U.S. Commodities Markets

U.S. Cattle: Moving Toward Tighter Supplies

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- The protracted drought in the southwestern and western states should create a structural supply deficit of cattle and beef that can last well into 2024.
- In the first half 2022 (H1-22) beef demand has been supported by the domestic re-opening trade and strong exports.
- Looking at the second half of 2022 (H2-22) we believe that fed cattle supplies will be accommodating through Q3 and contract during Q4. The continued culling of upstream breeding stock, heifers and beef cows, will limit midstream feeder and live cattle supplies.
- The Fed's commitment to combatting record inflation through active and "restrictive" monetary policy will present headwinds for domestic beef demand and for the U.S. cattle supply chain.
- Pasture availability, domestic beef demand, health of the U.S. consumer along with the relative strength of the U.S. dollar are the critical questions that will impact margins throughout the cattle supply chain in H2-22 and H1-23.

Drought remains intact in key cattle producing states

Drought remains intact in key cattle producing states. For most of H1-22 the lingering drought in the southwest cattle producing states (Texas, New Mexico, western Oklahoma, western Kansas, and Nebraska) has accelerated the placement pace of cattle into feedlots. October – March cattle placements totaled 12.0 million head (mh) +3.5% YoY and was the second largest volume in 10 years. Texas, Kansas, and Nebraska placements

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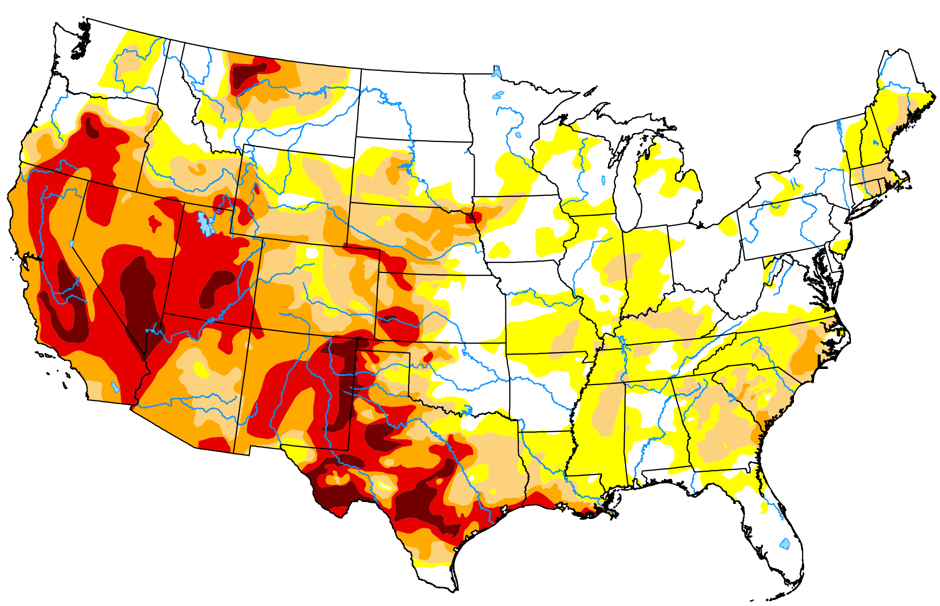
June 28, 2022 U.S. Drought Monitor



Source: The National Drought Mitigation Center at the University of Nebraska-Lincoln, USDA, and NOAA.

Please see disclosure starting on page 5.

totaled 5.2 mh, +5.3% YoY. The placement structure continued to favor yearlings in the northern feedlots and calves in the southern feedlots which resulted +9% YoY rise in marketable cattle during May – September. The record or near record monthly placements of cattle has created a bifurcated supply structure defined by accommodating supplies into the summer and early fall with declining animal numbers in Q4 and beyond.

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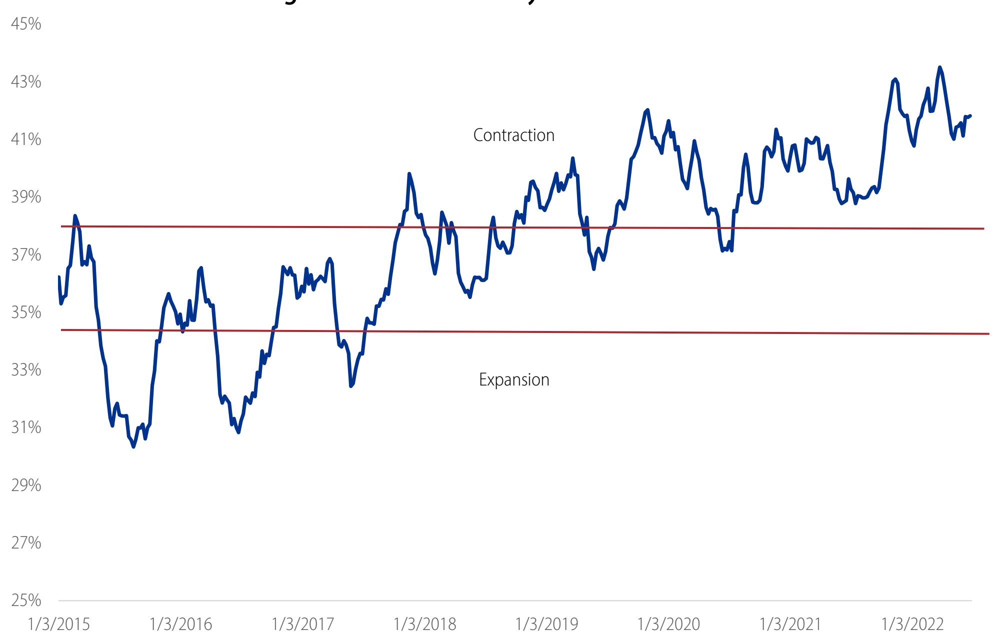
The cattle breeding stock is contracting at a record pace

Through June, heifers have been moving into feedlots at an unprecedent pace. While the absolute YTD volume of 2.9 mh is -3.9% YoY, weekly data illustrates that heifers bought by feedlots represented 45% of the total volume. This is the largest composition of female animals being sold to feedlots since 2008.

YTD beef cow slaughter is +14.3% YoY is the strongest pace in 5 years and is another fundamental signal that illustrates the relative speed and depth of the culling. Breeding herd slaughter (beef cow + heifers) as a percentage of total slaughter shows the most aggressive culling pace since 2012.

Beef Cow + Heifer Slaughter As % of Weekly Total



Source: USDA, HilltopSecurities

The domestic reopening trade is supporting beef demand

During H1-22 the domestic reopening trade and strong export demand has supported beef demand and the choice cutout value. During January the choice cutout made both a seasonal and YTD high of $293.50/cwt with all primals trading at or close to record levels. Seating data from OpenTable, along with QSR and fast casual dining traffic data combined with low U6 unemployment and rising wages illustrates strong causality that the H1-22 domestic reopening trade supported domestic beef demand and the choice cutout value. This scenario helped support estimated gross packing margins which was positive for live cattle demand and prices.

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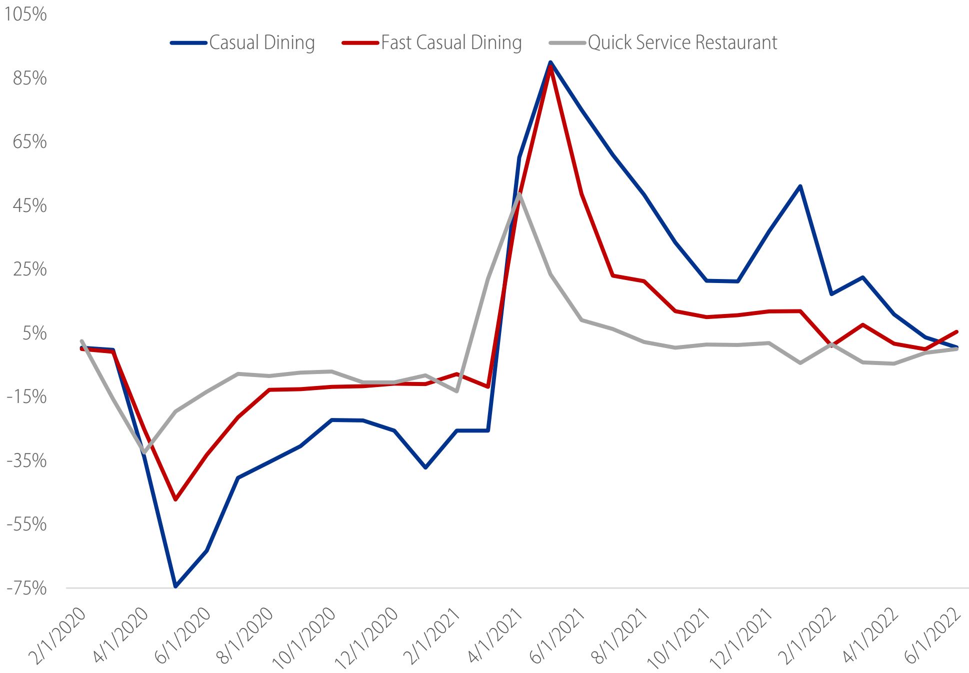
Monthly Traffic Change By Restaurant Type



Source: Bloomberg, HilltopSecurities

U.S. beef exports have been supportive

While it is difficult to replicate 2021's record beef export program, YTD U.S. export sales are the second largest in 10 years. Export volumes to Asia and China overperformed despite the global supply chain and logistical challenges. We see the U.S. beef's favorable trade status with key Asian importers along with enhanced reopening, restocking, demand as two key fundamental catalysts that supported

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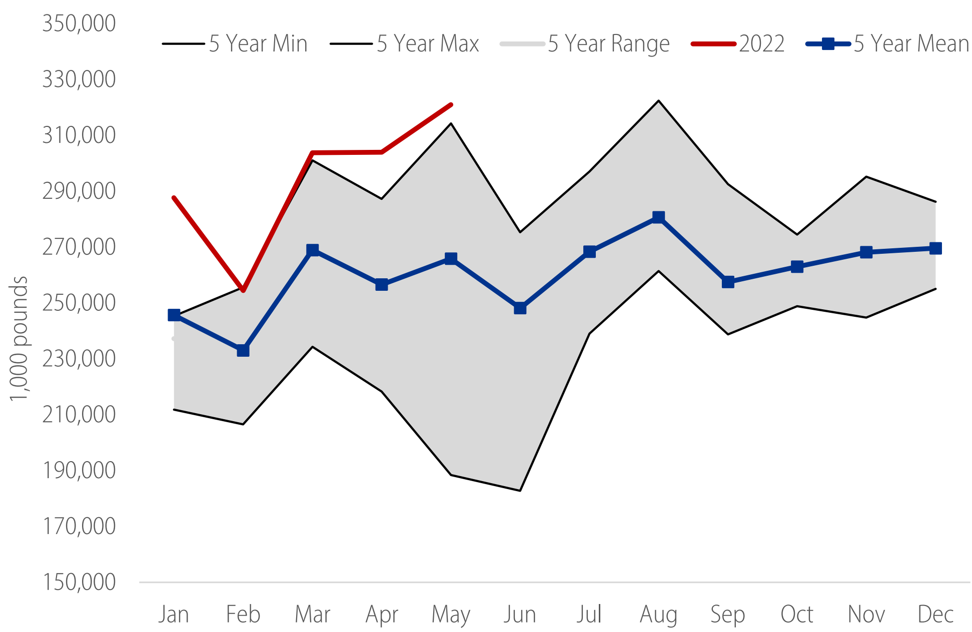
5-Year Historical Monthly U.S. Monthly Beef Exports



Source: USDA, HilltopSecurities

H1-22 beef exports. However, strength of the U.S. dollar along with the record large estimated Brazilian and strong Australian beef export programs can present headwinds for U.S. exports in H2-22.

Ahead of the USDA's biennial Cattle Inventory report we expect to see a YoY decline in the heifers for beef cow replacement, heifers expected to calf along with a smaller calf crop.

Lower cattle and beef supplies are imminent in Q4 '22 and beyond

The reported -1% YoY Jan. 1, 2022 calf crop should translate to lower fed cattle supplies during Q4 '22 and Q1'23. Despite the drought conditions throughout the southwest and western plains, higher frequency data illustrate that feeder cattle placements have started slowing. Whether the slowing placement pace is a function of reduced upstream supplies or cattle moving to pasture, we see a material probability of slowing YoY monthly placements during H2-22. Ahead of the USDA's biennial Cattle Inventory report we expect to see a YoY decline in the heifers for beef cow replacement, heifers expected to calf along with a smaller calf crop.

H1-22 feeder cattle futures prices outperformed live cattle

Anticipating contracting upstream cow/calf supplies, CME prompt feeder cattle futures were +7.6% during H-1 22. Despite the strong downstream consumer and export demand, H1-22 CME prompt live cattle futures were -1.9% YTD. We believe that live cattle price performance is attributed to accommodating supplies of fed cattle along with COVID-related pressures that delayed the Q1-22 domestic reopening which pressured packer margins and slowed the demand for cattle.

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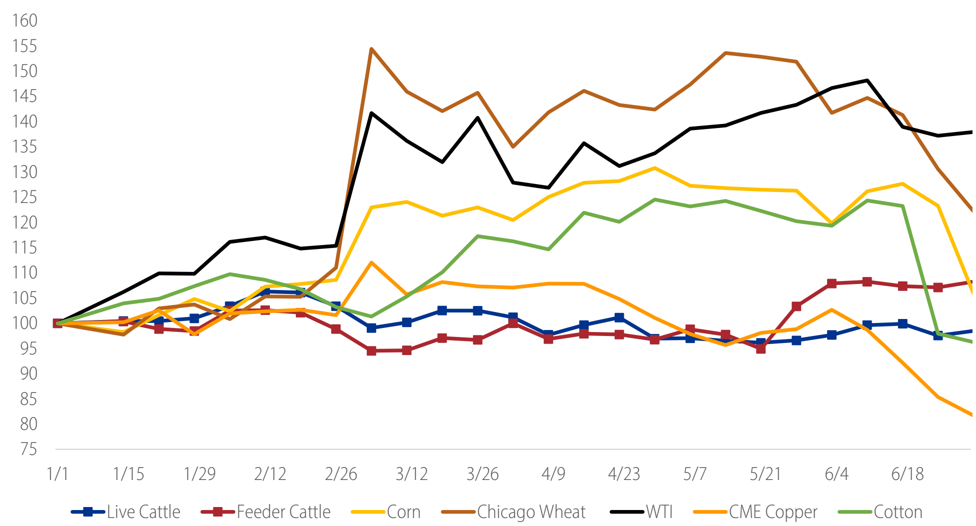
Year-To-Date Futures Performance



Source: Bloomberg, HilltopSecurities

Fed's commitment to lowering inflation should create headwinds

With the Fed aggressively using "restrictive" monetary policy to tame domestic inflationary pressures, the risks of both a statistical and real economic recession and a hard landing are amplified. In particular, the Fed is keen on slowing wage growth and incrementally increasing the unemployment rate to help mitigate domestic inflation. Each of these macro variables are structurally negative inputs for domestic beef demand and for the cattle supply chain. Implications of the Fed's policy measures can negatively impact QSR and fast casual dining traffic, choice box beef values along with upstream packing margins and cattle prices.

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Summary

During the first half of 2022 beef demand has been enjoyed structural tailwinds from strong exports and the broad domestic reopening trade. Fed cattle supplies have been accommodating as the intractable drought has hastened the pace of feedlot purchases.

Heading in H2-22 decreasing live cattle supplies in Q4 and H1-23 can support prices. We also see the domestic macroeconomy incrementally creating structural headwinds for downstream consumer level beef demand. While declining animal supplies can support higher prices, softening beef demand can suppress the choice cutout and pressure packing margins and offset live cattle's price trajectory.

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