



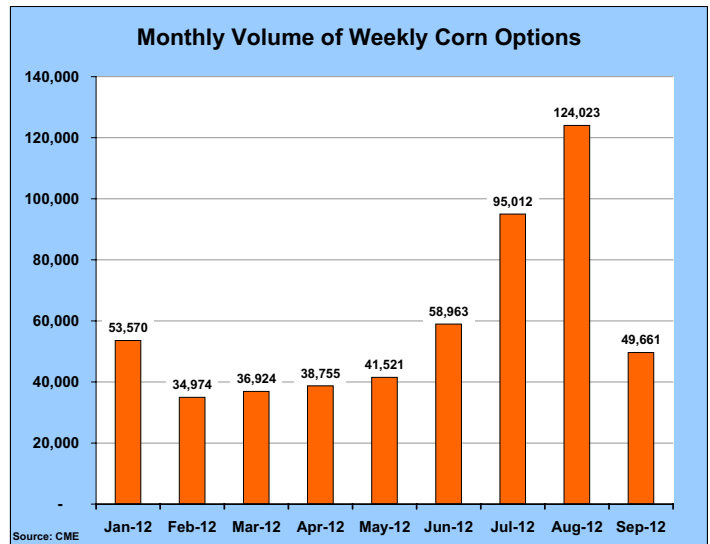
Using Weekly Options ahead of USDA Volatility

October 9, 2012

The USDA will release an updated Supply & Demand report on Thursday, October 8th, and given the historically low levels of production that are forecasted for corn this year, *weekly* options offered by the CME Group can be an efficient and cost-effective way to manage risk going into the report. Premiums for traditional options have been very high due to increases in volatility. Weekly options, which have a narrower time frame and therefore lower premium, are a way to help offset the risk of major moves in the days following key reports. Weekly options in corn have been trading since May of 2011. The enclosed chart shows the monthly volume of trade.

These options have become more popular as speculative and hedging tools as the lower premiums (and reduced hedging costs) have helped to entice traders. Weekly options in corn, soybeans, and wheat were introduced on May 23, 2011, and soybean meal and oil weekly options were launched on September 26 that same year. By the end of August 2012, cumulative volume since inception had reached 852,000 contracts, with corn being the most heavily traded. The average daily volume in weekly corn options for the month of August was 5,668 contracts, a new record high. In September, the average volume was 2,613 contracts.

Weekly options are offered in three succeeding Friday expirations at a time, and they constantly rotate. There are no weekly options



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The Hightower Report

Futures Analysis & Forecasting

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expiring on the weeks in which a standard or serial option expires. Weekly options have the same contract specifications as standard and serial options. The underlying contract month is the closest to nearby futures for which options are still trading. As one option expires, a new option is listed on the following business day. The weekly options have a life span of about 28 days, which means traders can benefit from the volatility in the market but over a very short time frame, thus reducing the time value in the option premium.

Not only are the weekly options helpful risk management tools for important, market-moving reports, they are also beneficial during specific periods of time in which weather can have an adverse impact on crops without having to pay for a standard options time value. Some of these weather events may include:

- Hurricane season
- Early frost & late freezes
- Widespread heat waves

The time period that a weekly option covers can work to a hedger's as well as a speculator's benefit.

Some Examples of Trade Strategies Using Weekly Options

1) A corn end user looking to hedge their short cash corn position ahead of the USDA report on October 11th might look at purchasing October Corn "Week 3" \$7.40 calls for 13 1/2 cents. As of October 8th, these calls had 11 days until expiration. (For comparison, the serial November Corn \$7.40 corn calls were listed at 18 1/4 cents, and the standard December corn \$7.40 calls were priced at 28 1/2 cents.) If the market trades to \$7.80 in the wake of the report, the \$7.40 calls should be trading near 41 cents.*

The option will still have 8 days until expiration after the report. The hedger will have the opportunity to 1) take the short-term gain, 2) hold the call, which could eventually turn into a long December futures position from \$7.40, or 3) sell a "Week 3" 790 call at 8 cents to end up with a \$7.40/\$7.90 bull call spread for a net cost of 5 1/2 cents.*

2) For a producer who does not want to sell more cash grain at the moment, a bearish report could be a significant blow to their bottom line. To offset this, they may want to purchase a "Week 3" October Corn \$7.35 put for around 10 1/2 cents. If the report is bearish and December corn trades down to \$7.00 on the

day of the report, the \$7.35 put should be trading near 36 1/2 cents.* The hedger would still have downside protection for another 8 days following the report, until October 19th.

3) A speculator going into the report with a long futures position in corn might look to buy an October Corn "Week 3" \$7.30 put for 7 1/2 cents. If the report is bearish, the put will act as an effective "stop" order at \$7.22 1/2, after accounting for the price of purchasing the option. This offers an attractive alternative to using an open stop order at \$7.22 1/2 that would turn into a market order if it were hit and could end up being filled at a much lower level if the report were bearish and the market were to move sharply lower after the release. If the market trades down to \$7.00 in the wake of the report, the \$7.30 puts should be trading near 32 1/4 cents.*

If the report is bullish, the trader could hold the long futures position and sell the out of the put at a very minimal loss given the low initial cost of the option.

Looking Ahead to Thursday's Report

In the wake of the recent break, we believe there is more risk to the upside than to the downside for the USDA report on Thursday.

There could be some downside risk to corn if the soybean yield estimate were to come in bearish and all the grain markets broke sharply in sympathy with soybeans.

But there are several bullish possibilities that could directly affect the corn market. The USDA could lower the corn yield slightly. Just a single-bushel drop in yield would result in an 87 million-bushel decline in production, which is significant given that ending stocks were projected at on 733 million bushels in the September report. There is also the possibility that that the harvested acreage number could be adjusted lower by 1 million acres or more, as this summer's drought may have caused more producers to abandon acreage than previously expected. A decline of 1 million acres could mean a drop of 122.8 million bushels!

The Grain Stocks report on September 28th suggested that US corn domestic feed usage may need to be adjusted higher by 100 million bushels or more for the 2012/13 season. The report also indicated that beginning stocks for the 2012/13 season were

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actually 193 million bushels below the forecast from the September Supply/Demand update, and the USDA will have to account for this somehow.

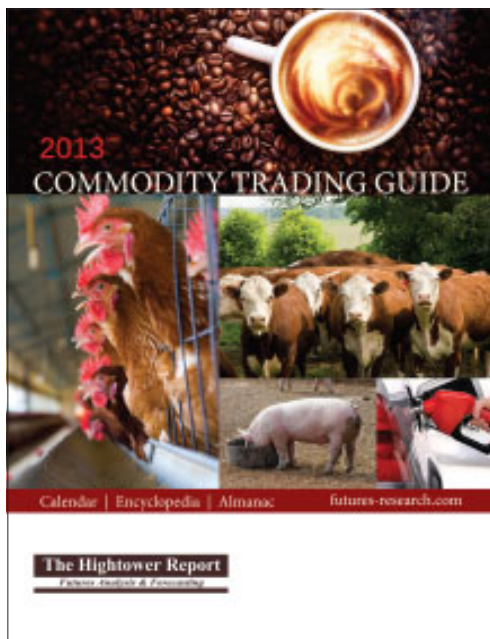
Clearly, there are several supply or demand considerations for the report which could result in a record low stocks/usage situation. The market would need to ration the current supply with higher prices. If the uptrend resumes, \$7.77 and \$7.94 would become next key resistance levels. Another leg up would leave a longer-term technical objective for December corn at \$9.04.

Suggested Trading Strategy: Buy December corn at \$7.42 or better and also buy the "Week 3" October \$7.30 put for 7 1/2 cents. Use \$7.94 as an upside objective for December corn.

The risk protection on this trade lasts until October 19th, when the put expires. If the put expires worthless and the option is not exercised, traders should either exit the position or use some sort of protection in the form of a stop or option after that date.

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

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