Do cattle on feed reports really affect the market?

Current option premiums are very low for both live and feeder cattle markets

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Investors, traders, and hedgers always seem to pay a lot of attention to government reports and releases.

Whether it's Canadian or U.S. interest rate releases, monthly unemployment reports, or grain supply-and-demand reports, how people react to these reports has always been of interest to me.

We previously looked at the monthly USDA crop and World Agricultural Supply and Demand Estimates (WASDE) reports and found reaction to these reports doesn't usually show anything too interesting based on historical patterns. (The typical weekly price fluctuation, both up and down, for corn, wheat and soybeans combined for any given week is around two per cent. The average absolute price movement, either up or down, in the week following the release of USDA reports is essentially the same. Some USDA reports can move markets, but usually during the crucial summer growing months.)

So what about any lasting price reactions to the cattle on feed (COF) reports?

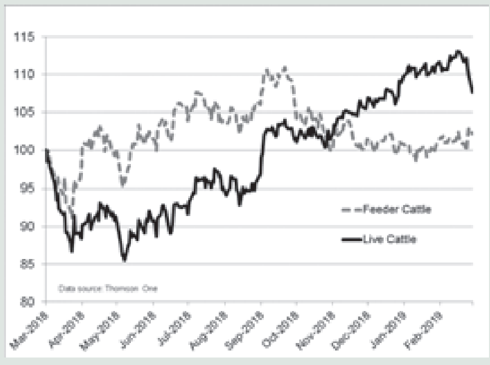
First, what are they? According to the USDA, cattle on feed are animals being fed a ration of grain, silage, hay and/or protein supplement for slaughter that are expected to produce a carcass that will grade select or better. It excludes cattle being "backgrounded only" for later sale as feeders or later placement in another feedlot.

Another section of the report is "placements," which are cattle put into a feedlot, fed a ration which will produce a carcass that will grade select or better, and are intended for slaughter.

Finally, there is also the marketings component which details cattle shipped out of feedlots to a slaughter market.

The survey is conducted in the 16 largest cattle-feeding states. About 2,000 known cattle feeders with a capacity of 1,000 or more head are enumerated. Feedlots with 1,000 or more head capacity represent about 85 per cent of all fed cattle in the U.S. The 16 largest states represent 98 per cent of U.S. cattle on feed in lots of 1,000 head or more.

CASH CATTLE INDEX PRICES



Combined, all this report information will affect the cattle market but just to what extent?

Looking back at 10 years of data, feeder and live cattle futures prices move up or down about two per cent in any given week. In the week following the release of the COF report, the absolute weekly price change is about two per cent as well. So there is no difference between after a report week and any other week.

Perhaps the market is just effective at pricing in the information from those reports ahead of time, since they really just tell you what has already happened. Unless there is a big surprise, which often isn't the case, the reports on average don't move cattle futures more than any other week.

Other clues for prices

That said, where else should you look for insight on what could potentially affect cattle futures? There are a few places.

First, the recent price patterns and trends are noticeably different between the two cattle markets. Spot live cattle prices are up almost 25 per cent since the March lows. Meanwhile, cash feeder cattle prices have been choppy and more or less sideways in the past year within a very tight range over the past four months (see chart).

Next, we can check the term structure of forward prices, defined as prices in the future or across time (see chart). For instance, the April 2019 live cattle futures prices is US$129 while next year's April 2020 contract is $120. Live cattle futures prices are inverted since the nearby price is $9/cwt higher than deferred prices. Maybe that suggests it's not worthwhile hanging on to the animals for much longer than you need to.

For feeders, forward prices are slightly upward sloping with March 2019 prices near $142/cwt while the January 2020 level is around $150. The feeder forward curve represents more or less a typical market showing a slight carry but nothing too compelling to either way.

Cheap options

How about volatility? For feeder cattle in particular, the implied option volatility is very low. In fact, option premiums are the cheapest in over two years. Live cattle option prices are near two-year lows as well. In both cases, it is very cheap to buy price insurance against a big move in cattle futures prices. You could interpret this as meaning that there is relative calm and a higher level of perceived certainty in cattle prices going forward. Maybe this is a good time to look at option-based hedging strategies.

Bottom line, times of quiet price activity and low volatility don't last forever. They are often followed by a period of above-normal price movement and increased volatility. This is especially the case with feeder cattle futures where the price pattern has been very much sideways, volatility has been low and option insurance is very cheap.

I've always found it best to look at market activity, chart patterns and trends instead of government reports for insights into what prices may do going forward. Regardless of where prices ultimately go, perhaps this is a good time to consider option-based hedging strategies to help round out your cattle-marketing strategies.

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CATTLE TERM STRUCTURE OF FUTURES PRICES (US$/CWT)