CAB CONNECTION

2018 year in review: More demand for more of the best

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The past year's beef cattle markets may be best characterized by two factors: supply and demand.

While the U.S. beef cow herd remains in expansion mode, the pace has greatly slowed, as seen by the share of heifers in the fed-cattle mix. That number moved up to average 35%, but it is still lower than the 36%-37% rate that typifies a liquidation phase. Projections were for the beef herd to be at least 9% larger on Jan. 1 this year than the drought-induced cycle low of 29.1 million head in January 2014.

Smaller inventories of fed cattle going back to the turn of the century spurred packers to begin reducing capacity a dozen years ago. That brought the industry to its current position of restricted processing capacity in the face of a now increasing fed-cattle supply.

We need not fear a market more saturated with high-quality beef.

Price trends

One result was three years of exceptional packer profitability, increasing in each of those years to record levels in 2018. Those very profit margins enticed packers to maximize production, processing an additional 7,000 head per week to average 497,000 fed steers and heifers. Expectations are for 2019 to bring on another 1% increase in fed-cattle harvest counts.

Though a continuation of 2017 trends, the magnitude of increase in packer leverage underscored the 2018 market. The cattle feeder's share of wholesale beef values plunged to a record of just 50% last May, according to market reports from Urner Barry and CattleFax. That ratio of 2-to-1 beat the June 2017 peak ratio of 1.88-to-1.

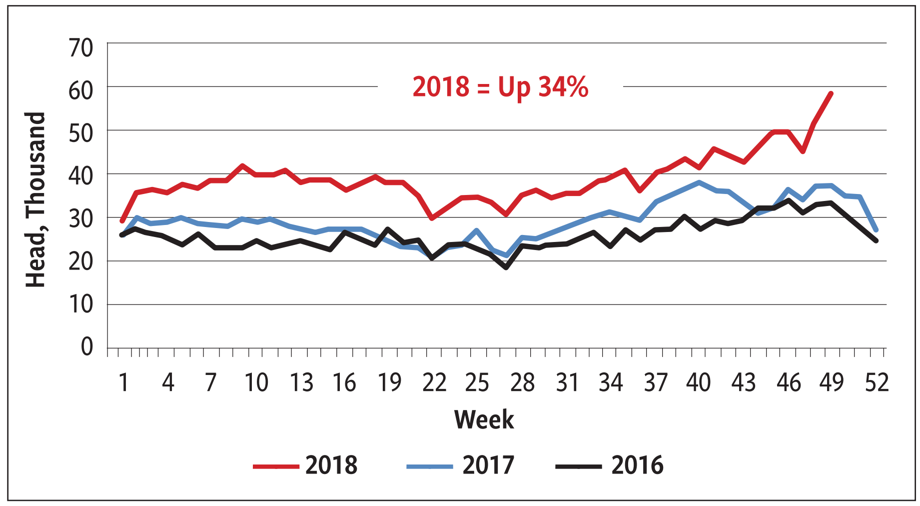
Fed-cattle prices traded in a smaller range in 2018, posting a lower average price for the third year in a row at $116.69 per hundredweight (cwt.), live basis, compared to the prior year's $121.10 per cwt. The 2018 market top came in February at $129.75 per cwt., leaving the much-anticipated second-quarter high a bit shy of expectations at $124.81 per cwt. during the first week of May.

One highlight for cattle feeders was that the annual price low came in $2-per-cwt. higher than the prior year at $106.87 per cwt. during the last week of June.

The range in fed-cattle price was also much narrower in 2018, with a top-to-bottom spread of $22.88 per cwt. That's in contrast to the much wider range of $39.94 per cwt. the prior year, dominated by a market-shocking void of finished cattle during the high-demand period of early May.

Adjustments to camera-assisted USDA quality grade lines in late 2017, immediately followed by adoption of dentition-based carcass maturity calls had feeders and packers eyeing year-on-year grading trends in 2018. The close proximity in time of those two changes likely obscures the opportunity for those outside of the packing industry to clearly link causes and effects. Even so, the culmination of several factors that affect marbling scores certainly shifted quality-grade shares.

Fig. 1: USDA Prime carcass production



SOURCE: USDA.

Continuing the trend since 2006, U.S. averages for quality grade improved. The proportion of Choice carcasses had climbed from that 2006 low of 51% of all fed-cattle carcasses to a 2017 high of 72%. The consistently larger Choice category relented in 2018, but just half a percentage point. That baby step backward was part of the ongoing historic move toward higher-quality carcasses as a significant rise in Prime carcass production stole the show.

From 2000 through 2013, there was little variation in the proportion of Prime carcasses in the mix, ranging from 2% to 3.5%. Prime was so scarce, not many outside high-end restaurants and a scant few retailers gave it a thought. Cattle feeders certainly didn't consider Prime grid premiums a significant component of normal production. Until the last few years, Holstein steers made up as much as 50% of Prime, so the remainder from native beef sources was rightly considered incidental in the big picture.

Differing premiums

Just five years ago the proportion of Prime carcasses began to grow, inching up to 4% in 2014, adding another point in 2015 and resting at 6% for each of the next two years. Doubling the Prime grade category in a handful of years was progress, but few noticed the significance until 2018, when it reached 7.8% of fed-cattle production. Rising 1.8 percentage points may still seem small to some, but that's a 35% tonnage increase in 12 months.

This rapid advance in Prime beef availability left its premium above Choice boxed beef unshaken through 2017. In fact, that year saw

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one retailer's huge spring forward-purchase arrangement sparked a supply problem for other end users, pushing the annual Prime cutout premium to $31.26 per cwt., compared to a $25-per-cwt. average the previous two years.

However, 2018 featured no market-moving purchase while the Prime category grew by 35%, bringing the annual Prime-Choice price spread to just $13.96 per cwt. on the cutout. Similarly, the spread between USDA Prime and all USDA branded-beef products narrowed to $9.05 per cwt., down from the prior year's $25.84 per cwt.

The caveat for the 2018 price comparison is that "USDA branded" included a larger proportion of Prime-graded beef last year, as well. The *Certified Angus Beef*® (CAB®) brand enjoyed a 31% sales volume increase in its CAB brand Prime category, while total sales for the company were up 8% in fiscal year (FY) 2018. Some weeks, Prime could have accounted for 10% of total sales — but only a quarter of it sold as Prime because demand for that level of marbling in end meats and grinds still lags.

Premium-Choice branded products were also more prominent in 2018, with the share of Choice production captured by these brands up to 31.5% by early December, two percentage points higher than in 2017. That was another function of stronger marbling trends pushing more carcasses over the important line from "Small" to "Modest" marbling, the entry point to premium-Choice.

At roughly 85% of the premium-Choice branded market, the CAB brand was on track by year's end to garner a three-percentage-point increase in Angus-type cattle accepted. Two-thirds of fed steers and heifers fit the description last year, a two-percentage-point increase on 2017. Coupled with a 1.5% larger fed-cattle supply, that created a 5% increase in eligible cattle presented to graders for evaluation under the brand's 10 carcass specifications.

The narrower Prime cutout premium saw average packer grid premiums for Prime carcasses decline. Although the year began with a first-quarter average above $16 per cwt., the typically high-quality third quarter's larger supplies eroded the Prime premium to $11.80 per cwt. vs. $18.14 for the same period in 2017.

The trend continued with the fourth-quarter Prime premium of $10.23 per cwt. down $5 in a year. CAB brand grid premiums, pulled slightly ahead in the second half of 2018, the $4.11-per-cwt. average up 13¢ on the same period in 2017.

A smaller Prime premium creates momentary demand concern for some producers. However, even at a $9- or $10-per-cwt. premium on a carcass basis, those Prime carcasses are still worth $75-$85 per head more than a Choice carcass at 860-pound (lb.) carcass weights. Moreover, as end users become more accustomed to the affordable availability, there will likely be more uptake and commitment at their level to feature Prime in meatcases and on menus.

This can only help our industry firm up its place at the head of the table in protein competition. With U.S. pork and poultry's record supply not likely to decline, we're seeing a record-wide price margin favoring beef above the two. CattleFax data say demand for Choice and higher-grading beef has increased even as supplies rebuilt from the deficit of 2014, led most significantly by increases in Choice and Prime availability. The message is clarified when we note the decline in both production and demand for Select and lower-grade beef more easily replaced by pork and poultry.

We need not fear a market more saturated with high-quality beef. Rather, we should embrace this shift, the fruit of a logical market response that will guarantee beef remains the preferred protein.