

# TIMELY INFORMATION

## Agriculture & Natural Resources

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### **2009 Wheat Crop Marketing: Never assume a trend will last forever. It won't.**

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Today, as harvest approaches, the wheat market is trading down for the third day in a row. July wheat started the week over \$5.70 on the board and right now is down 20 cents on the day at \$5.27 ½. Tuesday morning and Wednesday morning the chart gapped down, opening lower than the previous day's close. These are not good signs for wheat growers.

Compounding the problem of generally low price – and it takes \$5 wheat to cover your expenses on a \$400 per acre wheat crop – is the radical turn for the worse our basis at harvest has been the last two years. It seemed like last year whenever wheat price on the board went up a dime, our basis went up a dime too, resulting in no net gain for the farmer. When prices fell on the board, basis didn't seem to fall as much, compounding the hit to farm revenue. The only saving grace last year was that in many parts of Alabama the wheat harvest was excellent. In fact, the 71 bushels per acre yield shattered the old record by 13 bushels. For the farmers in the areas hit by poor weather, the high costs were hard to cover and wheat was produced at a loss.

This year, the scenario seems to be worse than last year. High cost of production coupled with lower prices, a high basis, and virtually complete price uncertainty means that only farmers producing top yields can expect a profit. It is normal that farmers in this situation look to squeeze every dime out of their crop that they can, and look for some way to protect a price floor while hoping to participate in a future price rise.

Buying a Put option on a futures contract is the only way to do this. Unfortunately, this kind of “crop insurance” is not cheap. Put options may be purchased at a wide range of “Strike Prices” for any month of the year that wheat is traded on the Chicago Board of Trade. The strike price denotes the price of wheat at which the option allows you to “put” a contract onto the seller of the option. In other words, if you bought a put option with a \$5 strike price, you would have the option to make someone buy from you a futures contract for 5,000 bushels of wheat at \$5 per bushel. When you sell your wheat crop on the cash market, the action of offsetting that sale by buying back your contract from the futures market is what actually provides the hedge. Naturally, you would only do this if wheat price on the board was less than \$5. That's what an option provides – the right but not the obligation to enter into a contract with another party. You wouldn't want to make someone sell you a wheat contract at \$4 and buy it back at \$5. You want to make someone sell you a contract for \$5 and buy it back for \$4, thus making \$1 on the trade.

According to today's market, and this fluctuates all the time, you would have to pay someone 32 ½ cents per bushel (the price went up ½ cent while I was watching) for a \$5 put option on July wheat. Your net hedged price with that \$5 put would then be the \$5 strike price less the 32 cent premium less your local basis. If your basis is going to be around \$1.50, your price floor would be \$3.17. You should be able to see the problem with using Puts at this point right off. Why would you want to put a price floor in at \$3.17? Even a \$5.20 Put costing nearly 40 cents per bushel only buys you a \$3.30 price floor.

With Put options, the higher the strike price, the higher the premium, so with a lower the strike price you pay a lower premium. Unfortunately, a lower strike price puts an even lower floor on your effective hedge price.

Call options give you the right (but not the obligation) to do the reverse of the Put, to make someone sell you a contract at the strike price. You would typically use a call option at harvest as "synthetic storage". At this point in the wheat season, I would be looking at September or December. December wheat is trading now at \$5.72 (down 22 cents on the day) and premium on the \$7 Call option is 50 cents. So one good strategy might be to sell your wheat at harvest and buy call options that will increase in value as wheat prices climb.

There is time, and if prices go lower, these Call option strike prices will also fall.

You might think there is money to be made by trading futures options, and you would be right. It is possible and even legal to buy both a Put and a Call option on the same commodity contract. The theory behind this is that when prices change, going either up or down, one option will decrease in value but that loss will be more than offset by the increase in value of the other. Unfortunately, this strategy seldom works. Premium prices reflect very well the volatility in the market, and usually, unless something really big happens, you don't make enough in the one to cover the premium of the other. Remember, over the long haul money in the futures market can't be made by you. It will only be made by floor traders and speculators and even most of them lose their shirt eventually.

So, in summary, it might be too late to set a realistic price floor for your wheat harvest this year. If prices recover watch the market for your chance. As prices rise, the Put options will get cheaper. But, the lower prices go now, the cheaper the Call option for the synthetic storage will be, and it might be possible to recover some of your losses at harvest when prices recover this fall. Also, nothing prevents you from using a combination of these two basic market strategies.