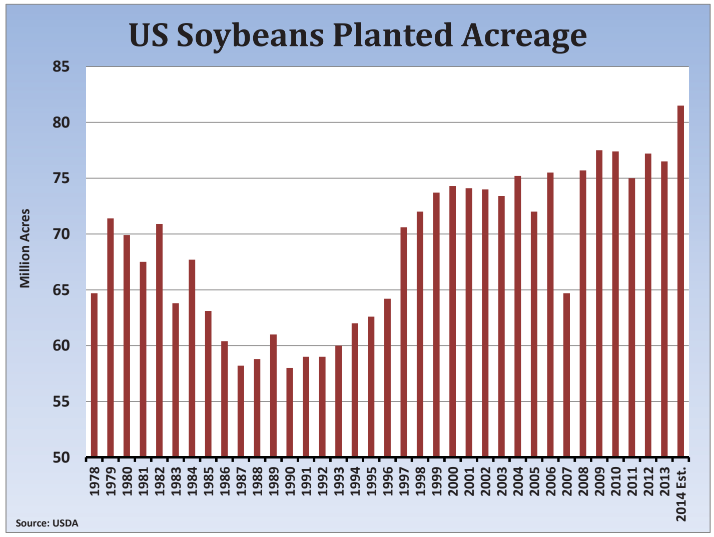
June 23, 2014

Hedge Strategies Using Options Ahead of USDA June 30th Reports

In this report, we will review what we believe is the fundamental set-up in the soybean and corn markets for the USDA Acreage and Grains Stocks reports on June 30th and what could be in store for the summer. We will also review the markets' personality and set-up for this season, which may help hedgers choose among the many tools available for both long and short positioning. We will provide suggestions on how to use CME Weekly options and Short-Dated New Crop (SDNC) options to enhance traditional hedge strategies.

Note: More than 25,000 Weekly options traded in the wake of the March 31st USDA Prospective Plantings report, and the volume for the SDNC options reached 38,832 for last year's June Acreage report.



Soybeans

FUNDAMENTAL SET-UP FOR 2014: If the weather remains favorable, the trade will soon be talking about a 46 bushel-per acre average yield, which is up just 1.8% from the current USDA estimate. The trade is expecting actual plantings to be up at least 1 million acres from the March Planting Intentions report, with talk of a jump of as many as 3 million. If there is a 2 million-acre increase and yield does indeed reach 46 bushels per acre, ending stocks would come in around 490 million bushels, up from 125 million for 2013/14. This would push the stocks/usage ratio to 14.2%, up from the record low 3.7% for 2013/14.

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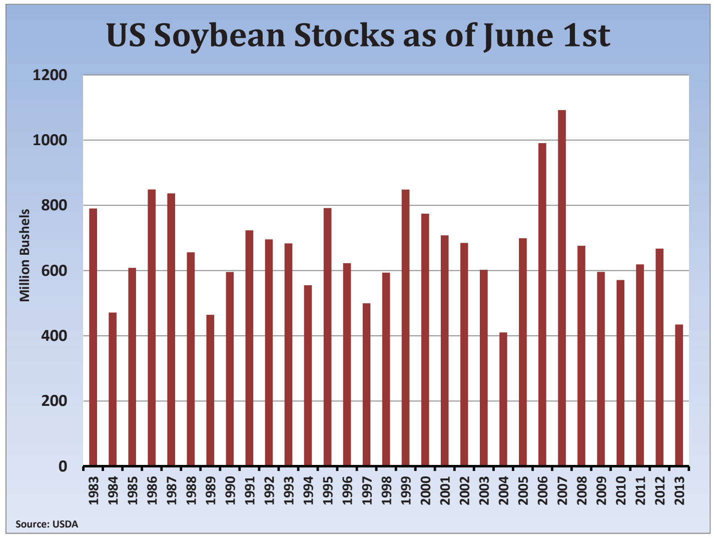
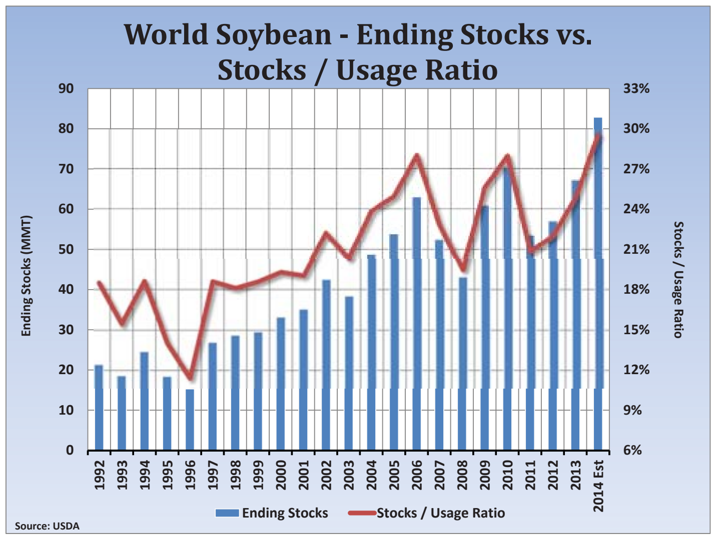
The extreme tightness in the old crop soybean supply is still not resolved, and August Soybeans and the August/November spread could still be explosive to the upside following the report. We remain very bearish for November soybeans and are expecting a test of the $10.00 level by late July/early August if the weather remains normal. Over the past three weeks, the cash market has not "acted" like it is heading into the tightest summer on record, and at this point, the trade seems to be assuming that last year's production will eventually be revised higher by 25-40 million bushels.

At present, traders look for June 1st stocks to come in near 380 million bushels, compared with 435 million reported last year at this time. This means that "if" we use the same amount of soybeans for the June-August time frame this year as last year, ending stocks would come in at just 86 million bushels, well below the current USDA estimate of 125 million bushels, which is considered to be a "pipeline minimum."

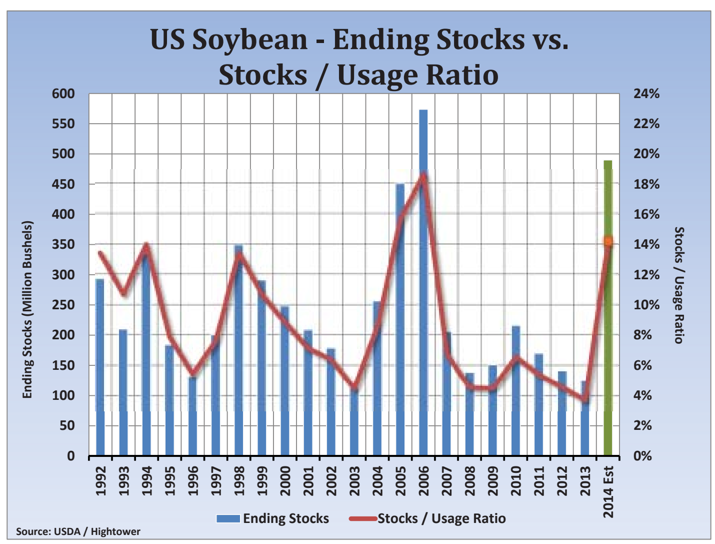


SOYBEAN MARKET PERSONALITY: Historically, the most weather-sensitive period of the year for soybeans is late July through mid-August. By mid-July, traders have a better feel on whether the crops will see stressful weather for the key reproductive period, and by August 1st, the market has usually priced-in either good or bad yield potential. We think the market is currently overpriced this year given the outlook for record or near record world and US ending stocks.



The table on the following page shows the reactions of November soybeans on the day of the June reports and the gain or loss for the market 10 days afterwards, on August 1st, on September 1st and then into harvest.

Recent history shows that poor weather can spark strong summer rallies. For the last four years, the average gain in November soybeans from the June 30th report through September 1st has been $1.83. But keep in mind that adverse weather has been the primary reason for those gains! Looking at the years in which a new record high yield was achieved, we see a tendency for sharp declines into harvest. A new record high yield and planted acreage in the US this year on top of the record production from Brazil and record world ending stocks projections could set the market up for a steep sell-off.



NOVEMBER SOYBEAN FUTURES REACTION TO JUNE STOCKS/ACREAGE REPORT

Year	Price Changes Day of Report	10 Days Later	Aug 1st	Sep 1st	Oct 31st	Notes
1990	0.00	0.25	-37.25	-8.00	-40.25	
1991	-11.00	-29.25	87.25	26.75	-2.25	
1992	***-4.00***	***-43.00***	***-68.50***	***-70.00***	***-69.50***	***Record Yield***
1993	21.50	53.50	48.00	2.50	-38.75	
1994	***-6.25***	***-52.00***	***-68.75***	***-53.25***	***-86.50***	***Record Yield***
1995	-4.00	60.00	10.50	29.25	80.25	
1996	14.25	62.50	-8.50	49.25	-78.50	
1997	-30.00	8.25	28.75	16.25	73.25	
1998	10.75	-38.75	-64.75	-95.75	-58.25	
1999	4.50	-33.50	2.50	34.75	9.75	
2000	-15.00	-28.25	-20.50	36.00	-17.00	
2001	23.00	44.75	27.75	20.25	-35.50	
2002	15.25	26.50	34.50	42.75	58.50	
2003	-5.75	-31.25	-36.25	22.00	241.75	
2004	***-30.75***	***-23.50***	***-103.00***	***-40.25***	***-141.50***	***Record Yield***
2005	***-22.75***	***65.25***	***38.25***	***-67.25***	***-101.50***	***Record Yield***
2006	13.00	-11.25	-21.25	-68.25	7.75	
2007	39.50	17.00	-27.25	25.75	128.25	
2008	14.50	-58.00	-279.00	-275.50	-648.75	
2009	***-2.50***	***-76.50***	***49.50***	***-30.00***	***-3.00***	***Record Yield***
2010	-9.50	85.50	107.50	***106.50***	323.50	***Weather Impact***
2011	-29.00	93.00	85.75	***151.75***	-86.50	***Weather Impact***
2012	24.25	162.75	188.75	***340.50***	119.25	***Weather Impact***
2013	-23.25	11.75	-70.50	***134.75***	28.25	***Weather Impact***
Higher						
Count	10	13	12	15	10	
Average	18.05	53.15	59.08	69.27	107.05	
Max	39.50	162.75	188.75	340.50	323.50	
Lower						
Count	13	11	12	9	14	
Average	-14.90	-38.66	-67.13	-78.69	-100.55	
Max	-30.75	-76.50	-279.00	-275.50	-648.75	

Long Hedge Strategies in Soybeans

1. **Neutral Strength Hedge:** SELL 1 August Soybean $13.00 put for 16 cents and BUY 1 September Soybean Short Dated New Crop (SDNC) $12.70 call for 24 cents. Net cost out of pocket is 8 cents.

Benefits: Old Crop tightness should cushion August in a decline, long call has just enough time to cover majority of weather through pod filling, strategy allows for 50 cents or lower pricing.

Drawbacks: Hedge protection is 35 cents above the current market, strategy doesn't cover harvest or late-breaking El Niño influences.

2. **Weak But Lower-Cost Hedge:** BUY a September Soybean SDNC $12.30/$13.00 bull call spread for 24 cents, or simply BUY 1 September Soybean SDNC $12.70 call for 25 cents.

Benefits: Coverage just beyond pod filling, relatively inexpensive, some adjustability in the event of an early summer slide, strategy is responsive (at or in the money to start), gives some limited El Niño coverage.

Drawbacks: Hedge is limited by short call, becomes less responsive on a slide in prices due to good growing weather.

3. **Aggressive Leveraged Hedge:** SELL November Soybean futures/ BUY 3 September Soybean SDNC $12.50 calls for 33 cents each/ SELL 1 (regular) November Soybean $11.40 put for 24 cents. Net premium outlay is 75 cents. Net delta to start is +0.58!

Benefits: Potentially self-financing, leveraged, adjustments improve positioning, minimal profit taking on bullish USDA or weather, initial break can be used to bank profit on short futures/short put component leaving simple hedge in place.

Drawbacks: Expensive, complicated, short put could limit financing, calls are off the market slightly.

Short Hedge Strategies in Soybeans

1. **Simple Hedge:** BUY 1 September Soybean Short Dated New Crop (SDNC) $12.30/$11.30 bear put spread for 28 cents. The net delta to start is -0.30.

Benefits: Coverage is right on the market to start, lower cost than straight November bear put (which would be 46 cents), ability to adjust (bank profit on short put) on a bullish report or weather-based rally, coverage for most of the weather window.

Drawbacks: Downside is limited by short put, hedge duration is 60 days instead of 121 days using November options.

2. **Short Duration Low Cost Hedge:** BUY a July Soybean Week 1 $13.50/$13.10 bear put spread for 10 cents. Net delta to start is -0.23.

Benefits: Limited cost, right on the money, allows for longer term hedge to be set on a rally.

Drawbacks: Short duration, heavy time decay, limited adjustment capability.

3. BUY November Soybean futures/BUY 4 September Soybean SDNC $11.50 puts for 13 cents each. Initial premium outlay is 52 cents. Net delta to start is virtually flat! The multiple puts are the hedge, while the long futures component hedges the cost of the puts and hedges against initial adversity off weather or acres.

In the event of a bullish surprise in the report, a bullish shift in the weather or a large Chinese purchase, the hedger could liquidate the long futures for any size profit, which in turn would reduce the cost of the hedge.

4. **Aggressive Bearish:** SELL August Soybean futures near $13.68 and BUY 2 July Soybean Week 2 $13.70 calls for 29 cents each. The net delta to start is -0.20.

Benefits: Adjustable because one call can be exited to lower the cost of the hedge, hedge less impacted by time decay and volatility decay, protection is in most bullish component of the complex (good and bad).

Drawbacks: Call costs initially limit hedge windfall, old crop fundamentals support August, 18 days until option coverage ends.

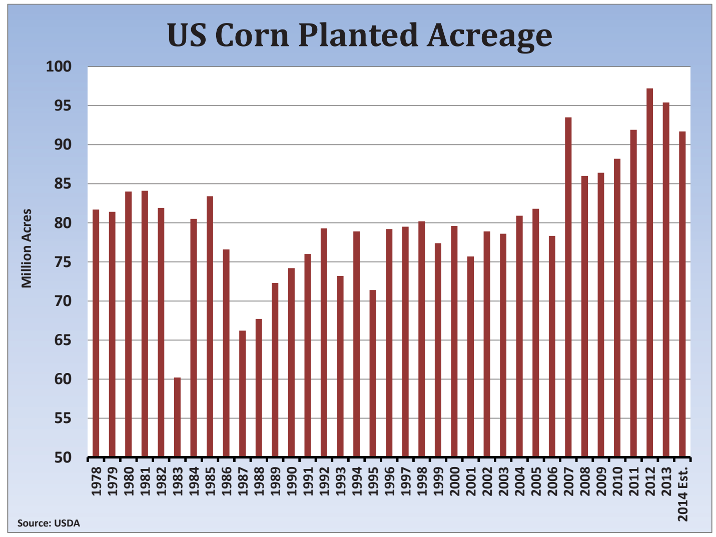
5. **Leveraged-Bearish (Based on Good Weather):** SELL 1 November Soybean $11.60 put at 39 cents and BUY 5 September Soybean SDNC $10.90 puts for 7 cents each for a net credit of 4 cents.

6. **Old Crop/New Crop Challenge:** SELL 1 July Soybean Week 1 $13.70 put for 37 cents and BUY 3 September Soybean SDNC $11.20 puts for 11 ½ cents for a net credit of 2 ½ cents.

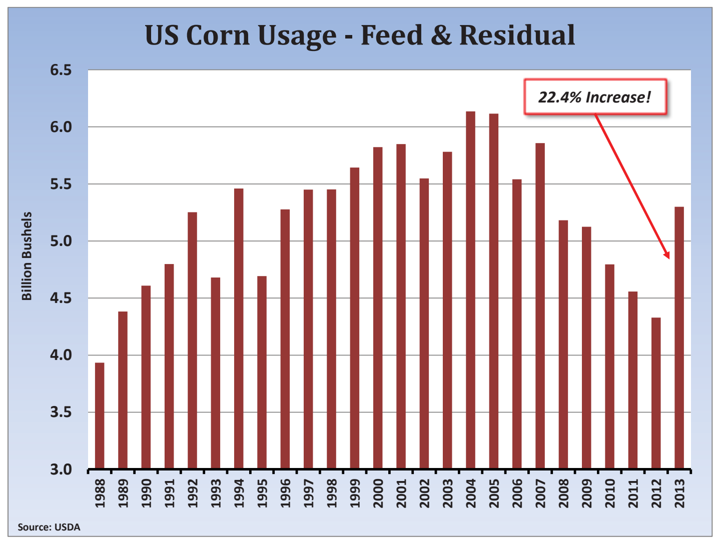
7. **Seasonal & Fundamental Decline in Volatility:** SELL the July Soybean Week 2 $13.80 call and SELL the July Soybean Week 2 $13.20 put for a net credit of 39 ½ cents.

Corn

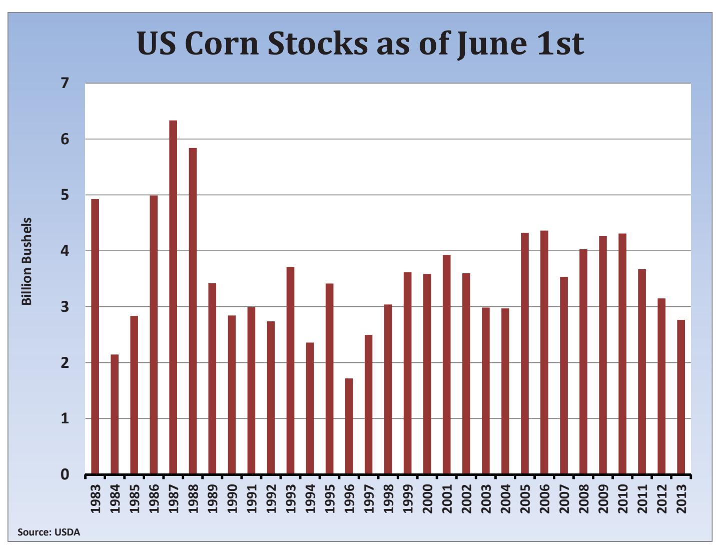
FUNDAMENTAL SET-UP FOR 2014: December Corn has already challenged the January 10th contract low at $4.35 ahead of the key reports. This makes sense given the good growing weather, the possibility that the planted acreage numbers could be bearish, and the possibility that June 1st corn stocks could be higher than expected due to lower than expected feed usage for the March-May time frame. With corn prices already 14.5% below the last key high, the market is pricing in very high yield expectations.



The short-term weather forecast remains nearly ideal, and crop conditions are likely to be some of the best on record by July 1st. There are some concerns that there has been too much rain for parts of Iowa, Minnesota and Wisconsin, but historically, "rain makes grain," and traders buying corn because of too much rain in June in have been burned in the past.

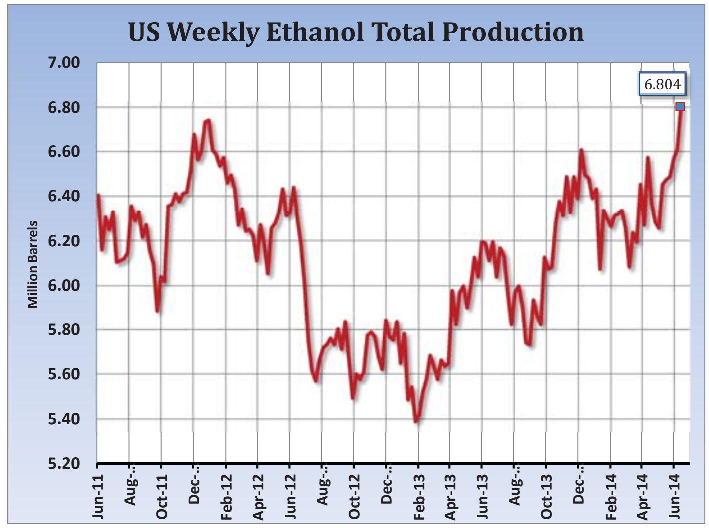


The June 30th Acreage report will offer the most up-to-date plantings estimate for 2014/15. Some producers in the far northern Midwest may have missed out on getting all of their planting done in time, but for the most part, producers across the rest of the Midwest, the plains, the delta and the southeast appeared to have had ample opportunity to plant more acres than they intended to in March. Unlike the set-up for soybeans, traders are likely expecting either a drop of 500,000 to 1 million acres or an increase of 500,000 to 1 million acres for the report. If the average US corn yield reaches 168 bushels per acre and if planted area increases by 1 million acres, ending stocks could increase to 2.116 billion bushels, and the stocks/usage ratio could reach 15.8%, up from 8.4% in 2013/14.



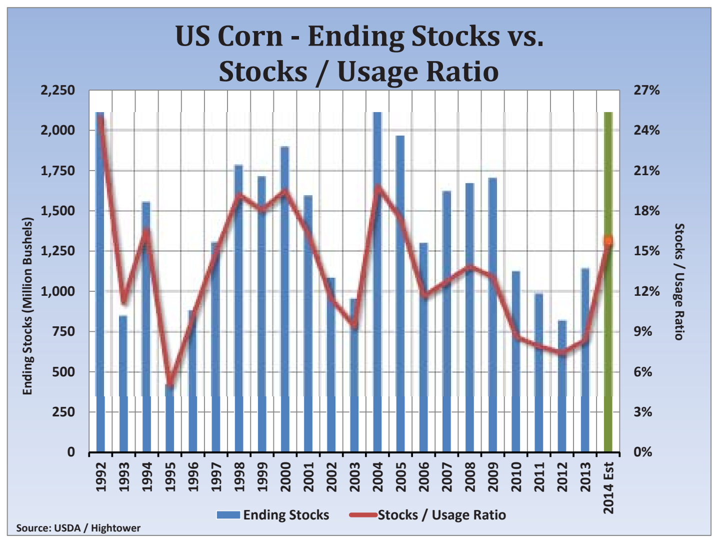
Lower feedlot supplies of cattle and losses to the pig population due to the spread of the PED virus suggest that actual feed usage could be much lower than the USDA's recent forecast. Traders believe the virus may have killed as many as 8 million head (about 10% of the supply) in the past year. The first evidence that feed usage is behind pace might show up in the June 1st stocks update. We would not be surprised to see 2013/14 feed usage revised lower by 150-250 million bushels, which could drive the estimates for 2013/14 ending stocks higher. This could have additional bearish implications for the 2014/15 crop, as it would drive beginning and ending stocks higher.

The recent surge in energy prices and the possibility for gasoline tightness around the globe, especially with the unrest in the Middle East, might spark very high profit margins for ethanol producers going into the summer. It could also spark a jump in US ethanol exports, which are already running very high for the first four months of 2014. The June 18th weekly ethanol production report showed record ethanol production and declining ethanol stocks, which suggests exports are active. Livestock production is extremely profitable as well. Forced to make a prediction, we would expect December Corn to price in a nearly unachievable yield into early July and then see demand increase with the lower prices.



CORN MARKET PERSONALITY: Historically, the most weather-sensitive period of the year for corn is the pollination period from late June to early July. If the crop makes it to then with little or stress from lack of moisture or too much heat, the biggest threat to the crop will have passed. In general, good rain in June and a lack of heat in July is a combination for high yield.

Currently, the corn market appears to be as closer to fair value than soybeans. We anticipate the key price-determining forces to be July weather, the energy component for corn, China's supply and demand, and the global economy.



The table on the following page shows the reactions of December corn since 1990 on the day of the June Acreage and Grains Stocks reports, 10 days afterwards, by August 1st, by September 1st and then into harvest. Note that in many years in which the crop achieved new record yields, much of the downward price move occurs by mid to late July. In some years there was an additional break into harvest. Note also that in three of the past six years, the June stocks report has sparked a limit-down move. Last year the market closed 27 ½ lower on the day of the report.

For now we are assuming that that average yield for the US corn crop will reach a new record high this year. Export demand could go either way, but for now it appears that China and the major exporters have adequate supply. If weather stays favorable, we suggest keeping downside targets of $4.04 and possibly $3.85. However, if by mid-July the trade is pricing in a yield around 170 bushels per acre and weak demand from China, the market could be close to putting in a seasonal low.

Long Hedge Strategies in Corn

1. **Conservative: BUY** 1 (just out of the money) July Corn Week 2 $4.55 call near 12 cents. The net delta to start is +0.45.

Benefits: Limited cost for a look at an important market pivot point, simple, allows for longer term hedge implementation at potentially lower price level.

Drawbacks: only 18 days of coverage, no adjustability, hedge loses sensitivity on a decline.

2. **Longer-Term Bottom: BUY** December Corn futures for around $4.40, **BUY** 1 July Corn Week 1 $4.35 put for 7 cents, and **BUY** 1 September Corn Short Dated New Crop (SDNC) $4.30 put for 10 cents. The net premium outlay is 17 cents, and there is a partial futures margining. The net delta to start is +0.38.

Benefits: Adjustable, long term, reduced premium costs due to use of SDNC option, hedge sensitivity remains constant.

Drawbacks: Hedge of hedge coverage declines over time, adjustment capacity ends after Week 1 option expires.

DECEMBER CORN FUTURES REACTION TO JUNE STOCKS/ACREAGE REPORT

Year	Price Changes Day of Report	10 Days Later	Aug 1st	Sep 1st	Oct 31st	Notes
1990	3.25	-19.75	-40.25	-52.75	-57.75	
1991	-4.50	-8.50	33.00	18.75	15.50	
1992	***-2.50***	***-23.00***	***-35.75***	***-37.50***	***-51.25***	***Record Yield***
1993	4.75	6.75	8.50	-3.00	19.50	
1994	***2.25***	***-18.75***	***-20.25***	***-18.25***	***-26.25***	***Record Yield***
1995	6.25	16.00	-2.25	12.50	52.00	
1996	8.75	18.00	-37.00	-19.75	-95.25	
1997	2.75	18.25	26.75	34.00	41.50	
1998	7.00	-26.00	-39.00	-55.00	-40.50	
1999	1.50	-21.00	0.25	-4.25	-26.75	
2000	-8.50	-16.25	-14.75	-9.50	-1.50	
2001	0.00	20.25	16.75	23.00	-2.75	
2002	-1.00	-6.25	19.50	30.75	4.00	
2003	***-6.25***	***-11.50***	***-6.50***	***16.25***	***23.50***	***Record Yield***
2004	***-10.50***	***-16.75***	***-39.25***	***-30.75***	***-64.50***	***Record Yield***
2005	-5.25	36.25	13.75	-14.50	-35.50	
2006	5.75	7.75	4.00	-16.00	60.50	
2007	-7.50	-2.25	-9.50	2.50	24.75	
2008	***-30.00***	-90.25	-201.50	-187.75	-355.50	
2009	***-30.00***	***-29.75***	***1.75***	***-48.00***	***-1.25***	***Record Yield***
2010	***29.50***	31.75	31.00	74.00	208.50	
2011	***-30.00***	64.50	95.25	139.50	26.50	
2012	***2.50***	137.75	161.00	170.25	121.00	
2013	***-27.50***	-7.50	-47.25	-35.75	-82.75	
Higher						
Count	11	10	12	10	11	
Average	6.75	35.73	34.29	52.15	54.30	
Max	29.50	137.75	161.00	170.25	208.50	
Lower						
Count	12	14	12	14	13	
Average	-13.63	-21.25	-41.10	-38.05	-64.73	
Max	-30.00	-90.25	-201.50	-187.75	-355.50	

3. **Short Term Challenge Hedge:** **SELL** 1 (in the money) July Corn Week 2 $4.50 call for 13 cents and **BUY** 3 September Corn SDNC $4.65 calls for 15 cents each. Net premium cost is 32 cents. Net Delta to start is +0.76.

Benefits: Adjustable, initial time decay and volatility decline windfall, leverage, initial rally is best outcome.

Drawbacks: In the money short option complications, premium outlay is moderate to expensive.

4. **Bullish:** **SELL** December Corn futures at the market and **BUY** 3 September Corn SDNC $4.80 calls for 8 cents each.

The net delta on this position is net short 0.22 contracts to start. On a post-report decline, a good portion of the call outlay could be funded. Ideally, the market sees a 24-cent break after the report, allowing the trader to lift the futures and receive a free look at the upside through the third week of August.

Short Hedge Strategies in Corn

1. **Conservative Hedge:** **BUY** a July Corn Week 2 $4.55/$4.30 bear put spread for 11 cents. Net delta to start is -0.28.

Benefits: Right on the money, little time value cost, adjustable, short put might not come into money.

Drawbacks: 18 day duration, limited windfall from adjustment.

2. **Time Decay-Leverage:** **SELL** 1 July Corn Week 2 $4.50 put for 16 cents and **BUY** 3 September Corn SDNC $4.30 puts for 10 each. Net premium outlay is 14 cents. Net Delta to start is -0.41

Benefits: Cheap for leverage, adjustable, time decay and volatility decay on short Week 2 put, hedge coverage considerably longer on hedge components than hedge financing component.

Drawbacks: At the money short put limits hedge windfall initially, a minor break and stall could complicate expiration of week 2 option.

3 **Aggressive Leverage:** **BUY** 3 September Corn SDNC $4.30 puts for 10 cents each and then look to **BUY** a December Corn futures as a hedge of the hedge on a break of more than 10 cents in the futures. Net delta to start is -0.90. Net premium outlay is 30 cents!

Benefits: Hedge risk is mostly premium related, highly adjustable, futures buy at 10 cents lower locks in a windfall, leveraged, 60-day hedge window.

Drawbacks: Initial rally reduces adjustment windfall efficiency, moderate to significant premium outlay, using futures increases middle ground uncertainty.

4. **Conservative - Long Strangle:** **BUY** a July Corn Week 1 $4.45 call for 8 cents and **BUY** a September Corn SDNC $4.40 put for 17 cents. The net premium outlay would be 25 cents.

Buying a Week 1 call and SDNC put could allow the trader to benefit from a temporary bullish surprise in the report and/or a bullish shift in the weather. If there is a major shift in sentiment to the upside, the Week 1 call option could easily appreciate enough to finance the SDNC September put, which doesn't expire until August 22nd. If prices break to a fresh low, it should result in a noted appreciation in the long put position.

5. **Very Conservative - SDNC Bear Put Spread:** **BUY** the September Corn SDNC $4.40 put for 19 cents and **SELL** the September Corn SDNC $4.20 put for 10 ½ cents, for a net cost of 8 ½ cents on the position.

If there is a smaller than expected increase in acres, too much rain or simply a post-report bounce, look to buy back the $4.20 put at 5 cents and hold the $4.40 put for an objective of $4.04 basis the December futures.

6 **Longer-Term Bearish:** **SELL** a July Corn Week 1 $4.40 put for 15 cents and BUY 3 September Corn SDNC $4.20 puts for 10 cents each.

The July Week 1 put expires on July 3rd, and the September SDNC puts expire on August 22nd. The net premium outlay is 15 cents, and the initial delta on the position is net short 0.37 futures.

If there is a post-report bounce or a weather scare rally, look to buy back the Week 1 put at 5 cents. If there is a rally specifically off of the acreage number, the trader could challenge the market and look for the Week 1 put to expire worthless.

7. **Longer-Term Bearish:** **SELL** December Corn futures at $4.45 to $4.48, and then **BUY** a September Corn SDNC $4.45/$4.90 bull call spread for net cost of 11 cents.

This position offers coverage against a temporary bullish reaction off of the report and/or the weather. For example, if there is a bounce to $4.66 in December Corn, the spread should be trading near 19 ½ cents. Aggressive traders who are still bearish on the bounce could lift the $4.45 call and stay short the futures and short the $4.90 call, looking for a break to $4.04.*

*Options values are based on pricing models and are not guaranteed.

Disclaimer

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