

Hedging in 2014

Wisconsin Crop Management Conference & Agri-Industry Showcase
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Futures trading is not suitable for all investors, and involves the risk of loss. Futures are a leveraged investment, and because only a percentage of a contract's value is required to trade, it is possible to lose more than the amount of money deposited for a futures position. Therefore, traders should only use funds that they can afford to lose without affecting their lifestyles. And only a portion of those funds should be devoted to any one trade because they cannot expect to profit on every trade. All references to options refer to options on futures.

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CHANGE – A transformation or modification

(Source: Dictionary.com)

Change has a considerable psychological impact on the human mind. To the fearful it is threatening because it means that things may get worse. To the hopeful it is encouraging because things may get better. To the confident it is inspiring because the challenge exists to make things better.

-- King Whitney, Jr.

Nothing endures but change.

-- Heraclitus, *from Diogenes Laertius, Lives of Eminent Philosophers*
(540 BC - 480 BC)

CHANGE – A transformation or modification

(Source: Dictionary.com)



Image From Consumerwarningnetwork.com



Image From Apple.com

CHANGE – A transformation or modification

(Source: Dictionary.com)



Image from swatek.com



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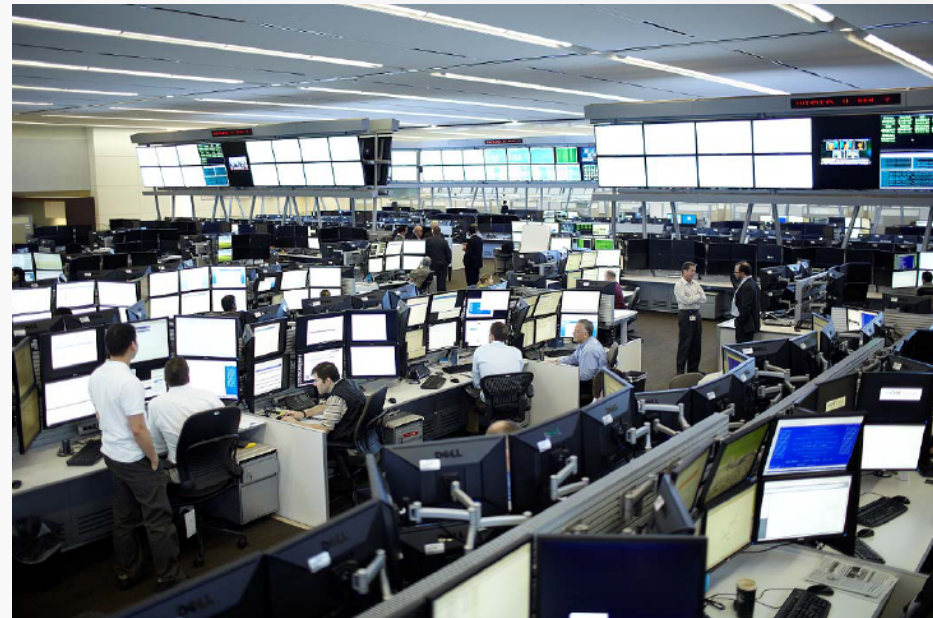
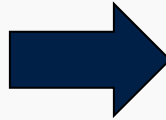
Image from fueladditivebenefits.com



Image from JohnDeere.com

CHANGE – A transformation or modification

(Source: Dictionary.com)

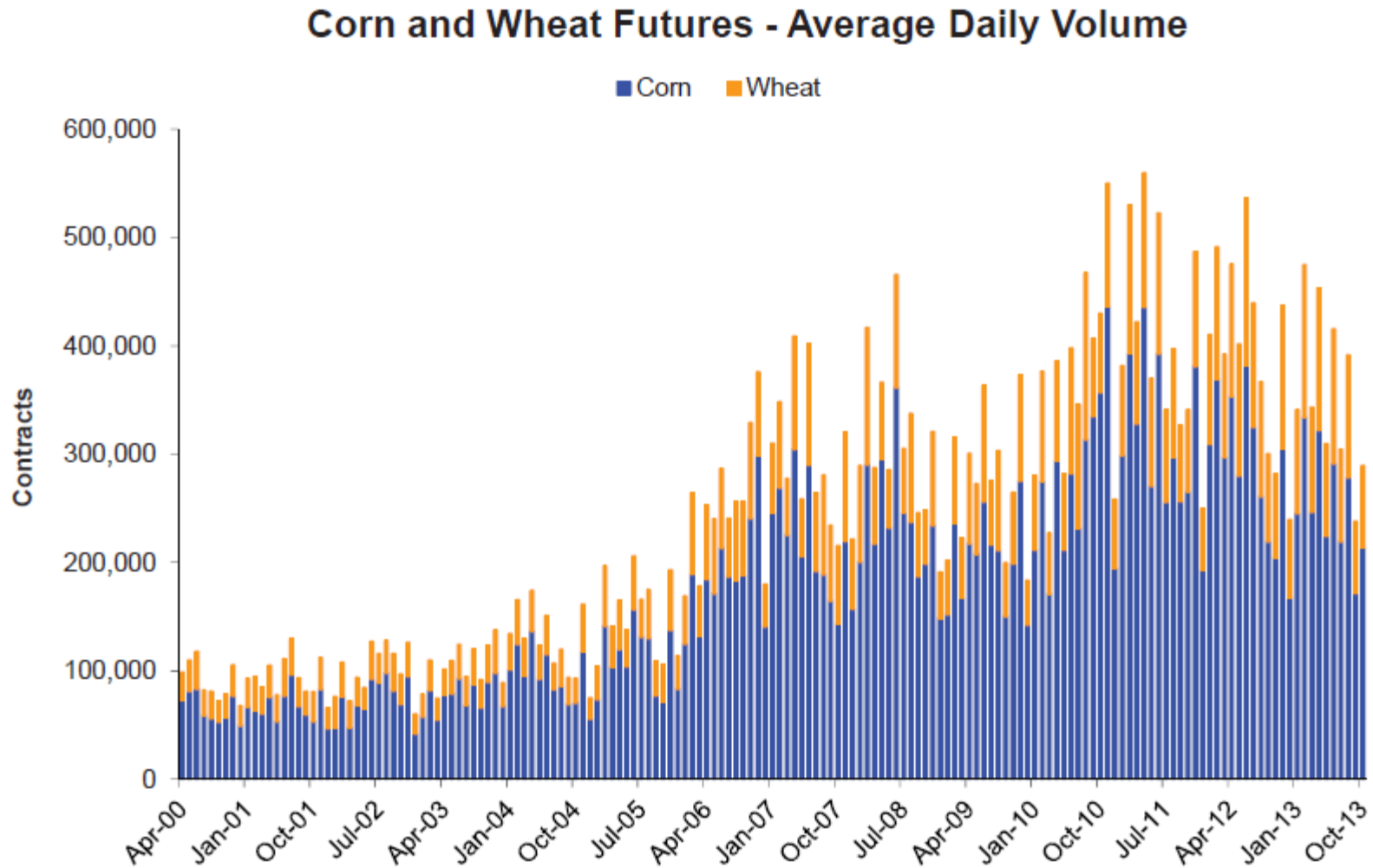


Outline

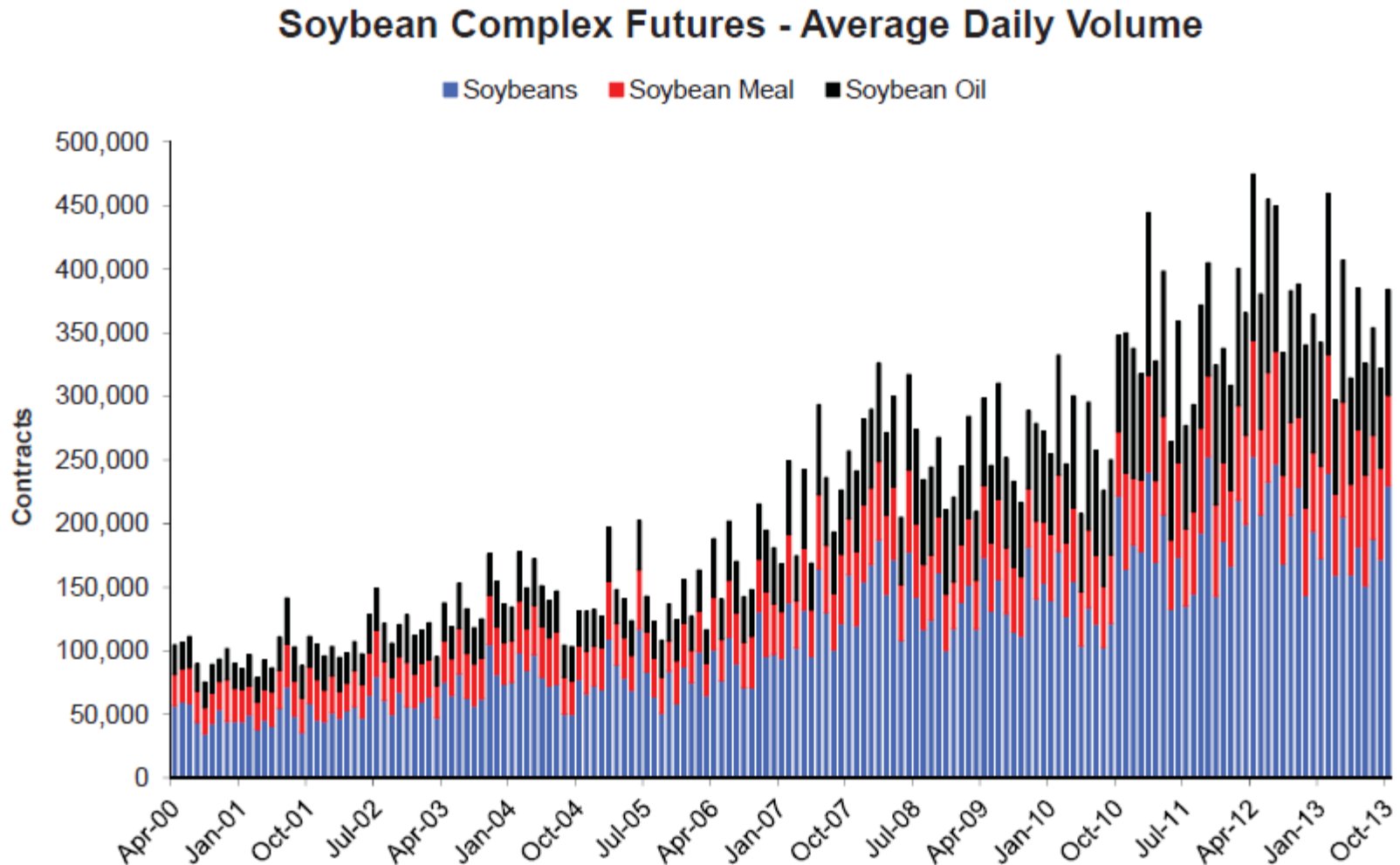
- Change in Market Size & Liquidity
- Change in Market Venue – Where We Trade
- Change in Market Make-up – Who Trades
- Change in Price Discovery – Contract Performance
- Change – Additional Hedging Tools
- What Does It Mean For A Hedger In 2014

Market Size & Liquidity

Corn and Wheat Futures – Volume Growth

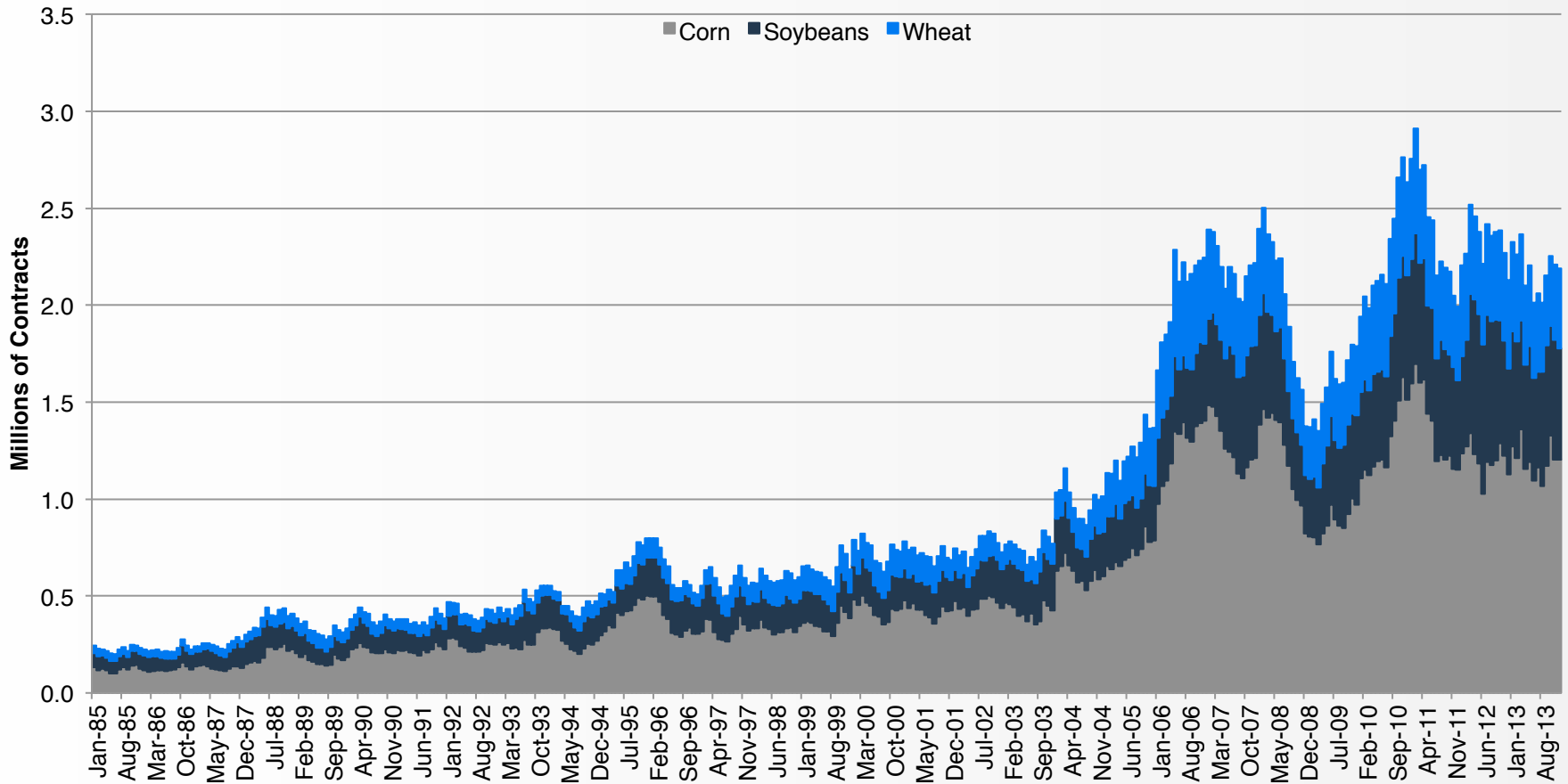


Soy Complex Futures – Volume Growth



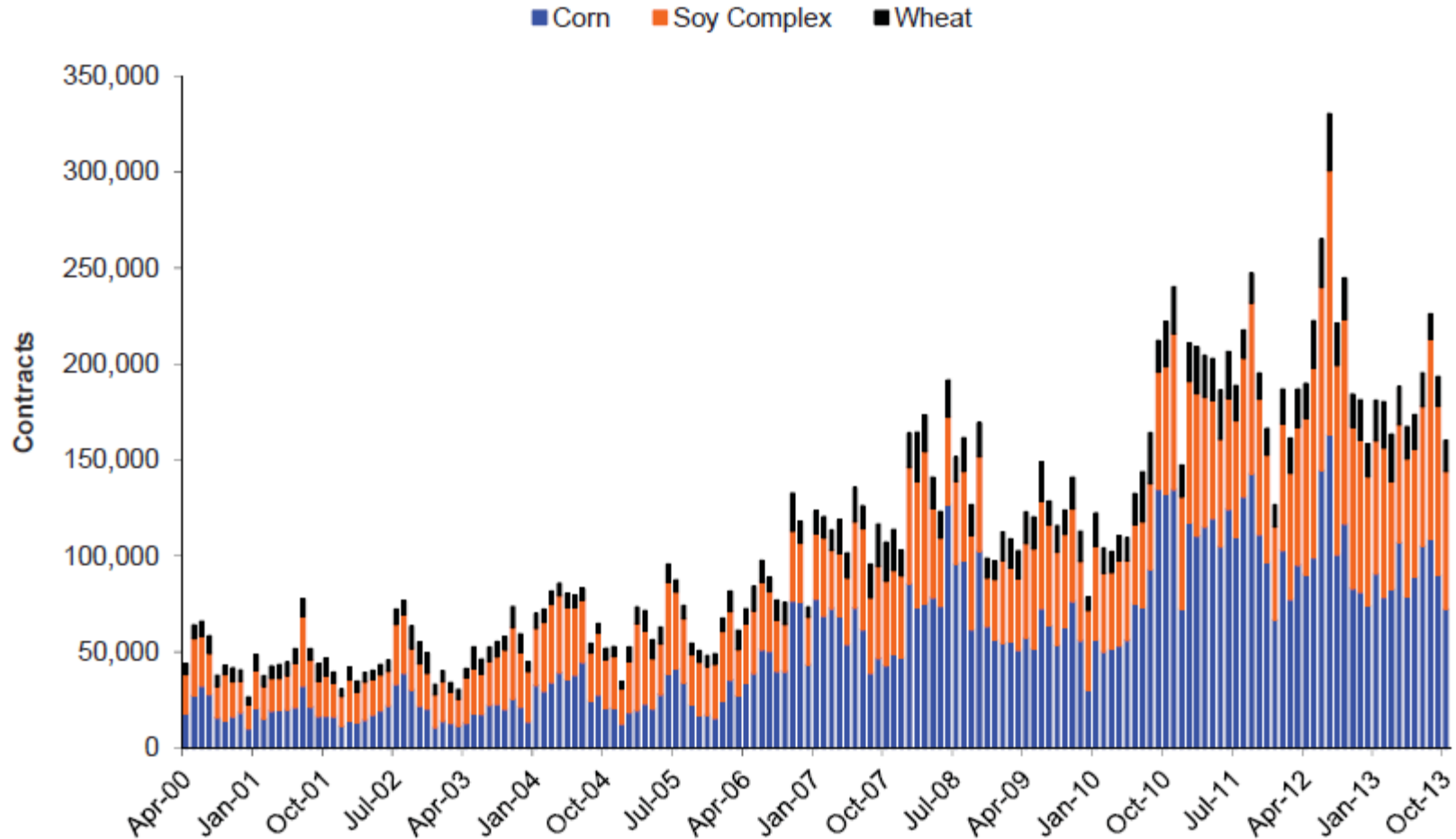
Grain and Oilseed Futures – Open Interest Growth

Corn, Soybean, and Wheat Open Interest



Grain and Oilseed Options – Volume Growth

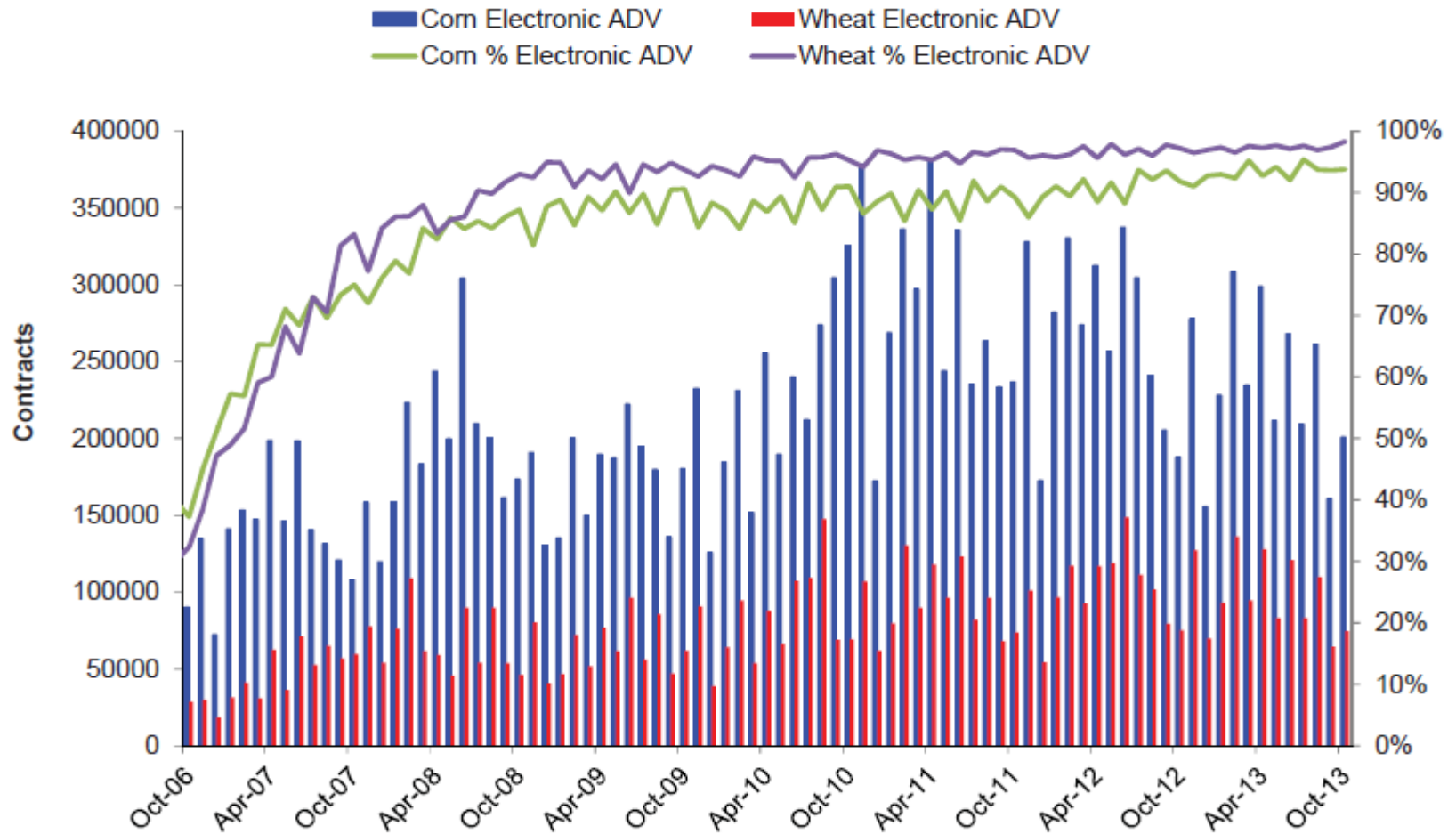
Options - Average Daily Volume



Market Venue

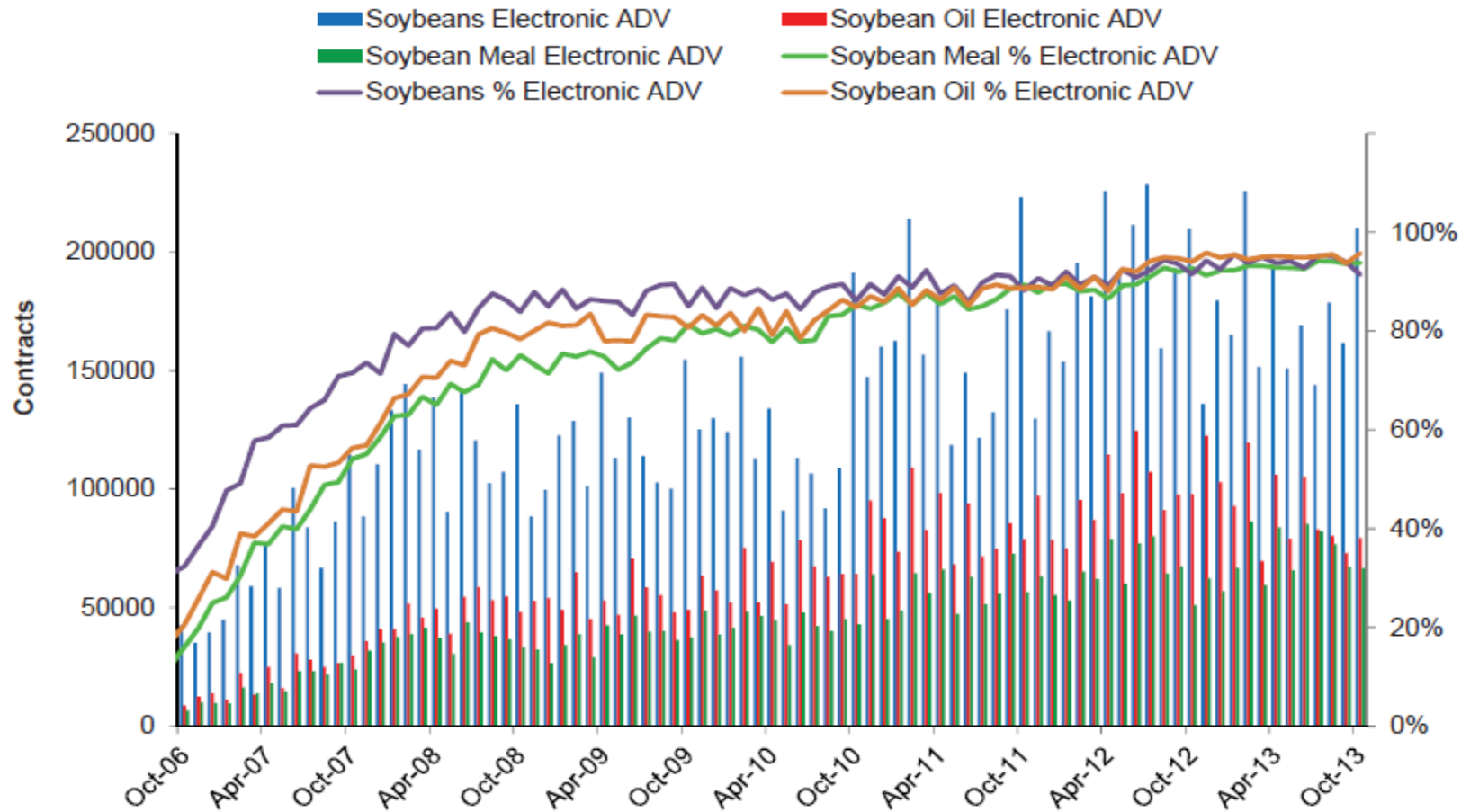
Corn and Wheat Futures – Electronic Trading Growth

Corn and Wheat Electronic Futures - Average Daily Volume



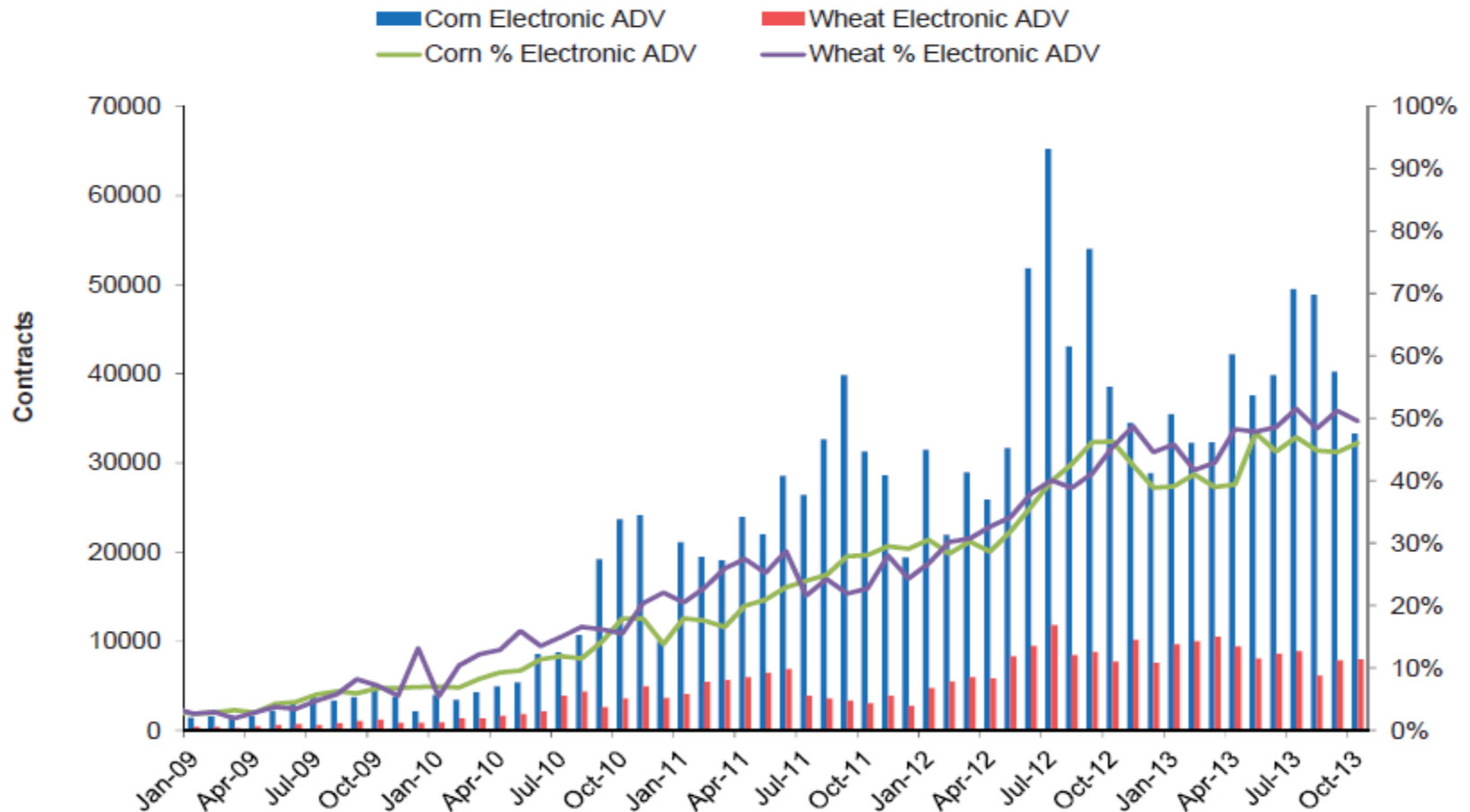
Soybean Complex Futures – Electronic Trading Growth

Soybean Complex Electronic Futures - Average Daily Volume



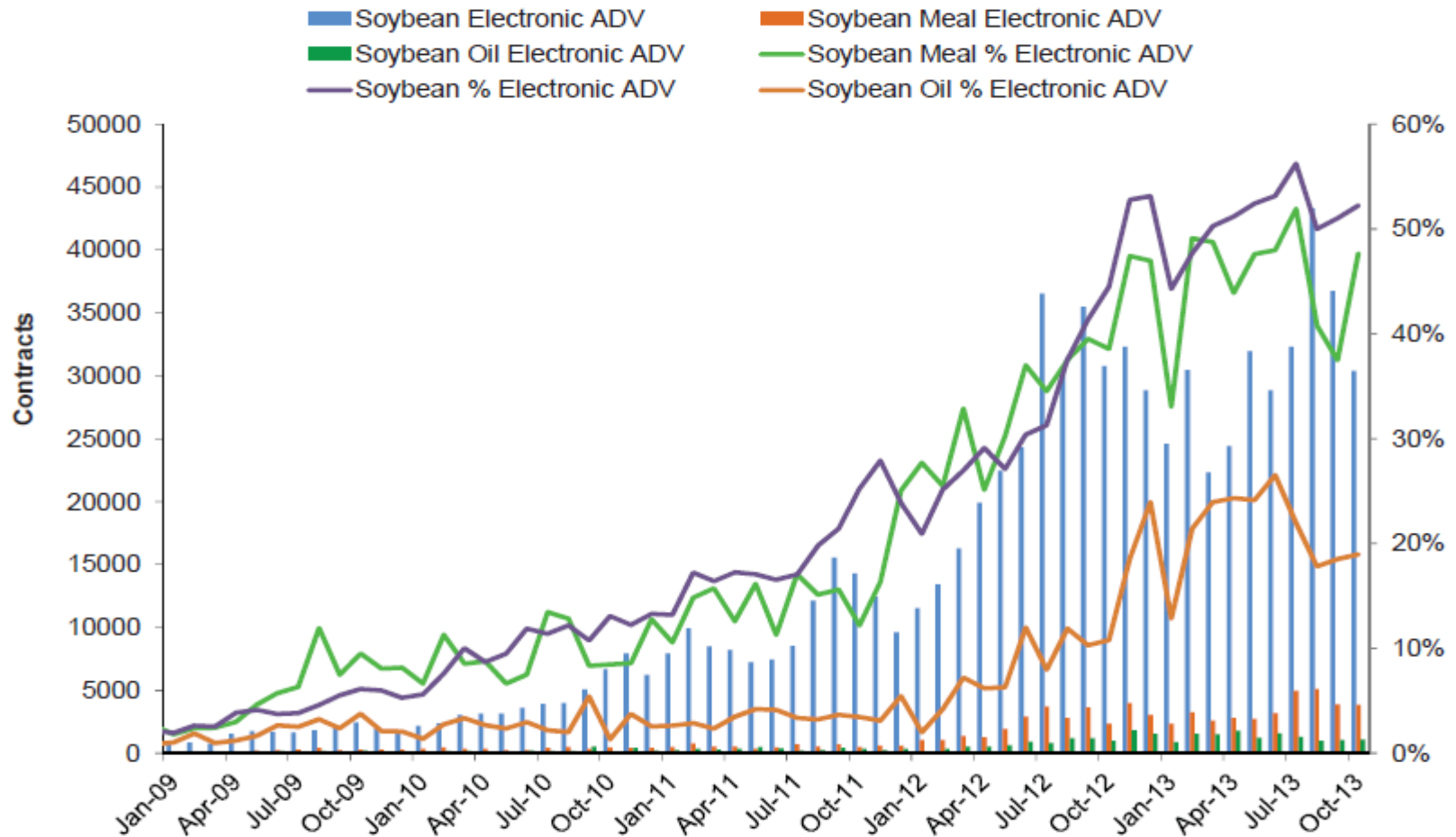
Corn and Wheat Options – Electronic Trading Growth

Corn and Wheat Electronic Options - Average Daily Volume



Soybean Complex Options – Electronic Trading Growth

Soybean Complex Electronic Options - Average Daily Volume



Market Make-up

Speculators are Necessary

“Liquidity is, in effect, the hostess gift that speculators bring to every market party, and without the capital poured into energy markets by institutional investors, prices may well be far higher and more volatile than they are.”

-- Philip K. Verleger

Owner and President of PKVerleger LLC

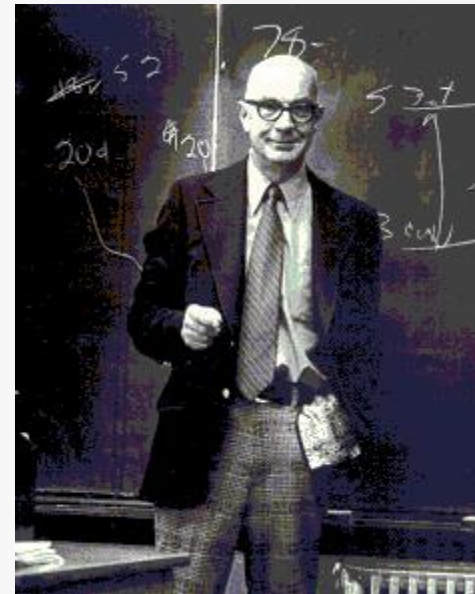


Speculators are Necessary

“The warehousemen are large scale operators who have skill and money. Only the professional speculators are equipped to oppose them; the effective competition in the storage market is provided by the large scale speculators.”

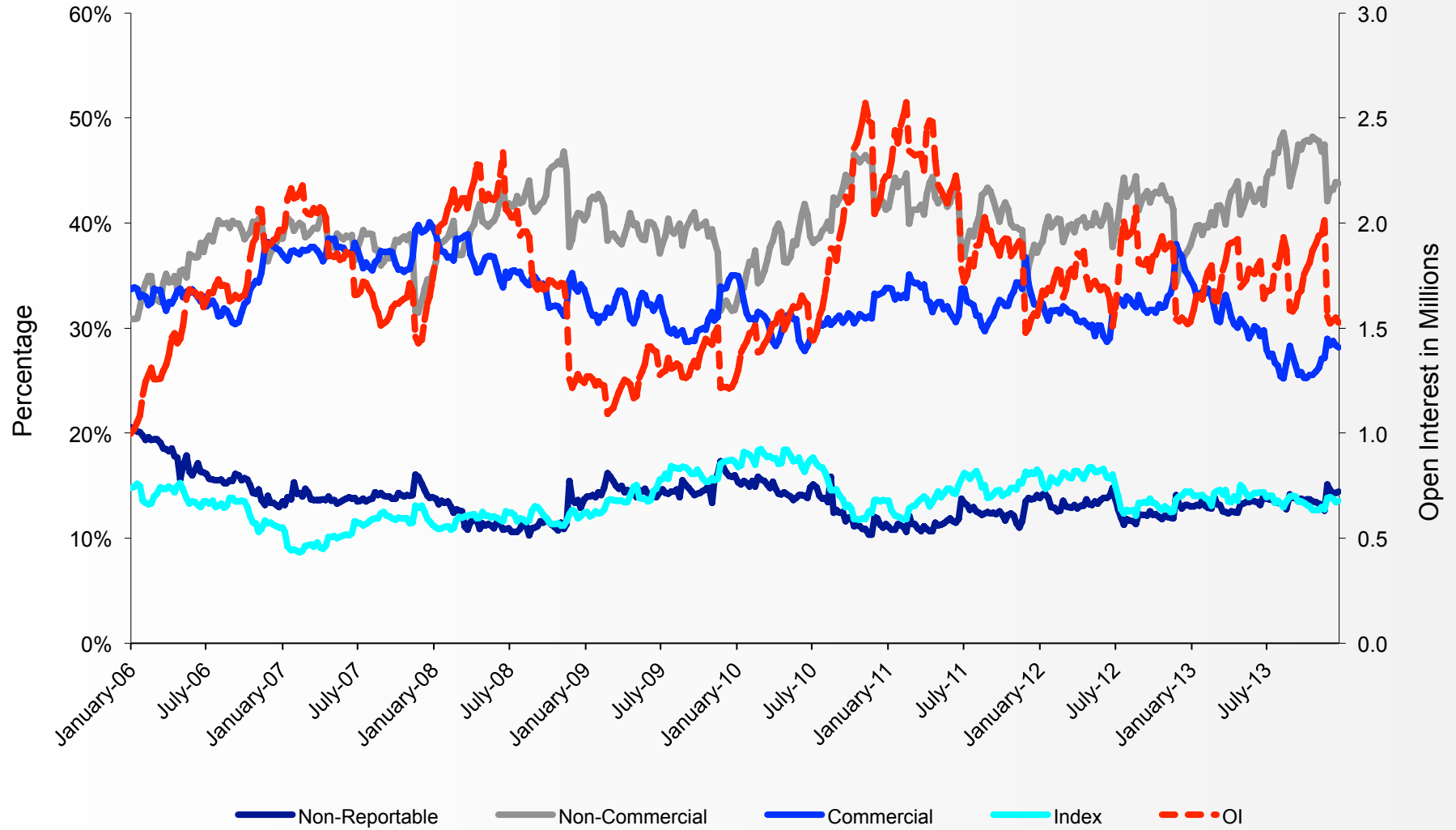
-- Tom Hieronymus

Professor Emeritus, The Office
for Futures and Options Research,
The University of Illinois



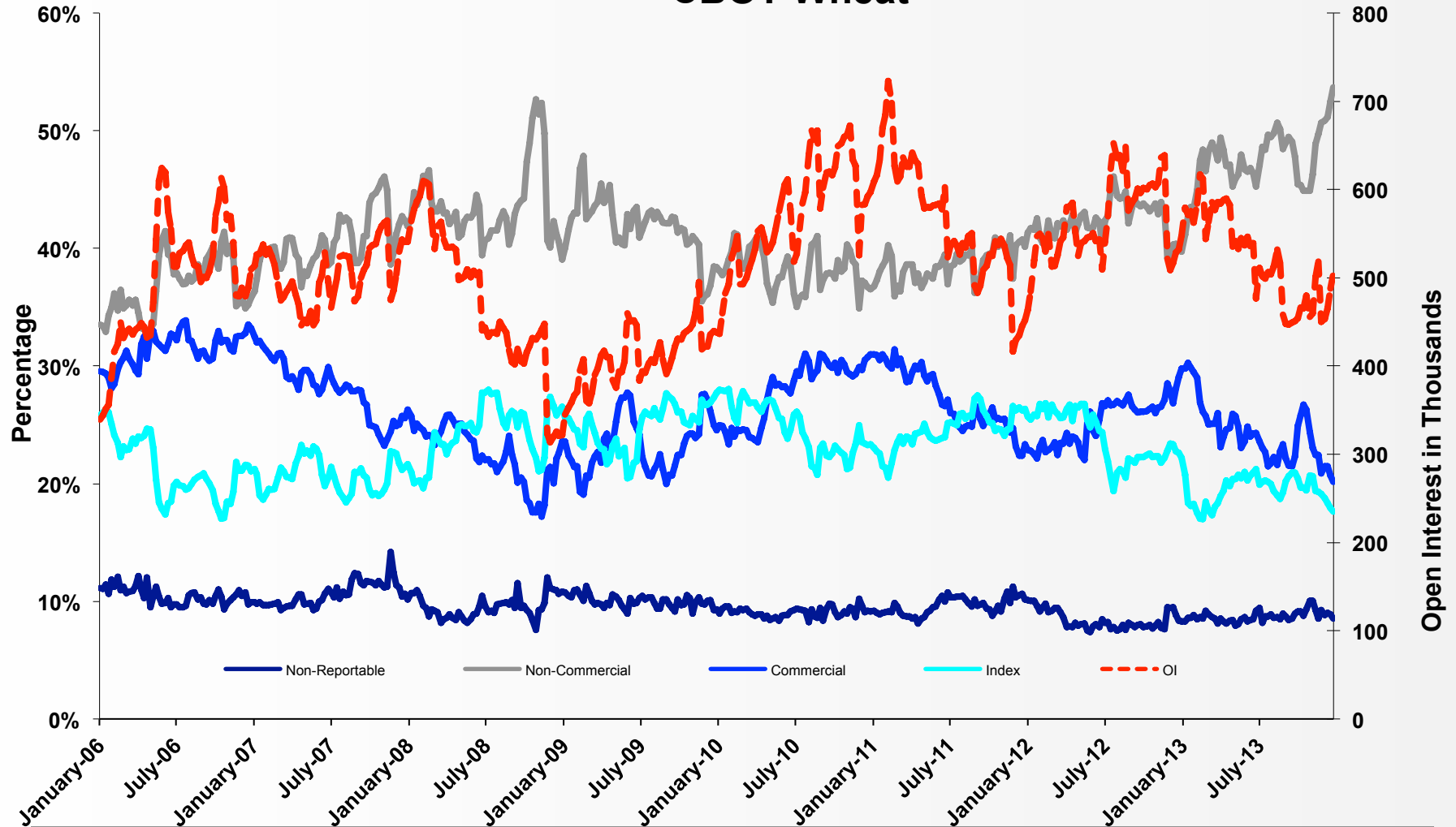
Market Make-Up - Corn

Percentage of Open Interest by Category
Corn



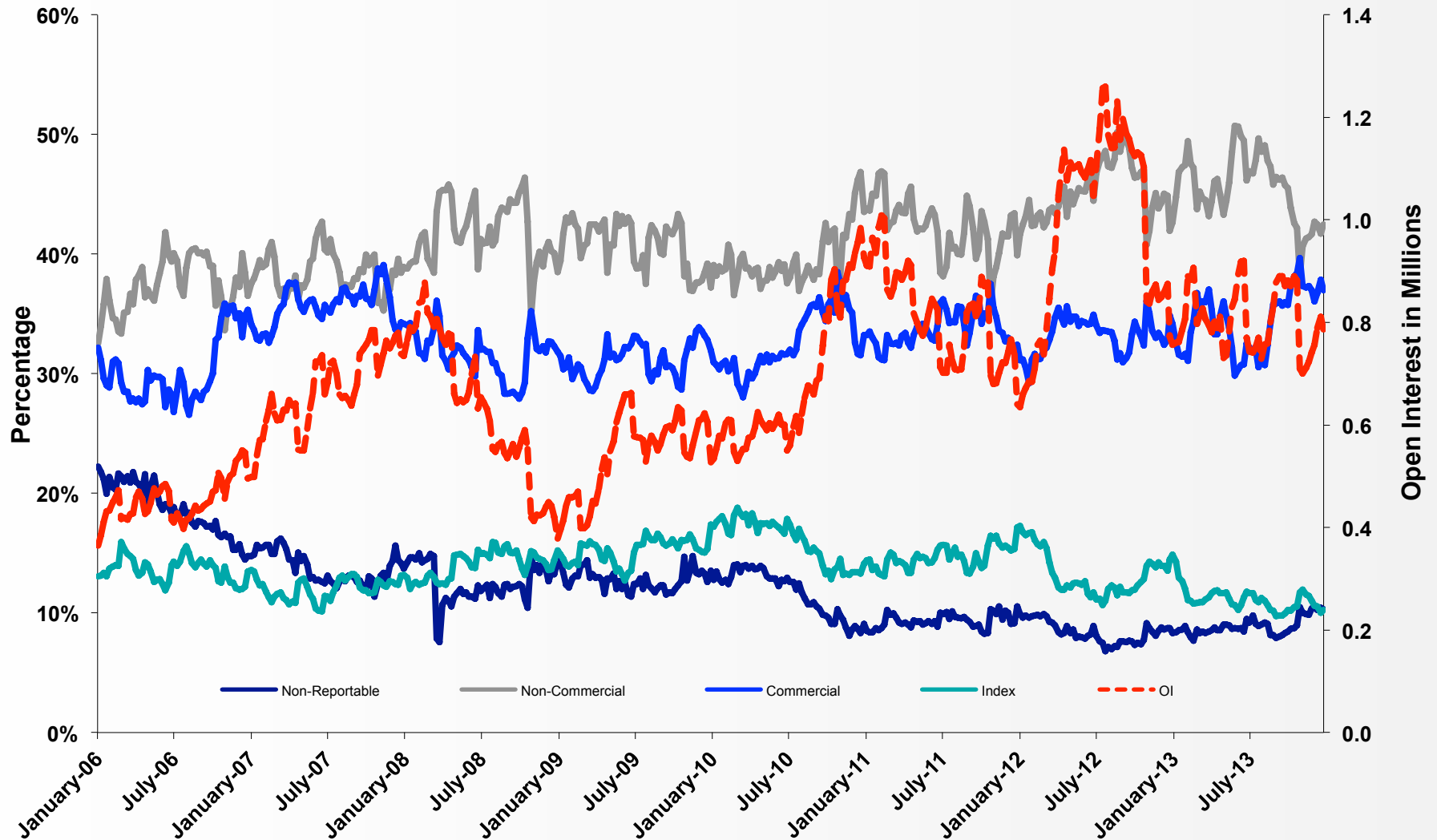
Market Make-Up - Wheat

Percentage of Open Interest by Category
CBOT Wheat



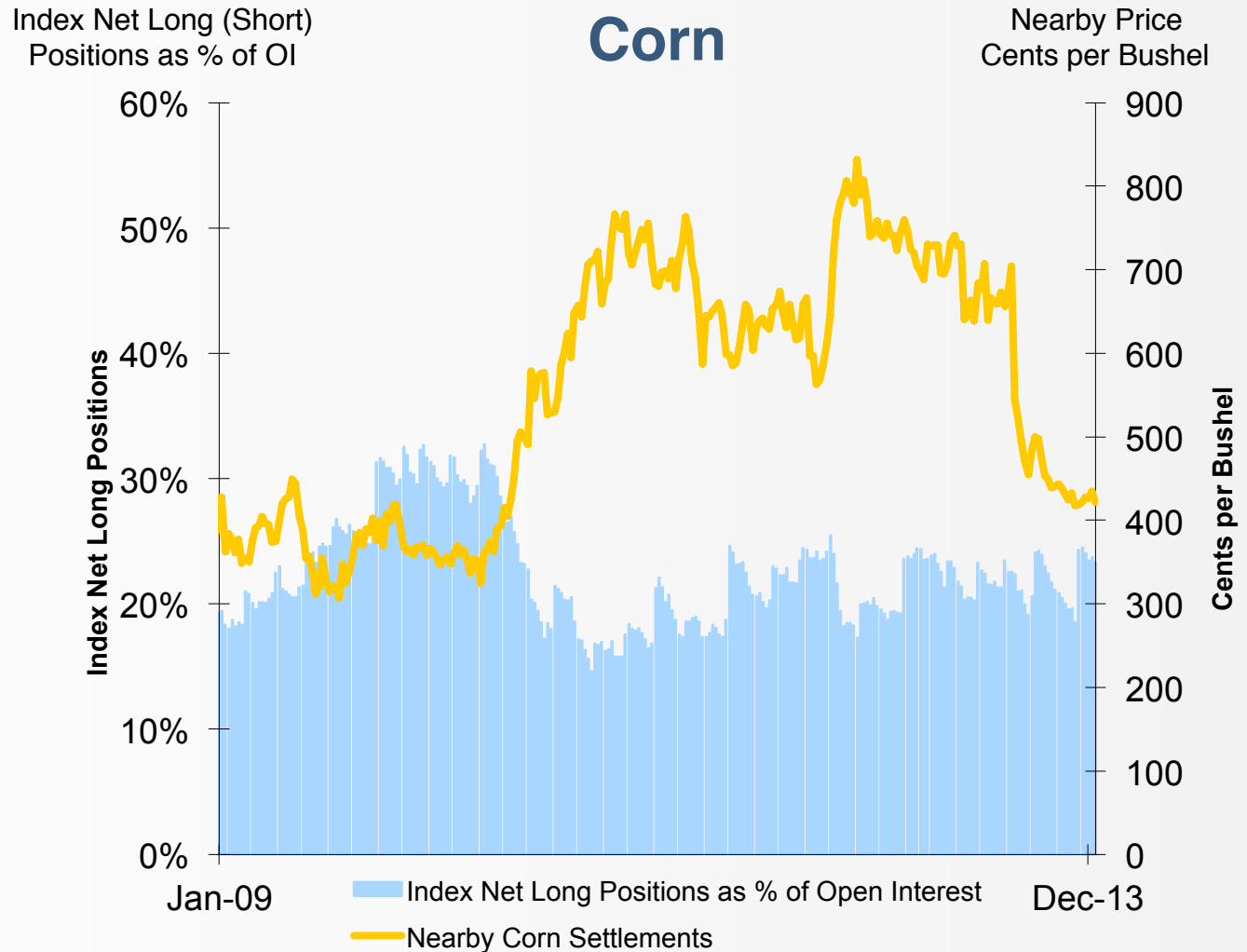
Market Make-Up - Soybeans

Percentage of Open Interest by Category
Soybeans



Index Fund Net Long Positions Have **Remained Steady** in Corn Futures Market

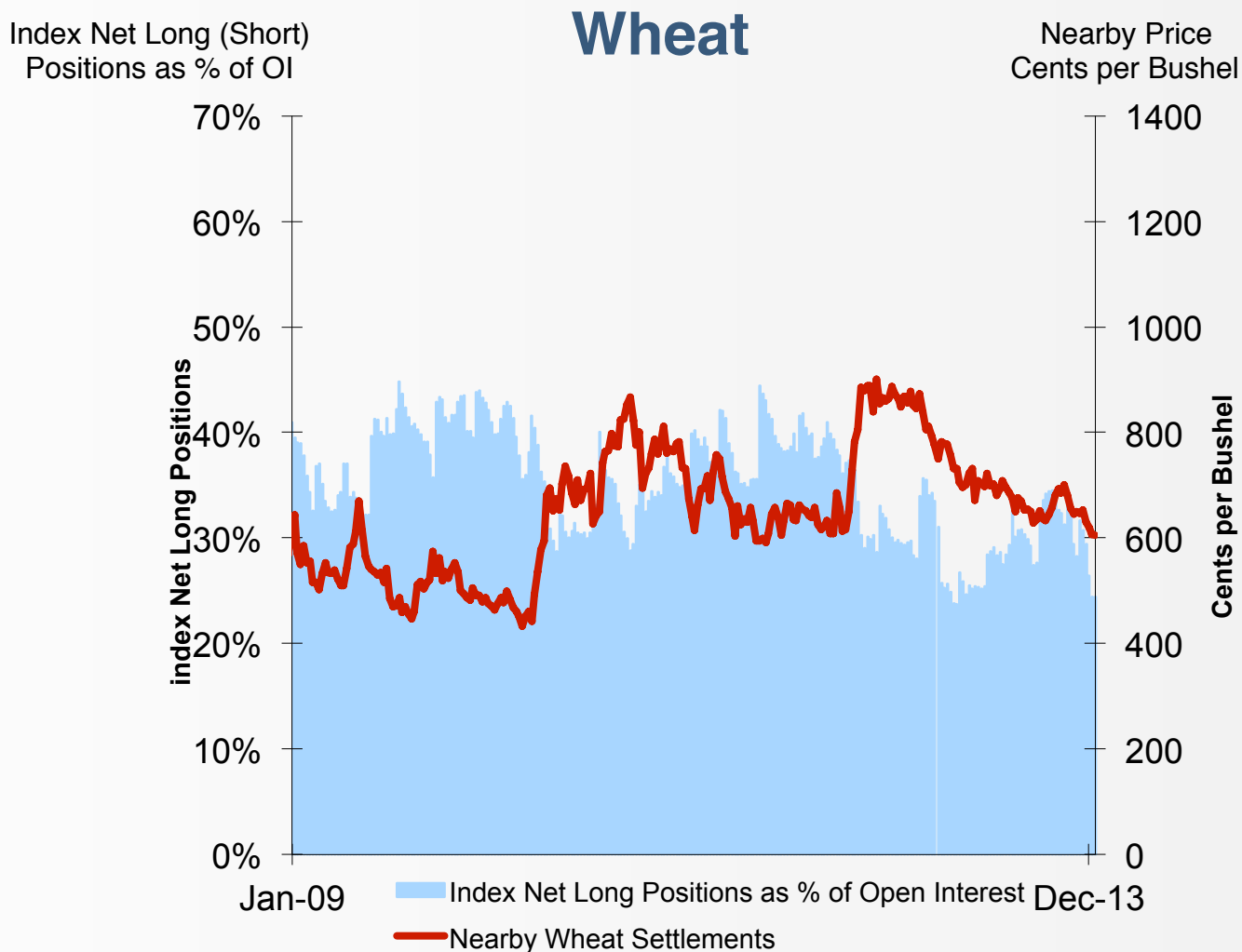
Though index fund positions as a percentage of open interest remained constant at around 20% over the last five years, prices increased 48%.



Source: www.cftc.gov

Index Fund Net Long Positions Have **Remained Steady** in Wheat Futures Market

Though index fund positions as a percentage of open interest remained steady over the last four years, prices have been consolidating for most of this time period.



Source: www.cftc.gov

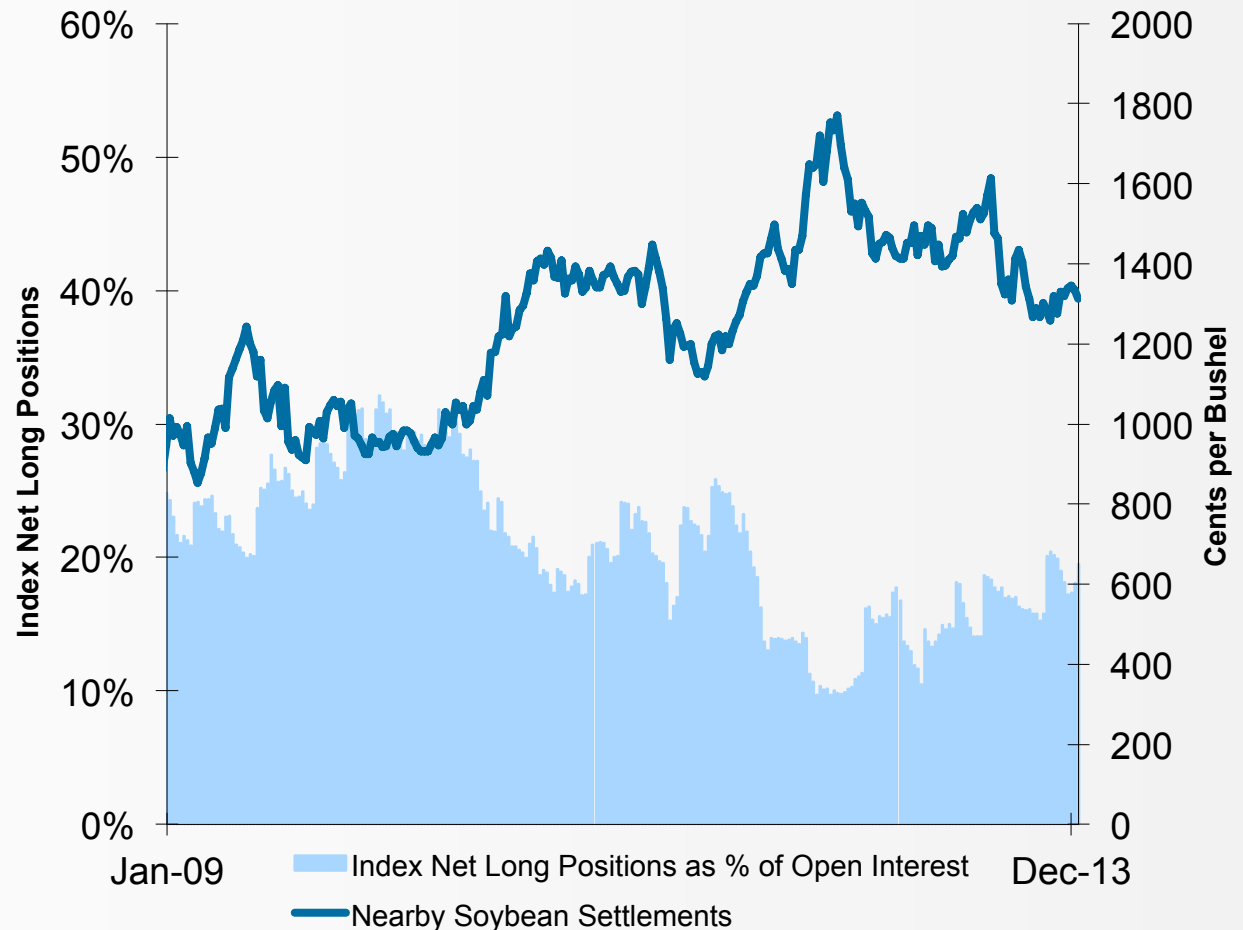
Index Fund Net Long Positions Have Declined in Soybean Futures Market

Index Net Long (Short)
Positions as % of OI

Soybeans

Nearby Price
Cents per Bushel

Index fund positions as a percentage of open interest has declined over the last four years while prices increased.



Source: www.cftc.gov

CME Group

Most attractive, valuable, diverse franchise in exchange sector

- Combination of unique assets provide competitive advantages
 - Balanced portfolio of diverse and benchmark products
 - Industry-leading trading platform, flexible architecture
 - World-class clearing, risk management expertise
- Additional growth opportunities
 - Early stages of globalization
 - Over-the-counter (OTC) and exchange-traded markets converging
 - Non-transaction based businesses
- Strong financial characteristics
 - Significant operating leverage
 - Unique variable dividend philosophy supplementing regular dividend
 - \$1.2B in dividends paid in 2012

Do Speculators Cause Distortions?

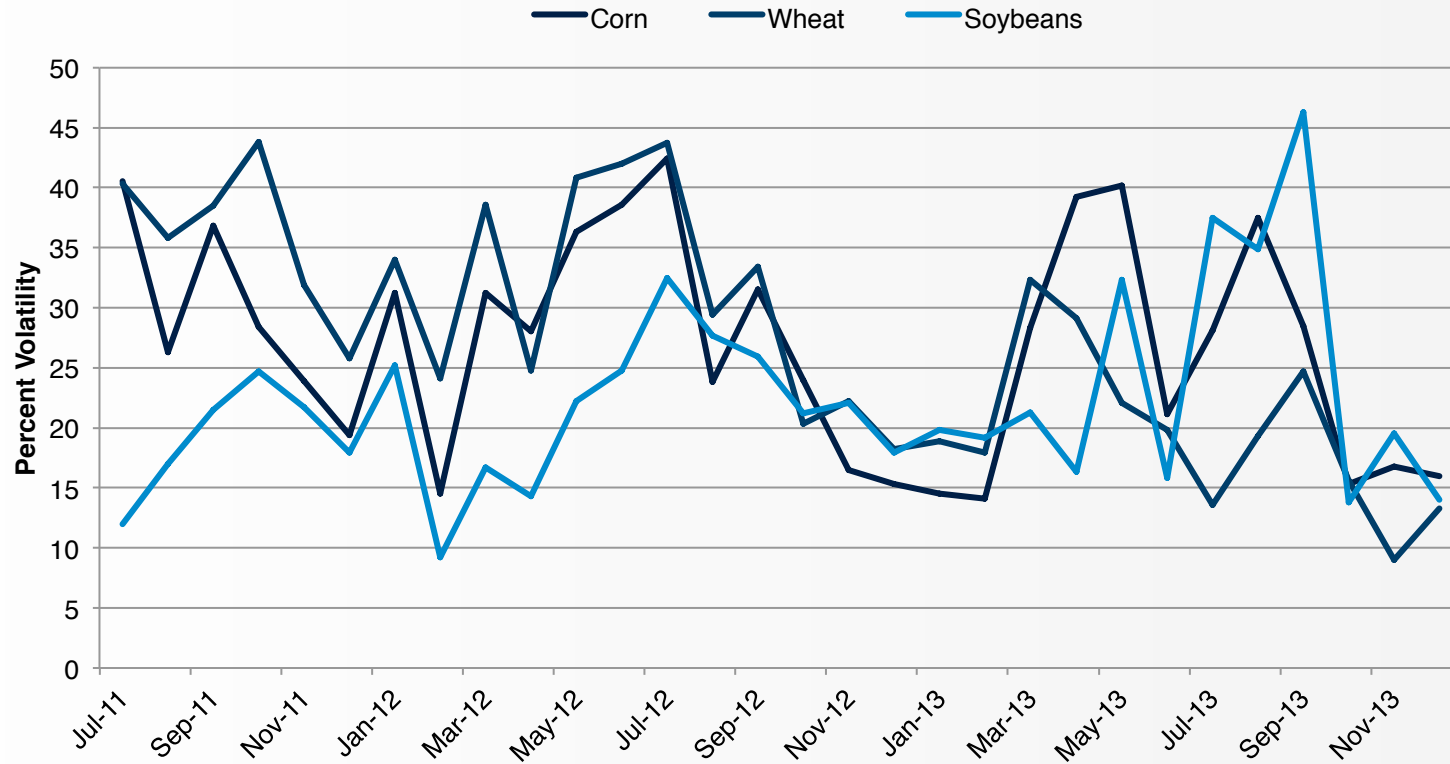
Irwin, Scott H., Sanders, Dwight R., and Merrin, Robert P. “Devil or Angel? The Role of Speculation in the Recent Commodity Price Boom (and Bust)” *Journal of Agricultural & Applied Economics*, 41(2009):377-391.

There is little evidence that the 2008 boom and bust in commodity prices was driven by a speculative bubble. Economic fundamentals provide a better explanation for the movements in commodity prices. The main factors driving prices up in the energy markets included strong demand from China, India, and other developing nations, a leveling out of crude oil production, a decrease in the responsiveness of consumers to price increases, and U.S. monetary policy. In the grain markets, factors driving up prices also included demand growth from developing nations and U.S. monetary policy, as well as the diversion of row crops to bio-fuel production and weather-related shortfalls. Demand factors reversed in quick order due to financial market meltdown and world-wide recession, leading to large price drops. The complex interplay between these factors and how they impact commodity prices is often difficult to grasp in real-time and speculators have historically provided a convenient scapegoat.

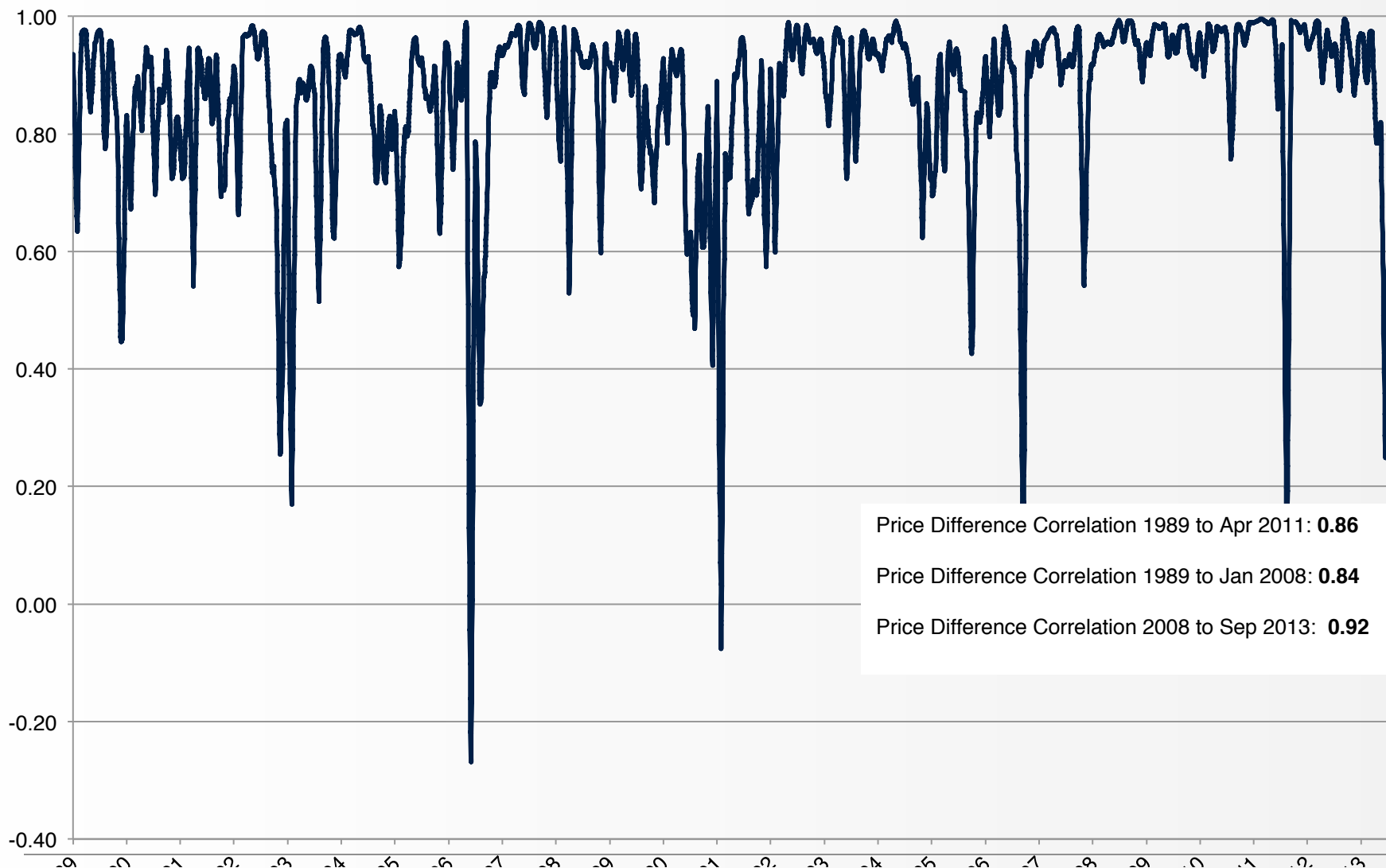
Market Performance

Grain Products – Historical Volatility

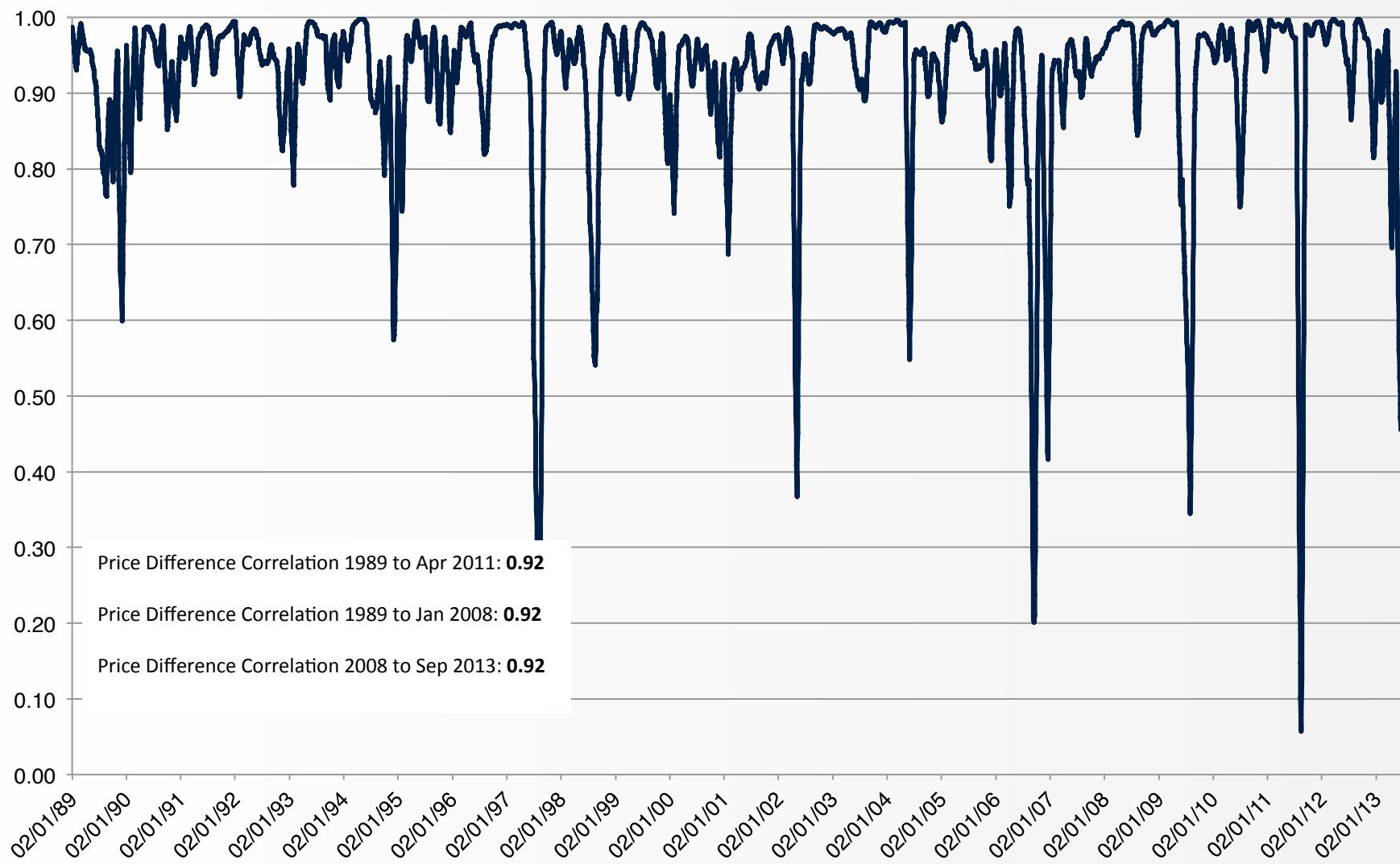
Monthly Historical Volatility



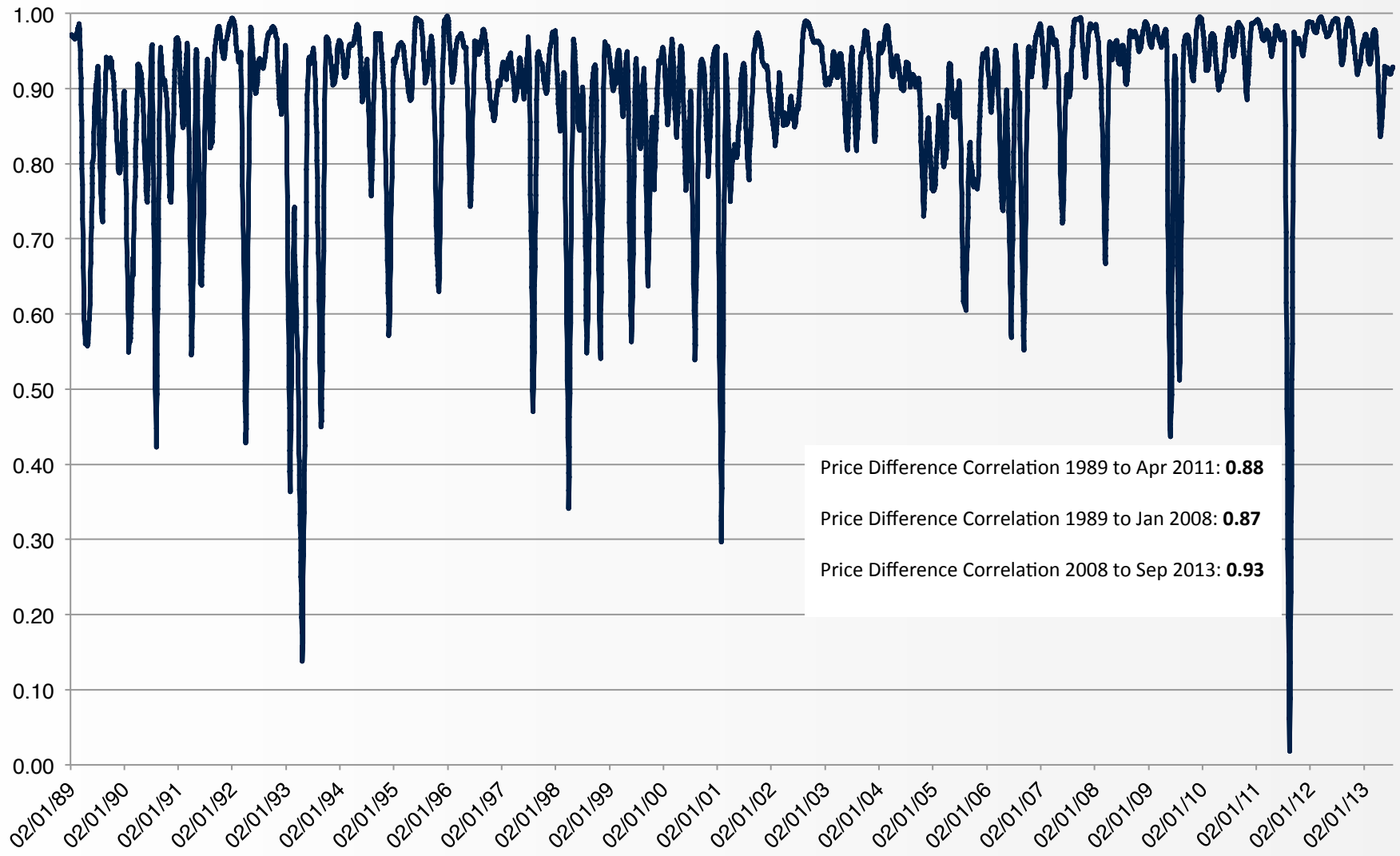
20-Day Moving Average Correlation on Price Changes Between Nearby Corn Futures and Spot Gulf Cash Prices



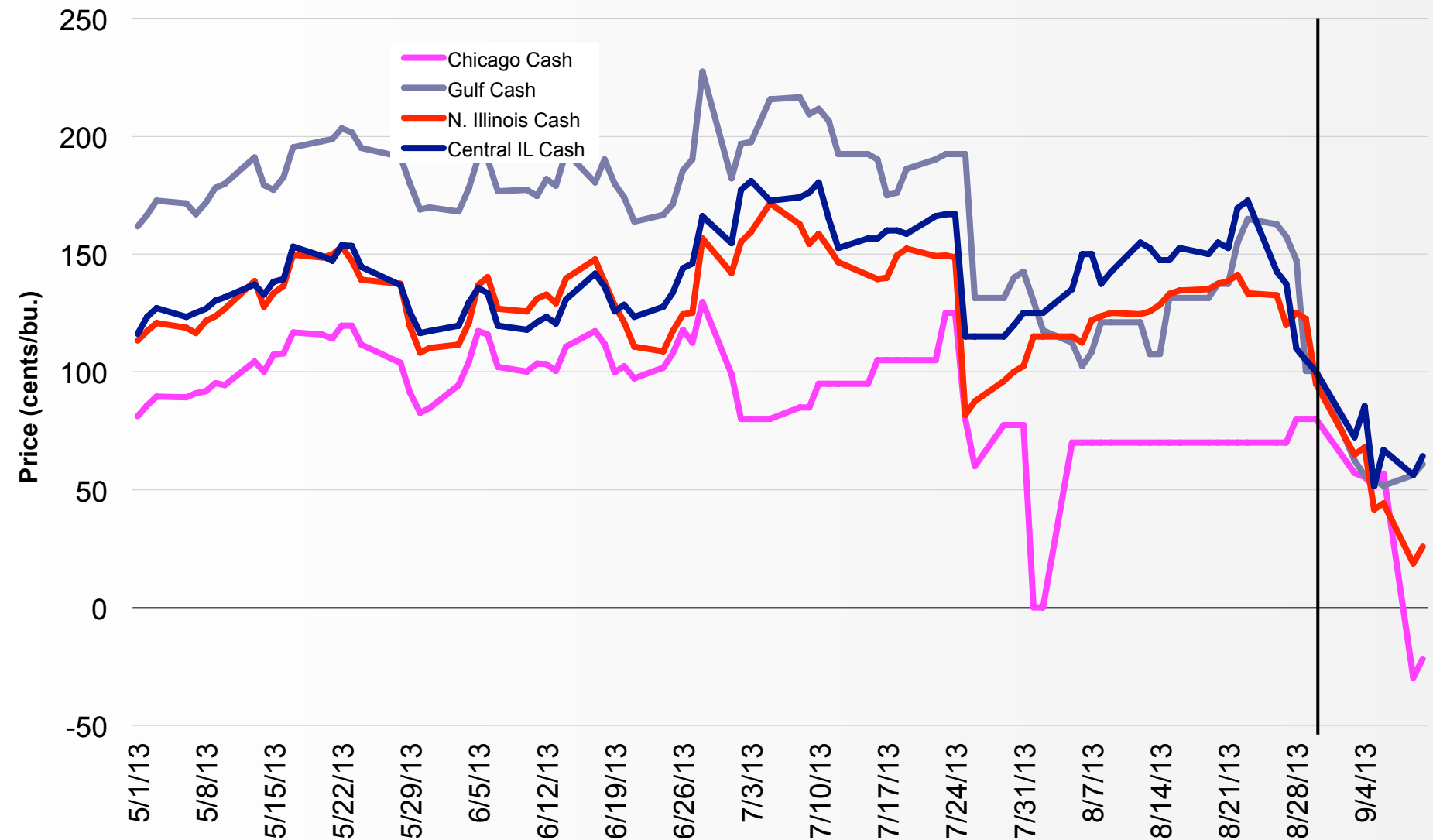
20-Day Moving Average Correlation on Price Changes Between Nearby Soybean Futures and Spot Gulf Cash Prices



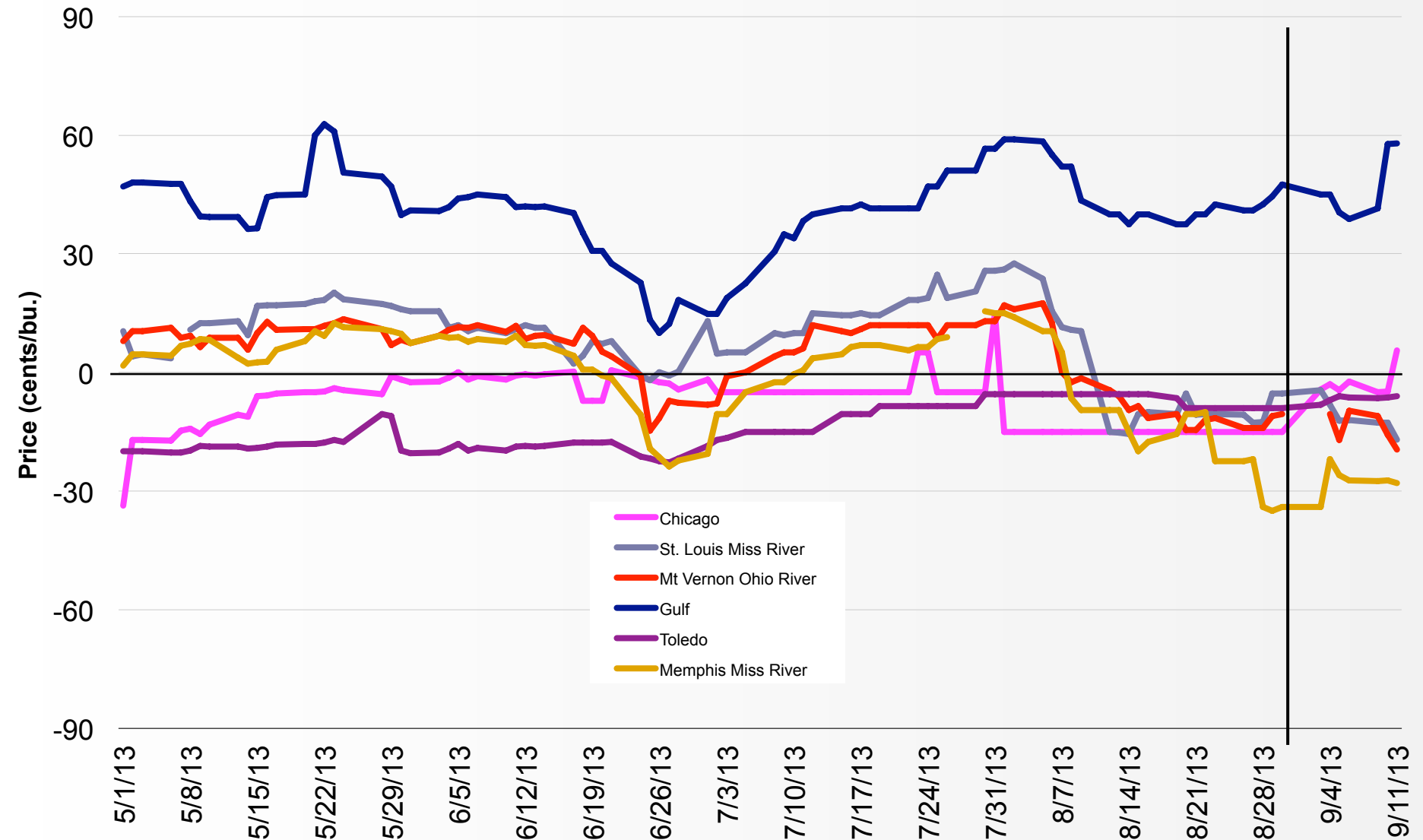
20-Day Moving Average Correlation on Price Changes Between Nearby Wheat Futures and Spot Gulf Cash Prices



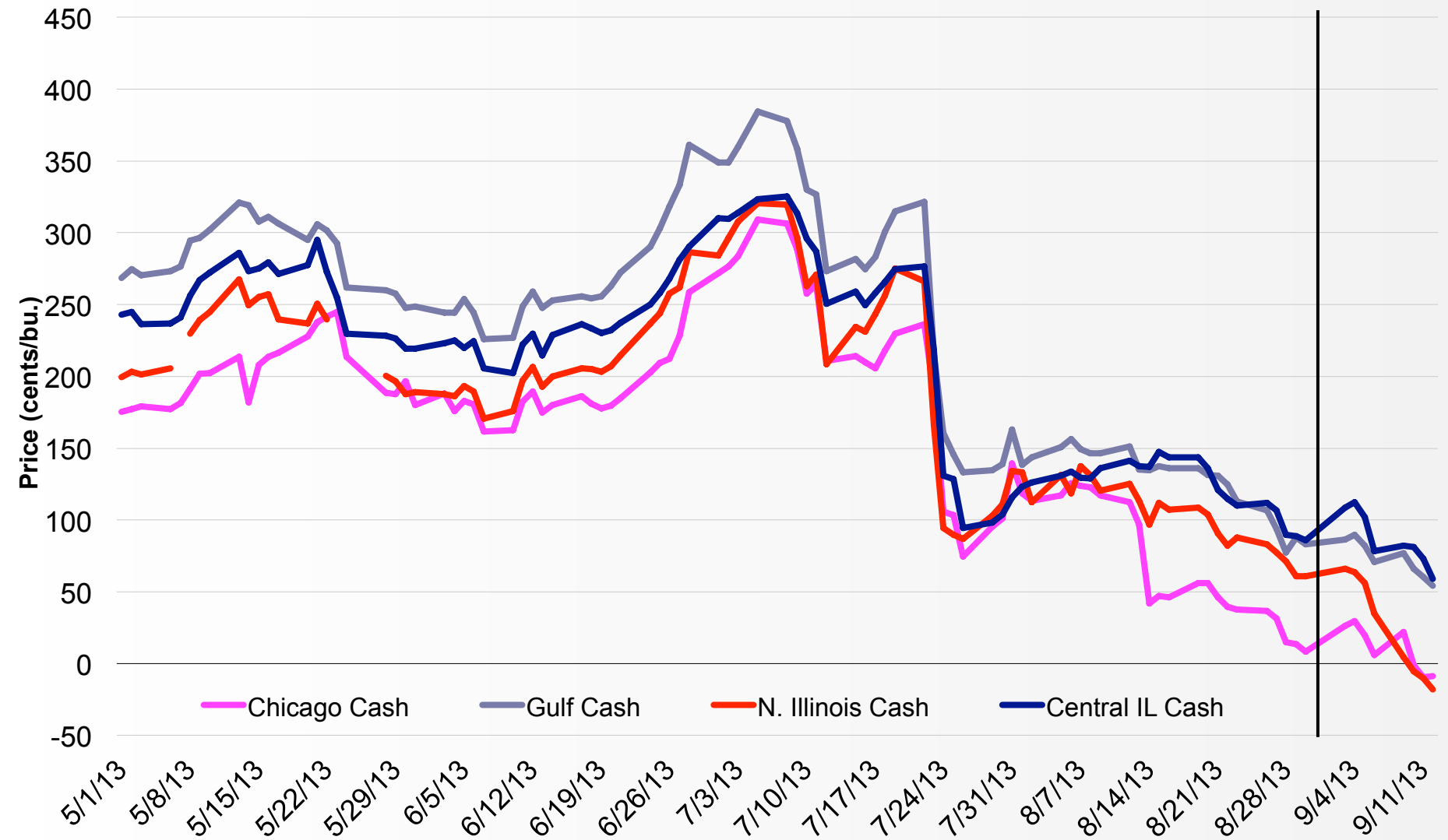
Basis Levels at Selected Spot Locations 2013 Sep Corn



Basis Levels at Selected Spot Locations 2013 Sep Wheat



Basis Levels at Selected Spot Locations 2013 Sep Soybeans



New Hedging Tools

Product Innovation

CME Group has enhanced Agricultural option suite by successfully launching innovative option products over recent years:

- Calendar Spread Options (CSOs)
- Weekly Options
- Short-Dated New Crop Options (SDNCO)

Short-Dated New Crop Options

- Definition:

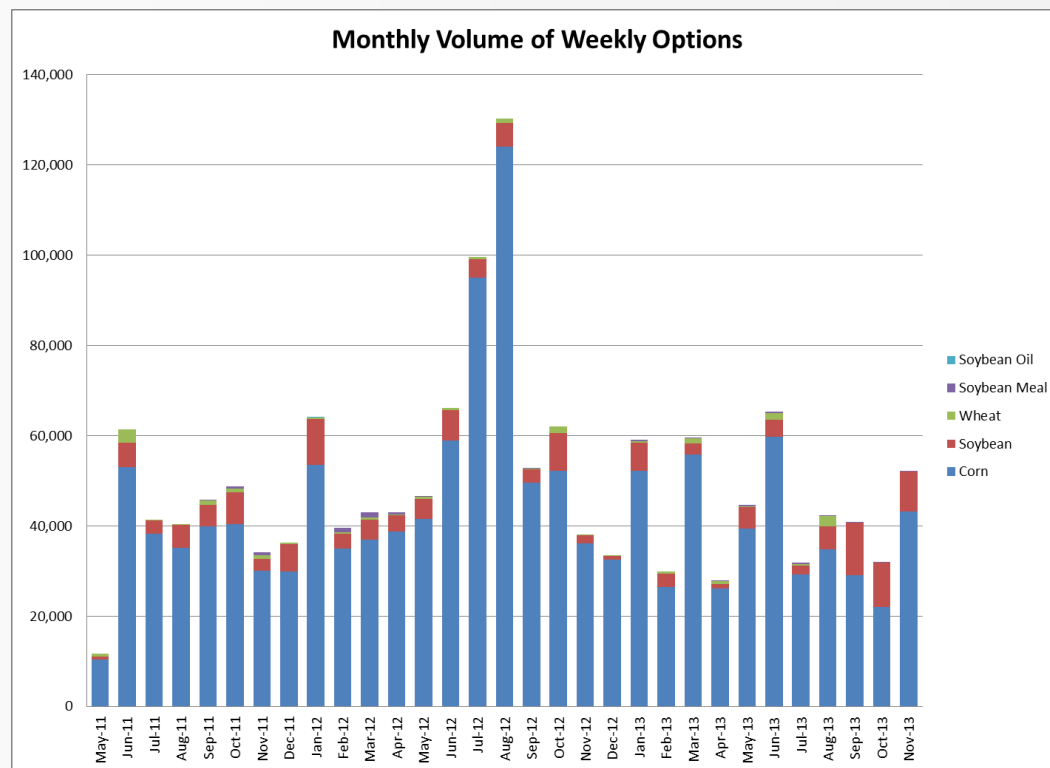
- The Short-Dated Options on the deferred (new crop) months are early expiring options that reference the December Corn Contract, November Soybean Contract and July Wheat Contract

- Key Benefits:

- Cost-effective: lower premiums due to lesser time value
- Facilitate hedging early in the planting and growing season
- Manage risk during specific windows of the growing season at reduced costs
- Useful for trading around key USDA reports
- Allow Greek sensitivity hedging
- Can be used to hedge old/new crop Calendar Spread Options (CSOs) positions
- Arbitrage opportunities between outright, CSOs and Short-Dated options

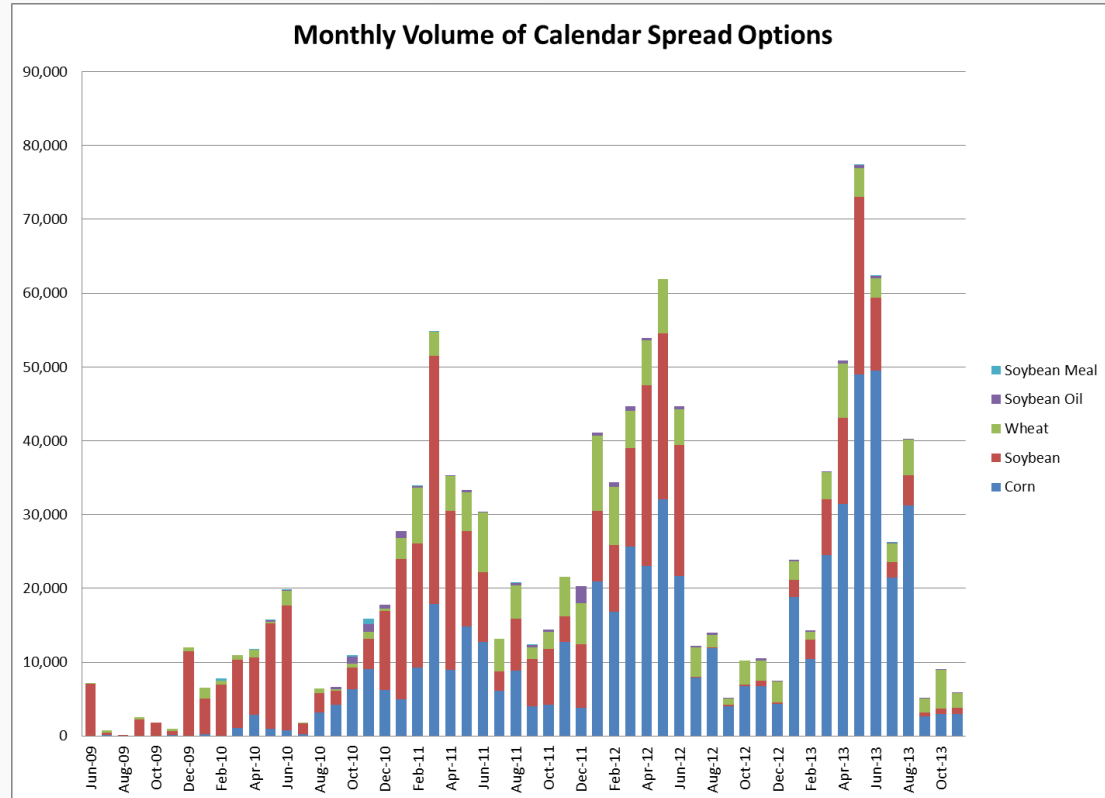
Weekly Options

- Weekly options on Corn, Soybean, and Wheat futures launched on May 23, 2011.
- Weekly options on Soybean Meal and Soybean Oil launched on September 26, 2011.
- Since launch through the end of Nov 2013, more than 1.52 million contracts have traded.
- 2013 YTD ADV=2,102. Corn is the most active, accounts for 86%, Soybean 12%, wheat/soymeal 2%.
- Nov 2013 total volume=52,035, 36% higher than Nov 2012.
- Record high monthly ADV 5,668 was set in Aug 2012, amid the drought.
- Reduce hedging costs due to low time value, thus low premium.
- Used to hedge short term events such as USDA crop reports and weather forecasts during growing season.
- Market familiarity leading to steady volume almost every day.



Calendar Spread Options (CSOs)

- CSOs for Corn, Soybeans, Wheat, Soybean Meal and Soybean Oil launched in June 2009
- Since launch through the end of Nov 2013, more than 1.16 million contracts traded.
- 2013 YTD ADV = 1,520.
- Nov 2013 total volume=5,812, 45% lower than Nov 2012.
- A new tool to hedge grain inventory and futures spread risk, especially old/new crop.
- CSOs are sensitive only to the value and volatility of the spread itself, rather than the price of the underlying commodity.
- More efficient and precise than combining options on two different months in an effort to replicate the spread.



Ramifications

What does it all mean to the hedger in 2014?

- Prices are higher and risks are greater than ever.
- Futures and Options markets are bigger, deeper, and more liquid than ever.
- Markets are more heavily regulated.
- Futures trading is more likely to take place on the CME Globex Electronic Trading Platform, typically at less cost than in the past.
- You will likely be trading in a market with greater price volatility compared to the past, which also implies greater margin requirements.
- The speculator assuming your risk is more likely to be an electronic proprietary trading firm rather than a floor local.
- Hedging effectiveness is actually improved in the modern market environment with higher correlations and strong convergence.
- Good Luck; Embrace Change; It's a Great Time to Work in Agriculture.

Thank you

