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Lean hog futures overly positive

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Abstract
Livestock Outlook: Superwide cash-futures hog price spread will narrow.

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BIG SUPPLIES: USDA's March Hogs and Pigs Report indicates larger market hog inventories and higher supply growth will likely continue into at least 2020, if not longer.

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Livestock Outlook: Superwide cash-futures hog price spread will narrow.

Lee Schulz | Apr 16, 2019

June, July and August lean hog futures were trading between $98.150 and $100.975 as of April 8. Those prices are well above mid-April cash hog prices in the $75 area. That gap, known as the basis, will narrow over the next nine weeks.

As pork supplies decline seasonally and cookout demand grows, rising cash prices will erase part of the gap. That all suggests this year's spring into summer cash hog price rally could be considerably larger than cash price gains of recent years. This rise is predicated on pork demand, particularly exports, keeping up with or outpacing supply.

However, if expected demand fails to materialize, cash prices could fail to rise as much as futures prices currently have dialed in. Then the basis gap could narrow by futures prices falling.

Hedger's heartburn

Futures markets account for all public and nonpublic information in determining an equilibrium price in the market. For example, the current June futures price is the market's best measure of what the actual price will be in June. If all of the market's expectations prove true, futures have little downside, thus producers have little need to hedge.

However, the superwide basis between spring cash prices and summer futures hints that at least some of the basis narrowing could come from futures sagging. That suggests selling futures to hedge could be wise.

Recent price action complicates decisions on when to put on hedges and when to lift them. For example, on March 6, the April lean hog futures contract settled at $57.075. In the span of 15 trading days, prices surged to $81.325 on March 27, and then quickly fell to $77.375 two days later before settling at $78.600 on April 8.

Deferred contracts showed a similar pattern, but at much higher prices, especially for summer contracts. Such whipsaw price action demonstrates that the futures road to price discovery can be rocky.

What can you net from a hedge?

Market participants use basis to "localize" a futures price. Hog basis, remember, is the difference between the cash hog price and the futures price — i.e., cash price minus futures price equals basis. Thus, adding projected basis to the current trading price of a futures contract you would sell to hedge gives the expected cash price.

Basis is typically more stable and more predictable than futures prices. Analysts often use a three-year historical average basis to estimate expected basis. The average covers enough years to smooth out aberrations but is short enough to adjust to changing seasonal patterns.

Your basis only one that matters

The choice of a cash price series to calculate basis is important. USDA's Market News Iowa-Minnesota Daily Direct Prior Day Hog Report (LM_HG204), for example, has five producer sold prices that are routinely reported: negotiated, other market formula (futures and options), swine or pork market formula, other purchase arrangement, and the total weighted average of all purchase arrangements.

The reported prices are all base prices and are on carcass weight units. Net prices are available in the National Daily Direct Prior Day Hog Report (LM_HG201) and are the total amount paid including all premiums, less all discounts per hundred pounds of carcass weight of swine delivered at the packing plant.

I use the Iowa-Minnesota (LM_HG204) producer-sold total weighted average of all purchase arrangements price as a barometer for the price received by Iowa producers selling in a manner representative of Iowa producers. Received bids or formula prices for producers on any given day may or may not be near this weighted average price.

All I have to work with are the prices published by USDA. Producers can calculate their own historic basis. Adjusting for transportation costs can further fine-tune the difference they might see between their realized price and those reported by USDA or traded every day at the CME. It's a chore. Still, the better basis data you have for your own farm, the better marketing decisions you will make.

From another angle, when contemplating selling futures to hedge, only one basis matters. That is what the difference between the price of the futures contract you'll sell and your local cash price will be at the time you'll buy back the futures contract to lift the hedge and sell the cash hogs. Knowing, or projecting, the basis for any other futures contract, relative to any other cash price, at any other location, or any other time is of little or no value to the marketing opportunity being analyzed.

Use more caution when hedging hogs

Current market conditions offer a reason for the relatively weak cash prices compared to strong summer futures prices. Notwithstanding the early March price surge, large immediate supplies have been pressuring cash hog prices.

Through the first week of March, pork output was up sharply from 2018. Big supplies confined the Iowa-Minnesota producer sold total weighted average prices for all purchase arrangements in the mid-$50 range. Total first-quarter hog slaughter was estimated at 31.843 million head, up 2.5% from 2018. Slightly heavier weights pushed first-quarter pork production up 2.8% to an estimated 6.831 billion pounds.

Recent basis values versus the June 2019 lean hog futures contract have been dramatic. From 2012 to 2016, mid-February through the first week of April cash prices averaged about a $14 discount to June futures. Two years ago, it was a $7 discount, last year a $14 discount, and this year a $21 discount. When evaluating potential net cash prices from hedging, producers should use historical basis levels with more caution than usual.

Hedging will lock in an exact net cash price if the actual basis at the time the hedger lifts the hedge matches what the producer projected it would be when the producer placed the hedge. Typically, basis at the time the hedger lifts the hedge and sells the cash hogs will be stronger or weaker than what the hedger projected it would be before they placed the hedge. The result is a net cash price somewhat higher or lower than was projected at the time the hedge was placed.

This year the difference between expected and actual basis could be especially stark and the resulting net price range particularly large. A stronger-than-expected basis would work to a seller's (or short hedger's) advantage.

Big supplies could pressure prices

A word of caution: USDA's March Hogs and Pigs Report indicates larger market hog inventories and a higher supply growth are likely to continue into at least 2020, if not longer. The inventory of pigs weighing 180 pounds and over was up 1.6% compared to a year ago. They've already been marketed. Pigs weighing 120 to 179 pounds were up 1.8%. They're coming to market now.

Pigs weighing 50 to 119 pounds were up 2.3% and are expected to reach market weight mid-May through June, while pigs weighing less than 50 pounds were up 2.5% and should be marketed July through mid-August. Large supplies could keep pressure on cash prices, which would keep basis weak.

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