1996 FARM BILL: PLANNING AND MARKETING LIVESTOCK AND DAIRY

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David Kenyon gave an excellent presentation and set the stage for much of what I am going to do. I am going to be a lot different from him in this respect: he has an amazing ability to take a few overheads and weave a really nice story around them. My approach will be to give some quick snapshots and then slow down when I get to the ones that are tied to the main message. On every overhead there will be a "take-away" point. I will pull that out for you so that you do not miss the main point that I want you to get. I am going to cover livestock, poultry, and dairy. I am going to look at both the direct and the indirect ramifications of the Farm Bill, with most of my time spent on the indirect ramifications (Figure 1).

Figure 1.

Market and Price Impacts of the 1996 Farm Bill: Livestock, Poultry, and Dairy

Impact of 2 types:

(1) Direct in form of expanded trade

(2) Indirect in form of feedgrain prices, CRP acreage, haying and grazing provisions

I would say to you, up-front, that the major impact of the Farm Bill, that ended all Farm Bills, on the livestock, poultry, and dairy sectors is going to come through what it does to grain and oilseed prices. Historically, cattle have not been a program commodity. There are some direct things surrounding the Farm Bill legislation and the trade legislation that affect cattle. I will scan through some of those very quickly. The indirect impacts will come from many of the things that David talked about as he went through his presentation on grains and oilseeds.

WORLD TRADE

Here is another one of those overheads with a lot of numbers. The Food and Agricultural Policy Research Institute (FAPRI), a policy institute that does research into the farm policies in this country in a substantial way, operating out of the University of Missouri and Iowa State, is the source of these estimates. I am starting with beef (Figure 2). (You will see this format several times as we go through the commodities.) In their projection to the year 2005, FAPRI shows the United States as a net importer of beef (the italicized line). That is not say that our exports will not grow; I think they will. We will export the high value middle meats and bring in a lot of manufacturing product. There is a tendency in this country for the cattle industry to sit and wait for the export market to bail them out. I have always thought that was a mistake. I still think that it is a mistake, but I think we will have growth in this area. When FAPRI says the U.S. is going to stay a net importer, all they are saying is we are going to export high value middle meats and some value added product. We are going to import a lot of processing meat. It is not inconsistent with what I expect to occur.

Figure 2.

Beef and Veal Trade: FAPRI Projections

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
	(1,000 Metric Tons)										
Net Exporters											
Argentina	457	477	443	412	390	388	410	444	466	471	477
Australia	1,065	1,081	1,104	1,158	1,200	1,238	1,267	1,292	1,308	1,314	1,309
European Union	525	403	399	199	267	332	402	427	455	483	496
New Zealand	491	498	503	499	497	498	501	505	508	511	513
Total Net Exports	2,860	2,926	2,871	2,728	2,844	2,982	3,139	3,253	3,331	3,352	3,346
Net Importers											
Former Soviet Union	125	293	332	332	296	255	211	165	124	91	59
Japan	900	927	964	941	964	981	1,019	1,080	1,144	1,201	1,250
South Korea	205	230	254	263	291	319	347	371	400	437	475
United States	***128***	***(15)***	***(180)***	***(319)***	***(205)***	***(65)***	***86***	***176***	***205***	***163***	***116***
Total Net Imports	2,860	2,926	2,871	2,728	2,844	2,982	3,139	3,253	3,331	3,352	3,346

- Beef exports do grow
- Still importing processing beef
- Sector expected to lose market share
- Japan a big market

Pork looks a bit different (Figure 3). Pork has been a sector that has put some quality control in place. Notice the increase in the net exporter column (italicized line), and FAPRI is expecting, to the year 2005, substantial growth in pork exports. I would agree, especially if we can get additional quality control measures in place and get this product such that it is acceptable in the international market that have really exquisite tastes and attitudes toward quality control, like Japan. There are some things developing in this arena of a global market economy as we move away from the traditional farm bills and in the presence of trade agreements, like the General Agreement on Tariffs and Trade (GATT) and North American Free Trade Agreement (NAFTA), that are going to make a difference to us.

For poultry (Figure 4), note the balance again (italicized line). Expect exports to grow, and grow substantially. That growth is in both absolute and percentage terms. The poultry industry has been accomplishing this for a long time. Notice again, the move up in the net exporter column.

If you look at the dairy sector (Figure 5), you will find FAPRI is not expecting to see very much happen in terms of exports in dairy (italicized lines). This is interesting because I think one of the things that is coming, as we back away from a policy program orientation in dairy, is that we are going to have to look to the international market. FAPRI does not see much happening there. That is butter at the top: there is no growth in exports to speak of and the volumes are small. That is cheese on the bottom line: there is no growth on that line and the volumes are relatively very small. As you look at non-fat dry milk, you see FAPRI is not expecting to see any substantial growth there. If dairy is going to enter the world market instead of concentrating on getting a benefit from a domestic program, it has

a ways to go to get itself ready to be a player in the world market. These analysts at FAPRI do a sophisticated job of modeling the world dynamics and sorting out what role the U. S. is going to play in this. They do not see very much happening out toward the year 2005.

Figure 3.

Pork Trade: FAPRI Projections

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
	(1,000 Metric Tons)										
Net Exporters											
Canada	285	292	320	327	315	308	318	323	313	311	325
China	200	210	228	215	198	200	205	191	180	187	193
European Union	694	723	479	501	543	495	421	475	504	498	548
Taiwan	330	313	314	309	297	291	294	290	280	277	280
United States	***49***	***79***	***314***	***420***	***560***	***605***	***643***	***688***	***767***	***743***	***649***
Total Net Exports	1,593	1,664	1,733	1,841	1,947	1,962	1,982	2,048	2,111	2,113	2,123
Net Importers											
Former Soviet Union	225	262	281	301	325	333	340	349	337	327	316
Hong Kong	218	219	213	217	222	220	217	221	225	222	220
Japan	800	838	840	891	916	932	937	939	958	975	1,004
South Korea	62	75	91	113	135	142	144	164	181	174	167
Total Net Imports	1,593	1,664	1,733	1,841	1,947	1,962	1,982	2,048	2,111	2,113	2,123

- Strong growth in exports
- "Middle meats" featured
- Net exports projected to grow sharply
- Japan a big market

Figure 4.

Poultry Trade: FAPRI Projections

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
	(1,000 Metric Tons)										
Net Exporters											
Brazil	442	462	476	493	506	513	531	543	554	566	577
European Union	633	621	565	589	739	735	774	847	888	930	964
Thailand	160	169	180	191	198	208	219	229	236	246	257
United States	***1,702***	***1,911***	***2,020***	***2,016***	***2,020***	***2,130***	***2,248***	***2,307***	***2,477***	***2,545***	***2,533***
Total Net Exports	2,934	3,167	3,241	3,306	3,484	3,621	3,819	3,986	4,220	4,364	4,419
Net Importers											
Former Soviet Union	474	473	444	424	409	396	386	377	371	367	366
Hong Kong	225	225	248	262	279	293	307	321	338	352	366
Japan	532	576	606	594	644	676	714	735	794	831	868
Mexico	160	180	194	201	211	218	226	233	242	250	258
Total Net Imports	2,934	3,167	3,241	3,306	3,484	3,621	3,819	3,986	4,220	4,364	4,419

- Net exports already large
- Projected to show major growth
- Japan a big market

Figure 5.

Dairy Trade: FAPRI Projections

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
	(1,000 Metric Tons)										
Butter											
Net Exporters											
European Union	273	204	240	209	216	225	243	259	273	285	295
New Zealand	234	261	207	219	229	236	243	243	244	244	243
United States	***73***	***79***	***81***	***80***	***84***	***89***	***81***	***79***	***82***	***83***	***85***
Total Net Exports	700	677	669	649	670	694	715	735	758	777	794
Net Importers											
Former Soviet Union	180	201	171	182	188	195	189	186	186	185	184
Mexico	7	9	9	10	11	12	12	13	14	14	15
Total Net Imports	700	677	669	649	670	694	715	735	758	777	794
Cheese											
Net Exporters											
Australia	120	129	141	146	152	162	174	189	204	219	234
European Union	520	540	507	495	509	516	510	498	484	469	454
New Zealand	169	180	243	246	252	257	264	271	276	280	284
Total Net Exports	864	896	952	950	978	1,001	1,018	1,031	1,040	1,047	1,053
Net Importers											
Japan	150	156	162	169	173	175	178	184	189	194	199
United States	***115***	***115***	***117***	***119***	***121***	***123***	***123***	***122***	***122***	***122***	***121***
Former Soviet Union	73	77	74	72	69	67	63	59	54	50	45
Total Net Imports	864	896	952	950	978	1,001	1,018	1,031	1,040	1,047	1,053
Non-fat Dry Milk											
Net Exporters											
Australia	187	191	198	198	199	201	206	213	221	228	235
European Union	330	176	234	233	239	253	265	281	288	303	318
New Zealand	167	185	160	170	175	181	185	188	191	193	194
United States	***159***	***104***	***97***	***82***	***77***	***58***	***58***	***58***	***58***	***58***	***58***
Total Net Exports	957	787	828	829	843	859	879	907	928	955	985
Net Importers											
Japan	106	102	103	105	107	109	111	113	115	117	119
Mexico	180	160	164	155	150	144	139	136	130	127	123
Total Net Imports	957	787	828	829	843	859	879	907	928	955	985

- Modest butter exports
- Net importer of cheese
- Lose share of dry milk exports
- Japan, Mexico important markets

If we look at recent year developments in beef and pork, we see growth in exports and a somewhat different picture on the import side. This chart, exports for beef and veal (Figure 6), shows the 1990 to 1994 average in gray, 1995 is the dashed line, and 1996 is the solid line. In the first half of 1996, in all of the meats on the export side, we were above 1995 and above the early 1990s average. On the import side in beef and veal (Figure 7), we were below 1995 and below the 1990 to 1994 average. I mention that just because there is always a preoccupation among producers with these "horrible" imports, and widespread concern about why we cannot export still more.

Figure 6.

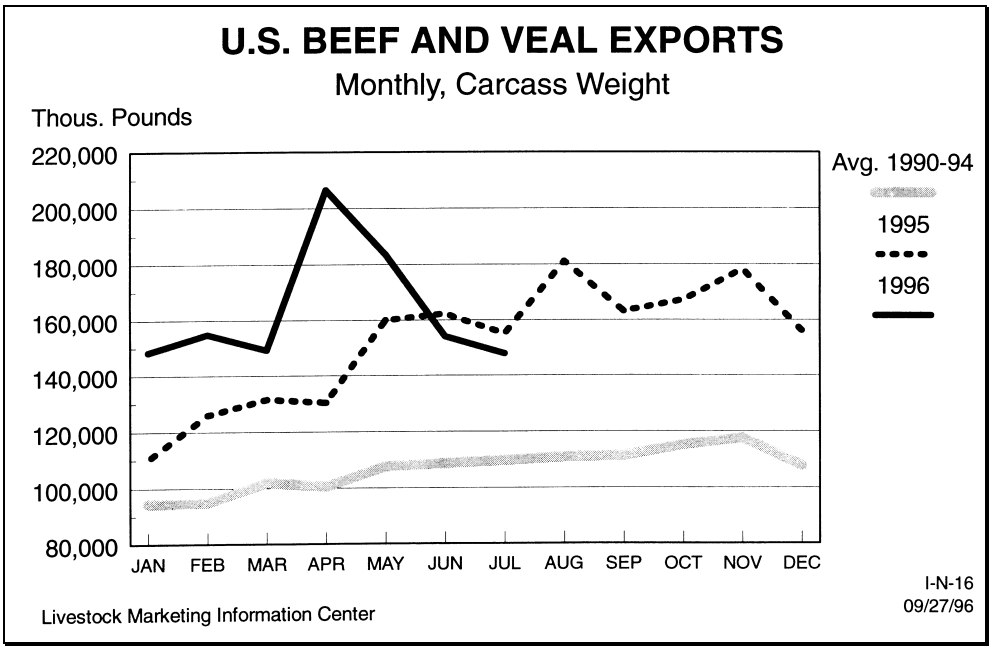
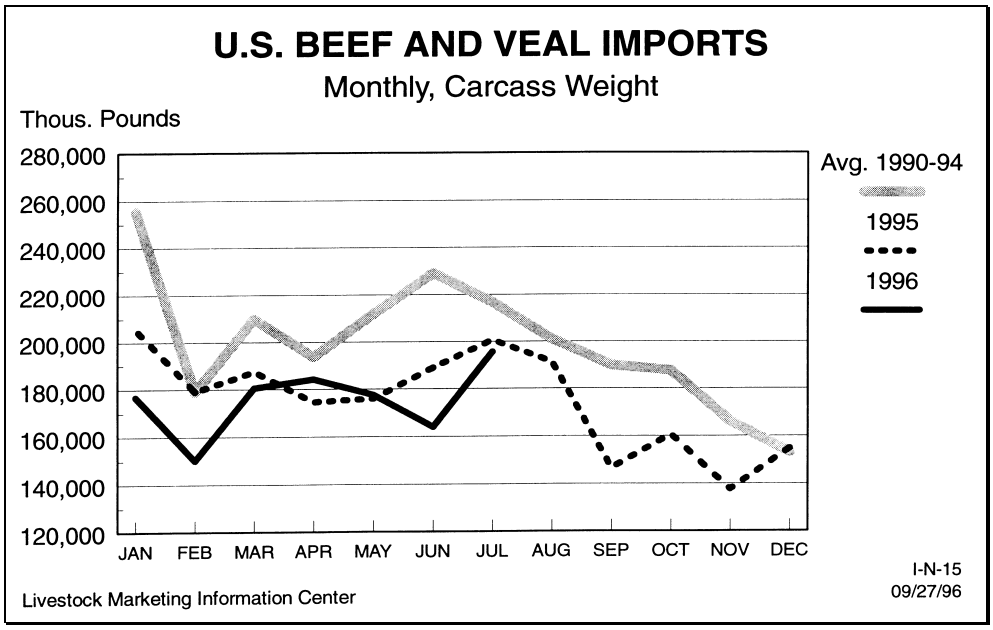


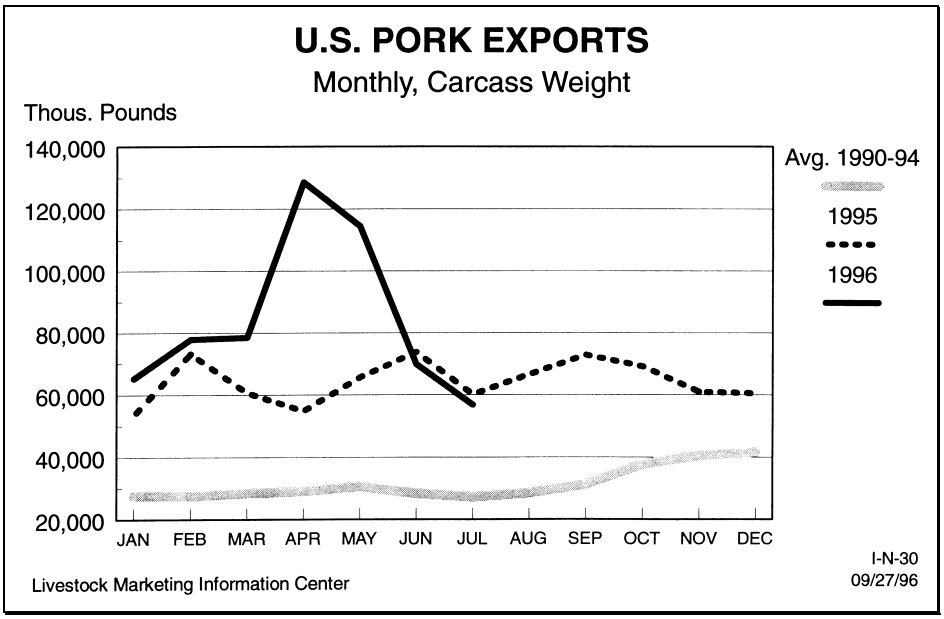
Figure 7.



We have really bad calf prices this year; calves selling at half the cost of production. It is not the import-export balance that has done that. We have exported more beef than we have imported. Very recently, poundage-wise, we have switched to being a net exporter of beef. The FAPRI people are not sure we are going to stay there; we may switch back and forth across that zero net export line. But it is not the world trade that is causing us price problems in cattle.

You might look, in passing, at that huge surge in the first half of this year in pork exports (Figure 8). A whole lot of that is the tenderloin and the loin and the more valuable middle cuts in pork. If you look at what that often does to domestic market, and I will pause and reflect on that for a moment, you see the shoulders and the trimmings and things going down in price while our middle meats are going up in price because those are what tend to go into the world market. All of the uncertainty that the prior speakers have talked about is there already in the livestock sector. We are exposed to a world market, and we are going to continue to be exposed to a world market.

Figure 8.



Broiler exports were up this year over early 1995 level, again way above the 1990 to 1994 levels (Figure 9). There is an active world trade in meats. We are certainly a net exporter of poultry, and we are growing in that status in pork as well.

BEEF

I will slow down on this overhead (Figure 10) because the primary thing that I see by way of impact out of the 1996 Farm Bill coming into the livestock sector from grain prices. Bill Tucker asked the question earlier about whether we were going to end up putting some of this former program acreage into forage and forage based systems. There is a lot of uncertainty out there that is going to feed over to us in our process of moving into a world market in grains and oilseeds.

Figure 9.

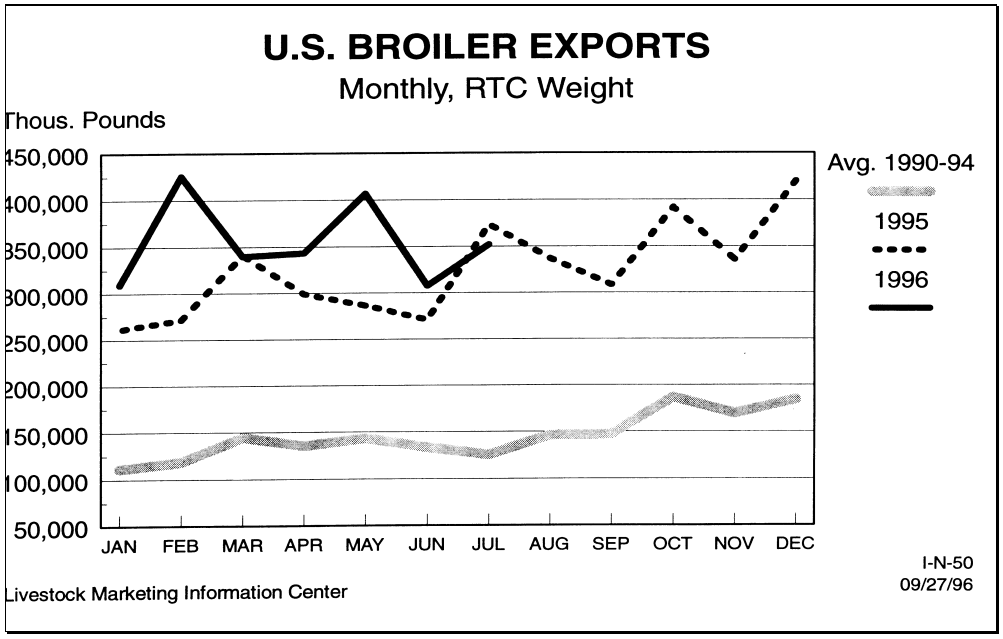


Figure 10.

The Direct Impacts: Livestock

The events of 1994-1996 clearly show the direct impact of corn prices on the livestock sector. Reviewing that period helps in looking ahead to the direct impact of farm legislation that is "ending farm bills as we had known them."

What I am doing in this overhead (Figure 11) is looking at a snapshot of the last two or three years of corn prices and the phenomenal impact they had in our livestock sector, especially in beef. I will use that notion as a launching pad to talk about what it is going to mean when we move into a world market and grain prices come back down, as I think they certainly will. We will look at the record high corn prices from this year, at losses in the feedlot sector, and at how these two occurrences prompted reduced feedlot placements.

Now you have the reason that your calf prices get cheaper—corn prices (Figure 12). It does not take a really high level of mathematics to figure out that if it takes 50 bushels of corn to feed a steer while he is in the feedyard, and if that corn goes up $2 a bushel, then you have to pay $100 more for the corn that you cannot pay for the calf. If you take a 500 pound steer or calf and divide that into $100, you have a $20 per hundredweight lower price for the calf for an equal, breakeven situation for the cattle feeder. That is how and why corn is such a big deal in the cattle sector. Calf prices have been at half the cost of production, and we have had increased beef cow slaughter. We need to keep in mind that we got no help last year or this year from the retail sector. Deflated retail prices set a record low this year. Demand for beef at the consumer level is still going down. It is gone down every year since

1979. We have not fixed those problems. Unlike pork and poultry, where we saw retail prices going up this year (I will show you that), to help bail us out of the corn-cost "hole," it was just a "hole" where cattle were concerned. We floundered around in it. I will not turn this presentation into a forum as to why we cannot fix those demand problems. You have heard me talk about that in other places and in other contexts.

Figure 11.

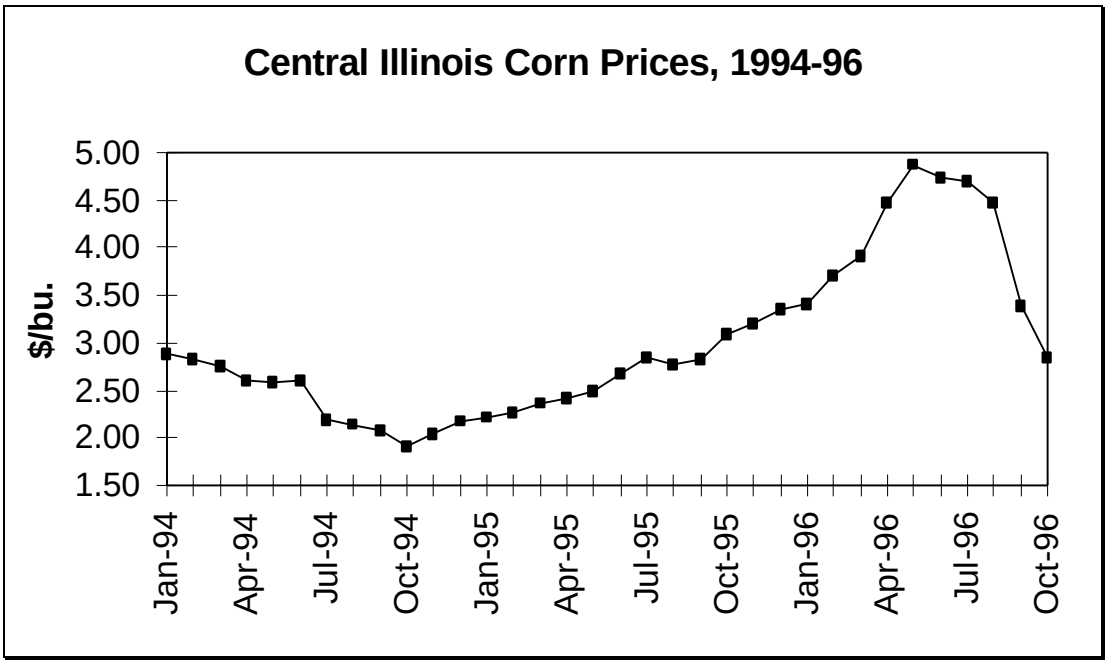


Figure 12.

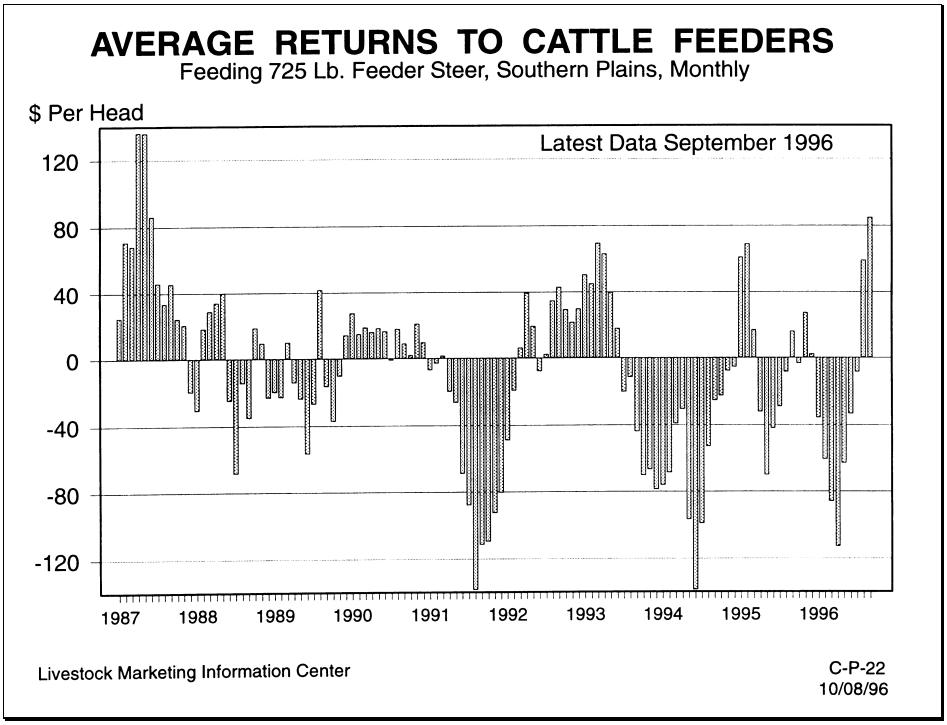
The biggest impact was on the beef sector.

- Record high corn prices
- Losses in feedlot sector
- Reduced feedlot placements
- Feeder steer prices below fed prices
- Calf prices at 1/2 cost of production
- Increased beef cow slaughter
- No help at retail beef price level

Figure 11 is the central Illinois corn price from January 1994 through September 1996. We know cash prices went above $5 in Virginia. John, what did they get to up in Harrisonburg, the poultry producing area? $6.25, you said? That is pretty tough. Unless we get some totally unexpected disaster, you are not going to see that again anytime soon with the absence of farm program controls.

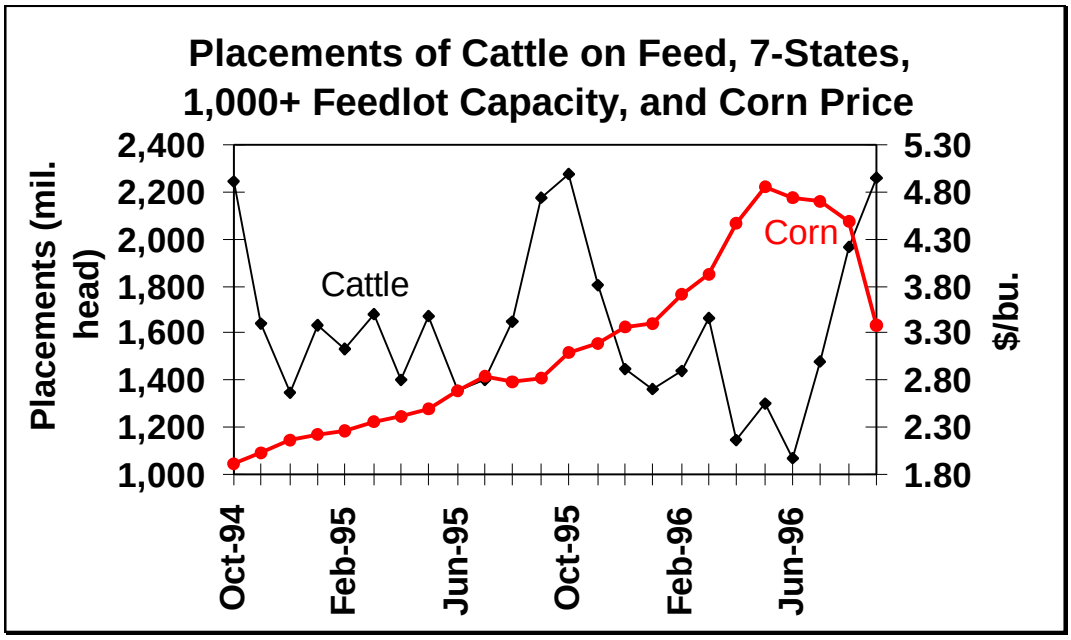
This chart shows cattle feeders lost money as corn prices surged (Figure 13). They lost a lot of money in 1994 because they fed the cattle too heavy. In the first half of 1996, they were again losing a lot of money and finally that manifested itself in the form of reduced placements and reduced bids on the calves—and your calf prices tumbled again. They have to cover that increased feed cost some place, and selling prices for fed cattle did not go up to help. This loss by the feedlot sector in the first half of the year was almost entirely due to the corn price surge that you have already heard several speakers discuss. John just told us corn went above $6 per bushel delivered into the northern Shenandoah Valley.

Figure 13.



See what happens? The corn price plotted here with cattle placements (Figure 14). If you look across the bottom of the chart, you see months. After a while, as corn prices keep going up, you start seeing the placements of cattle in the feedyards come down. We were coming in through March 1996 fully recognizing what was coming: if we kept using corn at the pace we had used it up to that point, we were going to run out of it—literally. Everybody was waiting for the other sector to blink. The poultry people had not blinked. The export movement had not blinked. The cattle feeders had not blinked. And the hog people had not blinked. All the groups were keeping their pace of usage up. That accentuated the problem somewhat because when we finally recognized we **all** had to back off, placements of cattle in the feedyards plunged in April, May, June, down over 10 percent from year earlier levels each month. There went the prices for your calves. Down we came again with feeder cattle prices. All of which is attributable to that rampaging corn price.

Figure 14.

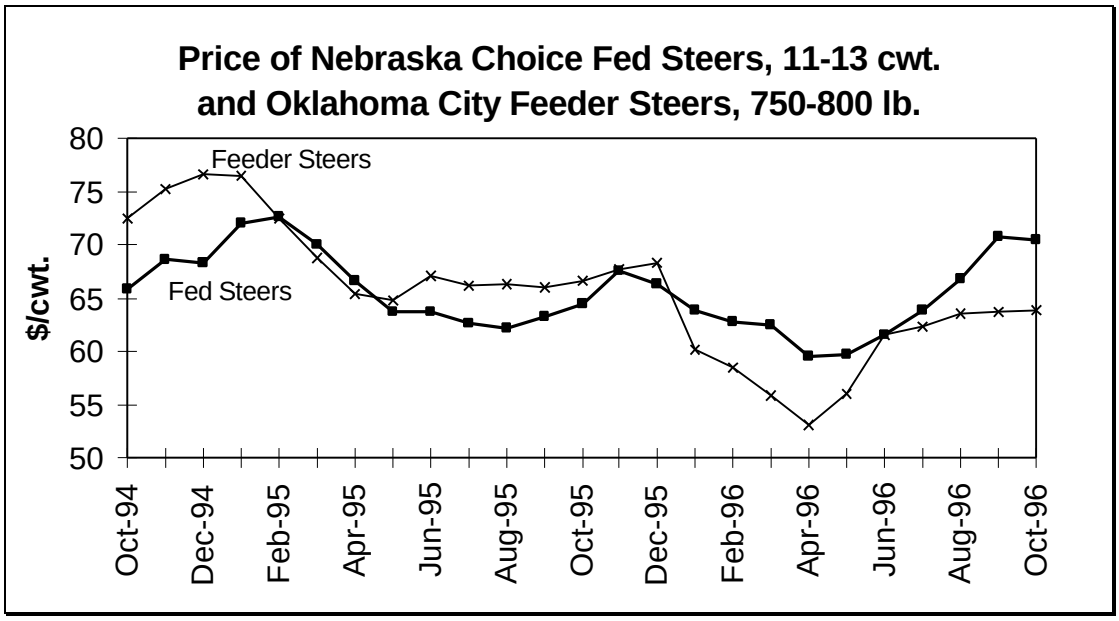


I spent time this summer testifying in Senate hearings called by some Senators from the Plains states who were really frustrated that their constituents were selling calves for $0.40 to $0.50 a pound. Clearly, they were looking for a villain. They wanted to pass laws that say the big packers cannot feed cattle, cannot own cattle, cannot contract cattle, and all that. If there is a villain in this mix with regard to those calf prices this past year, it was the setaside requirement on the 1995 corn crop. If we had added that 7.5 percent Acreage Reserve Program (ARP) acreage back, we would have had another 5 million acres of corn planted in 1995, and we would never have seen this $6-plus corn.

The corn and the grain industry implored USDA not to have a setaside requirement in 1995, as all of you will remember. USDA did it anyway. Stocks were very tight; we were very susceptible to any weather problems; and we still cut the acreage. Remember 1983, the PIK year? We cut the acreage 37 percent, had the worst drought in this century, and many livestock, poultry, and dairy producers in Virginia did not survive through the summer of 1985 when, even if you could find corn, you were paying up toward $5 a bushel for it.

We have to understand what does what here. Sometimes the farm programs that presumably were in place to stabilize prices and bring stability to the market place have gone in the opposite direction, and I have just commented on two of them. All Figure 15 shows is that by the time we got out into the summer of 1996, as was just pointed out, feeder cattle prices were way below fed cattle prices. That is high priced corn pushing feeder cattle and calf prices below fed cattle prices. I am building the case for what is going to happen in the other direction when the corn situation eases. And it will.

Figure 15.



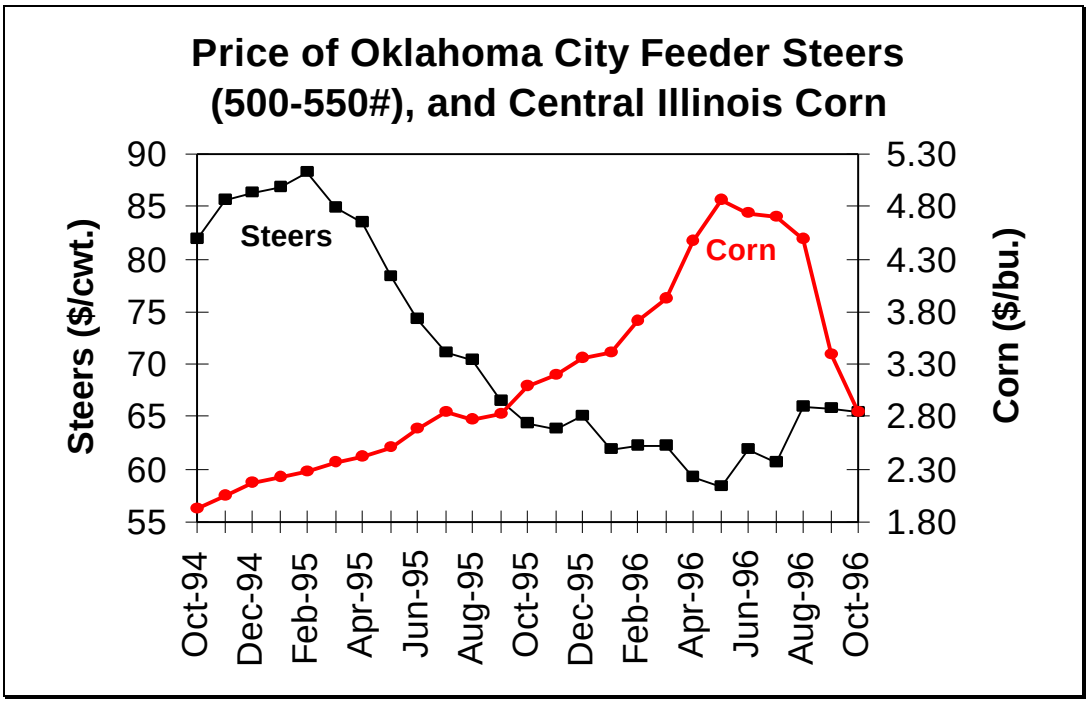
I probably should have just put Figure 16 up as the illustration of the impact of corn prices on the cattle sector, left it alone, and let you sit there and look at it. You do not have to have a model to figure out **there is an inverse relationship between corn costs and calf prices: when corn prices go up, calf prices come down**. In October 1994, when cash corn was down to $2 a bushel, the steer calf was up toward $0.90 a pound. We can handle that, we can get along fine with $0.90 calves. All of us make money on our calves at these prices. By the time we got to almost $5 a bushel on corn, calf prices were in the $0.40s and $0.50s. It is inevitable. The strong economic relationship is there. It is going to happen. **You cannot have high priced corn and high priced calves at the same time**. Maybe, as I said, I should have put this graph up and talked about what this corn scenario across the past 18 months has done to the cattle sector. Maybe it would have been sufficient.

Question from the audience:

Look at the right hand side of your chart where, in August, the calf price leveled off and then declined even more, but the corn price had come way down. Why did the calf prices not go up when corn prices came down?

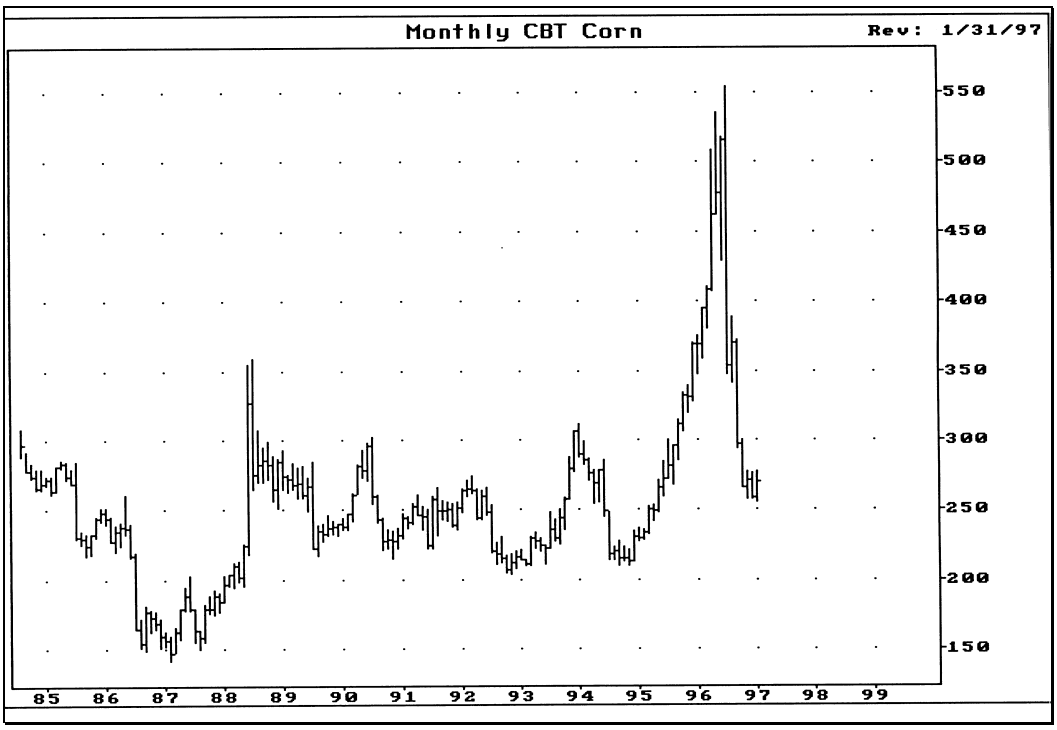
What he is looking for is immediate and precision turning. He is saying, "Corn prices came down some, but calf prices have not gone all the way back up." It is going to take a little time. The feedlots are going to get their operating margins back in shape first. We also had a cyclical increase in cattle numbers, as I know you know, which put a lot of calves on the market this fall. By the time the spring of 1997 gets here, calf prices will be back above the fed cattle market. Just give it a little time; it is not going to happen over night.

Figure 16.



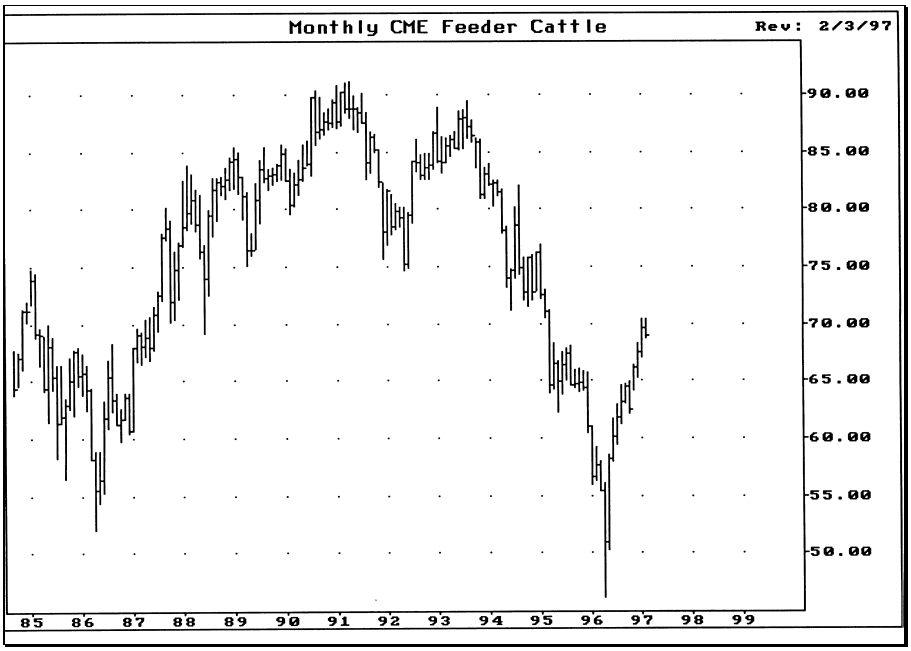
This chart (Figure 17) shows an interesting little picture. It is what is called a "continuation chart" in corn futures. It goes all the way back to 1985. I will not explain it in great detail, but it tracks the price of the cash corn market via the nearby futures. See this peak in corn prices?

Figure 17.



Here is a similar continuation chart in feeder cattle (Figure 18). Just to make the point, note how feeder cattle prices came down. The cattle feeder has to buy two things: a bunch of feed and a calf. If he has to pay a ton of money for the feed, he cannot pay much for the calf, not unless the fed cattle market is going up. But fed cattle prices have been going down because of demand problems and a cyclical increase in supply—and the industry did not get any help from the demand side. Beef cow slaughter was up in the first half of the year because of all these problems and a drought in Texas.

Figure 18.



This chart shows what keeps you under the gun (Figure 19). This wide line is the 1990 to 1994 average beef price, this dotted line is 1995, and this solid narrow line is 1996. If the 1996 line had been up here at 1990 to 1994 levels, your calf prices would have been $10 a hundredweight higher, in spite of corn prices. But we did not get any help from retail: those prices decreased. Now keep that thought in mind because I have comparable charts for pork and for chicken that I will put up later that show that there was some help in higher retail prices for those meats.

Message

The main message is, "The 1996 Farm Bill opens up production potential" (Figure 20). *It will now allow large corn, soybean, and wheat crops to be planted with no contols, which is going to bring feed costs back down. Starting in 1997, calf prices will begin to move back to a premium to fed cattle prices. Declining beef demand and some increased beef supplies as we get cheap corn and put more cattle on feed are going to keep some pressure on prices. Calf prices will not go back to $1.00 or higher the way they were in 1990 and 1991, but they will get better during 1997.*

Figure 19.

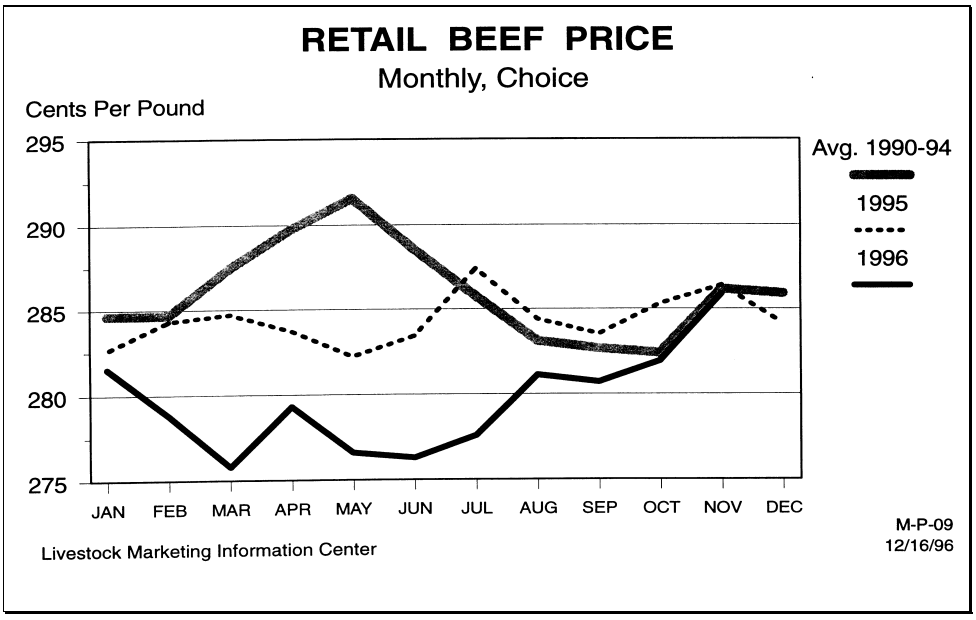

RETAIL BEEF PRICE
Monthly, Choice
Cents Per Pound
295
290
285
280
275
JAN
FEB
MAR
APR
MAY
JUN
JUL
AUG
SEP
OCT
NOV
DEC
Avg. 1990-94
1995
1996
Livestock Marketing Information Center
M-P-09
12/16/96

Figure 20.

The Message

The 1996 "Farm Bill" opens up production potential. Large corn, soybean, and wheat crops will bring feed costs back down. Starting in 1997, calf prices will begin a move back to a premium to fed cattle prices. Declining beef demand and increased beef supplies in the face of cheap corn will keep pressure on fed cattle prices. Calf prices will not go back to $1.00 and higher.

My Recommendations

- Make cow/heifer investments using calf prices in $80s, peaks at $90, for 1998 and beyond.
- Refine and use price risk management tools for calves, stocker cattle, and feeder cattle--the profit margins will not be lucrative or necessarily persistent.
- Make retained ownership decisions carefully recognizing there is no automatic increase in profits.
- Take advantage of the seasonal pattern in prices (low in fall, higher in early spring).
- Push your industry leaders to make progress on product development and on moves to be "consumer driven."

Recommendations

Looking ahead, I would make cow-heifer investment decisions using calf prices in the $80s, with maybe a peak at $90 through 1998. Refine and use price and cost risk management tools for calves, stocker cattle, feeder cattle, and corn. Remember, you have to worry about the feed cost side. The past two years have made that message vividly clear.

Make retained ownership decisions carefully. One sure way to lose more money is to decide that a calf is too cheap to sell. You keep him, and you lose more money. The market is not always going to guarantee you profits from retained ownership. It is not that simple. You have to recognize that not only do you increase your revenue when you are growing a steer from 500 to 700 pounds, but you also increase your costs, and you have to compare those two changes at the margin. **Unless the expected added revenue exceeds the added costs (including an interest charge on the value of the 500 pound calf that is not sold), do not retain ownership.** And try to forward price the 700 pound steer to lock in any profit margins that the market is offering.

Take advantage of seasonal price patterns. Calf prices are low in fall and they are high in spring. If you had put on a blindfold anytime in the middle of October and bought the spring cattle futures for the past ten years, about eight out of the ten years, it would have worked beautifully for you. You should have already bought them this year. March feeder cattle futures have gone up $6 to $7 a hundredweight the past month (October 15 to November 15). Use long hedges to lower the cost of the calves you are going to have to buy in the spring. We have to learn how to do those things, that is what David Kenyon was talking about. If we can learn how to do those things and do them well, we are going to be competitive in the marketplace—that I see coming.

Push your industry leaders at the state and national level. (I said I was not going to do this, and here I am doing it.) Push them to make some progress on product development and on moves to being consumer driven at the retail level. We are trying to sell 1996 customers 1976 automobiles, and they do not want them. They just flat do not want them. About one out of every five steaks, no matter where you buy it, no matter how you fix it, is basically inedible because it cannot be chewed. If you cannot chew it, you cannot eat it. We are not fixing that problem. I could spend a day telling you why we are not fixing it, but we are not fixing it. A whole lot of your frustration about calf prices goes right back to the fact that this industry is falling behind, is continuing to offer an outmoded product while the consumers wants and needs are for something else. We have to change that.

PORK

Record corn and feed prices; pressure on feeder pig prices (Figure 21). We did not see any sustained losses to finshers or to finish people. A primary reason we did not, in spite of the corn, is that the feed-to-gain conversion is a little better in pork, but we also got some help on the retail price and on the hog prices. You did not see any rampant herd liquidation in the face of this high priced corn. If corn goes to $5, it helps a bit if hogs go to $67 a hundredweight—as they did. You know we never spend much time at $67 hogs in this country. We got there late last spring and in the summer months. It was one of those 3 percent of the time things David Kenyon was talking about.

Figure 21.

The Indirect Impact: Pork

The impact on the pork sector will be significant but less extreme than for beef. Corn costs are important but less critical, and this becomes apparent on examination of the 1994-1996 period. It shows:

- Record corn and feed prices
- Pressure on feeder pig prices
- No sustained losses to finishers
- A modest breeding herd liquidation
- No strong impact on sow slaughter
- Help from strong retail prices

There is not a big feeder pig business in this country anymore, but I put in this chart up to show you that the same thing happens in hogs that happens in cattle (Figure 22). The flat line at about $44.00 that shows the average feeder pig price for the early 1990s and these other two lines show 1995 and 1996. It is a little different format than I had before, but when corn prices go up, if we still have an industry that is selling feeder pigs, you virtually have to give them away.

We are talking $25 per head for a 50 pound feeder pig. That is what corn can do to you when it goes to $5.00 and more. We did not see any sustained herd liquidation in pork primarily because the hog selling prices were high. I think it is primarily because the hog industry is getting its product offering refined and modernized, getting the quality variation down. Smithfield's Bladen County, North Carolina, plant uses scanning technology to sort individual cuts into different levels of leanness, not just carcasses. If they had not done that and had not had that type of refined process and technology, I do not think Smithfield would have ever been able to enter the Japanese market. It is been a big market for them. But they probably get 75 to 80 percent of their hogs, and this is my guess, from no more than 5 to 7 producers. They have a type of control via genetics that we have not come close to getting in the beef sector, and it does make a difference in quality control.

One of the things you might have expected when corn prices went really high is that hog slaughter would also go really high. Sow slaughter, in particular, should increase because you might expect some response to those really high feed costs (Figure 23). We ended up with a herd size not much smaller than we had in early years, down 3 to 4 percent during the high priced corn. We did not force any massive liquidation. It looks like the hog people are surviving this avalanche of high corn costs in pretty good shape and will be ready to compete for market share.

Figure 22.

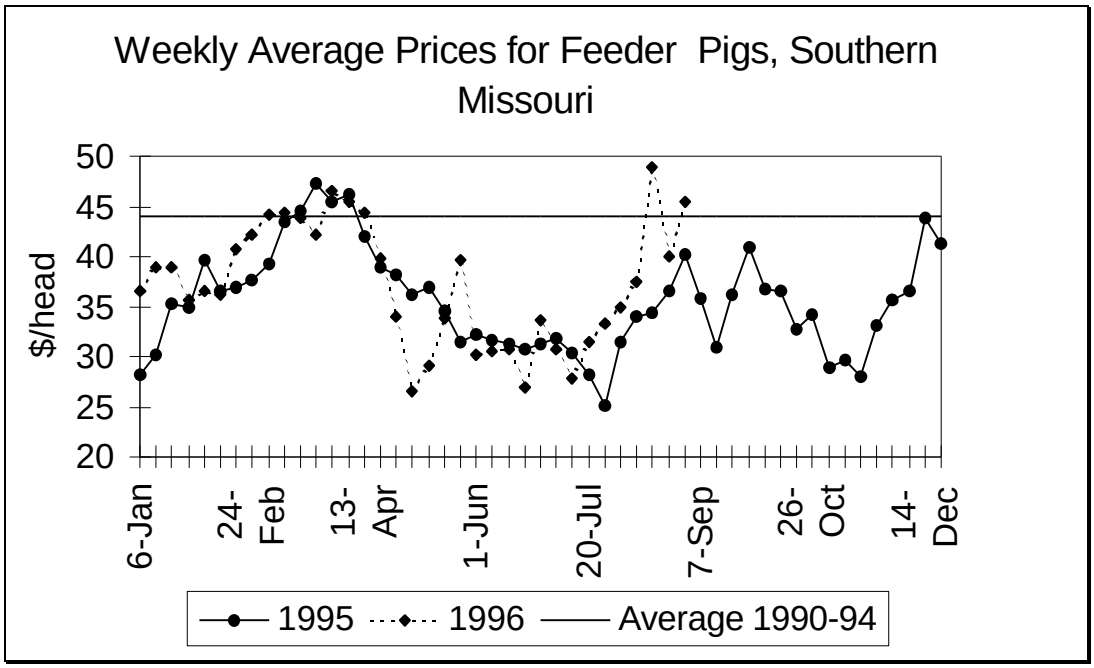
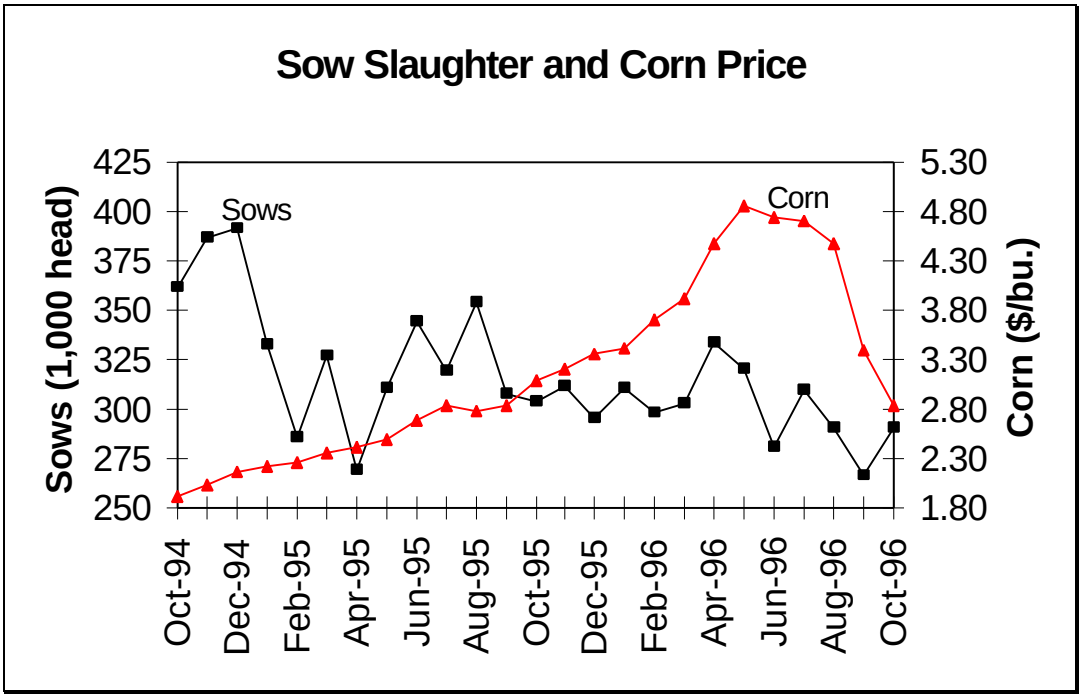


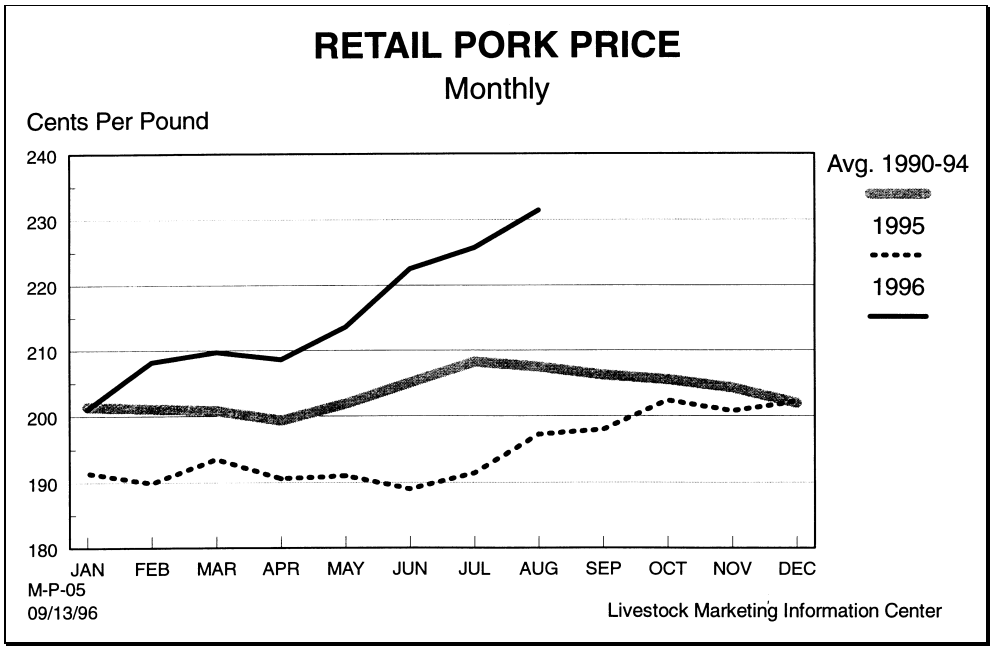
Figure 23.



Remember the retail price path that we were following in beef (Figure 24)? Here are the 1990 to 1994 average pork prices (wide line), the 1995 retail pork prices (dotted line), and the 1996 pork prices (narrow line). You had some "pull" from the top end, demand-wise, with higher prices pulling your hog prices higher and offsetting those increased corn costs that we were running into. In some sectors,

and beef is still one of them, we keep talking about cutting costs and somehow pushing expanded usage up through the system. But there is no "pull" from the top end, no increased consumer demand in terms of prices they are willing to pay, and that makes a huge difference over time.

Figure 24.



Message

We will stop on Figure 25 and talk about the messages. What is going to help the pork sector grow and gain market share is that it is moving to a consumer-driven status with quality control measures, branding of fresh pork product, investments in a modernized product offering, and feed conversion below 3 to 1 on the feeding floor. By the fall of 1997, assuming no calamity in weather and corn costs back down in the $2 to $2.50 range (and probably closer to $2.50 than $2, it will take until 1998 before we get it down towards $2, but it is coming, I think), pork will be able to compete strongly with poultry at the retail level.

Recommendations

I would make investment decisions using hog prices in the mid-$40s. We are going to see them periodically above $50, and we are going to see them periodically below $40. There is a cycle still out there; there is a seasonal pattern still out there. I believe we are going to see hog prices be able to hold in the $40s generally. That is well above cost of production, I might add, for the large, efficient producers unless you factor in corn above $3. I think this industry is going to have some profit incentives to grow. Use price risk management strategies for slaughter hogs, and cost risk management strategies on the feed side.

Figure 25.

The Message

The 1996 Farm Bill will help the pork sector grow and gain market share. It is moving to "consumer-driven" status with quality control measures, branding, and investments in a modernized product offering. Feed conversions below 3:1 on the feeding floor and corn at $2.00 to $2.50 will keep costs down and allow retail-level price competition with poultry.

My Recommendations

- Make investment decisions using hog prices in the mid-$40s (around $60 on the new lean pork futures).
- Recognize cyclical influences will periodically mean prices above $50 and below $40 ($67 to $68 down to $54 and less on the new futures).
- Use price risk management strategies for slaughter hogs, cost risk management for feed.
- Use genetics the packers want and be willing to look at contracting.
- Take advantage of the seasonal pattern in prices (low March/April and October/November, high in the summer).
- Support industry's efforts to be consumer driven and market oriented.

Use the genetics the packers want. If we are going to keep independent, entrepreneurial hog producers in this state, they cannot do their own genetics by holding back the gilts they like the looks of. Nobody in today's marketplace is going to want those hogs. You have to go to PIC; you have to go to DeKalb; you have to go someplace and buy your genetics, in my opinion. You have to make sure the only packer in your area, and we typically only have one, approves of those genetics before you buy them. If we do not like to operate that way, there is not going to be much place, I am afraid, for the independent hog producer in the future, I do not care how little corn costs.

It is a competitive marketplace again. Someone said earlier, a lot of producers have been wanting the government out of agriculture for a long time, now they are out. What are we going to do with it? It is going to be a very risky, difficult marketplace that you are going to have to get ready to cope with. Take advantage of the seasonal pattern in prices. We see a huge seasonal pattern in hogs. Low prices in March and April, low prices in October and November, and the highest daily slaughter levels during the year are in November. There are also sharply higher prices in June, July, and August. If you can get on a program where you can head slaughter hogs toward the July market, you may be talking about a $55 to $57 hog market that turns into a $43 to $45 hog market by October. There is still that much swing in the seasonal price patterns in hogs in this country. It is because we still have many hogs that are being farrowed in open sheds exposed to the weather. Those pigs are born in the spring. They hit the market in October and November. Or we have them born in the fall, and they come to market in March and April. If you can counter that, there is a phenomenal opportunity out there for those of you who have the resource base and the management to cope.

I think we need to continue to support the industry's efforts to be even more consumer driven. It is coming from private investments, but a coordinated industry agenda is important.

POULTRY

I say, John Johnson, that the poultry industry survived, but with reduced margins, . . .

"What margins?" Johnson asks.

I knew he was going to say that. That is only in turkeys. You are only in bad shape in turkeys. I have got to admit I am looking at averages and I have to be careful. I do not think the monthly average chicken margins ever went negative. They did in turkeys, probably primarily because the conversions are that much different.

"Yes," Johnson agrees.

Increased production—we grew right on through the year (Figure 26). No major decrease in chicks hatched. Reduced, but generally positive margins, was true for chickens; they went negative for turkeys. Help came from very strong retail prices. Again, like the pork sector and unlike the beef sector, there was some help from higher retail prices (Figure 27).

That is federally inspected chicken production on this chart (Figure 28). The narrow line is 1996 and 1995 is the dashed line. The wide line is 1990 to 1994. Production is still growing. Production was up virtually every month in the first half of the year. Turkey production looks less impressive, but it is generally growing (Figure 29).

Figure 26.

The Indirect Impact: Poultry

Poultry survived the corn-price crisis with reduced margins. As was the case with pork, the increased feed costs were being offset by higher selling prices. For 1994-96, the sector shows

- Increased production
- No major decrease in chicks hatched
- Reduced but generally positive margins
- Help from very strong retail prices

Figure 27.

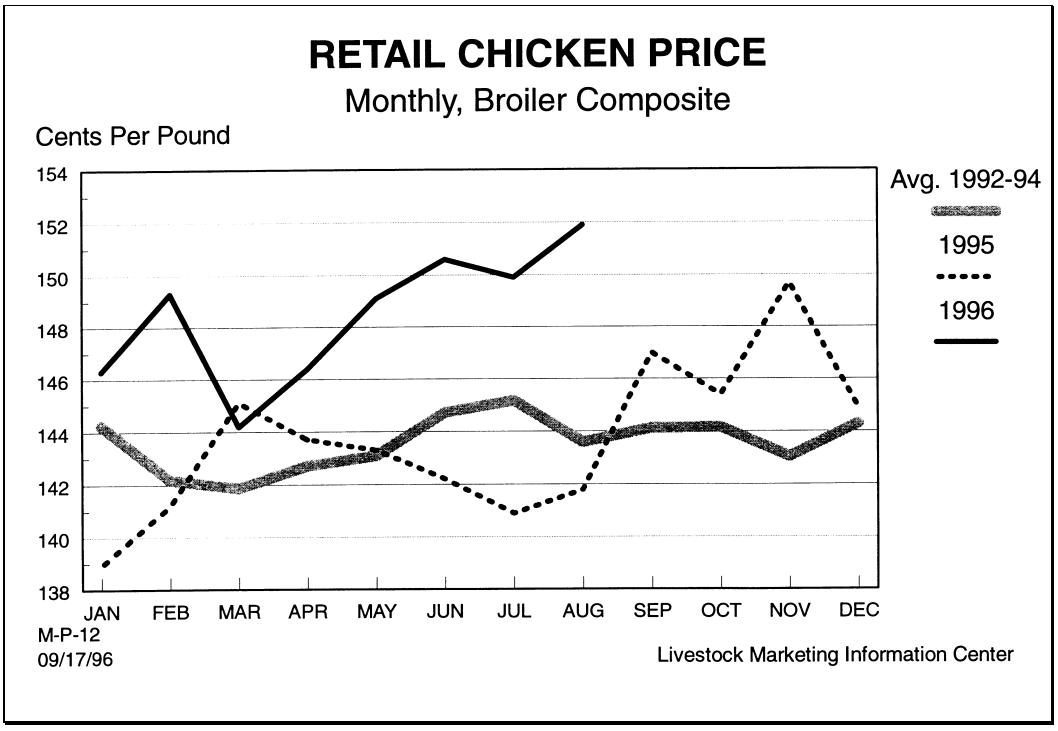


Figure 28.

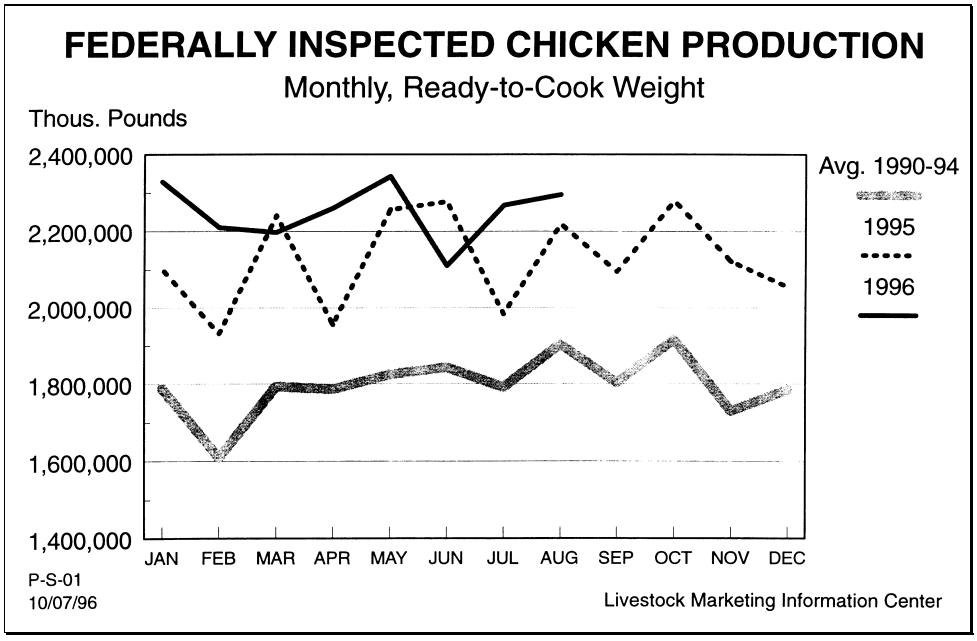
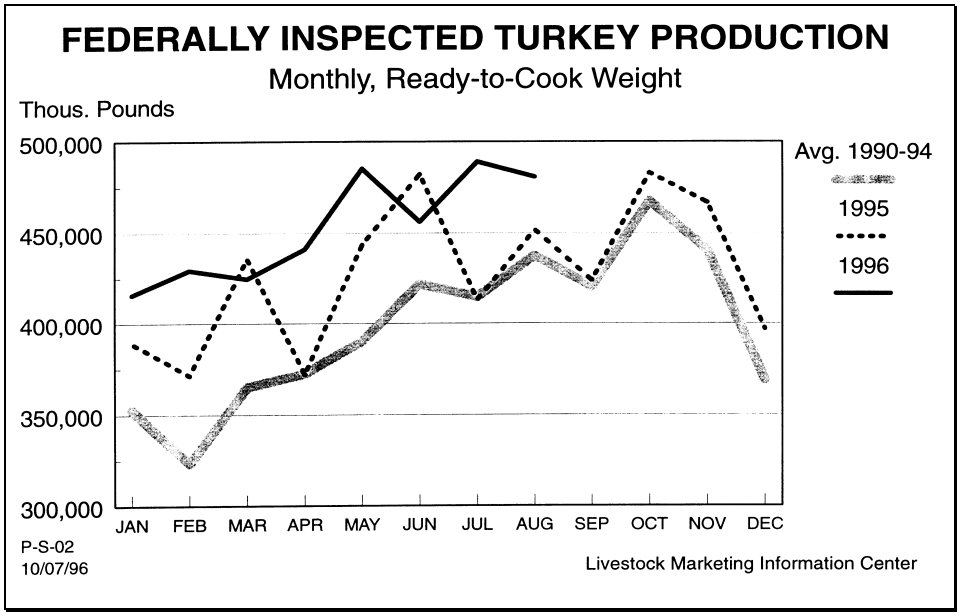
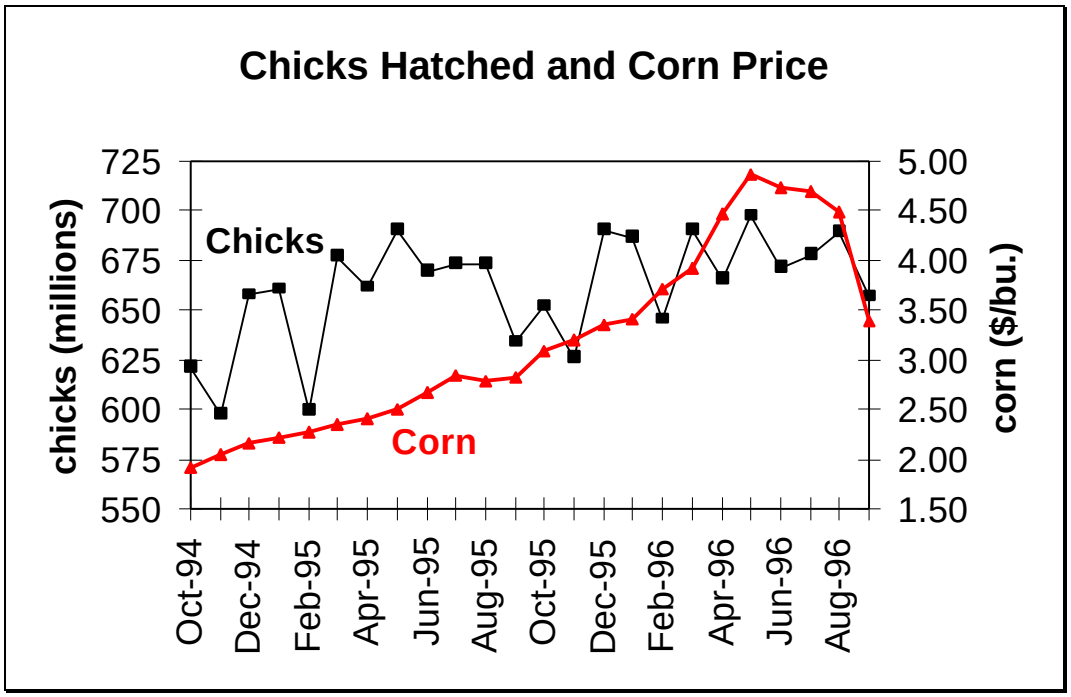


Figure 29.



I thought chicks hatched and corn prices might show something interesting so I plotted it (Figure 30). Remember when we plotted the corn prices and the calf prices on the same graph? You would think that you ought to see an impact on chicks hatched from that surging corn market. It is not there. This industry has the capacity to keep growing. They have taken market share every year since 1976. Beef has lost roughly 30 pounds per capita of market share, from 96 pounds down to about 66 pounds. Poultry in total, including turkeys, has gained most of that 30 pounds, with total meat consumption showing only modest increases across that time period.

Figure 30.



Here you go, John (Figure 31). If you look at national data that I can get my hands on and calculate a margin (the right hand column, "Net Returns") on a quarterly basis through the first two quarters of 1996, and corn had certainly surged by then, the margins were still positive. I do not know what the third quarter would show, but I expect it too will be positive. What happened in the chicken business, then, is that the margins were down compared to earlier years like 1994, but did not turn negative.

Figure 31.

Net Returns to Poultry Programs: Broilers

Year	Quarter	Production Costs		Wholesale Price	Net Returns
		Feed	Total		
		(cents/lb.)			
1994	(1)	17.9	28.2	55.2	4.0
	(2)	17.5	27.9	60.0	9.2
	(3)	16.7	27.1	55.9	6.2
	(4)	15.2	25.6	51.8	4.1
1995	(1)	15.0	25.3	51.7	4.3
	(2)	15.5	25.8	53.5	5.5
	(3)	16.3	26.7	60.7	11.5
	(4)	17.3	27.7	59.6	9.1
1996	(1)	19.6	29.9	56.3	2.8
	(2)	21.5	31.9	61.0	5.0

- Margins were generally positive for eggs where price in quarter 1 of 1996 was 92.0¢/dozen compared to a 1994-96 low of 66.7 in quarter 2 of 1995.
- For turkeys, net returns in 1996 were negative. Selling price did not move up, and feed costs went from a low of 20.4¢/lb. in quarter 1 of 1995 to 30.2 in quarter 2 of 1996.

There is a footnote down here that says turkey net returns in 1996 **were** negative. The selling price just did not move up, and the feed cost went from a low of about $0.204 per pound in quarter one of 1995 all the way up to $0.302 in quarter two of 1996. That is a 50 percent increase in feed costs. Turkeys, with a poorer feed conversion, could not hold that margin together since they were not getting any help from higher retail prices, as chickens were. Substantially higher retail prices helped chicken integrators absorb some of these horrendously higher corn and feed costs.

There is a lot of poultry product in cold storage and there is some concern about that. It does not surprise me. Notice production has been up, and prices have gone up substantially, partly on a pass-through, I think, of the higher feed cost. When you increase production and try to move it at higher prices, consumers back off. They have backed off, and there is some product in storage, but I think this industry will come out of it in pretty good shape.

Message

The 1996 Farm Bill will bring cheap feedstuffs, which will help the other sectors compete (Figure 32). *Pork, in particular, will be helped. On the other side of the coin, feed costs are so important to the poultry sector that they are going to get a benefit from lower feed costs. The lower feed costs are going to keep prices down and make poultry very competitive at the retail level.*

Figure 32.

The Message

The 1996 Farm Bill will bring cheap feedstuffs, and this helps the other sectors compete. Pork in particular will be helped since that sector is poised for growth. On the other side of the coin, feed costs are the bulk of poultry costs and cheaper corn clearly helps poultry keep costs down and selling prices at competitive levels.

My Recommendations

- Firms should continue to enhance the long-standing "consumer-driven" status.
- Investments in expanded capacity should be sound so long as the industry's member firms invest in R&D.
- Effective cost-risk management strategies will be important.
- Exports should continue to grow.

Recommendations

Firms should continue to enhance the long term consumer-driven status. This is an integrated industry that implicitly understood that if you offer consumers something they want, they will reward you for it. It is been willing to make investments because of that. Since it controls all stages of production, it can make sure product changes occur. We have very difficult problems getting that type of coordinated agenda in beef which is over on the other end of the continuum with a bunch of separate and adversarial profit centers. In poultry you have one profit center, and it continues to make product adjustments and stay in a consumer-driven status.

Investments in expanded capacity should be sound as long as the industry keeps putting some money in Research and Development (R&D), and I am talking primarily about market and product development, I am not talking R&D as in more efficient production. I am confident the industry is going to work on production efficiency. I think the **sufficient condition** for success in the poultry sector is to spend R&D money on the product and market development side.

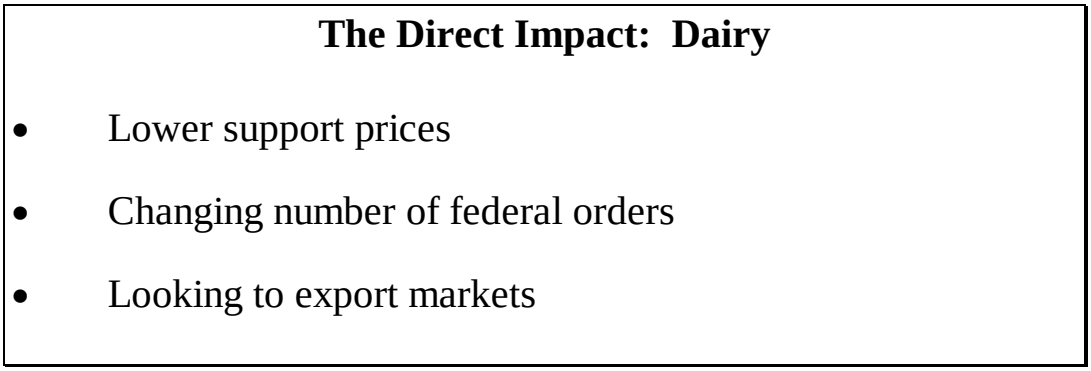
Effective cost-risk management strategies will be important. The poultry industry got hurt this year by high feed costs. Many of you have read articles in the newspapers coming from CEOs and presidents of some of the firms talking about what a bad year they have had and why they have had it with regard to the high-priced feed. It did not have to be that way. Maybe this was the needed attention-getter. As we go into the markets that Ron Trostle, David Kenyon, and everybody else has said they think will be even more volatile, and I agree with that, we have to sharpen those risk management tools.

I think exports are going to continue to grow and help this sector move forward and get bigger.

DAIRY

There is some direct impact here and a lot of people have talked about dairy (Figure 33). There are a lot of things we do not know yet about dairy, because there are a lot of things that provision was made for in this Farm Bill that still have to be done. We are going to see lower support prices and then no support prices. We are going to see changing number of federal orders, that is mandated. We are going to see an industry that has to look to the export markets. I have already implied, that given the evidence we have seen so far, we are not faring very well in exports.

Figure 33.



You can glance down through these price support issues (Figure 34). Point number 2 is important. Most of you know support price declines to a low of $9.90 per hundredweight in 1999, and is then replaced with a recourse market loan. Market prices in recent years have been above the support price. They will probably be above the support price for the next few years; therefore, price volatility is going to be something the dairy sector is going to have to deal with that it is never dealt with before. We have a futures market trying to get started in fluid milk. Thus, we are creating a price risk management instrument if we can get it trading. I would really encourage you, John Miller, and those of you in the dairy business, to get behind this new futures offering and make it happen. It is always hard to start a market.

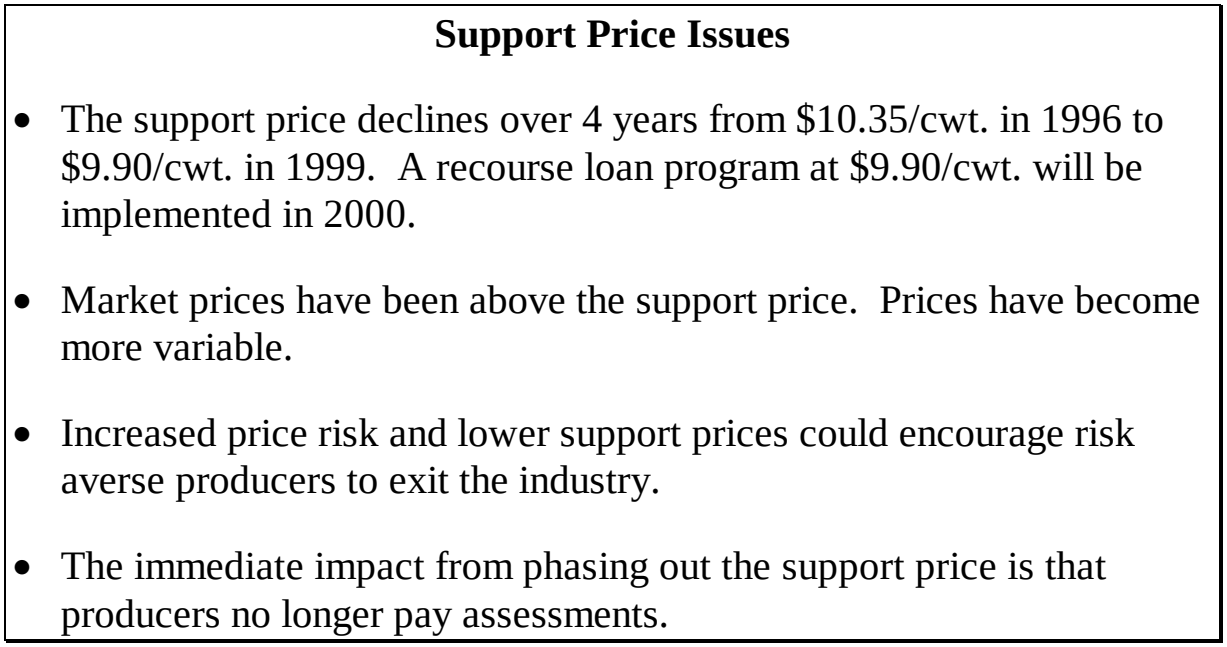


Figure 34.

Somebody mentioned this morning we keep asking producers in this state to produce barley, which is a winter grown feedgrain and does not have drought problems. The problem is we have been asking farmers to give it away. We have no market. All during this corn crisis, you could buy barley for 60 to 70 percent of corn prices Why? Somebody has to make a market. We need to work on it, and I think we will.

Somebody needs to make a market in dairy, because you are going to need a risk transfer instrument. I think we will see increased price risk. We may see some risk averse producers, because they are not used to this, get pushed to the sidelines.

Let me mention the federal marketing issue is uncertain (Figure 35). We have to come down to 10 to 14 federal orders. The Wisconsin point is not necessarily going to be the only price basing point. The effects of order consolidation are unknown. As you can see here, the USDA has commissioned several groups to study the impact of order consolidation using multiple basing points for pricing. I think there

are some studies expected to be out in 1997. It makes it difficult to know exactly what the direct implication of this is because we do not know some of the study findings at this date.

Figure 35.

Federal Marketing Order Issues

- The farm bill consolidates the order from 33 to no more than 14, but no less than 10.
- Eau Claire, Wisconsin, will no longer be the only basing point for orders east of the Rocky Mountains.
- At this point in the process, the effects of order consolidation is unknown. By itself, the provision is not expected to have a major impact on regional milk prices.
- The big issue is where will the lines be drawn--a problem because of utilization rates.
- The USDA has commissioned several groups to study the impact of order consolidation and multiple base points. A ruling by the AMS is scheduled for April 1997.

If we look at some indirect impacts, dairy got hit hard in this state by the record corn prices (Figure 36). Jim Pease made reference to some of the smaller dairy farms going under. We were hearing stories, back in the spring and summer months when cash corn was $5 and up, that "For Sale" signs were going up on some dairy farms. It was a repeat of what we went through in 1983 and 1984. It was the straw that broke the proverbial camel's back in some cases. We have been able to pass through to the consumer much of the burden of the higher feed costs, to be frank about it, because milk prices are as high as $18 to $19 per hundredweight at some points in Virginia now. They will not stay up there, however. The declines have already started to occur.

Figure 36.

The Indirect Impact: Dairy

In dairy in 1994-96:

- Record corn and feed prices
- Milk prices higher
- No strong demand/export growth to date
- Virginia a top-10 state in competing for growth (research result)

Those of you who get John Miller's monthly magazine, there is a pull-out article in it this month based on research Chris Nubern did with me. We looked at how Virginia was going to fare in a competitive marketplace. I must say to you that I was pleasantly surprised at how competitive Virginia can be. To give you an idea, one of the things we did was to model a scenario where we kept the level of production constant and allowed any state to increase its production up to 30 percent, which means some other state had to lose it. We were interested in where that production would go in a free market with no government program. Virginia fared very well and was in the top ten states that the model looked to for production to keep the combined costs of production and shipping to a minimum. California came in first, not a big surprise, their costs are lower. But Virginia was quite competitive, and I was very encouraged by that.

If we do this thing right (and we have very good yields in the state per cow) we can manage to keep this dairy situation together. If you look at what is happening in Virginia with regard to the number of farms and cows per farm from 1983 to 1995, we are up to 106 cows on an average size farm (Figure 37). There is something in economics called "economies of size," which means if you are a little bigger, you can do it a little cheaper. It is a powerful force in every type of program we can think about, it does not matter whether it is dairy, corn, or wheat, or what it is, and it is certainly at work in dairy in this state.

Figure 37. Cows per farm

This chart shows the average U. S. milk production per cow (Figure 38), and Virginia has done better than that. There are things that are really good in this state that come from the research, technology, and education efforts at the state universities. It comes from the research, extension, and teaching efforts that the state dairymen have helped support over time.

Here is a sobering chart (Figure 39). This is the Virginia market price for milk in what economists call both nominal terms (not adjusted for inflation) and in constant dollars, dollars which have been adjusted using 1982-1984 as a base. This is scary because this means that in inflation adjusted dollars, the selling price is coming down. This creates cost-price pressure. You have to get your costs down to stay in business: not one time, but over and over and over again. It is like a treadmill: as long as your nominal selling prices are flat or declining, you have to run faster on the technological treadmill to keep costs down in order to survive. Your recent $18 or $19 per hundredweight is a short term phenomenon; it will come back down to the $13 to $15 average range for the state very quickly. As long as your nominal selling prices are flat, and your inflation adjusted prices are coming down, none of your costs can inflate—labor cannot, feed cannot, machinery cannot, none of them can. If they do, you have to offset them by increased productivity per cow.

Figure 38. Average milk production per cow, U.S.

Figure 39. Virginia milk prices, nominal and real

Message

In dairy, the message is clear (Figure 40). *Virginia can compete, but only if we stay at the cutting edge of production efficiency and learn to use price and cost risk management tools effectively. Moving to an export-driven market will be slow, and milk prices are likely to be pressed lower as production expands in the face of the cheap feed that we will soon see. There is no program support price at levels that will protect most Virginia producers.*

Figure 40.

The Message

The 1996 Farm Bill continues a move toward "free market" and a backing away from support/safety-net orientation. Over time, this will set the stage for Virginia producers.

My Recommendations

- Expect M-W equivalent prices to decrease sharply from current levels
- Work on keeping cash costs below $13 in SR, below $12 in LR
- Use feed cost management strategies
- Learn about milk forward pricing opportunities and use them
- Expect a more risky decision environment and be prepared
- Push for efforts to develop new and consumer-friendly product offerings

Recommendation

At the industry levels, aggressive programs to enhance export demand are needed.

Since the dairy producers will have to worry about selling price variability, the industry should support the development of a usable futures contract. In combination with existing corn and soybean meal futures that allow management of exposure to feed cost risk, the new futures in milk and dairy products could allow progressive dairymen to lock in a profit margin, at least on occasion, and protect their businesses.