

CATTLE MARKET SITUATION AND OUTLOOK

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Introduction

The US beef market has survived a roller coaster ride in near bullet-proof fashion. While difficult to pick a pivotal date to start the ride, the significant feedlot losses in 2002 that led to an 8% decrease in cattle on feed in January 2003 laid the ground work for record prices in October of the same year. The Canadian announcement of BSE on May 20 and the US BSE announcement on December 23 will make 2003 a year difficult to forget. Beef imports from Canada for under 30 month old beef resumed in September 2003, but live cattle trade was banned for 27 months until it reopened in mid-July 2005. At this writing, US beef exports are at 25% of the pre-BSE level and are still waiting word on resuming beef exports to Japan. US beef exports will resume but attempts to predict when have proven futile. As we make long term forecasts we will assume that trade resumes.

Another turning point was January 1, 2005 when the USDA showed its first year-over-year increase in cow inventories since 1996. The breeding herd has entered the expansion phase of the cattle cycle and beef supplies will begin increasing in 2006 and beyond. Yet, it appears that cattle prices may have moved to a new price plateau with higher highs and higher lows as we move through the cattle cycle. Annual average fed cattle prices for 2003 and 2004 were within \$1/cwt of the previous record high weekly price. Part of this price shift has come from higher cowherd costs and part from increased beef demand. Beef demand, which bottomed out in 1998 and has increased 27% in seven years, will support prices, but the added supplies will lead us to lower prices in the coming three to five years.

Cattle production cost structure continues to evolve. Increased corn acreage and yield is making 10 billion bushel crops the norm and 12 billion bushel crops within reach. The dramatic increase in ethanol production and planned expansion is increasing the demand for corn, but at the same time increasing the supply of distiller's grains and solubles (DGS) that are well suited for cattle feed. The energy prices that favor ethanol demand also favor feeding the DGS wet and local. At the same time the demand for pasture land from corn production, recreational uses, and environmental programs is pricing it out of the hands of many beef cowherds. Thus, the cost of producing a calf is increasing while the cost of feeding it to slaughter, at least in some regions of the country, is decreasing.

With this backdrop let's consider the supply and demand factors that are going to shape cattle prices over the next one to five years and beyond.

Demand Factors

Domestic beef demand which had fallen by 50% from 1980 to 1998 has rebounded 27% from its low in mid 2005. Demand has not been at this level since 1991 and is helping to support prices as supplies grow. Demand is a two-dimensional concept, both price and quantity. Per capita consumption is expected to increase as cattle inventories grow and prices are expected to decline. The amount of the decline will depend upon demand. Factors that impact domestic demand include the price of beef compared to competing meats, consumer income, and consumer preference.

Retail beef prices have average 33% higher than retail pork prices for the 25 years of 1980-2004. This ratio was as low as 14% over pork in the mid-1990s, but was over 40% in 2003-04. The relatively higher price may be difficult to sustain without consumers switching to a lower cost alternative, but the fact that pork demand and price have increased along with beef bodes well for beef in the future.

Beef prices relative to poultry have come down in recent months at the wholesale level. Choice boxed beef prices have been more than two times the price of wholesale chicken (12 City Composite Ready-to-Cook) in over two-thirds of the months since September 1999. This price ratio has been below 2 since May and was 1.86 in August. Beef will never be cheaper than chicken, but consumers are less likely to switch to chicken when it is priced closer to beef prices.

Consumer income has been a demand driver in the late 1990s and beyond for beef. However, there is concern about disposable income in the near term with dramatically higher energy prices cutting into household spending. In addition to higher gas and home heating prices, the higher energy prices result in higher costs throughout the marketing channel, i.e., transportation, processing, refrigeration. As a result consumers looking to economize may eat out at restaurants less often or switch to a lower cost meat for home meals. Long term, if higher energy prices persist, the economy may adjust through increased inflation and while prices are expect to return to the long-term relative relationship, the transition can be difficult.

Consumer preference for beef appears to have had a major positive impact on the beef demand turn around just as it did in the down turn in the 1980s. Throughout the 1980s and early 1990s there were concerns about the negative effects of beef on health. However, the popularity of the low-carb diets in weight loss programs made it fashionable to eat beef again. While the low-carb fad appears to have run its course and the Atkins Diet company filed for bankruptcy, the number of people that self report as being low-carb or high-protein consumers is higher than three years ago. Thus, there has been a ratcheting up of protein demand.

Another consumer trend that had a negative impact on beef demand in the 1990s but has improved in recent years is the demand for convenience. Food consumed away from home continues to increase and is now nearly as many dollars are spent on food

away from home as is spent on food at home. The recent increase in the number and variety of “heat and eat” beef products has been supportive of beef demand.

Exports are also important to cattle prices as beef supplies increase. Through July 2005, US beef exports were approximately 25% of their pre-BSE pace. Japan is the largest single market that has not reopened and South Korea is also a significant market that is yet to open. There was speculation early on that South Korea would follow Japan’s lead, but it now appears that the two countries are negotiating separately with the US. South Korea appears to be willing to accept beef from cattle that are less than 30 months of age which is the trade practice within North America and the other countries that the US is trading with. Japan continues to insist on 20 months of age or younger.

Even when these countries allow US beef exports, it will take time to rebuild exports to pre-BSE levels. While there is not doubt there is a great deal of political positioning between the countries on such issues, there is also a genuine concern among at least a portion of Japanese consumers about the safety of US beef. Sound science alone will not be enough to win back all the former consumers of US beef in Japan and other countries. Time, quality, and value will also be needed. Also, there is greater competition from Australia, which has increased grain fed beef production targeted at Japan, and Canada, which has increased slaughter capacity and will export more beef in the future. Both countries have a functioning animal ID system that is appealing to some trading partners.

Demand factors to watch over the next five years include:

- Beef price relative to the price of pork and poultry
- Health reports regarding low-carb diets
- Export recovery in Japan and South Korea

Supply Factors

US commercial beef production in 2004 hit its lowest level since 1994. It has increased in 2005 and is expected to show a year-over-year increase for the next three to five years and perhaps beyond. The last expansion posted five years of increasing slaughter during a time of declining demand. It is possible that expansion could last beyond five years if demand is strong enough to support profitable returns an additional year or two. Ultimately, losses will come to signal a contraction of inventories and the cycle will continue.

The January Cattle inventory report indicated the number of beef cows in the US was up 0.6%, the first year-over-year increase since 1996. The number of beef replacement heifers also increased. Through Labor Day total cattle slaughter in 2005 was down 1.8% from the same period in 2004. Steer slaughter was 2.4% higher, but heifer and cow slaughter was 5.5% and 7.3% lower, respectively when compared to the year before. Beef cow slaughter was 8.0% lower. Thus, producers are holding cows and keeping more heifers. This will limit supply near term, but is not expected to result in a

net decrease in beef supplies in part because of increased Canadian cattle imports. Also, cow slaughter in 2004 was the lowest level in many years and heifer slaughter has declined for four consecutive years. The calf crop that is the lowest since the early 1950s is expected to be larger in 2006 than it is in 2005. This additional supply will begin impacting the market in 2007 and beyond.

Another source of domestic supply is increased carcass weights. Average carcass weights were 649 pounds in 1985 and averaged a record 758 pounds in 2002. Carcass weights declined in 2003 and 2004 due largely to market conditions, but are expected to continue their upward trend in the future. Weights have been higher than the same week a year earlier since the fall of 2004.

Cattle and beef imports also add to the US beef supply. Beef imports are on pace to set a new record in 2005, up 5% through the first half the year over the record set in 2004. Canada was the largest import source for the US in the first six months of 2005 contributing 31.9% of the total. Australia, New Zealand, and Uruguay accounted for 21.0, 19.6, and 15.5 percent of US imports, respectively. Australia and New Zealand imports were lower thus far in 2005 compared to the year before, while Canada and Uruguay were higher. Beef imports from Uruguay in 2004 were 28 fold larger than 2002 when they were banned from trade most of the year due to foot and mouth disease. Their imports were 5.6 times higher than their previous high in 1996. This is grass-fed grinding beef and competes with similar beef from Australia and New Zealand.

Beef imports from Canada were suspended in 2003 from the May 20 announcement of BSE until September 1 of the same year. Imports were restricted to beef from cattle under 30 months of age. Canadian plants had to designate whether they were under or over 30 month plants and cattle were "mouthed" to determine age. Canadian beef imports in 2004 were over 1 billion pounds and were within 3% of their 2002 record levels. They are on track to exceed 1.3 billion pounds in 2005. Live cattle imports from Canada resumed in mid-July. For the first eight weeks on imports ending September 10, feeder cattle imports totaled just under 50,000 head and slaughter steers and heifers totaled 63,800 head. There are no breeding stock, dairy cows or heifers, cull cows, or over 30 month cattle imported. The weekly average slaughter steer and heifer number for the last two weeks of August and first two weeks of September was 63% of the 2000-2002 weekly pace for the same time of the year. The feeder cattle imports are higher than the normal flow from Canada, but less than the weekly pace in late summer 2002 when western Canada was in a drought and was shipping a lot of feeder cattle to the US.

Canada has expanded slaughter capacity and has made a strategic decision to feed and slaughter more of their cattle in country and export beef. Media reports are that Canadian cattle slaughter plants will increase slaughter capacity by mid-2006 by more than 28% compared to 2004 capacity. However, through July 2005 the largest slaughter week was only 8.7% larger than the largest week in 2002. Thus, it is doubtful that they will experience the full growth now that the US border has reopened to live cattle.

Production and Price Forecast

Table 1 summarizes cattle slaughter, beef production, and beef disappearance from 2001 to 2004 and forecast for 2005-2007. Note that 2005 production is expected to be slightly higher than 2004 and increase more substantially in 2006 and 2007. Although not in the table, supplies are likely to increase into 2009 and perhaps beyond. Per capita consumption accounts for production, imports, exports, and cold storage and divides the “disappearance” of beef by the US population. This consumption reflects the supply available at the retail counter for consumers and it is expected to increase about 2% in 2006 and level off in 2007.

Table 1. QUARTERLY COMMERCIAL CATTLE SLAUGHTER, BEEF PRODUCTION, and PER CAPITA BEEF DISAPPEARANCE

Year	Comm'l Slaughter 1,000 Hd	% Chg.	Comm'l Prodctin Mil. Lbs	% Chg.	Per Cap Consum Retail Wt	% Chg.
2001	35370	-2.4	26107	-2.5	66.3	-2.2
2002	35735	1.0	27090	3.8	67.7	2.1
2003	35494	-0.7	26238	-3.1	64.9	-4.1
2004	32728	-7.8	24548	-6.4	66.1	1.8
2005	32562	-0.5	24809	1.1	66.3	0.3
2006	33576	3.1	25742	3.8	67.5	1.9
2007	34405	2.5	26509	3.0	67.2	-0.5

Source: Livestock Market Information Center

Table 2 summarizes Western Kansas prices for Choice steers and 700-800# and 500-600# steers for 2001-2004 and forecast prices for 2005-2007. Prior to September 2003, Choice Kansas steers were above \$83.30 only one week and that was \$85.35 in March 1993. In 2003, they averaged \$83.30, were higher in 2004, and should set a new record annual price in 2005. Two thousand five is expected to be the high year of the price cycle with lower prices forecast in 2006 and beyond. However, it does appear that cattle prices have moved to a new price range that is higher than in the past. That doesn't rule out fed cattle prices in the \$70s, but does suggest that we spend much less time in the \$60s even though we averaged under \$68 for 1993-2002. The increase in demand discussed above and reduced supply are expected to support prices at the higher level. Feeder cattle prices are expected to move up accordingly.

Table 2: Price History and Forecast for Western Kansas Steers: Choice, Yearlings and Calves, July 2005.

Year	Choice Steer 11-1300# (\$/Cwt.)	Feeder 7-800# (MF & LF #1)	Feeder 5-600#
2001	72.23	88.62	99.97
2002	67.51	80.92	90.95
2003	83.30	91.28	99.93
2004	84.52	105.76	117.50
2005	85-86	107-109	124-127
2006	81-85	93-102	105-116
2007	81-88	90-102	101-115

Summary

Beef production is expected to increase in the years ahead as the cattle cycle starts another revolution. Annual prices appear to have peaked in 2005 and will be lower in 2006 and beyond, but appear to have moved to a new higher price range that already has had higher highs and should have higher lows as well. Beef exports that were banned by many countries due to BSE on US soil are slowly reopening and the major markets of Japan and South Korea are expected to open in 2006 or before. Once opened, it will take time to rebuild exports to their pre-BSE levels. Domestic demand is still the most important market for US beef and it has been improving since 1998 as consumers' preference for low-carb diets has increased their demand for beef. Higher energy prices in late 2005 will cut into disposable income of consumers and may weaken demand for beef, but at least in the immediate aftermath of Hurricane Katrina, which saw sharply higher gas prices, beef and cattle prices actually increased.

After enjoying the recent run up to record prices producers need to realign marketing and risk management strategies to reflect declining prices. There will continue to be profitable opportunities, but we will see more red ink as we move forward.