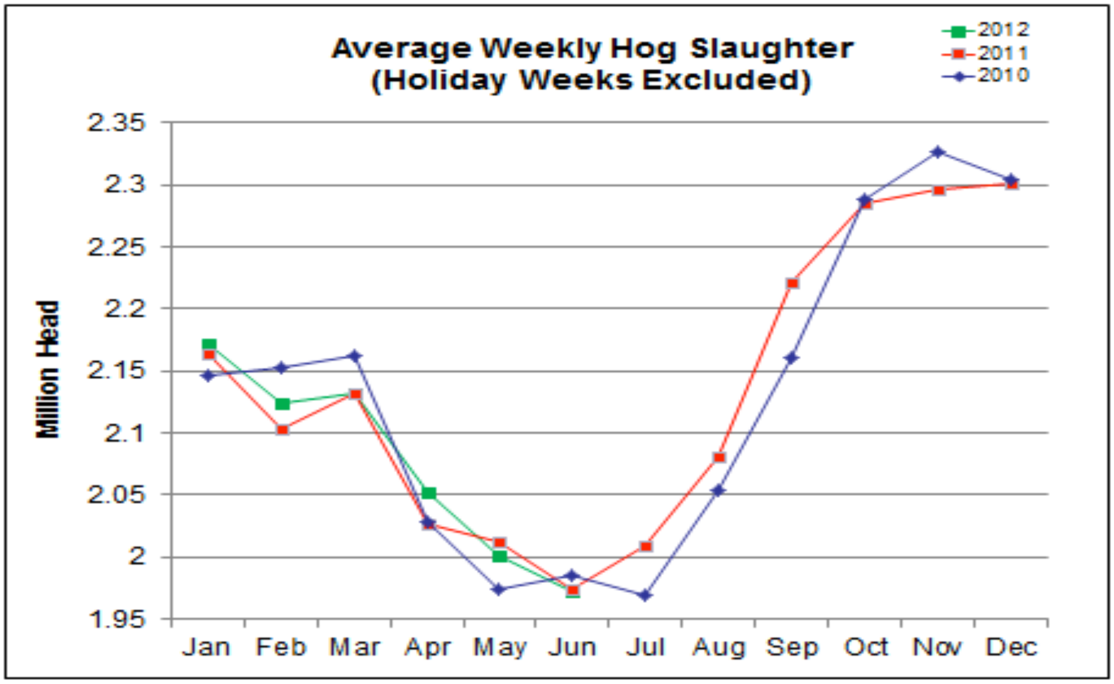
Topco's Meat Market Outlook
August 18, 2011

Feed costs and inclement weather has reduced pork production and soaring foreign demand have all combined to push U.S. pork prices to record highs. The most recent quarterly *Hogs and Pigs* report showed that the U.S. breeding herd stood slightly (0.3%) above a year earlier as of June 1. Not only that, but the increase in the breeding herd from March 1 to June 1 was somewhat above the average of the last ten years. Although corn prices have risen quite a bit more in percentage terms than cash hog prices, the futures markets have long offered producers the opportunity to lock in pretty decent profit margins throughout 2011. Not everyone takes advantage of this opportunity, but the optimism that the futures market conveys is not lost upon the "non-hedgers" in this business. And so there is no sign of a material reduction in pork supplies in the foreseeable future, and certainly not within the next six months. Based on USDA's estimates of the winter 2010-2011 and spring 2011 pig crops, hog slaughter in the third quarter should be *up* about 2% from a year earlier; in the fourth quarter it should be somewhere between unchanged and down 1%.

Seasonally, production is at its lowest point of the year right now, and will increase rather sharply beginning in August, see Average Weekly Hog Slaughter graph below. There is nothing terribly unusual about this basic pattern, but this year's increase promises to be a bit greater than normal. Thus, there is no great, bullish threat posed to wholesale pork prices from the supply side. In fact, there is no threat at all from this angle.



It is the demand side of the equation that makes us uncomfortable. Specifically, it is the potential demand from outside the U.S. border, and even more specifically, it is the potential of massive purchases of U.S. pork from China. Before we start talking about China, though, let's provide the backdrop.

The primary bullish theme in the worldwide meat market—we will refer to this again in our discussion of beef prices—is the expanding affordability of meat proteins among populous, developing regions of the world (we are talking mainly about China/Southeast Asia; Korea; Eastern Europe; and the Middle East). The United States happens to be the least-cost producer of pork in the world, at least among major suppliers. This provides a natural competitive advantage. U.S. pork exports have grown from 1.287 billion pounds in 2000 to 2.666 billion in 2005 to a projected 5.04 billion pounds in 2011—22-23% of all U.S. pork production is now being exported. On a side note – U.S. deficit arguments and subsequent credit downgrade in addition to sovereign debt crisis in Europe have impacted currencies producing a global pork market where the wholesale price from the U.S., Canada and Denmark are essential equal in U.S. Dollars or Japanese Yen.

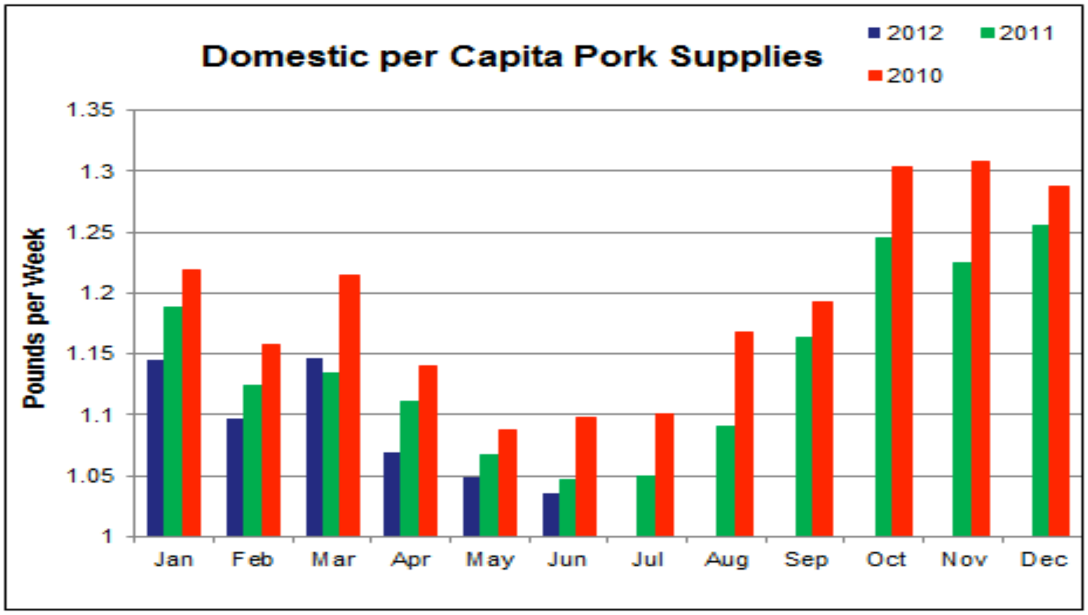
According to the latest official statistics, Japan is the leading importer of U.S. pork, accounting for one third of all U.S. pork exports; Mexico is second, accounting for 22%; Canada ranks third, accounting for 11%; and China/Hong Kong/Taiwan as a group ranks fourth, accounting for 9%. Korea, while comprising a greater share of the U.S. export market share earlier this year, took 7% of U.S. exports most recently. We should mention Korea as a special case, because late in 2010 Korea was beset with a major outbreak of Foot and Mouth disease which forced the elimination of roughly one third of its total hog population and led to aggressive importation of pork from abroad. The urgency of this program reached its zenith in the first quarter of this year, but the Korean government has since lifted its substantial tariffs on imported pork through the end of the year. Thus, as Korea struggles to rebuild its domestic herd, its demand for imported pork will remain relatively strong in the second half of 2011.

China is a big mystery to the rest of the world, because no one knows exactly what they are up to. But according to Chinese government figures, pork prices there are record high. One way to keep food cost inflation under control is to import more corn in order to resuscitate its domestic pork supply, which appears to be China's long term strategy; another way, of more immediate impact, is to import pork directly. But nobody knows how much of the latter might be involved.

We would not delve so deeply into this topic were it not for the fact that China's actions will make a big difference in the outlook for U.S. pork prices within the next few months. China's population is estimated to be 1.34 billion. If the intent is to control pork price inflation in the near term, then this can only be accomplished through massive purchases from abroad. Presumably, these purchases would consist mostly of frozen, split carcasses, therefore affecting all cuts equally (in terms of quantity, anyway).

Without this additional export business from China, pork prices would clearly be headed downward from here. U.S. pork exports would remain quite large by historical standards, but because of historically large production, domestic pork supplies would still be ample. China, therefore, stands to make the difference. At the time of this report, there are no hard facts available regarding volumes or delivery schedules.

Our expectation is that the China/Hong Kong/Taiwan will import about 80 million pounds of pork per month from the U.S. from August through November, roughly double the current rate. Total U.S. pork exports, then, should average 420 million pounds per month through the end of the year, compared with the current rate of 410 million pounds and 354 million pounds during August-December 2010. If that is to be the case, then the supply of pork available to the domestic market will be reduced rather dramatically. Following on page 3 is a chart of domestic pork supplies per capita.

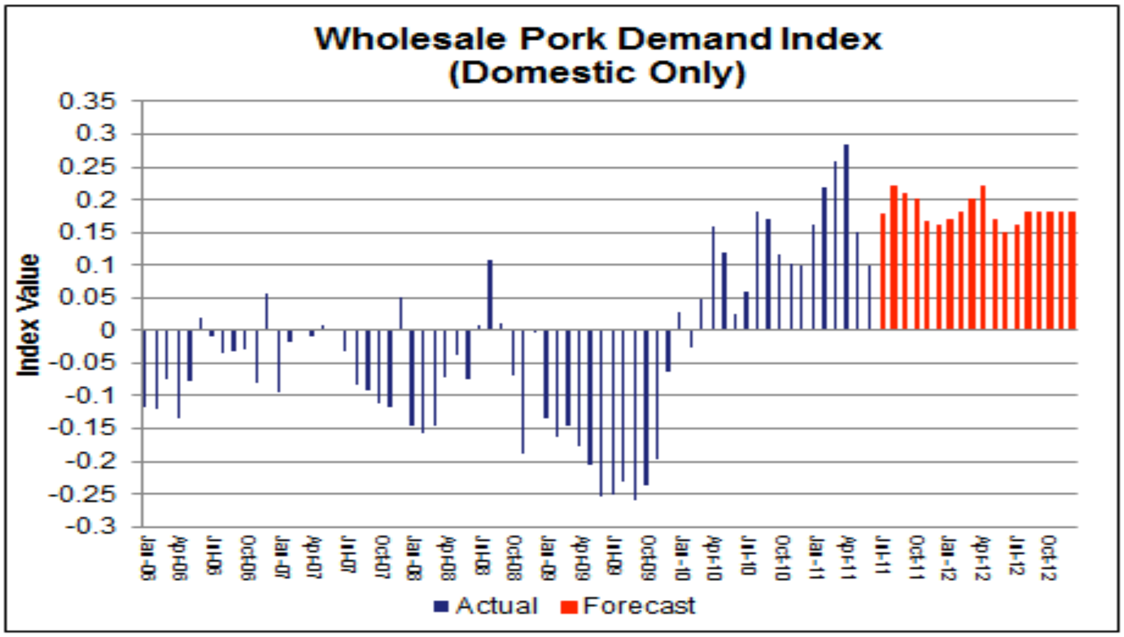


There are two salient points to be gleaned from this picture. One is that domestic pork supplies will be down significantly relative to a year earlier, and relative to the ten-year average, throughout the remainder of 2011 (and probably into 2012 as well). The other is that in spite of this surge in demand from China, domestic supplies will still increase into the fall. Thus, we anticipate that prices of all pork cuts except hams will show some semblance of a typical seasonal decline into the fall.....but the starting point will be delayed and will be relatively high, and the fall lows will be relatively high as well.

Meanwhile, domestic demand for wholesale pork remains suspect, for the simple reason that wholesale costs of pork have risen fairly steadily (seasonal factors aside) and quite sharply over the past 18 months. The first half 2011 vs. first half 2010 are as follows:

20-23 lb Hams	+5.5%
Bone-in Loins	+10.2%
14-16 lb Bellies	+25.9%
Boneless Picnics	+17.2%
Butts	+26.1%
Spareribs	+17.1%
72% Lean Trimmings	+8.4%
42% Lean Trimmings	+5.7%

Consumer-level prices, therefore, are clearly on an upward path, which always causes a slowdown in the rate of product movement through the "pipeline", and thereby acts as a drag on demand in the wholesale market—unless consumer spending power is increasing exceptionally, which it is not. Domestic wholesale demand has held up surprisingly well in the face of this "headwind", but we are naturally somewhat skeptical. The graph on page 4 shows domestic, seasonally adjusted pork demand at the wholesale level, including our projections for the balance of the year.

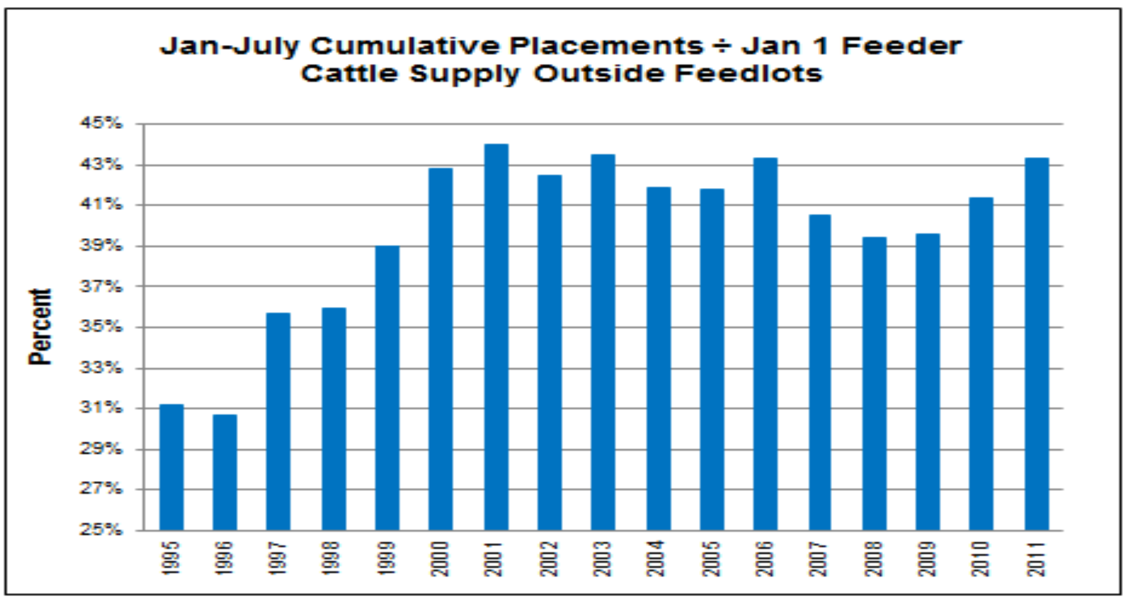


To summarize our price expectations for specific products, we offer the following estimates of general price ranges in August and November:

	August	November
20-23 lb Hams	$.85-$.90	$.85-$.95
Bone-in Loins	$1.40-$1.50	$1.10-$1.20
14-16 lb Bellies	$1.30-$1.40	$.95-$1.05
Boneless Picnics	$1.05-$1.10	$.80-$.90
Butts	$1.15-$1.25	$.95-$1.10
Spareribs	$1.70-$1.80	$1.45-$1.55
72% Lean Trimmings	$.90-$1.00	$.75-$.85

In the world of beef, tightening supplies will clash with growing export demand to create a distinctly bullish outlook as time goes on…..not necessarily right away, but this dynamic should become quite evident by about November. Let's begin with the basics. It is no secret that the U.S. beef cow herd has been shrinking. The number of beef cows in this country has declined every year since 2005, and has contracted 5.6% over the past five years. If there is a surprise in this equation, it is that the herd continued to shrink in the first half of 2011 despite very high feeder cattle and calf prices and generally profitable—at least on paper—returns to cow-calf operations. One major problem is that the Southern Plains in general and Texas in particular, have suffered from one of the most severe droughts of the past century. Without grass, you can't raise cows and calves. Pasture conditions are much, much more plentiful in the Northern Plains, but Texas alone accounts for about 16% of the total U.S. beef cow herd; Texas/Oklahoma/New Mexico combined account for almost one fourth.

The severe drought in the Southern Plains has also contributed to a brisk rate of placements of calves and yearlings into feedlots in the first half of 2011. At the beginning of this year, the total supply of feeder cattle outside feedlots was down 3.6% from a year earlier, yet the number of cattle placed into feedlots from January through July was *up* 1% (increased placements as percent of cattle supply shown in chart on page 5). You do not need a computer to figure out that the available supply of feeder cattle in the months ahead will be significantly reduced. This is going to create a very tight supply of finished cattle in the coming winter and spring seasons.



However, the high placement rate up to this point will keep "front-end" cattle supplies ample at least through September and probably October. In fact, the inventory of cattle on feed 90 days or longer on August 1 will be record large for that date, and up 14% from a year ago. And so the near term cattle supply will be much more comfortable than the long term.

Before moving on to the demand side of the equation, we should address the upcoming tight supply of lean processing beef and its potential impact on ground beef prices. Once again, the calculus is pretty simple: if the beef cow herd is shrinking**,** then the supply of slaughter cows will also shrink. [Beef-type cows account for 77% of the total U.S. cow herd, and dairy cows 23%.] The tightening will be exacerbated when the beef cow herd moves from a liquidation phase to a stabilization phase, since in the latter case producers will be more inclined to retain cows rather than send them to slaughter plants. We suspect that this development could occur within the next six to nine months, especially if availability of forage expands. It is not very difficult to imagine an 8% year-over-year reduction in cow slaughter during the fourth quarter and a 10-12% decline in the first half of 2012.

On top of that, the supply of imported lean processing beef will remain restricted as long as the Australian dollar trades so strongly against the U.S. dollar. As of today, the Australian dollar is worth approximately US$1.08 (vs. US$.90 at this time last year) and shows no sign of backing down. What this extraordinary exchange rate does is render bids from U.S. beef processors less competitive in Australian dollar terms. According to official statistics from Australia's Department of Agriculture, Fisheries, and Forestry, shipments of beef from Australia to the U.S. were down 24% from a year earlier in the first half of 2011, and down 30% in June.

Australian beef production is growing, but until there is a major change in the currency exchange rate, the total supply of lean processing beef in the U.S. will be quite limited. This will not only keep ground beef prices elevated, but it will also divert more chuck and round cuts into ground beef production, thereby providing a floor underneath prices of those items. And that brings us to the subject of export demand, which is focused on the end meats.

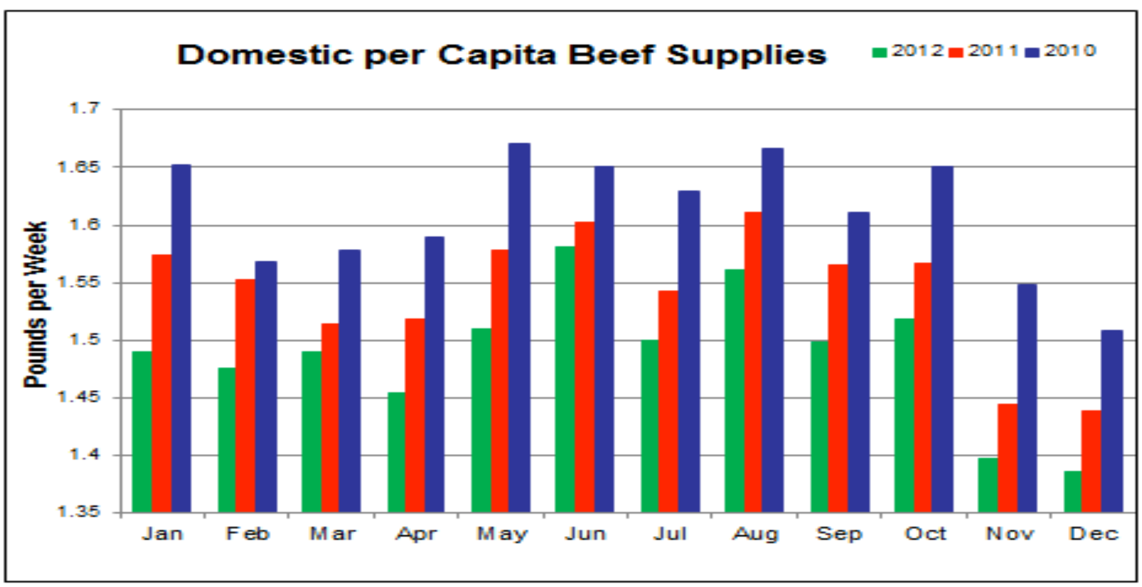
Similar to pork, one of the main supportive factors in the beef market has been—and should continue to be—a very strong demand for U.S. beef from abroad. Although exports presently account for only about 12-13% of the total market, their influence in the wholesale market is quite pronounced. Worldwide demand for beef is growing as income levels in developing economies increase (as we discussed previously). There just are not many major beef producers in this world—the supply base consists, basically, of Brazil; Argentina; Uruguay; Australia; New Zealand; the U.S; Canada; and Mexico. The European Union is currently on the same list, but its supply base is clearly shrinking and for practical purposes cannot be counted among those regions with the capability to become a worldwide exporter of beef. Naturally, this emerging demand begins with the lower-priced items—chuck and round cuts, as well as trimmings.

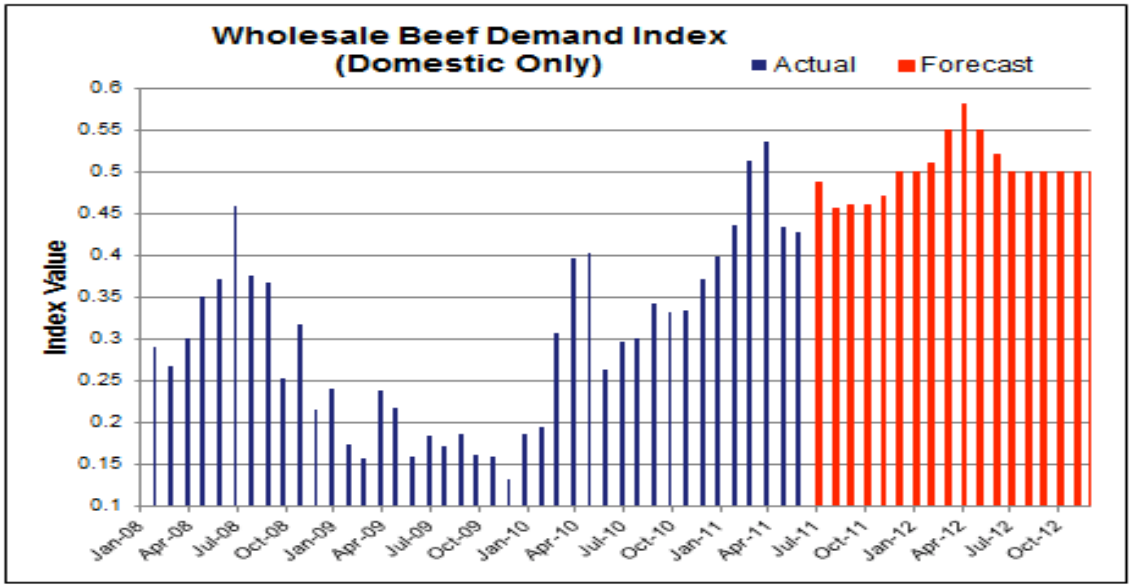
In the first half of 2011, U.S. beef exports grew 26% from a year earlier. Japan, Canada, Mexico, and Korea ranked almost equally as the top customers for U.S. beef, each accounting for roughly 17% of the total, and collectively accounting for slightly more than two thirds of total U.S. beef exports. We anticipate a slightly smaller—but still quite healthy—rate of increase in the second half of the year, partly because the year-ago comparisons are higher. But the point is that the long term prospects are quite favorable. The result should be that chucks, rounds, and ground beef should continue to carry a big share of the total cutout value, a substantially larger share than that which prevailed prior to 2008, when the severe downturn in the economy started to affect demand for middle meats while the export market boomed at the same time.

And that brings us to the subject of domestic demand, which is still the most important part of the total. First of all, we have to acknowledge the simple fact that wholesale beef prices have been on an upward march for a year and a half now, and that consumer-level prices are adjusting upward accordingly. Margins among both restaurants and supermarket chains have been pinched in the process, and the general trend toward higher consumer-level prices is firmly entrenched.

That having been said, there should be a tendency toward stronger domestic demand at the wholesale level, simply because the domestic supply (after adding the reduced quantity of imports and subtracting the heightened level of exports) will be "pinched" hard enough to dig down into the less elastic, "hard core" layer of beef demand—analogous to digging down into the ground until the soil becomes increasingly difficult to penetrate. The "bedrock" in this analogy would be the foodservice entities that will order pretty much the same amount of product regardless of the wholesale cost. There are eventual limitations, of course, but the point is that the smaller the domestic supply becomes, the higher prices must climb in order to ration demand.
And so we show two charts one below and one on page 7. One is the projected domestic supply of beef per capita; the other is the projected level of domestic beef demand at the wholesale level.

Our projected combinations of supply and demand suggest that live cattle prices will average near $110 per cwt through September, and then begin to creep upward. Prices in the first quarter will press $120, and our guess is that by April, they will reach into the upper $120's. The 2011 high, by the way, was $123.

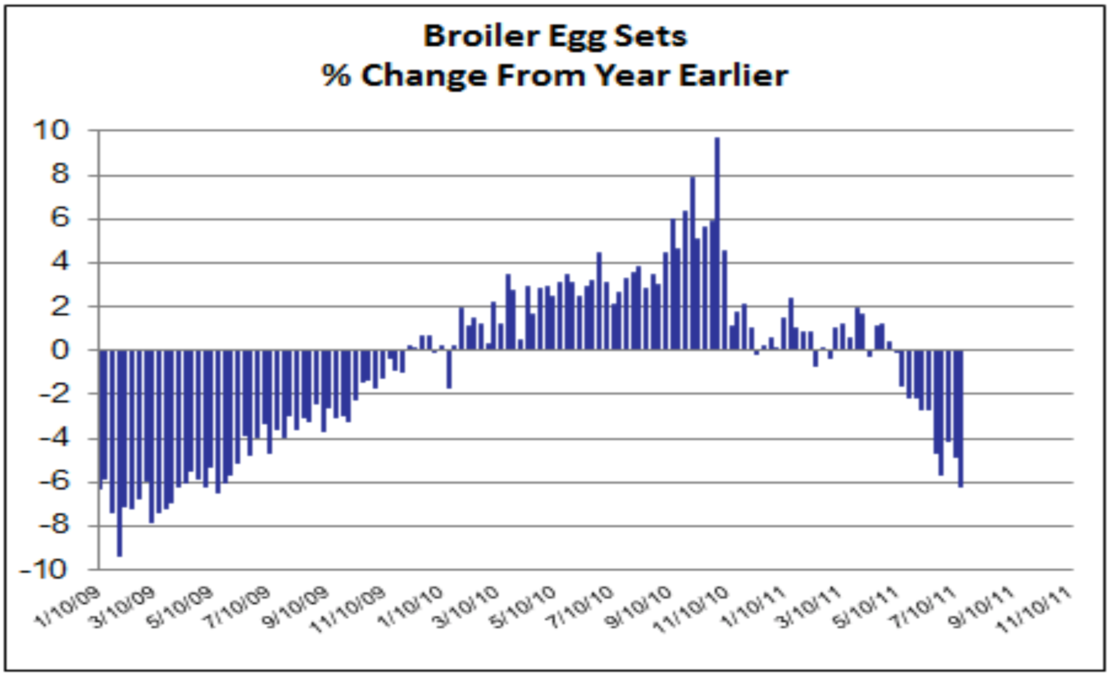




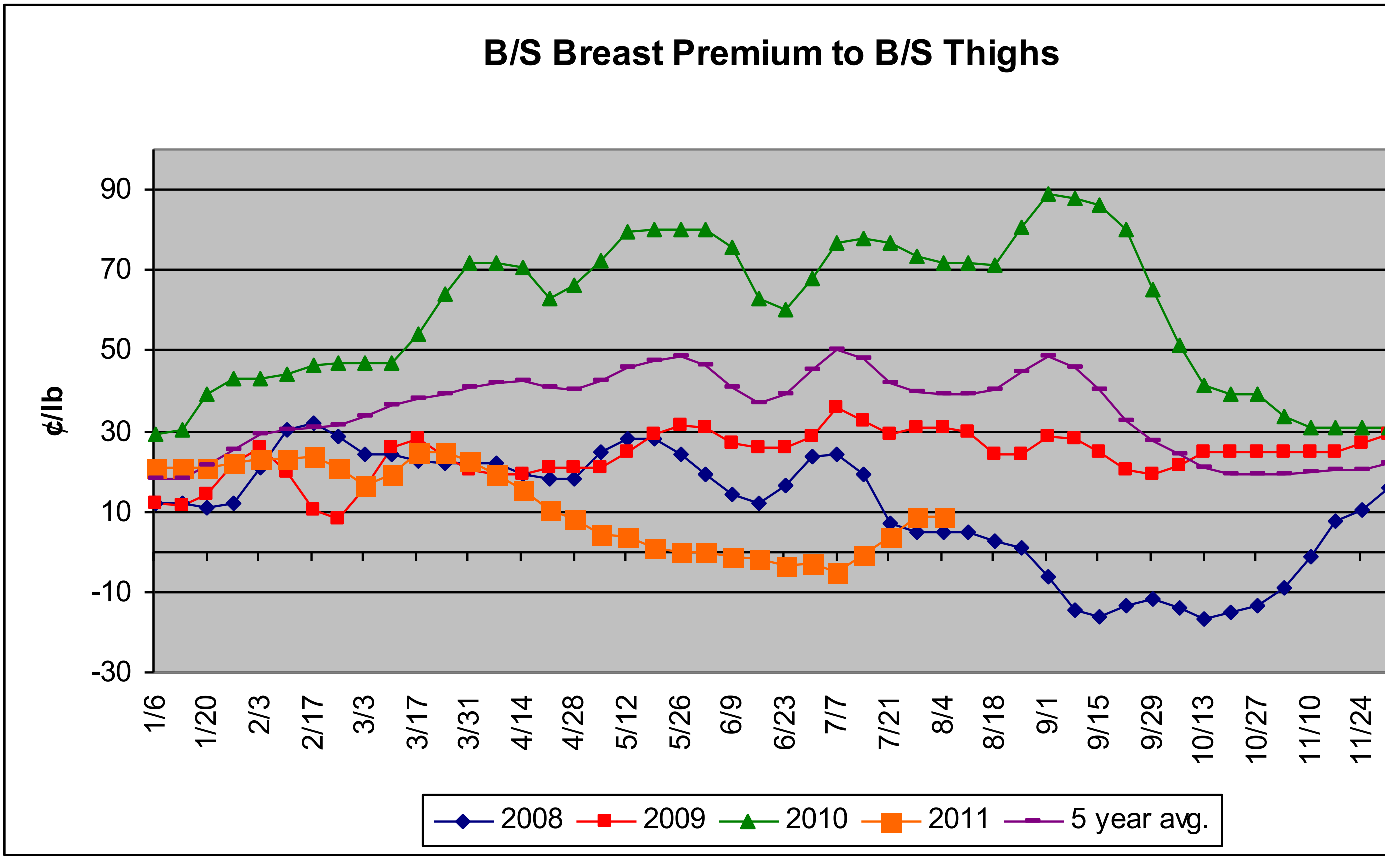
Moving on to chicken, the major dynamics seem pretty clear: as corn prices have pressed upward, averaging near $7.00 per bushel in the second quarter, chicken prices have remained fairly flat. Not surprisingly, production had to eventually be cut back. It has not been a pretty picture for major chicken processors. Tyson reported $37 million of operating income in its chicken segment in its most recent quarter, but a margin of only 1.4%....better than a loss, but not exactly stellar. Pilgrim's Pride reported a net loss of $121 million, while Sanderson Farms reported a loss of $16 million.

Industry expectations entering 2011 were for improved broiler demand due to chicken's competitive advantage to both beef and pork. As a result, the industry continued to expand their hatchery supply flock through the 3rd and 4th quarters of 2010. Pullets placed into the flock start laying eggs after six months, so the industry had already set the stage for larger broiler supplies well into mid 2011. Escalating feed costs resulted in a slight increase in heavy hen (from breeding flock) slaughter through May, but jumped 19% during June. Impacts of a reduction in the layer flock, greater breeder slaughter, are not necessarily immediate, as these are the less productive hens. At the same time the industry was increasing breeder slaughter, they had been placing new more productive layers in the flock. Pullet placements did not drop below year prior until May, so it will be difficult to expect significant declines in production until late 4th quarter 2011. Breeder flock needs further contraction to impact pricing. The number of chicks placed into grow out barns – short term production indicator – averaged 1% above year ago levels through May, but have since moved significantly lower, averaging 3.4% below year ago levels in June and July.

Despite cutbacks, year-to-date broiler slaughter is only down .3% from a year ago and year-to-date production is up 2.6%. Further cutbacks are required to balance supply and demand or wholesale chicken prices will continue to remain soft and deliver losses to processors. In any case, the trend in production points downward; the chart of egg sets as a percentage change from a year ago on page 8 shows the industry has gotten more serious in cutting back over the past 5 weeks and nearing the same intensity experienced in early 2009.



Wholesale boneless-skinless chicken breast prices have traded significantly from their levels in 2010. Boneless breast quotes averaged just $1.29 per pound through the first seven months of 2011, the second lowest for that time frame of the last 25 years (only 2006 was lower). Over the last four months—since the beginning of spring—quoted prices were down 20% from a year earlier. While increased supplies, particularly elevated bird weights have helped to pressure prices, diminished demand is likely more responsible. While wholesale prices are less expensive on a wholesale basis, BLS retail price reporting for boneless breast meat did not show any declines at the retail level until June and July as many retailers have opted to hold their price in order to support declining margins. Thus, retail demand for boneless-skinless chicken breasts has remained weak, as consumers turned their attention towards less expensive options. This has, in particular, lent support to boneless-skinless thigh prices, which in the spring months jumped to their highest pricing since September of 2005. This resulted in b/s thighs trading at a premium to b/s breast meat for only the 3rd year on record and the first time since the fall of 2008, see graph showing historical b/s breast premium to b/s thighs on page 9. Wholesale b/s breast prices have climbed 10% over the past 30 days; we expect another nickel to the upside but falling prices post Labor Day. Given elevated supply and diminished demand, we expect wholesale prices to fall 10-15% by October/November timeframe.



Wing prices are down 36.2% year-to-date – nothing cures high prices like high prices as wholesales wings reached $1.74/lb in January 2010. Prices have declined consistently during the 1st quarter of 2011, hitting a bottom in April at their lowest levels since August of 2005. Food service demand, of which wing prices are highly dependent on, has remained sluggish due to the continued struggles of the U.S. economy. Not helping matters is the fact that wing prices soared to record highs a year ago, which resulted in many restaurants turning their attention to other options such as boneless wings. Despite rebounding off their recent lows, prices have continued to remain at their lowest levels since 2005, and we would suspect to see increased demand as an end result. However, weak seasonal demand is likely to keep prices under pressure through the 3rd quarter of 2011. Wing prices could see a 10-15% increase by the end of the year.

The total picture has not been quite as bad as the breast and wing markets might suggest, because the leg quarter market has fared much better in comparison. Quoted prices of leg quarters during the first seven months of 2011 averaged $.42 per pound, the third *highest* for that period within the last 25 years; over the past four months, they were up 23% from a year earlier and touched $.50 per pound this week for the first time since June 2008. Lower leg quarter prices in June has attracted renewed buying from many export countries, including Mexico, Caribbean, Central America, Cuba and others. The UB market quote is at the high end of the trading range in comparison to other market reports so we expect the current strength in leg quarters to be relatively short lived. On average, fourth quarter prices decline $.07 per pound from the third quarter.

U.S. chicken exports grew modestly in the first half of 2011, averaging 1% above a year earlier at 519 million pounds per month. The customer base is changing, though. Whereas Russia dominated the picture in recent years, so far in 2011 it has received just 3% of the total. This is largely due to Russia's official commitment to become self-sufficient in its poultry supply, a policy that has brought about major investment in production facilities. The distribution of U.S. chicken export business is now quite diverse, which seems to be a more solid strategic position for the industry; thus, the outlook for U.S. chicken exports appears pretty favorable.

In the world of turkey, high feed prices and tight supplies have pushed frozen whole turkeys to $1.08 per pound, $.10 per pound greater than a year ago. In complete antithesis to the broiler industry, the turkey industry has been able to pass along higher costs of production as a result two processors leaving the industry and 2009's cutbacks stemming from over production and high feed costs in 2007-2008. Within the first five months of 2011, frozen whole bird prices increased to $.14 per pound as Buyers came to the market early to place orders to guarantee quantities and preferred sizes. Demand pushed prices higher before finally stabilizing through June and July.

Remember that heavy product demand during the 2010 holiday season left year-over-year stocks at a large deficit entering 2011. As a result, we expected poult placements to increase early in 2011 to ensure basic supply availability. Placements averaged nearly 4% greater than a year ago during the first quarter. Birds placed within the first quarter would have likely been processed during the second quarter. Prices stabilized during June and July as more turkeys became available at this time and buyers were increasingly more reluctant to book at record summer prices. The turkey market has tightened as of late pushing pricing $.02 per pound higher. Turkeys remain available, but are likely limited to small hens and varied size ranges. Frozen toms will remain scarce, if available at all, as high feed costs make their production unprofitable. We expect the frozen turkey market to remain tight the remainder of the year, as poult placements declined 2.5% during the second quarter when corn prices went above $7 per bushel. Frozen turkeys are going to set a new record high, likely between $1.13 and $1.16 per pound.

There is a good chance there will be fewer fresh turkeys available this holiday season as well. Producers place birds for the fresh production during July and August. Our first indication of expected supply comes from the USDA's July poult placements which decreased 5.3% from a year ago and August is forecasted to be lower as well. Current market sits at $1.19 per pound, $.12 per pound greater than a year ago. Over the past five years, fresh turkeys have increased $.11 per pound on average from the third week in August to November's peak. If we meet this average increase, then fresh turkey prices would reach $1.30 per pound during November.