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Dear Ag Industry Associate,

It is hard to believe that we are now fully into the holiday season with Thanksgiving this past week and Christmas right around the corner. In traveling with my family over the holiday weekend, I certainly had a chance to reflect on all that I have to be thankful for in my life and I am sure you likewise felt that same sense of appreciation celebrating with your own families. One of the things that probably didn't come to mind I am guessing in taking inventory of the many things you are thankful for is the wide variety of contracting choices available in the market to manage the risk of forward margins.

We are fortunate to have such a mature, developed market with many different alternatives to choose from. While this is certainly a positive thing, it can be confusing to understand how these various contracts work and what differentiates one from another. In the last few Margin Managers, we have featured articles discussing some of the more common alternatives used including forward agreements and futures contracts. In this month's feature, we explore the world of swaps. While similar in many respects to futures and forwards, there are some notable differences that we highlight. As with any contracting alternative, it is important to understand their features and benefits as well as advantages and disadvantages of each in order to make more informed decisions on which type of contract may work best depending on your particular circumstances.

As always, we update the current margin outlook for the hog, dairy, beef cattle and crop industries in our latest installment of Margin Watch. While markets were relatively muted this past month, news of the presidential election results in Argentina has been a major point of discussion. In a surprise victory, opposition candidate Mauricio Marci defeated the ruling party candidate Daniel Scioli ending the era of Peronism on a platform pledging political reforms. Among other things, these include the reduction or elimination of export tariffs that have crippled the farm sector. In addition, the EPA finally released the Renewable Fuel Standards (RFS) mandates for 2014, 2015 and 2016 which likewise will have an impact on future corn prices and the margins for both producers and consumers of this commodity.

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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February 24-25, 2015
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Hog Margin Management Chicago, Illinois

March 2-3, 2015
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Understanding Swap Agreements

For our final installment in the series on contracting agreements, we will turn our attention to the world of swaps. While perhaps not as widely used or well understood as futures and forward agreements, swaps are really not much different in many respects and provide agricultural hedgers with another valuable tool in their arsenal to manage forward profit margins. Swap agreements are certainly more common in the financial markets where they originated, and are used extensively by many different types of businesses and government entities.

One of the most popular examples in this realm is probably the interest rate swap. This involves an agreement between two parties where a variable rate is exchanged for a fixed rate of interest over a certain period of time. Many businesses borrow money on variable rate notes and in an environment of historically low interest rates, have preferred to “swap” this out for a fixed rate over the life of their borrowing term. This obviously gives them greater control and forward visibility on their debt payments over time, which may be a priority for their management teams.

Another example would be a currency swap which is widely used by importers and exporters who either source raw materials or sell finished goods overseas and have input costs paid or revenues received in a foreign currency. Here too, they may wish to “swap” unknown exchange rates in the future for known exchange rates today such that their margins are secured and they protect the risk against rising input costs or falling revenue value based solely on negative foreign currency translations following an unfavorable move in exchange rates.

In the agricultural markets, swaps have also become more commonplace in providing hedgers another vehicle to manage their risks. While there are different examples of swaps in the ag markets, they essentially can be thought of as a hybrid or cross between a forward agreement and a futures contract in that they share elements of each. First, swaps can either be customized to meet the particular needs of the contracting parties as to the size of the contract and term of the agreement, or they can be standardized to mimic a futures contract with identical exchange specifications. Many of the swap agreements typically found in the agricultural markets are of this latter form where their terms are standardized to be lookalike or copycat contracts of exchange equivalency. The benefit of this approach for the issuing party of the swap agreement is that they have an equivalent vehicle by which to hedge their risk against the contracts they commit to with counterparties.

To explore an example of a swap agreement in the agricultural market, let's consider a contract on hogs that is a futures equivalent of the CME Group specifications. The issuer of the contract might be an entity such as financial institution or brokerage firm, with the contracting party being a hog producer exposed to the risk of lower prices before the hogs are ready to be marketed to a packer. For this example, let us assume that it is early December and the hog producer wishes to protect their risk on hogs that will be marketed next spring and priced against the June 2016 futures contract with the packer. As an alternative to selling a futures contract on the exchange, or entering into a forward agreement directly with the packer, the hog producer elects to use a swap agreement with a financial counterparty.

Understanding Swap Agreements *Continued From Previous Page*

The mechanics of the contract will function very similarly to that of a futures or forward agreement, although there are some differences. Similar to having a pre-established relationship with a packer prior to forward contracting or with a brokerage firm prior to trading futures, the hog producer will need to establish a formal relationship with the counterparty providing the swap agreement. This consists of a “master agreement” that spells out the exact terms of contracting between the two parties, and will also involve submission of financials to establish creditworthiness as there will be financial obligations between the parties. Once the relationship has been established and formalized, the hog producer can place an offer to execute a swap agreement at a certain price, such as \$76.00/cwt. for example against the June 2016 futures.

If the reference CME June futures price were to reach this level such that the offer is accepted, the hog producer would formally enter into a swap agreement with the issuing counterparty. While the execution of the contract in this sense is very similar to how a forward agreement or futures contract would work with a packer or brokerage firm, moving forward with the contract is where they would differ. With a forward agreement, there would be a physical settlement of the contract whereby the hog producer would be required to deliver hogs to the packer upon settlement to fulfill the agreement. With the swap, there is a financial settlement instead upon termination of the contract, with no requirement on the part of the hog producer to deliver physical animals in the cash market.

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Understanding Swap Agreements *Continued From Previous Page*

In this respect, the financial settlement of the swap agreement is similar to how a futures contract functions, although the settlement procedure may be different. With a futures contract, there is a daily settlement procedure where the contract is “marked-to-market” every day, with any gains or losses from the previous day’s settlement paid out or paid in to an account with performance bond requirements that must be maintained as mandated by the exchange. While a swap agreement may also function this way, what is more common is that there is simply a single settlement procedure upon termination of the agreement. What this means is that once the hogs reach a target weight and are sold to the packer in the cash market, the hog producer will terminate their swap agreement with the counterparty and they will settle up one time based on the terminal value of the June 2016 hog futures on that particular day in the future.

This single settlement procedure is therefore very similar to the way a forward agreement would work in the cash market. Either the hog producer will be indebted to the swap issuer if the market goes up between the time the contract is executed and once it is finally settled, or the swap issuer will be indebted to the hog producer should the market instead move lower during that interim. To financially settle the agreement upon termination of the contract, either the hog producer or the swap issuer will need to pay the other party the difference between where the contract was executed at \$76.00/cwt., and where the market is actually trading on the day the contract is finally closed.

This is why financials will be required when initiating a relationship with a swap provider as debt gets built up in these agreements unlike the account margining process and daily settlement procedure that regulates futures contracting. Also, because the swap issuer may have to margin the position on behalf of their counterparty over the life of the contract, they typically will charge more in execution costs relative to what it would cost to simply trade futures.

A swap contract may be an attractive alternative for an agricultural hedger depending on their specific circumstances. In a situation where the producer may not want to have the supply commitment and physical delivery requirement of a forward contract, a futures or swap agreement becomes a viable alternative. Because however contracting with futures can be capital intensive based on how the market moves after a hedge is initiated, the swap agreement may prove attractive if it does not include the daily margining requirement that is a feature of using futures.

As with any contracting alternative, there are advantages and disadvantages associated with each. There is no absolute right or wrong way to protect a particular risk exposure around forward margins, but understanding the features of various contracts and considering your particular circumstances, you can make a more informed choice on what type of contract may work best for your operation in a given situation. ■

Margins were weaker over the second half of November, with lower milk prices primarily responsible for the deterioration as feed costs were mixed during the period. Forward dairy margins are comparatively stronger, above the 70th percentile of profitability over the past 10 years while spot Q4 and Q1 margins are only about average from a historical basis. Milk prices remain pressured from large cheese and butter inventories as well as continued heavy Midwest production. The October Milk Production report showed that while total U.S. production of 17.1 billion pounds was only up 0.1% from last year, there were strong gains in cheese-producing states such as Wisconsin which was up 4.5% from 2014 while production in California was down 5.5% from last year. USDA Cold Storage data showed October total cheese stocks at 1.146 billion pounds, down a slight 0.3% on the month but still up 15.4% from last year. October butter stocks totaled 179 million pounds which were down 4.5% from September but 21% higher than last year and the second highest figure for the month of October in the past five years. Feed prices meanwhile showed little feature since the middle of November as harvest wraps up across the country. Cash corn basis remains very firm from limited farmer selling, while soybean meal prices have been supported by strong export and domestic processor demand. Longer-term export concerns remain for both markets however given the ongoing strength in the U.S. dollar, and the recent election win in Argentina for Mauricio Marci who is pledging reforms including an abolition of export taxes for grains and oilseeds. Our consultants continue working with clients to identify targets for scaling into margin protection in deferred periods where levels are more attractive from a historical perspective. Flexible strategies continue to be favored which will allow for an improvement in margins 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.

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Hog Margin Watch: November



Hog finishing margins were generally weaker over the second half of November with the exception of the spot Q4 period following a recovery in nearby December Lean Hog futures at the CME Group. Prices were largely steady over the past two weeks, with slightly higher corn and lower soybean meal prices offsetting one another while hogs were flat to slightly weaker in deferred contracts. From a historical perspective, margins remain quite weak and rest in the bottom quintile of the previous 10 years with only Q2 projecting a positive margin barely above breakeven. Hog prices continued to face pressure from strong production amidst a backdrop of demand concerns. Pork production for the week ending November 28 totaled 454 million pounds, down 10.6% from the previous week due to the Thanksgiving holiday but up 6.3% from last year and 3.99% higher than 2013 as well. Year-to-date pork production is up 7.1% from last year and 5.2% from 2013 with total pork in Cold Storage at the end of October at 602.7 million pounds according to the USDA, 13% higher than 2014. Meanwhile, concerns remain over prospects for the export market with renewed strength in the U.S. dollar and widespread expectations for the Federal Reserve to start raising interest rates next month. Moreover, repercussions from MCOOL hang over the market with a decision on the amount of tariffs that both Canada and Mexico can levy on U.S. exports due December 7. Feed prices had limited feature over the past two weeks with both corn and soybean meal trading in narrow ranges. Cash basis levels continue to be firm on limited farmer selling and strong demand for soybean meal. With continued deterioration in forward projected margins, our clients have been primarily focused on making strategic adjustments to existing positions. Adding flexibility to hog hedges following the significant selloff recently has been a particular priority.



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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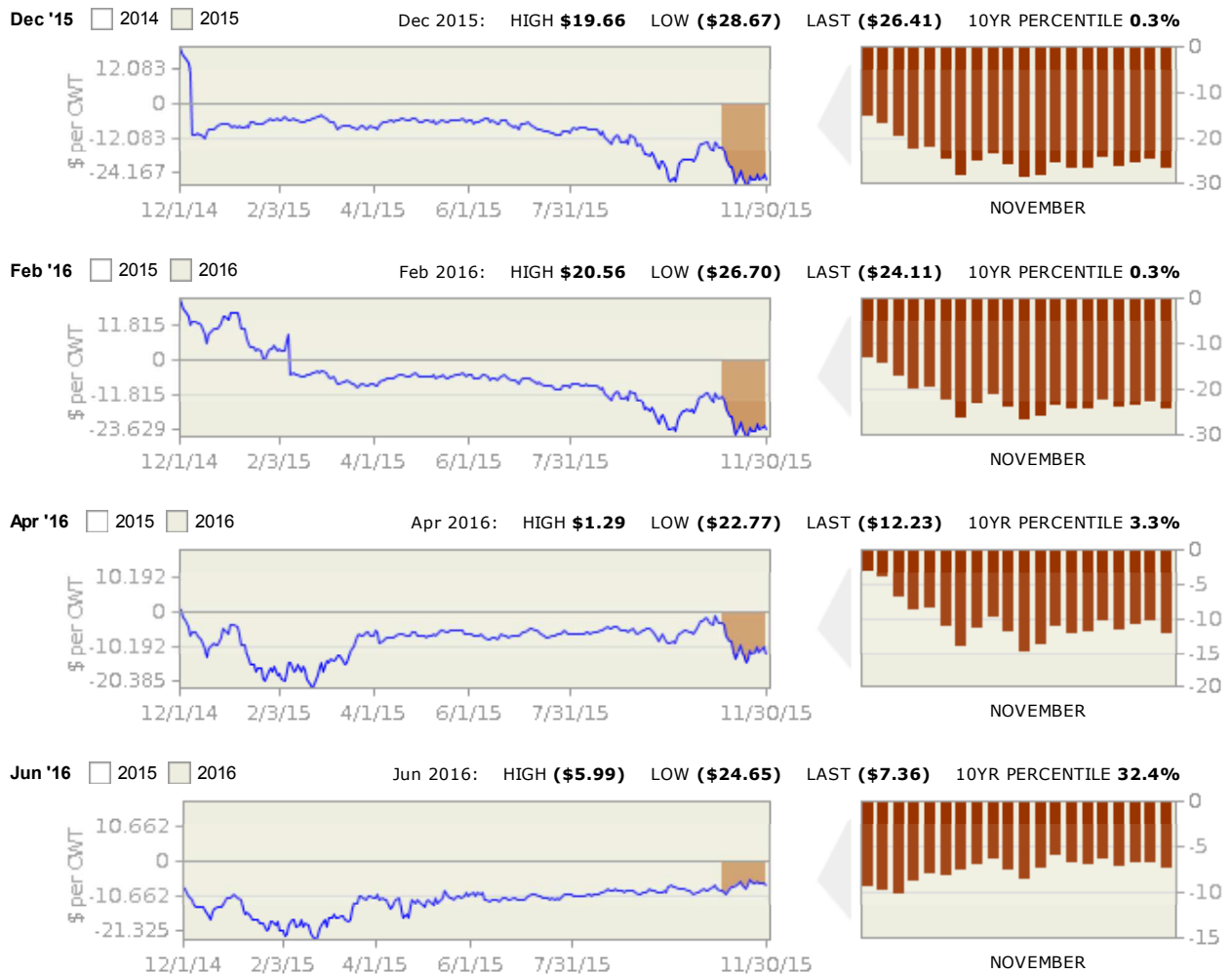
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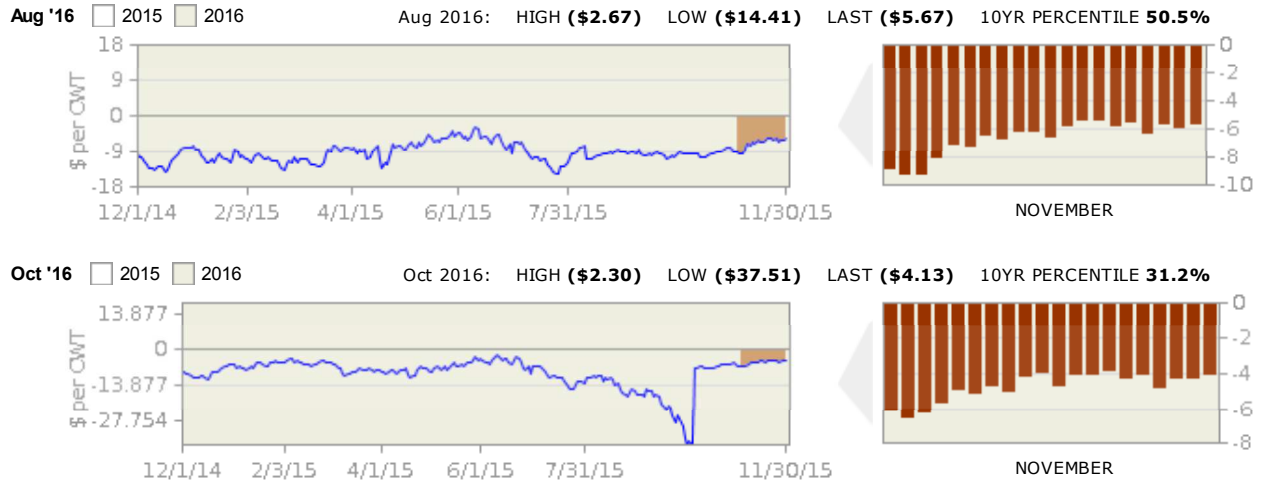
Beef Margin Watch: November



Beef margins improved slightly since the middle of the month as cattle prices stabilized following the recent selloff while corn prices held relatively steady over the past two weeks. Despite the improvement however, margins remain deeply negative throughout 2016 with profitability well below average in the bottom decile of the past 10 years. The cattle market remains depressed with large stocks of beef in cold storage, although a decline in the number of cattle being placed on feed has perhaps begun to stabilize the market to some degree. According to the USDA, October feedlot placements of 2.281 million head was down 3.7% from last year with heavier-weight cattle again favoring the placements as animals weighing over 800 pounds were up 5.5% or 35,000 head from 2014. Meanwhile, total beef stocks in cold storage of 511.6 million pounds at the end of October were 34% higher than last year. Boneless beef stocks again accounted for the majority of the increase, up 38% from 2014 and comprising 92% of total beef supplies in cold storage. Corn prices were largely steady over the past two weeks with limited feature as harvest has largely wrapped up across the Corn Belt. Cash basis levels remain very strong with limited farmer selling, although concerns remain over export demand given ongoing strength in the U.S. dollar. Additionally, Mauricio Marci won the Argentine presidency in a surprise victory, and has promised reforms including an abolition of export taxes. With limited forward placement opportunities, our clients continue to focus on making strategic adjustments to existing positions in order to manage their equity at risk. Adding flexibility to both corn hedges given low implied volatility and cattle hedges following the recent stabilization in prices are a focus right now.

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: November



Corn prices and margins were fairly steady the past two weeks. The biggest news came from Argentina where the results from the presidential runoff election were recently decided. The opposition candidate Mauricio Macri defeated the current ruling party candidate Daniel Scioli. One of the platforms that Mr. Macri ran on was a reduction and/or elimination of grain and oilseed export taxes. The corn export tax runs as high as 20% and given that some estimates put Argentinian corn stocks as high as 21 million metric tons the knee-jerk reaction of the markets was an expectation of additional large quantities of corn hitting the global export market immediately. The current proposal is for the elimination of the corn tax, but there have been many different scenarios floated. The exact details most likely will not be known until after Mr. Macri takes office on December 10th. The U.S. corn export sales have picked up steam, this week's reading of 80 million bushels of sales was the largest so far this marketing year, and eclipsed the next highest mark by almost three times. This trend will need to continue for exports of corn to meet the current USDA estimate, as the current pace of corn export sales are lagging the average pace of the last ten years by over 12%. The corn market also received confirmation from the EPA for the 2014, 2015, and 2016 Renewable Fuel Standards blending mandates. The EPA retroactively set 2014 at roughly what was actually produced, 16.28 billion gallons of total renewable fuels including advanced biodiesel. The mandate for 2015 was set at 16.93 billion gallons of total renewable fuels, close to the estimated production for this year. The EPA set the total renewable fuel levels for 2016 at 18.11 billion gallons, higher than the initial proposal released in May of 17.4 billion gallons, but well below the statutory levels of 22.25 billion gallons set by Congress in the 2007 bill for 2016. The EPA has the ability under the law to issue waivers from the RFS levels set by Congress in the original bill. Basis in some local markets is exhibiting strength, allowing our clients to work with our consultants to take advantage of that strength while maintaining the opportunity for price improvement down the road.



The estimated yield for the 2015 crop is 175 bushels per acre and the non-land operating cost is \$400 per acre. Land cost for 2015 is estimated at \$250 per acre¹. Basis for the 2015 crop is estimated at \$0.25 per bushel.



The estimated yield for the 2016 crop is 175 bushels per acre and the estimated operating cost is \$400 per acre. Land cost for 2016 is estimated at \$250 per acre¹. Basis for the 2016 crop is estimated at \$-0.3 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: November



Soybean prices and margins were modestly higher the past couple of weeks. News from Argentina about the results of the runoff election for president dominated the market. The opposition candidate Mauricio Macri was declared the victor over current ruling party candidate Daniel Scioli. One of Mr. Macri's common campaign themes was to reduce and/or eliminate the grain and oilseed export taxes, which ran as high as 35% on soybeans. After Mr. Macri's victory, the marketplace speculated as to when the estimated 20.0 million metric tons of Argentinian beans would hit the global export market, certainly an immediate elimination of the tax would facilitate their release to the market. However as news from Mr. Macri's team began to trickle out, a more gradual reduction appears to be the assumption at this point. An elimination of the corn and wheat taxes with a 5% reduction to the soybean tax seems to be the latest flavor of the day. Exact details of the new policy most likely will not be known until after Mr. Macri takes office on December 10th. Argentina's Farm Ministry recently estimated an additional 800 thousand hectares of soybean area planted over last year, while plantings in Brazil are estimated to be 75% complete, about a week behind normal. U.S. exports sales continue to shine in spite of the strong dollar and ample global supplies. The pace of soybean export sales are running almost 5% above the average pace needed to meet the USDA estimate. With local basis in some areas exhibiting strength, our clients are working with their consultants to capitalize on the strong basis while maintaining the opportunity to participate in price improvement at a later date.



The estimated yield for the 2015 crop is 50 bushels per acre and the non-land operating cost is \$325 per acre. Land cost for 2015 is estimated at \$175 per acre¹. Basis for the 2015 crop is estimated at \$-0.05 per bushel.



The estimated yield for the 2016 crop is 50 bushels per acre and the estimated operating cost is \$325 per acre. Land cost for 2016 is estimated at \$175 per acre¹. Basis for the 2016 crop is estimated at \$-0.32 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: November



Wheat prices and margins were weaker the past couple of weeks. News from Argentina about the results of the runoff election for president dominated the market. The opposition candidate Mauricio Macri was declared the victor over current ruling party candidate Daniel Scioli. One of Mr. Macri's common campaign themes was to reduce and/or eliminate the grain and oilseed export taxes, which ran as high as 23% on wheat. The current proposal is to eliminate the taxes on corn and wheat, while reducing the soybean tax by 5%. Exact details of the new policy will most likely not be known until after Mr. Macri takes office on December 10th. All wheat exports continue to lag the average pace needed to meet the USDA estimate, at last reading they are off by just over 4%. Total anticipated exports of wheat are 518 million bushels against the recently reduced USDA projection of 800 million bushels. Private estimates of global wheat production have been steady, while reductions of area planted have been slightly reduced, largely impacted by the persistent dryness in the Ukraine. Russian winter wheat prospects remain in better shape than in the Ukraine. Conditions for U.S. winter wheat have been on the upswing with favorable moisture hitting the key plains states. Our consultants continue to work with clients on specific game plans to fine tune current positions as well as to set alerts to capitalize on favorable opportunities as they occur going forward.



The estimated yield for the 2015 crop is 70 bushels per acre and the non-land operating cost is \$300 per acre. Land cost for 2015 is estimated at \$125 per acre¹. Basis for the 2015 crop is estimated at \$-0.3 per bushel.



The estimated yield for the 2016 crop is 70 bushels per acre and the estimated operating cost is \$300 per acre. Land cost for 2016 is estimated at \$125 per acre¹. Basis for the 2016 crop is estimated at \$-0.16 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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