

Decisive Marketing

by Melvin Brees

December 19, 2008

2008 Marketing Lessons

As 2008 draws to a close, it has been an unusual year for grain markets. Grain prices rose to record highs, completely shattering old price records. This offered very profitable returns to producers who took advantage of these prices. Then prices collapsed causing many other producers to miss out on the high prices. Regardless of how well or how poorly a producer may have done in 2008, the year provided some new marketing risk management lessons as well.

It is a big world out there. Dealing with today's markets requires much more than watching production prospects or domestic crop supply and demand balances. Worldwide financial conditions, world supply and demand for competing grains, currency values, politics and many other factors influence grain prices. Wheat production in Eastern Europe and Australia, along with improved incomes in developing countries, affects the corn market. European use of diesel fuel and improved diets in China impacts soybean prices. The value of the dollar has an effect on exports of all grains. Export taxes on Argentine soybeans or wheat export curbs in other countries can add to United States export demand. World population growth, demand for non-agriculture commodities and many other factors in the world economy directly affect grain prices in the US.

Domestic factors, outside of agriculture, also play a growing role in what happens to grain prices. Changing energy prices have led to rapid growth in biofuel production, especially for corn-based ethanol. This has required increased corn acreage, added to corn prices and is changing basis patterns for the cash corn market. Large commodity trading funds, using technical trading techniques (price action, charts, etc.) are blamed by some for distorting price movements. The current economic/credit crisis or recession adds to market risk as commodity prices respond to negative news in the stock market. These and other factors contribute to unexpected grain market moves that often appear unrelated to grain market fundamentals.

Weather, production, carryover supplies and expected demand remain important to grain price discovery. But many factors outside of agriculture play a growing role in daily price fluctuations and grain price levels, making prices difficult to predict. These factors, along with many others not mentioned here, have resulted in price volatility and huge price risks during the past year.

Price opportunities do not last! This is not a new revelation, but it seems like it has to be re-learned every time markets move to record, or near record, levels. Grain prices began long-term uptrends more than two years ago. Corn and soybean price rallies became steep

uptrends beginning in September 2007 and peaked at record highs by late June 2008. Then prices collapsed. The decline to prices below those offered in September 2007 only took about five months.

History has shown that grain prices at record levels do not last very long. This year, as in past bull markets, market strategies that captured prices during the rally and near the price highs were very successful. Those who waited too long missed out! These market patterns and producer's reactions to them have not changed. Strategies to capture prices during a rally should always be a part of a market plan.

There is risk in depending upon cash contracts. In spite of the fact that the futures markets are designed to allow management of price risk, the majority of farmers have preferred using cash contracts to make pre-harvest sales. Many producers typically are uncomfortable with the complexities of the futures markets, the use of brokerage accounts and providing cash to margin futures positions. Cash market contracts have been considered low-risk and relatively simple to use. However, in 2008 some serious problems with using cash contracts arose.

Grain elevators and other grain buyers who contract with producers for harvest delivery of grain use futures hedges to manage their price risk. When prices began the rallies toward the new record highs, these grain buyers were faced with staggering margin requirements to maintain their hedges. These unusually large margin requirements were exceeding the credit limits for many of them. Unable to finance additional margin requirements, they were forced to stop offering cash contracts. This prevented farmers from making pre-harvest cash sales at some of the best grain prices ever!

The other problem with cash prices surfaced as some grain buyers were forced into bankruptcy. Producers who delivered grain may have to wait in line with other creditors to get any payments for their grain. The other problems result from bankruptcy court rulings. Farmers who had contracted grain, but have not delivered it, are now faced with the obligation to deliver it at much lower prices. The buyer in bankruptcy can force the delivery of grain at whatever price the market is offering or refuse it. But until then, the producer cannot sell it to anyone else.

Using futures to hedge or options to protect prices avoided the problems with cash contracts and they provided effective methods of capturing very good prices in 2008.

Risk Management has become expensive. When cash buyers experience financial problems or cease offering cash contracts, more of the price risk management burden is shifted to farmers. However, the use of futures hedges or option strategies increases cash demands on producers to manage price risk.

A futures hedge is a relatively low net cost (brokerage fee and interest on margin) marketing strategy, but the cash flow requirements were very large in this past year's volatile markets. Cash flow needs included \$2000 or more per corn contract and \$4000 or more per soybean contract to comfortably have met initial margin requirements before triggering additional margin calls. Then cash flow needs soared to as much as \$3 to \$4 per bushel for the moves in corn prices and nearly \$8 per bushel for moves in soybean prices. Although this cash requirement eventually flowed back into the margin account, it could have resulted in cash flow and credit needs in hundreds of dollars per acre.

Buying put options lowered the cash flow exposure, but increased the net cost of marketing by the amount of option premium paid. This could easily have been \$0.60 to 0.70

per bushel for corn and \$1.00 or more for soybeans in premiums for at-the-money put options. Depending upon the percentage of the crop sold, this added up to several dollars per acre in marketing costs. Some may have used out-of-the-money put options or a combination strategy of buying and selling options in an effort to lower the net premium costs. If this was done, it was important for both the producer and lender to understand the strategy and any additional cash flow or margin risks that were associated with these strategies.

Marketing risks that became apparent in 2008 need to be considered in 2009 business planning. Volatile markets influenced by outside factors can result in fleeting opportunities to protect profits. While many have been concerned with the increased input costs expected in 2009, increasing amounts also need to be budgeted for risk management. Futures/option strategies offer opportunities whether cash contracts are or are not available. It is important that both the producer and lender understand these risk management strategies. It may even involve setting up a separate line of credit just for risk management. If nothing else, this past year's lessons suggest that risk management continues to grow more complicated with increasing cash needs.

www.fapri.missouri.edu