June 2011 – Livestock Market Update
Department of Economic Analysis

In this edition:

- The General Economy: Bob Young, Chief Economist
- Livestock Update: John Anderson, Livestock Economist
- Energy Update: Matt Erickson, Economist

Recommended links:

- AFBF Economic Podcasts (UPDATED)
- Farm Bill Development Considerations: Board Presentation by Bob Young (SILO)

Next Market Update:

- Crop Market Update: released on July 13, 2011

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The General Economy: *Debt Limits, Queens, Bonds and Farm Bills*

It is tough to pick up, turn on or listen to any economic or political news channel these days and not hear lengthy discussion on the political impasse associated with raising the national debt limit. One might wonder why we even establish a debt limit on the nation. Almost from the initial signing of the Constitution, Congress has placed limits on the amount of debt the administration is allowed to issue. Prior to World War I, Congress typically authorized issuance of debt for specific purposes. The Panama Canal is a good example. The War Revenue Act of 1898 gave the Treasury the ability to use certificates of indebtedness of various lengths with short-term paper primarily intended for big investors and the longer term paper going to smaller investors. Overall, the Act authorized $500 million in notes. World War I was financed in part by the Second Liberty Bond Act of 1917, which interestingly enough was the primary legislative vehicle for setting debt limits until the early 1980's.

There are two kinds of federal debt that are held by government accounts such as the Social Security or Medicaid Trust funds and that held by the public. The 'public' in this case can be citizens of the United States, large multi-national investment funds or foreign sovereign wealth funds. Debt held by Government Accounts totaled $4.6 trillion at the end of Fiscal Year 2010, while the debt held by the public sat at $9.0 trillion.

Passing legislation to raise the debt limit has led to great drama in the past. For example, in 1996, Congress twice directed that payments made under Title II of the Social Security Act would not be considered subject to debt limit obligations. In other words, even if we really spend it, if we say it doesn't count, then it doesn't… Only in Washington… Congress did pass legislation raising the debt limit eventually.

There have been other sleight of hand approaches in the past. In 2002, 2003 and 2004, the Treasury was repeatedly forced into a position of approaching default on a fairly frequent basis and had to resort to extreme measures to keep the government afloat. From the 2003 experience, the House Budget Resolution essentially assumed an increase in the debt limit and when the Budget Resolution was adopted by the House and the Senate it was "deemed" to have been passed in the House even though a direct vote was never taken. In many of these cases, the federal government was within $15 million of hitting the limit. To put that in perspective, in 2002, $15 million represented about 15 minutes of government spending.

We now find ourselves caught in this maelstrom once again, but this time with a strong desire to substantially reduce expected spending as part of any limit increase. And again, we are likely to hear concern about financial market meltdown if something isn't done. Only this time, it may happen. There have already been at least two warnings by large bond rating companies that they may need to lower the credit rating of the United States if actions are not taken to bring the nation's spending and revenue streams more into balance. There have also been reports of major financial houses beginning to take action to move away from government bonds or to at least reduce their exposure to U.S. government debt.

All of this comes about at precisely the same time the Federal Reserve is about to bring QE2 to a close. Many think this is a cruise ship operated by the Cunard Line, but it is in fact, Quantitative Easing 2, the second round of purchasing of Treasury Bills by the Federal Reserve. Since last fall the Federal Reserve has been buying roughly $20-$30 billion of Treasury Bills per week. That demand for government bonds will stop as of the end of June. At almost exactly the same time, we will be heading toward the crisis point on the Debt Limit.

So, take $25 billion a week out of the Treasury Bill market, add the uncertainty over whether or not the government is about to go into default, then stir in failure to get a budget deal before the July 4 recess and what do you think happens to bond markets between now and the end of July?

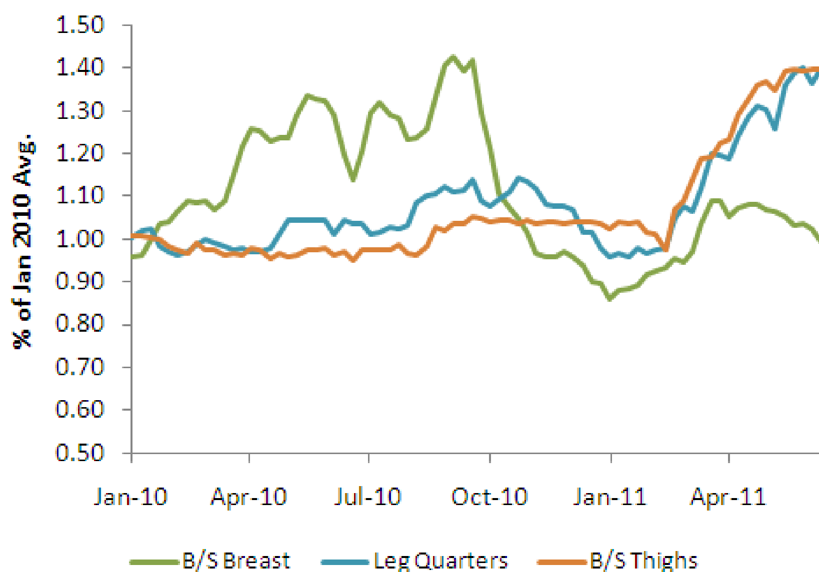
There is at least a possibility of a tremendous weakening of demand for U.S. government paper. And with a lack of demand – should the government try to float paper – you have to think the price of those bonds goes down. Lower bond prices mean higher interest rates, rates that could move on us pretty quickly in this environment of uncertainty. Market crashes have driven Congress to actually take action on things in the past. In Rahm Emanuel speak – "You never want a serious crisis to go to waste."

Which takes us to farm programs. Top on everyone's list to reduce federal government spending, Democrat or Republican, Conservative or Liberal, are farm programs. In particular direct payment programs are front and center. In fact, one could go so far as to say legislation could be introduced in the next few weeks as part of this whole debt limit/spending reduction drama to eliminate direct payments. And in this kind of crisis environment…

Livestock Update

Are Consumer Preferences for Poultry Changing?

Last month's newsletter ended with a brief observation about wholesale poultry prices, noting that leg/leg quarter prices were showing quite a bit of strength while breast prices were basically flat. That trend has, if anything, intensified in the past month. Figure 1 shows wholesale prices for selected poultry cuts as a percentage of the average price for each cut in January 2010. The January 2010 date is a bit arbitrary, but it is close to the recession-induced lows for most of the cuts depicted in the figure.



Source: USDA Economic Research Service through Livestock Marketing Information Center

Figure 1. Change in Wholesale Poultry Prices since January 2010: Selected Cuts

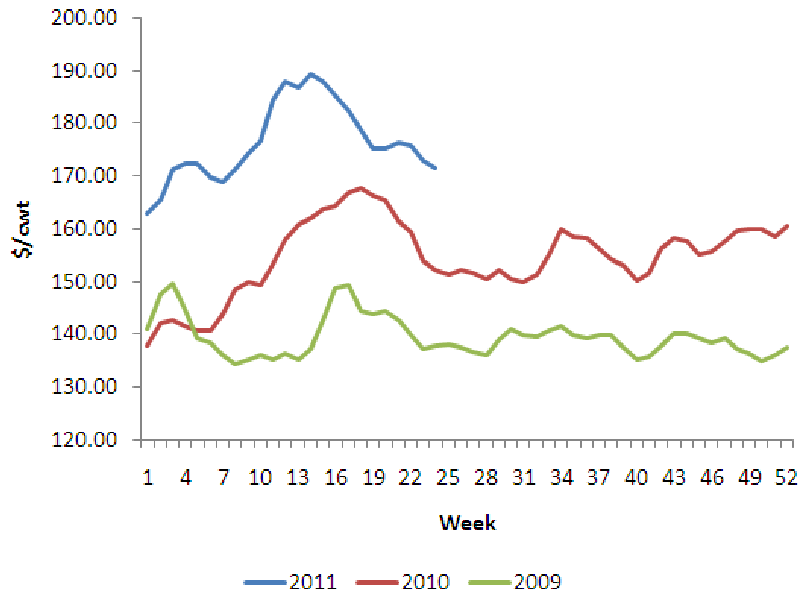
Note how dramatically the prices on leg quarters and boneless/skinless (b/s) thighs have increased since around early-February of this year. Prices on these dark meat cuts have far out-performed prices on b/s breasts. In fact, within the past month, the price per pound for b/s thighs has surpassed the price of b/s breasts. This is not exactly unprecedented: b/s thigh prices exceeded b/s breast prices for several weeks in the fourth quarter of 2008. However, 2008 was a year of record broiler exports. High dark meat prices at that time clearly reflected strong export demand. That is definitely not the case presently. According to USDA Foreign Agricultural Service (FAS) data, year-to-date exports of broiler legs and leg quarters through April were down 8% from 2010 and down 23% from 2009. In short, to the degree that there has been any strength in wholesale broiler prices – and there hasn't been just a whole lot – it has been due to strong dark meat prices. The real news is that this recent strength in the broiler dark meat market appears to be due to demand from domestic consumers. Does this represent a permanent shift in demand? It's hard to say. Right now, spending-averse consumers are looking for value-cuts in the meat case, and broiler dark-meat is filling that role. Consumers may move back to higher-valued products as the economy recovers more fully. On the other hand, they may decide that they like dark meat after all. With access to key export markets (particularly Russia) likely to be curtailed for a long time to come, poultry companies have a strong incentive to aggressively pursue the latter outcome through product development and promotion.

Cattle Market Update

Cattle prices have rebounded nicely in the last couple of weeks. Last week, both Live Cattle and Feeder Cattle futures moved sharply higher to close out the week. The August Feeder Cattle contract added about $8 for the week while June Live Cattle improved by around $6. Cash prices were a bit less ambitious but still posted nice gains. On a live basis, cash prices were $2 to $4 higher last week, adding to gains of around $1 the prior week. Last week's 5-Area price worked out to $109.44, up a little better than $4.50 from the recent low two weeks ago.

The jump in cash cattle prices is not yet supported by wholesale beef prices. The weekly comprehensive cutout value continued to slide lower last week (though the daily Choice and Select cutouts did show

some slight improvement at the very end of the week). Figure 2 shows the weekly comprehensive cutout value since 2009.



Source: USDA Agricultural Marketing Service through the Livestock Marketing Information Center

Figure 2. Weekly Comprehensive Boxed Beef Cutout Value: 2009 to 2011 year-to-date

With cash cattle prices moving up over the past couple of weeks, the further decline the comprehensive cutout implies a significant tightening of packer margins. Spot movement of boxes has picked up a bit, and that (along with the very modest uptick in Choice and Select cutouts to finish the week) seems to be feeding ideas that demand is improving – or at least that it is just about to. Demand-side optimism also probably owes something to sharply lower energy prices. Crude oil prices have fallen steadily in the last two weeks, with the nearby light crude contract on the CME last week trading down to its lowest level in about six months. While lower energy prices are certainly welcome, there is good reason to interpret their possible effects with some caution. Energy prices are largely falling because of concern that the global economic recovery (such as it has been) may be fizzling out. The European debt crisis, which has never really gone away, is back on the front-burner; and there is growing concern that the US government will not deal expeditiously with our looming debt-limit deadline. None of these external factors send a particularly positive signal for meat demand. But so far, the market is focusing on the salutary effects of lower fuel costs on household budgets, and that has helped move prices back up. At this point, we'll take what we can get.

Of course, rebounding prices at this time of year always raise an obvious question: is the seasonal low in? The answer from me, unfortunately, is probably not. In the past 15 years, the low price for the May-August period has come prior to mid-June in only three years. More fundamentally, we have likely not seen the end of the pressure from heavy front-end supplies, though the quick pace of marketings over the past month (see *Cattle on Feed* summary below) is encouraging on that score. Also, recent gains will be hard to maintain unless wholesale prices fairly quickly follow cattle prices higher. Consumers are still skittish about spending, and competing meats (especially chicken) are relatively inexpensive. This does not bode well for a surge in wholesale prices over the short run. It is possible that the lows of two weeks ago will hold, but unless boxed beef prices begin a sustained move higher right away, it is more likely that those lows will at least be tested again sometime within about the next month.

With respect to the supply side of the market, USDA released the June *Cattle on Feed* report last Friday. Key numbers in the report are summarized below:

Table 1. June *Cattle on Feed* (*COF*) Summary: Actual vs. Pre-Report Figures

		% of Previous	Pre-Report Estimates*	
	1,000 head	Year	Average	Range
On Feed June 1	10,928	104.1	105.5	104.3 – 106.8
May Placements	1,810	89.2	92.5	87.2 – 95.1
May Marketings	2,002	107.3	103.2	102.1 – 104.0

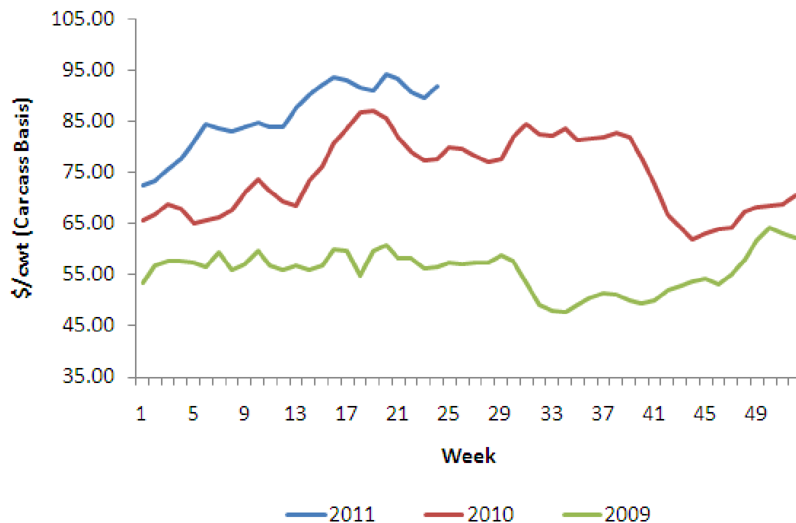
*Source: Dow-Jones Newswires through the Livestock Marketing Information Center.

The June *COF* was almost as bullish as the May report was bearish. This month, both the total on-feed and placements figures were well to the low side of expectations. May marketings far exceeded even the most ambitious pre-report estimates.

The placements figure for May seems to confirm that April placements included quite a bit of pulling cattle ahead. It is instructive to combine April and May placements to see how total placements in that two month window compare with previous years. For 2011, combined April/May placements are down 1.6% from 2010. April/May 2010 placements are still a little over 1% higher than the 2004-2009 average, however. Overall, this report should relieve some of the concern about supply pressure extending beyond the third quarter that was stoked by the May report.

Hog Market Update

Hog prices remain strong. Last week's national average base price (51% - 52% lean) worked out to $91.85. As Figure 3 illustrates, that's a little better than two dollars higher than the prior week and still within a couple of dollars of the high price for the year. Wholesale pork prices were supportive of the cash market last week, with the pork cutout moving steadily higher to finish the week in the mid-$90s.



Source: USDA Agricultural Marketing Service through the Livestock Marketing Information Center

Figure 3. Weekly National Average Base Lean Hog Carcass Price (51%-52% Lean): 2009 to 2011 year-to-date

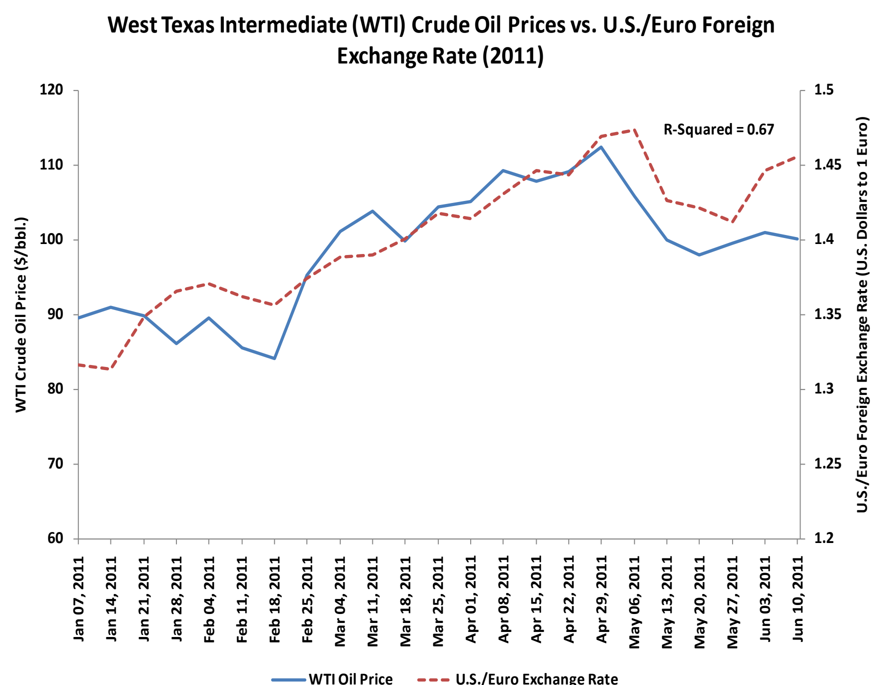
This Friday, USDA will release the latest *Quarterly Hogs and Pigs* report. So far this year, producer margins have been generally okay. Iowa State University estimates have shown small but positive (around $10/head or less) margins in 4 of the first 5 full months of this year. There is, consequently, some expectation that the upcoming report will show a small increase in the June 1 breeding herd inventory. Of course, expectations of future profitability remain quite uncertain due to volatile conditions in the feed market. Two weeks ago, prospects for Q3 and Q4 profits actually looked pretty grim; however, that situation is somewhat improved as Lean Hog contracts have generally moved higher while Corn contracts have fallen sharply, particularly last week. Break-evens for 2011.Q4 are still plenty high – ISU's farrow-to-finish budget suggests fourth quarter break-evens in the $87 to $89 range. Still, a roughly 80 cent drop in old crop corn futures over the past week-and-a-half or so means that those figures are considerably better than they have been in some time. In fact, this dip in the corn market actually looks like a pretty good opportunity to price some corn. The recent sell-off reflects what will likely turn out to be a short-run focus on a flurry of weak macroeconomic indicators, falling oil prices, and political uncertainty in the heat of the recent debate over an early end to the volumetric ethanol excise tax credit (VEETC). Taking a bit longer view of things, fundamental support for corn prices remains exceptionally strong: stocks are low, the crop is late in much of the country, acreage is already down from March intentions and may fall even more in the June *Acreage* report, and Missouri river flooding is threatening to pare acreage even more in the heart of the Corn Belt. With these factors in view, a bet on lower corn prices right now looks awfully risky.

Energy Update: ***OPEC and the Summer Headwind of Uncertainty***

Energy markets, particularly oil, generated a lot of uncertainty this past month leading up to the OPEC meeting held on June 8 in Vienna, Austria. However, once the meeting took place, differences between the 12-member group magnified as the member countries failed to reach consensus on oil production targets for the first time in nearly 20 years. With anticipation of global demand increasing over the summer months and expectation of world refineries coming back into operation after routine maintenance, the need for supplies may become apparent as early as this summer. Regardless, with the 12-member group of OPEC controlling approximately 80 percent of global oil reserves, uncertainty will continue to bestow itself with regular force given the continuing unrest in the Middle East and OPEC deciding not to increase oil production targets. Let the summer fun begin!

<u>Oil and a Weak Dollar</u>

Since the first week of 2011 (January 7) until now (June 10), we have seen weekly U.S. crude oil prices jump from $89.54 per barrel to $100.05 per barrel, or an approximate 12% increase. When analyzing price volatility in oil markets, sometimes the market signals can drive a person downright crazy! However, one of the first signals that I look at when analyzing energy markets and markets in general, is the value of the dollar relative to the Euro or against a bundle of currencies. Why is the value of



the dollar important in analyzing crude oil markets? The answer: Oil markets are measured and denominated in dollar unit terms. This means that when the dollar weakens relative to say the Euro, for the same dollar price, oil is essentially cheaper in Euro terms. This reduction in Euro priced oil increases European demand. This concept has held true for most of 2011. As indicated above, we have seen oil prices increase by approximately 12 percent. Likewise, the value of the dollar relative to the Euro has weakened by approximately 11 percent. Coincidence? Perhaps not.

Clearly crude oil price movements are not driven solely by changes in the value of the dollar. If that were the case, analyzing oil markets would be quite simple. The fact of the matter is that it also involves a multitude of supply, demand and macroeconomic factors weighing in on the market as well. But, plotting the U.S./euro exchange rate against crude oil prices in 2011 suggests that approximately 67 percent of the oil price changes can be explained by the overall value of the dollar against the Euro which indicates a moderate to fairly strong relationship.

The June OPEC Meeting (Continued from previous June Energy Newsletter)

The major event over the past month was held on June 8 when the 12-member group of OPEC met in Vienna, Austria to discuss a proposal to raise oil output, indicating a sign of concern about the impact oil prices are having on the global economy. The overall outcome of the meeting was best summed up in 9 words from Saudi's oil minister when he denounced this meeting as "*one of the worst meetings we have ever had*." In the end, the Saudi attempt to increase production quotas was blocked due to Iran and five other countries blocking the proposal while three other countries supported the Saudi proposal. This should not come as a surprise since Iran now holds the rotating presidency of OPEC. The fact of the matter is that Saudi Arabia wants oil prices around $70 to $80 per barrel and Iran and Venezuela want oil prices around $100 to $120 per barrel.

Now think about why each country wants oil prices at their respected levels. Here's a hint: it's not because they are looking out for the best interests of the United States. For Saudi Arabia, oil priced at $70 to $80 per barrel is in their best interest because it reduces the urgency in the U.S. and Europe to develop alternative energy sources. As for Iran and Venezuela, they have put the "cold-shoulder" on the United States and Europe because of their addiction to OPEC oil.

So, how much does the U.S. depend on OPEC oil? The table makes this fairly obvious. On a year-to-date basis (February 2011), 6 out of the top 10 countries providing oil to the United States are OPEC member countries (countries highlighted in yellow are OPEC member countries). In fact, 44.7 percent of total U.S. oil imports came from OPEC member countries. If this doesn't persuade your

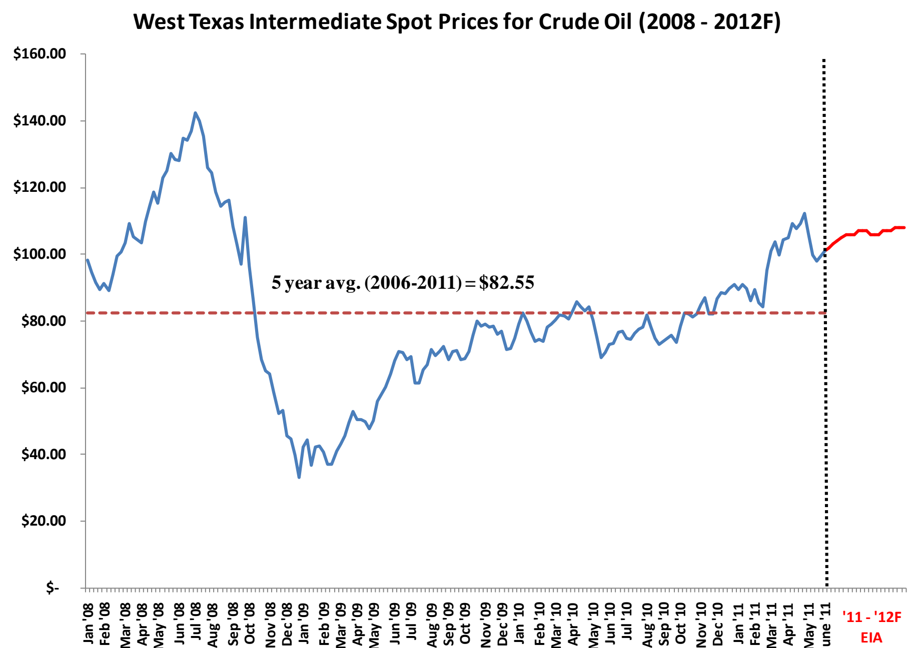
U.S. Oil Imports Year-to-Date 2011 (February 2011)

	Imports (Thousand Barrels per Day)	% of Total Imports	% of Domestic Product Supplied
Canada	2,598	25.5%	13.7%
Saudi Arabia	1,107	10.9%	5.8%
Venezuela	997	9.8%	5.2%
Nigeria	972	9.5%	5.1%
Mexico	713	7.0%	3.8%
Russia	486	4.8%	2.6%
Algeria	484	4.7%	2.5%
Iraq	372	3.6%	2.0%
Angola	342	3.4%	1.8%
Virgin Islands	232	2.3%	1.2%
Other	1,896	18.6%	10.0%
Total	**10,199**	**100.0%**	**53.7%**
OPEC Countries	***4,558***	***44.7%***	***24.0%***
Persian Gulf Countries	1,567	15.4%	8.2%

perception of our OPEC reliance on oil, then think globally. Recognize that 80 percent of global oil reserves are controlled by OPEC's 12 members, the rise in demand for OPEC oil between the second and third quarters is predicted to be 2.1 million barrels per day, 75 percent of OPEC spare capacity is controlled by Saudi Arabia and 1.3 million barrels per day of net output of oil was taken off the market since Libyan oil production came to a halt caused by civil war. Now the equation becomes even more reliant on OPEC oil. From my perspective, the result from this meeting strikes a sense of urgency in becoming an energy independent nation. The outcome of this meeting is a clear sign that the United States needs to develop a long-term strategy of implementing a comprehensive energy policy that uses domestic sources. Besides, we have already seen and are continuing to see how our markets react to Middle East uncertainty.

June 2011 EIA Short-Term Energy Outlook Highlights

Forecasts for crude oil for 2011 and 2012 have decreased from May to June. Expectation of oil markets tightening through 2012 by means of world oil demand growth and slowing growth in supply from non-OPEC countries continue to raise forecasted prices for oil through 2012. The June outlook forecast has prices for WTI spot crude oil averaging $101.91 per barrel for 2011 and increasing to $107 per barrel in 2012. Currently for 2011, crude oil prices are averaging just short of the $100 per barrel benchmark at $98.50 per barrel. Comparing the current 2011 average crude oil price against the June forecast for 2011 and 2012, respectively, EIA expects average crude oil prices to increase 3.4 percent for the rest of 2011 and increasing 8.5 percent in 2012.



Gasoline prices are projected to average $3.60 per gallon while diesel prices are projected to average $3.87 per gallon for 2011. During the first part of May, retail gasoline prices increased to average $3.96 per gallon because of the Mississippi River flooding which created unexpected refinery outages and caused disruptions in distribution, counterbalancing the impact of lower crude oil prices over the past month. Currently for 2011, weekly national retail prices for gasoline are averaging $3.53 per gallon, which is currently $0.07 per gallon lower than the June forecasted average for 2011 and $0.14 per gallon lower than the June forecasted average for 2012. In addition, current weekly diesel retail prices are averaging $3.80 per gallon, which is currently $0.07 lower than the June forecasted average for 2011 and $0.15 per gallon lower than the June forecasted average for 2012.

Natural gas prices for 2011 are currently averaging well below 5-year average levels (2006 – 2011: $6.03 per MMBtu) at $4.26 per MMBtu. Price projections for the rest of 2011 are forecasted to be at similar average levels around $4.25 per MMBtu. Prices for natural gas are expected to remain relatively cheap as inventories are expected to build over the summer months along with record high inventory

levels during the second half of 2011. Natural gas prices continue to be relatively cheap heading into 2012, but inventories are expected to begin to tighten as average prices for 2012 are projected to increase to $4.58 per MMBtu.

	2011 Current Average	May Outlook 2011 Forecast	June Outlook 2011 Forecast	May Outlook 2012 Forecast	June Outlook 2012 Forecast
WTI Crude ($/barrel)	$98.59	$102.67	$101.91	$107.00	$107.00
Gasoline ($/gal)	$3.53	$3.63	$3.60	$3.66	$3.67
Diesel ($/gal)	$3.80	$3.89	$3.87	$3.93	$3.95
Natural Gas ($/MMBtu)	$4.26	$4.24	$4.25	$4.65	$4.58

All Prices for "2011 Current Average" Column end June 10 and June 13, resepectively

Source: EIA