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This Issue

Feature Article

Margin Watch Reports

Dear Ag Industry Associate,

With the exception of the dairy industry, margins remain depressed, affecting producers in the hog, cattle and crop industries. USDA released a flurry of reports this past month that did nothing to reverse that trend. In addition to the regular monthly WASDE, Cattle on Feed, Milk Production and Cold Storage reports, there were also key quarterly reports, including the Grain Stocks and Hogs and Pigs data. Many in the swine industry have been waiting for the latter report in particular, as it represents a key piece of fundamental information about the supply side of the market.

Perhaps as a result of the focus on this data, less attention has been paid to news of the changes USDA plans to make to some other reports. These changes will affect how the pork cutout will be calculated and how packers will report swine sales under Livestock Mandatory Reporting, among others.

Our feature article this month outlines these report changes and how they may impact producers. In addition, our regular Margin Watch feature summarizes the impact of other key September reports and provides insight on forward margins for the hog, dairy, cattle and crop industries. If you have questions or would like additional information, please call 1.866.299.9333 or email mail@cihedging.com.

Sincerely,

Chip Whalen
Managing Editor

Chip Whalen is the managing editor of MarginManager and the vice president of education and research for CIH. He teaches classes on margin management throughout the country and can be reached at cwhalen@cihedging.com.

Upcoming Education Events

Margin Management for Lenders
Chicago

Oct 19-20, 2016

Commodity Price Management
Chicago

Nov 2-3, 2016

What Hog Producers Need to Know About Changes to USDA Reports

You may have heard that USDA will soon implement changes to its hog industry reports. But if you are like many hog producers, you may not know exactly what those changes will mean for your operation.

This article will summarize the most significant changes, their intended effects and their potential impacts on hog producers' bottom lines.

As the Industry Changes, So Does Reporting

The USDA produces many different reports, with the primary goal of delivering timely, accurate information that facilitates price discovery. As industries change over time, it may become necessary to update how data is measured and disseminated. While some changes are minor, others can have a more dramatic effect on when and how prices are reported.

Negotiated Formula Purchases

Many hog industry participants had expressed concerns that the definition of "negotiated" purchases resulted in an artificially low number of hogs reported in USDA's Agricultural Marketing Service (AMS) Market News reports, in particular, the National Daily Direct Hog Prior Day Report (LM_HG201), the Iowa/Minnesota Daily Direct Afternoon Hog Report (LM_HG206) and other purchase reports. Some also questioned the validity of the resulting benchmark negotiated price given the low volume of reported prices in that category.

To address those concerns, Congress authorized the addition of a new category for packer purchases called "negotiated formula purchase." As defined by section 59.200 of the 2015 Reauthorization Act, "the term 'negotiated formula' is a swine or pork market formula purchase under which the formula is determined by negotiation on a lot-by-lot basis, and swine are scheduled for delivery to the packer not later than 14 days after the date on which the formula is negotiated and swine are committed to the packer." Previously, open market hogs that were negotiated for sale to a packer on a lot-by-lot basis for "spot" delivery within 14 days were not reported as negotiated when the agreed-upon price between buyer and seller was based on a swine or pork market formula.

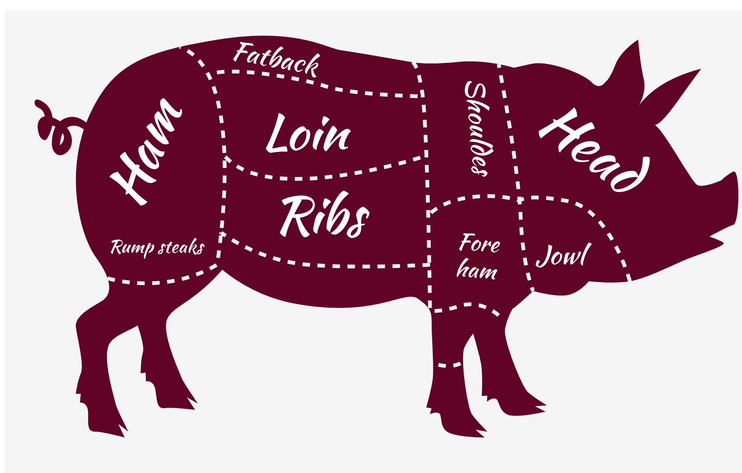
An example would be a purchase of a specific lot of hogs for a price based on a differential, such as a premium over the USDA Western Corn Belt or Iowa/Minnesota index. Prior to the rule change, the packer would have reported the transaction as a "swine or pork market formula purchase." As of October 12, however, transactions where the price is negotiated on a lot-by-lot basis will be categorized as "negotiated formula purchase." The likely result will be an increase in the number of hogs reported as negotiated on a daily basis. However, producers can help ensure the change has the desired positive impact on transparency by confirming that hogs sold on a lot-by-lot basis to packers are being accurately reported. They may also wish to track the daily reports to monitor whether the percentage of negotiated purchases is actually increasing.

Catch the Early Report

Another change to livestock mandatory reporting revolves around when reported purchases appear in daily reports. Previously, loads of hogs that traded after the 1:30 P.M. cutoff – but before the next day – were not reported until the Prior Day report on the following day. A new rule calls for those late afternoon purchases to be reported sooner, and in both the morning and afternoon reports the following day. The daily morning report will now include all hogs purchased between 1:30 P.M. Central time the previous day and 9:30 A.M. on the report day. The afternoon report will now include all hogs purchased in the 12-hour period between 1:30 P.M. the previous day and 1:30 P.M.of the report day. The goal of the change is to aid price discovery by providing more immediate price data, and should provide greater visibility on cash hog trading, as well as more direction to CME futures during the trading session. For producers, the take-away is that while both reports will now include a greater volume of hogs, the morning report will likely gain in importance as it will include a significantly larger number of purchases.

More Primals Will Impact the Cutout – and Producers' Pay

One of the most significant changes to USDA reports concerns the calculation of the pork cutout. The pork cutout is an estimated value of the overall hog carcass based on current wholesale prices for each of the composite primals, or cuts, of pork. AMS has changed the make-up of the ham primal, adding individual muscles – including insides, outsides and knuckles – to more accurately reflect current industry practices.

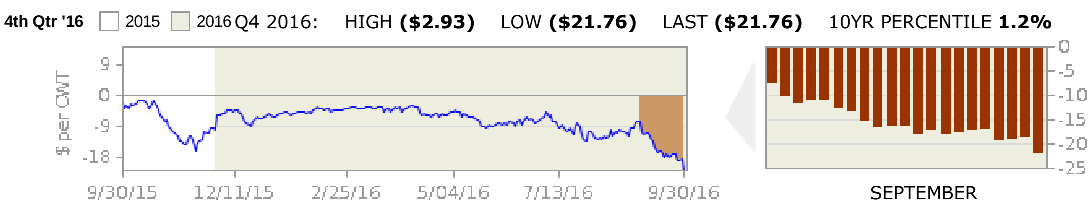


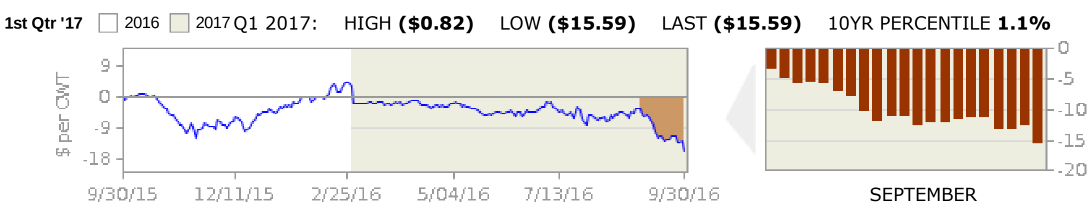
According to an AMS historical study, the enhanced list of ham sub-primals will likely result in a lower value for the ham primal as a whole, as well as the overall cutout, relative to current reporting practices. That means many packers and their suppliers will likely respond to the change by adjusting their contracting formulas. Therefore, hog producers who are currently paid as a function of pork cutout value should consider discussing with their packers whether – and how much -- their kill checks will change.

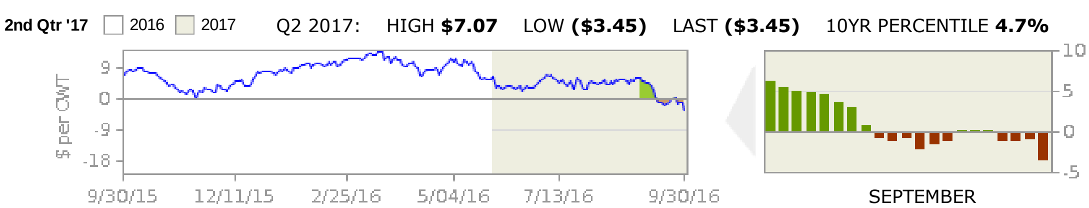
Originally scheduled to go into effect on September 12, the change was delayed until October 31 after AMS discovered that they had applied more labor costs than necessary in their initial review of cutout calculations and needed to correct historical ham primal and pork carcass cutout values.

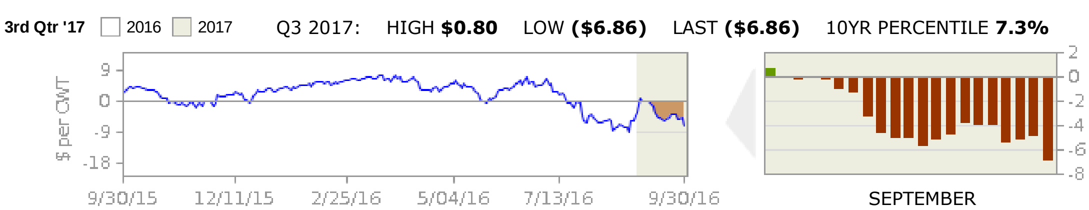
If you have questions about the upcoming changes and how they may affect your operation, please call 1.866.299.9333 or email mail@cihedging.com.

Margins continued to plummet through the second half of September, as hog futures dropped to fresh contract lows, with feed costs holding relatively steady since the middle of the month. Hog finishing margins are exceptionally depressed through Q1, at the first percentile of the previous 10 years, while forward margins are also negative and in the bottom decile of the past decade. USDA released their Quarterly Hogs and Pigs report, which confirmed industry expectations of larger hog supplies. As of September 1, “All Hogs and Pigs” were reported at 70.9 million head, up 2.4% from a year ago and above the range of expectations. While the “Kept-for-Breeding” figure of 6.016 million head was right at industry expectations, the “Kept-for-Marketing” figure of 64.835 million head was 2.6% higher than last year when the market was only expecting an average increase of 1.1% from 2015. Both the June-August “Pig Crop” and the June-August “Pigs-Per-Litter” figures were higher than expected, and help to explain why weekly slaughter figures have trended above what would have been anticipated from the last quarterly inventory survey in June. It appears that the industry has resumed its long-term growth trend in farrowing productivity following the PED epidemic in 2014, and analysts are now revising their estimates higher for hog slaughter forecasts late this year into early 2017. On the feed side, USDA also released their September 1 Quarterly Grain Stocks report, which was considered neutral. Corn stocks in all positions were pegged at 1.738 billion bushels, 19 million below the average trade guess but within the range of estimates. The figure was 22 million above the previous forecast for September 1 stocks. Given this backdrop, our hog producer clients continue to focus on adding flexibility to hog positions, while maintaining strong feed coverage.





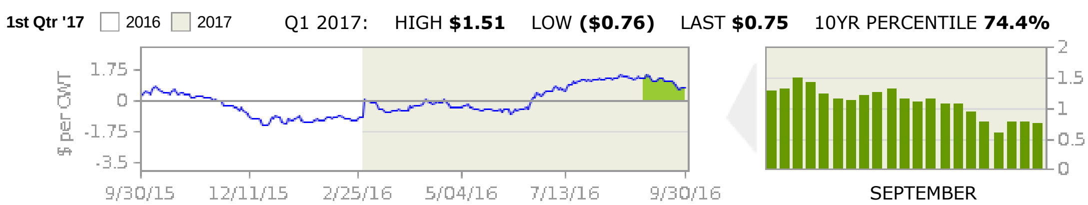


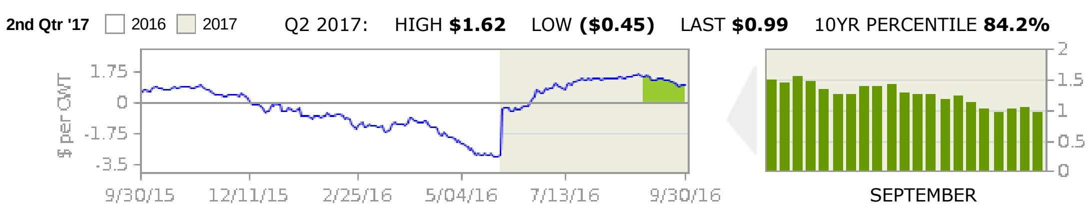


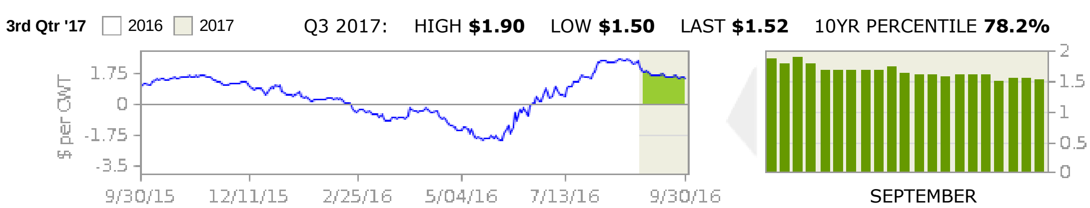
The Hog Margin calculation assumes that 73 lbs of soybean meal and 4.87 bushels of corn are required to produce 100 lean hog lbs. Additional assumed costs include $40 per cwt for other feed and non-feed expenses.

Dairy Margin Watch: September

Dairy margins have deteriorated since the middle of September due to declines in milk prices coupled with steady feed costs. However, dairy producers are in much better shape than their colleagues in the swine and cattle industries as their margins remain above average and at relatively higher 10-year percentiles of profitability. USDA's monthly Milk Production report showed August milk production at 17.7 billion pounds, up 1.9% from last year. Production Per Cow averaged 1,895 pounds, which was also up 27 pounds from August 2015. The number of Milk Cows on Farms increased 9.36 million head. That figure is the highest in nearly 20 years, and reflects an increase of 45,000 over last year and 16,000 over July 2016. USDA's Cold Storage report also confirmed continued high stocks of dairy products. As of August 31, butter stocks were at 322.2 million pounds and total cheese stocks at 1.243 billion pounds. While monthly stocks of both butter and cheese showed a seasonal decline, the draw on butter was much lighter than a typical August, while the draw on cheese was in line with the long-term historical trend. On the feed side, USDA's Quarterly Grain Stocks report was neutral for corn, with final 2015-16 ending stocks pegged at 1.738 billion bushels, down 19 million from the average trade estimate but up 22 million from the previous forecast. Following the recent decline in milk prices, our clients are now evaluating strategic adjustments to add flexibility back to their milk hedges, while maintaining protection against lower prices. Strengthening feed hedges has also been an area of focus as we head into harvest.







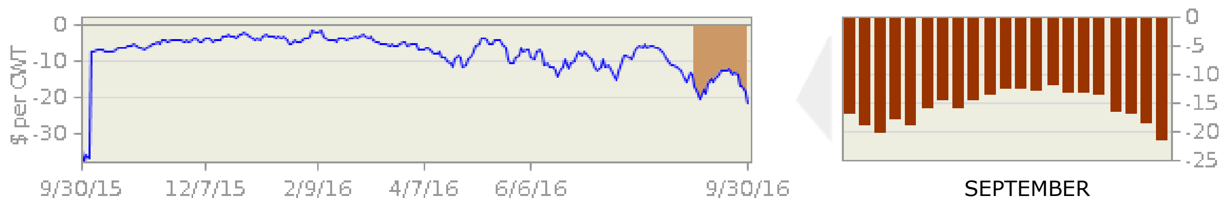
The Dairy Margin calculation assumes, using a feed price correlation model, that for a typical dairy 62.4 lbs of corn (or equivalent) and 7.34 lbs of meal (or equivalent) are required to produce 100 lbs of milk (includes dry cows, excludes heifers not yet fresh). Additional assumed costs include $0.90/cwt for other, non-correlating feeds, $2.65/cwt for corn and meal basis, and $8.00/cwt for non-feed expenses. Milk basis is $0.75/cwt and non-milk revenue is $1.00/cwt.

Beef Margin Watch: September

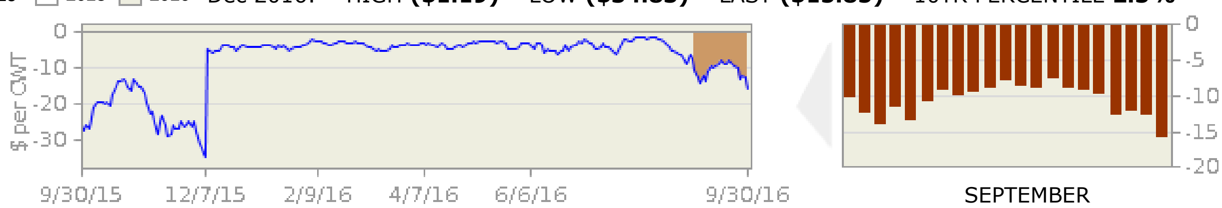
Beef margins have deteriorated sharply since the middle of September as cattle futures dropped to fresh contract lows, while feed costs held relatively steady. Even in forward marketing periods against future placements, the losses in feeder cattle did not offset lower fat cattle prices from a margin perspective, and cattle finishing margins remain deeply negative through next summer. USDA's monthly Cattle-On-Feed report was considered neutral, with figures in line with industry estimates. Cattle placements in August totaled 1.879 million head, up 247,000 or 15.1% from a year ago and about 2% higher than expectations. Placements again skewed heavy; cattle over 800 pounds were up 21.2% from last year and placements in the 700-799 pound range were up 18.5% from a year ago. Meanwhile, USDA reported that total beef in Cold Storage increased during August, a month when stocks typically decline. Beef supplies in Cold Storage on August 31 totaled 476.619 million pounds, up 7.021 million or 1.5% from July, compared with a 10-year average decline during that time period of 1.32%. USDA's Quarterly Grain Stocks report pegged September 1st corn stocks at 1.738 billion bushels. The figure was 19 million bushels lower than the average trade estimate, but 22 million bushels more than the previous forecast, and was considered neutral. As a result, traders are now looking to the October WASDE report for further insight about corn yield and production as harvest advances. Following the recent sharp break in cattle prices, our clients are looking to add flexibility to existing positions, while also strengthening delta on feed hedges as we move further into the harvest season.

Live Cattle Marketing Periods:

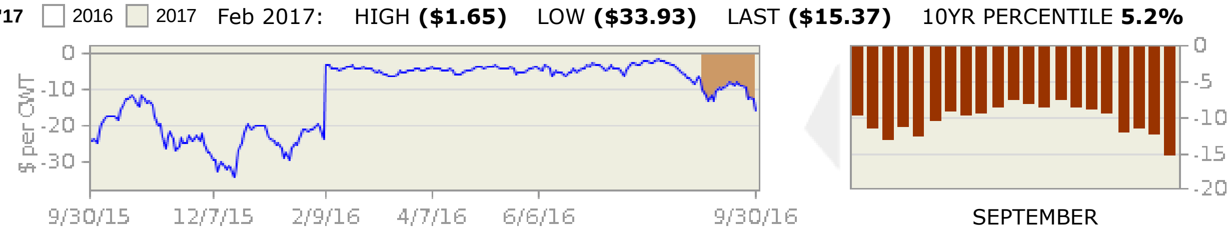
Oct '16 2015 2016 Oct 2016: HIGH **($1.60)** LOW **($37.51)** LAST **($21.44)** 10YR PERCENTILE **0.6%**



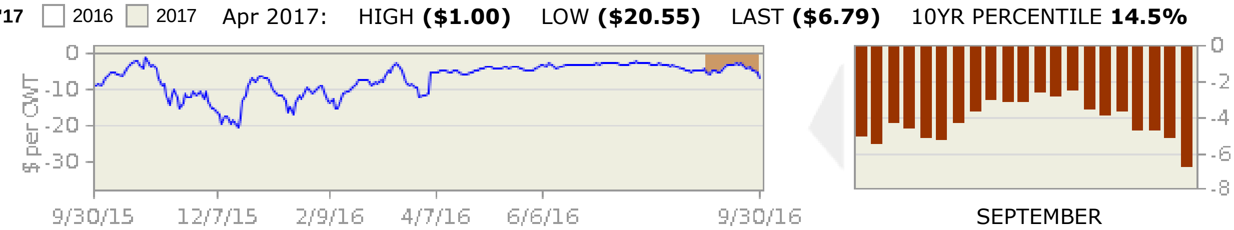
Dec '16 2015 2016 Dec 2016: HIGH **($1.19)** LOW **($34.83)** LAST **($15.85)** 10YR PERCENTILE **2.3%**



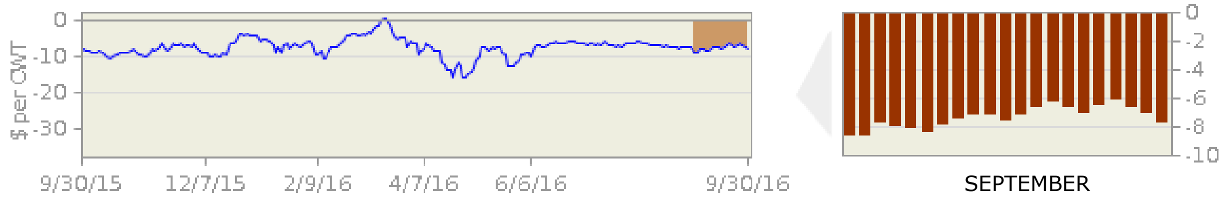
Feb '17 2016 2017 Feb 2017: HIGH **($1.65)** LOW **($33.93)** LAST **($15.37)** 10YR PERCENTILE **5.2%**



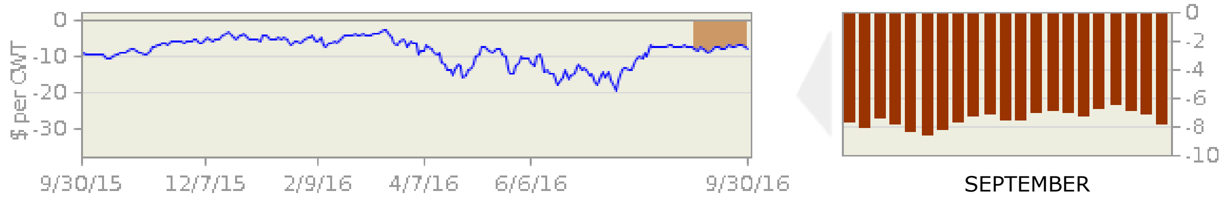
Apr '17 2016 2017 Apr 2017: HIGH **($1.00)** LOW **($20.55)** LAST **($6.79)** 10YR PERCENTILE **14.5%**



Jun '17 ☐ 2016 ☐ 2017 Jun 2017: HIGH **$0.65** LOW **($15.72)** LAST **($7.66)** 10YR PERCENTILE **26.9%**



Aug '17 ☐ 2016 ☐ 2017 Aug 2017: HIGH **($2.49)** LOW **($19.19)** LAST **($7.78)** 10YR PERCENTILE **24.4%**



The Beef Margin calculation uses Feeder Cattle futures to price inbound animals and assumes each will consume 55 bushels of corn and cost approximately $250 per head (for other feed and non-feed expenses) to gain 550 pounds and reach a market weight of 1,250 pounds.

Commodity & Ingredient Hedging, LLC

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Corn Margin Watch: September

Corn prices and margins moved higher over the past two weeks, as the corn market has continued to rally, largely on strong export sales and shipments. The marketing year is off to a robust start, with one-third of the USDA corn export estimate already sold and shipments running just ahead of the pace needed to meet this year's estimate of 2,175 million bushels. In the Quarterly Grain Stocks report, corn stocks as of September 1, 2016, were at 1,738 million bushels. This number will be the official ending stocks figure for the 2015/16 crop year and was below pre-report expectations by just 19 million bushels. The U.S. corn harvest has reached 24% completion, behind the five-year average of 27%. Harvest progress may slow in Iowa and Minnesota due to rain this week, and hurricane Matthew's path along the east coast is being carefully watched. Next week's October WASDE report will reveal updates to yield and acreage estimates, while also taking into account the stocks report. Our corn producer clients are considering adding flexibility to existing hedges that will offer the opportunity to participate in any recovery in corn.

The estimated yield for the 2016 crop is 182 bushels per acre and the non-land operating cost is $595 per acre. Land cost for 2016 is estimated at $238 per acre [1]. Basis for the 2016 crop is estimated at $-0.15 per bushel.

The estimated yield for the 2017 crop is 184 bushels per acre and the estimated operating cost is $547 per acre. Land cost for 2017 is estimated at $228 per acre [1]. Basis for the 2017 crop is estimated at $-0.3 per bushel.

[1] The Corn Margin Watch yield, land and non-land operating cost values are based upon central Illinois low productivity farmland crop estimates in the "Historic Corn, Soybean, Wheat, and Double-crop Soybeans" report published by the Department of Agricultural and Consumer Economics at the University of Illinois.

Soybeans Margin Watch: September

Soybean prices and margins moved slightly higher over the past two weeks. In the Quarterly Grain Stocks report, soybean stocks as of September 1, 2016, were at 197 million bushels, five million bushels below pre-report expectations but six million bushels more than last year. The 197 million bushels figure will be the official ending stocks tally for the 2015/16 soybean crop year. Soybean export sales and shipments in the new marketing year are both running ahead of the pace needed to meet the USDA export expectation. In fact, soybean sales have reached almost 50% of the USDA export expectation just four weeks into the marketing year. Favorable crush margins in China have driven much of the activity. The U.S. soybean harvest has reached 26% completion, just 1% behind the five-year average, but 10% behind last year's pace. The anecdotes of yield have been impressive and outpace USDA's estimate of 50.6 bpa. The October WASDE report will reveal updated acreage and yield estimates, as well as incorporate the fresh stocks data into the balance sheet. The Brazilian soybean seeding is 5% in the ground; beneficial rains have boosted soil moisture to reach adequate levels for seeding across much of the key bean growing regions, which should accelerate planting progress. Later soybean seeding dates matter little to the bean crop, given normal growing conditions; however they do add weather risks to the Safrina corn crop down the line. Coming off this year's disappointing Brazilian corn production, a timely soybean crop seeding is desired. Our soybean producer clients are considering adding flexibility to existing hedges that offer participation to upside movement.

The estimated yield for the 2016 crop is 52 bushels per acre and the non-land operating cost is $365 per acre. Land cost for 2016 is estimated at $238 per acre [1]. Basis for the 2016 crop is estimated at $-0.25 per bushel.

The estimated yield for the 2017 crop is 53 bushels per acre and the estimated operating cost is $290 per acre. Land cost for 2017 is estimated at $228 per acre [1]. Basis for the 2017 crop is estimated at $-0.35 per bushel.

[1] The Soybeans Margin Watch yield, land and non-land operating cost values are based upon central Illinois low productivity farmland crop estimates in the "Historic Corn, Soybean, Wheat, and Double-crop Soybeans" report published by the Department of Agricultural and Consumer Economics at the University of Illinois.

Wheat Margin Watch: September

Wheat prices and margins stayed in a tight range over the past two weeks. However wheat did move slightly lower following the Quarterly Stocks and Small Grains reports. The stocks of wheat on September 1, 2016, were estimated to be 2,527 million bushels, 129 million bushels more than the pre-report average expectation. They were also a stout 430 million bushels greater than last year's stocks. All wheat production in 2016 was estimated to be 2,310 million bushels, slightly less than expectations but 258 million bushels more than last year. Yields this year reached a record of 52.6 bpa despite a harvest of 7% fewer acres. All U.S. wheat export sales, at 54% of the total USDA current estimate, are running just behind the pace needed to meet expectations. On the global market, Egypt cancelled their zero-tolerance policy for ergot fungus and re-established the international standard, while production deficits forced India to lower their wheat import tariff from 25% to 10%. U.S. winter wheat seeding is 43% complete, just 1% behind the five-year average. Our wheat producer clients are considering adjusting existing hedges by adding more flexibility to offer opportunity to participate in upside surprises.

The estimated yield for the 2016 crop is 67 bushels per acre and the non-land operating cost is $358 per acre. Land cost for 2016 is estimated at $158 per acre [1]. Basis for the 2016 crop is estimated at $-0.35 per bushel.

The estimated yield for the 2017 crop is 68 bushels per acre and the estimated operating cost is $240 per acre. Land cost for 2017 is estimated at $150 per acre [1]. Basis for the 2017 crop is estimated at $-0.4 per bushel.

[1] The Wheat Margin Watch yield, land and non-land operating cost values are based upon central Illinois low productivity farmland crop estimates in the "Historic Corn, Soybean, Wheat, and Double-crop Soybeans" report published by the Department of Agricultural and Consumer Economics at the University of Illinois.