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In The Cattle Markets

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Cattle Feeding Risk

Despite recent rains, soon enough there will be yearlings marketed in the northern plains. The fed cattle and related markets have been relatively steady in recent weeks. During the lull, it seemed like a good time to look at the feeding margin to see if it has stabilized also. The feeding margin will likely dictate the price level bid for yearlings soon and for calves throughout the fall. The feeding margin risk will likely dictate actions feedlots take to manage the risk of lower fed cattle prices and higher feeder cattle and corn prices.

One way to look at feeding margins is to consider a fixed horizon. Using Livestock Gross Margin (LGM) data, one can look at expected and actual margins to see what could be locked in and what would happen if the margin was fixed or left open to market forces. The expected margin for six months out is far enough ahead to allow feedlots to protect profits or to adjust bid levels on feeders. This specific LGM margin would reflect a 1,250 pound steer to be sold six months out less the costs of a 750 pound feeder purchased one month out and of 50 bushels of corn purchased four months out.

Over the last decade, this duration (or six-month-ahead) LGM expected margin has averaged $145 per head. Thus, that level would be consistent with the long-run margin for other feed, feedlot fixed costs and labor. Another way to look at the $145 per head is that in a competitive environment higher margins will tend to be bid away and lower margins will likely be difficult to maintain. Usually this expected margin fluctuates between $100 and $200 per head. The most recent example comes from July of 2015. At the end of the month, the expected margin for cattle to finish in January of 2016 was $77.70 per head. This marked the ninth month in row where the expected margin was below $100 per head. Thus, the margin has stabilized at a level unfavorable for feedlots and likely reflects high bid prices for feeder cattle.

The actual or realized margin for this duration LGM is much less well-behaved. In October of 2014 the actual margin was $518.30 per head and in April of 2015 it was only $15.02 per head. It is currently penciling out at about $65 per head for July of 2015. Locking in the margin could limit gains, while not locking in the margin could lead to losses. LGM bundles together protection against lower fed cattle prices, higher feeder cattle prices and higher corn prices. Because of the way it is structured, LGM seems to be a favorable way to manage margin risk when the expected margin is high or when the volatility in the underlying markets is high. Neither of those situations exists at the present. The risk, however, remains.

Other ways that feedlots could address the feeding risk involve unbundling the margin components. Will corn be needed? The corn futures market shows modest carry, limiting how far ahead it may pay to purchase corn. The volatility for new crop corn remains modest. Thus, buying call options on corn may be a strategy to consider. Feeders (as an input) could be hedged using futures or call options. The volatility for feeders remains modest too. That would leave live cattle price risk. Put options may be the most reasonable protection tool to consider. Using futures would lock in the low margin and some upside is necessary to reach (if not to exceed) breakeven levels. Fortunately, the volatility in the live cattle market remains modest.

The Markets

The cattle markets were mostly higher for the week on the cash side and steady on the futures side. While cash corn was lower, DDGS prices were higher for the week. New-crop corn futures rose toward the end of the week after some actual volatility around the production report.

Data Source: USDA-AMS Market News		**Week of 8/14/15**	**Week of 8/7/15**	**Week of 8/15/14**
5-Area Fed Steer	all grades, live weight, $/cwt	$150.62	$151.13	$154.92
	all grades, dressed weight, $/cwt	$238.44	$237.60	$243.65
Boxed Beef	Choice Price, 600-900 lb., $/cwt	$242.66	$234.84	$257.35
	Choice-Select Spread, $/cwt	$8.11	$5.97	$7.10
700-800 lb. Feeder Steer	Nebraska 7-market average, $/cwt	$234.86	$232.25	$237.91
	Oklahoma 8-market average, $/cwt	$221.78	$220.74	$219.97
500-600 lb. Feeder Steer	Nebraska 7-market average, $/cwt	$270.30	$252.60	$276.35
	Oklahoma 8-market average, $/cwt	$251.67	$244.54	$254.78
Feed Grains	Corn, Omaha, NE, $/bu (Thursday)	$3.55	$3.60	$3.54
	DDGS Price, Nebraska, $/ton	$139.10	$135.40	$95.80