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# MARGIN MANAGER

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December 2014

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Dear Ag Industry Associate,

In this year-end issue of *Margin Manager*, we look back on our education programs and discuss the lessons learned. It was an exceptional year for margins in the hog and dairy industries while profitability has been more challenging for crop and beef producers. Despite these differences, there were common themes in our classes. We explore these themes in our feature article, “Lessons Learned”. This will hopefully provide some guidance for managing margins as we begin the New Year.

We also review the year-end margins of the crop, hog, dairy and beef cattle industries, and how our clients are managing these fluctuating margins. In many cases they have deteriorated quite a bit from where they existed previously. The landscape moving into 2015 certainly looks more challenging for producers, and active margin management will be more important to secure profitability than a passive approach that may have worked well this past year.

We look forward to a busy year ahead with new classes and featured content in Margin Manager and marginmanager.com to advance your understanding of the margin management approach.

Happy New Year!

Chip Whalen
Managing Editor
V.P. Of Education & Research
CIH

*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*

## Upcoming Margin Seminars

**Beef Margin Management**
**Chicago, Illinois**

**March 11-12, 2015**
**(866) 299-9333**

**Margin Management for Lenders**
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**April 22-23, 2015**
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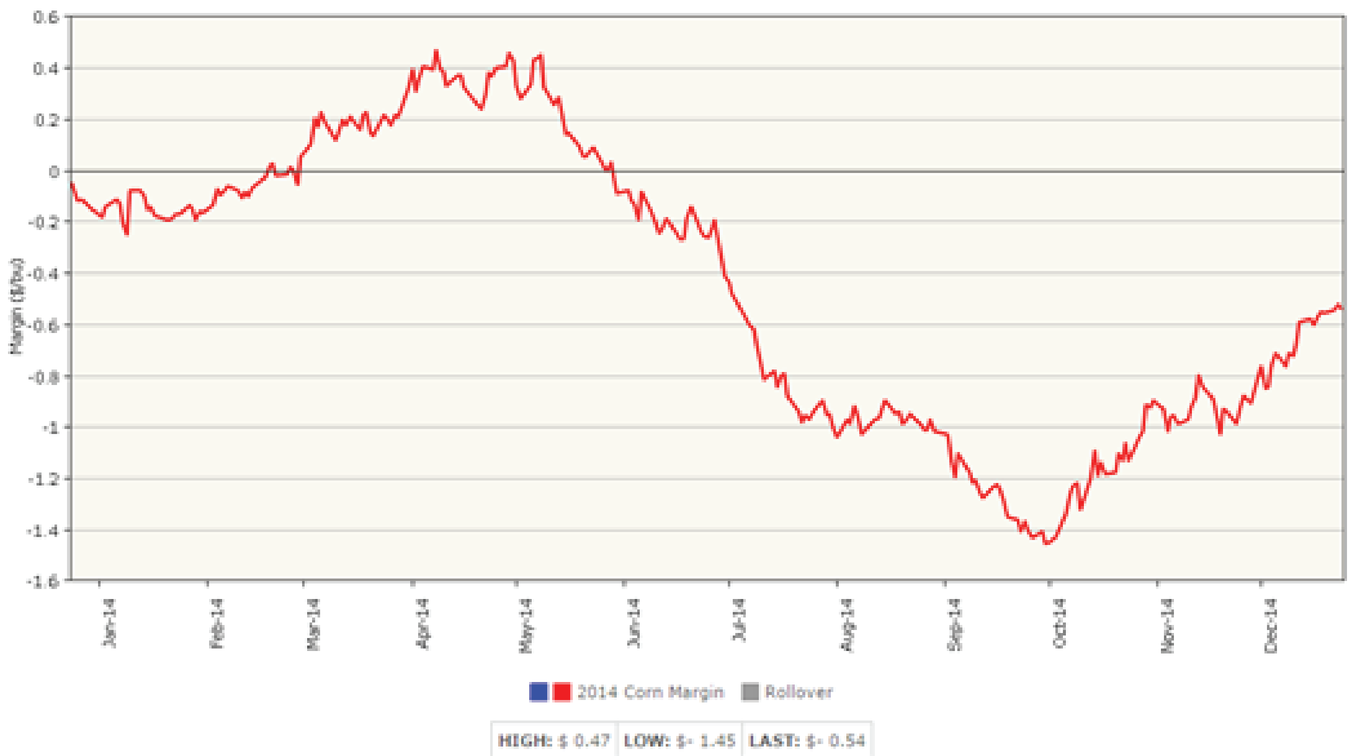
# 2014 Educational Programs Year-End Review – Lessons Learned:

December has been a busy month at CIH. We recently finished 3 educational programs in our office for hog producers, crop producers, and dairy operations. While all were well attended, the crop audience was at capacity and we had a wait list for potential cancelations. Ironically, we had to cancel our previous crop program due to a lack of interest and registrations. Why is that? The charts below show the current profit margins for corn and soybeans that were just harvested this year. As you can see from the graphs, the margins have been deeply negative and at 10-year lows for this model Midwest operation. Although it may simply be coincidence, producer interest in managing forward margins has clearly increased since our last class.



## 2014 Educational Programs Year-End Review – Lessons Learned:

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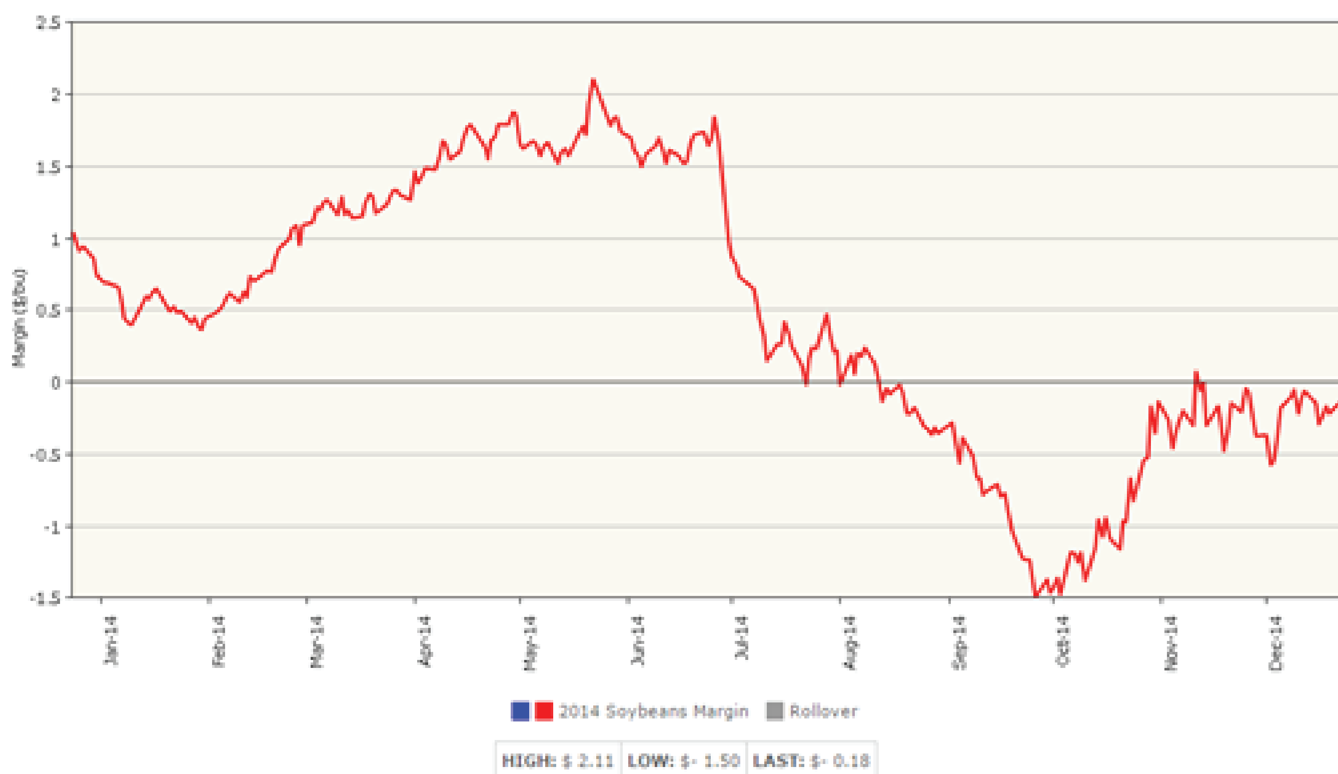


Besides the negative margins though, what you will also notice from the graphs is that the margins were not always negative and it was possible to protect a positive margin earlier this spring. While admittedly, the margin opportunity back in April and May was not nearly as strong as what most crop producers have enjoyed the past few seasons with very high corn and soybean prices, it was much better than what exists today. Unfortunately, we are seeing a similar dynamic play out in other industries as well. After enjoying extremely strong margins throughout 2014, many dairies were apathetic about protecting opportunities in 2015 despite margins that existed above the 90th percentile of the previous 10 years. Following a recent rise in projected feed costs though and a sharp decline in the value of milk, these opportunities are now history with forward dairy margins still positive but well below what could have been protected just a few months ago. The following chart displays the projected Q2 2015 margin for a model Upper Midwest dairy operation with the blue line denoting the 90th percentile of the past 10 years:

## 2014 Educational Programs Year-End Review – Lessons Learned:

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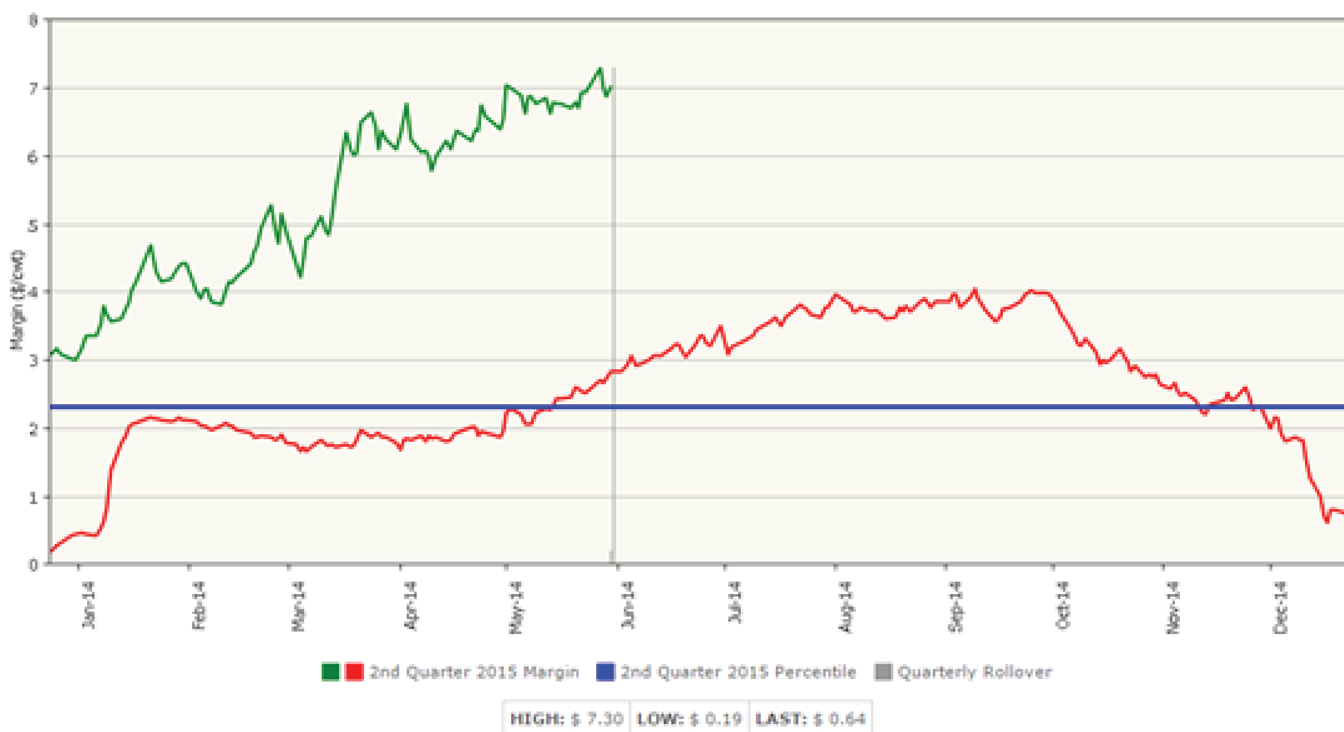


Not to overlook the hog industry, margins here too have seen a significant retrenchment following a similar combination of higher projected feed costs along with lower hog prices. I picked out a particular marketing period in the chart below to highlight a couple points. Q4 of 2015 is currently projecting a loss for this model hog operation of approximately $1.28/cwt. Despite this, the margin was recently as strong as over $5.00/cwt. positive and existed above the 80th percentile of the previous 10 years.

## 2014 Educational Programs Year-End Review – Lessons Learned:

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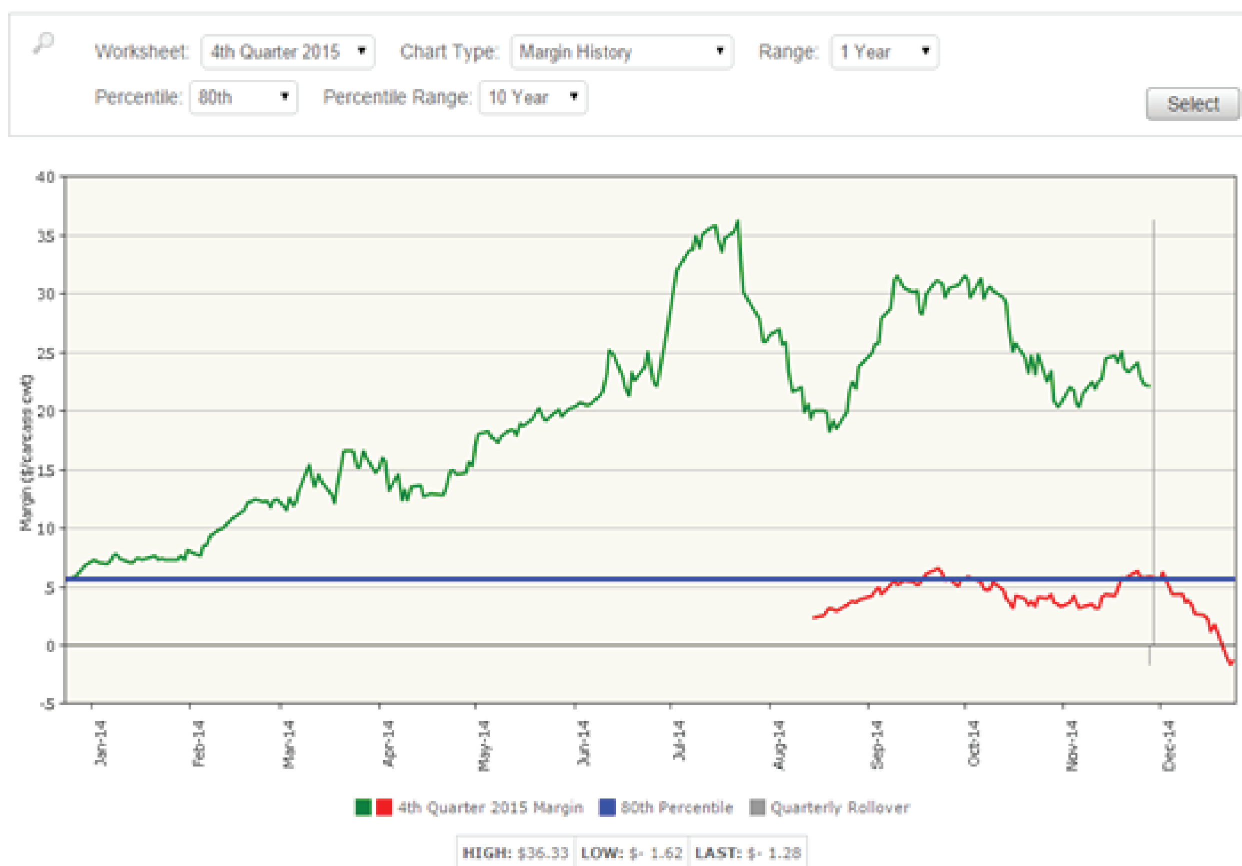


I point this out because like the crop and dairy examples, the best opportunity to capture a positive margin typically occurs well ahead of the actual marketing period that margin will be realized in. By following margins far in advance, you put yourself in a much better position to identify and capture these profit margin opportunities. Q4 of 2015 is a year away, but it is often best to begin tracking these margin opportunities more than a year into the future. The second point to highlight is that the margin existed above the 80th percentile of the previous 10 years. In most years, the margin will at least reach the 70th percentile of historical profitability, and about half the time, it will also at least touch the 80th percentile. A lesson we have learned not only in 2014 but in past years as well is to have and execute a margin management plan to protect opportunities that exist at above-average percentiles of historical profitability. Many of the hog operations that we work with have a good percentage of their Q4 2015 margins already protected with various strategies based upon these opportunities previously showing up above the 70th and 80th percentiles.

Protecting the financial health of your operation by managing profit margins is like maintaining a healthy lifestyle and attending regular doctor visits. An ounce of prevention is worth a pound of cure. If you only visit the doctor when you're sick, it can be

## 2014 Educational Programs Year-End Review – Lessons Learned:

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difficult to undo the damage. Likewise, if you're only concerned about your profit margins when you're losing money, it may be too late. Actively managing risk can help you avoid losses and strengthen your operation over the long-run.
A common theme in our classes is that many producers come to learn more about options and using flexible strategies to manage risk. These types of applications work best in environments such as the current one where margins, although positive, are not necessarily projected at levels where one feels comfortable locking something in. While option strategies allow flexibility for margins to improve, they also involve costs which most producers don't like. Part of margin management however entails managing a position over time in order to improve forward margin opportunities.

We recently added a new class called "Strategic Position Management" to address this topic and dedicate more time to help producers understand how to manage a long-term position from when it is first initiated to the actual marketing period where purchases and sales will be realized in the local cash market. Going back to the Q4 2015 hog example, many of the aforementioned hog operations that had previously established margin coverage are now looking to adjust those positions in order to increase flexibility for their margins to improve. While it is impossible to know what the market will ultimately do between now and late next year, it is possible to work with what the market allows you to do as prices fluctuate over time. In addition to adding flexibility, these types of strategic adjustments can also allow you to address and reduce cost in a position so that these option strategies become more affordable. Ideally, you can arrive at a position that allows for maximum flexibility at a minimum cost, but it does require active position management over time to achieve that result.

While there are sure to be future years like 2014 with blowout margins in the spot market, history shows us that more often than not, margins exist at levels that are not always so strong. Managing forward margins starts with recognizing opportunities when projected profitability is attractive from a long-term historical perspective. From there, in order to capture these opportunities, a plan should be in place to identify strategies that may be considered to scale into margin protection at various thresholds. Finally, those positions must be actively managed over time to help improve upon margin opportunities as market conditions and prices fluctuate. We invite you to learn more by exploring our 2015 education calendar and attending one of our classes in the upcoming year. The more you know about strategy alternatives to manage margin opportunities, the better equipped you will be to assure the long-term profitability of your operation.

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# Hog Margin Watch: December

Margins were mixed over the last two weeks of the year as they improved in Q2 and Q3 but deteriorated in spot Q1 as well as Q4 of 2015. Overall, there were only minor changes in price despite the USDA's Quarterly Hog and Pig report which some worried would spark increased volatility in the market. Forward margins remain at or above the 80th percentile of the previous 10 years through Q3 while only just above average in Q4, though still positive. December 1 all hogs and pigs were reported up 2% from last year at 66.05 million head versus the average trade estimate expecting a 1.4% increase from 2013. Pigs kept for breeding were estimated at 5.969 million head, up 3.7% from last year when the market was anticipating a 3% increase while those kept for marketing were pegged by USDA at 60.082 million head – up 1.8% from a year ago. Overall, the report was considered neutral although slightly bearish against the nearby slot with hogs in the 120-179 pound category about 1% higher than market expectations. This along with the higher farrowing intentions in upcoming quarters probably explains the price weakness in nearby and far deferred contracts. Feed costs have been largely subdued over the past couple weeks without much feature in the market. Corn exports remain on target to meet the current USDA estimate although market participants are waiting on the quarterly stocks report to be released January 12 in order to gauge other domestic disappearance, particularly feed demand. Soybean meal has succumbed to recent weakness following reports of larger crop estimates from CONAB in Brazil along with favorable South American weather thus far this growing season. Our clients continue setting targets in deferred periods to establish new margin coverage while also evaluating opportunities to make strategic adjustments on existing positions. With recent strength in deferred hog values, our consultants have been working with clients to establish a plan to strengthen 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: December

Dairy margins were mixed over the last half of December, strengthening slightly in nearby periods while flat to weaker in deferred slots without much price volatility over the past two weeks in either the milk or feed markets. 2015 margins remain above average over the 60th percentile of the past 10 years, though far below the strong levels they existed at previously well above the 90th percentile. USDA released the November Milk Production report which pegged U.S. output at 16.5 billion pounds, up 3.4% from 2013 with both production per cow and total cow numbers up from last year. Production per cow averaged 1,782 pounds in November, up 42 pounds from 2013 while total cow numbers during the month were reported at 9.28 million head – up 4,000 from October and 82,000 above last year. Cold Storage data was likewise bearish with USDA reporting American cheese stocks at 634.6 million pounds in November, up 11.3 million pounds or 1.8% from October during a time of year when cheese stocks typically decline 10 million pounds between October and November. Meanwhile, although grain prices declined slightly into the end of the month, the change had a negligible impact on forward margin projections. USDA will release their January WASDE and quarterly stocks report on the 12th, and market participants will be looking for the numbers to help clarify the pace of domestic disappearance as it relates to feed demand. Crop conditions remain favorable in South America with CONAB recently increasing their production estimate for Brazil's soybean crop, which has weighed on the soybean meal market. Our clients continue to make strategic adjustments on existing positions, particularly adding flexibility back to milk hedges following the significant decline in price. Flexible strategies continue to be favored in deferred periods for new coverage to allow for potential margin improvement.

*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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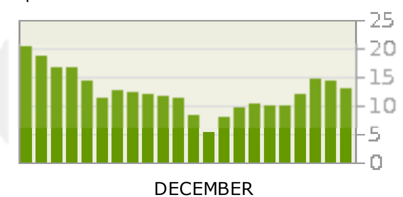
# **Beef Margin Watch:** December

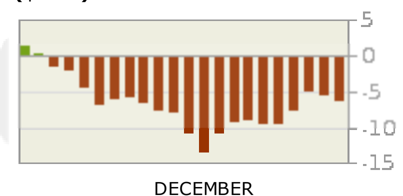
Beef finishing margins improved since the middle of December as cattle prices recovered while corn costs declined slightly. Despite the improvement however, margins remain negative for all but the spot February period and well below average from a historical perspective. USDA released the November Cattle on Feed report which was considered largely neutral relative to market expectations. December 1 cattle on feed supplies were pegged at 10.87 million head, up 1% from last year with November placements of 1.79 million head down 4% from a year ago. Both figures were at the average of pre-report expectations with marketings of 1.475 million head slightly below the average trade guess, down 11% from last year. Total beef in Cold Storage at the end of November was reported at 396.6 million pounds, up 18.7 million pounds or 5% from October although down 12% from last year and 10% below the five-year average. Beef stocks in cold storage typically build 2.28% from October to November, although the data was not considered bearish given that beef supplies remain historically tight. Boneless beef supplies were up 4.9% from the end of October due to higher imports. Corn prices meanwhile have succumbed to some recent pressure perhaps tied to year-end liquidation, although features in the market have been limited. USDA releases their next quarterly stocks report along with the monthly WASDE on January 12, and that should reveal more about the pace of domestic disappearance particularly as it relates to feed demand. With opportunities to establish new protection on deferred placements limited by negative margins, our clients continue to focus on adjustments to existing positions. Adding flexibility to both corn and cattle hedges has been a recent priority following strength in the former market and weakness in the latter.

## Live Cattle Marketing Periods:

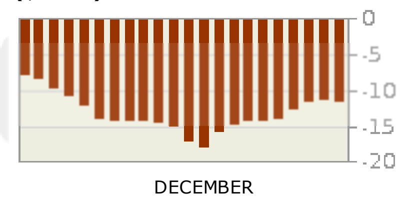
**Feb '15** 2014 2015 Feb 2015: HIGH **$22.28** LOW **($2.95)** LAST **$13.26** 10YR PERCENTILE **95.7%**



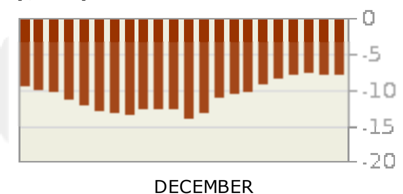

**Apr '15** 2014 2015 Apr 2015: HIGH **$19.18** LOW **($13.47)** LAST **($6.37)** 10YR PERCENTILE **12.4%**




**Jun '15** 2014 2015 Jun 2015: HIGH **$13.23** LOW **($17.93)** LAST **($11.52)** 10YR PERCENTILE **8.3%**




**Aug '15** 2014 2015 Aug 2015: HIGH **$21.15** LOW **($14.73)** LAST **($7.77)** 10YR PERCENTILE **23.3%**



*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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| --- | --- | --- |

# 2015 Educational Program Schedule

Strategic Position Management
Feb 25 *(clients only)*

Beef Margin Management
Mar 11-12

Margin Management for Ag Lenders
Apr 22-23

Commodity Price Management
May 13-14

Crop Margin Management
Jul 8-9

Hog Margin Management
Jul 22-23

Dairy Margin Management
Aug 5-6

Margin Management for Ag Lenders
Oct 21-22

Beef Margin Management
Nov 11-12

Dairy Margin Managment
Nov 18-19

Hog Margin Management
Dec 9-10

Crop Margin Management
Dec 16-17

*Trading futures and options carry the risk of loss. All dates subject to change. Please check cihedging.com/education for more information and the latest additions to the schedule.*

# Corn Margin Watch: December

Corn margins have fallen slightly since the middle of December after being higher for the majority of the period. 2014 was a year that saw deeply negative margins as production ultimately overwhelmed demand for the first time in five years. The marketplace will shift its focus to domestic demand and South American production in the next few weeks as NASS finalizes 2014 supply figures on January 12 in its Annual Production report. No major adjustments to supply are expected for the final production figure. NASS will also release the Quarterly Stocks figures on the 12th which will help market participants gauge whether the current USDA demand forecasts are on target as the report will reveal the first quarter's usage. Export sales amount to 61% of the current USDA expectation compared to 55% on average for this time in the crop year. Export shipments are lagging to a degree with 27% of the expectation shipped versus 31% on average for this point in the year. Corn use for ethanol has been quite strong, running 5% above year ago compared to the USDA expectation of 0.3% by year-end. On the global front, South American weather remains ideal to produce substantial crops this spring. Competition for exports should rise in the coming months as the world supply remains ample to meet demand. China has removed the ban on MIR 162 imports from the U.S. which allows an additional DDG outlet for U.S. ethanol producers using GMO corn. Our consultants are working with clients to help make strategic adjustments to existing protection strategies that would increase the delta in current hedges to capitalize on the higher price of late while retaining the opportunity to benefit further should prices continue to move higher.

*The estimated yield for the 2014 crop is 180 bushels per acre and the non-land operating cost is $612 per acre. Land cost for 2014 is estimated at $243 per acre [1]. Basis for the 2014 crop is estimated at $-0.19 per bushel.*

*The estimated yield for the 2015 crop is 174 bushels per acre and the estimated 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 $-0.2 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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# Soybeans Margin Watch: December

Soybean margins have lost ground since the middle of December but have been generally sideways since late October. The year finished with red ink for producers on the spot market. The transition from the tightest stocks-to-usage in history for old-crop to ample new-crop supplies was challenging indeed particularly for soybean meal. The marketplace will now shift focus to domestic demand and South American production as NASS finalizes 2014 supply figures on January 12 in its Annual Production report. No major adjustments to supply are expected for the final production figure. NASS will also release the Quarterly Stocks figures on the 12th which will help market participants gauge whether the current USDA demand forecasts are on target as the report will reveal the first quarter's usage. Like the supply expectation, first quarter demand is not likely to cause much excitement as demand categories are largely transparent. Export sales for soybeans are currently 88% of the USDA expectation compared to 73% on average for this time in the crop year. Shipments are also ahead at 59% shipped compared to 45% on average. Soybean meal export sales are also ahead of the pace to meet the USDA estimate with 63% sold versus 50% on average; however, the shipment pace is right at the average pace required to meet the forecast. The November NOPA crush figures were reported at 161.2 million bushels, below expectations but record for any November and fourth largest on record for any month. On the global front, South America weather is nearly ideal with only a few pockets of concern at present. Harvest will begin in the coming weeks in Northern Brazil and will provide some competition with U.S. exports provided no logistical issues arise as in the past. In China, the government has lifted the ban on MIR 162 imports from the U.S. which allows an additional DDG outlet for U.S. ethanol producers and is deemed supportive to domestic protein prices. Our consultants are working with clients to help manage existing protection strategies. Some of our clients are considering adjustments to those strategies that would add delta to current hedges to capitalize on the higher prices while retaining flexibility to participate in higher prices should that continue.

*The estimated yield for the 2014 crop is 52 bushels per acre and the non-land operating cost is $364 per acre. Land cost for 2014 is estimated at $243 per acre [1]. Basis for the 2014 crop is estimated at $-0.1 per bushel.*

*The estimated yield for the 2015 crop is 52 bushels per acre and the estimated 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 $-0.25 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:** December

Wheat margins have slipped substantially since the middle of December as additional demand expectations have been tempered. Margins for the year finished nearly $1 above the lowest levels back in September, but remained in red territory. Winter weather has graced the Midwest of late with much of the Central Plains states having adequate snow providing cover to the winter wheat crop. Cold temperatures are forecast over the next few weeks but should have little effect on the dormant crop. Ultimately it is spring weather that will determine yield potential early this summer. NASS will finalize 2014 winter wheat acreage on January 12th in the annual Winter Wheat Seedings report. No major adjustments are expected to seeded area. U.S. exports have been paltry at best over the last few weeks as global competition remains. Market participants had expected news from Russia amounting to an export ban and expected the U.S. to gain market share. Russia has in fact issued a de facto export ban as it has placed an export tariff of €35 per metric ton on all shipments. The increased price for importers makes Russian wheat non-competitive on the global marketplace. The tariff goes into effect on February 1 for future shipments until July 1 which has Russian exporters rushing to ship product throughout January. With record global production projected, rigorous competition for exports through the first half of the year will remain. Our consultants continue working with clients to protect these forward margins with flexible strategies on existing coverage that will allow for potential margin improvement over time. Some of our clients are considering adjustments to current protection strategies that would capitalize on the recent fall in price while still preserving the opportunity to participate in higher prices should the market move higher.

*The estimated yield for the 2014 crop is 67 bushels per acre and the non-land operating cost is $366 per acre. Land cost for 2014 is estimated at $163 per acre [1]. Basis for the 2014 crop is estimated at $0.1 per bushel.*

*The estimated yield for the 2015 crop is 72 bushels per acre and the estimated operating cost is $328 per acre. Land cost for 2015 is estimated at $158 per acre [1]. Basis for the 2015 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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