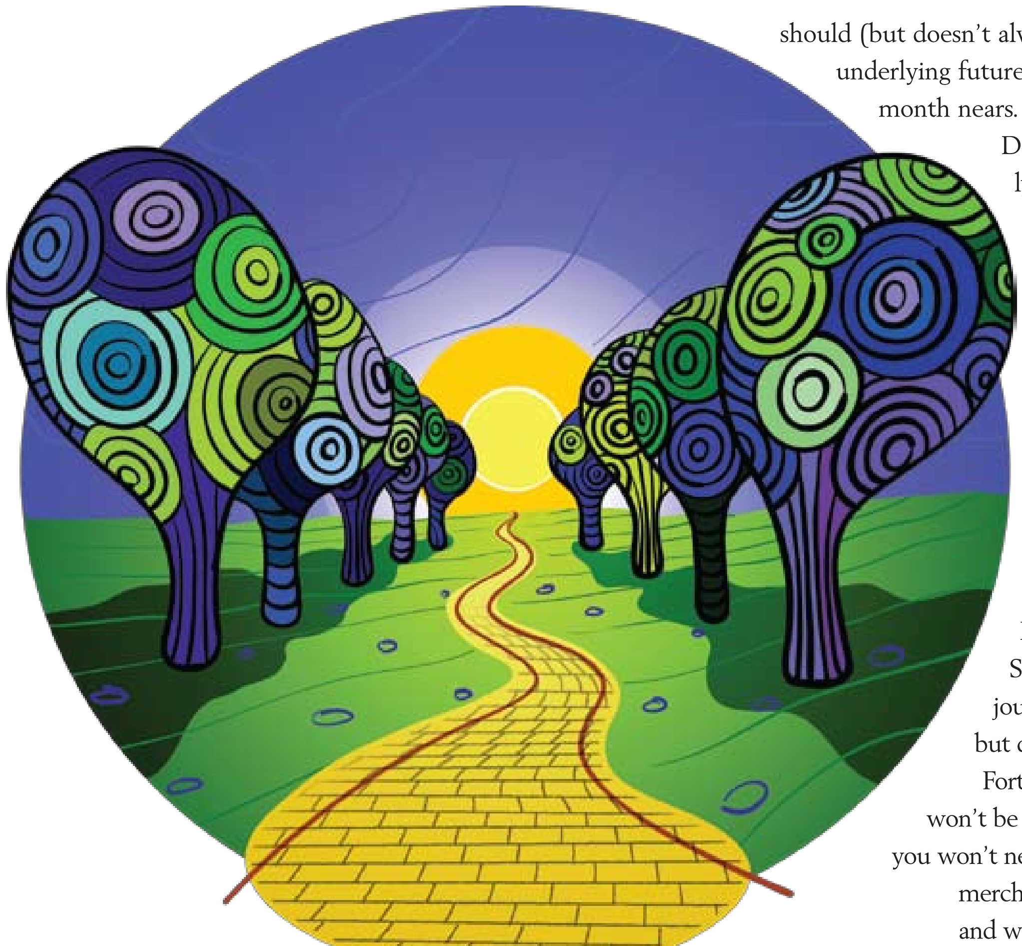
By Diana Klemme



'We're Not in Kansas Any More, Toto'

"Shock and awe" might have described Dorothy's reaction when she found herself in Oz with her little dog, Toto. Her plain and familiar world of Kansas had suddenly been transformed into a kaleidoscope of color, a new world full of events far outside her sphere of experiences — a place where things were often not as they seemed.

Sounds a lot like the grain business these days, doesn't it? Merchandising expectations that were as familiar and comfy as a pair of old slippers suddenly don't fit. In Oz, soybean futures can be over $9 while basis plummets to record low levels. Wheat can trade at $5/bushel over corn! Ethanol plants have pushed corn disappearance to record high levels, yet corn basis this summer has rarely stirred. Traders talk about global shortages of grains at the same time futures spreads drift towards "full carry."

"Convergence" seems elusive — where cash basis should (but doesn't always) move closer to the underlying futures price as the delivery month nears.

Dorothy's efforts to successfully navigate her new world of Oz often proved frustrating. Risks arose in unexpected places — hostile apple trees attacked her, and the Wicked Witch tried to lull her to sleep in a beautiful but deadly poppy field. But Dorothy was a survivor — she quickly learned the value of alliances, enlisting the Munchkins, then the Tin Man, Cowardly Lion and The Scarecrow to help her on her journey. She longed for Kansas but dealt with the reality of Oz.

Fortunately, as a grain trader you won't be attacked by hostile trees and you won't need Munchkins. But your merchandising world is changing and wishing for the good old days won't bring Kansas back — at least not anytime soon. Just how does the Oz of grain trading differ from Kansas?

Grain Trading 101

In the past, basic merchandising and hedging has included various principles and assumptions:

1. Basis risk is lower than outright futures price risk.
2. Basis is reasonably predictable; firm when supplies are tight, weak when supplies are ample.
3. Basis levels are also reasonably predictable — what happened before, often repeats.
4. Cash and futures tend to come closer together during the futures delivery month (convergence).
5. Basis tends to follow seasonal patterns: weak at harvest, firmer as the crop year progresses.
6. Futures spreads will tend to have wide carries when deliverable supplies are large and basis is weak.
7. Futures speculators mostly followed two schools: technical chart analysis, or fundamental traders who watch supply & demand.

These general patterns and presumptions gave elevators/hedgers confidence to buy grain, sell futures, and reasonably anticipate some specific outcome over time. Grain hedgers could gather and evaluate historical basis information, identify patterns and plan seasonal strategies. It's still fine to be cognizant of what basis used to do — but assuming that basis will continue to follow past patterns or absolute values can now get managers in serious financial trouble.

The Land of Oz — since 2006

Since 1996, the published soybean basis in Decatur IL during August had 'never' traded lower than -28 Nov futures, and peaked one year at +145 Nov. Surely it would be safe to own soybeans for August this year when the basis was -35 Nov, betting on a quick recovery. But Decatur's published bids in August ranged from -35 to -65 Nov! Old assumption = loss this year

Pre-Hurricane Katrina, barge freight on the Illinois River had never exceeded 450% of the benchmark rate (100% = around 14¢/bu on corn). Since September 2005, barge freight peaked at over 800% (8 x 14¢), and has spent little time lower than 300%. Old guidelines = loss this year

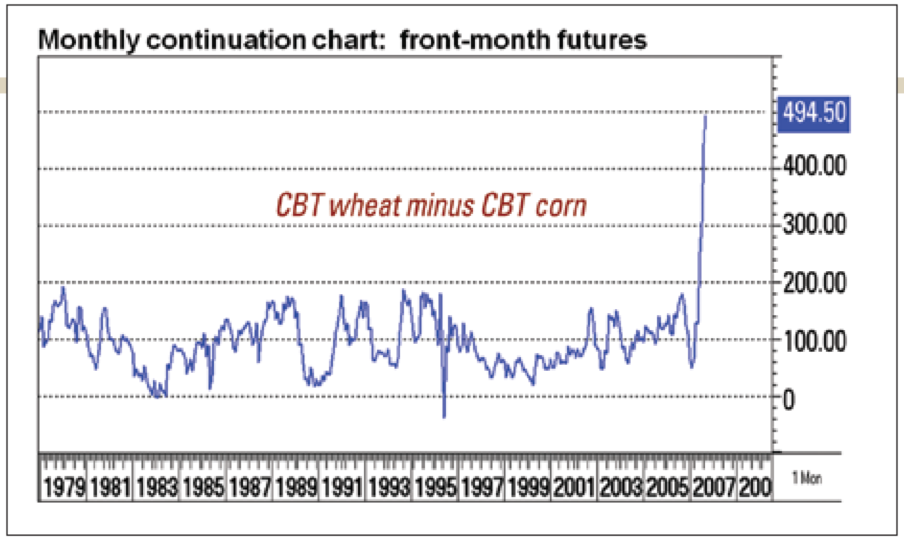
Global wheat supplies are plummeting and overseas buyers are scrambling to cover needs. CBOT wheat futures are approaching $9/bushel, and yet the basis for cash soft red wheat in Kansas City is weaker than -100 Dec7 (CBT) futures! Old basis expectations = loss

Everyone knows that wheat can't go more than maybe $3/bushel over corn, it's just never happened! Until 2007, when it climbed almost $5 above corn. Old spread assumption = loss

For farmers, surely selling 2009 crop wheat on a "hedge to arrive" contract with July09 futures at $5.50 (CBOT) has to turn out great. Maybe so, or it could be a disaster several ways for the farmer: Futures might be sharply higher than $5.50; basis may be far weaker than the farmer anticipates, and production costs for 2009 can't be defined yet. Old strategy = who knows in '09?

The road from Kansas to Oz

Several key factors have upended the grain trader's world. The explosive growth in the Asian economy has propelled many costs higher. Ocean freight has skyrocketed as a result of the demand for raw materials and the inevitable port delays. Higher crude oil



and petroleum prices force higher transportation costs and fuel surcharges. An aging fleet has lost a large number of barges to scrap or to relocation to South America. High construction costs force higher rates to pay for more barges.

Sharply higher freight costs force basis levels to adjust. Destination basis tends to rise and origin/interior basis tends to weaken to offset the freight.

The explosive growth of commodity index funds has provided a steady stream of buying in agricultural commodity futures. Pension funds and other sources have raised this pool of money to in excess of $100 billion that steadily accumulates and holds long futures — almost all in nearby futures months. This buying has sustained the climb to current price levels, but has also impacted futures spreads. Index fund longs almost always shift their holdings to the next month shortly before deliveries begin. This brings selling to the front month and equivalent buying to the next contract month, often pressing the futures spreads wider despite soaring prices and rising demand for the real commodity.

Global feed grain, oilseed and wheat usage have continued to rise, yet production has not kept pace or barely so. Global carryover inventories are at record low levels in some crops — forcing buyers to pay whatever it takes to secure feed or foodstuffs. For some countries, the price of wheat is irrelevant to the government; it's a political decision not an economic one. Wheat is a staple food and monarchs or dictators do not want a hungry population. China, Egypt, some other African countries are examples. Their buying has propelled cash prices higher, pulled futures with it, and also raised the demand (and cost) for freight.

Despite this global demand, the U.S. breadbasket remains largely an area of plenty, with shortages of space, railcars and barges. It may seem unimaginable in the face of a 13.3-billion-bushel corn crop that U.S. corn at $3.50+ could be one of the cheapest feed grains in the world in the fall of 2007. Yet it is.

Now the U.S. dollar has fallen to record low levels against the euro, making U.S. products a bargain to overseas buyers. An Iowa corn farmer, however, or a Nebraska elevator manager, doesn't deal with these overseas aspects — they just see hundreds of millions of bushels of corn piled on the ground, cheap basis, but rising futures. Seems like a disconnect for sure. Aren't bumper crops supposed to depress prices and shouldn't farmers reap all the benefit of high prices?

Recognize the market factors

Become more aware of the global influences on your commodities and on freight. It isn't just about the weather in the Midwest or the Plains anymore; instead, Brazil's, or Australia's weather may dominate market direction. And price changes in the United States brought on by global factors, can change the level of farm selling in Texas or Minnesota, and affect your local basis.

Stay in touch with the general value of competing commodities, and with the world supply/demand for key crops. You don't need to be an expert in international trading, but it helps to understand that countries that must have wheat will pay what it takes, and others will look for alternate feedgrains and will pay to get them. Understand why the value of sorghum — traditionally an "afterthought" crop for many areas — has raced ahead of corn in value. Then it makes sense when a buyer calls begging for offers on milo. (The EU will not buy GMO corn or DDGs from United States, but U.S. sorghum is fine.)

Accept that futures spreads are strongly affected by the movement of investment-money positions. The only spread that's a "given" is the value you see today.

Traveling the Yellow Brick Road

Risk is no longer just about whether you're long or short basis and whether basis will reach some arbitrary objective. The old Hedging 101 principles are worth keeping, but put them on the top shelf instead of on top of your desk.

With futures increasingly reflecting a global marketplace, more of the burden to reflect local prices will now fall on the basis. Higher futures mean increased risk of basis falling to levels never seen before. Just because corn basis in the Midwest has never gotten as cheap as -100 doesn't mean it can't happen!

The CBOT and other groups are evaluating futures contracts to see if the changes in agriculture warrant changes in the futures contract to better encourage convergence. In the meantime, accept that basis is more volatile these days, there's no guaranteed floor on the basis, and adjust your trading style accordingly.

Merchandising is a fully integrated position. Once you have open contracts — purchases or sales — you also have implied freight exposure and spread risk. Plan far ahead for financing needs: Set up reserve credit lines, basis repos (see August/September issue of FEED & GRAIN), or other sources of funds. This year wheat went to $9; the soy complex could be the next sleeper market.

Define clearly what origination strategies you consider acceptable when buying for the current year, as well as one or two years forward; Hedge to arrive's? Minimum price? Farmers may not understand yet about this new basis environment and have unrealistic expectations. Set operating margins commensurate with the greater risks in today's environment. Handling $8 wheat obviously costs more than handling $3 wheat, and buying 2009 crop carries much greater risk: Is it worth it?

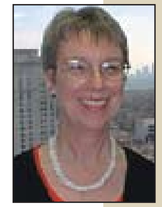
Successful traders in 2007 and beyond recognize that it doesn't matter what absolute basis you buy or sell, or what spread you set. What matters is the net margin you can take out of the position.

Be willing to forward sell basis values that are "cheap" if doing so eliminates risk and puts an acceptable return in the bank. Or if you own grain but haven't forward sold it, consider being more aggressive about protecting futures carries when they're good rather than waiting for "great."

Lock in freight costs if that successfully finalizes your strategy and don't obsess on whether freight might get cheaper later.

Insist on detailed, accurate monthly financials along with daily Position Reports and contract summaries. Analyze the reports closely and think ahead to what might go wrong, or how you can lock in profits and reduce exposure. Get reports showing time slots, delivery destinations, along with the names.

The Yellow Brick Road is a rather curvy and unpredictable trail. Be flexible and be ready — and willing — to change your game plan as circumstances warrant. ■



Diana Klemme is a longtime contributor to FEED & GRAIN. Contact her at Grain Service Corporation, Atlanta, GA, by calling (800) 845-7103 or e-mail at diana@grainservice.com