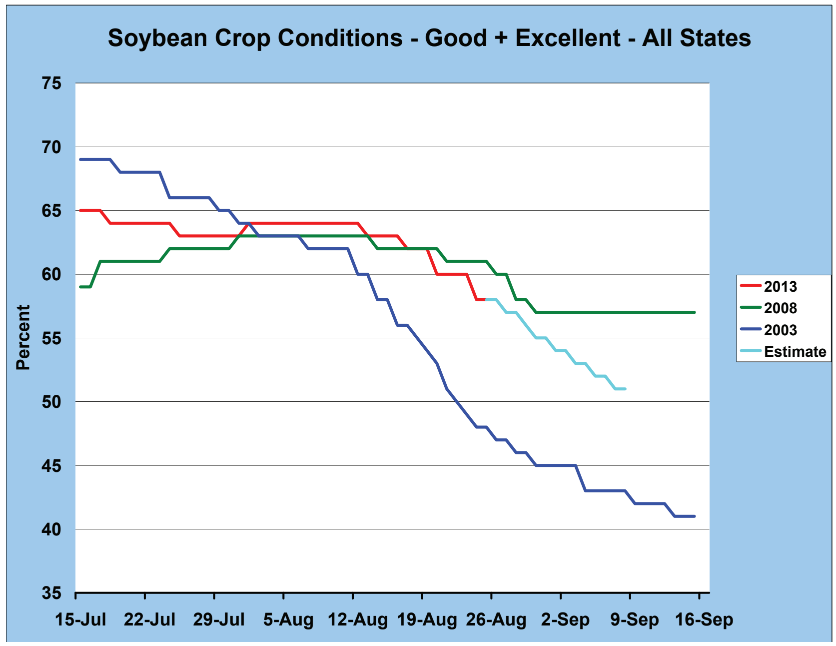
August 29, 2013

Volatility Opportunity in Soybeans

The soybean market is at a major inflection point for the 2013/14 crop season, and the Tuesday following the Labor Day weekend could confirm either that a major top was put in place with the sweeping reversal on August 27th or that the market is beginning another leg higher.

Will we get 85% coverage of 1/2 inch or more of rain for the entire Midwest over the weekend, or will we get 50% coverage of 1/10 to 1/4 inch? The difference could be significant. With a good portion of the crop still setting pods and nearly 40% of the central Midwest crop under significant stress, a decent rain could be a significant factor for yield. This August will rank as one of the driest on record for the central Midwest, and August moisture is one of the key variables in determining whether soybean yield will be above or below trend.

Many traders are already expecting another decline in soybean crop conditions for the weekly update on Tuesday, September 3rd, and if there is still low rain coverage next week, conditions may be down again for the following update on Monday, September 9th. The chart on the right shows our estimates of how conditions could trend if it remains drier than normal over the next few weeks.



This Special Report was prepared by

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Since mid-July the portion of the crop rated good to excellent has dropped from 65% to 58%. But the crop may be in even worse shape than these numbers indicate. In many cases soybeans may still "look good" from the road when in reality the stress the plants experience during the critical reproductive period may have more of an impact on the yield. The current drop in conditions appears to be similar to the 2003 and 2008 crop years (see chart on page 1). Both of these years saw below trendline yields, with 2003 coming in 13.7% below trend at 33.9 bushels per acre and 2008 coming in nearly 4% below trend yield. August rainfall was lacking in those years as well.

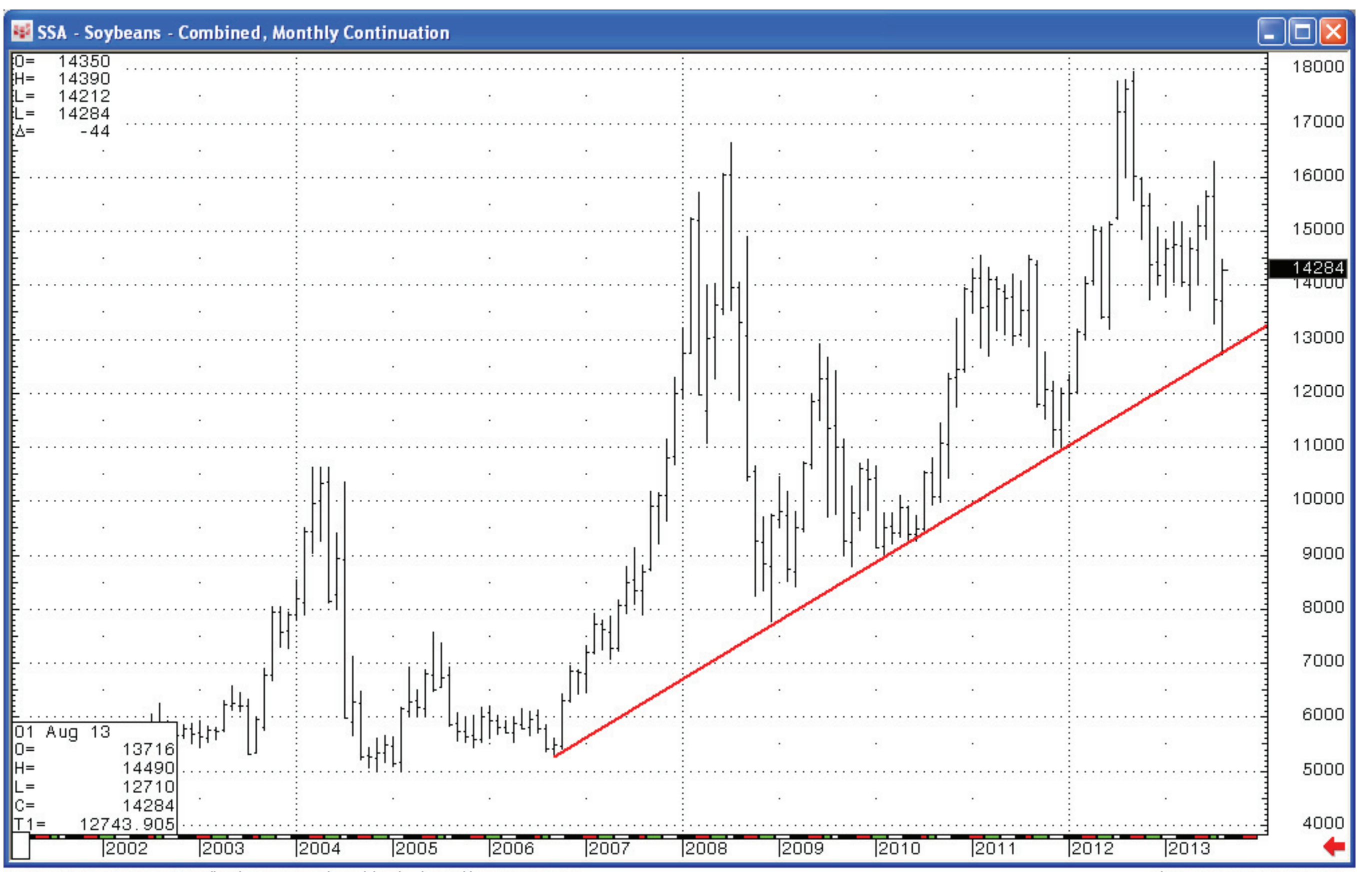
The USDA's yield estimate for 2013/14 is currently at 42.6 bushels per acre, up from 39.6 in 2012/13. Some meteorologists are predicting that this August could prove to be the driest on record for the US Midwest. Other historically dry Augusts were 1971, 1976, 1984, 2003, and 2008. In 1971 the USDA's production estimate fell by 4.8% from the August report to the final report. It fell by 4.1% in 1976, 8.6% in 1984, 14.3% in 2003, and only 0.2% in 2008.

The average decline across all of those years is 6.4%. If we were to assume that rate of decline for this year, production could eventually slip to 3.046 billion bushels, a 209 million-bushel decline from the August forecast. Ending stocks are currently estimated at 220 million. If production falls by 209 million, the market will need to move to a high enough price level to reduce demand by at least 120 million bushels.

On top of the lack of moisture, the soybean market will face the potential for additional losses if the forecast turns colder during September.

Technical Setup

Technical analysis also points to a major inflection point ahead for soybeans. The bear case is simple. Relative strength hit 80 on Monday, and open interest was up more than 100,000 contracts in just 14 trading sessions, suggesting an overbought condition. November soybeans hit $14.09 1/2 on Monday against a $14.09 3/4 contract high from September 12, 2012 before closing lower on the day. The reversal and double top is seen as a bearish indicator.



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The bulls will argue that Monday's gap through the June highs constitutes a bullish setup and suggests another leg higher. Trend-following funds are just beginning to buy the market. They were net long just 61,000 contracts as of August 20th versus the record net long of 224,822 contracts set in May 2012. Bulls also remind us of the old technical adage "double tops rarely hold and triple tops never hold." Meal gapped into contract highs on Monday, and the soybean monthly continuation chart held the major uptrend channel off of the 2006 lows.

Is this a risky weekend to stand aside, or it is an opportunity for well-positioned traders?

The bull case would point to the deteriorating yield potential and a possible run to $15.04 for November soybeans. The bear case would look for late season rains to hold yield potential firm, and it would cite the 6% jump in Brazil planted area and a surge in global oilseed production as additional factors that could drive November soybeans back to the $12.63 to $12.29 zone.

Volatility strategy:

1) **Bear Leg**: SELL 1 October Soybean $13.50 put at 30 cents, and BUY 2 November Soybean $12.90 puts for 21 cents each. The net cost of this leg is 12 cents.

2) **Bull Leg:** SELL 1 October Soybean $13.80 call at 37 cents, and BUY 2 November Soybean $14.50 calls for 27 cents each. The net cost of this leg is 17 cents.

The net cost of this entire position is 29 cents. If November Soybeans run to $15.04 in the next two weeks, the October $13.80 call should be trading around $1.24 ½, and the 2 November $14.50 calls should be worth around $1.65 total. As a result, the bull leg, with a net cost of 17 cents, should be valued near 40 1/2 cents for a net gain of 23 1/2 cents. In that case, the October $13.50 put should be worth zero (for 30 cent gain) and the 2 November $12.90 puts (which were purchased for 42 cents) will be worth about 3 cents for a loss of 39 cents. This means the bear leg would have lost 9 cents, and the entire position would should a net gain of 14 1/2 cents.*

At this point the trader would only be up 14 1/2 cents, but there would be just 7 days left before the October options expire, while November options would still have 42 days left. The trader could exit (or mostly exit) the bull side of strategy and still have plenty of time to see the values of the puts increase into harvest.

If November Soybeans break to $12.50 in the next two weeks, the October Soybean $13.80 call should be trading near 0 and the 2 November $14.50 calls should be worth near 4 1/2 cents. As a result, the bull leg, with an initial net cost of 17 cents, should be valued near 4 1/2 cents, for a net loss of 12 1/2 cents. However, the October $13.50 put should be worth around $1.00 1/2 (for a 70 1/2 cent loss), and the 2 November $12.90 puts, which were purchased for 42 cents, should be worth around $1.31 (an 89 cent gain), for a net gain of 18 1/2 cents on the bear leg and a combined gain of just 6 cents on the entire position. *

There will only be 7 days left before the October options expire, while the November options will still have 42 days left. The trader can exit (or mostly exit) the bear strategy and still have plenty of time to see the values of the calls increase into harvest, especially if there is a cold weather scare.

These are hypothetical results from either a sharp run up or a sharp break in the next few weeks, provided the trader holds all six legs. This strategy has significant leverage and flexibility for traders to welcome volatile action in the soybean market over the next few weeks and months. Lifting each leg as the market presents the opportunity to do so could leave the trader will a significant gain in the end.

For example, on a sharp rally into the middle of next week, bearish traders might want to lift the short October put and one of the November calls. On a sharp break into the middle of next week, bullish traders might want to lift the short October call and one of the November puts.

**Option values in these scenarios are based on pricing models and are not guaranteed.*

-Terry Roggensack