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July, 2014

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Upcoming Margin Management Seminars

Dairy, Aug 20-21 (Las Vegas)

Beef, Sep 16 (Twin Falls)

Lenders - Sep 17-18 (Chicago)

Hog, Dec 9-10 (Chicago)

Crop, Dec 17-18 (Chicago)

Dear Ag Industry Associate,

The margins of crop producers and those of livestock producers have certainly charted different courses so far in 2014. A large part of this divergent path stems from plummeting corn prices due to expectations for a huge crop harvest this season. Contributing editor, Mike Liautaud, explores the changing landscape for crop producers in 2014 as supply will exceed demand for the first time in several seasons. The dynamics of the current market are a reminder that a long-term view needs to be taken when managing forward profitability which Mike discusses in his article.

We also sat down with Jon Greteman this month who is a client service manager for CIH in Des Moines, Iowa. Jon likewise discusses the issues facing crop producers this season, and how they are managing their forward margins in the face of negative returns currently being projected. Jon highlights the importance of maintaining flexibility and preserving the opportunity to achieve profitability while protecting against further losses.

On that topic, another item we cover this month is the concept of implied volatility, and how this can be an objective measure of an option's cost. The current environment is lending itself more to the use of flexible strategy alternatives to manage forward profit margins, and we discuss how some producers may opt for these types of strategies despite what would otherwise be suggested by looking at their margin opportunities.

Finally, the latest margin watch projections for the crop, beef, hog and dairy industries are included as we track how profitability has changed over the month, and the factors driving those changes.

Sincerely,

Chip Whalen
Managing Editor
V.P. Of Education & Research
CIH

Managing Editor, Chip Whalen is the Vice President of Education and Research for CIH, a leader in Margin Management. Over the past 15 years, Mr. Whalen has lectured extensively throughout the country, introducing agricultural lenders, producers and industry associates to the margin approach to risk management. He has also written articles for many leading agricultural publications.

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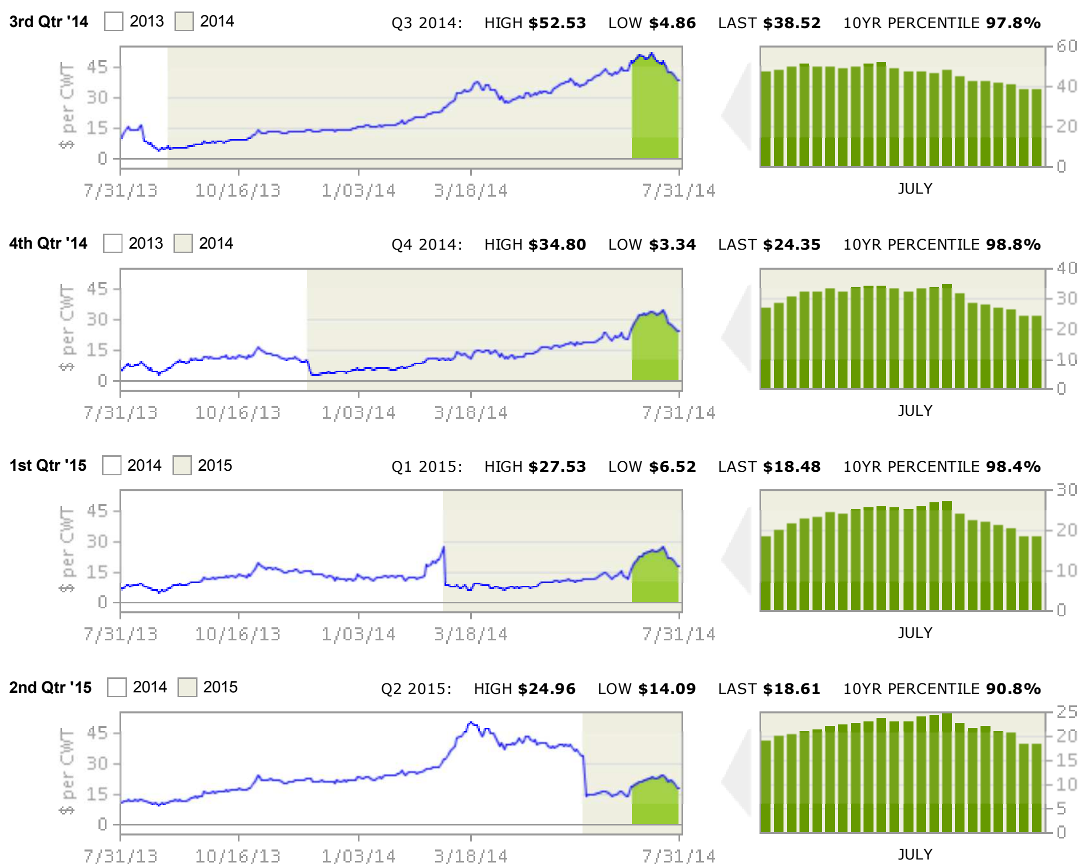
Hog Margin Watch: July

Hog margins dropped sharply since the middle of July, due entirely to weakness in hog prices as feed costs likewise were lower over the past two weeks. Despite the $5.00-$14.00/cwt. decline in margins over the last half of the month, hog margins still remain at or above the 98th percentile of the previous 10 years through the first quarter of 2015, and at the 90th percentile in Q2 of next year. Hog prices dropped the most in the nearby August and October contracts, despite the continued discount of spot futures to the CME Lean Hog index heading into expiration of the August contract. Ideas that expansion is occurring while PEDv accessions continue to decline is combining with the weakening trend in the cash market as indicated by the recent drop in the CME Lean Hog index and cutout values. Also, despite the fact that less hogs are coming to market, weights continue to make up much of the loss in terms of total pork production which is only down 1.1% year-to-date and even less than that at -0.4% when adjusted for actual slaughter days. Corn prices meanwhile continue to drop on ideas that yields will be much higher than what USDA is currently estimating. The next WASDE will be released August 12, and most traders expect a yield closer to 170 bushels/acre or above compared to the July forecast of 165.3 bpa. Crop conditions remain very high at 75% good-excellent, and are the highest since 2004 for the last week of July, which produced a record yield in that particular year. Our clients continue to build new margin coverage in deferred periods, and have been active recently making strategic adjustments to existing margin management strategies. In particular, the opportunity to add flexibility back to hog hedges following the significant decline in price looks attractive right now.



The Hog Margin calculation assumes that 73 lbs of soybean meal and 4.87 bushels of corn are required to produce 100 lean hog lbs. Additional assumed costs include $40 per cwt for other feed and non-feed expenses.

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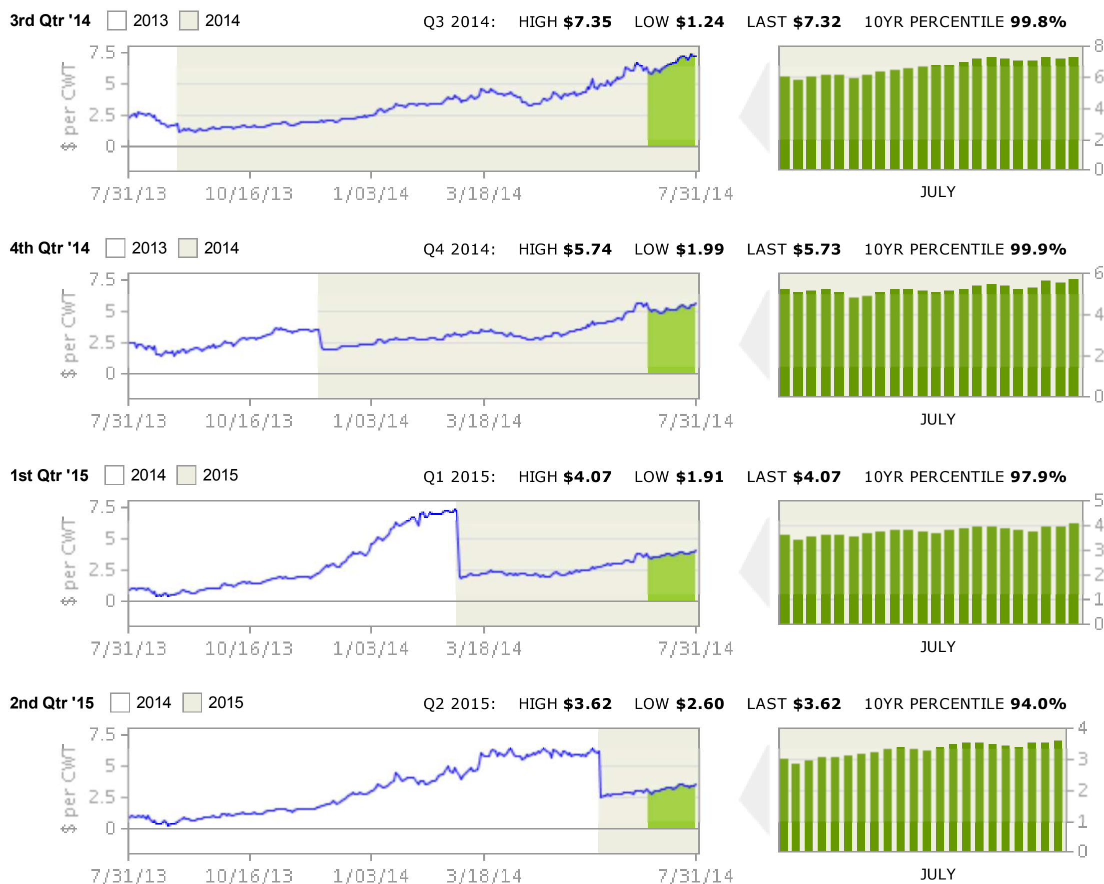
Dairy Margin Watch: July

Dairy margins improved since the middle of July, following a combination of both higher milk prices and lower feed costs. Margins remain very strong at well above the 90th percentile of the past 10 years through the first half of 2015, offering excellent opportunities to establish forward protection. Milk prices are drawing support from a decline in both cheese and butter stocks reported in the latest USDA Cold Storage report. Butter inventories on June 30 fell to 186 million pounds, down 3.3% from May and 41.6% lower than last year. The figure was also the lowest volume of butter stocks for the end of June in almost 10 years. Cheese stocks also declined to 1.06 billion pounds as of June 30, down 0.4% from May and 7.6% lower than last year. There are other head winds though for milk prices moving forward. China's milk powder imports appear to be slowing with June imports of WMP down 33% from May on a daily average basis, while Fonterra's latest forecast for farmgate milk prices is down from their initial estimate due to declining global dairy prices and high stocks in China. There are also signs of expansion with a continued decline in dairy cow slaughter which is down 9.4% year-to-date. Feed costs remain contained as corn has sunk to new lows on expectations of higher yields to be forecast in the upcoming August WASDE. Crop conditions at 75% good-excellent are the highest since 2004 for late July, and the fifth best crop rating for this time since records began in 1986. Our clients continue to scale into margin protection for deferred periods with flexible strategies that can benefit from a potential improvement in margin over time. Despite historically strong margins currently being projected, low implied volatility is making flexible strategies more attractive, and use of these strategies has become increasingly popular even in spite of the current margin strength.



The Dairy Margin calculation assumes, using a feed price correlation model, that for a typical dairy 62.4 lbs of corn (or equivalent) and 7.34 lbs of meal (or equivalent) are required to produce 100 lbs of milk (includes dry cows, excludes heifers not yet fresh). Additional assumed costs include $0.90/cwt for other, non-correlating feeds, $2.65/cwt for corn and meal basis, and $7.00/cwt for non-feed expenses. Milk basis is $0.75/cwt and non-milk revenue is $1.00/cwt.

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Written by Chip Whalen, Managing Editor

The Relative Cost of Options

Many producers have increasingly turned to using options in their margin management plans over the past several years. I think there have been several factors that have contributed to this trend. First, there has been quite a bit of volatility in both profit margins across the various livestock and crop industries, as well as the prices of the individual commodities that comprise the costs and revenues of those industries. We have seen record high prices in many of these commodities recently, including corn, wheat, soybeans, cattle, milk and hogs. We have also witnessed significant price moves both up and down in each of these commodities. Options provide price protection while offering opportunity. With greater fluctuation in price, the opportunity cost of simply fixing a price level as opposed to protecting a price level increases. Second, I think there has been an increased level of understanding in how options work and the effective use of these tools to protect price levels and profit margins. While there is still quite a bit of education that is needed to help agricultural producers feel more comfortable using these strategies in their margin management plans, we have certainly seen more adoption of options going into producers' toolboxes over time.

A common objection to using options however remains the cost of the premium paid for maintaining the flexibility that they provide. It is certainly true that options carry a cost, and this cost can be substantial depending on many factors including how much time is remaining to the option's expiration and how volatile the underlying price of the commodity has been. One way to measure the relative cost of an option is to consider its implied volatility. This is calculated by taking the option's premium and plugging it into a model with other inputs such as the time to expiration, interest rates, the option's strike price, and volatility of the underlying futures contract upon which the option is priced. The resulting value of implied volatility can then be used to measure the nominal premium of the option within an objective context so that it can be evaluated effectively. As a general note, the nominal premium of an option can rise simply as a function of an increase in price in the underlying commodity. As an example, if corn is trading at $7.00/bushel, the nominal premium of options to protect a purchase or sale price at that level is going to be higher than if corn is trading at $3.50/bushel, simply as a function of corn being twice as expensive. This does not necessarily mean that the implied volatility of those options is higher however.

> ***"Options provide price protection while offering opportunity."***

Implied volatility has to do with the market's perception of how volatile the underlying commodity's price will be in a future time period. If in the previous example, there is widespread uncertainty as to whether corn is trading at the $7.00 price level on its way to $10.00, or if the price is primed for a crash back down to $4.00, this is very different than a perception that corn is going to stay around the $7.00 price level

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FALL/WINTER 2014 Educational Programs

Dairy Margin Management (Vegas) Aug 20-21
Beef Margin Management (Twin Falls) Sep 16
Margin Management for Lenders (Chicago) Sep 17-18
Beef Margin Managment (Fort Morgan, CO) Oct 7
Beef Margin Management (Garden City, KS) Oct 28
Strategic Position Mangement (Clients Only) Nov 11
Beef Margin Management (West Point, NE) Nov 18
Hog Margin Management (Chicago) Dec 9-10
Crop Margin Management (Chicago) Dec 17-18

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plus or minus $1.00 relative to the dynamics in play at that point in time. In the present environment, corn has experienced a significant drop in price over the past few months. The main fundamental factor contributing to this decline is the expectation of a record-large crop to be harvested this fall with production exceeding total demand for the first time since the 2009-10 marketing year. The resulting increase in total corn stocks both in absolute terms as well as in relation to total usage is expected to keep a lid on prices and act as an impediment to any rally attempt over the medium-term. At the same time though, lower prices have boosted margins for a number of industries including livestock feeding and ethanol production. Lower corn prices will also make exports more attractive to foreign buyers, although the U.S. dollar has recently been showing strength. Increased demand will offer support to corn prices which will probably begin to temper further losses following the significant drop in price we have already experienced.

Given parallel expectations for limited upside potential and limited further downside pressure, the market's collective expectation for corn prices has become one of a compressed range which can be thought of in terms of reduced volatility moving forward for a significant move in either direction. Whether or not this expectation plays out with actual price action in the weeks and months ahead, the result is lower option premiums across all strike prices for several months forward in time. What does this mean from a hedger's perspective in trying to manage forward margins? Consider the crop producer on the one hand. Here, margins are depressed and actually negative for both the current crop in the ground as well as the 2015 production. The obvious choice here would be to use a flexible strategy in order to preserve the opportunity for a positive margin over time. Therefore, an option position would make sense for a crop producer given their current projected profit margins. Now consider the livestock or ethanol producer. Here, the margin may not only be positive, but may actually be very strong from a historical perspective. The inclination would be to "lock-in" the projected strong margin opportunity, although the implied volatility is suggesting otherwise.

One way of thinking about options in a low volatility environment is that the premium is depressed in relative terms and therefore "on sale." The chart on the following page shows the implied volatility of March 2015 Corn options:

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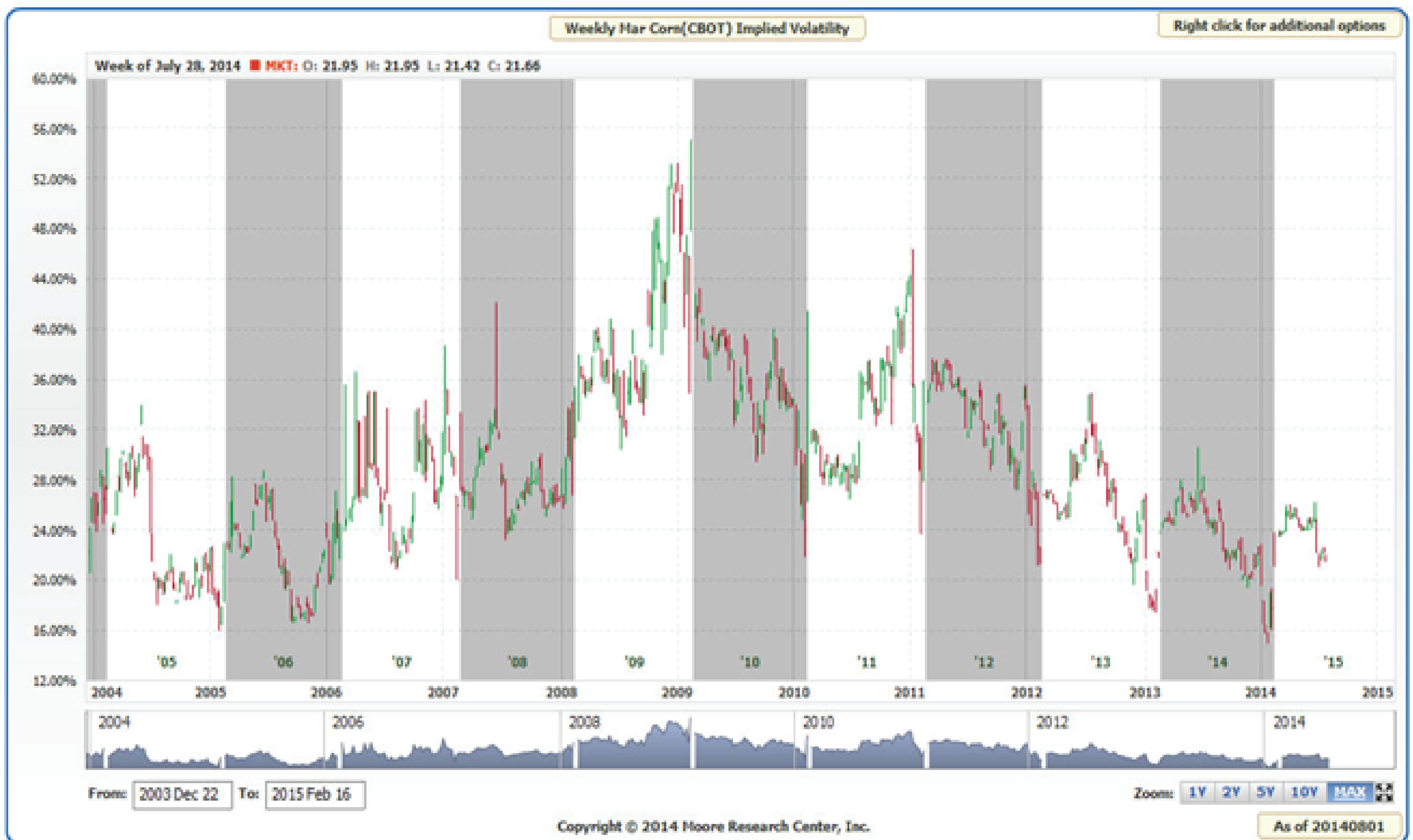


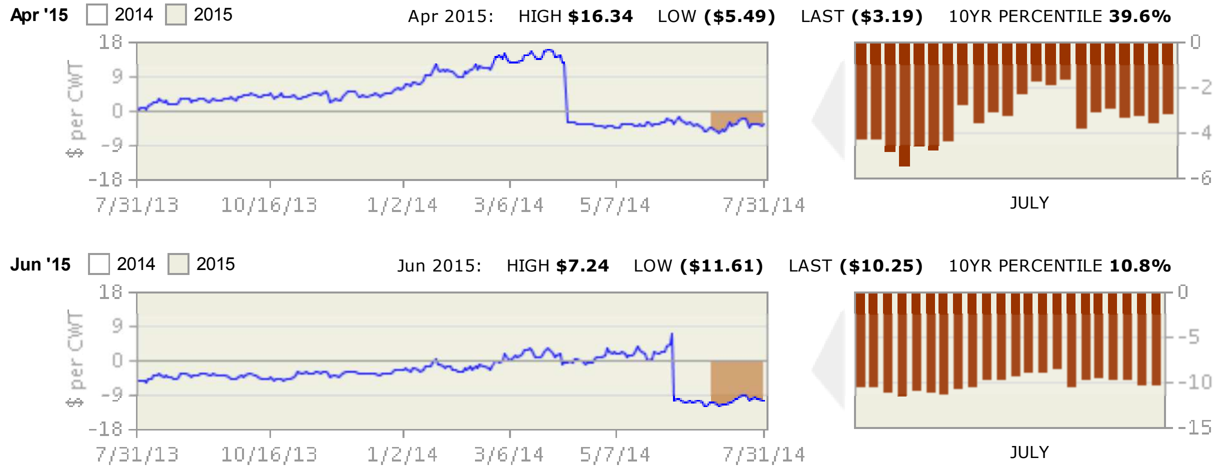
The chart plots where implied volatility for the March Corn options has traded relative to where it is currently priced today. Current implied volatility is trading around 21%-22%. From a historical perspective, implied volatility under 20% is cheap when looking at the chart going back 10 years to 2004 while implied volatility over 40% would be considered expensive. When you purchase an option, you own a right to a purchase or sale price of the underlying commodity at a certain level over a period of time. In other words, you own an asset that is depreciating as a function of time decay and how close the option is to expiration. In a low volatility environment (such as we have today with corn), you are purchasing a deflated asset in that expectations are muted for a significant price move over a period of time. In a high volatility environment by contrast, you would be purchasing an inflated asset where the loss of premium through time decay may become more pronounced if volatility begins to contract.

Getting back to the livestock or ethanol producer and managing forward profit margins in those industries, it may be better to use flexible strategies to protect margins given the low implied volatility of options because the premium is attractively valued or priced. Ideally, the margin improves over time where the flexibility can be traded out for a fixed price commitment, but incorporating more flexibility into margin management strategies can be a distinct benefit in a low implied volatility environment. While the choice of using one strategy alternative over another will come down to the individual preferences of different operations and their unique considerations and risk profiles, the current low implied volatility of corn and other commodities for that matter should not be overlooked when evaluating various strategies that can be used to manage forward profit margins. ■

Beef Margin Watch: July

Beef margins were generally stronger since the middle of July, with the exception of deferred margins against the February and April 2015 marketing periods where feeder costs are still open relative to fat cattle values. Cattle and corn prices have been moving in opposite directions over the past two weeks, with the cattle market posting new highs while corn has been printing new lows. Beef finishing margins remain historically strong through the February marketing period, above the 90th percentile of the previous 10 years while April and especially June margins are historically depressed. Cattle prices have drawn support from the latest monthly Cold Storage and Cattle on Feed reports from USDA. Total beef stocks at the end of June were 357.8 million pounds, down 25.7% from last year and 18.4% below the five year average. Boneless beef stocks are especially tight, with prices up 40% from last year and moving higher counter-seasonally during the month of July. The Cattle on Feed report showed June placements of 1.455 million head, the smallest June placement level since 2009 and down 6.2% from last year when the market was expecting a 3.8% decline on average. In addition, the semi-annual cattle inventory survey results were likewise bullish with 4.1 million head of heifers held back for beef cow replacement, down 2.1% from 2012 as there was no survey last year due to the government sequester. The beef cow herd at 29.7 million head was also 2.5% smaller than 2012, with the 2014 calf crop estimated at 33.6 million head which would be the smallest since 1948. The combined data suggest a continued tightening of cattle and beef supplies in the months ahead, while rebuilding efforts remain slow. Corn prices have been pressured by expectations for a larger yield to be reported in the August WASDE, with crop conditions at 75% good-excellent – the highest since 2004 for this point in late July. Our consultants continue to evaluate flexible positions with clients given the historically low implied volatility which has allowed these strategies to be more attractive as a margin management alternative.

Live Cattle Marketing Periods:



The Beef Margin calculation uses Feeder Cattle futures to price inbound animals and assumes each will consume 55 bushels of corn and cost approximately $250 per head (for other feed and non-feed expenses) to gain 550 pounds and reach a market weight of 1,250 pounds.

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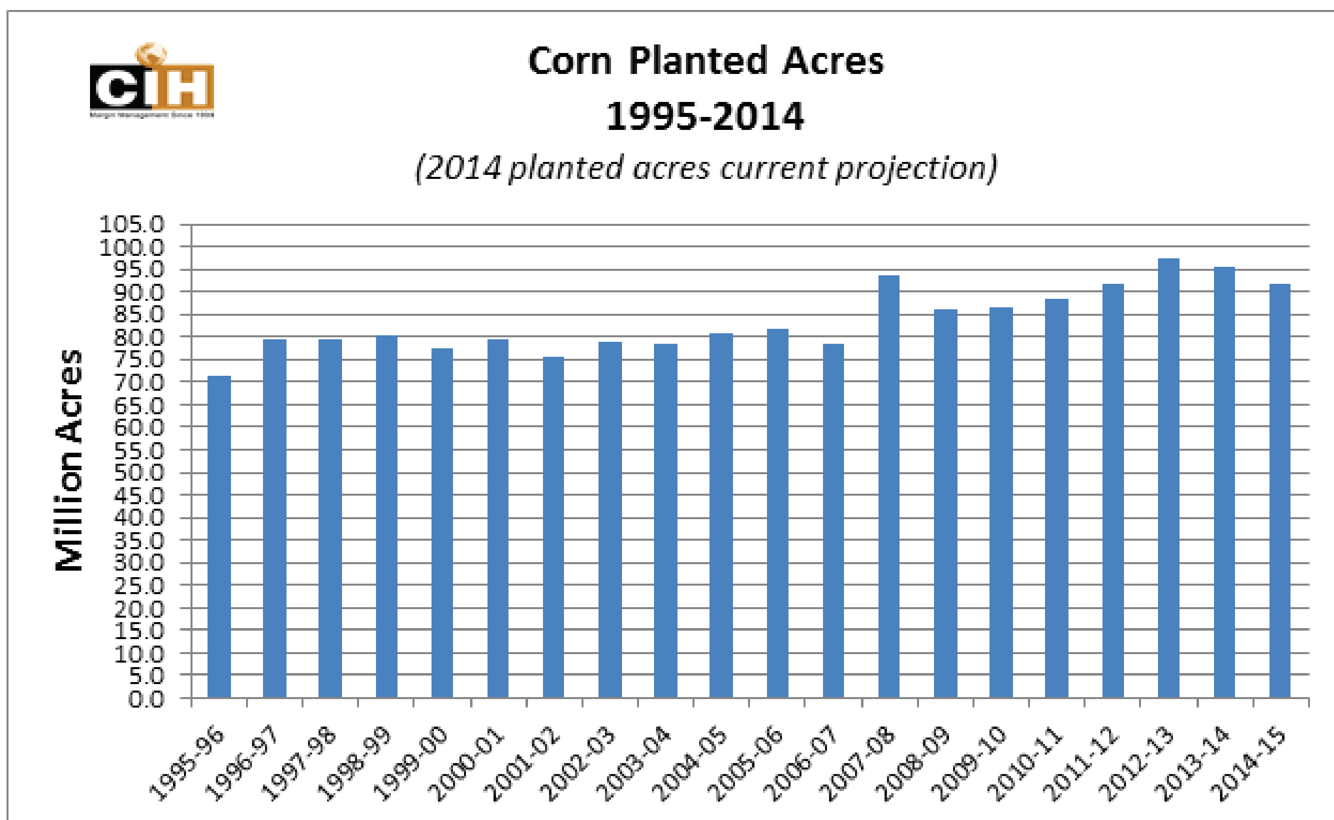
Written by Michael Liautaud, Editor

Changing Dynamics for Crop Producers

As a general note, declining feed prices have been a boon for the livestock industry. For crop producers, the foreseeable future looks to be a rough road in terms of profitability. Spot corn prices are back to levels last seen in 2010 while cost of production in most areas is significantly higher than previous years. The situation has producers staring at a deeper shade of red on the balance sheets than they've seen for some time.

The charts below illustrate how the market has gotten to this point. Starting in 2002, the USDA began breaking out ethanol as its own demand category on the monthly World Agricultural Supply and Demand Estimate report. Each year, corn used for ethanol increased and in 2005 the Energy Policy Act mandated an annual consumption of 7.5 billion gallons of ethanol by the year 2012. Two years later in 2007, the mandate was increased to 15 billion gallons of ethanol by 2015. While the mandate is lower today, producers and possibly more importantly end users understood that the available supply of corn was likely to diminish substantially. Although yields continued to set records through 2004, it was clear by 2007 that farmers needed to commit more crop ground to corn as demand expanded and prices rose. In 2007, farmers committed 93.5 million acres to corn an increase of 19% over the previous year and the largest seeded corn area since 1943. Planted area has leveled off and varied in a small range since.



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Corn margins have deteriorated further to finish July as expectations for better yields dominate current pricing. Crop conditions have remained stable at historically high levels with the latest condition report showing 75% of the domestic crop rated in good-to-excellent condition. The overall crop ranks as the fifth best crop since 1986 as cooler weather and adequate moisture have allowed for a nearly perfect pollination of this year's corn crop. The upcoming August USDA supply and demand report will be the first to incorporate a survey-based analysis of actual yields and will help the marketplace reign in a more accurate picture of the coming supply. The trade continues to openly debate better yields than are currently forecast. Without any significant increases in demand categories, the trend of larger expected ending stocks is likely to continue. Adding to new crop price pressures has been the farmer's need to clear space in the bins for the upcoming harvest. The June 30 Quarterly Stocks report revealed that corn on farm in storage amounted to roughly 1.86 billion bushels or nearly 600 million bushels more than last year as of June 1. On the demand side, new crop export sales to date amount to 274 million bushels, behind last year's pace by 61 million bushels. The Brazilian government recently approved subsidies to either the farmer or logistical company that wishes to transport corn from the interior to export terminals. The move is expected to add to the current global export competition U.S. exporters currently face. Nearby corn margins are currently at the 5th percentile of the last five years while deferred 2014 corn margins are at the 13th percentile. Our consultants are working with clients discussing margin protection of these forward values, maintaining flexibility with strategy alternatives. Given that the market has continued to fall, some of our clients continue to consider adjustments to current coverage that would create a range of protection to lower prices with consideration to crop insurance levels while preserving the opportunity for margins to improve in the event prices move higher.

The estimated yield for the 2014 crop is 180 bushels per acre and the non-land operating cost is $612 per acre. Land cost for 2014 is estimated at $243 per acre [1]. Basis for the 2014 crop is estimated at $-0.13 per bushel.

The estimated yield for the 2015 crop is 180 bushels per acre and the estimated operating cost is $612 per acre. Land cost for 2015 is estimated at $243 per acre [1]. Basis for the 2015 crop is estimated at $-0.2 per bushel.

[1] The Corn Margin Watch yield, land and non-land operating cost values are based upon central Illinois low productivity farmland crop estimates in the "Historic Corn, Soybean, Wheat, and Double-crop Soybeans" report published by the Department of Agricultural and Consumer Economics at the University of Illinois.

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On the demand side, corn use for ethanol was growing rapidly, which helped producer's nearby profitability but also created a negative of sorts in higher values of land and input costs. While prices were edging higher, for the cash rent producer, cost of production was moving higher as well. Fast forward to the last couple of years where corn demand to produce ethanol has plateaued to a degree and you get the situation producers are faced with today, a period where supply is exceeding demand.

Where does this leave the crop producer moving forward? Nearby and deferred margins are currently negative and little can be done at this point to secure a profitable situation. While there are strategies a producer could employ to mitigate any further deterioration, unless market prices move higher, producers will face losses in the coming months. Producers have been rewarded with the 'do nothing' strategy in previous years but will likely need to become more proactive in managing forward profit margins. This entails starting with a plan, a margin management policy that looks farther out in time at forward margin opportunities and actively managing those.

Year	**Corn Used for Ethanol** *(Billion Bushels)*	**Year-over-Year % Change**
2003-04	1.168	17.3%
2004-05	1.323	13.3%
2005-06	1.603	21.2%
2006-07	2.150	34.1%
2007-08	3.049	41.8%
2008-09	3.677	20.6%
2009-10	4.591	24.9%
2010-11	5.021	9.4%
2011-12	5.011	-0.2%
2012-13	4.648	-7.2%
*2013-14	5.075 *estimated*	9.2%
*2014-15	5.050 *estimated*	-0.5%

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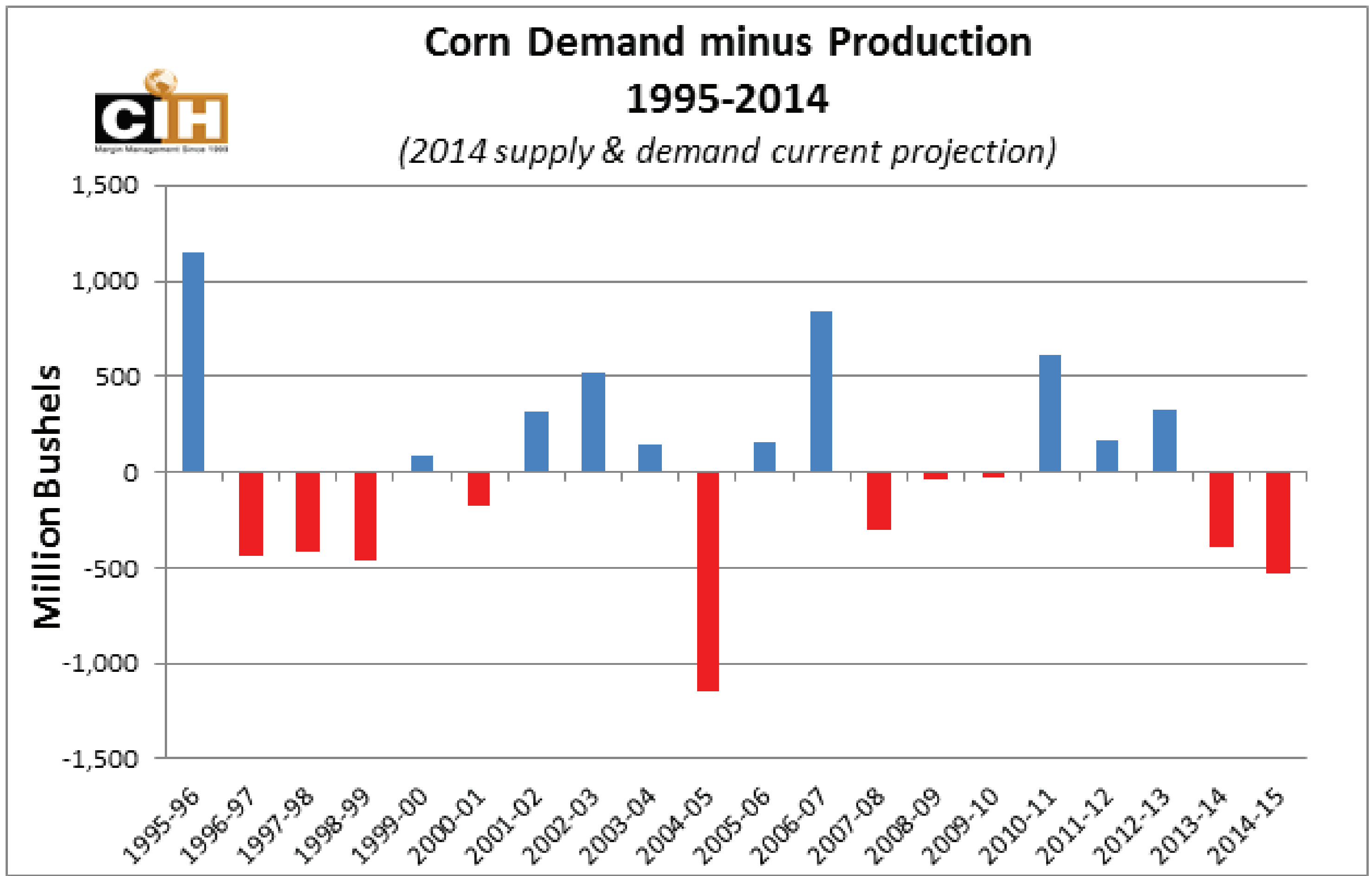

Although the current situation for the 2015-16 corn marketing year likely represents a loss for many producers, it was projecting a profit last summer. Some producers have enacted a margin management plan that will look 2 to 3 crop years ahead as supply and demand dynamics change over time. Those producers have benefitted by actively managing their forward margins and making adjustments to protection strategies over time. These producers have come to realize that managing those protection strategies further out in time than they normally would have has allowed them to stay ahead over the long run and achieve goals they've set as an organization. ■

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Soybeans Margin Watch: July

Soybean margins have deteriorated slightly since the middle of July as weather conditions continue to point to great yields come harvest. Crop conditions have remained stable at historically high levels with the latest crop condition report showing 71% of the domestic crop in good-to-excellent condition. While current conditions remain ideal, August heat and precipitation will ultimately determine this year's soybean crop. The upcoming USDA supply and demand report may incorporate adjustments to current yield projections as NASS incorporates June and July weather statistics into their yield projection model. Adding to increasing supply worries has been news that China is asking the USDA to issue non GMO certification letters on any and all DDGs that are exported to their country and has issued an import ban on any shipments that do not contain the certification. Considering the USDA does not currently support such a request, exports of DDGs to China has effectively been shut down. Regarding export sales, cumulative sales in the new crop position amount to 588 million bushels, up 37 million bushels from the same point last year. The USDA expects exporters to ship 1.675 billion bushels in the coming crop year. The elevated sales go a long way in justifying that expectation. Soybean meal sales, too, are quite elevated as exporters have committed 3.66 million metric tons for future delivery compared to 1.39 million metric tons at the same point last year. Both nearby as well as deferred 2015 soybean margins are now at the 24th percentile of the last five years. Our consultants are working with clients to manage these forward profit margins. Given that New-Crop margins have continued to fall, some of our clients are considering flexible margin protection strategies on any new coverage as well as adjustments to current protection strategies that would provide protection to all lower prices while retaining the flexibility to participate in higher margins should prices improve.

The estimated yield for the 2014 crop is 52 bushels per acre and the non-land operating cost is $364 per acre. Land cost for 2014 is estimated at $243 per acre [1]. Basis for the 2014 crop is estimated at $-0.2 per bushel.

The estimated yield for the 2015 crop is 52 bushels per acre and the estimated operating cost is $364 per acre. Land cost for 2015 is estimated at $243 per acre [1]. Basis for the 2015 crop is estimated at $-0.3 per bushel.

[1] *The Soybeans Margin Watch yield, land and non-land operating cost values are based upon central Illinois low productivity farmland crop estimates in the "Historic Corn, Soybean, Wheat, and Double-crop Soybeans" report published by the Department of Agricultural and Consumer Economics at the University of Illinois.*

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Wheat Margin Watch: July

Wheat margins continued to deteriorate since the middle of July on continued weakness in the global marketplace. Domestically, the spring crop continues to develop well as weather conditions remain ideal. Most recently, NASS reported the crop to be 70% in good-to-excellent condition, above average for this point in the year. The Wheat Quality Council has begun its crop tour and has reported excellent yields in North Dakota. The council sees yields averaging 48.6 in the state up from 44.9 last year and would represent the best yields since the tour's beginning. The better yields help confirm the USDA's production increase in the recent supply and demand report. On the global front, Russian wheat is currently the world's cheapest supply as the Ruble has fallen sharply on geopolitical fears. Further, new crop production in Russia continues to be estimated at higher levels as market participants expect 4 to 6 million metric tons to be harvested above the current expectation of 53 million metric tons. However, the elevation of sanctions against Russia has importers worried about future supply availability out of the Black Sea. In the E.U., harvest has been slowed as rains have created difficulty in the fields. There have been reports of damage to the crop due to weather but that the damage is not widespread. Nearby wheat margins are now at the 12th percentile of the past five years with deferred 2014 wheat margins now at the 18th percentile. Our consultants continue working with clients to protect these forward margins with flexible strategies that will allow for potential margin improvement over time. Given the continued weakness in futures' prices and the continued rumblings of international conflict, some of our clients are considering adjustments to current protection strategies that would protect a range of lower prices while still preserving the opportunity to participate in higher prices should the market rebound.

The estimated yield for the 2014 crop is 67 bushels per acre and the non-land operating cost is $366 per acre. Land cost for 2014 is estimated at $163 per acre [1]. Basis for the 2014 crop is estimated at $-0.1 per bushel.

The estimated yield for the 2015 crop is 67 bushels per acre and the estimated operating cost is $366 per acre. Land cost for 2015 is estimated at $163 per acre [1]. Basis for the 2015 crop is estimated at $-0.1 per bushel.

[1] The Wheat Margin Watch yield, land and non-land operating cost values are based upon central Illinois low productivity farmland crop estimates in the "Historic Corn, Soybean, Wheat, and Double-crop Soybeans" report published by the Department of Agricultural and Consumer Economics at the University of Illinois.

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INTERVIEW

Discussing the real-world application of the margin approach

A Conversation with Crop and Hog Margin Consultant, Jon Greteman

This conversation took place by phone between Brendan Dorais, Manager of Business Development and Jon, who works from CIH's Des Monies office.

BD: How will the current production risk issues (pedv) effect hog marketing decisions going forward?

JG: PEDV is certainly a risk that margin management plans can take into account. In general, producers are leaving a significant portion of deferred coverage (beyond 6 months out) in more flexible type strategies in case production issues cause their hog marketings to change.

BD: How can I protect extremely strong deferred hog margins but participate in improving margins if we have similar markets next year?

JG: Due to this year's record setting hog market, a lot of producers are anxious to build hedging strategies that allow them to participate in margin improvement. We can assist them in understanding and building strategies that protect stong margins, but also allow them to improve if market conditions allow.

BD: What can I do to protect 2015 corn prices from deteriorating?

JG: 2015 corn prices are materially higher than nearby prices and offer more attractive margin opportunities. Using options leaves flexibility in case planting and crop development next year are less than ideal.

BD: What can I do to prevent current crop margins from further erosion?

JG: Options are an attractive way of protecting margins while leaving some flexibility. As Chip's article on options volatility points out, they are also relatively inexpensive right now. We can use puts to mitigate further downside risk or purchase calls to reopen upside against sales. Either way, they enable you to add protection while allowing participation if market psychology changes.

> *"Managing margins further out in time gives clients the confidence to be able to make expansion decisions and lock in profits when the opportunity is there."*

BD: How can I take advantage of storage I have?

JG: There is currently a significant carry in both the corn and bean markets. It may make sense to add coverage in deferred periods rather than nearby. You may also benefit from getting away from harvest basis during a potential record harvest.

BD: An opportunity has come up to rent additional land. What can I do to protect myself if I sign a longer term rent contract?

JG: Managing margins further out in time gives clients the confidence to be able to make expansion decisions and lock in profits when the opportunity is there. ■

Futures and options trading involves the risk of loss.