Margin Management Since 1999

MARGINMANAGER

Your resource for understanding the margin management approach

Learn more at MarginManager.com **April 2017**

This Issue

Feature Article

Pages 2-4

Manage Your Counterparty Risk 2

Margin Watch Reports

Pages 5-11

Hog 5

Dairy 6

Beef 7

Corn 9

Soybean 10

Wheat 11

Dear Ag industry associate:

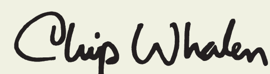
When Grassland Dairy Products cancelled contracts with several producers in Wisconsin, it forced those producers to scramble for a replacement processor. Fortunately, it appears that most of these affected dairy farmers have found new supply outlets for their milk. But the lesson is clear: If you utilize contracting to manage your forward margins, you need to consider the parties on the other end of those contracts.

This month's feature article, "Manage Counterparty Risk" uses the example of Grassland to highlight the need to ensure your margin management plan accounts for counterparty risk. We discuss the challenges faced by those producers who had forward contracts or exchange-traded positions on the affected milk production. And we review counterparty risk considerations that producers may wish to address when creating or updating a margin management policy.

In addition, as another planting season commences, our regular Margin Watch feature provides insight on recent weather developments and crop progress, as well as other factors affecting forward margins in the crop, livestock and dairy sectors.

As always, if you have questions, please feel free to contact me.

Respectfully,



Chip Whalen
Managing Editor

Chip Whalen is the managing editor of MarginManager and the vice president of education and research for CIH. He teaches classes on margin management throughout the country and can be reached at cwhalen@cihedging.com.

Upcoming Education Events

Ethanol Margin Management Seminar
Chicago

May 10-11

Dairy Margins Management Seminar
Chicago

June 20-21

Futures and options trading involves the risk of loss. Past performance is not indicative of future results.

Manage Your Counterparty Risk

Recent news that a dairy processor abruptly cancelled contracts with a group of Wisconsin dairy farmers has highlighted the need to address counterparty risk as part of your margin management plan.

Grassland Dairy Products, which handles a majority of the cream sold in Wisconsin, recently sent a letter to several of their milk suppliers saying that it would not accept any shipments from them after May 1. That was after the company had itself received only two days' notice that its Canadian processor would stop buying Grassland's ultra-filtered milk (UFM). The change, which represents a loss for Grassland of one million pounds of milk shipments per day, came about when Canada reclassified UFM as a lower-priced class of milk as part of a new national dairy ingredient strategy. As a result, Canadian UFM is priced at a discount to American UFM, which is now at a competitive disadvantage. Dairy processors in New York have likewise seen contracts canceled from Canadian customers. In all, about 100 dairy producers in the two states have been impacted and forced to find a new home for their milk on very short notice.

Challenges Raised

In addition to the challenge of finding new processors, the affected dairy producers face uncertainty over existing milk contracts for periods after May 1. Although some producers may have taken positions on the exchange to lock in or protect price levels on that milk production, other producers had established forward contracts with Grassland earlier in the year that set price throughout 2017 at more favorable levels. While Grassland has yet to announce what it plans to do with these contracts, the possibility that it may terminate them will add to the pain these dairies are already feeling in the face of milk prices that have dropped substantially since the beginning of the year.

The best path forward for these producers isn't straightforward and will depend on several factors. For the lucky subset of these dairies that were able to find an alternative outlet for their milk supply, they will need to determine how they will be paid under any new agreement. That's because any differences will impact the value of any exchange-traded contracts they may have put in place to manage their milk price and dairy margins. As a first step, they need to determine if they will be priced under a different Federal Marketing Order, particularly if they need to ship

their milk out of state. Secondly, if they have a new hedge ratio between Class III and Class IV milk, they should look to reallocate their current hedge positions accordingly.

Additionally, if their mailbox breakeven price is higher due to increased hauling or balancing deductions, these producers may need to adjust their existing open positions and hedge policy. As an example, if a producer estimates their Class III/Class IV breakeven mailbox price to be $16.50/cwt. under a previous contract and a new milk handler will be deducting an additional $0.75 from the dairy's milk check, the new breakeven price will be closer to $17.25/cwt. Let's assume the producer has an open hedge position where they are short deferred Class III Milk futures at $17.00/cwt. to secure a $0.50 margin based on their old Grassland contract. Under this new hypothetical agreement with a different milk processor, the producer is now locked into a loss of $0.25/cwt. In that scenario, it may be prudent to replace the futures contract with an option position that would offer more flexibility for a positive margin to eventually be secured.

What about the likely larger pool of producers who are not able to find a new outlet for their milk? This is obviously more complicated and a producer may need to consult with their lender and risk management team about liquidating positions. Without a sure outlet for their milk supply, any producer that holds a short futures position would be facing higher risk. That's because if milk futures prices rise to above the level of the short futures position, the producer could incur a loss on the contract and may also not be able to take advantage of the higher cash market price. A producer with a short futures position should, at a minimum, consider replacing that position with a long option position to minimize upside exposure in the event that the futures market rises. The best case scenario would be a producer who has a hedge position in the market with an unrealized gain. At the very least, these positions could be closed out without incurring losses or potentially converted to long option strategies using the accumulated equity in the position.

Make it Part of Your Margin Management Policy

As discussed in a previous article, a comprehensive margin management plan will go beyond the basics of defining triggers for establishing and adjusting margin protection; it will also spell out contingency levels of protection in case those triggers are never reached. Another key part of any comprehensive policy is a plan to address counterparty risk. Although a single processor might optimize payments and simplify your logistics, it also makes you extremely vulnerable to any disruptions from that processor. As the Grassland producers learned the hard way, issues that bring counterparty risk to the forefront often occur unexpectedly. That's why you should think about addressing that risk in your margin management policy. For example, you might want to include the provision that you will always maintain more than one outlet for your output. You could address that requirement by establishing a relationship with a second buyer and regularly shipping some portion of your production to them.

Another way to manage risk is to use futures and options to protect forward margins. Because of their liquidity, these exchange-traded alternatives are valuable tools for managing risk. The clearing and settlement procedures of futures and options provide further safeguards that can help mitigate some of the counterparty risk entailed with using only local processors in the cash market.

You may also want to think about other counterparty risks you face and how to manage them. For example, you may want to consider diversifying supply sources for inputs as well as outlets for production, and mixing up contracting alternatives between the cash market and futures market to incorporate more flexibility.

If you have questions, or would like help identifying and addressing your counterparty risks, please contact CIH at 1.866.299.9333.

Hog Margin Watch: April

Hog margins improved over the second half of April following a recovery in hog prices, as feed costs held mostly steady. Finishing margins remain below average from a historical perspective, but are still positive through Q3 with negative margins indicated further out in Q4 and Q1 of 2018. Hog prices are drawing some support from indications of strong demand despite increased year-over-year pork production, which is up 2% for the year to date. U.S. pork exports during February were 450.2 million pounds, down 7.8 million (1.69%) from January, but up 63.4 million pounds (16.38%) from February 2016. USDA reported total pork supplies in Cold Storage as of March 31 at 555.1 million pounds, down 16.9 million pounds, or 2.96%, from February. This is higher than the average 1.14% draw from February to March over the past 10 years. The figure was also down 58.8 million pounds, or 9.57%, from March 2016. Grain prices have held relatively steady since the middle of April with limited feature in the market. A recent bounce was tied to short covering, with an unusually large fund short position in both corn and soybeans, and less-than-ideal planting weather across the U.S. Corn Belt. Corn planting progress for the week ending April 30 reached 34% complete, down from 43% last year, but in line with the five-year average. Soybean planting progress was pegged at 10% complete, which is slightly ahead of both last year and the five-year average of 7% for the end of April. Traders will be looking ahead to the May WASDE, which will provide the first 2017-18 new-crop balance sheet. Following the break in price, our hog producer clients have been adding flexibility to existing hog positions, while strengthening feed hedges.

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.

The information contained in this publication is taken from sources believed to be reliable, but is not guaranteed by Commodity & Ingredient Hedging, LLC, nor any affiliates, as to accuracy or completeness, and is intended for purposes of information and education only. Nothing therein should be considered as a solicitation to trade commodities or a trade recommendation by Commodity & Ingredient Hedging, LLC. All references to market conditions are current as of the date of the presentation. Futures and options trading involves the risk of loss. Past performance is not indicative of future results. Please visit www.cihmarginwatch.com to subscribe to the CIH Margin Watch report.

Dairy Margin Watch: April

Dairy margins were slightly stronger over the last half of April, due primarily to a small recovery in milk prices as feed costs held mostly steady. Margins remain positive and above average through Q1 2018, offering dairies opportunities to protect breakeven levels with flexible strategies that will allow for further margin improvement over time. Milk prices have recovered despite a continued build in both production and dairy product stocks as the market works through the spring flush. USDA reported March milk production at 18.71 billion pounds, up 1.7% from last year, with milk per cow estimated at 1,995 pounds vs. 1,974 in 2016. The milking cow herd also showed an increase from last year at 9.38 million head vs. 9.321 million in 2016. Meanwhile, natural cheese in Cold Storage on March 31 totaled 1.293 billion pounds, up 37.2 million pounds, or 2.96%, from February compared to the average build of 1.47% over the past 10 years. The March figure was also up 101.1 million pounds or 8.49% from 2016. Butter stocks in Cold Storage totaled 272.5 million pounds, up 2.6 million, or 0.98%, from February and up 29.4 million pounds, or 12.1%, from last year. Feed costs didn't register much movement over the past two weeks, although recent wet weather – which has slowed corn planting across the Midwest – did lead to a round of commodity fund short covering. While corn planting progress at 34% complete through the end of April trails last year's level of 43%, it is in line with the five-year average for this point in the season. In preparation for the growing season, our dairy producer clients have been making adjustments to existing margin strategies, adding flexibility to milk positions while strengthening feed hedges.

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 $8.00/cwt for non-feed expenses. Milk basis is $0.75/cwt and non-milk revenue is $1.00/cwt.

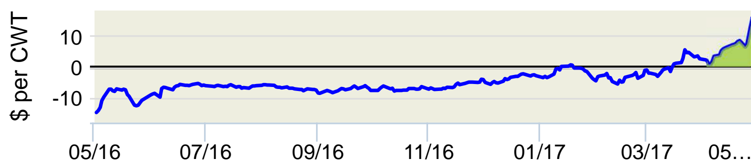
The information contained in this publication is taken from sources believed to be reliable, but is not guaranteed by Commodity & Ingredient Hedging, LLC, nor any affiliates, as to accuracy or completeness, and is intended for purposes of information and education only. Nothing therein should be considered as a solicitation to trade commodities or a trade recommendation by Commodity & Ingredient Hedging, LLC. All references to market conditions are current as of the date of the presentation. Futures and options trading involves the risk of loss. Past performance is not indicative of future results. Please visit www.cihmarginwatch.com to subscribe to the CIH Margin Watch report.

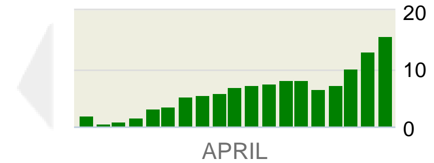
Beef Margin Watch: April

Beef margins have appreciated significantly since the middle of April following a sharp rise in cattle prices, while corn costs held mostly steady. Beef finishing margins are now positive through fall marketing periods, and approaching breakeven levels in winter months against deferred summer placements. The rally in cattle prices to new life-of-contract highs followed what was generally considered a bearish monthly Cattle on Feed report. USDA reported the number of cattle on feed as of April 1 at 10.904 million head, essentially unchanged from a year ago and consistent with pre-report market expectations. However, March placements totaled 2.102 million head, up 11% from last year when the market was expecting only a 7.5% average increase from 2016. The figure was also above the range of expectations of between a 2% and 9.5% increase from last year. Traders were expecting a market correction following the heavy placement total, particularly in deferred fall contracts that represent the marketing period for those cattle. Despite this, cattle prices rose sharply as traders responded to other signals, including indications of strong demand. USDA reported total beef in Cold Storage on March 31 at 464.5 million pounds, a draw of 38 million pounds, or 7.56%, from February, much higher than the average draw between February and March of just 1.38% over the past 10 years. Corn prices have not seen much movement recently, although a round of commodity fund short covering was tied to heavy weekend rain across the Midwest that has slowed planting progress. Our cattle producer clients who benefited from leaving upside flexibility on cattle price hedges have recently been looking to strengthen the delta of those positions to take advantage of margin improvements. In addition, many producers are focusing on aligning feed coverage with cattle hedges ahead of the long growing season.

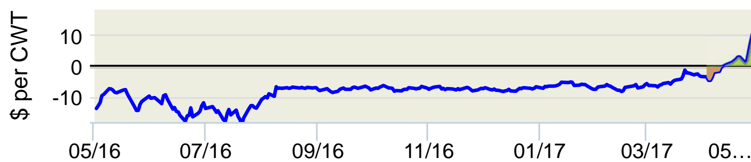
Live Cattle Marketing Periods:

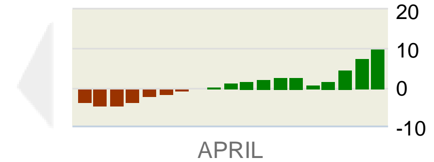
Jun '17 2016 2017 Jun 2017: HIGH **$15.62** LOW **($14.79)** LAST **$15.62** 10YR PERCENTILE **100.0%**



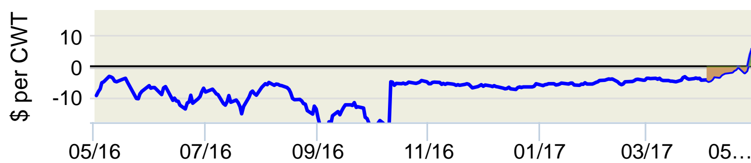


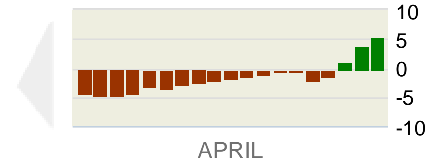
Aug '17 2016 2017 Aug 2017: HIGH **$10.05** LOW **($19.19)** LAST **$10.05** 10YR PERCENTILE **99.0%**



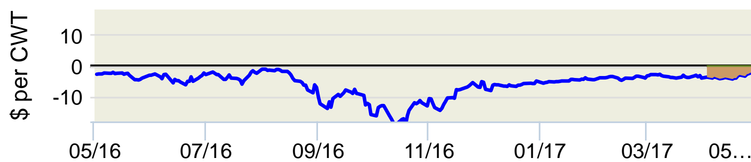


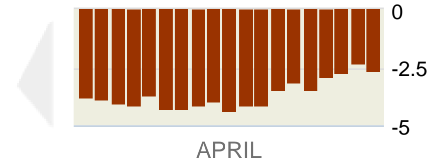
Oct '17 2016 2017 Oct 2017: HIGH **$5.44** LOW **($21.47)** LAST **$5.44** 10YR PERCENTILE **95.6%**



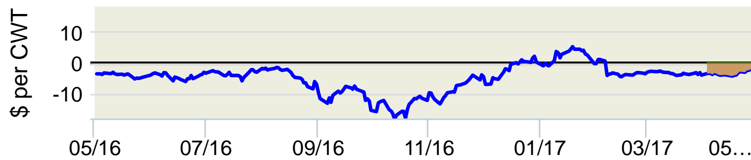


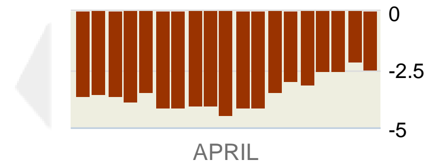
Dec '17 2016 2017 Dec 2017: HIGH **($1.19)** LOW **($20.08)** LAST **($2.64)** 10YR PERCENTILE **54.9%**



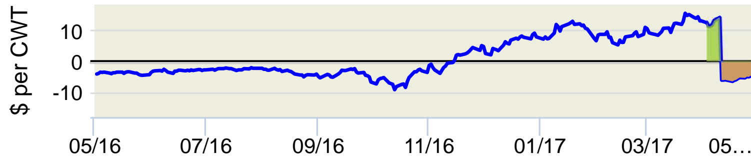


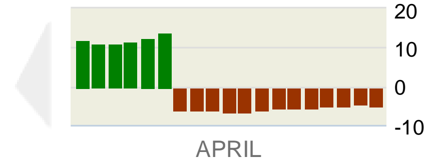
Feb '18 2017 2018 Feb 2018: HIGH **$5.05** LOW **($18.30)** LAST **($2.47)** 10YR PERCENTILE **45.9%**





Apr '18 2017 2018 Apr 2018: HIGH **$15.25** LOW **($9.28)** LAST **($5.17)** 10YR PERCENTILE **19.5%**





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.

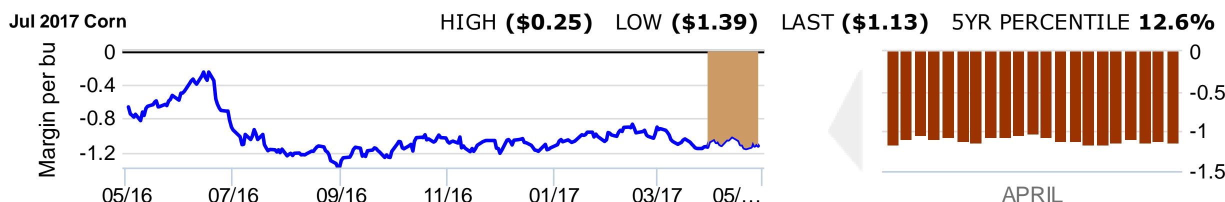
The information contained in this publication is taken from sources believed to be reliable, but is not guaranteed by Commodity & Ingredient Hedging, LLC, nor any affiliates, as to accuracy or completeness, and is intended for purposes of information and education only. Nothing therein should be considered as a solicitation to trade commodities or a trade recommendation by Commodity & Ingredient Hedging, LLC. All references to market conditions are current as of the date of the presentation. Futures and options trading involves the risk of loss. Past performance is not indicative of future results. Please visit www.cihmarginwatch.com to subscribe to the CIH Margin Watch report.

Commodity & Ingredient Hedging, LLC

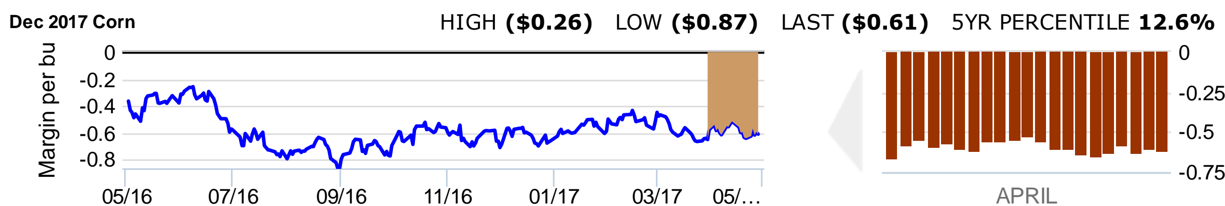
120 South LaSalle St, Suite 2200 ▪ Chicago, IL 60603 ▪ 1.866.299.9333

Corn Margin Watch: April

Corn prices and margins were slightly lower over the past two weeks, but remain in a tight range. Wetness has blanketed much of the Corn Belt, which halted planting progress this past weekend. Regardless, the crop is still 34% in the ground, matching the five-year average pace, and the current forecast provides a window of opportunity for the planters to resume moving after a brief drying-out period. The market is eagerly awaiting the May WASDE report, when the initial new crop corn balance sheet will be revealed. The same report will also update the demand side of the old crop balance sheet, where there may be gains in the ethanol category, as well as the export expectation. However, weekly ethanol production has trimmed back from the torrid pace since last fall, as plants perform seasonal maintenance ahead of the summer driving season. Meanwhile, export sales and shipments are both ahead of the average pace needed to meet the USDA estimate of 2,225 million bushels. The corn market was shocked last week from reports that the Trump administration was preparing draft paperwork to withdraw from NAFTA, however the next day President Trump tweeted reassurances that he was open to a renegotiation rather than a complete withdrawal from the treaty. Secretary of Agriculture Sonny Perdue was said be a crucial defender of NAFTA and its benefits to agriculture inside the White House. Many corn producers are maintaining flexible hedge positions as corn seeding continues and the crop progresses into emergence and critical pollination phases.



The estimated yield for the 2017 crop is 182 bushels per acre and the non-land operating cost is $595 per acre. Land cost for 2017 is estimated at $238 per acre [1]. Basis for the 2017 crop is estimated at $-0.22 per bushel.



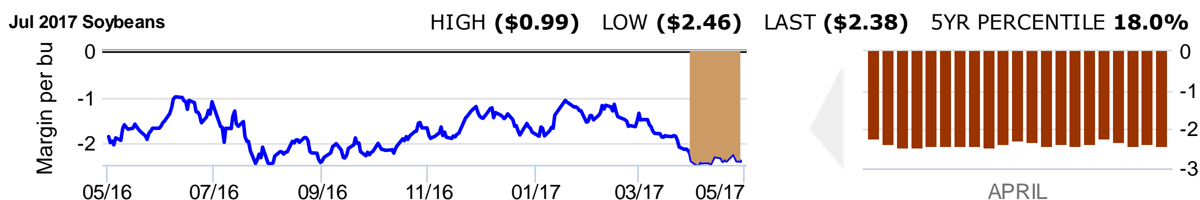
The estimated yield for the 2018 crop is 184 bushels per acre and the estimated operating cost is $547 per acre. Land cost for 2018 is estimated at $228 per acre [1]. Basis for the 2018 crop is estimated at $-0.25 per bushel.

[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.

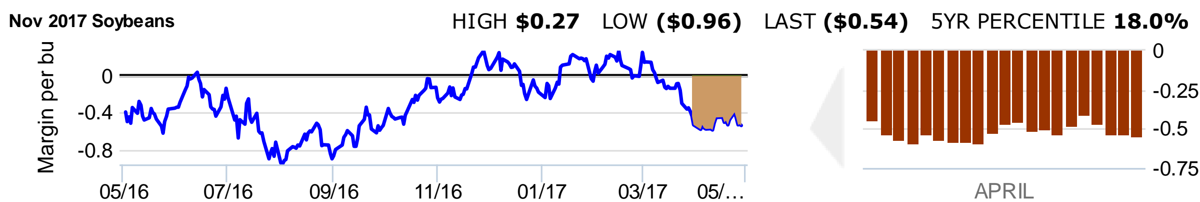
The information contained in this publication is taken from sources believed to be reliable, but is not guaranteed by Commodity & Ingredient Hedging, LLC, nor any affiliates, as to accuracy or completeness, and is intended for purposes of information and education only. Nothing therein should be considered as a solicitation to trade commodities or a trade recommendation by Commodity & Ingredient Hedging, LLC. All references to market conditions are current as of the date of the presentation. Futures and options trading involves the risk of loss. Past performance is not indicative of future results. Please visit www.cihmarginwatch.com to subscribe to the CIH Margin Watch report.

Soybeans Margin Watch: April

Soybean prices and margins moved lower over the past two weeks, but remained in a tight range. Heavy rains across the breadbasket halted planting progress this past weekend, but seeding of beans at 10% is three points ahead of the five-year average. The planters will roll after a brief drying-out hiatus as the forecast presently offers a favorable window through mid-May. The soybean market awaits the release of the May WASDE report, which will reveal the first look at the new-crop bean balance sheet, as well as updates to the demand side of the old crop. Soybean sales now stand at over 100% of the current expectation and have shipped almost 90% to date, however past USDA reports indicated tougher competition from South America this summer. The export pace of beans from Brazil has ramped up as the harvest there has finished. In Argentina, wetness had led to a slow start, but the harvest is currently making solid progress and is now estimated to be just over 30% complete. Last week all agricultural markets reacted to reports out of Washington that the Trump administration was preparing a draft to withdraw from NAFTA. The following day, President Trump reassured markets via an early morning tweet that after speaking with Mexican and Canadian leaders he was again open to a renegotiation, rather than a complete withdrawal. Secretary of Agriculture Sonny Perdue was said to be a critical proponent of the treaty, outlining its importance to agriculture, and key to getting the administration to walk back from scrapping the almost 25-year-old agreement. Many soybean producers are considering converting existing fixed hedges into more flexible positions as planting progresses and the uncertainty of summer weather nears.



The estimated yield for the 2017 crop is 52 bushels per acre and the non-land operating cost is $365 per acre. Land cost for 2017 is estimated at $238 per acre [1]. Basis for the 2017 crop is estimated at $-0.35 per bushel.



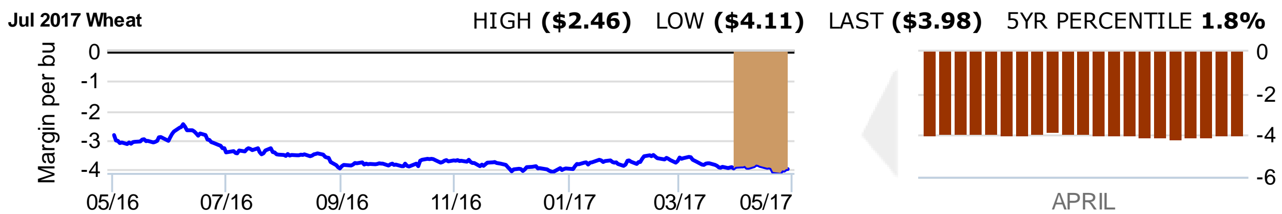
The estimated yield for the 2018 crop is 53 bushels per acre and the estimated operating cost is $290 per acre. Land cost for 2018 is estimated at $228 per acre [1]. Basis for the 2018 crop is estimated at $-0.3 per bushel.

[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.

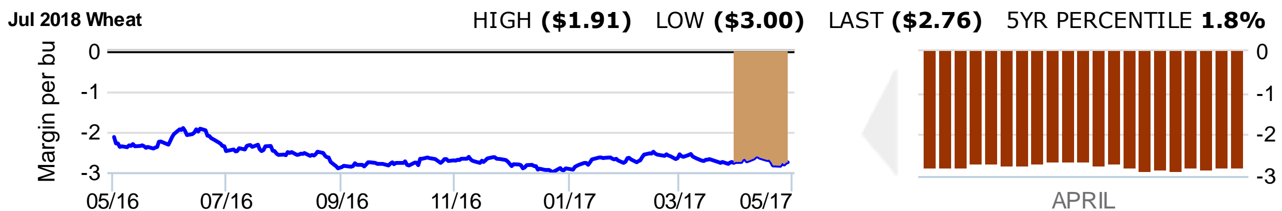
The information contained in this publication is taken from sources believed to be reliable, but is not guaranteed by Commodity & Ingredient Hedging, LLC, nor any affiliates, as to accuracy or completeness, and is intended for purposes of information and education only. Nothing therein should be considered as a solicitation to trade commodities or a trade recommendation by Commodity & Ingredient Hedging, LLC. All references to market conditions are current as of the date of the presentation. Futures and options trading involves the risk of loss. Past performance is not indicative of future results. Please visit www.cihmarginwatch.com to subscribe to the CIH Margin Watch report.

Wheat Margin Watch: April

Wheat prices and margins were lower over the past two weeks, but rallied hard after a weekend of heavy rains and yes, snow. The Oklahoma and Texas panhandles, along with western Kansas, received snow in excess of a foot. The late season snow led to reports of lodging in some areas. While damage assessment from the storm may take weeks to sort out, the annual wheat crop tour kicks off this week so the market will receive anecdotal initial storm damage observations from the fields of the plains. USDA has reported that conditions were consistent over the past three weeks at 54% in the GD/EX categories, but that figure will certainly diminish in the next update. The wheat market also eagerly awaits the May WASDE report, which will reveal the first look at the new-crop wheat balance sheet, while the old crop demand side will likewise be updated. Exports sales of wheat are near 100% sold, but shipments are lagging at 80% of the expectation with five weeks left in the marketing year. Wheat producers are monitoring the situation in the plains, while considering strengthening existing hedges to capitalize on the move higher.



The estimated yield for the 2017 crop is 67 bushels per acre and the non-land operating cost is $358 per acre. Land cost for 2017 is estimated at $158 per acre [1]. Basis for the 2017 crop is estimated at $-0.6 per bushel.



The estimated yield for the 2018 crop is 68 bushels per acre and the estimated operating cost is $358 per acre. Land cost for 2018 is estimated at $150 per acre [1]. Basis for the 2018 crop is estimated at $-0.3 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.

The information contained in this publication is taken from sources believed to be reliable, but is not guaranteed by Commodity & Ingredient Hedging, LLC, nor any affiliates, as to accuracy or completeness, and is intended for purposes of information and education only. Nothing therein should be considered as a solicitation to trade commodities or a trade recommendation by Commodity & Ingredient Hedging, LLC. All references to market conditions are current as of the date of the presentation. Futures and options trading involves the risk of loss. Past performance is not indicative of future results. Please visit www.cihmarginwatch.com to subscribe to the CIH Margin Watch report.