It was a very wet fall (record wet) in some areas and has been followed by periodic winter storms leaving behind wet, muddy feedyards and colder than normal temperatures. This has hurt performance and yields, with little opportunity for cattle to recover. Although the past few weeks have helped some yards clean up, but the damage to feeding performance was more like "losing 30-45 days of gain" with some cattle down 2% to 3% on red meat yields and weights roughly 50 pounds under last year while affecting industry averages by a more moderate 15 pounds. However, in the wake of these few weeks of cleanup, there will be more moisture coming in the weeks ahead and might possibly set things back again. Colorado and Texas have remained in great shape, so a wetter late winter or spring in this areas will be watched closely. Because of the government shutdown, release of the official USDA weight data is delayed, but all indications point to continuing weight declines. Keep in mind every 3% reduction in weights, or a move from 870 lbs to 843 lbs, is similar to a 15,000 head per reduction in fed cattle slaughter.

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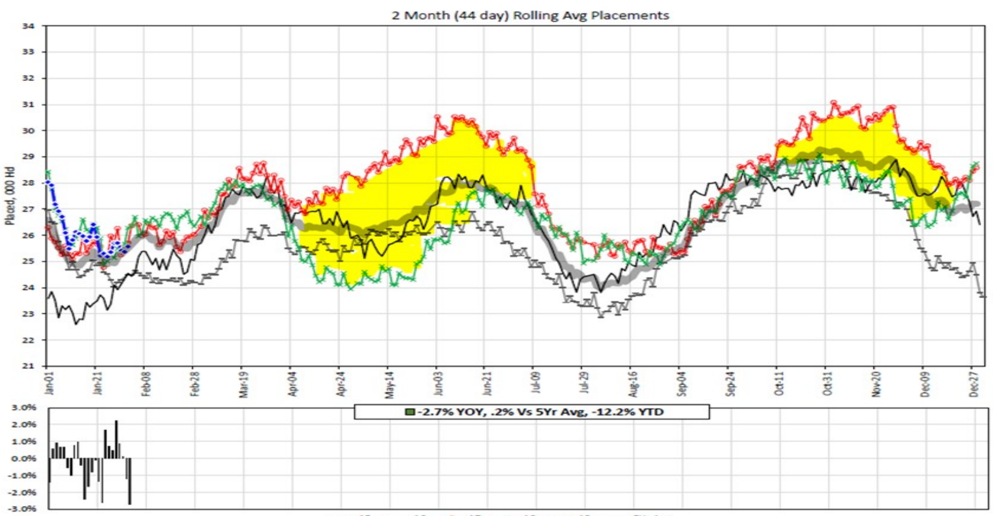
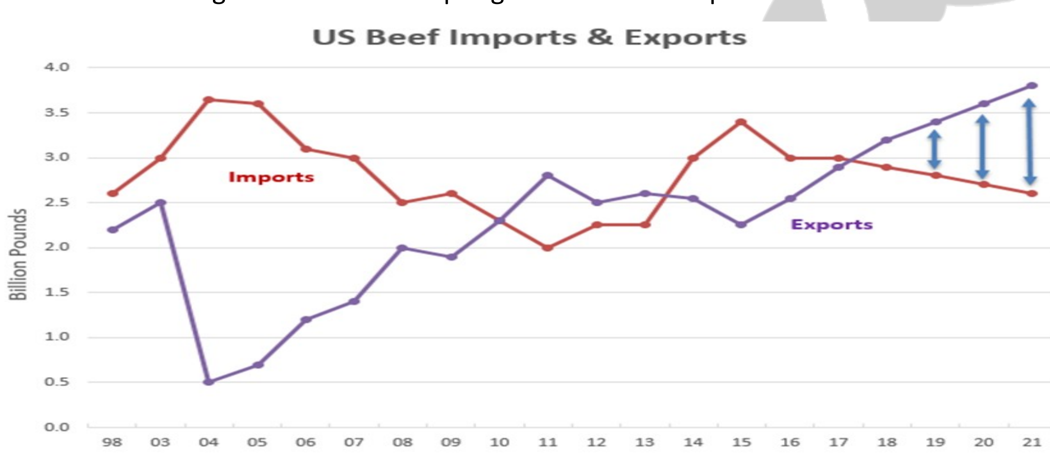
Placement data has shown no real year over year growth since last summer. While late fall and early winter marketings have kept pace with last year, the tighter supplies implied by the smaller placements have yet to materialize. Expectations are for more placements to be coming but has yet to be seen. As you can see by the chart, placement rates have been smaller than expected. We believe that this is coming from extreme growth in the far western regions as well as good placements from larger corporate yards but both of those are being offset from the smaller yards. With prices in Iowa at a premium to the southern plains, this makes sense. While USDA's Cattle on Feed data reflects the larger yards in Iowa, state survey data covering the smaller yards illuminates the potential for a major difference in the total supply picture. We pointed this out in last months commentary. Combine these issues with the extremely wet winter this year as well as our strong demand curve and we should have the model for a stronger market this spring and summer as well as weaker basis patterns than hedgers have been used to in recent years.



The net US beef supply is a developing story and factor that commands the attention of few traders or commercials. China and other Asian destinations have been buying large quantities of beef from Australia and Brazil. Australia accommodated this larger demand last year because of drought-induced increases in slaughter rates, which has forced the liquidation of their herd by some 7% to 10% as compared to their 5 year average. This will reduce Australia's available supply in 2019 and any relief that rains may bring in the coming year will shrink this supply even more as they attempt to retain cows and heifers back for expansion. That may shift China's business to the US. This may help boost US exports by 6% in 2019 and 2020 while reducing US imports at the same time. As noted in the above chart, the US may be a net beef exporter for an extended period. If approximate, 1.0 bln pounds in next beef exports is roughly a 4% net reduction in supply. On average a 4% affect in supply should bring about 6-8% move in prices, but with a potentially greater effect in times of strong demand like the spring and summer. Exports to start of 2019 have been slow to



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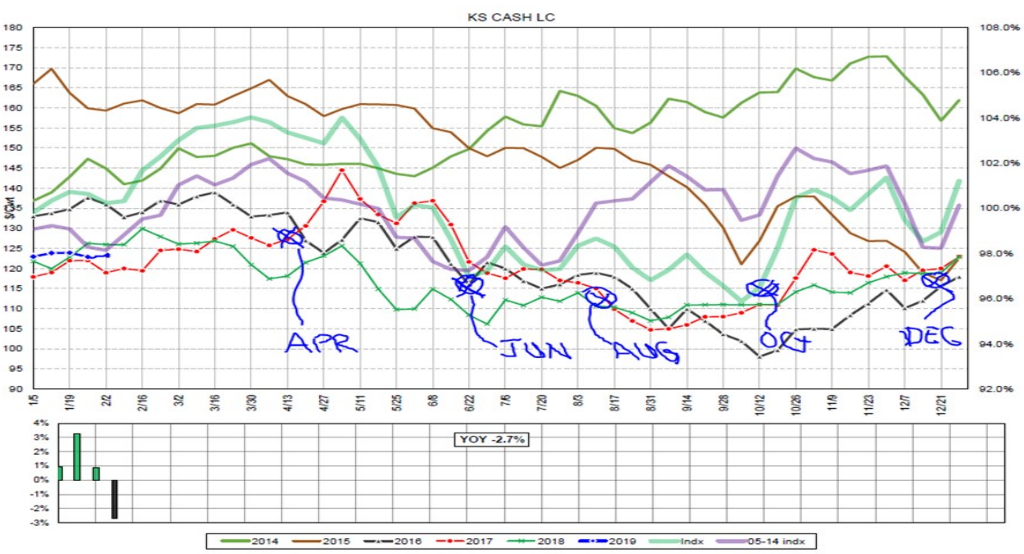
develop but we feel this is related to the uncertainty surrounding negotiations to remove of the tariffs and eliminate the trade tensions between the US, China, and Mexico. Once this is resolved, traders can get back to business as usual and the chart above will start to be seen in the future trade data. Also keep in mind that the big trading company Marubeni, which owns Creekstone Premium Beef, a small packing plant in KS, is in the process of expanding that plant to a double shift plant. Taking this plant from 1,500 to 3,000 head a week is the rumored work in process and expected to start on this extra capacity flow this summer. This is important because that extra capacity is likely to be all exported to Japan, adding to the export flow of the chart noted above.

Conventional wisdom in the cash trade sees prices peaking at $128-$132 this spring before falling to $100-$105 by mid to late summer. Traders are convinced last week's spike reversal in futures was the "key" to the top for the market for this springs market at $129.50 on the April contract and $118+ on the June contract--much like last year. They also are betting on basis moving from the small current discount to futures to a large premium to futures this spring. However, what made last year's markets peak in early winter was the large year-over-year increase in placements, with calves and yearlings placed on top of each other for the summer. In addition, supplies were pulled ahead because of a very strong basis and weather was wide open causing great feedlot performance. 2019 likely will be different in many respects. . Hence, prices likely have not topped in cash or futures and basis should remain much weaker than the shorts are expecting. Fed cattle supplies are expected to be seasonally tight through February and March , ahead of modest supply increases and much stronger beef demand heading into late April, May, and June. However, expected larger placements in the months ahead, will lead to larger fed cattle supplies in August, September and October. We can't rule out a test of the $124 area on the charts for April and $114 for the June. However, this should be about all that the correction holds, or perhaps $122 and $112, respectively, in a worst-case scenario. From there, the bullish patterns and trade should prevail. $128 for April and $118 for June on the weekly charts and $130 and $120, respectively, on the daily charts are key points funds may be looking at to add more longs. Conversely, this $124 and $122 area are key levels for the recent longs to possibly stop out. We don't see cash moving under $120, before summer and are interested in seeing where the demand might take our spring highs. Resolving the China trade issues we hope will prompt China to "relax their strict regulations for US imports for all ages of cattle". This would not only support the end cuts but more importantly the fat products and drop credit items. While end cuts can improve 10% to 20% on such demand, the drop credit items can move even more, depending on the items.



Futures prices from 2/1 were placed on this cash chart to show that the board has 2019 priced pretty close to last year, but seems to not be factoring any larger demand. As well it has also factored in a repeat of 2018's record margins. Any changes to the Asian export trade don't seem to be reflected either. Nor does any weather premium. These potentially price supportive influences are an important message to embrace.

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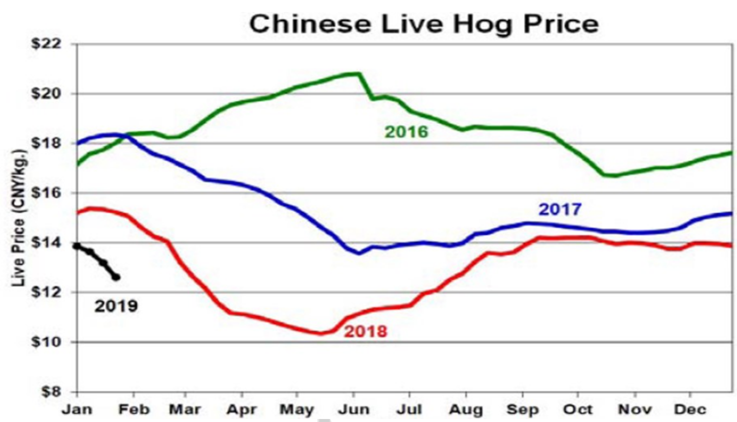
As you can surmise, we maintain a bullish and long only bias. Cattle and beef prices should continue strong well into the summer. Any move lower that we might find for late summer and fall are most likely going to come from a much higher price level than here. In order to manage risk, however, we made the decision to roll our puts up at the dead highs last week, which we are happy about. While a correction in prices can and has devalued our long call positions, the relative move from here in price risk is minimal based on the puts we own and small delta on the calls. Here forward, we will focus on rolling calls down, and roll the puts back down when the correction has proven its value and/or adding long futures, depending on what volatility signals tells us about position adjustments. Our focus will remain bullish February, April and June contracts; with an emphasis being bull spread and shorts in the August or October contracts. However, until we hear the expected favorable news from China, we fear selling anything, even for the fall, would be too risky to manage at this point.

<u>Hogs and Pork:</u>

African swine fever (ASF) outbreaks continue to be reported in China and now into Mongolia and Eastern Europe. Belgium has started building a wall/fence to contain the spread of the disease. China has reported an 8% to 10% reduction in their sow herd due to culling associated with ASF and may well be underreported. This could mean 3 mln sows are confirmed culled and could reach 6 mln sows or more. This points to a baseline we have discussing for months, that has the total reduction in supplies may range from a minimum of 30,000,000 head and possibly as large at 100,000,000 head. This compares to the US hog inventory near 70,000,000 head. The conclusion here is that there should be 50-100 mln less hogs available over the coming year, mostly during the last half of 2019 and first half of 2020.



Prices are searching for their late winter and early spring lows. Higher prices will follow, but from where we will find out in the coming weeks. We would like to engage hogs from the long side, but as the recent weeks and months have shown us, buying the premiums have been a futile effort at best and the reason for most of our losses we posted in January.

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

Regards,

Scott Shepard

February 5, 2019

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