The Cattle Crush Spread Heats Up

Feeding Corn to Yeast Does Have Consequences

Those who know of the late Herbert Stein, economic advisor to Richard Nixon, may know him for being the father of Ben Stein of multiple talents or for his oft-repeated quote, "If something cannot go on forever, it will stop." I remember him as well for his role in Nixon's misbegotten program of wage and price controls. His role in helping beef start to disappear from grocers' shelves in 1973 actually led Nixon to suggest on national television Americans eat more chicken and fish.

We threw Nixon out of office the next year; you are free to make whatever connections you wish.

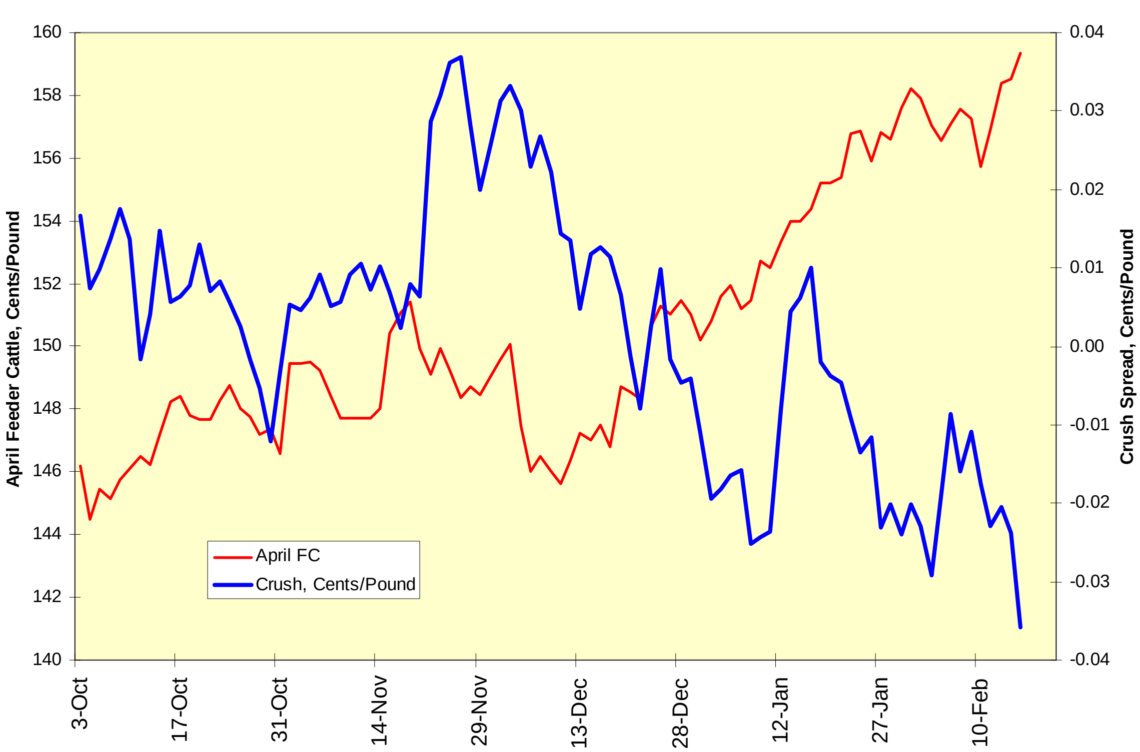
The Cattle Crush Spread

As I prefaced March 2011's How Corn Prices Are Affecting Three Leading Poultry Processors, "Commodities are not pretty." In economic terms, livestock always were viewed as a conversion device for transforming low-value corn into high-value meat and by-products. As an even uglier aside, the meat content of cattle was a break-even proposition; the profit came in the hides and offal. For those seeking financial exposure to commodities; bless you, actual exposure can be grim.

Physical commodity processes take time. It takes close to five months to fatten feeder cattle weighing between 700 and 800 pounds apiece to live cattle weighing between 1,100 and 1,350 pounds apiece. This time lag and weight differential account for the unusual mix of contracts required for what the industry calls "the cattle crush spread." The standard combination of contracts for the so-called "cattle crush" spread is four corn (C), five feeder cattle (FC), and 10 live cattle (LC).

There are eight of these spreads every year; let's focus on the one involving April feeder cattle, May corn and August live cattle.

The April Feeder Crush



As you can see, the board crush is now negative. Last year's drought in the key Texas-Oklahoma region and the ongoing diversion of 40% or so of the U.S. corn crop to ethanol distillation have raised the prices of feeder cattle and corn, respectively. If price elasticity of demand is working, and it usually is, we should see demand for beef decline relative to that for other protein sources, including Nixon's chicken and fish.

The only real way out of this mess is to have the price of corn fall to accommodate the higher price of feeder cattle. That is unlikely to happen for May as this is last year’s corn in storage. Importing corn from the Southern Hemisphere is a non-starter.

Meatpackers such as Tyson Foods (TSN) will feel the pressure of this lower demand for beef. Tyson’s total return of 14.86% since last October’s low trails the S&P 500’s 24.64% return by a wide margin. Americans who eat food, a category that may include you, are going to experience some real grocery price shock this summer. They will have to reconcile it with Ben Bernanke’s insistence inflation is not high enough to suit his taste.

Can I offer, “Let them eat fish” as a quotation, or is that taken already?