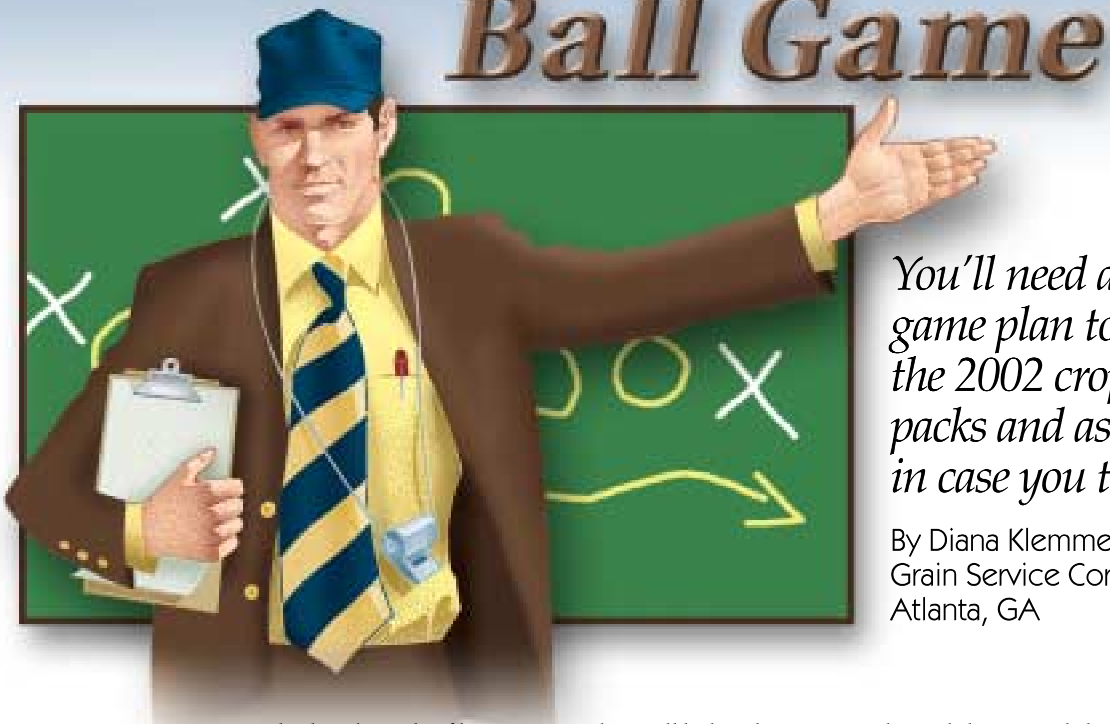
A Whole New Ball Game



You'll need a flexible game plan to merchandise the 2002 crop — and ice packs and aspirins handy in case you take hard hits

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The hard work of harvest may be well behind you, but the hard work of merchandising the rest of the 2002 crop still lies ahead.

Making specific predictions this early about basis and spreads later in the crop year has little to no value — too much can change in the interim. A coach doesn't lay out an exact blueprint of every play before the game. A good coach drills the team relentlessly in fundamentals and designs plays to call up when the situation is right. The coach instills confidence in the players, but also makes sure there's a trainer on the sidelines with bandages and ice packs for the injuries that occur. This is a year where seasoned merchandisers and rookies alike will make a lot of mistakes, and the ice packs may come in handy.

Making money the last three to four years has been relatively easy: Buy at harvest and hedge, hold inventory as long as spreads paid more than your cost of carry, then liquidate ahead of the next crop. Carrying hedged wheat inventory for two to three years paid well! But this year is a whole new ball game and it only gets tougher from here.

Basis has already been higher than in recent years, making it hard to judge what is a "good" basis, either to own or to sell. Don't rely on historical benchmarks; respond to today's signals from the marketplace. The market is telling you to liquidate ownership soon when the cash basis is inverted. Continuing to hold might pay off, but the odds are seldom good.

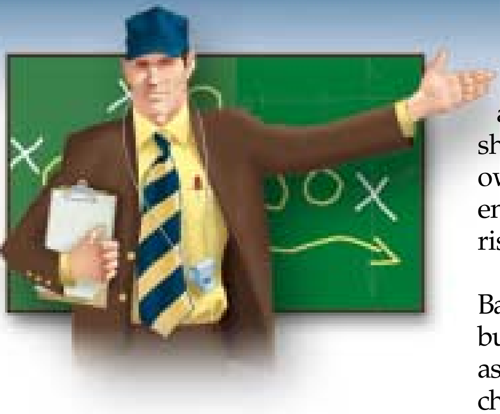
Sharply inverted futures (or cash markets) offer merchandising opportunities that can be as good for an elevator as long basis and wide carries. Shorting the basis when you can ship delayed price (DP) bushels lets you benefit from the long-term declining basis, at the risk of short-term moves against you. You "earn" the inverse rather than being

Ex.: Selling and shipping delayed price soybeans

Assume it's December 2002
January soybeans $5.62
July 2003 soybeans $5.40 (22¢ futures inverse)

- Sell the basis at +15 Jan = +37 July futures (assumes 22¢ inverse)
- Ship unpriced DP inventory to fill the sale; receive payment and hold the funds
- Assume farmers price the DP inventory in June; basis is at +15 July.

Basis Gain = 22¢ plus the value of money from December until June (6 mos.)



penalized by it as the example at left illustrates. Getting net short basis without having any DP ownership to ship is entirely different, however, and can be a high-risk strategy in a short crop year.

Watch your timing this year: Bargaining power is greatest when buyers are extremely aggressive. Sell as the basis is rising; don't get caught chasing the pack on the way down.

When there's no carry for a backstop, missing opportunities this year penalizes you beyond the weakening basis.

Expect futures spreads to continue to offer only minimal carry — or to be sharply inverted — on corn, soybeans and wheat this year. Waiting for the predictable high percent of full carry of recent years on corn, especially, will cause you to miss opportunities. Any futures spread that covers your interest cost of holding is worth protecting this year, especially when logistics don't allow you the option to ship immediately. (The December 02/March 03 corn spread is a good example. It traded to over 7¢ carry in early October, but had inverted by late November.) You might sacrifice a few cents of lost potential if the futures carry widens after you set it, but there's no limit to how far a spread can invert.

The Chicago Board of Trade Waterway Delivery System is generally conducive to allowing corn and soybean futures carries to develop, but it doesn't guarantee they'll develop. Many traders expected that crops were still big enough to keep enough grain in the pipeline at harvest and that exports were weak enough to build modest carries on front-end spreads. But this year proved the opposite. Eastern domestic corn basis strength forced the export basis high enough to prevent almost all deliveries against December corn futures. And the aggressive fall soybean export program to China pushed Gulf basis so high futures inverted at harvest!

Merchandising returns from holding inventory can come from basis staying flat but having wide futures carries, or from flat spreads accompanied by volatile basis. The former is easier to manage, but the latter can still be profitable. (Holding in an inverse is tougher.) Expect even greater basis volatility in the last half of this crop year than in the first half, despite tight supplies. With no futures carries to encourage hedgers to accumulate inventory, basis could collapse quickly when farm selling surfaces.

For that reason, beware holding sizable long basis positions well into the crop year. Time ceases to be on your side to wait out the inevitable drops in a volatile basis period.

Basis doesn't have to remain at high levels, despite tight stocks. Buyers and resellers may cover needs early, leaving a near absence of favorable spot bids at times, especially later in the summer. Hot spots will develop, but there's no way to know where or when, and you can't plan a merchandising program waiting for them to appear.

With world stocks also tight, expect erratic export programs that can quickly undercut values. The South American soybean crop will enter the world market this spring and could quickly turn the US from the main supplier into the residual source and push Gulf basis lower. But if serious problems arise in South America, the U.S. would be the backstop and U.S. Gulf basis would soar. Corn may see a similar outcome, with China the wildcard supplier than can strip export business away from us.

Expect the largest basis swings in areas of greatest supply. Distant deficit areas will need to reach deeper into the interior than normal to source sufficient supplies. Ohio and western Nebraska, for example, should see a narrower overall corn basis range than Iowa or Minnesota — they started off strong and are likely to stay strong.

Buy "tight"' and sell "loose" for maximum merchandising flexibility the balance of this year. Flexibility is worth a lot this year where opportunities can come and go quickly. Selling loose terms may allow you to buy in a sale, swing shipment times around to your advantage, or to benefit from generous grade discounts. Selling trains "FOB your origin" is a "tight" term; selling trains on a rate-base point such as "Basis Kansas City" or "Basis Chicago" is an example of selling "loose." The latter allows you to more readily substitute other origins to fill your obligation. Offering equivalent leniency on your purchases reduces your flexibility.

You may trade in remote markets this year that have different practices, and may trade with new partners. Discuss contract terms carefully and document them in writing. Compare written confirms and contracts carefully with your version and reconcile any differences immediately. Don't rely on verbal assurances such as, "Oh, don't worry about that, I know what we agreed to … "

The next few months will try your patience and test your trading skills. Keep your approach flexible; recognize when a strategy isn't working; be ready to adapt. And keep a few aspirin handy. F&G

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