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Dear Ag Industry Associate,

It has been a beautiful fall season thus far with very favorable weather across a broad area of the U.S. Harvest conditions have been quite cooperative as activity quickly winds down in the Corn Belt, and attention turns to the approaching holiday season with Halloween and the World Series behind us. As a Cubs fan, it was bittersweet to watch a truly remarkable turnaround season for a young team to finally defeat their division rival Cardinals at home in Wrigley Field. Clinching their first NLCS berth since 2003 and first postseason series victory ever in the "Friendly Confines" was quite an accomplishment and wonderful to see. Not so friendly to the meat markets however this past month was a report from the World Health Organization classifying processed meats as a "Group 1" category of substances including alcohol, asbestos and tobacco smoke with "sufficient evidence" of causing cancer.

The International Agency for Research on Cancer (IARC), the WHO committee that released the report, also cited red meat including beef, pork, veal and lamb as agents that are "likely carcinogenic" based on "limited evidence". This news has had a big impact on the livestock markets, particularly for hogs, as many of the news stories surrounding the release of this study prominently featured references to and pictures of bacon and ham – two of the most commonly consumed processed meats derived from pork. The latest installment of Margin Watch discusses the impact of this development for the hog sector as well as providing updated forward margin projections for the dairy, beef and crop sectors.

Meanwhile, the feature article this month continues our series into comparing contracting alternatives. In *Contracting With Futures*, we discuss how a futures contract works and contrast this with using a forward contract in the cash market. While similar to forward contracts in some respects, there are important distinctions with using a futures contract, particularly in regards to the settlement procedure. The article discusses this in detail and covers other important distinctions between the two contracting alternatives. With a solid understanding of these two separate contracting alternatives, we will explore swaps in our final installment next month.

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 with Futures

In our last installment, we discussed forward contracting agreements in the cash market along with some of the considerations that go along with this type of contracting. For this month's article, we will turn our attention to the futures market and focus on contracting with futures. A futures contract is a standardized agreement between a buyer and seller that establishes a price for an underlying asset such as a commodity or financial instrument for a future period. The terms of the contract such as the size or quantity of the instrument, the quality and the specific settlement procedures between the buyer and seller are pre-established by the exchange at which the contract trades. In addition, the exchange performs the role of clearing the contract which helps to guarantee the performance of the agreement by both parties to the contract. In this way, a futures contract differs from a forward marketing agreement where the terms of that contract are negotiated directly between a buyer and seller, with each party at risk to the other for potential non-performance of the agreement reached between them.

While the features of a forward agreement and futures contract differ from one another, in many respects they are similar. They both establish a price between a buyer and seller for a future period, and in this way allow a producer to set a purchase or sale in advance to help protect forward margins in their business. Where they differ primarily concerns their settlement procedure and how the contract performance is executed. In the case of a forward agreement as we reviewed last month, there will be a single settlement upon delivery of the underlying asset. As an example, let's assume the two parties in this hypothetical agreement are a crop producer who grows corn and a neighbor in the local area who raises hogs. In the springtime, the two agree to a forward contract where the crop producer will sell their corn to the hog farmer at harvest time for a fixed price, and deliver this corn in the first half of November upon completion of their harvest. The price they establish in the spring will be a function of the forward futures contract that will represent the spot market during the delivery window. In this case, the December Corn futures contract would represent that spot period in the first half of November.

Let's say that in April the December Corn futures price is $4.50/bushel. We will also assume that in this particular local market, a normal basis for the first half of November would be 25 cents under December futures. As a result, the crop farmer agrees to sell his corn to the neighbor who finishes hogs for $4.25/bushel – the $4.50 December Corn futures prices minus the basis of 25 cents under futures. At this point in time, no funds are exchanged between the two parties although there are provisions in the agreement that lay out how each will have to perform on the contract to fulfill the agreement. The main stipulation for the crop farmer is that he is obligated to deliver the corn to the hog producer during the first half of November. In turn, the hog farmer will be obligated to pay the crop producer in full upon receipt of the grain. This is how the contract gets "settled" and each party performs on their end of the agreement. A forward contract has a single settlement upon delivery.

Now let's examine the futures market by contrast. As an alternative to contracting with each other, the hog producer may elect to secure his feed input cost by purchasing a corn futures contract on the exchange. Likewise, the farmer may choose to protect the value of his corn crop by selling a corn futures contract through the exchange. Using the same example as before, let's assume that each is protecting their risk for the forward harvest period in November and therefore decides to contract using December Corn futures. In order to trade a futures contract, each party will need to post a performance bond to initiate the position. The performance bond represents collateral that is deposited with the exchange through an intermediary which is the brokerage firm that will clear the trade with the exchange. We will assume for this example that the performance bond requirement to trade corn futures in April is $1,500 per contract. This will require both the corn farmer and the hog finisher to each deposit a minimum of $1,500 into a brokerage account for each contract they will need to execute in order to protect their individual risks.

With December Corn futures trading at $4.50/bushel, the notional value of the contract is $22,500 which is the size of the contract at 5,000 bushels times the current market price of $4.50. Therefore, with a performance bond or initial margin requirement of $1,500/contract, both the hog farmer and crop producer each have deposited the equivalent of just under 7% of the contract's notional value as collateral to guarantee performance of their separate agreements. In terms of what they have agreed to, this also differs from the forward contract we discussed previously. In

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that arrangement, they have a commitment to each other that involves physical delivery of and payment for the corn at the agreed upon settlement date – the delivery period in the first half of November. With a futures contract, each party will instead have a financial commitment to the exchange that will have to be maintained over the life of the contract until it is closed out or offset. While some futures contracts such as corn have a physical delivery settlement procedure as part of the specifications of how they are standardized by the exchange, the reality is that only a very small minority of futures contracts are settled through physical delivery. The vast majority are simply closed out or offset ahead of the contract's expiration. Now let's examine how each party will have to perform on their separate agreements in the futures contracts they buy and sell. Unlike having a direct obligation to one another as stipulated in the forward contract, each party will have a financial commitment to maintain with the exchange to guarantee the performance of their contract. How this works in practice is that there is a daily settlement procedure for the futures contract. With the close of the futures market each day, a closing or settlement price is posted for each futures contract that trades on the exchange. Open positions are then "marked" to this price, and each brokerage account is credited or debited on a daily basis with the accrued gains or losses from the previous day's closing price.

As an example, we will assume that both the crop producer and the hog farmer execute their futures contract at a price of $4.50/bushel in April when they open their separate positions. The crop producer sells December Corn futures at $4.50 to establish a sale price for their crop while the hog farmer purchases the December Corn futures contract at $4.50 to establish a purchase price for their feed needs. Each of them deposits $1,500 into a brokerage account to initiate their performance bond requirement, as stipulated by the exchange. Now let's say that on the day they execute their trades, the December Corn futures contract closes or settles at $4.50/bushel. At this point, neither party is ahead or behind on their position as the market price that is being marked is the same at which they executed their separate contracts. (See Table of Margin Example on following page)

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MARGIN EXAMPLE

Corn Hedge Margin = $1,500 per contract

Day	Margin Deposits	BUYER Account Balance	Settlement Price	Account Balance	SELLER Margin Deposits
1	$1500	$1500	$4.50/bu	$1500	$1500
2	$1500	$2000	$4.60/bu	$1000 M.C. $500 $1500	$1500 $2000
3	$1500 M.C. $500 $2000	$1000 $1500	$4.40/bu	$2500	$2000
4	$2000	$2000	$4.50/bu	$2000	$2000

M.C. = Margin Call

1

On day 2, let's say that December Corn futures close 10 cents higher at $4.60/bushel. The hog producer will therefore have a gain in their brokerage account of $500 or $0.10/bushel x 5,000 bushels/contract. Another way of looking at this is to think about what each party would need to do in order to close out their position in determining whether there is a gain or loss. Because the hog producer bought the contract to establish a long position in the market, he would need to sell the contract back in order to close it out. If he now can sell the contract he purchased at $4.50 back to the market at $4.60, he would realize a 10 cent gain on the position. Even though he is not yet closing out his position, his account is nonetheless credited for this unrealized gain based on where the contract is marked to the new market price. As such, the value of his account will increase to $2,000 ($1,500 initial performance bond requirement + $500 unrealized gain).

The crop farmer on the other hand will see a debit posted to their brokerage account. With the market now trading at $4.60, in order to close out of his sale obligation at $4.50, he would need to buy the contract back at $4.60 realizing a 10 cent loss. As a result, the value of his brokerage account will drop from $1,500 at the end of day 1 to $1,000 at the close on day 2 ($1,500 initial performance bond requirement - $500 unrealized loss). One stipulation of the exchange is that the initial perfor-

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mance bond requirement must be maintained for as long as the contract and the corresponding obligation on the position remains open. Because of this, the current value of the farmer's account at $1,000 will require him to post additional or "maintenance" margin in the account in order to maintain the minimum performance bond requirement. As such, a margin call will be issued by the farmer's brokerage firm at the end of day 2, requiring him to deposit additional collateral to the account in order to maintain the position in the market. In this example, the farmer will receive a $500 margin call at the end of day 2 to bring the value of his account back up to the initial performance bond requirement.

Now let's say on day 3 the market declines and December Corn closes 20 cents lower at $4.40/bushel. Each open position is marked to the new settlement price, resulting in a loss of equity for the hog producer but a gain for the crop farmer. The 20 cents represents a $1,000 change in value on a 5,000 bushel contract, meaning that the value of the hog producer's account will decline from $2,000 at the end of day 2 to $1,000 on the close of day 3. This means that the hog producer will be in the same position the crop farmer was the day before, with deficient equity in their brokerage account in order to maintain the open position in the market. As such, the hog producer's brokerage firm will issue a $500 margin call to address the difference in the current value of the account and the minimum amount necessary to be maintained in order to keep the position open.

The crop producer on the other hand will see a $1,000 credit posted to their account resulting from the 20 cent drop in the futures price. Assuming they met the margin call from the day before, this means that the value of the account will increase from $1,500 at the end of day 2 to $2,500 at the end of day 3. Another way of thinking about this is while the hog producer has a margin deficit in their account, the crop farmer now has a margin excess of $1,000 ($2,500 account value - $1,500 performance bond requirement). Just as the exchange will require any margin deficit to be covered on a daily basis to maintain performance on the contract, any margin excess is likewise free to be withdrawn from the account.

This is an important distinction between a single settlement procedure in the forward contract versus a daily settlement procedure in a futures contract. While the thought of meeting margin calls may be unsettling to some and the idea of maintaining capital requirements on a daily basis might seem arduous, it is a two-way street in that unrealized gains can also be drawn upon so that cash flow can go both ways. If the market is moving against the hedge, this will present a negative cash flow situation relative to using a forward contract; however, if the market is moving in favor of the hedge there will be a positive cash flow development which would not be available through use of a forward contract.

Moreover, the mechanics of a daily settlement procedure help ensure that the performance of all open interest in the market is maintained to the benefit of every position. Because all accounts have to be settled on a daily basis, no debt is built up that would present a systemic risk. The mechanics of a single settlement procedure in a forward contract by contrast necessitate that one party will be in debt to the other party depending on how the market moves, with counterparty risk present until the settlement occurs. Because of this, it is important when using a forward contract that you know your counterparty and have faith and confidence that they will honor the terms of the agreement. Non-performance can be an issue if one of the parties runs into financial hardship before the forward contract is settled.

Another distinction that is worth highlighting is the difference between how a forward contract stipulates the requirement of physical delivery as part of the settlement procedure while the futures contract does not. This may present an added risk for the seller, who is required to make delivery. If for example the corn farmer suffers a drought whereby his crop is decimated and he is unable to physically deliver the bushels of corn to his neighbor, the forward contract may stipulate that these bushels must be replaced in the open market at prevailing costs. With a futures contract, the farmer would simply be able to offset their financial obligation to the exchange by buying back the futures contract without having the added burden of having to physically supply the lost grain.

In our next installment, we will examine another type of contracting alternative called a swap. As we will see, a swap will have features of both the forward contract as well as the futures contract and can be an attractive alternative for some producers depending on their situation. ■

Hog Margin Watch: October

Margins deteriorated sharply over the second half of October due entirely to a freefall in the hog market, with corn steady over the past two weeks and soybean meal weaker. Margins are now back to the bottom quartile of the previous 10 years through 2016, with only Q2 showing a positive margin at present just above $4.00/cwt. The sharp drop in hogs has come about as continued heavy production due to large slaughter runs and huge weights is hitting the market at a time when demand concerns abound. The recent report from the WHO's International Agency for Research on Cancer that placed processed meats in the group's Class I category for items that provide "sufficient evidence" of causing cancer has received widespread press coverage prominently featuring bacon, ham and other pork products such as hot dogs, salami and bologna derived from hogs. While the science used in the study to reach the panel's conclusions is considered controversial and inconclusive, there is no doubt that it comes at an unwelcome time for the hog market. Meanwhile, USDA's Cold Storage report showed pork stocks of 656.4 million pounds at the end of September, up 19.2% from last year and a record high for the month. On a positive note, feed prices have been under pressure as the harvest winds down and yield reports continue to impress across the Corn Belt. The October WASDE suggested that production may still be adjusted slightly higher in the November report, and demand concerns are intensifying for corn given strong competition in the global market and strength in the U.S. dollar. Our consultants have been primarily focused on making strategic adjustments to existing positions, particularly adding flexibility to hog hedges following the recent sharp drop in price.

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.

Dairy Margin Watch: October

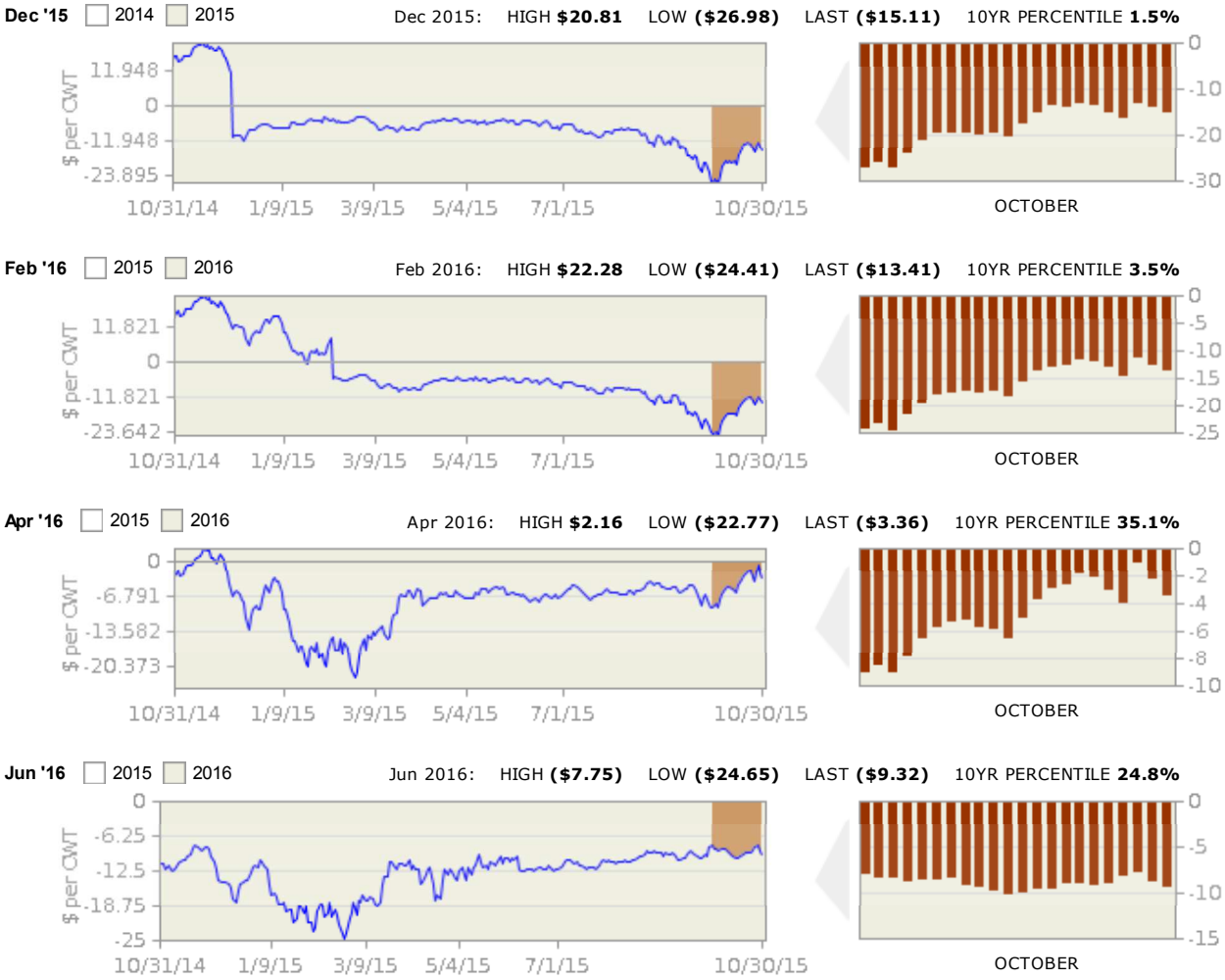
Margins were mixed over the past two weeks, deteriorating slightly in spot Q4 and Q1 while improving in deferred periods. While nearby dairy margins are only about average, deferred margins in Q2 and Q3 are at or above the 80th percentile of the past 10 years. Milk prices remain under pressure in nearby periods but have begun to stabilize and move higher recently in deferred contracts. USDA's September Milk Production report pegged output at 16.6 billion pounds, up 0.4% from last year but seasonally 1.4% less than August on a daily average basis. The September figure also represented the smallest year-over-year increase so far in 2015 as milk production per cow slows. Meanwhile, the monthly Cold Storage data from USDA reflected strong domestic demand for butter, which has begun to support Class IV contracts relative to Class III. U.S. butter stocks of 187.5 million pounds were up 23.1% from last year, but down 10.4% from August with the 24.7 million pound drawdown exceeding the five-year average of 19.3 million pounds during the month of September. Meanwhile, total cheese stocks of 1.1459 billion pounds were down 19 million pounds or 1.6% from August, but remain 13.4% higher than last year. Corn prices held relatively steady since the middle of October as harvest winds down across the Corn Belt while soybean meal and alfalfa prices were slightly weaker. Yield reports continue to impress, suggesting USDA may revise corn and soybean production slightly higher in the November WASDE. Our consultants have been working with clients to scale into deferred margin protection at attractive historical percentiles with flexible strategies that allow for both strong feed coverage and higher milk prices to be achieved over time.

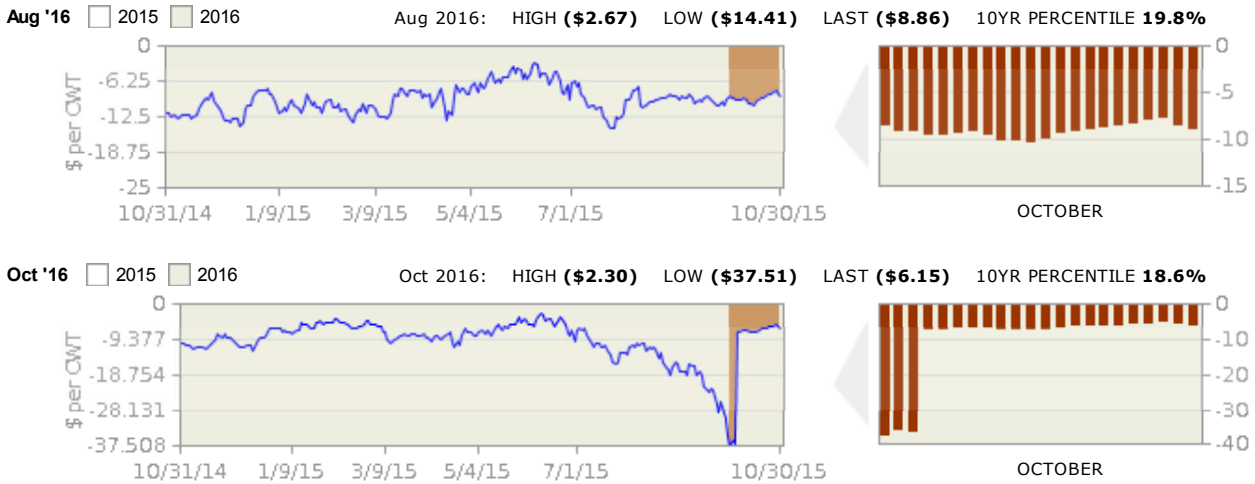
The Dairy Margin calculation assumes, using a feed price correlation model, that for a typical dairy 62.4 lbs of corn (or equivalent) and 7.34 lbs of meal (or equivalent) are required to produce 100 lbs of milk (includes dry cows, excludes heifers not yet fresh). Additional assumed costs include $0.90/cwt for other, non-correlating feeds, $2.65/cwt for corn and meal basis, and $8.00/cwt for non-feed expenses. Milk basis is $0.75/cwt and non-milk revenue is $1.00/cwt.

Beef Margin Watch: October

Beef margins improved since the middle of October with higher cattle prices while corn held relatively steady over the past couple weeks. Finishing margins remain deeply negative through 2016 with a lack of any forward crush opportunities though as cattle feeders continue to grapple with high costs relative to projected forward revenue. USDA's September Cold Storage report showed beef stocks at 496.4 million pounds, up 5.5% from August and 32.7% above a year ago. The figure also was above analysts' estimates and 20% above the five-year average of 413.7 million pounds for the month of September. The recent report from the WHO's International Agency for Research on Cancer that placed processed meats in the group's Class I category for items that provide "sufficient evidence" of causing cancer and also labeled red meat as "probably" carcinogenic based on "limited evidence" was not well received by the meat industry, although the impact has probably been more negative for the hog market than for cattle thus far. The USDA's latest Cattle on Feed report showed the total number of cattle on feed in September up 2.3% from a year ago at 10.218 million head, although placements of 1.931 million cattle during the month were down 6.1% from a year ago and the smallest for the month since the USDA began the data series back in 1996. Corn prices were relatively flat over the past two weeks as harvest winds down across the Midwest. Based on continued strong yield reports from producers, USDA may slightly raise the production estimate in the November WASDE report, but attention will quickly turn to demand. Corn remains uncompetitive in the global market with renewed dollar strength and negative ethanol blending margins adding to demand concerns. Our clients continue to manage their equity at risk below breakeven with flexible strategies that will allow for margin improvement in a rising 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 margins continue in the red as corn prices have shown a very slight improvement over the past two weeks. The corn market has had little to digest in the form of new information over the same time period. As harvest nears completion anecdotes from the fields remain strong, except in those areas that were impacted by the extremely wet spring. The next report from the USDA is due November 10th but is unlikely to reveal material changes to production and yield. Rather the final corn crop acreage, yield, and production information for the 2015 crop year will be released with the USDA's Crop Production Annual Summary Report this coming January. The January report will rely on data gleaned from the December Agricultural Survey. This survey will be conducted the first two weeks of December and gives over 83,000 U.S. farm operations the opportunity to include their 2015 production results in the final USDA figures. One adjustment the USDA may consider in the November report is corn exports. The current estimate is for exports to remain at levels attained last year. To date, export sales of new crop corn are reported to be 495 million bushels or 27% of the total needed to meet the current estimate. On an average of the past ten years 42% of the USDA's estimate has already been sold at this point in the marketing year. Abundant global supplies and strength in the U.S. dollar have adversely impacted the competitiveness of U.S. origin corn. The warm, dry weather has accelerated the pace of harvest this fall. At last reading the corn crop harvest is estimated to be 85% complete, this compares to 62% complete last year. As harvest nears completion our consultants are working with clients to adjust positions to coincide with the current market conditions and expectations. They are also on the lookout to set proper alerts to capitalize on favorable forward margin opportunities as they may occur.

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 $-0.12 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 $-0.35 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.

Soybeans Margin Watch: October

Soybean prices and margins pulled back slightly over the past two weeks in spite of very strong export inspections. The pace of soybean exports quickened the entire month of October with China aggressively accelerating their bean import purchases. Shipments of 102 million bushels last week were the largest weekly total this year with China reportedly receiving 62% of that total. To date, cumulative sales of soybeans are 1,002 million bushels or 60% of the USDA's estimate. On an average of the past ten years 56% of the estimate has been sold at this point in the marketing year. If this pace continues, the USDA may have to reconsider the export reductions they have made in previous reports for new crop sales. The next report is due November 10th. According to the monthly Fats and Oil report from NASS the September crush rate totaled 134.6 million bushels. On the global front the pace of soybean planting in Brazil is trailing historical averages but looks to catch up with favorable extended weather outlooks. The forecast for soybean production in Brazil continues to be a record measuring over one hundred million metric tons. The warm dry fall here has the soybean harvest running above average, at last report, the harvest was estimated to be 92% complete, eleven points above last year and four points above the five year average. As the harvest season comes to an end, our consultants are working with clients to adjust positions to fit the current market fundamentals and expectations. They are also busy setting targets to capture favorable forward margin opportunities as they may occur.

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 $-0.35 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.

Wheat Margin Watch: October

Wheat prices and margins further advanced the past two weeks, albeit modestly. The advances mostly were attributed to concerns of dryness in the winter wheat growing regions. Moisture from hurricane Patricia largely missed the central plains leaving soil moisture there below optimal levels. NASS reported winter wheat conditions at 49% Good/Excellent compared to 59% last year. Wheat export sales to date have a cumulative total of 314 million bushels. This represents 55% of the total to meet the current USDA estimate of all wheat exports. On an average of the past ten years 62% of wheat has been sold at this point to meet the estimate. Analysts have been adjusting Australian wheat production estimates lower as below optimal rainfalls have taken their toll on yields. In fact, last week the U.S. attache' in Australia lowered the estimate for 2015/16 wheat crop to 24 million metric tons, 3 million metrics tons below the current official estimate. Our consultants are working with clients to adjust their positions to current market conditions and expectations, while also setting a plan in place to capture attractive forward margin opportunities as they occur.

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 $-0.3 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 $-0.3 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.