Are You Riding the Risk Train?

Feed price outlook remains uncertain.

Story by
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Cattle prices may have you smiling — unless you have to feed your cattle. Corn, wheat and soybeans are all trading at unprofitable breakeven levels for most cattle feeders, and relief may be months away.

"High feed prices are never a good thing," says Dale Durchholz, AgriVisor Services Inc., Bloomington, Ill. "Great Plains breakevens have been running at a loss based on fall fed-cattle markets. Selling feeder cattle may be a better option than feeding them out right now. Then you can transfer the risk."

Corn prices could trade this summer above $3 per bushel (bu.) for as long as weather is a factor in making the crop.

"I expect this volatile pattern to continue," says Darrell Good, University of Illinois (U of I) Extension economist. "The sharp, rapid price decline of the summer of 1977 is not expected to be repeated in 2004, but trend yields would result in lower prices by harvest. Corn prices are expected to remain well-supported, even with good yield prospects."

Mike Zuzolo, Risk Management Commodities Inc., Lafayette, Ind., points to several factors that may make it difficult for cash corn prices to drop much before fall.

"Both global and domestic ending stocks for coarse grains/corn are likely to find difficulty rising this marketing year due to a combination of lower planted area, strengthening demand and low supplies of wheat. That makes it harder for wheat to get cheap enough to become a useful feed substitute for corn," he says. "Our recommendation has been for cattle feeders to work aggressively to lock in cash needs through late summer on any price weakness. Our target for December corn futures has been $3 to $3.10 per bushel."

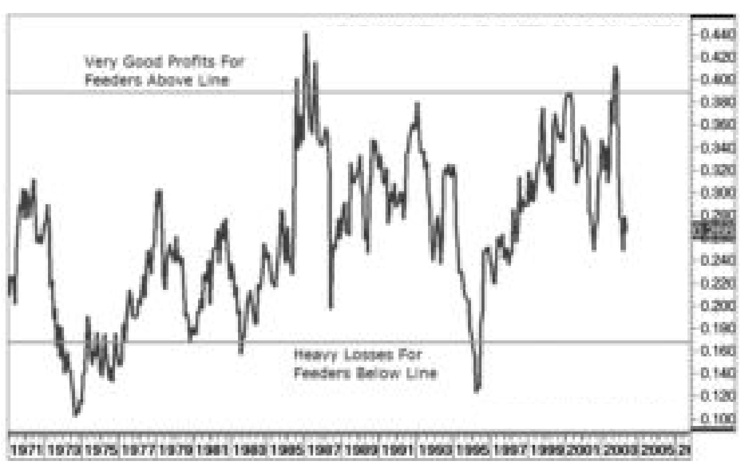
Adds Durchholz, "You can protect yourself from any weather surprises by purchasing $3.50 calls. If we have a decent corn crop, then you can pitch the calls. With a reasonable crop this summer, lower cash prices back into the mid-$2-per-bushel range are possible in the fall."

The December corn historical seasonal chart (see Fig. 1) shows daily corn futures prices for four years when the contract was near historical highs. Zuzolo says in each of those years, December futures expired near $2.79 per bu. "This is very interesting, and denotes that we need to be most concerned about summer prices," he says.

Zuzolo expects world stocks-to-use ratios to continue to shrink in wheat and coarse grains without near-perfect U.S. and Chinese growing conditions this year. In addition, the current U.S. export pace for corn and wheat has been very strong. Export inspections for both have been running more than 20% higher than a year ago.

Fig. 1: December futures corn historical chart

Fig. 2: Lead month live cattle-to-corn ratio



Source: *CME/Risk Management Commodities Inc.*

"The weaker to sideways trend of the U.S. dollar should keep our exports at a healthy pace, especially given low stocks of competing supplies in other countries, and, more specifically, the fact that China is likely to continue to keep exports at a minimum the balance of the marketing year," he says. "Our analysis suggests that the U.S. dollar will have difficulty moving any higher with tensions in Iraq, crude oil and unleaded gas prices running at multiyear highs and the impact on growth in the economy."

Strong cattle prices persist

Global factors will also affect cattle prices this summer and fall. While cattle have been at attractive levels, those levels are not enough to offset expensive feedgrains. What's more, Durchholz says ongoing concerns about Canadian feeder cattle imports, residual fallout from bovine spongiform encephalopathy (BSE) concerns and beef exports will continue to keep feeder and fed-cattle price direction in question.

"Trying to guess the outlook for cattle prices is a minefield," he says. "Higher fed-cattle prices are unlikely since we have been trading above the historically high $80-per-hundredweight (cwt.) area. Even though beef demand is good, producers need to protect their costs and play defense. You need to determine how much you are willing to lose to cover your out-of-pocket expenses and obtain put option protection for the most you are willing to lose."

Zuzolo agrees protection is wise, given the live cattle-to-corn price ratio chart (see Fig. 2). "This is a good depiction of where cattle feeders find profit and loss. When fat cattle don't go higher with corn prices, the ratio drops to levels in the bottom line," he says. "This chart picks up very well 1973, 1980, 1983, 1988 and 1995 — all years when corn prices rallied and fat cattle didn't keep up. This caused a large sucking sound in the cost of production for cattle feeders."

Similar losses could occur this year. While Great Plains feedlot estimated selling prices this spring were $6 per cwt. greater than a year ago, breakevens were about $12 per cwt. higher. Even with premiums for better quality carcasses on fed cattle, analysts say producers will be hard pressed to turn a profit in the near future.

Few feed alternatives

Unfortunately, producers have few alternatives to corn for finishing cattle, because most other feedstuffs are trading at unprofitable levels. "Wheat and milo are high, and we are just now seeing forage quality and supplies being established," Durchholz says. "USDA (U.S. Department of Agriculture) increased prospective hay acres 400,000 this year, but we don't know yet what the tonnage will be from those acres."

While some producers may be able to pencil wheat into rations, Zuzolo is not optimistic. He expects a national average yield of 40 bu. per acre, which would place U.S. wheat ending stocks at a tight 370 million bu.

"Wheat is able to compete effectively as a feed source in place of corn when wheat drops to a 70¢ premium to corn," he says. "We don't have that this year."

Few stockers were on wheat pasture this spring in Oklahoma. Oklahoma State University (OSU) Extension economist Derrell Peel says the major summer stocker areas had excellent moisture early on, but a lack of available cattle and extremely high purchase prices have kept opportunities at bay. In addition, some reports of strong bred heifer and cow prices indicate producers may be holding cows and heifers in anticipation of demand from drought-reduced areas and for herd rebuilding.

Little relief in sight

The rough economic patch could extend into another year for cattle on feed. USDA projects corn prices in 2004-05 will be slightly higher than 2003-04 as total use surpasses supply. Marketing advisors recommend producers be prepared to lock in lower feed costs and manage fed-cattle price risk to maximize profit opportunities, including any premiums for high-quality carcasses.

In its annual corn outlook, USDA forecast use will likely set records as livestock herds grow, raising feed needs, and industrial uses for corn expand. USDA representatives say traditional feed demand may not be as strong as it would be without other feed ingredients like ethanol coproducts. Dried distillers' grains (DDG) from the ethanol production process can assume some of the corn demand, but prices are still high for DDG as a feed ingredient as well.

Continued strength in the cattle market could ease feed cost concerns somewhat. USDA's Economic Research Service (ERS) this spring reported, "The stronger the industry herd expansion response to higher prices, the tighter beef supplies will be through 2006. … The recent reduction in cow slaughter is very positive as the first step toward expansion, but real movement toward expansion cannot occur until heifers are retained this fall from this year's calf crop. The extent to which this occurs will further tighten beef supplies and will not contribute to increased production until mid-2007.

"Until then, supplies will remain tight and prices fairly strong," the ERS report says. "While the industry is apparently ending the liquidation phase of a much-extended cattle cycle, the expansion phase has yet to materialize."