



Bull markets are exciting but they surely make life tough for grain traders and managers! Smart merchandisers, however, stay alert for anomalies that develop in volatile markets. *Merriam-Webster Dictionary* defines anomaly as:

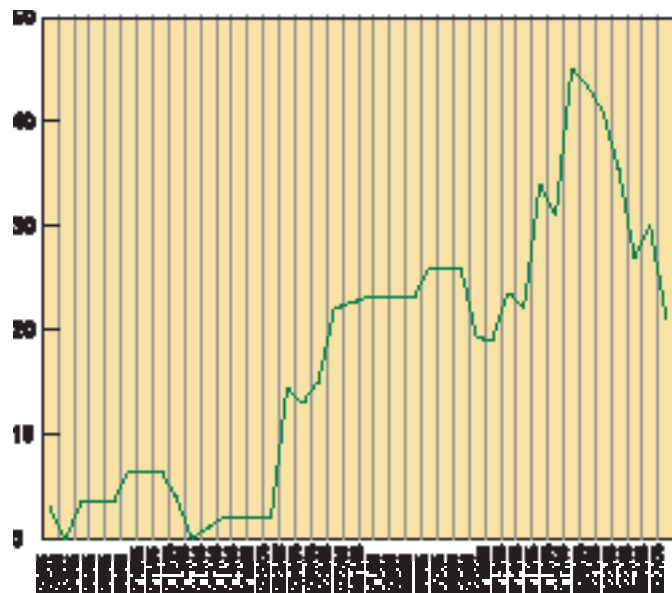
- deviation from the common rule
- something different, abnormal, peculiar, or not easily classified.

One anomaly from the 2005 rally involved '05 crop soybean spreads. In June 2005, the massive influx of speculative buying pushed soybeans nearly to \$8.00 with volume concentrated in November 2005 futures. Sixty percent of the total soybean open interest of 335,000 outstanding contracts on June 27 were in November futures;

on the other hand, open interest in individual deferred contracts such as March 2006 was less than 3% of the total. As the market rallied, buying in November futures pushed them to an ever-greater premium over deferred months, finally to almost 45 cents inverse over July 2006 before settling back when futures fell hard.

Futures spreads reflect and are part of the underlying cash markets. When available

supplies exceed nearby demand, basis weakens and futures spreads tend to develop generous carries. The combination increases the overall return for someone to own



and hold the surplus inventory until it is needed. In the fall of 2004, for example, the November 04/July 05 soybean futures spread traded between 23 and 27 cents carry, or 50 to 60 cents opposite from current values for the Nov05/July06 spread.

The size of a crop doesn't determine whether futures spreads will offer generous carries, though. Big crops often push prices lower and farmers may opt to store rather than sell, reducing the need for market incentives to hold grain. Conversely, high prices can bring heavy farm selling that pushes basis weaker and builds futures carries. But those "rules" only apply when there's actually a crop to store or sell. In the months before harvest all bets are off!

This year's anomaly occurred at the same time grain elevators were buying huge quantities of new-crop soybeans that would arrive during harvest. The futures inverse signaled to merchandisers that owning new-crop soybean inventory and carrying short hedges beyond November would be a losing strategy, creating a dilemma, perhaps even a merchandising land mine.

Long inventory + inverse = losses?

Short inventory + inverse = opportunity?

The example which follows assumes buying soybeans in a representative Midwest processor market during harvest with October basis at 25 cents under November futures. It assumes a 40 cent inverse between November and July '06 futures, which makes the October basis equal to +15 July. (-25 November plus a 40 cent inverse) Add nearly 5 cents/month in interest cost to hold soybeans, and a merchandiser who's long inventory will need to sell a basis of +53 July by June — just to break even after eight months!

Go long during harvest in October			
Time:	Oct	Jan	June
Basis	-25 Nov		
+ Spread	40 Nov/July*		
=	+15 July	+15 July	+15 July
+ Interest		+15¢	+38¢
Equivalent basis =		+30 July	+53 July

* inverse

Such an extremely high June basis is remotely possible, but certainly not typical.

Most merchandisers would react to this by selling soybean ownership, ideally early enough to refill the warehouse with corn, which does offer a positive return for holding. But elevators would find it a challenge to ship all their soybeans during the harvest transportation crunch. One alternative is to liquidate all hedged soybean inventory in November or December when basis usually rises. That spreads out the shipping, avoids the “cost” of the inverse, would free up space for January to-arrives, and generates cash flow!

If the spread anomaly signaled elevators to liquidate ownership to avoid losses, maybe the inverse anomaly also offered a lifeline.

Shorting DP inventory

Alert merchandisers quickly penciled how the inverse between November '05 and July '06 futures could work for them. Selling and shipping Delayed Price (DP) inventory on a post-harvest basis recovery would put the elevator short the basis; the farmer will price their DP beans later. The elevator can hold and use the money until the farmer sells. That “saves” the elevator 7.5% in borrowing cost, around 5 cents/month. (State laws vary on the use of funds from selling DP inventory.)

Selling at -5 November and earning nearly 5 cents/month in interest savings means the value of the sale rises each month. By June the sale is worth +73 July futures. Assuming the published basis in June is +10 July (just for example), and the farmer decides to price, the elevator makes 63 cents! Most elevators also charge a Delayed

Sell 30 days after harvest, go short basis:

Time:	Nov	Jan	June
Basis	-5 Nov		
+ Spread	40 Nov/July*		
=	+35 July	+35 July	+35 July
+ Interest		+15¢	+38¢
Equivalent basis =		+50 July	+73 July

* inverse; interest at 7.5%,

Price service charge for grain received during harvest; that revenue would add to the profits. This is a great merchandising opportunity even if the futures inverse is 20 to 25 cents instead of 40 cents!

The sizable potential profit for elevators from the program also meant managers could plan to offer farmers very cheap DP rates this fall to encourage farmers to surrender title at harvest. If prices remain above loan level, farmers won't have any LDP to collect so retaining title is less important than last year.

Grab the lifeline!

To prepare for this program months before harvest, the merchandiser has to set the spread to protect the inverse. Just looking at it and recognizing its potential won't help.

Buy July '06 / Sell November '05 (futures)

Some merchandisers actually set the soybean spread across a full crop year, buying November '06 and selling November '05.

Asleep at the switch?

How did the soybean spread get so far out of line that such opportunities could exist? It's largely a function of the time frame. In June of 2005 few speculators would look at such arcane spreads that tie into cash basis. Small firms may view the spread as too risky — the inverse could have gotten much

larger and turned the lifeline into a land mine. Large grain companies and processors probably spotted the situation but benefited from it. The inverse made elevators and farmers willing sellers for 2005 harvest and kept basis weak.

Beware of land mines

There are some anomalies you should avoid. Old crop/new crop futures inverses are a huge land mine. There's no limit to how far a spread can invert, and if a carryover is tight an inverse can explode. In 2004, the July '04/November '04 soybean spread soared to a \$2.24 inverse. Elevators who sold DP soybeans early last summer and “rolled” the sale forward in a 50 cent inverse (bought November '04 / sold July '05), betting farmers wouldn't price before harvest, faced huge losses.

When opportunity knocks

Spread or basis anomalies won't announce their arrival, but sharp merchandisers are always watching. This time it was soybeans; next time it could be in corn or wheat. The key is to not just recognize the potential but to act on it. Grab the lifeline but know where the land mines lie! ■



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