PROTECTING THE 2013 CALF PRICES

By Brett Crosby, Custom Ag Solutions

The cattle industry is in an interesting position. On the bright side, consumers keep paying more for beef, suggesting demand erosion from high prices is not outpacing reduced supplies. Also, low inventory numbers have spurred moderate demand feeder cattle feedlots despite a high cost of gain environment. On the down side, the cost of gain is near record levels due to relatively high corn prices and the drought over Kansas and Nebraska has dramatically reduced available wheat pasture for grazing. This has curtailed light-weight calf prices, and raises concern about next year's feed costs if the drought continues through spring.

On top of all of this, nobody is sure how the economy will react to the fiscal cliff we will plunge over in January, and we've learned from 2008-2010 that beef is not a recession-proof food. In 2009 live cattle prices and the feeder cattle index declined as much as 17% from the same months two years earlier, while boxed beef prices saw same month declines exceed 19% from 2007 to 2009. These price declines were consumer driven, as retail beef prices declined by over 10% from 2007 to 2009. Obviously, hedging at current price levels is the safe play for producers worried about the fiscal cliff triggering a major recession.

Feeder cattle futures offer a good hedging tool for producers who want to hedge 2013 calf prices early, before forward contracts for fall delivery are available. Feeder cattle hedgers should remember that there is still substantial upside potential to this market at these price levels, though. While soybeans might compete aggressively for corn acres, planted corn acres may easily equal last year's plantings. If the drought abates in the Midwest and a record corn crop pours in, prices for calves weighing over 650 pounds could skyrocket this fall. In the near term, the same scenario is possible for light-weight, grass-ready calves if rain starts falling in the plains and ranchers begin restocking their pastures with light grass calves. Either of these situations could lead to explosive moves higher in feeder cattle futures and expose a short hedger to sizeable margin calls.

Producers who hedge their 2013 calf crop in this price environment need to follow two simple rules. First, don't rush it; never hedge the entire calf crop all at once. Prices may be volatile over the next several months, and entering the market over a period of several weeks or even several months will increase the chances of hedging at close to the average price for the winter. For example, a producer who wants to sell four loads of calves in November should consider selling one August Feeder Cattle contract per month over the next four months, exiting the positions once a forward contract (i.e., video auction, etc.) is negotiated in July or August. Second, limit potential margin calls by using options. In an environment where a little moisture could catapult feeder cattle futures to record heights, buying puts outright or selling the board and buying an out-of-the-money call limits hedgers' exposure to upside movement and margin calls.

With good moisture in the plains and the Midwest, 2013 calf prices could set records. If the drought continues and/or the fiscal cliff precipitates a major recession, though, prices could fall precipitously. With this potential price risk in mind, hedging at least a portion of the 2013 calf crop is prudent, but hedgers should be careful, following these simple rules: Don't rush it, and protect any position against large margin calls by using options.

Custom Ag Solutions has worked closely with the USDA's Risk Management Agency (RMA) to 1) educate agricultural producers about risk management and crop insurance; and, 2) research and develop new risk management programs and tools that increase the financial stability of U.S. agricultural producers. Brett Crosby and his family ranch in Wyoming.

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