Q & A

STEVE DECOOK: Fundamentally sound

INTERVIEWED BY **DANIEL P. COLLINS**
PHOTOGRAPHY BY **BRENT ISENBERGER PHOTOGRAPHY**

Steve DeCook has traded grain and livestock markets from a fundamental perspective for five decades. His commodity trading advisor (CTA), Fundamental Futures Inc., had a successful 19-year run, averaging better than 15% per year with more than $100 million in assets under management, before closing shop in 2002. DeCook continued to trade for friends and family, but when he saw a huge new fundamental factor come into the agricultural markets in 2004, it got his competitive juices flowing and he launched his new CTA, Four Seasons Commodities Corp. His Hawkeye — he is based in Des Moines, Iowa — spread program would put on bear spreads in front of the long-only commodity index rolls. The huge size of these indexes, particularly the Goldman Sachs Commodity Index, made this a consistent winning trade and DeCook was one of the first to exploit it.

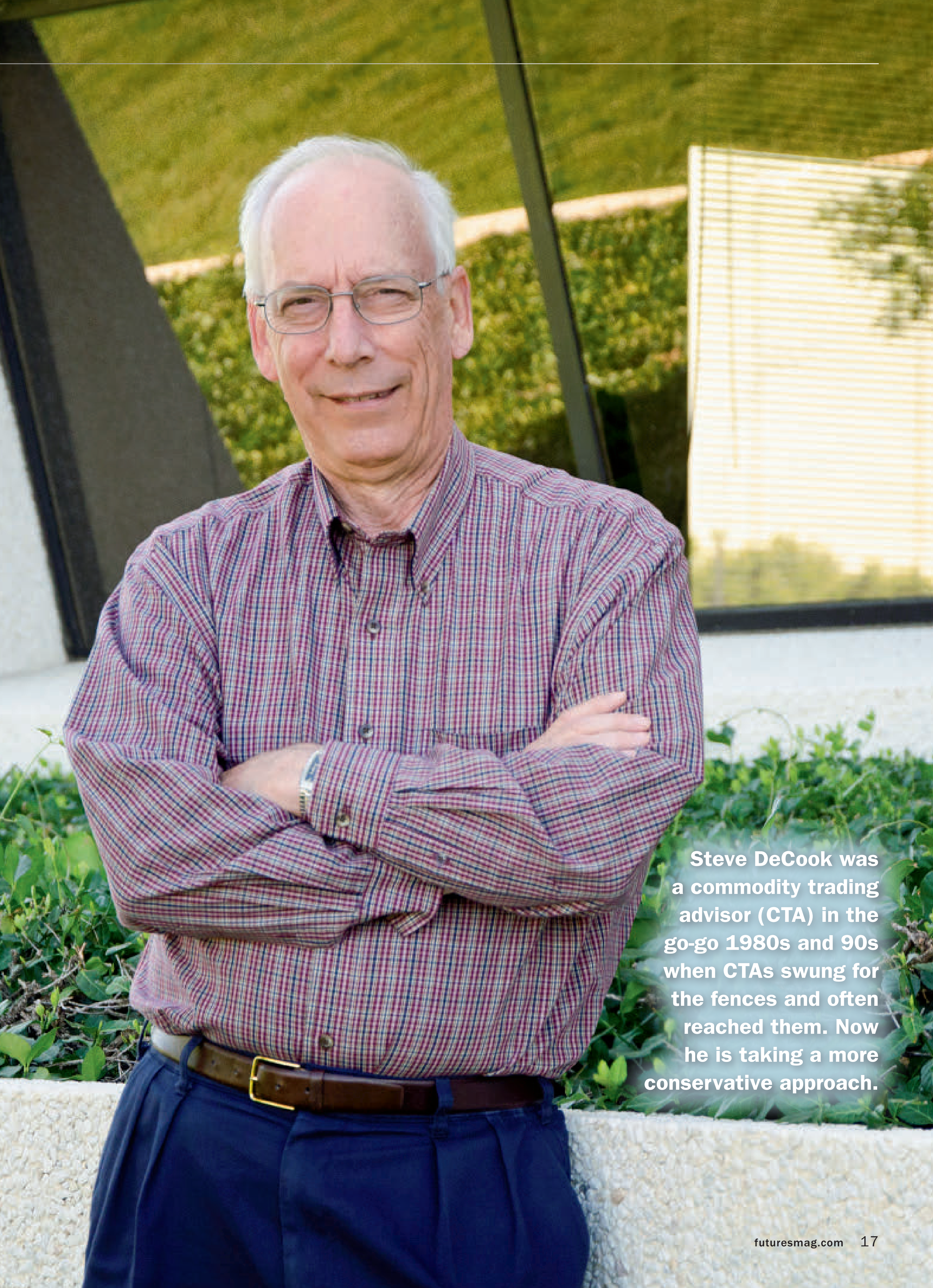
We talk to DeCook about running a CTA in two different eras, the evolution of the money flow trade and the fundamentals in the grain markets.

FUTURES MAGAZINE: Steve, you operated a CTA in the 1980s when it was a relatively new asset class and in the 2000s after alternative investments were more established. Talk about the different eras.

STEVE DeCOOK: Back then I traded heavier. We would trade one contract per $25,000, now we are trading one contract per $100,000. So, I am trading smaller. Another thing, I am trading pretty much all spreads, which is less risky. [Though] the way spreads are moving around nowadays, that is not always true, but generally spreads are less volatile. We have volatility in the market now for reasons that [are unclear]. It is hard to find an explanation for a fundamentalist as to why things happen the way they do sometimes. So in general we are trading smaller and trading spreads to reduce our exposure to the market. Our returns are [smaller], also. We are aiming at 10%, whereas in the 1980s and 90s we were [targeting much more]; one year we made 80%.

FM: There is less risk tolerance by both retail and institutional investors. How did you adjust to this?

SD: One thing that is different now is back then you had the commercial crowd, you had the floor crowd and you had the general public. Well the general public is gone and they have been replaced by the funds, an even greater influence than the general public ever was. Back then traders wanted to see where the general public was because we wanted to



Steve DeCook was a commodity trading advisor (CTA) in the go-go 1980s and 90s when CTAs swung for the fences and often reached them. Now he is taking a more conservative approach.

fade whatever they [were] doing. Now the funds are replacing them, but you don't have the same attitude. The floor crowd is a smaller influence now.

FM: Aren't you competing now against the floor crowd?
SD: They are watching the funds too, to see if they need to follow them.

FM: You traded in an era when Commodity Corp. would drop you if you averaged less than 15% over three years; now people are targeting less. Is it a hard transition?
SD: It is not hard to get used to because it is a self-imposed risk control. Whether some fund is risk-averse or not, I still have my own rules as far as limiting exposure to losses in the market.

FM: When you launched your new CTA in 2004, it was mainly to take advantage of money flows created by the growth in investments into long-only commodity indexes. Are the opportunities still there to take advantage of these money flows?
SD: Not so much anymore. Once somebody figures it out then it doesn't work anymore. It worked pretty well for a couple of years, then everyone figured it out. Because of a new paradigm, today I am not doing much of that. For example, five years ago the lead month always would go to full carry to the next month as you approached first notice day. Now look at May corn trading 30¢ over July. We have such a demand structure for ag commodities, led primarily by China, that those rules don't work anymore. We have a different demand structure in the market, which wants and demands the lead option; we have relatively low inventories of grain available; and that big monster China is lurking in the background ready to buy anything, whether it is foodstuffs or raw materials. So, the idea of the lead option always being cheapest because of fund roll just doesn't work anymore.

FM: When you started this there weren't as many folks trying to get in front of the roll. Has it become a more difficult trade? Are spreads moving toward full carry much earlier or not at all?
SD: In some cases not at all. At one time, the full carry used to happen just before first notice day. That moved back into the middle of the month or during the Goldman roll, which was the fifth to ninth business day of the [preceding] month. And now if it is detectable at all, it's maybe before that. It might be the first of the month a full month before first delivery day. Everyone is continuously trying to get ahead of the crowd and by the time you get to the point that you expect a big roll, it already has been done and there is nothing left there anymore.

FM: Many folks also see the inflow into long-only commodity indexes as manipulating the price of commodities, particularly crude oil. What is your opinion of the long-term impact these products have had on price?
SD: Whenever the price of something isn't where somebody wants it to be, whether it is a politician or somebody in the industry, the first target is always the speculators, the traders. You have to blame somebody. Back in the 1970s, cattle prices were low and the cattle industry wasn't happy about it and they wanted to blame the speculators. They wanted to have a ban on anybody going short the market. It is the same way the politicians are talking about oil today. Funds can have a short-term effect for a day or two, maybe even a week, but it always comes down to supply and demand. There have been all kinds of investigations over the years. There is always somebody demanding an investigation as to how the speculators are affecting the market. I don't know how many studies there have been, but they all come up with the same conclusion that speculators didn't have anything to do with it.

One thing that [people] don't understand is that the market is an anticipatory market. Today's supply and demand numbers don't mean very much if [traders are anticipating] supply and demand numbers 90-180 days down the road. They don't get that.

FM: The end result is they got position limits into Dodd-Frank. What do you think the impact of those limits will be?
SD: It doesn't affect me because I am not close to the limits. It is fine to have limits, but I am not sure what the right limit should be. It is not going to change the way the markets move, and I don't think it is going to change price.

FM: You have been involved in the industry for several decades. Tell us what you think the impact the MF Global situation is having. What are your customers telling you?
SD: We had several of our accounts at MF Global; they eventually transferred to other houses and got some of their money back. We ended up losing one account. Some people used their commodity account as a pseudo bank account to keep excess cash. They felt confident and comfortable about having excess cash, which is good because you didn't have a margin call to

Go to **futuresmag.com/DeCook** for an unabridged version of this interview.

worry about. Now people are reluctant to do that. Leaving a lot of extra cash in your account probably is not a great idea.

FM: You have been through a few of these crises, but never has segregation been breached. How bad can this be for the industry?

SD: People eventually do forget about it, except if you were directly hurt, which a lot of people were. It seems like flat-out criminal activity to me.

FM: The other big new factor in agricultural markets is the battle over food vs. fuel. Over the last decade the percentage of the U.S. corn crop dedicated to ethanol production has gone from less than 10% to approximately 40%. What impact is this having on markets?

SD: If you reduce your demand by 40%, obviously the price of corn is going to be lower. If corn is going to be that much lower, then you would draw the conclusion that food prices would be lower too. On the other side of the coin, if you stopped producing ethanol now, gas prices would jump 75¢ to $1 a gallon, so energy prices would be higher. You have to conclude that food prices have been driven higher by ethanol, but energy prices have been held lower. I am not sure how you balance those two out. When you take a bushel of corn [to make ethanol] one third of it is ethanol, one third of it is distillers grain (DDGs) and one third of it turns into carbon dioxide. So when you use 5 million bushels of corn for ethanol, one third of that is not lost, it turns into a high-protein feed for livestock.

FM: Is that growth in ethanol demand sustainable?

SD: That gets into politics. We have been exporting ethanol to Europe and Brazil, but we are kind of at a blending wall ceiling as far as domestic production. It is going to increase over the years, but not near the percentage increase we have seen over the last [decade].

FM: When we spoke in the second half of 2006 you said that corn was about to set a low that would last our lifetime. So far you have been spot on. Any change in that prediction?

SD: I would raise the price now. I don't see corn getting under $4 for a long, long time. There is so much demand in the world. The cost of production right now is around $5, so if you get under that you will start to reduce acres. I just can't see corn under $4. And over the next 12 months, I don't see it under $4.50-$5, I don't think we will spend a lot of time under $5, but we may if we have a big crop this year. I think $4 is a low that I don't think will be taken out for a long time, if ever.

FM: You no longer are concentrating on money flows. What are the main factors affecting the corn, wheat and soybean markets now?

SD: If you had to put it in one word, it would be 'China.' They have an insatiable demand. They have moved to a capitalistic system and people are learning that they can work where they want to work, they can go to school if they want to, they can save their money, they can have a TV, they can have a refrigerator, they can have a cell phone. Things that 20 years ago were only for the rich. The city people are having these things and enjoying them. They are finding out that the capitalistic system is an okay thing. And with that, the diet improves too. They have a huge hog population. Last year they had 40 million tons of corn they pulled out of reserve to hold down domestic prices and set aside the demand. They had a bumper crop, but they still needed to pull down their reserves. They still have not filled that reserve; they are looking at the U.S. to fill [it]. They are hoping that the U.S. has a big crop this year and the price will be cheap enough this fall to refill their reserve with 40 million tons of corn. They are just a demand factor out there that we never have had before. Any time you analyze any market, the first question is, 'Where does China fit in to all this?'

FM: Give us your medium- and long-term outlook on corn, wheat and soybeans.

SD: Weather is a big issue and our longer-term weather people are estimating a corn yield this year of 160-165 [bushels per acre], which would be a very good crop but not a bin buster. On beans, I would guess in the 43.5-44 [bushels per acre] area, which would be above trendline yield. With those numbers, I would say the market is fairly well-priced today. It probably would put corn down a little, but I don't think it would stay there. I told you that I don't think corn will go under $4; I don't think beans over the next year will be able to go under $13. If South America can rebound and have a good crop next year, there would be more downside risk at that time. But between now and end of year, I don't see a lot of downside no matter how good the crop is, and if you have a weather problem, it is hard to say what number you could get to on the topside. On balance, it is a good time to be a farmer. Prices are going to be relatively good for the foreseeable future. Wheat is a follower of corn. We do have ample stocks; we do have a good crop coming on. It probably can get cheaper than corn during harvest coming up, but for the rest of this year corn and wheat are going to stay attached to each other. F

MARKETS

Will the US swim in corn and search for beans?

BY CHIP FLORY

Weather patterns may be favorable for the grain sector in the 2012 growing season. They will need to be to temper the current high prices.

Combine equal parts Chinese buying, South American crop problems and reduced U.S. crop prospects, then stand back and watch the bean market grind relentlessly to $15.

No, it's not that easy. Soybean's bullish fundamentals and bull market took time to develop. Not only did traders have a "prove-it" attitude toward China's demand, South America's production problems and lower U.S. planting intentions, the bean market first had to wrestle speculative money away from corn.

- How much 2011 corn is left?
- La Niña vs. El Niño
- Chinese demand

The "Corn Economy" didn't give up control willingly. Many in the cash market still argue that corn is calling the shots in overall grain trends and claim the much stronger-than-normal post-harvest corn basis proves their case. These analysts have a long list of factors supporting corn basis: Expanded on-farm storage giving farmers greater ability to hold more of the crop off the market; stronger export demand than projected by the U.S. Department of Agriculture (USDA); stronger-than-projected U.S. feed and corn-for-ethanol use and (the market's favorite) the corn was never there to begin with.

As is usually the case in the grain markets, no single factor is responsible for old-crop corn's strong basis and futures' stubborn ability to trade above $6. Since fall 2011, May 2012 corn futures (which represent 2011-crop supplies) closed under $6 just five times. Each time the May contract dipped below that level, end-users quickly extended coverage in the cash market and futures. That turned $6 into solid, long-term support for nearby delivery corn.

When May corn futures entered the delivery period, the first several days of the process saw the front-month contract climb to a big premium to not only new-crop futures, but the spot contract traded at more than a 30¢ premium to July futures. That's a strong indication of tight supplies and strong demand. The market's message to farmers: Deliver corn now!

That will tighten supplies of corn even further for the last quarter of the 2011-12 marketing year and likely result in chaotic market action.

For grain updates, go to **futuresmag.com/Grains**

Old-crop corn may have traded stubbornly above $6, but even that impressive price doesn't compare to the new leader in the grain markets. Soybean futures rallied nearly $4 from a mid-December 2011 low to an April 2012 high just over $15. While soybeans marched higher, May corn and May Chicago wheat futures traded in an extremely choppy $1 range.

There's really no need to ration old-crop (or new-crop) wheat use. Wheat is trading above normal levels, based on U.S. and global stocks-to-use ratios, only as a tag-along to soybean's rally and corn's ability to remain relatively high. Ever-tighter South American soybean supplies along with still-strong export demand for U.S. soybeans forced the bean market to grind higher in an attempt to "find the price" that slows global consumption. Corn futures took a different approach — trade high enough, long enough to eventually slow demand.

Corn yield holds the answer

New-crop corn yields will set the price

trends for 2012-13. That's obvious, but with huge planted corn acreage and still-strong demand, it's especially true in 2012.

If 2012 growing conditions are excellent and we see a national average corn yield of 168 bu. per acre, there's little doubt the national average cash corn price will drop below $5. But, if the rest of the growing season is poor and the national average yield is 150 bu. per acre (the past two crop's national average yields), Pro Farmer expects a $6-plus national average cash corn price. And that's an average — made up of lower and higher prices. The price high for new-crop corn futures under the "poor" scenario undoubtedly would clear the $7 level for at least a short period of time.

That's because of a crop that's already in the bin. A South American drought likely cut the 2011-12 Argentine corn crop to less than 20 million metric tons, compared to 2010-11 production of 23 million metric tons. In a good year, the Argentine corn crop is a touch bigger than South Dakota's corn crop, and not quite as big as a good Indiana corn crop. Nonetheless, Argentina currently is the second-largest corn exporter in the world. And in a world hungry for feed grains, the market pays very close attention to production in the South American exporting country.

Argentina's short corn crop this year already has increased demand for old-crop U.S. corn, but it has a residual effect as well. Argentine corn exporters have made a living "filling the supply gaps" from the U.S., which means some of Argentina's old-crop corn slips into the U.S. new-crop marketing year. That's why a short crop in Argentina will help support bigger new-crop U.S. corn exports.

And to get a clear picture of the year ahead, we also must take one more look back to the 2011-12 marketing year. Old-crop carryover really represents the supply-side cushion for the year ahead. USDA's current estimate of 801 million bu. (and Pro Farmer's estimate of 706 million bu.) are probably too low. Yes… too low. Admittedly, the outlook gets "cloudy" at this point.

If no more bushels were added to the 2011-12 U.S. feed supply from this point forward, Pro Farmer would expect even higher old-crop corn prices just to slow use enough to keep 700 million to 800 million bu. of corn "in the bin" at the end of the 2011-12 marketing year. In reality, a lot of bushels will be "added" to the old-crop supply.

Soft red winter wheat harvest will be earlier than normal and yield potential looks to be very good. That will increase the amount of wheat used for feed in corn's 2011-12 marketing year, displacing corn used for feed.

Also, early planting and emergence of the 2012 corn crop means there is a chance that about 900 million bu. of corn planted in 2012 could be harvested before Sept. 1. If that corn is used as feed or exported, it

MAKING SENSE OF CORN

Corn supply/demand

	2010-11 USDA	2011-12 USDA	2011-12 Pro Farmer	2012-13 *Pro Farmer* projection: Excellent	Average	Poor
Planted (mil.acres)	88.2	91.9	91.9	95.9	95.9	95.9
Harvested (mil.acres)	81.4	84.0	84.0	88.4	88.2	88.0
Yield (bu./acre)	152.8	147.2	147.2	168.0	162.0	150.0
Beginning Stocks (mil.bu.)	1,708	1,128	1,128	706	706	706
Production (mil.bu.)	12,447	12,358	12,358	14,849	14,288	13,200
Imports (mil.bu.)	28	20	20	10	10	10
Total Supply (mil.bu.)	**14,182**	**13,506**	**13,506**	**15,565**	**15,004**	**13,917**
Feed and Residual	4,793	4,600	4,650	5,250	5,000	4,800
Food, Seed, Industrial	6,428	6,405	6,400	6,500	6,475	6,450
Ethanol for Fuel	5,021	5,000	5,000	5,075	5,050	5,000
Total Domestic use	11,220	11,005	11,050	11,750	11,475	11,250
Exports	1,835	1,700	1,750	2,000	1,900	1,800
Total Use	**13,055**	**12,705**	**12,800**	**13,750**	**13,375**	**13,050**
Carryover	**1,128**	**801**	**706**	**1,815**	**1,629**	**867**
Carryover, Days' Supply	31.5	23.0	20.1	48.2	44.4	24.2
Stocks-to-Use Ratio	8.6%	6.3%	5.5%	13.2%	12.2%	6.6%
Projected Avg. Price/bu.	$5.18	$6-6.40	$6.30	$4.75	$5.00	$6.25

Sources: Pro Farmer

BEANS ON THE RUN

Soybean supply/demand

	2010-11 USDA	2011-12 USDA	2011-12 Pro Farmer	2012-13 *Pro Farmer* projection: Excellent	Average	Poor
Planted (mil.acres)	77.4	75.0	75.0	73.9	73.9	73.9
Harvested (mil.acres)	76.6	73.6	73.6	72.9	72.8	72.7
Yield (bu./acre)	43.5	41.5	41.5	45.0	42.5	40.0
Beginning Stocks (mil.bu.)	151	215	215	240	240	240
Production (mil.bu.)	3,329	3,056	3,056	3,279	3,094	2,909
Imports (mil.bu.)	14	15	15	15	15	15
Total Supply (mil.bu.)	**3,495**	**3,286**	**3,286**	**3,534**	**3,349**	**3,164**
Crush	1,648	1,630	1,620	1,630	1,610	1,590
Exports	1,501	1,290	1,300	1,525	1,480	1,350
Seed	87	86	86	88	88	89
Residual	43	30	40	50	40	25
Total Use	**3,280**	**3,036**	**3,046**	**3,293**	**3,218**	**3,054**
Carryover	**215**	**250**	**240**	**241**	**131**	**110**
Carryover, Days' Supply	23.9	30.1	28.8	26.7	14.8	13.1
Stocks-to-Use Ratio	6.6%	8.2%	7.9%	7.3%	4.1%	3.6%
Projected Avg. Price/bu.	$11.30	$12-12.50	$12.75	$11.50	$13.25	$15.00

Sources: Pro Farmer

FOLLOW THE LEADER

Wheat supply/demand

	2010-11 USDA	2011-12 USDA	2011-12 Pro Farmer	2012-13 *Pro Farmer* projection: Excellent	Average	Poor
Planted (mil.acres)	53.6	54.4	54.4	55.9	55.9	55.9
Harvested (mil.acres)	47.6	45.7	45.7	48.4	48.1	47.8
Yield (bu./acre)	46.3	43.7	43.7	46.5	44.0	42.0
Beginning Stocks (mil.bu.)	976	862	862	802	802	802
Production (mil.bu.)	2,207	1,999	1,999	2,249	2,116	2,008
Imports (mil.bu.)	97	120	120	100	100	100
Total Supply (mil.bu.)	**3,279**	**2,982**	**2,982**	**3,151**	**3,017**	**2,909**
Food	926	930	930	940	935	930
Seed	71	79	80	78	78	78
Feed/Residual	132	180	170	180	165	140
Total Domestic Use	1,128	1,189	1,180	1,198	1,178	1,148
Exports	1,289	1,000	1,000	1,075	1,050	1,025
Total Use	**2,417**	**2,189**	**2,180**	**2,273**	**2,228**	**2,173**
Carryover	**862**	**793**	**802**	**878**	**789**	**736**
Carryover, Days' Supply	130.2	132.2	134.3	140.9	129.3	123.7
Stocks-to-Use Ratio	35.7%	36.2%	36.8%	38.6%	35.4%	33.9%
Projected Avg. Price/bu.	$5.70	$7.20-7.40	$7.10	$6.00	$6.50	$7.00

Sources: ProFarmer

will offset use of 2011-crop corn. And if it isn't used, it still will be included in the Sept. 1 corn stocks tally.

And Sept. 1 corn stocks are the official old-crop carryover. USDA's National Ag Statistics Service (NASS) has proven the past two years that corn is corn... it does not matter in which year it was planted. That could inflate the 2011-12 corn carryover... which inflates 2012-13 beginning stocks... which makes the 2012 Supply & Demand balance sheets a complete mess ("Making sense of corn," page 21).

Based on conditions in early May, Pro Farmer is leaning up from the average scenario to excellent. If the early growing season weather pattern that brought generally normal to above-normal temperatures and ended a would-be drought in the northern Corn Belt continues through mid-summer, yield expectations will rise and pressure on new-crop corn prices will build.

Outlook for soybeans

While USDA's old-crop corn carryover estimate held at 801 million bu., soybean carryover drifted lower and was likely to slide even more into the end of the marketing year. So while corn is fearing a Sept. 1 surprise, soybean futures are trying to slow use to hold carryover around 240 million bushels. The further old-crop carryover slides this year, the smaller the supply-side cushion for the 2012-13 marketing year.

Until early May, it appeared the bean market finally had found the price that would slow the price advance. May soybean futures posted a downside key reversal the day they posted a contract high above $15, triggering a round of long liquidation. But South America's drought tightened exportable supplies in Argentina and Brazil. And with the pace China was buying old- and new-crop beans in early May, exportable supplies from both South American countries were evaporating quickly.

In early May, it was estimated that 80% of the 2011-12 Brazilian soybean crop already had been sold to domestic crushers or committed to exports. That left only about 475 million bu. (13 million metric tons) of soybeans to meet export commitments and to supply domestic users until the 2013 harvest.

And, once again, because South American stocks normally "fill the gaps" in U.S. supplies for the globe's importers, a short crop in South America increases the U.S. new-crop soybean export forecast.

It's that expected big increase in U.S. exports in 2012-13 that has many market-watchers anticipating higher bean prices in the months ahead. Even under the excellent crop scenario, 2012-13 soybean carryover is expected to be steady this year. That, however, does not mean a steady national average cash soybean price. It will take a lower-than-this-year average price to encourage nearly 250 million more bushels of use than year-ago ("Beans on the run," page 21).

But even an average growing season points to a sharp drop in carryover and an increase in prices. A poor growing season would force prices sharply higher just to keep total use about equal with the current marketing year.

Wheat will be a follower

Saying the supply and demand balance sheet for wheat has become irrelevant would be an overstatement, but just barely. Wheat price trends will be determined by action in corn in the year ahead (just as it was in the year behind). The bright spot for wheat is a dark cloud for corn — the feed and residual category. With most of the growing season for the winter wheat crop already in the rearview mirror and good odds of big yields already baked into prices, the market is down to watching the spring wheat crop for supply-side worries.

It's a weather thing

The 2011 growing season was dominated by La Niña conditions. La Niña is an episode of cooler-than-normal Sea Surface Temperatures (SSTs) that reduces moisture in the atmosphere and lowers the chances for rain in the U.S. Corn Belt. The La Niña episode was over by April and some long-term models suggested El Niño would be in place by summer 2012.

El Niño is warmer-than-normal SSTs that increases moisture in the atmosphere and increases the chance for rains in the Corn Belt. With that in place, odds are increasing for trendline or above corn and soybean yields in 2012. That's not a big negative for the soybean price outlook, but it could leave the U.S. swimming in more than a billion and a half bushels of corn at the end of the 2012-13 marketing year, with a price well under $5. F

Chip Flory is the editor and publisher of the weekly Pro Farmer newsletter. Flory develops the market outlooks for Pro Farmer. Learn more at www.profarmer.com.

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TRADING TECHNIQUES

Exploiting anomalies in the grain complex with options

BY PAUL D. CRETIEN

Grains are one of the more interrelated commodity complexes. Understanding their similarities — and differences — can reveal key opportunities in spreads between their futures contracts.

The grain complex: wheat, corn, soybeans and oats, is in some ways closely coordinated but at times widely different in the price movements of its futures contracts. "Cumulative percent price change" (right) shows how the futures performed from January through March 2012. Continuing their close correlation, wheat and corn played tag, with wheat being slightly more volatile. Meanwhile, soybeans increased at a relatively steady pace and oats slacked off in early March before catching up with soybeans by the end of the month.

Grain price divergences
Forecasting spread trades

Average percentage changes during the three months tend to support the notion that wheat and corn form a good pair for price spreads. Wheat declined on average 3.71% while corn dropped by an average of 3.99%. Oat and soybean futures increased on average 1.18% and 3.36%, respectively.

Overall, it is clear on the cumulative percent price change chart that soybean futures are the only one of the four grains to grow consistently during the first quarter of 2012, and that wheat and corn currently are in a trendless condition despite forecasts of higher food prices caused by low inventories. Only the substantial price gains for July wheat and corn futures on March 30 — 7.46% and 6.56% — give a hint of possible upward trends.

Volatility measures

On March 26, the options market placed July corn futures ahead of wheat, oats and soybeans in terms of predicted volatility. The curves on "Comparing July grains" (right) indicate the close fit among wheat, corn and oats, with the July soybean futures falling behind in the volatility forecast despite their faster growth trend over the past three months. As measured by the height of the call price curve as a percentage of the strike price where the futures price equals the strike price, the results are 6.68%, 6.41%, 6.02% and 4.30% for corn, wheat, oat and soybean July futures, respectively.

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With 88 days to expiration of the July calls on March 26, the options market made predictions for the upper and lower price spreads during the remaining trading days. The spreads as a percentage of the strike price nearest the underlying futures price were 26.2%, 25.8%, 23.9%, and 17.4% for corn, wheat, oats and soybeans. The price spreads are between upper and lower futures prices at expiration that would result in neither a gain nor a loss from a delta trade on March 26, buying the number of calls indicated by the slope of the options price curve for each July futures contract sold short.

The spread implies futures price variations over the next 88 days of approximately 9% to 13%, up or down from the current futures price or about half of the predicted spread in either direction.

"Calls on wheat futures" (right) shows the May, July, September and December price curves for July wheat on March 28. Separations between options price curves on "Comparing July grains" are caused by differences in options market forecasts for grain futures volatilities at the same expiration date, while the curves on "Calls on wheat futures" are spaced apart because of changes in time to expiration and will shift up or down together depending on the market's assessment of wheat futures volatility. (One way to think about wheat futures volatility is the chance there will be a futures price variation large enough to make purchasing a put or call option potentially profitable.)

On "Calls on wheat futures," the curves for successively longer times to expiration have the following heights above the strike price: May, 3.95%; July, 6.33%; September, 7.91%; and December, 9.85%. It is typical for the price curves to be spaced closer together at longer times to expiration and to have larger spreads as expiration nears and accelerates the erosion of shorter-term time value premiums.

In "Building forex volatility strategies" (April 2012), it is suggested that variations of call or put prices from hypothetical or theoretically correct price curves could be the basis for spread trades between adjacent strike prices. Put and call options tend to be priced by variants of the Black-Scholes option pricing model, and this practice makes it easy to spot any option that is temporarily mispriced.

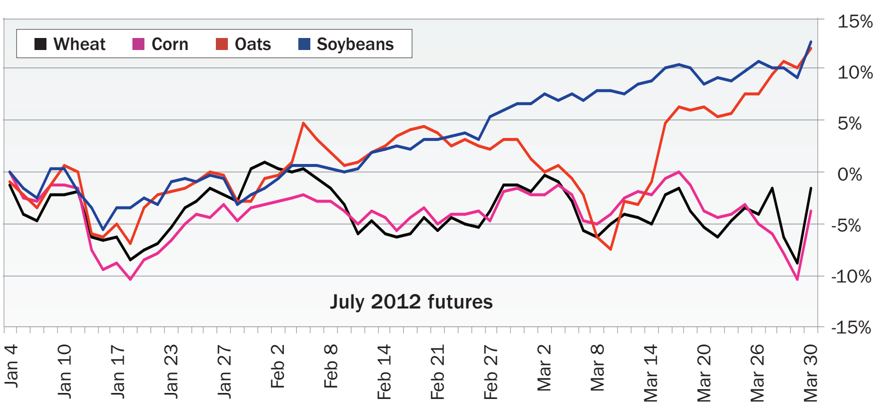
Exploiting anomalies

Call price curves on the July grains and wheat futures charts are formed by actual market prices, and those market prices fall close to a theoretically correct curve based on fundamental option pricing variables: Time to expiration, volatility of the underlying futures contract and the current futures price relative to the strike price.

An alternative method for constructing an options price curve is the LLP model available as an Excel spreadsheet that can be downloaded from futuresmag.com. The model uses market prices to compute a regression curve. Deviations of market prices from the regression curve generally

CUMULATIVE PERCENT PRICE CHANGE

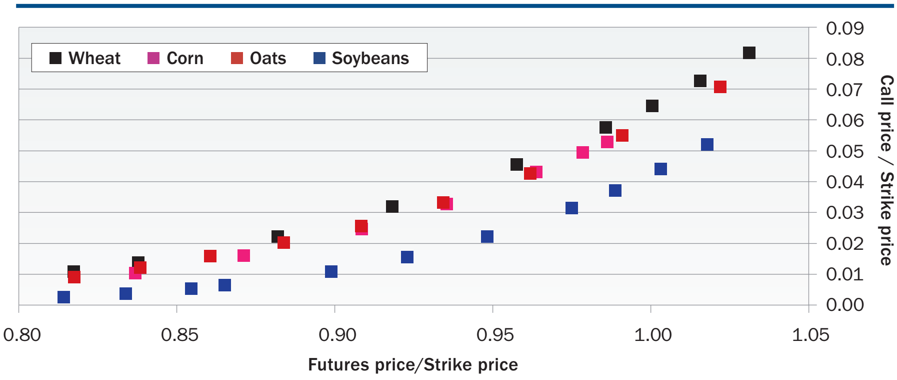
The four grains tend to move generally in the same direction, but they can diverge widely over time on a percentage basis.



Source: Barchart.com

COMPARING JULY GRAINS

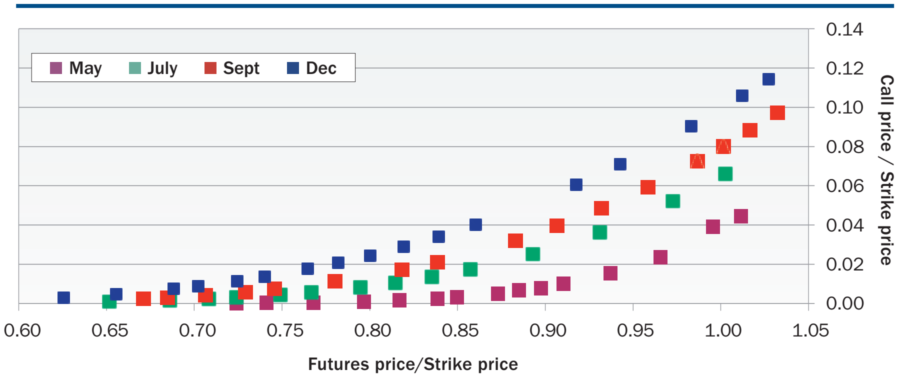
As measured by the height of the call price curve as a percentage of the strike price where the futures price equals the strike price, the July futures for corn, wheat and oats are relatively close in volatility, while soybeans were off the pace.



Source: Barchart.com

CALLS ON WHEAT FUTURES

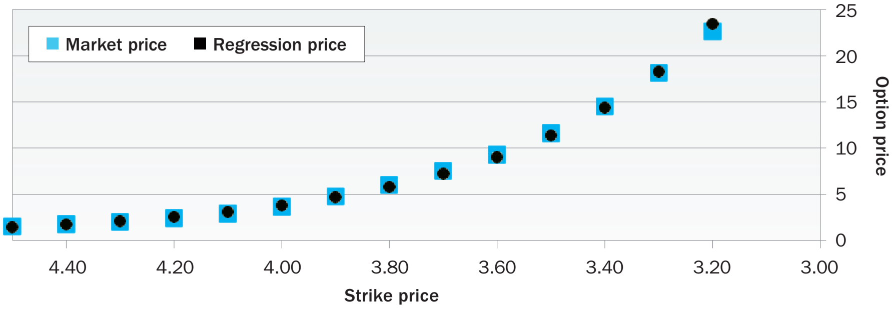
As we can see here, the longer the time to expiration, the higher the market price is above the strike price.



Source: Barchart.com

CALLS ON JULY OATS

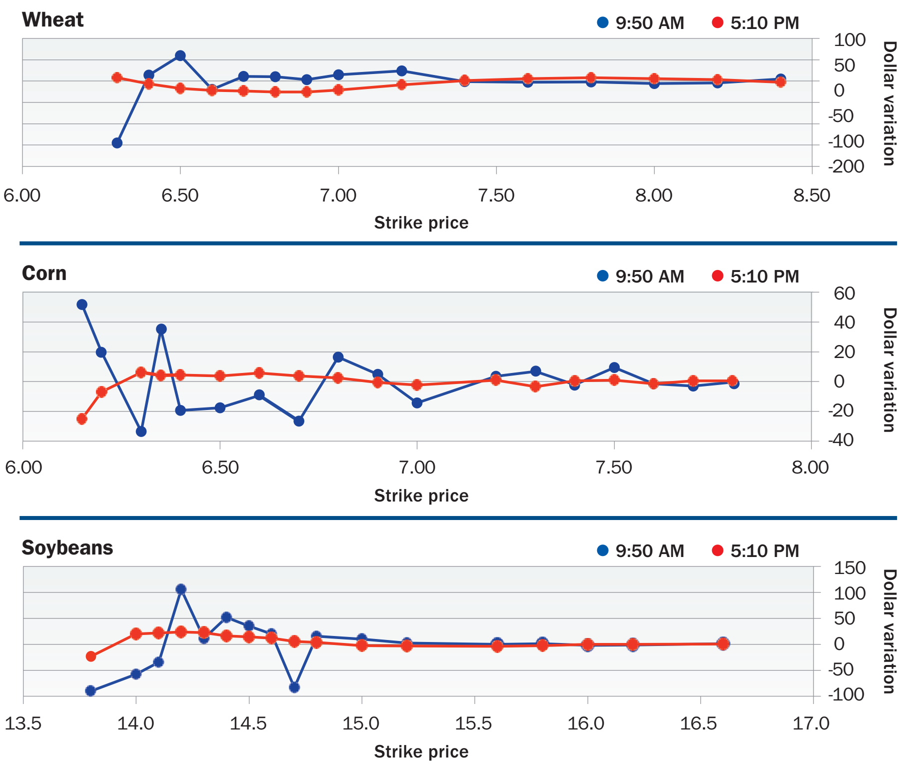
This chart displays the amount market prices vary from our regression model's forecasts. The black dots are the forecasts, and the blue squares are the actual prices.



Source: Barchart.com

JULY GRAINS

As we can see, when prices are close to in-the-money, the variations from the theoretical price can be significant.



Source: Barchart.com

are small in terms of option price points.

"Calls on July oats" (right) shows the accuracy with which the regression analysis matches the option market prices. The blue squares represent market prices for 14 strike prices and the black dots in the blue targets are prices predicted by regression analysis.

When variations in options points are multiplied by the number of dollars per point, the results indicate over- or underpricing by the market for each strike price. Because options prices tend to regress toward the predicted or theoretical price curve, trading opportunities may occur.

Even when the predicted prices seem to be right on target, there may be substantial variations in terms of dollars. This was pointed out in "Building forex volatility strategies," in which some currency option points are worth $100,000 or $125,000 while variations from the predicted curve are microscopic. For grain options, each option point is valued at only $50, but variations frequently are large enough to suggest trading situations.

Spread trades extending from morning to afternoon are possible by using the analysis shown in "July grains" (right), which includes price charts for July wheat, corn and soybeans. In each chart, the market prices and predicted prices are close to the theoretical price curve for large strike price (out-of-the-money) options. This is true for both a.m. and p.m. prices. However, when strike prices are smaller and the calls are near to or in-the-money, the variations are much larger in the morning and smaller — closer to the price curve — in the afternoon.

The ability to profit from this type of analysis depends on whether the morning and afternoon prices shown are actually available for trading. A suggested method is to compute the regression price curve based on listed prices early in the trading day and create spread trades with long options that are under-priced and short adjacent over-priced options. When plus and minus variations alternate through the list, some calls will be paired with more than one in the opposite direction. Spread trades in the area of smaller strike prices should be more profitable because of larger variations from the predicted curve.

It is tempting to think that variations could be picked out of an option price chain simply by drawing a line though the prices as they curve up with smaller strike prices; however, "Calls on July oats" shows why this may be an impossible goal. Computer analysis may be required to show magnified variations — even at the relatively small $50 per point given by grain options.

As always, the organization and pricing in the options market is impressive. Traders in general are able to trust relationships among pricing variables that have at least four decades of experience with an ever-expanding options market. F

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