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Price Protection Can Help Cattle Producers in Volatile Markets

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Many risks are ever present for agricultural producers. To attempt a listing of all the risks would likely be somewhat surprising and quite lengthy. The risks that come to mind quickly are weather risk and price risk. The United States Department of Agriculture's Risk Management Agency (RMA) has created ways to help many producers — both grain and livestock — manage both of these risks.

BEFORE THE CORONAVIRUS

Managing weather risk has been an ongoing concern of producers. However, the interest in managing price risk has been more sporadic. Producers, being generally optimistic, are reluctant to lock in a certain price that eliminates the opportunity of a higher price if by chance the market offers it later in the production cycle. The pandemic has reminded producers of and heightened the interest in price risk management.

If you are a cattle producer, think back to the outlook for cattle prices in late January 2020. On Jan. 1, the U.S. cattle inventory report estimated beef cow numbers to be down from the previous year by 1.2%, the first decline since 2014.

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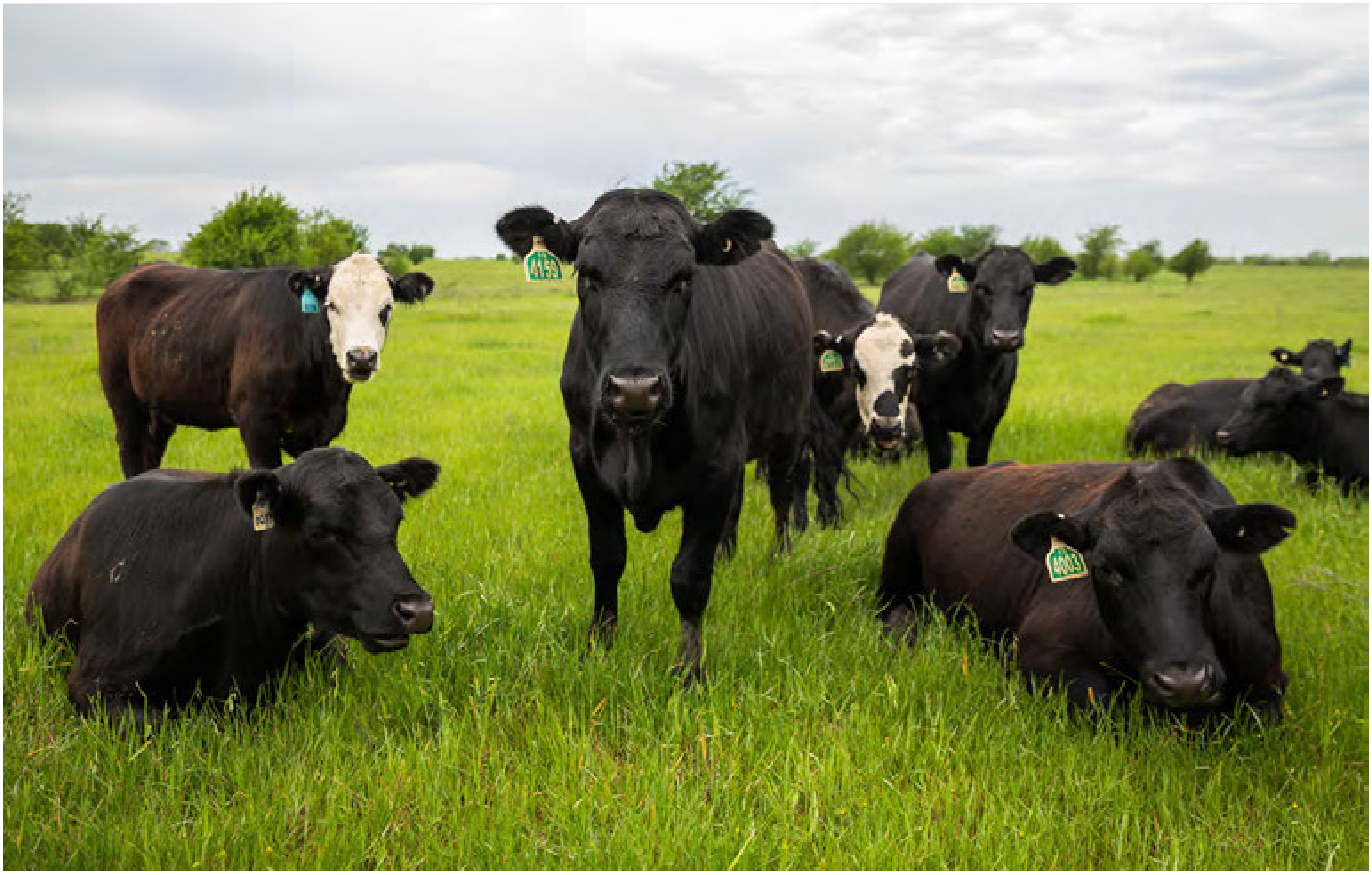

The calf crop was estimated to be down 0.9%. In a market where supply and demand determine prices, the fundamentals were in place to support stronger prices. Projections in the fall for purchased stocker calves or retained home-raised calves indicated a profit when sold at heavier weights in the spring. Few producers who owned yearling cattle thought much about price protection at the time.

SUPPLY AND DEMAND DISRUPTED

Then the pandemic caused huge disruptions to both the supply and demand for many food items, including beef. Consumers changed their buying behavior due in part to many working from home and eating more meals at home. The food service (primarily restaurants) demand dried up almost overnight and panic buying ensued at the retail level. Some cattle processors darkened plants due to surging cases of COVID-19, while others had to reduce capacity because workers felt unsafe at work and stayed home. Food service products could not easily be retrofitted for the retail market. With reduced processing capacity and a product shortage, a much stronger beef demand was created at the retail level and boxed beef prices skyrocketed. At the same time, feedyards with ample cattle ready for harvest were unable to move those cattle to processing facilities since the processing capacity had been reduced. So live cattle prices adjusted by approximately 25%, and the price softness was felt down the production chain to yearling cattle and calves. No one in January would have ever thought the cattle market would experience this kind of decline.

PRICE PROTECTION HAS POTENTIAL

The chain of events that created the lower prices caused cattle producers to think back and wish they would have done some kind of price protection. Nothing can be done for what has already happened, but producers can learn from the experience and consider ways price protection can be used in the future. Fortunately, there are several choices a cattle producer has to help with price protection. Some of these products have been around for a long time, while others have been available for only about 20 years.

HEDGING

Hedging on the futures market by selling a futures contract is very popular. This strategy locks in a certain price with no opportunity for any upside potential. Typically, the only reason a producer would experience a different price would be that the actual basis was different than projected.

The reason many producers do not like hedging is margin calls. Large margin calls can shake the emotions of the calmest producer. Purchasing options on futures contracts is attractive because of the potential for a higher price. A “put” option provides a minimum floor price and leaves the upside open. No margin calls are required.

The reluctance by some producers to use options is premium cost. If a “strike” price close to the underlying futures contract is chosen, premium cost could be considered pricy, especially in volatile markets. Many strategies exist as to ways producers can pick and choose combinations of put and call options to achieve a higher floor.

LIVESTOCK RISK PROTECTION

Around the turn of this century, RMA created a product they named Livestock Risk Protection (LRP). RMA provided a 13% subsidy on the premium, hoping it would entice producers to use it. The product is sold and serviced by private insurance agents. The use of the product has been disappointing. Effective July 1, 2020, the subsidy has been increased to 20-35% depending on the level of coverage chosen. One of the more attractive features of LRP is that any size group of cattle less than 3,000 head can be protected.

OPTIONS ARE AVAILABLE

If the recent fluctuations in the cattle markets have made you interested in price protection, please become informed of the products available. We at Noble are available to discuss these products with you.