# May 2011 - Livestock Market Update
# Department of Economic Analysis

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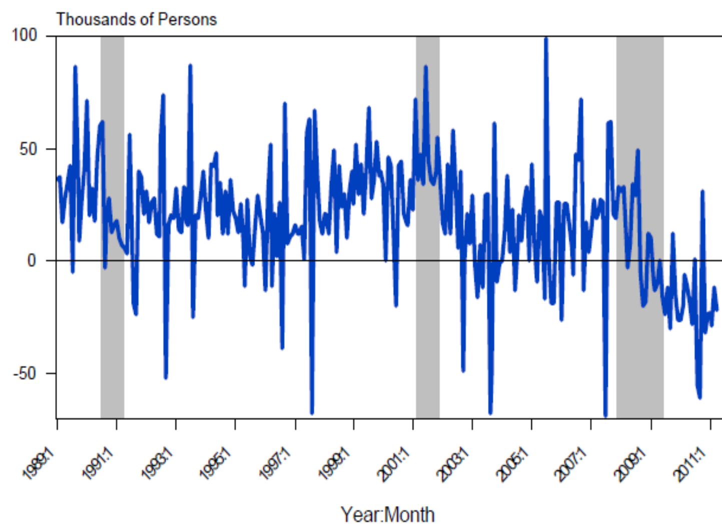
## The General Economy

This is a time in most recoveries where you're just not sure. The worst of the down-turn is behind you. It looks like the recovery is starting to get some legs. But the recession memories are still just a little too fresh in everyone's mind to be totally discounted. And on top of all that we need to add a couple of very major policy variables either one of which on their own add considerable uncertainty.

The April jobs report – recall that we write the Board report in mid May – showed the third month in a row with job creation in excess of 200,000 net new jobs. The April data actually came in at 244,000 new jobs, the highest level since the census inflated observations of last May. The private sector generated 268,000 new jobs, with state and local government positions declining by 22,000. Previous reports have pointed out the likely drag on future employment gains state and local governments will likely place on overall numbers for some time to come. That pattern is also clear from the graph. This extends back to 1969 and shows that we have not seen a period like this one for at least forty years.

**Figure 1 State and Local Government Payroll Employment – Change from Prior Month**




The peak in local government employment occurred in May, 2009 with 14,939,000 employees. Since then these same local governments have shed 447,000 positions and are now back down to roughly the staffing levels witnessed in 2006.

This downsizing of government is also showing up in the level of overall economic activity for the nation as a whole. First quarter 2011 GDP growth came in at only 1.8%, even though the consumer contributed 1.9% growth and gross investment

contributed a full percentage point. Net exports were essentially neutral as a growth in imports was offset by stronger exports. But government consumption, at the federal, state and local levels combined, placed a 1.1% drag on the overall economy. This is a trend that is going to continue.

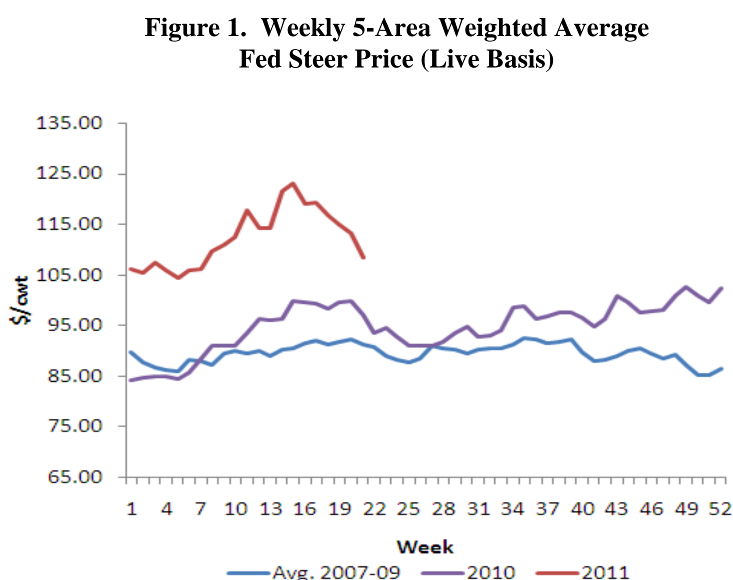
The two policy actions clouding the horizon are the end of QE2 and action on the federal debt limit. Both of these issues are likely to lead to higher interest rates. The end of QE2 will literally take tens of billions of dollars a month out of the pool to purchase federal treasury notes. This reduction in the demand for these notes will likely lead to a reduction in the price of the same notes, in turn raising the associated interest rates. This political gamesmanship surrounding the raising of the debt limit will continue to boost the perceived and potentially real risk associated with holding that same federal debt. If you want me to continue to purchase that debt, you have to lower the price of a risky asset. Again, lower prices for bonds translates to higher interest rates. One could easily tell a story of interest rates for federal paper one to even two full percentage points higher than they are today by the end of the year.

## Livestock Update

### *Cattle Market Slump*

Summer has not even officially started yet, and it's already shaping up to be a rough one for the cattle market. After a very strong first quarter, fed cattle prices have suffered a major meltdown since peaking in the second week of April, as Figure 1 below illustrates. The 5-Area weighted average live steer price has declined by nearly $15 (or about 12%) since the week ending April 8. That's a drop of almost $2.50 per week on average. Last week was quite bit worse than average, with the 5-Area price dropping by about $4.80 from the prior week.

**Figure 1. Weekly 5-Area Weighted Average Fed Steer Price (Live Basis)**




**Notes: Data from USDA Agricultural Marketing Service through Livestock Marketing Information Center.**

Last week's release of the May *Cattle on Feed* report didn't do anything to help the market out. Key numbers in the report are summarized below:

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

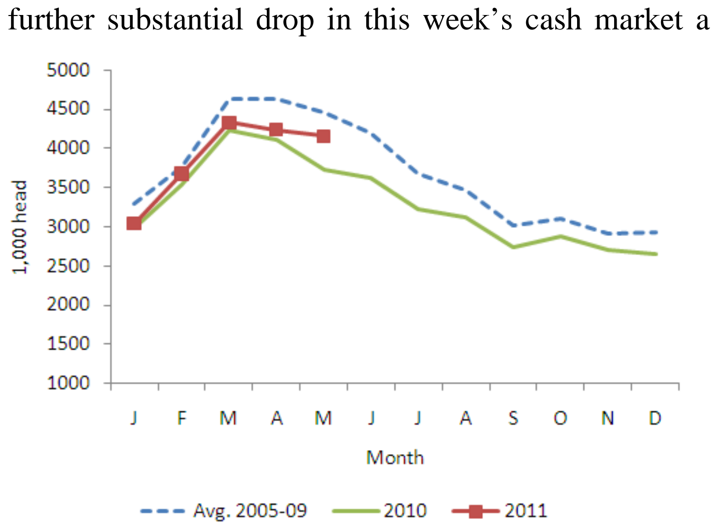
| | | % of Previous | Pre-Report Estimates* | |
|---|---|---|---|---|
| | 1,000 head | Year | Average | Range |
| On Feed May 1 | 11,200 | 107.4 | 106.5 | 105.1 – 107.0 |
| April Placements | 1,795 | 109.9 | 104.3 | 101.0 – 107.1 |
| April Marketings | 1,807 | 97.3 | 96.4 | 95.0 – 98.0 |

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

Clearly both the total on feed number and the April placements figure caught the market off guard. Both numbers were above even the highest pre-report estimates. USDA noted that the April placements figure was the second largest since this *COF* series began in 1996. Marketings were at least on the high side of expectations, but that's about the most positive thing that can be said about the report. Futures

markets reacted strongly to the report, with most live cattle contracts trading at or near limit down during Monday's session, making a further substantial drop in this week's cash market a strong possibility.

**Figure 2. Estimated Number of Cattle on Feed Over 120 Days**

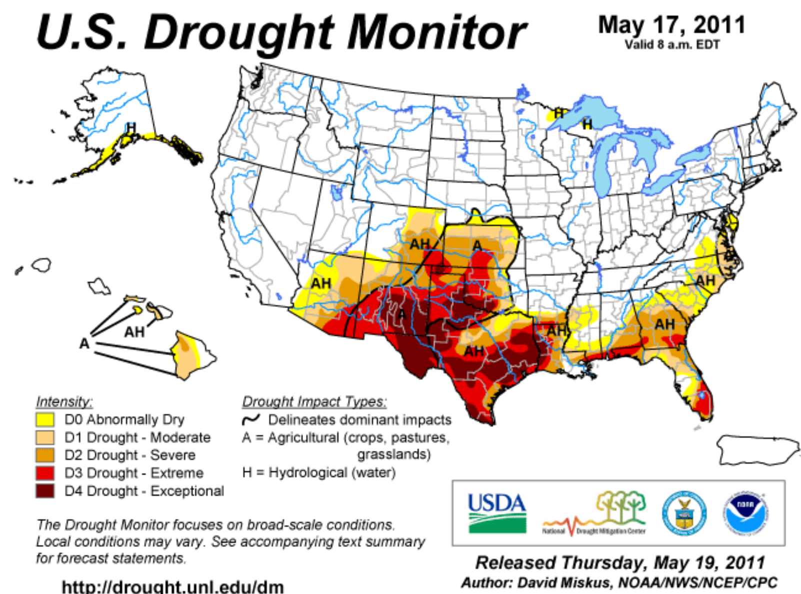



**Notes: Data from USDA National Agricultural Statistics Service through Livestock Marketing Information Center.**

With last week's *COF*, the long-awaited transition to price-supportive tight supplies appears to have been pushed back still further. Front-end fed cattle supplies have likely increased in recent weeks. The number of cattle on feed over 120 days (calculated as the total on feed number less the last four month's placements) is over 10% larger than it was a year ago, as shown in Figure 2. While front-end numbers have drifted seasonally lower over the last couple of months, the decline has been quite a bit slower than normal.

Placements were skewed a bit toward the light end of the weight scale in April. Placements were larger in every weight category but were up by far the most – over 23% – in the under 600 pound category. The average weight of calves placed (estimated by applying an average weight of 550 pounds, 650 pounds, 750 pounds, and 850 pounds to each of the COF placement weight categories) was 713 pounds in April: 9 pounds below last month and 4 pounds below last year. These lighter weights most likely reflect two factors: tighter calf numbers (they really do have to be getting scarcer somewhere) and a worsening and widening of drought conditions in the Southern Plains forcing more calves into feedlots. That second factor probably deserves more attention than it has been getting. While the general public has been focused on Mississippi river flooding, the Southern Plains region has been quietly burning up. Figure 3 shows last week's US Drought Monitor, produced by the National Drought Mitigation Center at the University of Nebraska.

**Figure 3.** US Drought Monitor, May 17, 2011
Source: National Drought Mitigation Center Online
http://www.drought.unl.edu/dm/monitor.html




For what it's worth, placements in Kansas, Oklahoma, and Texas – areas particularly hard hit by the drought – were up by 21%, 33%, and 28%, respectively, compared to a year ago. Of course, the drought also carries additional important implications for the market. First, lack of forage availability will make herd expansion impossible in the affected areas. Further forced liquidations appear likely at this point. Given that the affected states represent some of the largest cow/calf producing states in the country, the drought may well

lead to another year of contraction for the national cow herd. Second, the drought has devastated the hard red winter wheat crop. (A similar situation in Europe is also jeopardizing the wheat crop there.) This adds even more support to what is already, from the livestock industry perspective at least, a frighteningly bullish grain market situation.

### *Hog and Broiler Market Update*

Last week, both the pork cutout and cash hog prices posted a second week of modest gains after moving lower for a couple of weeks beginning in mid-April. In fact, the pork cutout reached its highest level of the year last week, hitting the $98 mark last Monday. Unfortunately, last week's *Cattle on Feed* report dealt the market a pretty sharp blow. Lean Hog contracts traded at or near limit down on Monday along with Live Cattle. The June Lean Hog contract is currently at its lowest level since last December. The bearish *COF* wasn't the only feature in the market. Pork movement looked rather sluggish last week. Even though the cutout was higher, spot sales at those higher prices were pretty disappointing: smallest level since back in February.

Hog and pork prices continue to feel pressure from the poultry market. In general, broiler prices haven't done much all year. Last month, while retail beef and pork prices edged higher (both posting new records at retail) the retail broiler composite price actually fell to its lowest level in a year. Wholesale boneless/skinless breast prices have done about the same, drifting lower for the better part of the last month. Interestingly, leg and leg quarter prices have been pretty strong this year, despite the fact that leg quarter exports through March remained substantially below 2010 levels. Higher prices suggest that domestic consumers are accounting for a greater share of leg quarter demand. If so, this is a notable development, reflecting a change in consumer preferences with respect to broiler products, continued trading down to lower valued products by US consumers, or a combination of both. In any case, improving demand for lower-valued poultry cuts may make broilers an even tougher competitor for domestic market share.

## **Energy Update: *The Bears Spring Out of Winter Hibernation In Full Force***

If you're a consumer (which we all are!), you are thinking to yourself "it's about time!" Over the past month, weekly West Texas Intermediate (WTI) spot prices fell 11 percent as a stronger dollar, demand destruction worries and other bearish market fundamentals struck the market full force. Alone, the commodity market sell-off that occurred May 5$^{th}$ dropped oil prices 10 percent on weak economic news released during the first week of May. However, has the burden been lifted off of consumers at the pump from $4.00 per gallon gasoline? The consumer's response is quite simple "No." From the beginning of the month, week-over-week (beginning May 6) oil prices decreased 6 percent, whereas the national retail gasoline price has stayed relatively consistent at $3.96 per gallon. Retail gasoline prices may catch up and drop slightly due to the recent bearish behavior of oil, but you should still expect summer driving to come at a "pretty penny" when filling up your tank at the gas station this summer.

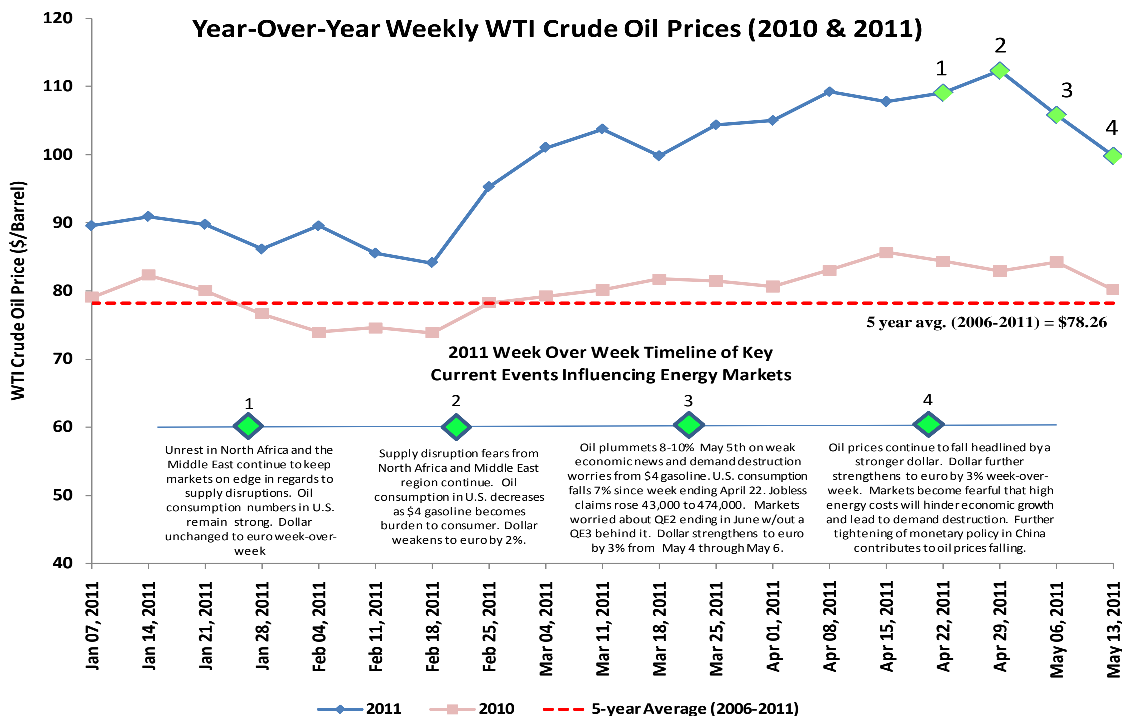
### *"Bear-Down"…. Oil Prices Fall Below $100*

Over the past month (week ending April 22 – May 13), weekly WTI spot prices decreased 8 percent from $109.11 per barrel down to $99.87 per barrel. Furthermore, oil prices dropped 8 to 10 percent alone from the news headlining the markets on May 5$^{th}$. With continued supply disruption uncertainty in the Middle East and North African region looming and spreading, what exactly has happened since the beginning of May that has caused oil to act bearish and fall below $100 per barrel? Tracking and finding the main culprit of daily bearish and bullish behavior in markets can sometimes drive a person crazy, but in this section, I want to discuss and focus on the story that occurred from points "3" and "4" from the graph below.

From week ending April 29th (point 2) to week ending May 6th (point 3), oil prices decreased 6 percent. The biggest drop off in price during this week span came between May 4th and May 5th when oil prices decreased 8 percent, falling from $108.79 per barrel down to $99.89 per barrel. The reason for this 8 percent decrease was due to weak economic news, demand destruction concerns, the dollar strengthening and concerns of QE2 ending in June without a QE3 behind it.

Weak economic news was generated for the first week of May as jobless claims rose 43,000 to 474,000. Over a two week time period (April 22 – May 6), $4 per gallon gasoline created concerns for the market as total U.S. petroleum consumption decreased 7 percent and total commercial crude oil inventories increased by over 7 million barrels. Another bearish factor that hit the markets on May 5th was QE2 ending in June without a QE3 to follow. Quantitative easing is an unconventional monetary policy used by central banks as a way to stimulate the economy when conventional monetary policy becomes ineffective. With QE2, the Federal Reserve has been pumping $75 billion per month into the economy in the form of buying Treasuries since November 2010. With QE2 set to expire in June 2011, and with no QE3 behind it, this will take liquidity out of the market which will hurt risky assets such as commodities. To round out the bearish activity for week ending May 6th (point 3), India increased interest rates followed by further speculation of China tightening monetary policy due to inflationary concerns. These monetary policy actions and others caused the dollar to strengthen by 3 percent to the euro from May 4th through May 6th.

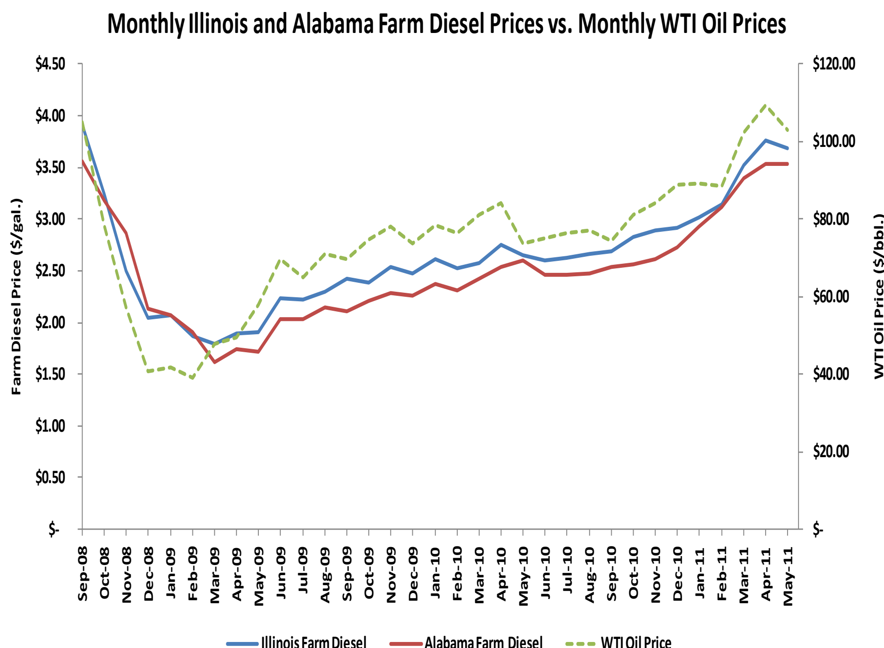
Oil markets continued their bearish intent through the week of May 13th (point 4). Decreasing oil prices were headlined by the appreciation of the dollar. Week-over-week (point 3 to point 4), the dollar strengthened to the euro 3 percent and strengthened 2 percent against a basket of major currencies as speculation intensified regarding further tightening of monetary policy in China. China's intervention in the currency market has kept its currency artificially low, causing the dollar to weaken against the yuan (currency in China). This intervention has driven inflation, giving China an incentive to let their currency move higher. Indeed, the yuan has increased over 4 percent against the dollar since June 2010.



In the next month, energy markets will be looking at two major events in June: the OPEC meeting and the overall impact of QE2 ending. When OPEC convenes together next month, they will reassess their current supply policy and determine whether or not to re-vamp oil supply or leave supply levels the same. As for QE2, the question becomes whether or not the economy can stand on its own two feet without the $600 billion stimulus injected into the economy. However, the long-term bull market outlook is still intact as political unrest in the region is continuing; an expected further weakening of the dollar looms and increasing global demand from emerging markets will help support prices. Gear up for a roller coaster ride in energy markets this summer!

***Farm Diesel and Fertilizer***

Currently, average farm diesel prices in Illinois are $3.69 per gallon and $3.49 per gallon in Alabama. Bi-weekly Illinois farm diesel prices decreased 2 percent from $3.76 per gallon to $3.69 per gallon. Week-over-week Alabama farm diesel prices decreased 1 percent from $3.52 per gallon to $3.49 per gallon. For the most part, farm diesel prices have followed trend with oil prices. Over the last month (April 22 – May 13), WTI crude oil prices have decreased approximately 8 percent. Likewise, the price for Illinois farm diesel has decreased 2 percent and the price for Alabama farm diesel has decreased 3 percent. However, expect farm diesel prices to stay relatively high as EIA projects oil to average $102.67 per barrel for 2011 and $107 per barrel in 2012 (more below under the "May EIA Short-Term Energy Outlook" section).




Put the situation in perspective. Since planting season is finished for some and still underway for others, let's analyze the approximate cost of filling up the tank of a 270 gallon diesel tractor. Using the current cost for Illinois farm diesel at $3.69 per gallon, the cost for each fill up is approximately $996 which is 37 percent more than the $726 average fill up cost in 2010 and 69 percent more than the $588 average fill up cost in 2009. It is also important to mention that this is only for one tractor. This exercise excludes a second tractor and all other farm machinery needed to complete a successful planting season!

Fertilizer prices for Illinois have increased slightly since the beginning of 2011: Anhydrous ammonia by 3 percent, liquid nitrogen (28 percent) by 6 percent, DAP by 3 percent and potash by 6 percent. Bi-weekly average fertilizer prices in Illinois remained unchanged (week ending May 12) with anhydrous ammonia at $797.94 per ton, liquid nitrogen (28 percent) at $355.29 per ton, DAP at $687.67 per ton and potash at $598.33 per ton.

Similar to prices in Illinois, fertilizer prices reported in Alabama have increased slightly since the beginning of 2011. Liquid nitrogen (28 percent) increased by 11 percent, DAP unchanged and potash by 7 percent. Week-over-week average prices in Alabama fluctuated with (week ending May 16) liquid nitrogen (28 percent) at $425 per ton (8 percent week-over-week increase), DAP at $690 per ton (2

percent week-over-week decrease) and potash at $595 per ton (unchanged week-over-week). For the most part, the 8 percent week-over-week increase in liquid nitrogen (28 percent) was due to the market rebounding as the two month average for Alabama liquid nitrogen (28 percent) was between $425 and $430 per ton.

One reason fertilizer prices increased slightly over the past couple months was due to higher energy prices creating increased costs for manufacturing, storing and transporting to the final destination point. Another reason is demand for fertilizer given the current tight supply situation for grain commodities, primarily corn. In the current situation of tight supplies for grain, fertilizer is a necessity as acreage production in the U.S. is at a max. Similarly, higher grain prices increase the demand for fertilizer in international markets. All of these factors are causing fertilizer markets to act bullishly at a time of tight grain supplies and production acreage at a max.

***May EIA Short-Term Energy Outlook***

The Energy Information Administration (EIA) released its May 2011 Short-Term Outlook at the beginning of the month and forecasts for crude oil for 2011 and 2012 has decreased from April to May. The May outlook forecast has prices for WTI spot crude oil averaging $102.67 per barrel for 2011 and increasing to $107 per barrel in 2012. This is a 3.5 percent decrease for 2011 and a 5.7 percent decrease for 2012, respectively, from the April outlook. Gasoline prices are projected to average $3.63 per gallon while diesel prices are projected to average $3.89 per gallon for 2011. The current weekly national retail price for gasoline is currently $3.96 per gallon, which is currently $0.33 higher from the May outlook projection for 2011. Furthermore, the current retail price for diesel is $4.06, which is currently $0.17 higher from the May outlook projection for 2011. Natural gas prices are currently $4.18 per MMBtu and EIA price projections for natural gas increased to $4.24 per MMBtu for the rest of 2011. These prices continue to be relatively cheap due to inventory levels projected to be robust. However, EIA continues to project natural gas inventories to tighten in 2012 with natural gas prices averaging $4.65 per MMBtu.

| | 2011 Real Weekly Average | April Outlook 2011 Forecast | May Outlook 2011 Forecast | April Outlook 2012 Forecast | May Outlook 2012 Forecast |
|---|---|---|---|---|---|
| **WTI Crude ($/barrel)** | $99.87 | $106.38 | $102.67 | $113.50 | $107 |
| **Gasoline ($/gal)** | $3.96 | $3.70 | $3.63 | $3.80 | $3.66 |
| **Diesel ($/gal)** | $4.06 | $3.98 | $3.89 | $4.07 | $3.93 |
| **Natural Gas ($/MMBtu)** | $4.18 | $4.10 | $4.24 | $4.55 | $4.65 |

***Real Weekly Avg. for WTI Crude and Natural Gas: May 13; Gasoline and Diesel: May 16***

*Source: EIA*