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Dear Ag Industry Associate,

There has been a proliferation in the use of swaps contracts over the years as both a speculative and risk management tool, and this includes the agricultural space as well. Many producers and end users have been exposed to these instruments by various parties as an alternative to futures contracts on the exchange as well as forward contracts in the cash market. While swaps have been around for a number of years, they have garnered increased attention recently – particularly in the financial markets. For many, these are new instruments and perhaps not as well understood as the traditional contracts they are familiar with such as futures and forwards.

In the next few Margin Manager installments, we will devote a series of articles to discuss each of these various contracting alternatives in depth. We will explore their features, benefits, advantages and disadvantages to discern how these contracts differ from one another. The conclusion of the series will compare the various alternatives against one another, so that producers and end users can better understand how and when they may choose to include these contracting choices as part of a comprehensive margin management plan.

In addition to this special feature, we also review current forward margins for the crop, hog, dairy and beef cattle industries in our regular Margin Watch reports. A recent focus on macroeconomic events as they relate to China's growth deceleration has reverberated back to our shores and affected the equities market in particular. Despite relative margin stability over the past month, this economic slowdown for a major producer and consumer of agricultural goods should have a profound impact on the forward margins of crop and livestock producers in the U.S. for some time to come.

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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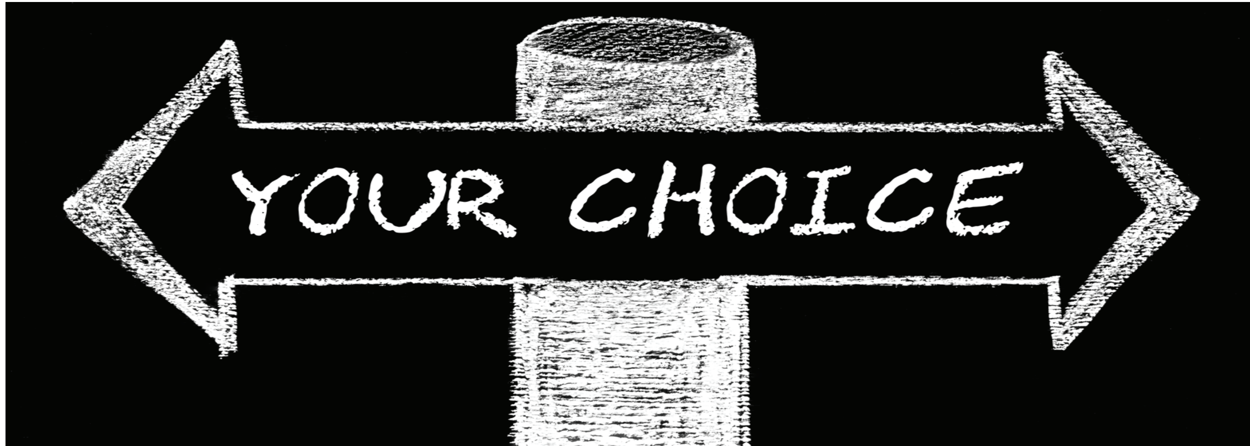
Contracting Comparisons



One of the fastest growing areas of derivatives is the world of swaps. While these instruments have been around for some time now, they have received increased attention in recent years. Perhaps the biggest focus has been on the financial side of the market, specifically credit default swaps that took much of the brunt for helping fuel the financial crisis in 2008. As a result of the fallout from that crisis, there has been a push to standardize many of these instruments and have them centrally cleared. There has also been more attention paid to how these contracts are executed and the regulation of swap execution facilities or SEF's. Outside of the financial realm, swaps are also widely used in the agricultural markets to facilitate hedging activities and risk management for a variety of different businesses including producers and end users. These contracts function similarly to futures and forward contracts, but differ in certain respects with regards to cost, margining, and counterparty risk.

In the next few editions of *Margin Manager*, we will explore swaps in greater detail and compare their features, benefits, advantages and disadvantages to those of futures contracts as well as forward agreements in the cash market. We will look at the structure and mechanics of a typical "vanilla" swap contract, or one that is built to essentially mimic a futures contract, and explore how these contracts function with respect to cost, margining and counterparty exposure. With a fuller exploration of how a swaps contract works, we will then devote separate articles to review the features of both a futures contract and a forward contract to highlight how they differ from a swap. From there, we will follow up with a final article to compare the different contracts against one another, and try to draw some conclusions on where each contract might fit into a particular operation's margin management plan.

As with any contracting alternative, it is important to understand how a contract works and where it may help a business achieve its goals and objectives. Not all contracts are right for all producers, and it is up to the individual operation to determine what contracting choices best help achieve their unique goals in light of their particular situation. No single contracting alternative is necessarily better than another and it may very well be the case that a mix of different contracts over various timeframes and margin opportunities represents the best fit for a particular operation in a given year. At a minimum, having a better understanding of how these contracts function should help an operation determine where and when they may want to consider using them, and how they fit in to a comprehensive margin management plan.

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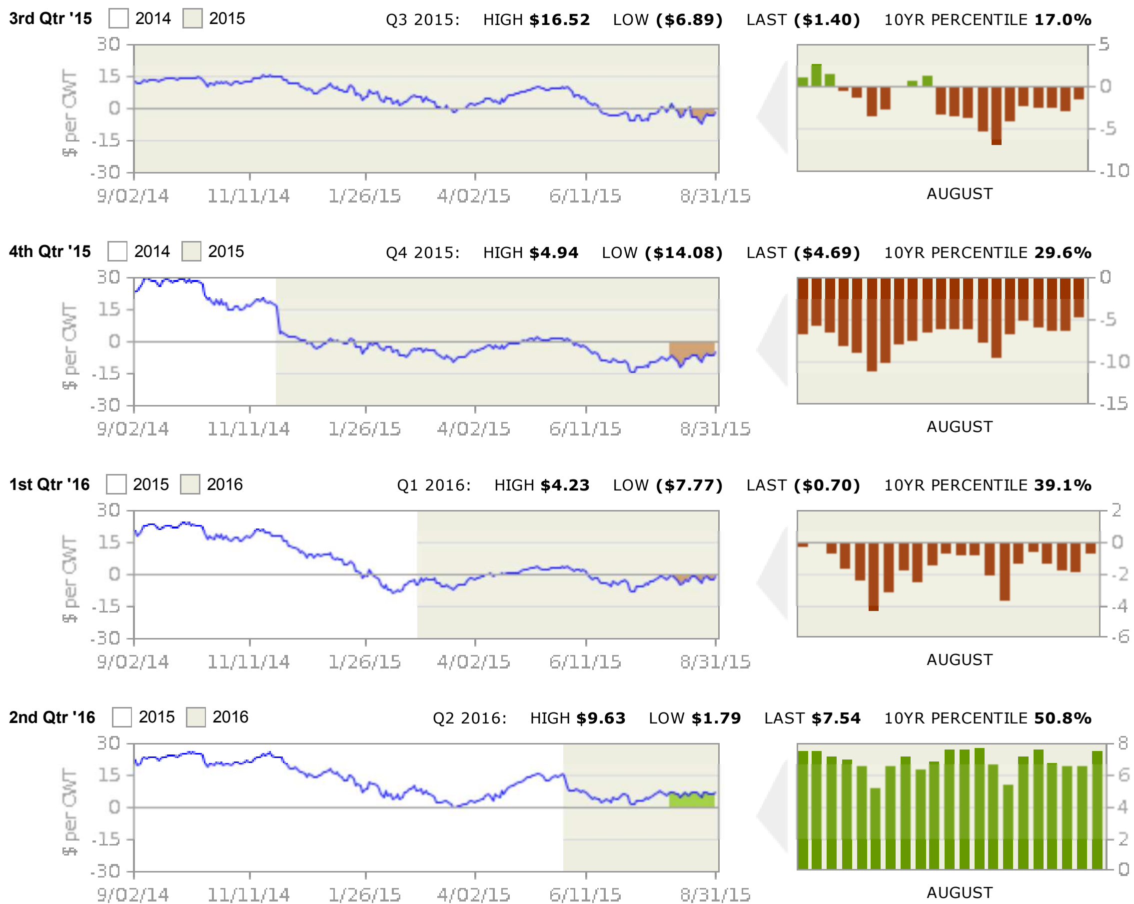
Hog Margin Watch: August

Margins were mixed over the second half of August, but generally weaker with the exception of the spot Q3 period. Prices were relatively flat on both the feed input side as well as with hogs since the middle of the month, with little feature in either market. In general, commodity markets have been influenced by outside factors recently, with extreme volatility in the equity market impacting currencies and the energy complex. Hog finishing margins remain below average and negative through the first quarter of 2016, with positive margins still projected in Q2. Hog prices have held up despite large production and heavy stocks. Federally inspected slaughter for the week ending August 29 totaled 2.214 million head, down slightly from estimates but up 11.4% from last year. Weights held steady for the week at 209 pounds, with total pork production at 462.8 million pounds – up 10.4% from last year. Meanwhile, USDA reported July total pork supplies in Cold Storage at 635.17 million pounds, up 641,000 pounds from June. Seasonally, pork supplies draw down 4.7% on average between June and July based on the past 10 years. Ham supplies in particular are heavy and at a new 10 year high which is not encouraging as hams usually help to support the pork cutout after Labor Day when demand for bellies and grilling cuts usually declines. Both corn and soybean meal were steady over the past two weeks with limited news. Both markets await further confirmation on yield prospects from actual harvest results with ongoing supply uncertainties, although demand may be more of an issue moving forward as many analysts feel that USDA is too optimistic in their current assumptions. Our clients continue to focus on Q2 for new coverage where margins are still positive with flexible strategies that will benefit from potential margin improvement over time.



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: August

In a reverse from the first half of August, dairy margins were again mixed but weaker this time in nearby periods through the remainder of 2015 while stronger over first half of 2016. Q2 margins are now back above the 80th percentile of the previous 10 years, with nearby margins ranging from the mid-60th to just over the 70th percentile. While feed prices were relatively flat since the middle of the month with limited feature, milk prices displayed more volatility. A brief spike in prices quickly reversed course with Class III contracts finishing the month very close to levels in mid-August. The strength stemmed from a surge in butter to $2.37/lb. following news from Fonterra's Global Dairy Trade (GDT) auction where the index rose 14.8% from the prior event, with AMF and WMP leading the gains. An announcement from Russia's Federal Service for Veterinary and Phytosanitary Surveillance that they had removed import bans from 29 New Zealand dairy companies supported the market, although CME butter prices remain at a significant premium to GDT butter. Meanwhile, USDA reported July milk production up 1.2% from June at 17.65 billion pounds, with both cow numbers and milk per cow increasing month-over-month. July milk production seasonally declines about 2.3% from June, and the Cold Storage figures were likewise bearish. USDA reported July butter stocks at 254.4 million pounds, up 41% from last year and only 0.5% or 1.34 million pounds less than June when the seasonal draw down is typically 11.4 million pounds based on the average of the past five years. Cheese stocks of 1.162 billion pounds were even more bearish, up 1.8% from June and 10% higher than last year as well as at a three decade peak. Our clients continue focusing on deferred periods where margins are historically more attractive for new coverage with flexible strategies that will benefit from potential margin improvement over time.

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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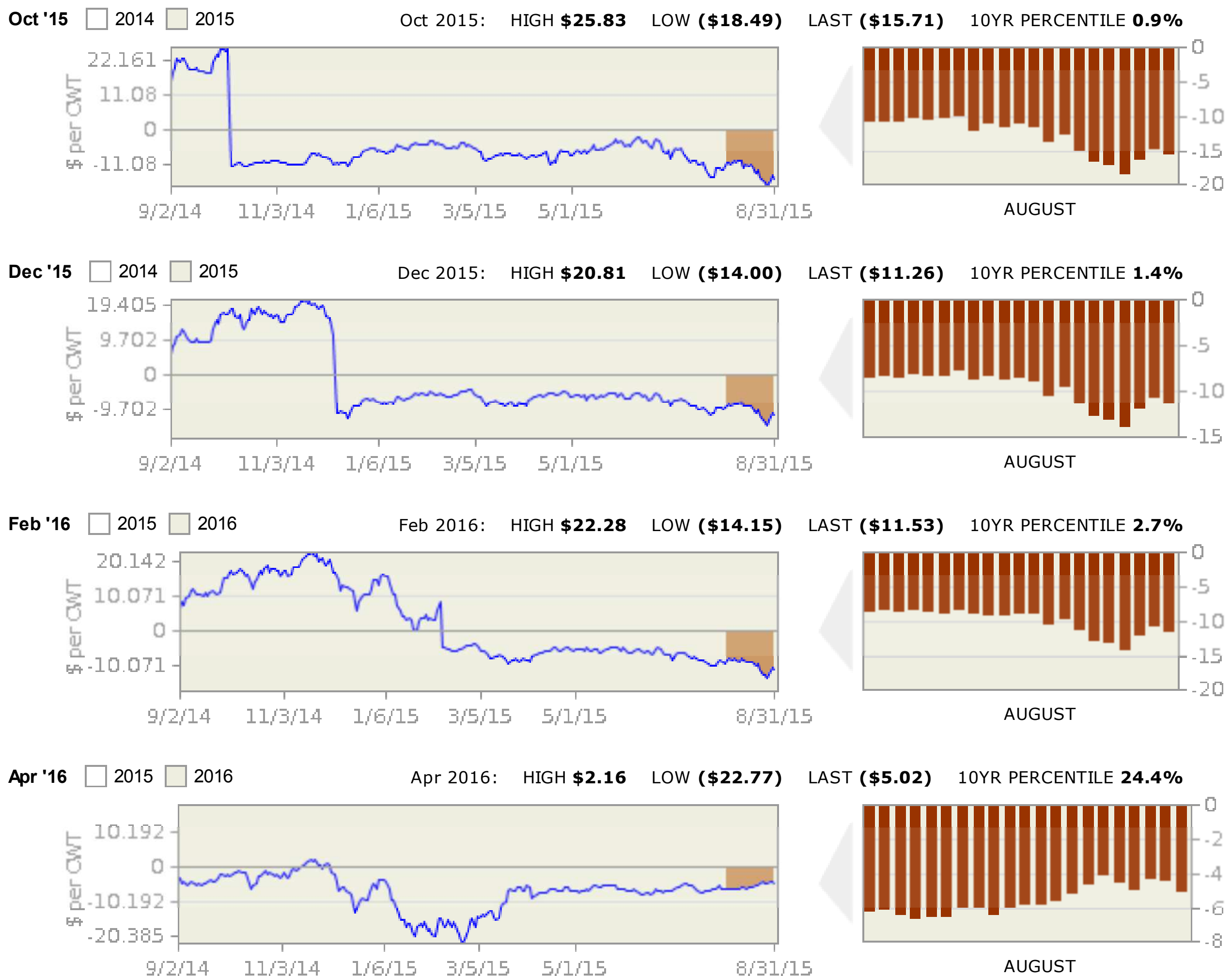
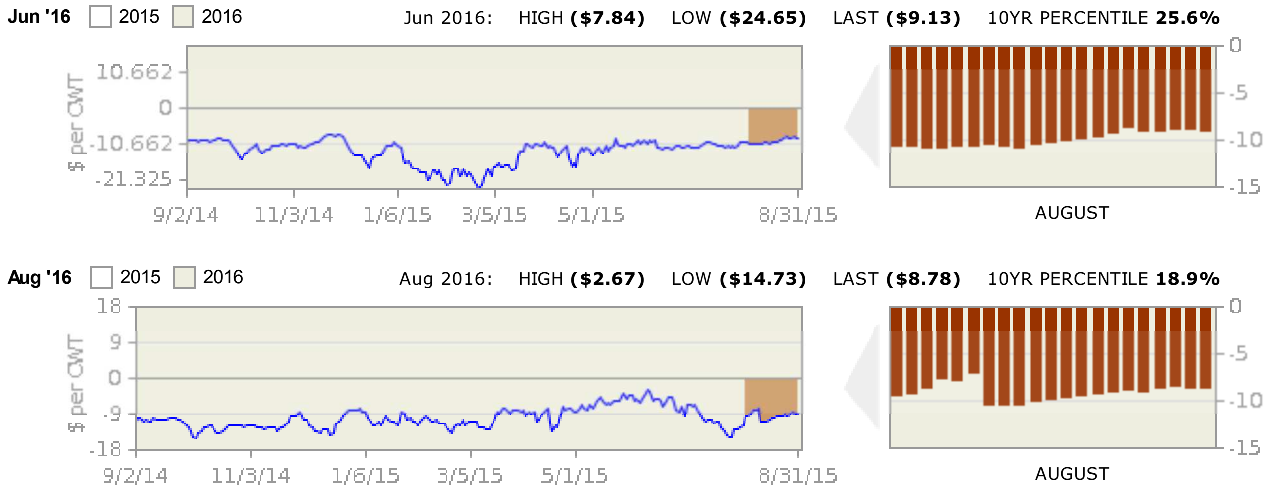
Beef Margin Watch: August

With the exception of far deferred marketing periods in the spring and summer of 2016 against future placements, beef margins were sharply weaker over the past two weeks as cattle prices declined since the middle of August while feed costs held relatively steady. From a historical perspective, beef finishing margins remain extremely weak – ranging from the 1st to the 3rd percentile of the past 10 years through the winter, and in the bottom quartile of historical profitability beyond that. Both the feed and livestock sectors have been influenced by outside factors over the second half of the month, with extreme volatility in the equities market impacting the dollar and the energy complex. The sharp decline in stocks was triggered by concerns that China's economy is slowing down much more rapidly than previously believed. Emerging markets have been under heavy pressure as a result, and there is concern over the future of beef demand and exports to Asia which has emerged in recent years as a major growth market. USDA reported 1.547 million head of cattle placed on feed during July, down 0.8% from a year ago when the market was expecting a 0.9% increase year over year. Total inventory of cattle on feed as of August 1 was up 2.6% from last year though, exactly in line with analysts' estimates. Meanwhile, USDA reported total July beef inventories in Cold Storage at 2.532 billion pounds, up 16.5% from a year ago and 10.7% higher than the five-year average. On the feed side, corn prices have been flat as traders await actual harvest results for further confirmation of USDA's latest yield forecast, with widespread uncertainty remaining on the supply side. Our clients continue to focus on making strategic adjustments to existing positions given the lack of forward margin opportunities. Adding flexibility to cattle hedges has been a recent focus given the current weakness in that market.

Live Cattle Marketing Periods:





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 Margin Watch: August

Corn margins were fairly stable since the middle of August. The corn market eagerly awaited forecasts of production and yield from the annual Pro Farmer Crop Tour, which takes place for four days over seven Midwestern states. The goal of the tour is to gather observations for accurate yields for each of the seven states surveyed rather than a yield tally for each surveyed field. Specific and uniform methods are deployed in each field to derive a district, state, and an entire Midwestern yield forecast. As a result of the four days of data collection the estimate for 2015/16 corn production was 13.323 billion bushels on yields of 164.3 bushels per acre. Both forecasts were lower than the recent NASS estimates of 13.686 billion bushels and 168.8 bushels per acre revealed in the August WASDE report. At the beginning of September NASS will be embarking on their own field studies as well as broader farm surveys to update the 2015/16 corn production and yield estimates in the September 11th WASDE report. Corn export sales for the new crop year continue to lag last year and the ten year average to meet the USDA's corn export estimate. The pace of sales for 2015/16 is running at 14.1% versus a ten year average pace of 19.8%. The latest weekly sales figure however was the largest to date for new crop corn, perhaps signaling a switch away from cheaper global exports given recent US dollar weakness. As a result of persistent heat and dryness, the EU recently lowered their forecast for corn production to 58.7 million metric tons versus an estimate of 65.5 million metric tons in July and 75.1 million metric tons last year. Our consultants continue to work with our clients to harness the volatility given recent macroeconomic events to set targets and execute strategic adjustments to existing positions. As always they are setting a margin management plan in place to protect attractive margins when opportunities present themselves.

The estimated yield for the 2015 crop is 182 bushels per acre and the non-land operating cost is $595 per acre. Land cost for 2015 is estimated at $246 per acre [1]. Basis for the 2015 crop is estimated at $-0.14 per bushel.

The estimated yield for the 2016 crop is 184 bushels per acre and the estimated operating cost is $586 per acre. Land cost for 2016 is estimated at $236 per acre [1]. Basis for the 2016 crop is estimated at $-0.14 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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Soybeans Margin Watch: August

Soybean margins continued to slide since the middle of August. Favorable rains fell across much of the Midwest at the critical pod-fill development stage, further reducing weather premiums. The market also received the results of the annual Pro Farmer Crop Tour. The annual four day survey over seven Midwestern states revealed soybean production and yield forecasts that were closely aligned with the most recent surprise estimates from the August WASDE report. The Pro Farmer forecast for 2015/16 soybean production was 3.887 billion bushels on yields of 46.0 bushels per acre versus the August NASS estimates of 3.916 billion bushels and 46.9 bushels per acre. At the beginning of September NASS will be embarking on their own field studies and farm surveys to update the 2015/16 soybean production and yield estimates in the September 11th WASDE report. In spite of the lower soybean prices export sales for the 2015/16 crop year are still lagging, the pace of new crop sales are 25.4% versus the ten year average of 29.6% of the USDA's soybean export estimate. The latest reading of export sales however did show some signs of life, it was the second highest weekly figure so far this marketing year, perhaps signaling a later than usual conversion from South American to US origin soybean exports. Our consultants continue to work with our clients to harness the volatility given recent macroeconomic events to set targets and execute strategic adjustments to existing positions. As always they are setting a margin management plan in place to protect attractive margins when opportunities present themselves.

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 $246 per acre [1]. Basis for the 2015 crop is estimated at $-0.2 per bushel.

The estimated yield for the 2016 crop is 53 bushels per acre and the estimated operating cost is $362 per acre. Land cost for 2016 is estimated at $236 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: August

Wheat margins deteriorated further since the middle of August. The accelerated pace of the spring wheat harvest continued, the USDA last reported that the spring crop is now 88% complete versus the five year average of 62% complete. Ag Canada, a private Canadian crop forecasting firm, updated the Canadian wheat production forecast which is now estimated to be 24.63 million metric tons, below trade expectations of 25.6 million metric tons and July's estimate of 27.1 million metric tons, as well as 16% below last year's production totals. Statistics Canada will be releasing updated stocks estimates at the beginning of September. The lower Canadian estimates may be offset by higher than anticipated yields in the EU, particularly from Northern Europe as well as ample harvests throughout Russia. The International Grains Council estimates world wheat production presently at 720.0 million metric tons compared to their former forecast of 710.0 million metric tons. Our consultants continue to work with our clients to harness volatility from recent macroeconomic events to set targets and execute strategic adjustments to existing positions. As always they are setting a margin management plan in place to protect attractive margins when opportunities present themselves.

The estimated yield for the 2015 crop is 67 bushels per acre and the non-land operating cost is $358 per acre. Land cost for 2015 is estimated at $166 per acre [1]. Basis for the 2015 crop is estimated at $-0.15 per bushel.

The estimated yield for the 2016 crop is 68 bushels per acre and the estimated operating cost is $359 per acre. Land cost for 2016 is estimated at $158 per acre [1]. Basis for the 2016 crop is estimated at $-0.15 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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