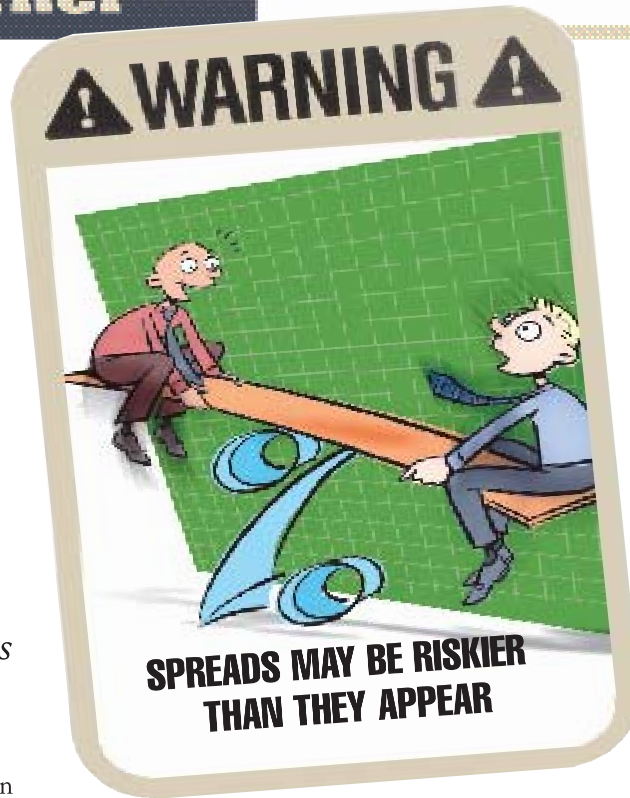
By Diana Klemme

Strategies for Spread Positions



Trying to outguess the markets or resist change when you make a bad decision can both be serious obstacles to successful grain merchandising.

"Strategies such as spread positions may be as risky as taking simple 'long' or 'short' futures positions." This or similar wording is found in futures account risk-disclosure forms but often shrugged off. That caution was especially appropriate in 2004 grain markets . . .

Businesses hedge to manage and reduce risk, substituting basis risk for futures price risk. And futures spreads are an important part of grain hedging programs; they provide an economic reward to hold or sell inventories. Highly volatile futures markets such as occurred in 2004 make hedging more difficult; basis often becomes more volatile and futures spreads may not behave as anticipated. Hedging has benefits aside from spreads and basis, however, allowing merchandisers to manage logistics for example. Volatility is not a reason to abandon hedging — it just calls for careful attention and flexibility.

Many grain traders — accustomed to surplus crops and carrying-charge markets in recent years — faced unfamiliar situations in 2003/04. Basis weakened despite known tightness in stocks. Soymeal basis plummeted in the spring even as southern traders were evaluating importing Brazilian soymeal for the summer. Carrying-charges appeared, then vanished. Inverses signaled merchandisers to liquidate ownership, then moved to carrying charges, forcing even seasoned merchants to continually reassess and modify plans. Managers who expected harvest soybean spreads to widen were forced to make tough decisions when the January 2004/March 2004 spread inverted by 25 cents in October 2003! Should they sell basis and liquidate all ownership before

Futures Spreads	Dec3/March4 Corn	July4/Dec4 Corn	Jan4/March4 Soybeans	May4/July4 Soybeans	July4/Aug4 Soybeans
7/15/03	8.75	6	2	1.75	
10/15/03	7.5	4.75	-25	-12	-26
11/28/03	4	-6.25	-2.25	-15	-28
12/10/03	-2.25	-4.5	.75	-14	-27
3/15/04		-11		-12.5	-46
4/15/04		-7.5		-1.75	-55.5
5/14/04		-7.25		-38	-60
6/15/04		-3.75			-76.5

positive = carrying charge; (-) = inverse

June 20 futures carries:		
	July 2004/March 2005 CBT wheat	29¢ carry
	Sept 2004/Dec 2004 corn	5¢ carry
	Dec 2004/March 2005 corn	6¢ carry
	March 2005/July 2005 corn	5.5¢ carry
	Nov 2004/Jan 2005 soybeans	2¢ carry
	Jan 2005/July 2005 soybeans	15¢ carry

January, or hold off, expecting basis to appreciate enough to offset the futures inverse as stocks tightened? By late November that futures inverse was gone and a small carry returned in December.

Elevator managers and merchants will face difficult decisions again for 2004 crop. Harvest futures spreads are a key part of most elevators' merchandising programs; they can make or break a crop year's P&L. Elevators typically buy and hedge a large volume of grain at harvest and look to spreads to pay their costs of carrying the ownership. Many managers will be conservative setting harvest corn spreads because so much rides on the decision.

Comparing the futures and cash carries of different commodities to find the best return for bin space is also a challenge. New-crop wheat, for example, currently offers a generous futures and cash return for storage, signaling managers who handle both wheat and corn that bins provide a better return filled with hedged wheat than fall (hedged) corn. The only way to be sure of the return, however, is to lock in the wheat futures carry now. Then if corn spreads widen this fall to show a better return than wheat, managers can sell and ship the wheat and free up the bin to hold hedged-corn.

But a lot of elevators only handle corn, sorghum, or soybeans. Prospects aren't great at present for sizable returns this fall for either corn or soybeans. It's early though and crops aren't assured; futures don't need big carries yet. When cash carries (including futures spreads) don't cover your holding costs, keeping short futures hedges in the more nearby month is the conservative approach. New-crop soybean spreads currently signal merchants to keep soybean hedges against fall purchases in November futures. Later, if the carry doesn't improve, the logical plan is to liquidate owned inventory. But things can change; the crop may be bigger than expected, or farmers may be eager sellers. Futures carries may improve for soybeans, and merchandisers can then adjust their plan, roll short hedges forward, and hold soybean ownership beyond November.

> ***"To manage spreads in volatile markets, remain flexible; adapt as market signals change."***
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> Diana Klemme, Grain Service Corp.

Rely on logic and hard analysis for 2004 crop spreads rather than assuming past trends will repeat. For example, the last three seasons the December/July corn spread reached approximately its widest carry by early in the months before harvest. In 2001 the spread widened some in November, but only 1 to 2 cents more than was available four months before harvest. But right now Dec4/July5 offers only 11 to 12 cents carry. That isn't enough to justify holding inventory, so most managers will ignore recent history and keep short hedges in December futures for now.

Some elevators can't move all their hedged grain at harvest due to shipping limitations, regardless of the futures carry. That raises the stakes, and some managers will decide that accepting a modest return is better than risking the futures carry disappearing. December 2004/March 2005 corn at 6 cents isn't great, but it covers an elevator's out-of-pocket interest costs for a few months.

When merchandising volatile spreads, think about basic trading principles.

■ **Full carry is the maximum return a futures carry can reach.** A rough calculation for CBOT spreads is 4½ cents per month plus interest. Use 1% over LIBOR for estimate purposes. December/March corn is a three-month spread; full carry would be about 15¢ this year using current prices and interest rates.

■ **There is no limit to how far a futures spread can invert (near month over deferred).** This is usually most dramatic between crop years, such as the current inverse of $2.12, July 2004 over

November 2004. That principle can be critical in deciding where to hold long futures against the sale of Delayed Price inventory (especially in soybeans).

■ **Balance time against expected return and risk.** Dec/March at 75% of full carry, or about 12¢, would be worth locking in four months before harvest. Dec/March at 6¢ (40% of full carry) may look good before harvest if you can't afford the consequences if that carry disappears. The less the potential to be gained by waiting, or the worse the consequences if things go wrong, the stronger your incentive to accept the "bird in the hand."

■ **Balance spread risk against the size of your position and against other risks.** If you are holding a very large basis position, you might opt to lock in a modest futures carry rather than waiting. Setting the spread reduces your overall risk in that case. On the other hand, holding a small basis position may give you confidence to be more aggressive in when to set a spread. Owning off-quality wheat also illustrates this principle. One prudent approach is to accept a decent futures carry on such wheat; that secures time to shop all markets, secure other wheat for blending, or perhaps even to hold the wheat over to the next crop year.

■ **The past doesn't determine the future.** Track records and historical patterns are interesting but may steer you wrong in volatile years where circumstances clearly differ from normal.

Expect basis, futures and spreads to remain volatile into 2005, perhaps into 2005/06. U.S. and global corn stocks are tight, world wheat supplies are tight but manageable, and the global soybean balance sheet depends on both the United States and South America successfully expanding production sharply for 2004 crop. Production problems could result in whipsaw market reactions.

Volatility brings frustration and risk along with opportunity. It's easy to get caught up trying to outguess the markets, and even easier to resist changing when you make a bad decision. Both can be serious obstacles to successful grain merchandising.

Admit mistakes, remain flexible, and fasten your seat belt for another wild ride. ■