



The Cost of Complacency

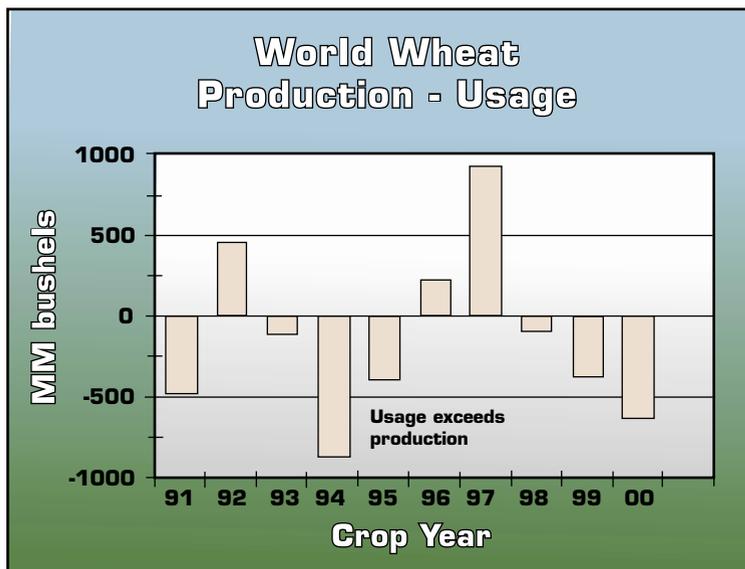


Figure 1. Wheat production exceeded usage in three of the past 10 years.

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Times have generally been good for grain merchandisers and managers for several years. Markets haven't shown much volatility and prices have mostly remained low. Futures occasionally yawned and awakened for a quick run, but always retreated. End users have done well covering needs 'hand to mouth' most of the time. Futures spreads have mostly offered generous carries and good returns for elevators that carried hedged inventory. Life's been pretty easy and that's when complacency can creep in. Complacency could be costly in 2001.

What's happened?

Grain and oilseed markets may be poised for a change because world grain carryovers have been shrinking. Coarse grain ending stocks have declined a net 30 million metric tonnes in three years to just a 57-day cushion. World wheat stocks have declined net 27 million tonnes in three years to only 67 days of usage worldwide. (In comparison, 2001 U.S. ending wheat stocks are forecast at 130 days of usage.) World wheat production has only exceeded usage in three of the past 10 years. The U.S. 2001 wheat crop isn't off to a great start; acres are down and conditions are far from ideal (Figure 1).

China remains a wild card; corn production is down sharply due to widespread drought, and China's ending stocks and their potential role as an exporter are the subjects of debate.

Soybean fundamentals are also cause for attention. This year's South American soybean crop is projected to be nearly 59 million tonnes, an 11% increase. Yet world soybean production will barely match usage. Mad Cow disease

will boost soybean and soymeal demand due to the EU ban on meat and bone meal for animal feed.

Cumulatively, world fundamentals reflect rising demand and production that isn't keeping pace — despite the absence of a catastrophic production failure. Yet futures markets continue to trade as if we need to discourage production and build demand.



The natural gas and fertilizer problems of 2001 will almost surely result in lower corn acres.



U.S. fundamentals are just as significant. We have a sizable corn carryover, but despite big yields, total U.S. disappearance over the past two years has exceeded production. The U.S. now holds 43% of the world's corn carryover; two years ago it was 36%. Potential production problems here may not seem especially important, but they certainly could be.

Market implications

Changing traders' attitudes does not come quickly after three years of weak prices and bearish outlooks. But, futures have done their job, and it's time to let the bear rest.

There's no reason to grab for the 1995/96 price charts — nothing as dramatic as \$5 corn is warranted. Assuming the U.S. sees only a minor drop in corn acres in 2001 and also gets a good yield (140 bpa), we'll be OK. Big cuts in corn acres or in yield will spell trouble. Figure 2 shows some combinations of theoretical U.S. corn acreage and yields for 2001. (2000 corn acres were 79.6MM, and yield was 137.7 bpa.)

Natural gas and fertilizer problems of 2001 will likely result in lower corn acres. If there are adverse summer conditions, the odds increase for sharply higher futures.

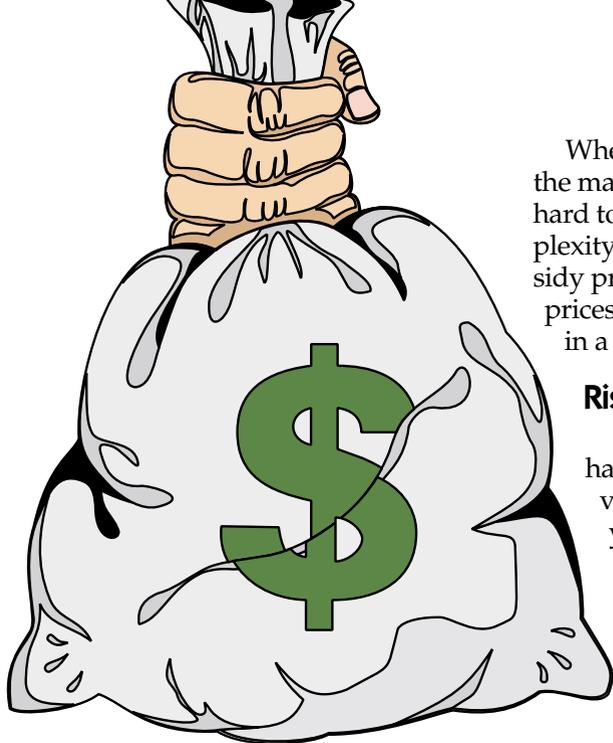
December corn futures at \$2.60+ offset most of the higher nitrogen cost. Availability of nitrogen is the bigger problem. This year will test the creativity and patience of farmers to find nitrogen. Expect some will use lower than typical application rates. Others may rely on side-

2001 U.S. Corn Production Scenarios

Scenario:	1	2	3	4
	Worst Case			Optimal
Pltd A.	77.0	77.5	78.0	79.0
Hvstd A.	70.07	70.50	71.37	72.70
Yield	130	134	138	142
Produc.	9,109	9,447	9,849	10,323
Usage	9,800	9,875	9,950	10,100
Net	(691)	(428)	(100)	+223

All figures in Millions. "Net" equals change to carryout: production minus disappearance

Figure 2. All cases assume at least slightly lower corn acres in 2001 due to high natural gas prices and shortages of nitrogen fertilizer.



...dressing or summer application through pivot irrigation and others may find hog manure suddenly smells a lot less offensive when other fertilizers aren't available.

Wheat is the most political of the major grains, and values are hard to anticipate due to the complexity of world support and subsidy programs. But the odds favor prices working higher, even if not in a dramatic fashion.

Risks of complacency

The grain industry hasn't had to trade and operate in volatile markets in three years. It's time to think back to earlier years and the risks your business faces if futures volatility increases and prices rise.

- Financing needs and handling costs increase
- Risks and costs rise on contract disputes or defaults
- Futures carries *might* lessen, although the CBOT delivery system is conducive to carrying charges
- The cost rises for mistakes in

your position report or hedging

- Buying feed 'hand to mouth' may penalize users when deferred futures no longer decline strikingly
- Option volatility typically rises, which changes the risk profile of short-option positions
- LDPs may vanish and deprive producers of the ability to work support programs in combination with cash grain.
- Natural gas and electricity costs are expected to remain high, adding to drying and freight costs.

A lot of grain traders and producers will relearn lessons in planning ahead and managing merchandising risks wisely if volatility and higher prices return. Just ask natural gas traders about the cost of complacency. **FG**

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