You'll Have To Pay More Now To Pay Less Later For Beef

I had a chance encounter on the street with an old commodity trading compatriot who introduced me to his wife as someone who once described hogs as a corn-processing machine. I laughed, admitted authorship and in the interests of delicacy sidestepped more direct descriptions of the livestock industry. Commodities are not pretty.

Nor are their price messages pleasing, either. All consumers want lower prices all of the time, and vice-versa for producers, but prolonged periods of low prices lead to underinvestment in production and subsequent price spikes. The opposite holds true for producers: If you want to induce what is known as demand-destruction, raise prices, pull up a chair and watch the forces of conservation and substitution act in real time…or in any other time of your choosing.

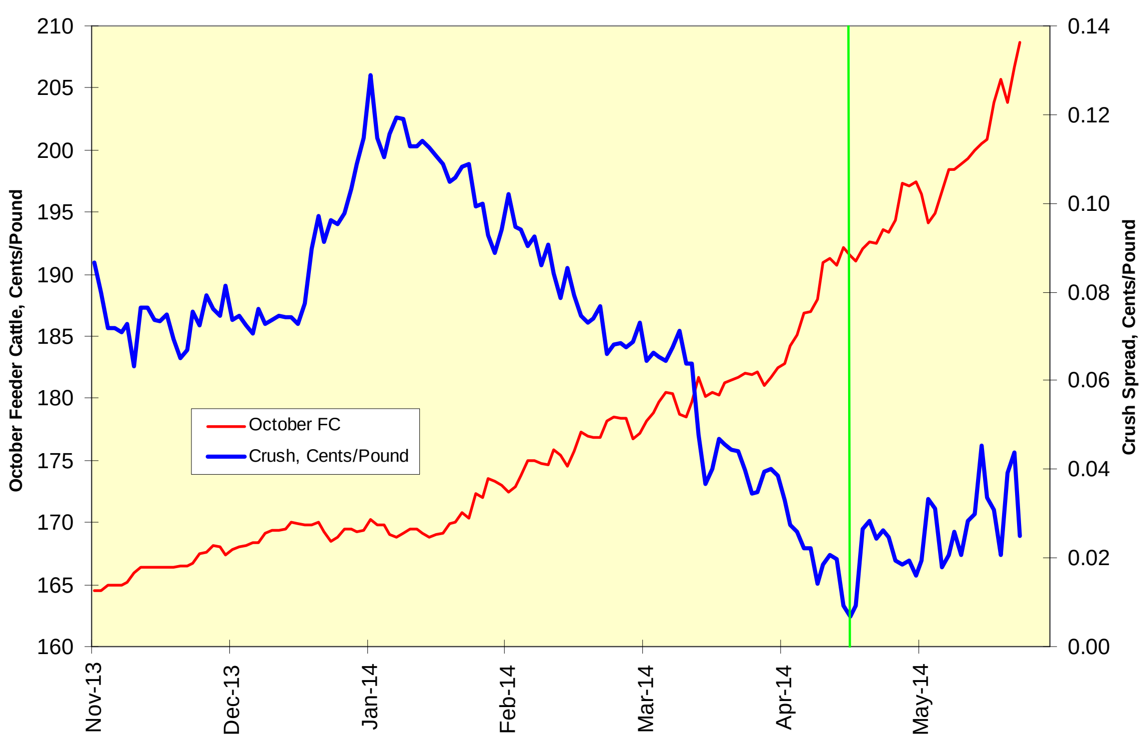
The Cattle Crush

This brings us, of course, to the rising price of beef. The USDA's index for ground beef prices rose 16.5% at the end of April (April? You guys know it is June? Let's crank the data-tron up a notch here!) from year-ago levels. As eating hamburgers at McDonald's (MCD) , Wendy's (WEN) and Burger King (BKW), just to name a few, is more popular than the soccer sophisticates keep trying to shove down my throat, these rising prices should constitute a red line in the sand, for all of the good that would do.

What is worse for beef consumers is all physical commodity processes take time. You can create financial assets relatively quickly and trade them at high-frequency, but tt 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 October feeder cattle, December corn and April live cattle. December corn represents the bulk of the new crop now growing on farms near you; it has declined more than 10.25% since May 9, 2014, marked on the chart below.

The October Feeder Crush



This cattle crush spread has been under pressure even with the decline in corn prices as feedlots keep bidding the price of feeder cattle higher. Consumers can and do push back, and total beef consumption has been declining since 2007 for reasons involving the income- as well as the price elasticity of demand. While October feeder cattle prices have increased 8.7% since early May, April live cattle prices have increased less than 5.4%. I fully expect demand to shift down the dietary curve from beef to pork and poultry.

If cow-calf operations and ranchers respond rationally to these price signals, they will start expanding herds from sizes last seen in the early 1960s. The U.S. has been offsetting shrinking herds with heavier cattle for years now, but there is only so much left in that little bag of tricks. If you want to see beef retain its central role in the U.S. dietary mix, the best way to do it is to pay the higher prices today to induce higher supplies tomorrow.