Make Informed Decisions

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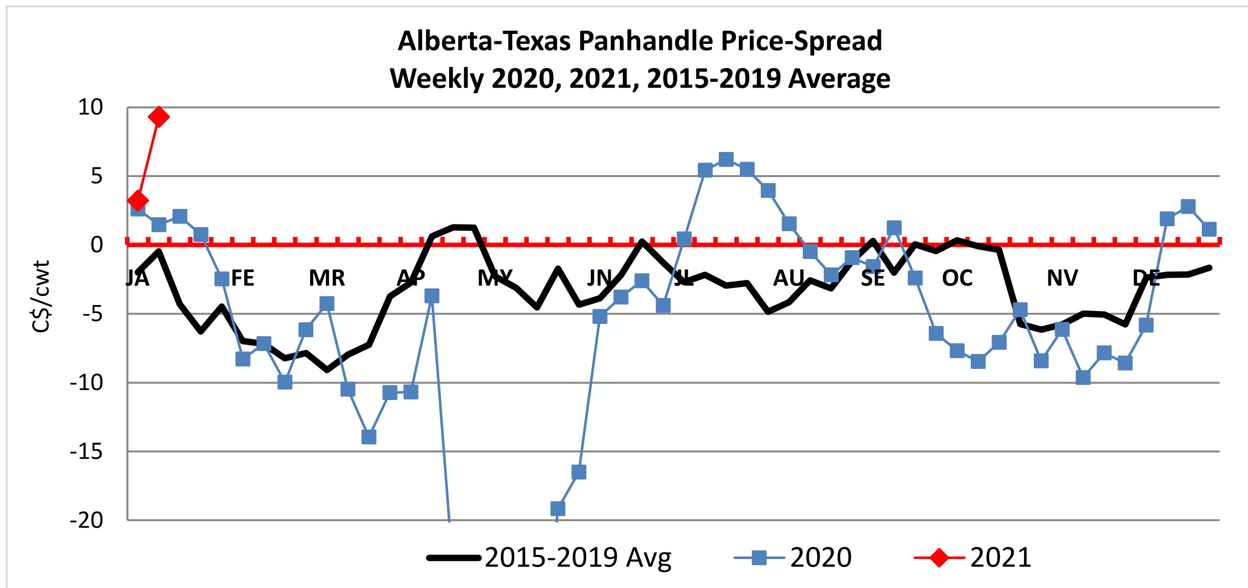
# The Spread Risk

During the last weeks of 2020 and the first of 2021, the Alberta-Texas fed cattle price spread went positive. That is, Alberta prices were stronger than prices in the United States. That was fascinating given the abundance of cattle and the fact that the industry was moving into and out of short kill weeks. This is especially puzzling given the large quantity of cattle on the set-aside program that are to be marketed in January.

The local spread or basis is supposed to reflect local supply and demand. The operative words are "supposed to." Over the last 20 years it has been almost impossible for me to see any statistical relationships between supply-demand and the spread.

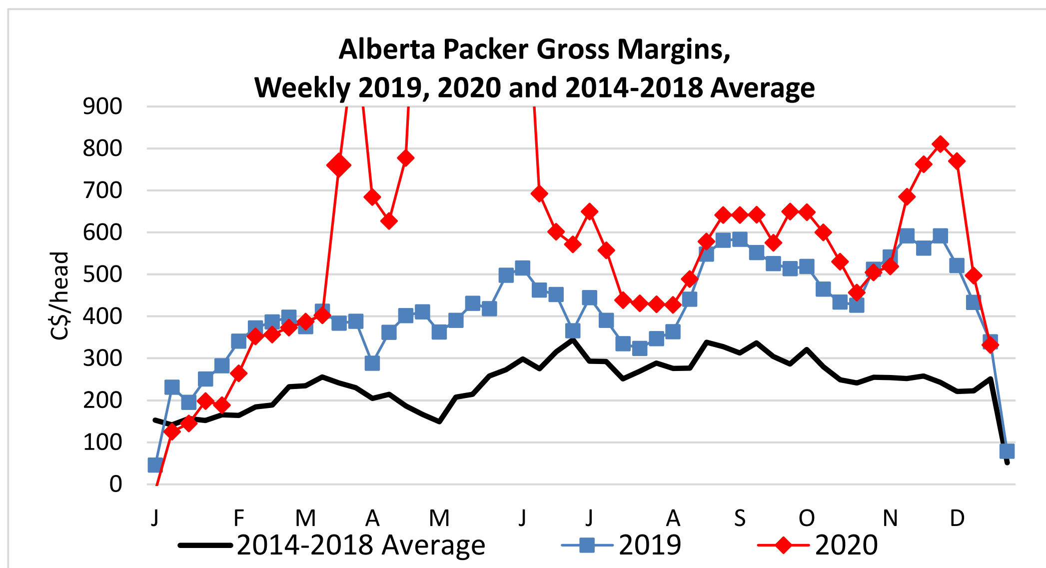



The spread had been staggering around C$-5/cwt and C$-10/cwt since late September. The week ending December 5 the spread was about C$-6/cwt. As of the end of the year it went to C$+2 and+3/cwt. At the end of the year, cash marketings on yearlings would have brought back feeding losses of $180-190/head. If the spread would have been at the levels they were in November, the losses would have been $300/head. Clearly the spread is a critical factor.

## Direct from Margins

The reduction in losses came directly from packer margins. The week ending December 5, Alberta packer gross margins before operating costs were likely around $750-800/head. That is extraordinarily good, obviously. That gross margin calculation is based on the U.S. cutout adjusted slightly lower for the Canadian market plus by-products, less the prior week's cattle costs. Extraordinarily good margins is a term that has been said almost constantly over the past two or more years.

Those great margins for the week ending December 5 would have been due to skyrocketing beef values and a weak cattle market. When the Alberta spread went positive near the end of 2020, it coincided with a decline in the beef market. Gross margins went from near $800 per head to just over $320. It is important to note that even though they were down, they were still well above the 2014-2018 average.




## Why?

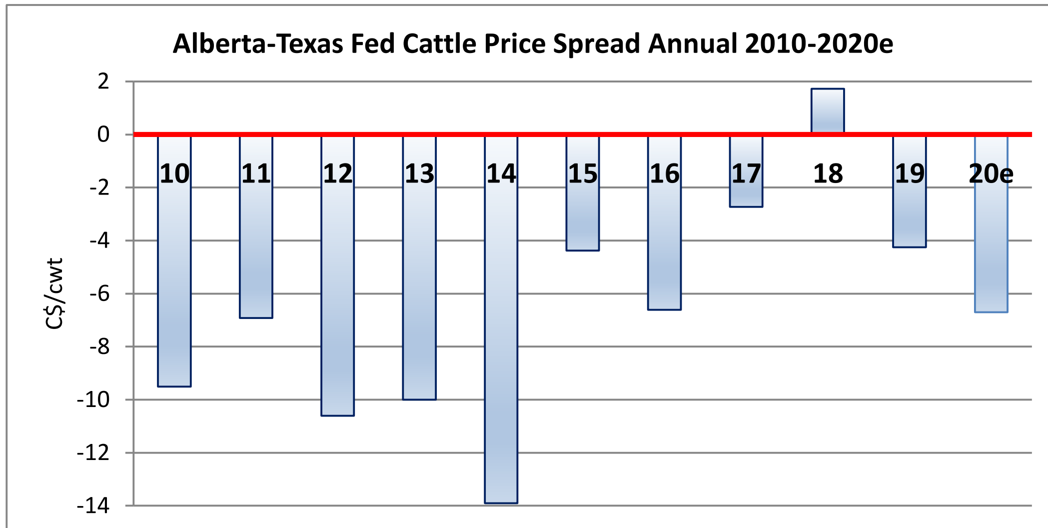
The point, however, is that if the spread had stayed at $-6, the packer gross margin would have been $450. Instead, the gross margin was as noted, just over $320. The difference of about $130/head in lower packer margins is roughly the same as the gain in feeder margins, give or take. That switch was due to the spread change.

The question then becomes why the spread improved so much, given what appears to be tough supply problems for cattle feeders. That is a huge amount of margin to give back given the supply situation. One reason why it happened might be supply-demand related. Cargill has been very busy with Saturday kills. JBS might have figured they were tight and made sure that they paid up for cattle they needed. Another reason might be that Cargill or perhaps JBS were trying to make sure that cattle stayed off the set-aside program. I also expect that Cargill has been getting an earful from its large volume formula sellers that do not sell cash cattle. They would be exceptionally upset when they think their marketings have not been priced off a competitive market.

The movement on the spread is much different than the movement of the basis in the U.S. The spread movement in Alberta reflects an added layer of risk for cattle feeders. Alberta shares in the risk of basis and how U.S. cattle feeders react to it. The spread, however, shows how much better or worse Alberta is than the entire U.S. industry. It can often go in the opposite direction as the U.S. basis.

In any event, the Alberta-Texas spread averaged C$-6.72 over the ten years from 2010-2019. The outlier years over that time was 2014 and 2018. In 2014, the Texas price was unusually strong as the U.S. industry adjusted to the drought induced culling. Alberta was not going to

keep pace. In 2018 packers started the year very short and bid up the local price to double digit positive spreads. They rarely seemed to be able to get ahead of the game that year. Spreads were also unusually tight in 2015, 2017 or 2019.




## Prudence Suggests

In 2020, the spread ended up at C$-6.43/cwt, which is almost exactly equal to the prior ten-year average. As noted continually in Canadian Cattle Market Report, the reasons for a negative fed spread in the west are the same now as they were 20 years ago. Those reasons are the following:

1. Alberta produces more fed cattle than it slaughters.

2. The U.S. floor price is determined by the cost of freight and logistics to the alternative U.S. market.

3. Canada is a surplus beef producer.

4. Canadian beef is still a lower priced option than U.S. product.

5. Alberta packer operating costs are higher than in the U.S.

Prudence suggests when contract planning, that the average basis or spread is the best guide. If basis contracts or other contracts can match the performance of 2015, 2017 or 2019, let alone 2018, that is a bonus.

Kevin Grier,

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