Rabobank

Beef Quarterly Q1 2014

Positive market fundamentals to remain

Globally, prospects for Q2 remain positive with some further possible upside due to the high prices and continuing scarce supply of competing proteins, which will limit consumers' ability to trade down to cheaper proteins.

Record prices in the US are likely to soften, but the impact of PEDv on hog prices is a potential positive wilcard during the spring grilling season and into summer.

Extraordinary growth of Chinese beef imports continued in Q1 driven by ongoing shortages in the domestic market, despite the likely slower growth after the 380% surge in 2013.

Into Q2, Brazil and Australia are best positioned to win export share due to growing availbillity, though rainfall will be the deciding factor. Longer term, the drought-induced liquidation in Australia will likely position Brazil in the driver's seat.

Rabobank International

Food & Agribusiness Research and Advisory

Published by the Global Animal Protein Sector Team

For a full list of authors, see back page

www.rabotransact.com
www.rabobank.com/f&a

Weather once again key driver of change in competitive positions

Rising supply to result in price pressure after Q1 record levels

Subduing winter weather will support growing cattle supply and some price pressure from the all-time record levels experienced in Q1 2014. However, the PEDv-induced surge in hog prices might limit decline into summer.

Brazilian prices reaching new records

Driven by low supply of animals and supported by strong international demand and increasing domestic consumption, Brazilian beef prices surge. Pasture has been impacted by weather issues, which can boost feedlot production this year.

Weather disrupting Australian supply...

Severe climatic and seasonal pressure provides extensive challenges to large regions of Australia.

... but supporting booming Chinese import demand

Lack of domestic expansion supports continuing strong import growth, but growth levels of 2013, up 380% YOY to 294 thousand tonnes cwe, will not be reached.

Global outlook

Market fundamentals remain very positive for the global beef industry. Firm demand as well as further tightening supply due to drought-induced herd retention in the US and some adverse weather conditions in Brazil and Australia—three main beef exporters—pushed prices up across the globe in Q1 2014 (see Figure 1). Combined with fluctuating exchange rates, these events have impacted competitive positions in export markets, with Brazil and Australia gaining export share in Q1 at the expense of the US (see Figure 2).

Prospects for the global beef industry remain positive in Q2, with further possible upside due to continuing pressured beef supply and scarce supply of competing proteins. This will support high prices and limit consumers' ability to trade down to cheaper proteins. In addition, with ongoing tight cattle supplies in the US, there are short-term opportunities for increased cattle supply in Brazil and Australia. Into 2H, Brazil will be best positioned to gain further export share as Australian supply will face drought-induced pressure.

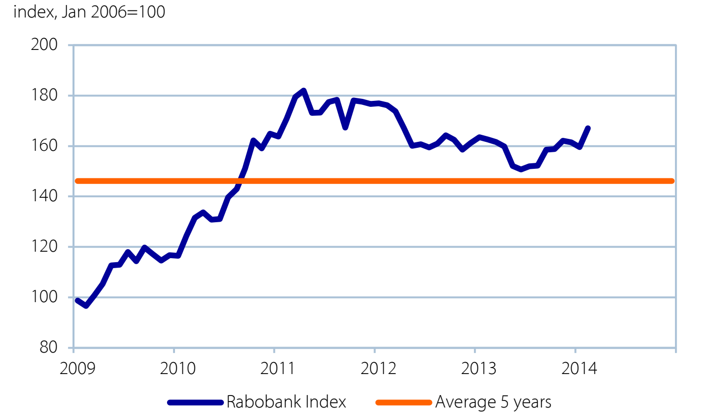
In the US, very tight supply, further hampered by the severe winter, pushed cattle and cut-out values to all-time record levels in North America during Q1. Seasonal considerations and higher cattle-on-feed numbers since late 2013, will reduce the supply pressure in Q2, but it will remain tight, which will support elevated cattle and beef price levels. In addition, the current outbreak of porcine epidemic diarrhoea virus (PEDv), which is spreading across the US and will likely result in a 6-7% drop in pork production, will keep pork prices elevated during the spring grilling season and into the summer. This could strengthen beef demand and limit—or even completely remove—the expected price pressure for beef in the US.

The tight situation on the export market due to lower US exports was further challenged by two droughts in a few important Brazilian states, which limited supply in Q1. In combination with a strong devaluation of the real, Brazilian cattle prices and exports surged to record levels. This situation will not change materially in the coming months, even when supply recovers to normal levels due to the continuing strong export demand.

In Australia, poor climatic conditions resulted in historically high slaughter levels in Q1 after the 14% increase in 2013 and January slaughter numbers jumped by 17% to 678,000 head. The drought will continue to impact Q2 performance with slaughter levels forecast to remain at elevated levels. Fortunately, strong export growth of both boxed beef (+25% to 170,000 tonnes Jan-Feb) and live cattle shipments (forecast 2014: +50,000 head) limited the price fall. Supply is expected to slow down in the course of Q2 but will remain above year ago levels.

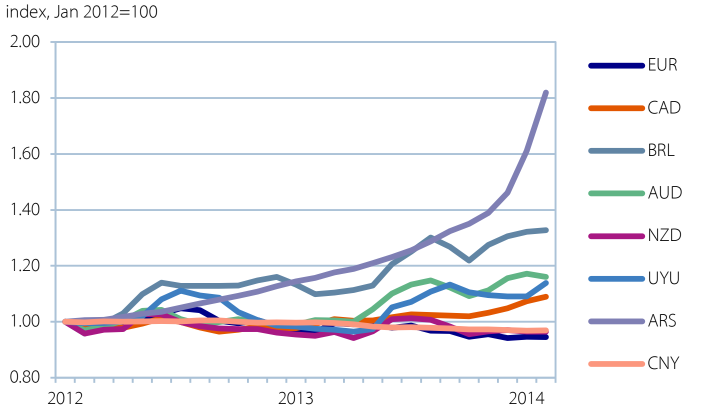
Beef demand growth will continue to come mainly from China. Rabobank does not expect 2014 beef imports in China to reach the growth levels experienced in 2013 (+380% to 294,000 tonnes). But with Chinese farmers hardly taking interest in expanding production despite strong profits and increasing government support, imports will grow. This is also because China recently opened for Australian chilled fresh beef products and might open their market for Brazilian beef soon.

Figure 1: Rabobank 7-nation finished Cattle Price Index 2009-2014



Note: Average live finished cattle prices weighted by share of global exports (Brazil, Australia, Argentina, Uruguay, US, Canada and New Zealand)
Source: Rabobank, 2014

Figure 2: Index exchange rate development against USD



Source: Rabobank on Oanda, 2013

Regional outlooks

US

Volatility was the biggest factor impacting the US cattle complex in Q1 2014. The year opened with tight fed cattle supplies, packers short of cattle as well as all end users in the pipeline holding short inventories. Adding to the complexity, the severe winter weather slowed livestock feed yard performance, further reduced slaughter rates and made deliveries of beef to end users difficult and often behind schedule.

As a result, fed cattle reached all-time record price levels, with fed steer prices reaching a new record price of USD 1.50/pound to USD 1.52/pound, while feeder cattle, cows and beef cut-out values peaked at USD 230/cwt (see Figures 3 and 4). The key driver for the record cut-out values was a surge in the prices of beef trimmings, beef chucks and rounds that could be used as alternative sources for ground beef, due to the steep decline in cows and non-fed slaughter.

Towards the end of the first quarter, winter weather began to subside and all indicators are that fed cattle supplies have reached their tightest levels with prices starting to level out and expectations that fed cattle supplies would increase into the spring and summer. However, the exploding hog market due to the rapid spread of PEDv will be the wildcard, as it could substantially reduce the availability of butcher hogs through the summer months and strengthen beef demand during the spring grilling season and into summer.

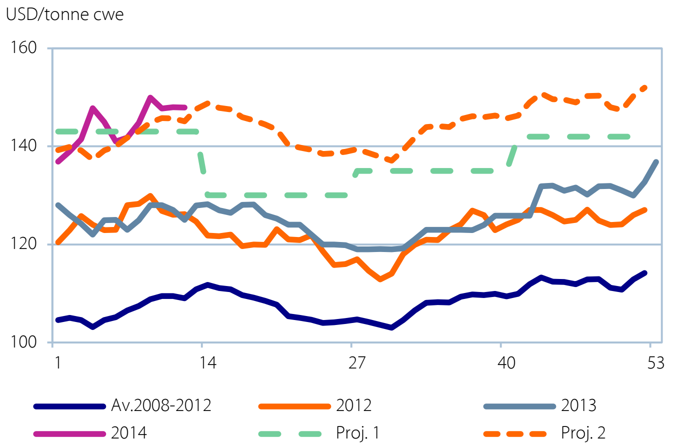
The increased fed cattle offerings are expected from seasonal considerations, but also because monthly cattle-on-feed placement estimates during the fourth quarter of 2013 and for January and February 2014 were all above year-ago levels, suggesting there should be a sizeable increase in fed cattle supplies starting in late spring and lasting deep into the summer.

Expectations are that fed cattle prices have reached a seasonal peak in the USD 150 to USD 152 price range. A normal seasonal correction from the spring high to the summer low projects a low of around the USD 130 level in late July or early August.

Feeder cattle prices may already be near the seasonal low, which could be delayed until as late as May but are not expected to be measurably lower than the current trading range. Given the known short supply of replacement cattle, lower feed grain prices, the continuation of excess feeding capacity as well as the fact that cattle feeders have returned to profits, prices are expected to rise towards the seasonal price high in the fall, with current projections suggesting prices near the USD 190 level.

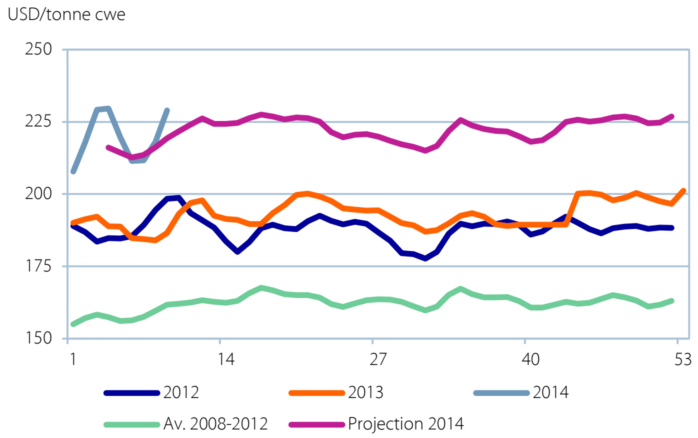
Cut-out values are expected to post a short-term correction before retesting the seasonal peak once the spring grilling season hits full swing. Under normal circumstances, cut-out values are expected to reach a low in the USD 210 to USD 215 range in late July to August. However, the shortage in hog slaughter due to PEDv could have a significant impact on total meat supplies and subsequent wholesale red meat prices during the summer.

Figure 3: US fed steer price



Source: USDA, 2014

Figure 4: US comprehensive beef cut out



Source: USDA, 2014

Australia

Poor climatic conditions have continued in Australia in 2014 throughout large areas of Queensland and northern New South Wales, which is keeping slaughter levels historically high. Total cattle slaughter in 2013 increased 1.1 million head (+14%) to 9.1 million head, which underpinned record beef production (see Figure 5). January slaughter increased 17% YOY to 678,000 head, with processing volumes in February and March also forecast to be higher than last year. With 79% of Queensland (accounting for over 30% of Australian cattle) now drought declared (the largest area ever recorded) and poor conditions around other key cattle-producing regions, cattle processing volumes are likely to stay high throughout 1H 2014.

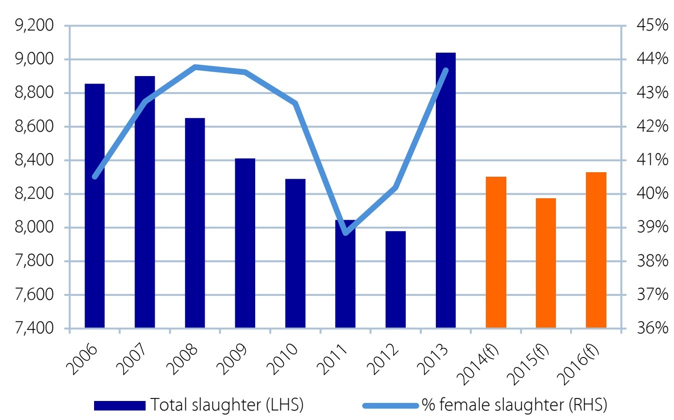
High supply of cattle and strong international demand supported record boxed beef exports for January and February. Total exports for the first two months of 2014 totalled 169,542 tonnes cwe, an increase of 25% (33,861 tonnes cwe) YOY. Strong international demand continues to come from China (up 42%), South Korea (up 31%), the US (up 29%) and Indonesia (up 219%), which all recorded strong increases year-on-year (see Figure 6). Exports will continue to be strong into the second quarter of 2014 while climatic and seasonal conditions remain poor. However, they will tighten significantly when changes prevail, which will likely be in 2H 2014.

Competition for Australian beef will be fierce as supply tightens, not only in 2H 2014 but also in the following years, with shipments destined for those countries where demand is strongest. This will underpin increased average export values and consequently returns along the supply chain. Strong demand for Australian product is expected to continue throughout 2014 as the US is in a herd rebuilding phase after years of severe drought. China is also predicted to continue to be a strong buyer of Australian beef, although the potential formal re-entry of both Brazil and the US this year will increase competition in the marketplace—acknowledging product from these countries is already in the market via the grey channel.

The outlook for the Australian live export industry is increasingly bright after a number of difficult years from both a market access and trade point of view. Forecasts suggest an increase of 150,000 head in shipments to Indonesia in 2014. Live cattle prices have been boosted by the lift in demand, with light steer prices out of Darwin currently at AUD 2.30/kilogrammes, compared to AUD 1.75/kilogrammes the same time last year.

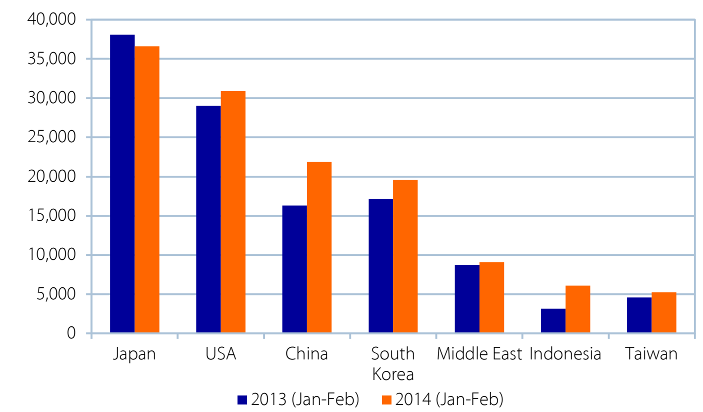
Recent patchy rain throughout large areas of northern and eastern Australia has provided some much needed relief for producers; and also provided a boost for farmgate prices. At the end of the first week of March, prices averaged AUc 317.25/kilogrammes, 5% lower YOY, but rising from an average of AUc 292.64/kilogrammes in the first two months of 2014. However, the recorded rain has by no means been enough to turn around the previous poor season throughout northeast Australia. Furthermore, the latest seasonal outlook predicts a drier-than-normal period for Queensland and northern NSW. This is expected to result in a continued high flow of cattle to markets and to put continued downward pressure on farmgate prices.

Figure 5: Australian yearly cattle slaughter



Source: ABS, MLA forecasts, Rabobank, 2014

Figure 6: Australian beef exports 2013-2014 (Jan-Feb)



Source: DAFF, Rabobank, 2014

Brazil

Low supply of animals at the start of the year, due to a drought that hit some producing regions during what should be the wettest months of the year, pushed up live cattle prices, which are reaching new records in nominal values. In Brazil, more than 90% of the cattle is fed on pastures, with only half receiving mineral supplements as a complement. Meanwhile, prices are also being supported by strong international demand, increasing domestic consumption of beef and a weaker real.

Live cattle prices in January 2014 were, in inflation-adjusted terms, 5% above the average of the last five years and 11% above the same month in 2013 (see Figure 7). If we consider nominal values, the increase was 16%. In February, prices reached BRL 120/15 kilogrammes, 25% above February 2013.

Both domestic demand and exports have strong prospects. Domestic demand is likely to increase on the back of the World Cup in June and the presidential elections in October. Exports will be driven by the continued depreciation of the real against the US dollar. The Brazilian Beef Exporters' Association (Abiec) expects exports to reach USD 8 billion in value and USD 1.8 million in volume, 20% higher YOY and a new record in volume. Exports now account for almost 20% of total production in Brazil.

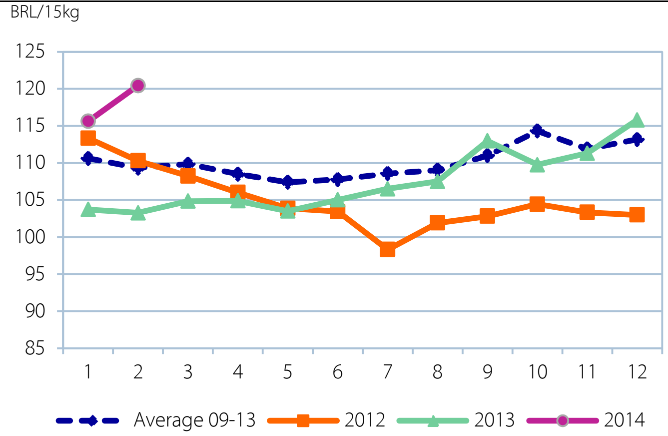
Looking at the challenges of competing beef exporters, a key factor in the medium term might be the growth potential of Brazilian beef production. There is great potential room for growth in Brazil's feedlots, which currently accounts for less than 10% of beef production.

Expected continued strong demand, both domestic and export, will result in firm cattle prices in Q2 2014 and likely beyond, even in periods of strong supply. The futures market also shows an optimistic scenario for the cattle sector in Brazil. During March, the October 2014 contracts were firmly above BRL 125/15 kilogrammes, up from BRL 108/15 kilogrammes in October 2013.

Improved profits for cattle producers' and, consequently, raised optimism in the field have not yet resulted in large investments in the sector. In fact, beef production has been losing production area to agricultural crops in Brazil, especially soybeans in the last couple of years. To raise production, the short term alternative for the beef sector is to gain efficiency, resulting in higher productivity per hectare. Given the positive outlook and the assumption of lower feed prices this year due to the record harvest expected in 2014, Rabobank expects an increase in feedlot numbers of more than 10% in Brazil.

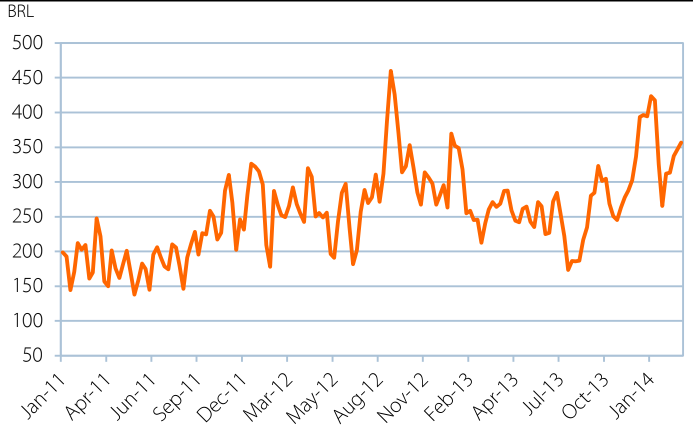
The rise in cattle prices has been passed on to wholesale beef prices, which could cause consumption migration to other meats during the course of the year. In an attempt to reduce that impact, JBS has started a new advertising approach for their branded fresh meat proposition. With this strategy, packers are maintaining strong margins even with the high prices they are paying to producers for live cattle (see Figure 8).

Figure 7: Brazilian live cattle prices, adjusted for inflation



Source: CEPEA, 2014

Figure 8: Domestic Brazilian beef packers' margins



Source: Rabobank, 2014

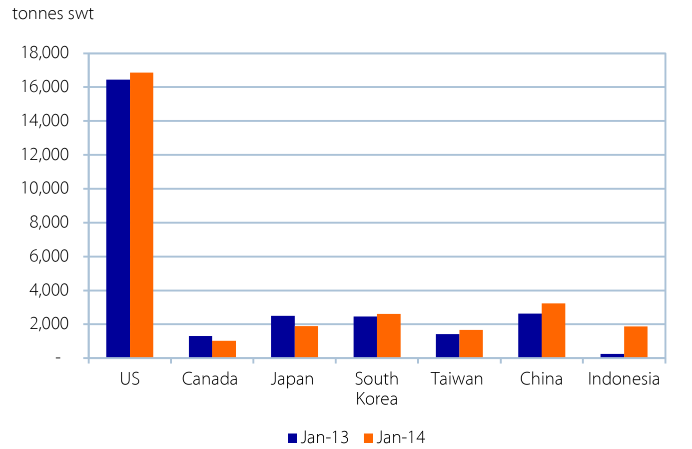
New Zealand

The New Zealand beef industry had a positive start to 2014, with good seasonal conditions throughout most of summer and strong international export demand providing an improvement to the severe drought conditions of the same time last year. Total January slaughter stabilised at 242,665 head, with lower cow slaughter offset by rising bull slaughter levels. This resulted in higher farmgate prices with the NI bull price averaging NZD 381 kilogrammes/cwt (+8%) at the beginning of March. With winter approaching, seasonally higher cull cow supplies are likely to build, resulting in gradual downward price pressure through the remainder of March and into Q2.

Beef exports increased 8% in January to 34,203 tonnes cwe, with average export returns up 1 dollar to NZD 5.66/kilogrammes. Shipments to China surged to 3,233 tonnes (+23% YOY). However, the US (+2% to 16,864 tonnes cwe) remained the key market (see Figure 9).

Export prospects are positive with strong demand likely from the US and China and significantly tighter supplies from Australia. However, the relatively high New Zealand dollar continues to put downward pressure on returns along the supply chain and erodes New Zealand's international competitiveness. The New Zealand dollar is expected to trade around the USc 0.85 range during 2014, limiting possible upside for both export and farmgate prices. Therefore, higher returns at the farmgate will be dependent on processor willingness to attract additional cattle beyond the usual seasonal culling period.

Figure 9: New Zealand beef exports by destination



Source: Statistics New Zealand, 2014

Canada

The long and extreme winter has been taxing for the Canadian cattle industry. Extreme temperatures have forced increased feed usage in order to reserve body maintenance on all classes of cattle. Hay use has been extensive, and a good growing season is needed simply to rebuild forage reserves.

On 1 January, the Canadian Cattle Inventory reported a 1% decline YOY. At 980,700 head, Canadian cattle on feed is up 10% YOY, as of 1 March. At 149,100, February placements were up 26% YOY and marketings, at 136,100 head during February, were up 6% YOY.

Canadian exports to the US continue to be heavily influenced by the new mCool laws. Shipments of feeder cattle (+64%), fed cattle (+13%) and slaughter cows (+14%) are all up YOY.

With the increased number of cattle on feed and the escalation in feeder cattle and fed cattle shipments to the states, it is obvious that Canada is going through their available cattle supply at a rapid pace, while the 1% reduction in cattle inventory shows limited interest, at least to date, in overall herd expansion.

Given the growing pattern of feeder cattle exports, it looks like Canada will become more of a feeder cattle supplier to the US. However, the slowdown in growth of slaughter cow exports to the states suggests that liquidation has slowed or halted, and indications are for stability and even growth as seasonal weather conditions improve.

Unnatural constraints continue to be forced on the Canadian market by mCool. The WTO ruling on this, expected later this summer, will have a significant impact on the long-term direction of that market. Combined with the severity of the winter, it is difficult to make any short-term judgements on the long-term direction of the market.

Argentina

For Argentina, 2013 has been the year of much-needed recovery after both production and exports plummeted in the previous two years after the massive herd liquidation in 2010. Slaughter and production increased by 9% in 2013 to 12.6 million head and 2.8 million tonnes, respectively, while export quantities reached 240 thousand tonnes (+14% YOY).

Beef exports were initially hurt by rising local costs and high cattle prices in dollar terms. However, a strong devaluation of the local currency towards the end of 2013 and into 2014—the Argentine peso depreciated 60% from January 2013 to January 2014—helped balance this situation and resulted in surging prices in ARS terms, which will likely continue (see Figure 10). This would normally result in exports rebounding in the coming months. However, in its fight against domestic inflation, the government has been limiting export licences in the beginning of 2014. This policy—not closing export markets entirely but limiting the volume exported—is likely to continue in the coming months. The rationale is that this will lower domestic meat prices, which is extremely important for staple beef. With this policy, we expect Argentine exports to continue to be low.

China

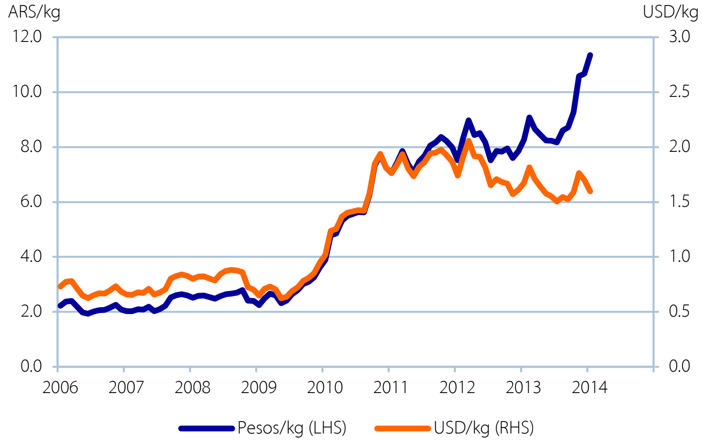
The Chinese beef market will remain tight in 2014. Despite high local prices, strong profitability along the supply chain and increasing government support, beef cattle raising remains unattractive for farmers. This is due to the long production cycle, higher capital requirement and limited credit access compared with other livestock businesses.

In Q1 2014, Chinese beef farmers' profits reached CNY 1,643/head (each head equals 500 kilogrammes), slaughtering profitability increased to CNY 712/head (up 25.8% from December 2013). Rising retail prices (+16% in Q1 2014 YOY) supported retail profitability (see Figure 11). For Q2, along with the weak demand in the season after the Spring Festival, profitability is expected to decline slightly across the supply chain.

Ongoing shortages in the domestic market will continue to support rising imports of frozen beef. However, the astonishing growth seen in 2013, up 380% YOY to 294,223 tonnes, is not expected to be sustained into 2014. High international beef prices will limit the affordability of expensive beef in China. The average import price of frozen beef slightly dropped to USD 4,224/tonne, down 67.5% from 2012. Meanwhile, exports dropped 52% due to tight domestic supply and high local prices.

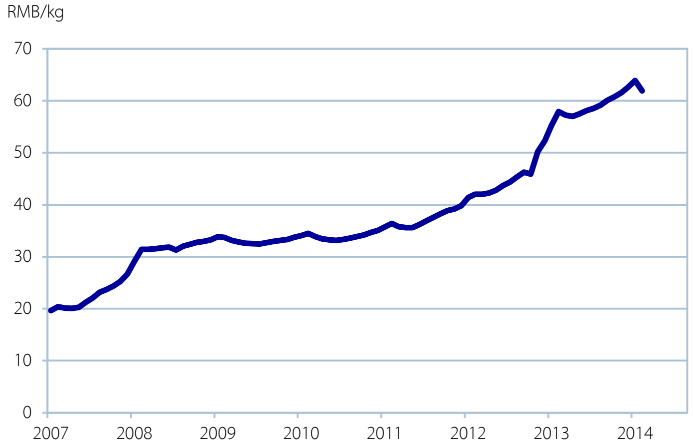
Australia remained the biggest supplier to China, accounting for 53% of the total import volume in 2013, followed by Uruguay (29%), which is catching up rapidly because of its competitive prices.

Figure 10: Argentine live weight cattle prices in ARS and USD



Source: Mercado de Liniers S.A., 2014

Figure 11: Beef retail price in China



Source: MOA, CAAA, 2014

Mexico

In 2014, we anticipate some improvements in Mexico's cattle and beef sector. Current conditions provide an incentive for Mexican feeders to retain cattle with declining feed costs and improving pastures while cattle and beef prices remain strong.

As growers' and feeder cattle returns are improving, Rabobank expects beef cow inventories to marginally rebuild at the expense of the dual-purpose herd (see Figure 12). Mexican cattle exports to the US will decline because of increasing competition for Mexican feeders. In 2014, we forecast cattle exports at 950 thousand head, down from one million head in 2013, and much below 1.5 million in 2012.

After beef production dropped 3.8% in 2013 due to the tight cattle herd and lacklustre economic conditions in the sector, we expect it will increase approximately 1% in 2014. Beef export growth, particularly for frozen beef, has been losing momentum as production has been declining. After the impressive growth of around 50% in 2012, export growth dropped to almost zero in 2013 due to a decline in domestic production. In 2014, we expect an increase of 8% as US production is anticipated to remain constrained.

The beef sector will continue operating under tight margins as beef and cattle prices remain high and consumption continues on the lacklustre side.

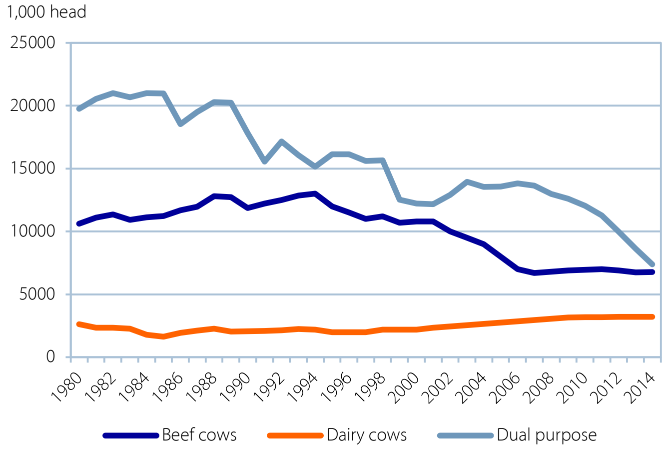
EU

The EU beef market remained steady in Q1 2014, with supply and demand more or less at par, resulting in stabilising prices for prime beef and seasonally recovering prices for ground beef due to the lower availability of cows going into spring (see Figure 13). Slaughter numbers are bottoming out after the 3.9% and 4.3% declines experienced in 2012 and 2013, respectively, with the EU cattle herd slightly bigger last December (+0.5%).

The only disturbance is occurring in Ireland, where the market for young bulls has dropped considerably. Despite efforts to build a new outlet for bulls coming from the dairy industry, the marketing of beef has been more difficult than expected now that supply is picking up. This highlights the growing struggle of what to do with 'dairy' bulls in the EU beef industry, a challenge which will increase in the coming years. With dairy cow numbers up 1.2% to 23.5 million head and suckler cows down 0.8% to 12 million head, the expected growth of dairy bull production after the quota abolition in 2015 is clear. In addition, the veal industry—the traditional outlet for dairy bulls—is under pressure. Fattening these bulls to a higher weight, in combination with strong marketing to processors, retail and consumers of both veal and beef, may be the best way to find a solution for this problem.

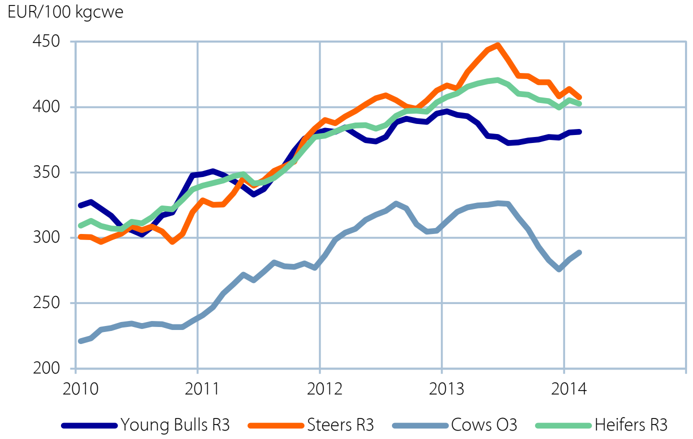
With markets more or less in equilibrium, EU beef prices are expected to hold firm at their current levels. Supply of cattle will remain stable while import growth will continue its steady increase of about 10%.

Figure 12: Mexican cow herd



Source: Statistics Mexico, 2014

Figure 13: EU beef prices by category



Source: European Commission, 2014

Rabobank International

Rabobank Food & Agribusiness Research and Advisory Animal Protein Global Sector Team Analysts

US – Bill Cordingley, Strategist
bill.cordingley@rabobank.com

US – William Sawyer
william.sawyer@rabobank.com

US – Don Close
don.close@rabobank.com

Argentina – Paula Savanti
paula.savanti@rabobank.com

Brazil – Adolfo Fontes
adolfo.fontes@rabobank.com

North East Asia – Chenjun Pan
chenjun.pan@rabobank.com

Australia – Lloyd Setter
lloyd.setterr@rabobank.com

New Zealand – Matt Costello
matthew.costello@rabobank.com

EU & Russia – Albert Vernooij
albert.vernooij@rabobank.com

EU – Gorjan Nikolik
gorjan.nikolik@rabobank.com

EU & Russia – Nan-Dirk Mulder
nan-dirk.mulder@rabobank.com

Mexico – Pablo Sherwell
pablo.sherwell@rabobank.com