MERCHANDISERS' CORNER

By Diana Klemme

Chicago Wheat Futures

Financial Tsunami of 2008

The uproar over the soft red winter wheat cash basis has grown increasingly louder. Farmers watched Chicago July 08 wheat futures soar to $11 this spring, but saw local bids lag by up to $2/bushel and their anger grew. Heads should roll!

Cincinnati is a good market to study. The Cincinnati market can reflect barge export values, regional mills, and feed demand from the Southeast. In July 2007 that basis was -50 to -60 but weakened further by late summer. Elevators and terminals remembered what happened and became more wary about bidding aggressively for summer of 2008. Financing needs were soaring in the face of rising futures, further depressing basis as buyers widened margins to offset their rising interest costs on hedges.

In early March 2008, flat price bids were still impressive — nearly $9/bushel. Farmers had been selling into the rally through the winter, but many sold on Hedge to Arrive (HTA) contracts. They expected the basis for harvest to improve from the steeply discounted harvest-delivery values the terminals were bidding (-100 on January 10, -165 on March 5, for example). Elevators that bought wheat last winter and spring for the summer of 2008 mostly hedged the purchases and waited — also thinking basis would surely improve, first from -100 and especially after basis fell to -165. And by early August, from the July low, basis did firm, rising to -180 Sept futures. Basis then chopped around through August and September, without offering any further net gains.

The summer of 2008 devastated the wheat P/Ls of many country elevators and dashed the hopes of farmers holding HTA contracts. Elevators that bought wheat early and hedged it faced basis losses of over $1/bushel. That basis break hurt elevators but also reduced the farmers' final price by $1 or more from what they could have forward-sold last winter. Setting the basis on an HTA from January 10 at $7.75 futures, for example, would have set a cash price of around $5.50/bushel (-220 basis approximately).

Soft Red Wheat	Futures	Cincinnati Basis	Cincinnati Cash
July 07 (ave) (spot)	$ 6.00 July7	- 55	$5.45
January 10 2008 for July delivery	$ 7.75 July8	-100 July	$6.65
March 5 2008 for July delivery	$10.50 July8	-165 July	$8.85
July 1, 2008 spot	$ 8.50 July8	-222 July	$6.28
July 1, 2008 spot	$8.65 Sept8	-237 (Sept)	$6.28

Hedging works because of the expectation that cash and futures will come close together during the delivery month at the delivery locations. Called convergence, this has allowed elevators to operate on modest margins, and bankers to consider hedged grain good collateral against funds advanced to meet margin calls. But 2008 turned that on end.

Farmers called their congressional representatives. Elevators tried to explain the losses to lenders and boards of directors. Exporters weren't immune; some faced losses if they had bought the basis early without having export sales to offset it.

Now the pressure reached a crescendo for somebody to do something. No one wants the risk that lenders will refuse to finance hedges against soft red wheat purchases or inventory! Congress called the CFTC on the carpet for answers. The CFTC called the CME/CBOT on the carpet to talk about contract performance. Everybody blamed the rising long positions held by Index Funds and other speculative and investment money.

The CME recognizes the situation is serious and is working hard to quantify the problem and identify areas for improvement.

CME/CBT proposal

There's always risk when an exchange changes the terms of futures contracts. A change may "fix" one problem but create others. The change may fail to fix the original problem, which risks an unacceptable delay in finding an alternate solution.

On August 5, the CME submitted their initial proposal of changes to their wheat contract to the CFTC for approval. These are measured changes that will mostly tweak the contract and may improve convergence somewhat but are unlikely to bring cash and futures together. CME offers a three-part proposal.

Part 1: Add delivery capacity; effective with the July 09 contract

CME proposes to add three areas where grain could be delivered to fulfill short futures, using shipping certificates.

a) unit train shippers in a 12-county area in northwest Ohio
Deliverable at -20¢

b) locations on the Ohio River, from Cincinnati to where the river meets the Mississippi River
Deliverable at par

c) locations on the Mississippi River, south of St Louis and down to Memphis
Deliverable at +20¢

Part 2: Add seasonal storage rates, but only for wheat (Effective July 09)

a) storage to rise to 8¢/bushel/month for the months July/August/September/October and November (JASON for short)

b) storage to remain at 5¢/bushel/month for the remaining seven months

Part 3: Lower the allowable vomitoxin for par delivery (Effective Sept 2011)

a) proposed maximum 2 ppm vomitoxin at par, 3 ppm deliverable at 12¢ discount and 4 ppm deliverable at 24¢ discount.

Adding delivery capacity means more firms will be able to originate wheat and deliver against a futures sale when cash basis is significantly discounted. The idea is that this will tend to weigh on front-month futures and improve convergence with cash. Reducing the vomitoxin level can make taking delivery somewhat more attractive for commercial longs, such as mills.

What it means for elevators

The change with the most immediate impact on hedgers is #2 — adding seasonal storage rates. Raising the storage rate from 5¢/month to 8¢/month effectively raises "Full Carry" on each futures spread by that 3¢/bushel. Holding wheat from July 1 to December 1 will now cost a long 40¢ in storage compared to 25¢ at present. This means futures carries can widen an additional 3¢/month. Elevators need to factor this into spread decisions on Chicago wheat hedges starting with the July 09 contract. Assuming the July9/December9 spread widens to 90% of full carry, Part 2 may add 13½¢/bushel to the futures carry.

The CME is currently analyzing other potential changes, all with pros and cons and would be even more controversial. For now these are just at the talking stage:

1) compelled load-out; where any long receiving delivery notice would be compelled to physically load out the grain within a defined time frame

2) modified compelled load-out — where there would be some flexibility for the longs.

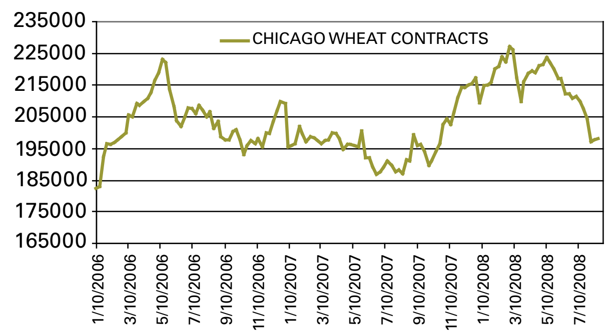
3) a new wheat contract, perhaps reflecting global values rather than U.S.

4) cash settlement

The culprit?

Much of the suspicion and blame for the complete collapse of the basis falls on the rising participation by Index Funds and hedging of Over the Counter swaps (OTC) that require the swap seller to be long on futures. This sector of activity has grown sharply in recent years. Since 2006 CFTC has published a weekly supplemental report on index fund positions in ag commodities. Interestingly, index funds owned almost 220,000 contracts as early as spring 2006, approximately 50% of outstanding wheat contracts. Compare that to index holdings of 185,000 contracts in the fall 2008, approximately 60% of open interest (futures only).

Index Fund Longs in CME Wheat (000 contracts)



Modest crop vs. 'Big Money'

The perception is that investment money's futures buying spree may have pulled price away from the value of the underlying cash and added to the basis collapse. There may be truth to that. U.S. production of soft red wheat is approximately 610 million bushels in 2008 when it hasn't exceeded 400 million bushels since 2000. Small crops such as SRW provide limited short-hedging volume to temper investment buying. But 610 million bushels is a huge soft red wheat crop relative to demand.

At the same time, foreign wheat production set a new record in 2008, nearly 2 billion bushels higher than 2007. Combined with soaring ocean freight, the foreign wheat made U.S. wheat increasingly noncompetitive, leaving the United States unable to increase our exports which in turn is pushing U.S. ending soft red wheat stocks to two to three times the typical U.S. carryout.

US SRW	Production	Exports	Ending stocks
'02 crop	321	105	52
'03	380	145	61
'04	381	122	88
'05	309	75	96
'06	390	145	89
'07	358	220	46
'08/09	609	145	175
	Million bu.		

Cheap basis has kept the cash value of wheat low enough to encourage *some* exports, and to make it potentially competitive with feed grains here in the United States. Cheap basis also provides incentives for warehouses to acquire and hold the surplus soft red wheat, anticipating that eventually basis will recover and compensate the warehouse.

The cheap soft red wheat basis at least makes it possible to feed wheat. At typical basis values, soft red wheat would be far too costly to compete in the feed market.

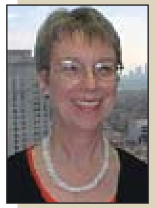
Current CBT wheat futures	=	$7.30
Approx basis	=	(2.05) Cincinnati
Cash wheat	=	$5.25 (= 8.75¢/pound)
Dec corn futures	=	5.50
Basis		(.50)
Cash corn	=	$5.00 (8.93¢/pound)

What about 2009 crop and beyond?

In time the best cure for cheap basis may be cheap basis: Someone with space and money will take on the ownership of surplus wheat and stockpile it. Assuming 2009 SRW acreage doesn't add to the U.S. surplus ,perhaps basis can then begin to climb from its abyss.

But heed this caution: If more waves of investment money pour into commodities, soaring wheat futures could soar again and force basis to even cheaper values. Many elevators won't post bids for 2009 SRW but will talk with farmers individually. Some are limiting their purchases, while some will only buy forward wheat if they can sell it into the cash market. For now the CME's proposed changes aren't a permanent fix for the basis. The changes won't perform miracles and basis won't soon return to "normal" historical values.

And in any case, increasingly volatile futures to add to basis volatility as costs of ownership and hedging rise. For now the basis volatility is to the downside; someday perhaps it will again be the other direction. ■



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