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June 2015

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INSIDE THIS ISSUE

Feature Article

Open Outcry Goes Dark

Pg **2**

***Margin Watch* Reports**

Hog ... Pg **5**

Dairy ... Pg **6**

Beef ... Pg **7**

Corn ... Pg **10**

Beans ... Pg **11**

Wheat ... Pg **12**

Dear Ag Industry Associate,

As many readers are likely aware, the CME Group is scheduled to close the agricultural futures trading pits and much publicity has been made of this development in the local and national press. The very fabric of Chicago's identity as a financial hub for futures trading revolves around the history of the trading pits at the Chicago Board of Trade and Chicago Mercantile Exchange. Many a career has been launched from those trading floors for generations of men and women from the Chicagoland area and neighboring Farm Belt states. Our feature article, "Open Outcry Goes Dark," discusses some of this iconic history of the Chicago exchanges and the development of the futures market over the past two centuries. While the event certainly marks the end of an era, it remains the case that the dual economic functions of price discovery and risk transfer are alive and well on the screen thus allowing livestock and crop producers dynamic opportunities to manage forward margins.

Meanwhile, recent heavy rainfall across the Eastern Midwest and key quarterly reports from the USDA have led to significant market movements and changing forward margin profiles. The latest installments of our *Margin Watch* reports discuss how the weather and government reports such as the Quarterly Hogs and Pigs, Grain Stocks and revised Planting Acreage have affected the margins for hog, dairy, cattle and crop producers.

Sincerely,

Chip Whalen
Managing Editor

Managing Editor, Chip Whalen is the Vice President of Education and Research for CIH, a leader in Margin Management. He teaches margin seminars throughout the country and can be reached at cwhalen@cihedging.com

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Open Outcry Goes Dark

The CME Group announced this past February its intention to close down open outcry, or floor based trading of agricultural futures this summer beginning in early July. This is only the latest in a long evolution in the development and growth of futures offering agricultural producers as well as buyers of agricultural commodities the ability to discover price and transfer risk. Before getting into what the open outcry going dark will mean for market participants, a brief history of futures trading might be interesting and insightful.

While it is tough to determine exactly when the first future actually traded, whether it was in the mid-1600s during the tulip mania in Holland or before, it is widely accepted that futures in the United States have their origins from the Chicago Board of Trade. The CBOT was founded in 1848 with the intention to promote commerce. The idea of forward price discovery and risk transference was not a new idea in 1848 but was certainly formalized with the establishment of a specific marketplace to conduct trade. The notion of futures as we know them today was still several years off. The reality is the early days of the Chicago Board of Trade simply provided a venue for buyers and sellers to negotiate customized cash forward and spot contracts while also providing a forum to resolve disputes that arose regarding those contracts.

In 1865 the Chicago Board of Trade established new innovative rules that really paved the way for futures as we largely know them today. The idea of a standardized contract identifying terms for quantity, quality, and delivery procedures was born. At the same time payment and contract settlement terms were developed as well. More specifically a requirement for margins was also initiated. Contract standardization and margining collectively created a new frontier that brought both hedgers and speculators together in a widely dynamic marketplace. Hedgers could now use futures as a temporary substitute for their eventual physical purchases and sales.

Today this concept is applied across all facets of commerce and industry, not just agriculture. Another offshoot of these rules is the practice of modern day “mark to market” procedures. The margining process is the bedrock of the financial integrity of the entire futures market and has evolved to include daily position settlements facilitating collecting in losses and paying out gains on all positions. In fact the benefits of daily recapitalization of positions were illustrated quite transparently when many over the counter (OTC) positions across the whole financial system in 2008 were left to accumulate unsustainable levels debt before being unwound or offset causing many systemic issues.

As standardization and margining are credited as being catalysts for the early growth of the futures market due to their widespread acceptance, electronic trading could be cited as another example of market participants determining the evolution of futures. While the Chicago Board of Trade is credited with establishing the first organized futures exchange in the U.S., the Chicago Mercantile Exchange (CME) created the technology for the Globex electronic trading platform which is now the standard for price discovery and risk transfer in the futures market. Initially conceived in 1987 as a “low impact” means of providing after-hours market coverage for currency trading, it took until 1992 when the technologies could actually become operational in the context of currency products.

Continued on following page

Open Outcry Goes Dark
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What really sealed the fate of open outcry trading however took almost another decade to develop. Due to the extended rally of the U.S. stock market by the late 1990s, the CME realized that the original S&P 500 futures contract had grown quite large and was becoming out of reach for many prospective traders due to its notional value. As a result, the CME developed a smaller sized E-mini S&P 500 futures contract, and deemed it would trade exclusively on CME Globex. Initially, the bulk of trade was transacted by traders equipped with CME Globex systems on the periphery of the open outcry futures pit to conduct arbitrage between the larger traditional contract and the smaller E-minis. In late 2000, the CME implemented an “open access” policy which meant that customers could trade directly on CME Globex as long as their clearing firm provided a financial guarantee for their trading activities.

Just prior to that in 1999, the CME introduced “side-by-side” trading in the Eurodollar complex which eventually extended to other products as well in both the financial and agricultural markets. This development meant that customers had the choice between executing their contracts through either the open outcry (pit) format or electronically on Globex. The electronic market was no longer simply an overnight platform to allow access to customers outside of the U.S. to trade markets during their normal business hours, such as in Europe and Asia. The Chicago Board of Trade introduced side-by-side trading in their agricultural complex on August 1, 2006, and later that year on October 17, the Chicago Board of Trade and Chicago Mercantile Exchange merged to become the CME Group.

Almost immediately after the development of side-by-side trading in the agricultural markets, the fate of open outcry or floor trading was sealed. The obsolescence of open outcry was quickly determined by market participants choosing the electronic market over the traditional venue. Whether it was the efficiency of speed or more likely the tighter bid-ask spreads on orders there is no doubt or debate that the migration to the screen was brought on by futures customers. In fact, the CME stated in their announcement of shuttering the open outcry trading of the futures pits that floor volume had dropped to 1% of total traded volume. The CME Group however will continue to offer floor based trading for options as well as the S&P 500 Index Futures.

The CME Group has traditionally maintained a policy of “let the market decide” between routing their orders to the pit or the screen. Customers appear to have decided with regard to futures trading at least that they prefer the electronic marketplace, which has prompted the Exchange’s decision to close the futures pits. While open outcry option trading will continue to be supported by the CME Group, many feel it is only a matter of time before all trading eventually migrates to the screen.

Despite this historic development, one thing to keep in mind after the agricultural pits go dark is that the market still serves the dual purpose of price discovery and risk transfer very well on Globex. Indeed, the market is as dynamic as it has ever been, and the efficiency and speed at which orders can be transacted allows for more trading to actually occur for the benefit of all market participants. Outside of former floor traders displaced by electronic trading and affected by the loss of a bygone era, most market users will not be impacted by this development. Indeed, without recent media

Continued on following page

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Open Outcry Goes Dark
Continued From Previous Page

coverage of the event, awareness of the pit closures may have even gone unnoticed.

The darkening of the open outcry pits is by all means a historic event worthy of the fanfare it's generating. Like the closing of the stockyards, the city of Chicago is certainly losing part of the fabric of its past identity. The reality though is the pits have largely been dark for several years now. Market participants will continue to have the ability to utilize the wonders of the forward price discovery and risk transfer functions of the CME Group, albeit an electronic version, for their margin management needs. Like many other industries, technology has fundamentally changed the way in which the futures market operates. Regardless of the format used to trade however, the main function of the market remains the same. Being able to both identify forward opportunities through price discovery and manage those opportunities through risk transfer is as alive and well today as it has ever been. ▪

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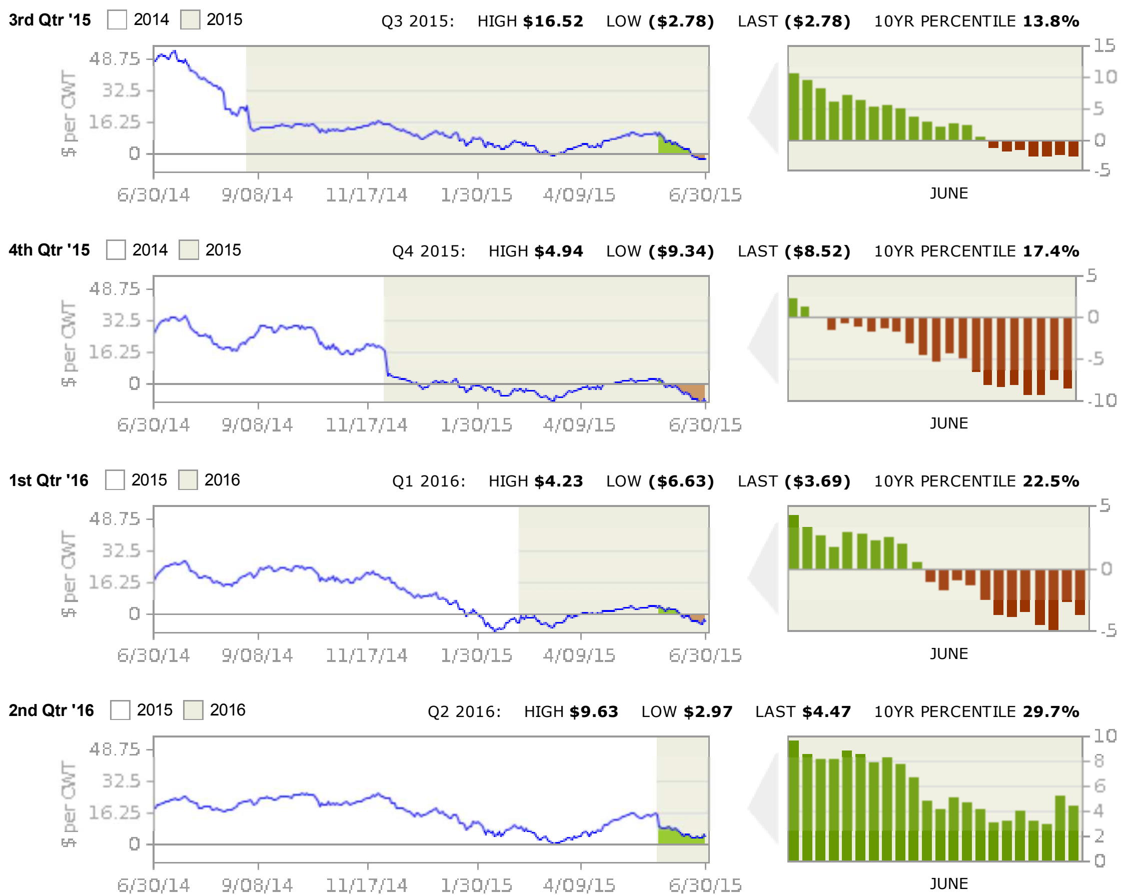
Margins continued to plummet over the second half of June following a sharp rally in feed costs with hog prices steady to slightly lower over the past two weeks. Two developments have really propelled the sharp gains witnessed recently in both the corn and soybean meal markets. First, excessive rainfall in the Eastern Corn Belt states of Illinois, Indiana and Ohio has caused ponding in many fields and given rise to concerns that yield will be compromised during pollination. Also, the wet weather has delayed late soybean seeding as well as winter wheat harvesting which is preventing some double-crop soybean acres from being planted. Second, the USDA released their revised June Acreage and Quarterly Stocks reports which were deemed bullish by traders. USDA reported corn planted area down 300,000 acres from the March Intentions, with harvested area down 600,000 acres. Assuming trendline yields, this change would lower production about 100 million bushels from previous estimates. June 1 corn stocks of 4.447 billion bushels were also down 65 million bushels from the average trade estimate, and soybean stocks of 625.4 million bushels were likewise down about 50 million from the average trade guess. USDA also released the Quarterly Hogs & Pigs report, which confirmed larger supplies of market hogs while indicating lower farrowing intentions in future periods. Hogs in the top two weight classes were up 13% and 11% from a year ago, versus expectations of a 10.2% and 9.8% increase, respectively. June-August farrowings meanwhile are projected down 3% from last year, with September-November farrowings down 4% from a year ago. These figures compare to expectations for farrowings similar to last year. Our clients have benefited from recent strategic adjustments to existing positions, particularly strengthening feed hedges while also adding flexibility to hog 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.

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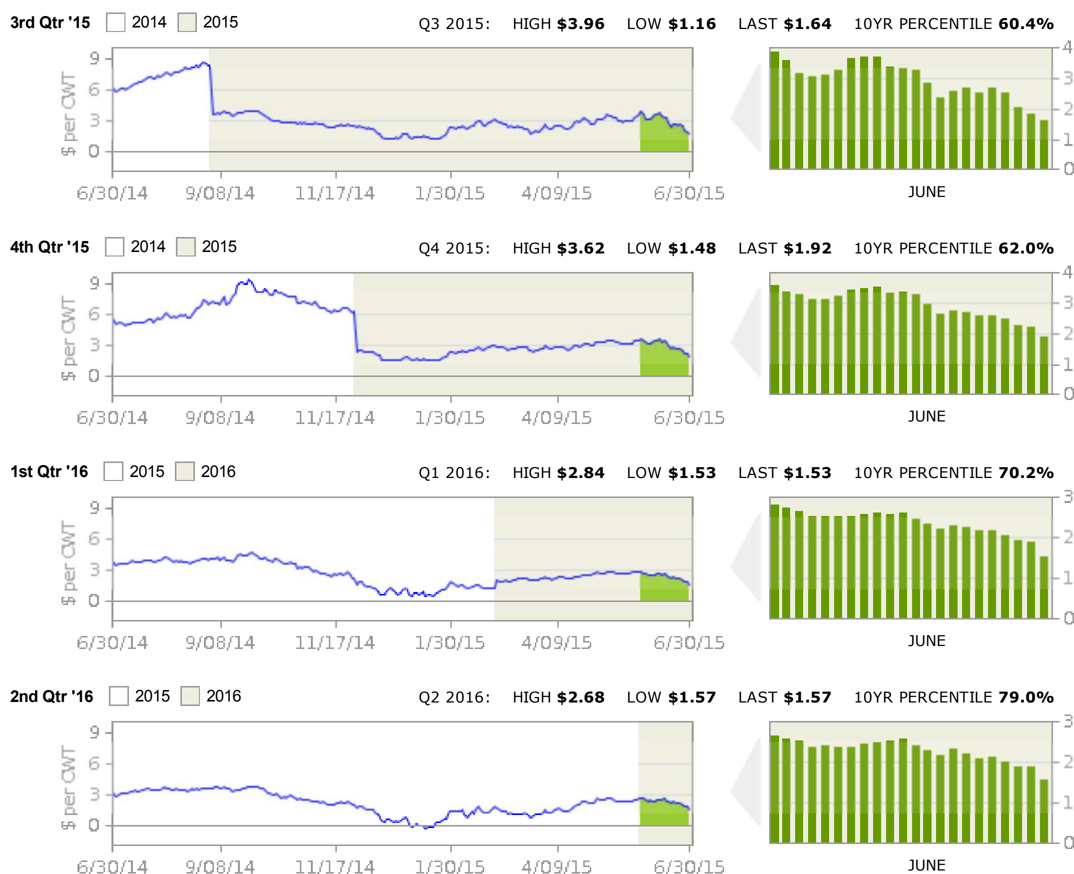
Dairy Margin Watch: June

Dairy margins deteriorated significantly over the past two weeks on a combination of sharply higher feed costs and continued weakness in milk prices. Recent strength in corn and soybean meal is coming from extremely wet weather in the Eastern Corn Belt that has caused ponding in many fields and raised concerns that yield will be compromised as a result during the July pollination period. Heavy rainfall has also delayed late soybean seeding and slowed the progress of winter wheat harvest which likewise has delayed planting of double-cropped soybeans. USDA meanwhile released their revised June Acreage and Quarterly Stocks reports which were considered bullish for corn and soybean meal. USDA reported corn planted area down 300,000 acres from the March Intentions, with harvested area down 600,000 acres. Assuming trendline yields, this change would lower production about 100 million bushels from previous estimates. June 1 corn stocks of 4.447 billion bushels were also down 65 million bushels from the average trade estimate, and soybean stocks of 625.4 million bushels were likewise down about 50 million from the average trade guess. Milk is being pressured by growing cheese and butter stocks while milk production continues to increase year over year. USDA's Cold Storage report reflected a sharp increase in both butter and cheese stocks during May, with the former growing almost 32 million pounds to 264.3 million and the latter up 20 million pounds from April to 1.1 billion. In addition to the monthly gains, both butter and cheese stocks continue to post year-over-year increases as well with May butter stocks up 26.2% from a year ago and total cheese inventories up 4.1% from last year. U.S. milk production totaled 18.35 billion pounds in May, down 0.2% from April but 1.4% higher than last year. Our clients have benefited from recent strategic adjustments on existing positions, particularly strengthening feed hedges while also adding flexibility to milk 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 $7.00/cwt for non-feed expenses. Milk basis is $0.75/cwt and non-milk revenue is $1.00/cwt.

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Beef Margin Watch: June

Beef finishing margins were mixed over the past two weeks, deteriorating sharply in nearby periods where cattle have already been placed while improving slightly in deferred marketing slots against future placements. Margins are still extremely negative and generally exist at the bottom decile of the previous 10 years as the landscape remains challenging for cattle feeders with tight supplies. Margins are being pressured by a combination of sharply rising feed costs and lower cattle prices. Corn has recently gained around 16% due to concerns surrounding heavy June rain in the Eastern Corn Belt that has created widespread ponding and caused crop condition ratings to decline. The development raises questions about yield potential as we head into the critical pollination period during July. Meanwhile, USDA released their revised June Acreage and Quarterly Stocks reports which were considered bullish for the corn market. USDA reported corn planted area down 300,000 acres from the March Intentions, with harvested area down 600,000 acres. Assuming trendline yields, this change would lower production about 100 million bushels from previous estimates. June 1 corn stocks of 4.447 billion bushels were also down 65 million bushels from the average trade estimate, as old-crop demand appears to be stronger than expected. USDA's latest Cattle on Feed report showed May placements down 10.2% from a year ago when the market was expecting a 9.6% reduction from 2014. USDA also reported inventories of boneless beef in Cold Storage at the end of May totaled 468.5 million pounds, up 24.1% from a year ago and 8% higher than the five year average. With forward margin opportunities limited, our clients continue to evaluate adjustment opportunities on existing positions. Adding flexibility to feed hedges and strengthening cattle hedges have been two areas of focus our consultants have been reviewing with clients recently.

Live Cattle Marketing Periods:

Aug '15 2014 2015 — Aug 2015: HIGH **$21.15** LOW **($14.73)** LAST **($9.36)** 10YR PERCENTILE **16.2%**

Oct '15 2014 2015 — Oct 2015: HIGH **$25.83** LOW **($11.91)** LAST **($9.49)** 10YR PERCENTILE **6.8%**

Dec '15 2014 2015 — Dec 2015: HIGH **$20.81** LOW **($12.03)** LAST **($8.63)** 10YR PERCENTILE **6.1%**

Feb '16 2015 2016 — Feb 2016: HIGH **$22.28** LOW **($9.55)** LAST **($8.50)** 10YR PERCENTILE **4.2%**

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.

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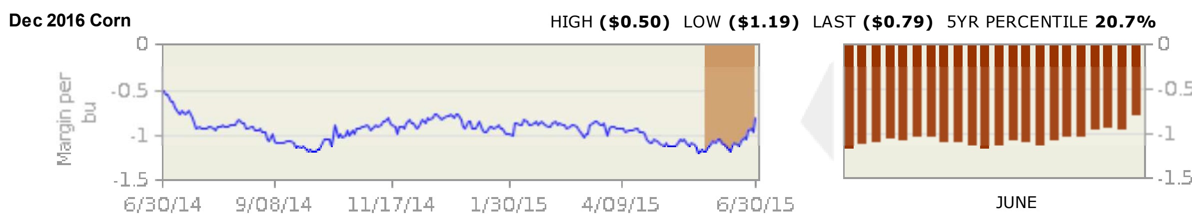
Corn margins are significantly higher since the middle of June and finished the period at the best level for 2015. New information was presented to the marketplace in the recent Planted Acreage report and Quarterly Stocks report, with both deemed supportive to prices. NASS reported the 2015 seeding results to be 88.897 million acres planted, down 302,000 acres from the March Prospective Planting report. Harvested acres are expected to come in at 81.101 million acres which is down 600,000 from the latest WASDE report. Without any change to yield (currently 166.8 bpa) or harvested acres for the remainder of the growing season, which is unlikely, production would drop 100 million bushels from the latest USDA forecast. The Quarterly Stocks report revealed corn stocks in all positions to be 4.447 billion bushels, below the pre-report estimate of 4.512 billion bushels. The March to May indicated disappearance is 3.30 billion bushels, compared with 3.16 billion bushels during the same period last year. Consumption has to equal 2.596 billion bushels for the remainder of the marketing year to meet the USDA forecast which would be the third largest usage on record for the fourth quarter. Both reports indicate lower new crop stocks via better old crop demand and lower new crop production than previously expected. While global supplies remain adequate to meet demand, uncertainty of future weather and domestic supplies will continue to have the greatest impact on prices through pollination. As mentioned in the last Corn Margin Watch, our consultants have begun the discussion with our clients on margins for the coming years. Together they are setting a margin management plan to protect attractive margins as the opportunity arises.

The estimated yield for the 2015 crop is 174 bushels per acre and the non-land operating cost is $615 per acre. Land cost for 2015 is estimated at $238 per acre [1]. Basis for the 2015 crop is estimated at $-0.08 per bushel.



The estimated yield for the 2016 crop is 174 bushels per acre and the estimated operating cost is $615 per acre. Land cost for 2016 is estimated at $238 per acre [1]. Basis for the 2016 crop is estimated at $-0.2 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.

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Soybean margins have surged higher since the middle of June and are approaching the best levels of the year. NASS reported updated planting figures in the Planted Acreage report as well as current supplies in the Quarterly Stocks report. Both reports confirmed the recent strength in prices. NASS reported the 2015 seeding results to be 85.139 million acres, up 504,000 acres from the March Prospective Planting report. Harvested acres are expected to come in at 84.449 million acres, up 749,000 from the latest WASDE report. Compared to pre-report estimates, this report on the face seems neutral. However, recent crop progress reports indicate that the soybean planting pace is well behind particularly in two states, Kansas and Missouri. A revision to the planted acreage may occur for this crop year due to the later planting. Adding to the acreage uncertainty is the double-cropped soybean acres that are counted in the total acres. NASS does not specifically estimate double-cropped acres, but have given statistics as to the approximate amount. The national estimate for 2015 is 6% of the total which this year amounts to 5.1 million acres. With the wetness over the last few weeks, harvest progress of winter wheat in particular has fallen behind the 5-year average with 38% of the crop harvested compared to 46% on average. Double-crop soybeans are typically planted following the harvest of winter wheat. The Quarterly Stocks report revealed soybeans stocks in all positions to be 625.4 million bushels, down from the average pre-report estimate of 674 million bushels. The March to May indicated disappearance is 701 million bushels, up 19 percent from the same period last year. Consumption has to equal 325.6 million bushels for the remainder of the marketing year to meet the USDA forecast. The average Q4 demand over the last five years has totaled 386 million bushels; 10-year average is 436 million bushels. The last Soybean Margin Watch mentioned that some of our clients considered decreasing the delta of hedges to capitalize on the lower market that would benefit should the market move higher while still maintaining protection to all lower prices. Those adjustments have proved quite worthwhile as prices have increased nearly $1.50. Some of our clients are now considering adding some delta to their protection strategies to capture the increase in margins.

The estimated yield for the 2015 crop is 52 bushels per acre and the non-land operating cost is $365 per acre. Land cost for 2015 is estimated at $238 per acre [1]. Basis for the 2015 crop is estimated at $0.05 per bushel.

The estimated yield for the 2016 crop is 52 bushels per acre and the estimated operating cost is $365 per acre. Land cost for 2016 is estimated at $238 per acre [1]. Basis for the 2016 crop is estimated at $-0.2 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.

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Wheat Margin Watch: June

Wheat margins are greatly stronger since the middle of June as recent weather has reduced the global supply expectation. NASS recently reported final year-end stocks for old crop in the Quarterly Stocks report. Final stocks were reported at 753 million bushels, up 41 million bushels from the latest WASDE report and were considered neutral to slightly negative. All wheat planted acreage was adjusted higher to 56.1 million acres, up 700,000 acres from the March Prospective Planting report. Harvested acres are expected to come in at 48.5 million acres, up 500,000 from the latest WASDE report. On the face these figures seem neutral to negative; however, market participants have questioned the USDA's current yield figure with the excessive rains that have fallen over the past two weeks as well as questions over the quality of Soft Red Wheat particularly in the eastern Midwest. Too much rain in a short period of time has cause ponding in some areas which can lead to quality deterioration and yield drag. The rains have also slowed the harvest progress of Soft Red Wheat. NASS recently reported harvest progress at 38% complete versus 46% on average. On the global front, Canadian wheat yields are expected to be nearly 10% below trend this year. Canada has seen the opposite of the Midwest, above normal temperatures and below normal precipitation. Ongoing dryness also persists in the Black Sea region particularly in Kazakhstan and Russia. The lower production expectation from foreign sources could lead to reduced exports in those countries and ultimately larger exports for the U.S. if lower global production is realized. The last Wheat Margin Watch mentioned that some of our clients considered decreasing the delta of hedges to capitalize on the lower market that would benefit should the market move higher while still maintaining protection to all lower prices. Those adjustments have proved worthwhile as prices have increased nearly $1.20 in two weeks. Some of our clients are now considering adding some delta to their protection strategies to capture the increase in margins.

The estimated yield for the 2015 crop is 67 bushels per acre and the non-land operating cost is $366 per acre. Land cost for 2015 is estimated at $163 per acre [1]. Basis for the 2015 crop is estimated at $0 per bushel.

The estimated yield for the 2016 crop is 72 bushels per acre and the estimated operating cost is $328 per acre. Land cost for 2016 is estimated at $158 per acre [1]. Basis for the 2016 crop is estimated at $-0.1 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.

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