

# Follow the Signals

A playbook for making money despite the challenges of 2012.

By Diana Kiemme

**I**n our [last issue](#), elevator owner Mike was reassuring his son Jason that even in severe drought years such as 2012 there are ways to make money. Mike reminded Jason to “remember Granddad’s words: *Don’t panic; learn to respect market signals.*”

Crops are small and demand must be curtailed. Market signals in 2012 crop are already loud and clear: Corn almost doubled in price since the fall of 2011; soybeans went more than twice as high, almost to \$18. Futures spreads in corn and soybeans range from minimal carries to steep inverses to encourage movement. Corn basis remains near record-high levels in many markets with harvest nearly 25% complete, but is record cheap along the lower Mississippi River. The 2012 crop demands a new playbook to understand these signals!



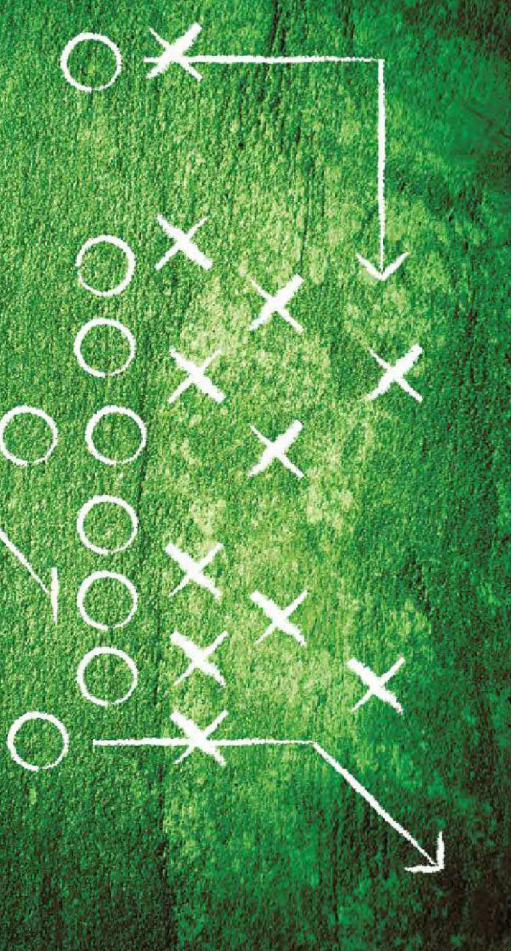
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Demand must fall in all sectors. Ethanol production from corn is forecast to decline by 10%, possibly more, and feed consumption of corn and DDGs will decline as well. Soybean crush will drop by a record

12% to a 17-year low 1.5 billion bushels, which then cuts soymeal production by 5.5 million tons. The United States just doesn’t have the soybeans to crush — unless they’re imported from South America next summer.

The first half of the soybean crop year will show heavy disappearance, followed by a steep decline. Soymeal users already find it nearly impossible to purchase meal past winter from some sellers, and only at extraordinarily high basis from others.

Soybean exports will fall 305M bushels to a seven-year low 1.1B bushels, yet export sales were already a record high 762M bushels by early September — mostly for shipment by late winter. This could mean near record-high



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weekly soybean exports until South America’s harvest begins about halfway through the U.S. crop year. By then U.S. exportable inventories could be nearly depleted anyway.

Regional dislocations will be pronounced at times due to the varied impact of the drought. The Midsouth and Delta states are already struggling with space; corn basis plummeted to -100 Dec in September on the combination of low water on the Mississippi, slow corn exports,

and the usual reluctance of exporters to fill vessels using only new-crop southern corn. At the same time, northern ethanol plants were bidding record premiums and finding little for sale.

Iowa’s entire soybean production is the lowest in a decade and less than Iowa typically crushes each year. Yet Arkansas, Louisiana and Mississippi will each harvest record soybean production, and Arkansas is wrapping up a record corn harvest, with Louisiana and Mississippi at

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their second largest corn crops ever. Iowa's corn crop is 400M bushels short of typical disappearance, but Minnesota's corn

crop is slightly above usage of recent years. These anomalies mean sellers need to watch markets outside their usual

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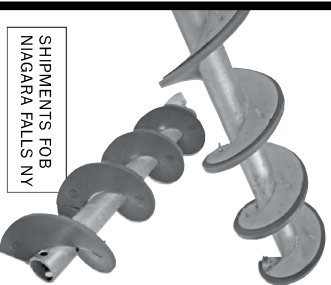
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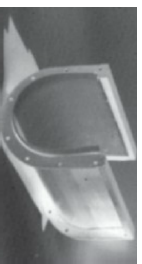
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Jason's granddad was right:

Listen to market signals. The 2012 U.S. corn crop is 1.1B bushels below last year's disappearance on corn and 500M bushels below on soybeans. But even so, the market doesn't need all of the bushels in the first month or two of the crop year. When local supplies are sufficient and farm/elevator selling fills the pipeline, carries will build through nearby basis weakening or deferred basis rising. The huge Delta corn crop pushed basis in September to -100 Dec along the river; yet bids for December remained around -0- Dec for a basis return of \$1/bushel for three months for folks who could buy and hold the corn. Some of the cheap corn moved north to elevators that wouldn't otherwise fill this fall. Follow the signals! Conversely, when nearby local supply or movement is *not* sufficient, basis will rise to draw out hedged inventory and then DP inventory, from

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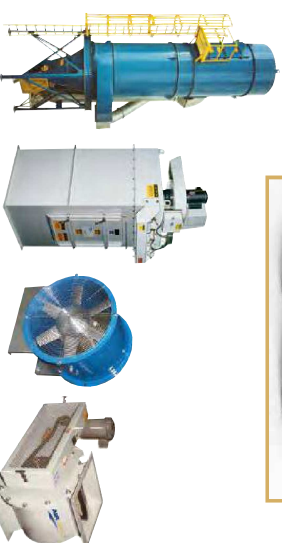
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local elevators. Deferred basis will tend to remain weaker in these cases, to discourage holding.

Futures spreads reflect fundamentals but are also pulled and tugged these days by outside forces. Managed money

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and even the algorithmic trading firms can quickly concentrate enough volume in nearby or deferred futures months to distort spreads as well — even if temporarily. (As funds built a record-large position in soybean futures, was it really “right” fundamentally for November 12 soybeans to trade as high as \$2.30 over July 13 or did it reflect “big money’s” focus on owning November futures?)

Carries can develop in futures, but they are not likely to be as generous as in recent years. December/March corn at 6-7¢ wouldn't be attractive most years, but it may be generous this season, for example.

Where futures remain inverted and basis is strong, markets tell hedgers to liquidate ownership. Follow the signals. The next step is to sell Delayed Price inventor(fes) and go short the basis. This turns a futures inverse in your favor; your farm customers will price their DP bushels later at what should be a lower

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basis. For example, shorting the basis on DP soybeans at some location at a basis of +20Jan for November delivery is a much higher basis value when futures are steeply inverted. On a recent day in harvest the Jan/March soybean inverse was 40¢ and Jan 13/July 13 was at a \$1.36 inverse.

+20 Jan sale for November

= +60 March (40¢ Jan/March inverse)

= +156 July (136¢ Jan/July 13 inverse)

Selling soybeans equivalent to +156 July and having farmers price them in early summer looks like a good

strategy. But if you plan to sell DP soybeans due to the inverse, also lock in the inverse by buying the deferred futures month and selling the nearby. Then when you sell the cash soybeans (against January futures for example) and take January futures, the January futures position is offset and the long hedge is fixed in the deferred months. You could lock in the inverse(s) in portions using different spreads, based on when you think producers are most likely to price.

Some firms are offering incentives to farmers to put soybeans on DP instead of storing their soybeans or putting them in farm bins. Such incentives could include no DP service charges

for soybeans priced by Aug. 31. Or the farmer might get a small premium over the elevator's published bid on any soybeans priced after May 1.

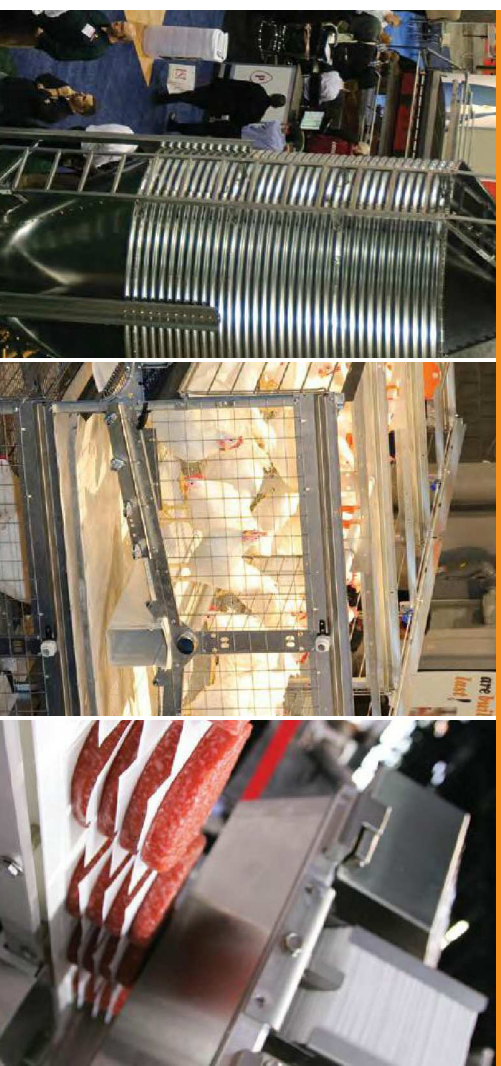
Futures often retreat seasonally during harvest but watch potential credit needs closely. Prices are higher this year and for many firms, the value of their total inventories may be no more than 10% above last year at this point. But if price has to work even higher to ration demand, your credit needs could escalate rapidly. Watch the signals.

■ **“Futures spreads reflect fundamentals, but are also pulled and tugged these days by outside forces.”** ■

Recognize that some traditional plays just won't work in a crop year such as 2012. Feed mills and crushers, for example, can't justify carrying owned-inventories of corn and soybeans from harvest until summer when corn or soybean futures are inverted, just to ensure having products you can offer for forward slots at traditional basis values. Doing things that make no economic sense is not the road to success. Instead, quote forward product basis as the market dictates — no matter how high the value is or how much the buyer may complain. You need to be compensated to take on the risks someone else is trying to eliminate. Train-loading firms will face special chal-



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lenges. Originating sufficient inventories will get tougher in many areas as the crop year progresses. Soybean exports

will fall dramatically by spring and corn will slow as well. Local domestic markets are going to dominate much of the

crop year, taking away freight advantages and putting small elevators on equal footing with sub-terminals.

Mike and Jason, along with

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