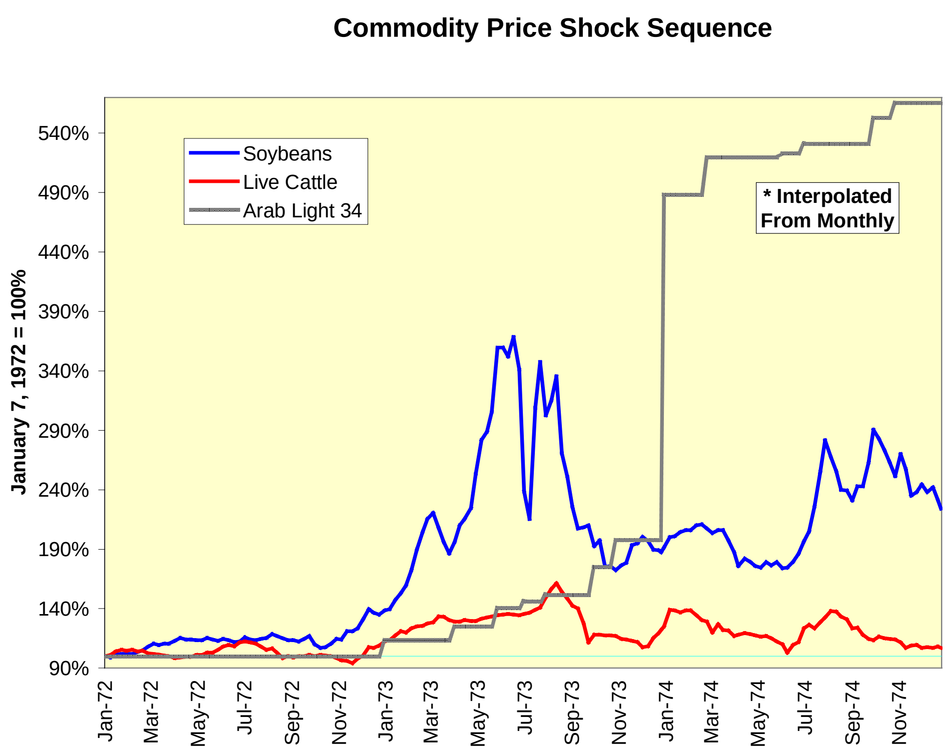
Where's The Beef?

Before gasoline there was beef, and before beef there were grains. The references here are not to causalities of production despite the obvious link between grains and beef, but to the visible manifestations of inflation in the 1970s. Higher commodity prices are the result, not the cause of inflation.

Inflation already had been a problem in the U.S. economy; President Nixon had imposed wage and price controls, a devaluation of the dollar and an increase in the official price of gold on August 15, 1971. The first great price breakout to the upside following the various economic mismanagements of the Johnson and Nixon administrations was the so-called Great Grain Robbery of July-August 1972. This was not an actual heist but part of an alleged cynical geopolitical deal wherein the Russians would look the other way while we laid waste to Vietnam and we would bail them out of the inevitable failures of communist agricultural policies. The present mutual cooperation regarding Iraq/Afghanistan and Chechnya is part of this grand tradition. At least the Russians were not arresting business leaders then because they had no business leaders then.

Before we go further, my usual sincere and serious warning to more sensitive readers is in order. Commodities are not pretty. Nowhere is this more true than in the animal and animal products markets.

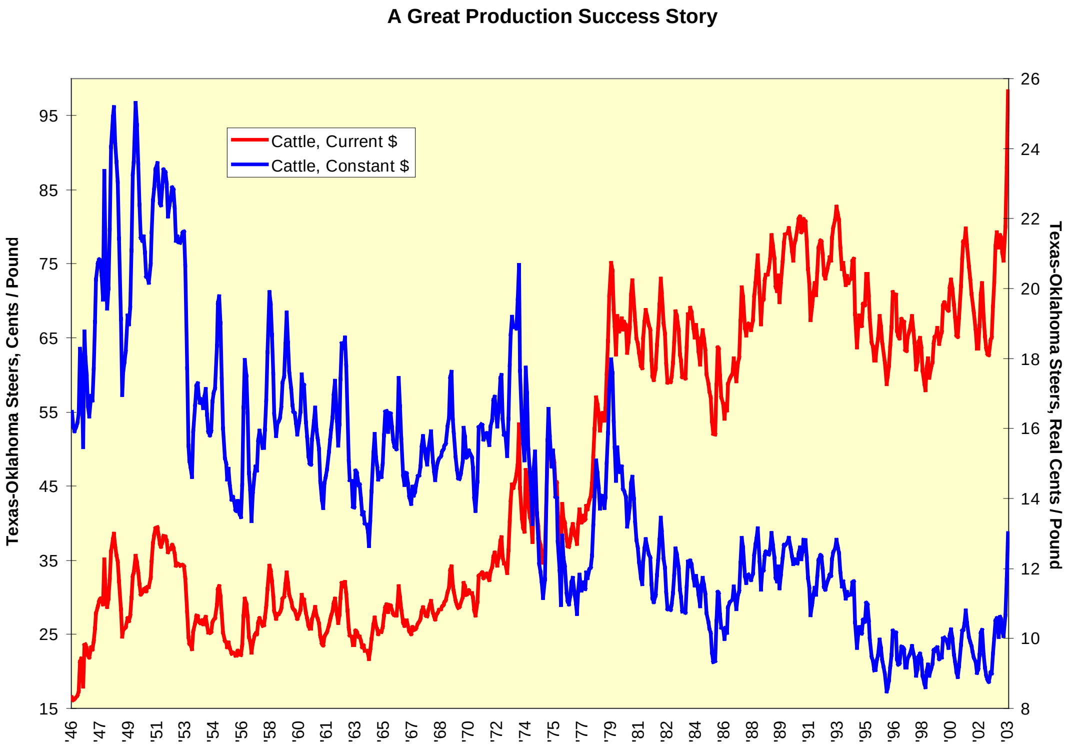
The subsequent jump in feedgrain prices led to a liquidation of cattle herds and a big jump in the retail price of beef in the summer of 1973. These events preceded the ultimate burner of inflation into the American psyche, the fourfold jump in crude oil prices, already rising, by OPEC in the aftermath of the Yom Kippur War of 1973.



Everything's (Really) Smaller In Texas

The cash market price for Texas-Oklahoma steers is the highest on record in current dollar terms. On one level this is alarming as it recalls the confirmation by cattle prices of other rising commodity prices in the early 1970s. We can ignore the special situations helping to produce this jump. In a bull market all news is bullish, and the outbreak of bovine spongiform encephalopathy (mad cow disease) in Canada and the cessation of cattle imports therefrom is just one of those events that would have come and gone had this not been a bull market waiting to happen.

On another level, however, we should not lose sight of just how efficient the American cattle industry has been in keeping prices on downward path over time. Cattle prices, deflated by the producer price index, are only two-thirds of the level reached in July 1973 and only 72% of April 1979 levels. Neither previous price spike ended the American love affair with the hamburger.



The Cattle Crush

In economic terms, cattle convert low-value feedgrain, principally corn, into high-value meat. 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 this 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).

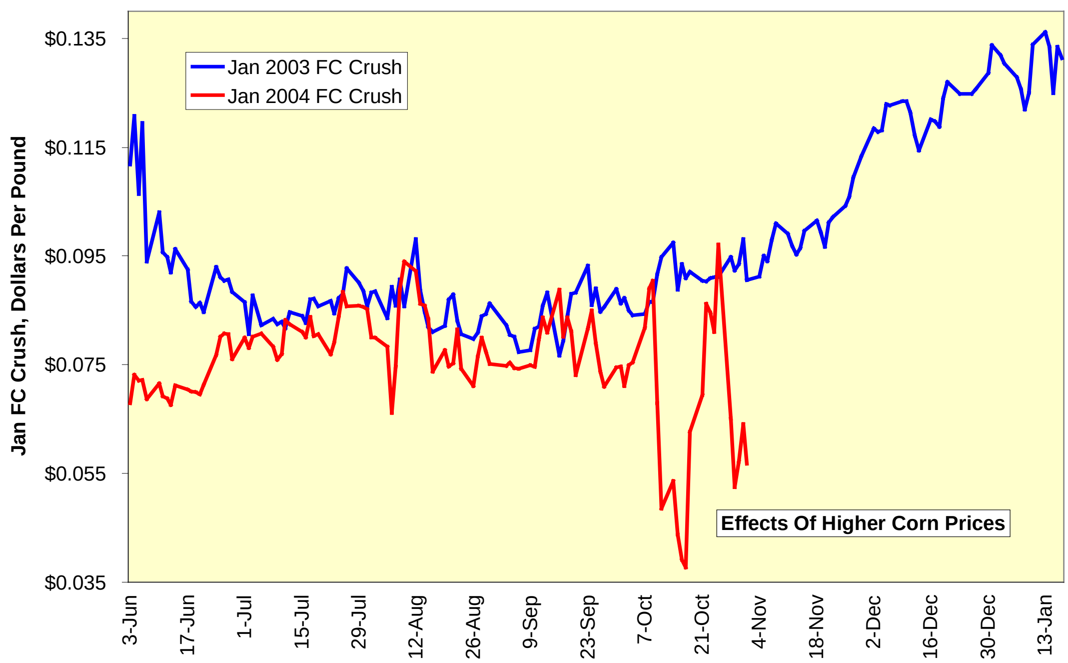
The month combinations, listed in order of the FC month involved, are:

1. **Jun LC - [Jan FC + Mar C]**
2. Aug LC - [Mar FC + Mar C]
3. Aug LC - [Apr FC + May C]
4. Oct LC - [May FC + May C]
5. Dec LC - [Aug FC + Sep C]
6. Feb LC - [Sep FC + Sep C]
7. Apr LC - [Oct FC + Dec C]
8. Apr LC - [Nov FC +Dec C]

The spacing of the FC contracts through the year is a function of the breeding cycle of cattle, an indelicate topic on which we will dwell no further. The futures industry has yet to accommodate their commercial customers: This spread involves three futures contracts, imperfectly aligned in both their size and timing, traded across three different futures pits on two exchanges. While the Chicago Board of Trade's corn contract is highly liquid, and the Chicago Mercantile Exchange's live cattle contract is somewhat liquid, the CME's feeder cattle contract is not very liquid at all. Great care in trading this spread is advised.

A cattle crush trader at present would focus on the January crush spread, that involving January feeder cattle, Mach 2004 corn and June 2004 live cattle. During the July-September 2003 period, the economics of this crush spread did not differ greatly from those of the January 2003 FC crush spread. However, the recent jump higher in March 2004 corn prices - they went from $2.205 per bushel on October 20 to $2.525 on October 31 - has threatened to make cattle feeding uneconomic.

Steer Clear



Some segment of the industry will have to absorb the pain of higher corn prices; either the cow-calf operations in accepting lower feeder cattle prices or the feedlots themselves in lower margins. If feedlots liquidate herds prematurely, the consumer will see lower beef prices in the short-term and higher beef prices in 2004.

Finally, the Department of Agriculture is proposing to end the ban on cattle imports from Canada early in 2004. Those cattle are ready for slaughter and will compete with American slaughter cattle (the actual industry name for what the futures industry calls live cattle). That will erode crush values further unless either corn prices or feeder cattle prices fall sharply.

Other ramifications abound. A liquidation of cattle-on-feed will put downward pressure on corn prices during an election year, and no segment of American society is as adept at, well, feeding at the public trough as agribusiness. And, higher beef prices will increase demand for alternative meat sources such as poultry and pork.

Livestock is one segment of the economy where American producers enjoy big productivity advantages in the global economy. Prices for cattle are not held down by - heaven forbid! - outsourcing to India or by exports from China. While the macroeconomic inflation numbers are still looking low due to factors such as these, basic commodities and foodstuffs are starting to party like it is 1973.