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3-10-1993

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Recommended Citation
Murra, Gene and Murra, Gene, "The Impact of "Arkansas Best" on Forward Pricing; Cattle Outlook" (1993). *Economics Commentator.* Paper 287.
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ECONOMICS COMMENTATOR

SOUTH DAKOTA STATE UNIVERSITY
No. 318 March 10, 1993

THE IMPACT OF "ARKANSAS BEST" ON FORWARD PRICING

by
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Most farmers have not heard about the "Arkansas Best" case. Yet, the case probably will have major impacts on how producers who use futures and options report the "gains or losses" from those activities on their income tax forms.

Prior to the Arkansas Best decision (a case not even related to agriculture), gains or losses from "true hedges" were reported as ordinary gains or expenses, not as capital gains or losses. That meant that losses or expenses (such as margin calls on a "sell futures" account or premiums on a buy a put" option account) were not subject to the $3000 capital-loss limitation. Losses merely were subtracted from revenue received from the sale of the commodity which was hedged.

The current IRS ruling is that only hedging activities which function as a substitute for inventory (such as buying calls as a substitute for stored grain) now fit under the old "deduct losses as a business expense for hedgers" category. Prior to the latest ruling, those activities were viewed as "capital in nature" and were taxed under capital gains or losses provisions. The previously acceptable "hedges" (see futures or buy puts) now are viewed in the "capital" area. The IRS did an about face.

The above situation is further complicated by the fact that the Farmer's Tax Guide for 1992 is inconsistent with the current ruling. Evidently, the example on page 25 of the Farmer's Tax Guide was prepared prior to the most recent ruling. That means that many tax forms already filed may be in error and subject to audit (yes, the decision appears to be retroactive).

(Continued on p.2)

CATTLE OUTLOOK

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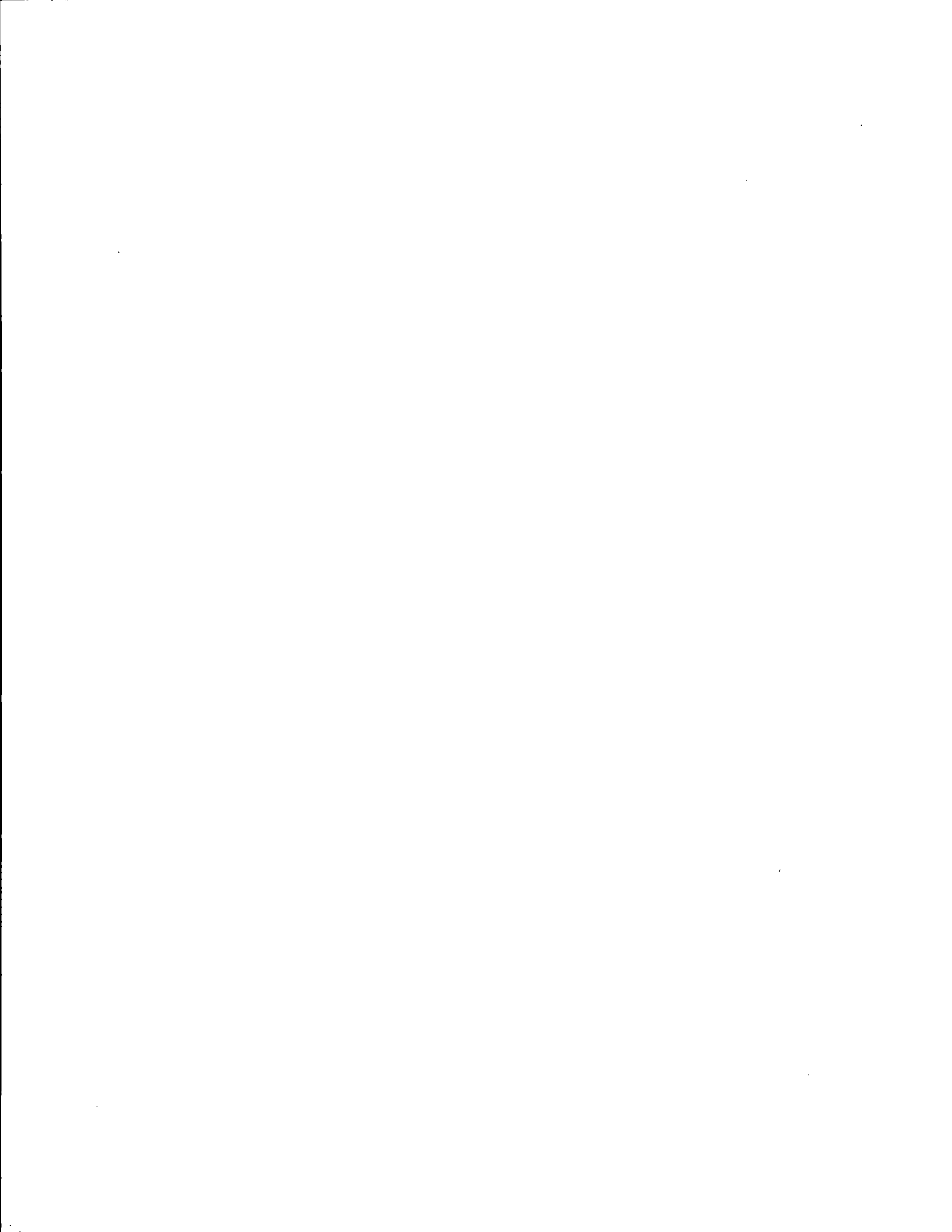
The Cattle on Feed reports issued for January 1st and February 1st were viewed by the trade as bearish. Yet, in both cases, prices on the futures board moved as if the reports were bullish. Not only did futures prices move higher (to an all-time high of $83.75 for February), but the cash market has stayed close to and usually above $80. What happened? And, will the bullishness continue?

First, trade expectations tend to be conservative in nature. "Experts," when called upon to make predictions, don't often give responses greatly different from other "experts". As a result, responses tend to be bunched in a fairly narrow range, thereby increasing the possibility that the actual report will be outside of the "range of expectations" -- or more apt to be bullish or bearish.

Second, for the early-1993 reports, the reports always were "in the same direction" as the expectations. There were no big surprises in direction, only magnitude.

Third, weather played (and continues to play) a much more important role in late 1992 and early 1993 than in recent years. Snowstorms in the major cattle feeding states have caused greater-than-normal death losses (probably not a big impacter on price) and have delayed the marketings of cattle which did not gain weight as fast as usual (probably the big impacter on price). As a result, $3 to $5 has been added to cash fed cattle prices and this has carried over into the futures market (at least the nearby contracts). The snowstorms had a bigger bullish impact (and continue to do so) than the bearish impacts of the cattle on feed reports.

(Continued on p.2)



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(Arkansas Best ... Continued from p.1)

What can producers who have used futures and options do? First, check with your tax preparer. Most tax preparers probably are not aware of the above changes since the decision has not been widely published. But, that doesn't mean they shouldn't be alerted! Second, don't try to work both sides of the fence. Don't try to claim all futures expenses (margin calls and/or premiums) as business deductions regardless of how they were used. Be consistent. Either do as you did before or change totally to the new system. Don't use the most favorable aspects of each and discard the unfavorable aspects. Finally, watch for changes. The IRS could do another about face and go back to the old method. Would that surprise anyone?

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(Cattle Outlook - continued from p.1)

So, what does that mean about prices for the rest of 1993? The meat industry (including beef, pork, poultry and lamb) will be forced to move record supplies through the market. Even if demand holds strong, some price pressure likely will be noted. While that pressure isn't there yet, it will be there later in the year.

For fed cattle, the price peak probably has already occurred. That doesn't mean prices will drop immediately. However, if the cattle really are on feed and if feedlots ever dry up enough so that gains return to normal, slaughter supplies should increase. That increase should be enough to push prices lower by mid-Spring (maybe the mid-$70's in May) and even lower for the Summer and Fall (generally below $75).

Lower fed cattle prices usually mean lower feeder cattle prices. While that is expected for later in 1993, large grain (corn) supplies at low prices should help support feeder cattle prices. While feeder cattle prices should move lower, the downside risk probably isn't as great as it is for fed cattle, meaning prices for 700-800 pounders closer to $80-85 than to $85-90. Watch the 1993 corn crop. Another big crop will support feeder cattle prices -- a drought will hurt them.

Feeder cattle prices for calves suitable for grass could even hold at current high price levels. Plenty of forage in most of "cattle" country should be a major supporter of prices.

In total, fed cattle prices seem to have the most downside risk, but feeder cattle prices also could move lower. The old advice of keep current and watch the markets certainly applies today.

ECONOMICS
COMMENTATOR

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