Strong Demand, but Inconsistent Profitability

Chad Hart
Iowa State University, chart@iastate.edu

Lee L. Schulz
Iowa State University, lschulz@iastate.edu

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Recommended Citation
Available at: http://lib.dr.iastate.edu/agpolicyreview/vol2014/iss3/4
Strong Demand, but Inconsistent Profitability
by Chad Hart and Lee Schulz
chart@iastate.edu; lschulz@iastate.edu

With the arrival of fall, the leaves change, the temperatures drop, and agricultural producers prepare for the winter ahead. This winter looks to be a reversal of fortunes across the agricultural complex. Over the past few years, crop producers have enjoyed record prices and profits, while livestock producers have suffered from high feed costs and negative returns. Now, several sectors of the livestock industry are looking forward to strong prices and good profitability. Meanwhile, the crop sector is staring at the lowest returns in several years. While there are some key differences in the structure of crop and livestock markets, the one similarity they share right now is strong demand for agricultural products.

Throughout 2014, the livestock industry, and especially the meat packing sector, has been concerned about the willingness of customers to accept higher prices for meat products. In both the cattle and hog markets, packers have been trying to hold the line on prices and reducing numbers to limit total costs. As we look at 3rd quarter demand from the packers, cattle demand is flat as prices have risen just enough to offset the reduction in consumption. Hog demand has declined over the past year as the price increase was not large enough to compensate for the consumption drop.

However, 3rd quarter demand from the retail meat sector paints a different picture. Customers have continued to walk up to the meat counter and are spending more on meat products than they were last year. For fresh beef, consumption is down nearly 5 percent on a year-to-year basis; however, with a roughly 15 percent increase in beef prices over the past year, beef demand continues to rise. It is a very similar story for pork—consumption is down slightly, but given a 10 percent price increase, pork demand is growing. So while the industry has been, and continues, worrying about a price backlash, consumers have shown that their meat demand is quite resilient.

The crop sector, on the other hand, does not have to worry about prices driving away consumers. Compared to a couple of years ago, crop prices have fallen dramatically. Corn prices are roughly half of their 2012 values. Soybean prices are hovering in the $10 range, after being in the high-teens for 2012. Total corn and soybean demand hit record levels for the 2013 crops. Projections for the 2014 crops show that demand is expected to grow.

Looking back at the strong demand for last year’s crops, the surge in demand came on a number of fronts. Feed and residual demand was much stronger in the first half of the year, compared to previous years. Expansion in the pork and poultry industries helped that cause. Corn usage via ethanol steadily climbed throughout the year as ethanol was cost-competitive in the fuel market; and international demand via exports also rallied throughout the year as the livestock sectors in other countries expanded as well. For soybeans, domestic usage was stable. It was on the export side that we experienced additional gains in demand. China is the dominant player here. Roughly 60 percent of all U.S. soybean exports are shipped to China. Continued growth in their market is key for a recovery in soybean prices.

The demand projections for the crops currently being harvested indicate growth in demand in several areas. The pork and poultry expansions are expected to extend through 2015, implying more feed demand in the coming year. That bodes well for both corn and soybeans. Ethanol production is forecast to stabilize, leaving corn usage for ethanol near record levels. Corn sweetener demand is set to consume an additional 30 million bushels. Soybean exports are expected to top last year’s record levels. The one projected weak area in corn demand at the moment is export demand. USDA is projecting a 167 million bushel drop in corn exports, based on larger world supplies.

So while both the crop and livestock sectors have very strong (and in the crops case, record) demand, the profitability outlook for the sectors is mixed. For the hog industry, 2015 is shaping up to be a profitable year. With low feed costs and good futures prices, hog producers see profits ahead and expansion is underway. One way to examine the potential profitability of hogs is to calculate the “crush” margin being offered on the various futures markets. The crush margin (patterned after the calculations for soybean crush facilities) in this case is the difference between the revenues implied by lean hog futures and the costs implied by corn and soybean meal futures and feeder pig purchases. Typically, for the Iowa hog industry, crush margins above $40 per head indicate profitability in the industry. The outlook for 2015 shows strong profitability through the spring and summer.

For cattle, crush margins are based on live cattle futures to estimate revenues and feeder cattle and corn futures to estimate costs. Crush margins above $150
per head indicate profitability in the industry. Crush margins for the fed cattle sector show profitability now, but that erodes quickly in the coming year. Feed costs are projected to remain relatively low over the projection period, but the cost of feeder cattle placements are at record high levels. Currently, the profitability in the cattle industry is not in the feedlots producing the finished animals, it is in the cow-calf operations, producing the animals to fill the feedlots. Over time, that profitability should push forward to the feedlots as the number of feeder animals grows.

Crop margins for 2015 are in negative territory for both corn and soybeans. The cost structure for both crops reflects the great returns crop agriculture has captured over the past few years. Land rents have been bid up. Seed, fertilizer, and chemical costs have increased. Crop production costs tend to follow prices, but there is usually a significant lag of one to two years. That lag generates significant profits in rising markets, but sizable losses in falling ones.