

In The Cattle Markets

Darrell R. Mark, Ph.D.

Asst. Professor, Department of Agricultural Economics, University of Nebraska–Lincoln

Are Ag Producers Out Of Grain Hedging Alternatives?

The events of the past few weeks in the grain markets are profoundly changing the way production agriculture does business. As a result, grain producers are nervous and livestock producers are frustrated, to say the least. Let's review some of the key events that have been unfolding for some time and have seemed to come to a head lately:

1. Speculative buying, particularly from index funds, in the grain market remains significant and growing. Some industry estimates are that the major index funds have about \$25 billion invested in the grain commodity markets alone. These index funds trade almost exclusively as long traders: they buy contracts in expectation of selling later for a higher price. Because of the sheer volume of index fund trading (estimated at 2-3 times the total crop production in some markets), this trading becomes self-fulfilling. The large amount of buying drives prices up and the contracts can then be sold back for a higher price. Recently, this has generated concern over convergence between the cash and futures markets. Convergence of the futures market to cash prices forces the futures market to be tied to the supply and demand for the underlying commodity and occurs because of the possibility of delivery. Convergence has continued to occur, but price volatility in the grain markets continues to increase.
2. Due to the frequency of the grain futures markets being bid limit higher or offered limit lower for several days at a time, which prevents traders from entering and exiting positions, the daily price limit on corn was increased to 30 cents/bushel (from 20 cents/bushel) and soybeans were increased from 50 cents to 70 cents/bushel. Further, these limits can be expanded to 150% in a trading session following a session when the price of two or more futures contracts traded to limit higher or lower. Earlier, the daily price limit for wheat was increased to 60 cents/bushel at all three exchanges. For all these commodities, the expanded limits have already been used.
3. The volatility in the grain futures market has also led to increases in margin requirements (the amount of money required to be posted as a performance bond in order to buy or sell a futures contract). On March 27, 2008, the CME Group instituted higher initial and maintenance margin requirements for both old and new crop speculators and hedgers for corn, soybeans, and soybean oil. For example, the initial maintenance margin for a corn hedger increased from \$1,000 to \$1,500.
4. These margin increases have significantly increased the transaction costs associated with hedging. For commercial hedgers, lines of credit that typically are used to cover margin calls have been or are rapidly being depleted as their short futures positions generate large margin calls as prices increase. Not only does this result in a significant

amount of money to finance due to larger margin requirements, but the cost of these funds likely is increasing as the hedgers' leverage increases. This affects both small producers seeking to hedge in the futures market, as well as large commercial grain trading companies. Several of the largest grain buyers and merchandisers, as well as numerous local farmer-owned cooperatives have ceased or limited cash forward contracting because offering these cash contracts to sellers requires them to offset their risk in the futures market. Because of the increased costs of futures hedging, grain basis is weaker than historical averages and grain buyers are not offering flat price contracts very far into the future. Some buyers currently do not offer cash forward contracts for delivery more than sixty days into the future, or past new crop delivery. Because grain producers, who also need to avoid the futures market for similar reasons, no longer have these cash contracting alternatives, they are left with significant risks that they cannot easily offset.

5. Last week, USDA released two key grain market reports that were both bullish to the corn market. The Planting Intentions reported the first survey-based estimate (as of March 1, 2008) of corn acreage for this year. If the 86 million acres reported in the intentions survey are planted, this would be 7.6 million acres less than last year, a drop of more than 8%. Assuming a national trendline yield of 155.5 bushels/acre (based on the past ten years), 86 million acres, after abandonment, will barely produce 13 billion bushels of corn, leaving ethanol buyers and livestock producers wondering where their source of corn will be. The Quarterly Grain Stocks report released last week seemed to confirm the recent increase corn demand: disappearance from December 2007 to February 2008 was 3.42 billion bushels, up 20% from the same quarter a year ago.
6. As a result of the bullish reports last week, the corn market surpassed historical highs and traded above \$6/bu. Earlier this spring, both wheat and soybeans posted all-time highs as well.

So where does this leave grain and livestock producers? In a nutshell, grain producers can't hedge with their traditional buyers and they need to given significantly higher input costs, and livestock producers can't hedge corn in the futures market and they need to given potential for higher corn prices. While the concept of grain producers selling directly to livestock producers isn't at all new or novel, it may be time to embrace the practice with more enthusiasm. Because both grain growers and livestock feeders have a business need to offset their risk and exchange the physical commodity, contracting with each other is a natural fit. The parties should carefully construct the forward contract and consider penalties for non-performance, as well as establish deposits or bonds to encourage performance. Of course, both parties should consult with an attorney for legal advice.

The Markets

The live fed cattle market traded last week on Wednesday, earlier than normal amid worries about lower price prospects. Dressed cattle prices in Nebraska were \$2-4/cwt lower last week, averaging \$138.26 for the week. Kansas live cattle prices averaged \$2.59 lower for the week as well. For the week, Choice boxed beef averaged \$138.08, down almost \$2/cwt from the previous week. The spread between Choice and Select widened slightly to \$1.13. Feeder cattle prices were generally steady last week in Kansas. In Nebraska, yearling steer prices were around \$1 lower and calf prices averaged \$5.43 lower. Cash corn prices surged last week following the Planting Intentions and Grain Stocks reports. Omaha, NE cash prices jumped nearly \$0.50/bu last week, and distillers grain price (basis Iowa) was \$5/ton higher.

	Week of 4/4/08	Week of 03/28/08	Week of 04/06/07
Kansas Fed Steer Price, live weight	\$85.15	\$87.74	\$100.04
Nebraska Fed Steer Price, dressed weight	\$138.26	\$141.17	\$159.79
700-800 lb. Feeder Steer Price, KS 3 market average	\$100.84	\$101.35	\$110.36
500-600 lb. Feeder Steer Price, KS 3 market average	\$125.79	\$122.47	\$134.88
700-800 lb. Feeder Steer Price, NE 7 market average	\$102.25	\$103.05	\$111.26
500-600 lb. Feeder Steer Price, NE 7 market average	\$118.93	\$124.36	\$127.74
Choice Boxed Beef Price, 600-900 lb. carcass	\$138.07	\$139.99	\$156.20
Choice-Select Spread, 600-900 lb. carcass	\$1.13	\$0.88	\$8.73
Corn Price, Omaha, NE, \$/bu (Thursday quote)	\$5.69	\$5.21	\$3.41
DDG Wholesale Price, Iowa, \$/ton	\$165.00	\$160.00	\$122.50