

7-19-1995

Cattle Situation: Short and Long Term; Rolling Hedge: Multiple Year Marketing Strategy

Gene Murra

South Dakota State University

Richard Shane

South Dakota State University

Follow this and additional works at: http://openprairie.sdstate.edu/econ_comm

 Part of the [Agricultural and Resource Economics Commons](#), and the [Regional Economics Commons](#)

Recommended Citation

Murra, Gene and Shane, Richard, "Cattle Situation: Short and Long Term; Rolling Hedge: Multiple Year Marketing Strategy" (1995).
Economics Commentator. Paper 319.

http://openprairie.sdstate.edu/econ_comm/319

This Newsletter is brought to you for free and open access by the Economics at Open PRAIRIE: Open Public Research Access Institutional Repository and Information Exchange. It has been accepted for inclusion in Economics Commentator by an authorized administrator of Open PRAIRIE: Open Public Research Access Institutional Repository and Information Exchange. For more information, please contact michael.biondo@sdstate.edu.



CATTLE SITUATION: SHORT AND LONG TERM

*Gene Murra
Extension Livestock
Marketing Specialist*

Anyone connected with the cattle industry knows that producers are concerned both about current low prices and about expectations for low prices in the future. Many factors, including supplies, demand, exports, imports, captive supplies and concentration, have been discussed as contributions to the situation. Some of those factors are discussed below in both a short term and long term context. Emphasis will be on the cow-calf side of the industry with some reference to the feedlot area.

Current and Short Term Situations

Calf prices peaked in the Spring of 1991. That Summer, when fed cattle prices dropped by \$14 (\$82 to \$68), there was some warning that calf prices wouldn't stay high forever. However, by the Fall of 1992, slaughter cattle prices were high enough (mid to upper \$70's) to support relatively high calf prices (although not as high as in 1991). Calf prices held surprisingly high in 1993 and then dropped about \$20 from the Spring to the Fall of 1994. This year, prices are even lower, with projections for continued low prices in the next 2-3 years.

Several factors are important in the assessment of calf prices. First, feedlots are feeling the effect of a period when losses were the rule and profits were the exception. They are in a poor equity position and are cautious when buying feeder cattle. Second, grain supplies are expected to be down and a high price is the result. Higher grain prices lead to lower feeder cattle prices,

(Continued on page 2)



ROLLING HEDGE: MULTIPLE YEAR MARKETING STRATEGY

*Richard Shane
Extension Grain
Marketing Specialist*

When commodity prices reach relatively high levels, commentators and other market participants begin to talk about rolling or multiple year hedges. However, there seldom is any discussion of how, when or why to initiate such a strategy.

The objective of a rolling, selling hedge is to capture a high price for a commodity that will be produced at some future time. Often the time of production is further into the future than contracts are offered for that production, say 1, 2, or even 3 years. In such instances, the producer can sell a futures contract a few months or even a year into the future. As this contract approaches expiration, it is bought back and a contract further into the future is sold. This action is referred to as rolling the pricing contract. This rolling continues until the desired time of price protection is reached. This strategy can span several years.

Some analysts advocate the continuous rolling contract. That involves selling the nearby contract and then rolling to the next contract as each contract becomes deliverable. This strategy involves many "rolls" over the span of a multiple year strategy. A method of more selective rolling may be adequate when a certain price level is desired. This selective rolling eliminates several commission fees. The continuous rolling hedge is advised when there are not good signs of when to roll a hedge.

A current example would be to sell December, 1995, Chicago Board of Trade (CBOT) wheat at \$5.00 to begin price protection for wheat

(Continued on page 3)

(Current and Short ... Continued from p.1)
especially when fed cattle prices are low. Third, fed cattle prices are low and are not expected to move much higher. In fact, many expect them to be even lower this Fall. Finally, feeder cattle supplies are large. The nation's cow-herd has been building since 1990--not fast but steady. That herd has produced more calves, which has helped push prices lower.

A few comments on the feedlot segment of the beef industry must be made. More beef is produced in the U.S. today from a herd that is 20-25 percent smaller than the one in 1975. A higher percentage of cattle are fed and they are fed to heavier weights. The feedlot industry has become more concentrated, although not nearly as concentrated as slaughter and processing segments. This has led to several developments.

First, more cattle are sold direct from large feedlots to packers. Less open-market pricing is conducted. When supplies are tight, concentration of firms often leads to prices higher than expected (note the cattle industry in the Spring of 1993 and the hog industry in July, 1995). However, when supplies are plentiful (as now), concentration may lead to lower prices. When captive supplies (even though a small percentage of total volume) are factored into the picture, even lower prices could be the result.

The short-term outlook is for fed cattle prices to stay in the lower \$60 to upper \$50 area. The \$70 level seems out-of-reach, \$65 is not but is being optimistic. There is just too much beef, pork and poultry available to allow for much upward move in prices. And, more cow slaughter this Fall could add to the problem.

Given the current and expected high price for corn and the above fed cattle outlook, it is not possible to be optimistic for feeder cattle prices. Earlier, before corn prices rallied so much, the \$80 area for 400-500 pound steers seemed reachable. Now, \$70-75 seems more probable and even that will require quality calves. Heavier steers could slip into the upper \$60's (maybe even low to mid \$60's) area.

If the above holds true, many producers will evaluate backgrounding. The use of grass or other roughage to add weight will be considered. In fact, the short supply of corn and the corresponding higher price encourage such a move. High prices ration the use of inputs (in this case, grain) and encourage the use of substitutes (in this case, grass).

Retaining ownership is not without risk. Forward price opportunities are not great. There is production risk to consider. Even then, retained ownership may be the best choice of several "not so good choices" for many S.D. cattle producers this Fall.

Long Term

The next two years (maybe even three years) could be tough ones for beef producers. Large supplies of beef and other meats will continue to pressure prices. While the demand picture, both domestic and foreign, is not bad, it isn't strong enough to solve the low price problem. It will take 2-3 years to move the normal supply of beef along with the added beef from herd liquidation to get supplies down to a level which will "match demand at higher prices."

Calf prices should bottom out in 1997 (some say 1996, others say 1998). It may be two or three years past the year 2000 before they are back up to levels noted around 1990-91. And, even that may be a little optimistic. Much will depend on how much liquidation really does occur. Many beef cattle are in herds of such small size that price is not the determining factor relative to expansion or liquidation. Other producers are reluctant to cut back if they have grass (a quality currently prevalent). And, much will depend on the grain industry and what happens in both the pork and poultry industries.

The lower calf prices go this Fall, the shorter the period of low prices will be. As has often been stated, the best cure for low prices is low prices. We should be able to test that theory this Fall and in 1996 (and maybe 1997).

(Rolling Hedge ... cont'd from p.1)

produced in 1996. As December approaches, buy back the Dec contract and sell a March contract. As March approaches, buy back the March contract and sell a July contract. On July 1, you would buy back the July and sell a Sept contract. This will give price protection through harvest. At harvest, you would buy back the Sept contract and sell the wheat. If you also initiated this strategy for 1997 produced wheat, you continue this process until the next harvest. This is an example of a continuous rolling hedge. If March approaches and the Sept contract has converged to the March but the July has not converged as far (the July price is lower than the Sept price), then a selective rolling hedge would be advisable. To do this, you buy back the March contract and sell the Sept contract (skip July).

When do you consider such a strategy and how high do prices have to be before it is recommended? To answer these questions, long term or monthly CBOT wheat futures prices must be examined. There, it will be noted that prices have been above \$5.00 in only three years, 1973, 1974 and 1980. Also, in the last 15 years, wheat futures prices have been above \$5.00 only twice and above \$4.50 three times. Finally, after each peak, wheat futures prices have steadily declined for at least two years. So, when wheat futures prices reach \$4.25 to \$4.50, producers should be getting positioned to use this rolling strategy. When wheat futures prices go above \$4.50 to \$5.00, the sale of two or even three years of wheat production should be initiated.

Why is this done? First, the chance of higher prices for even the current year is very low. The probability of continually lower prices for the next two to three years is very high. There is the chance for a higher price after the initiation of the strategy. If this occurs, there will be margin calls that could be large. However, price patterns suggest that over time prices will decline and this margin money will come back into your hedging account. Because of the potential short term need for large amounts of margin money, you must have unlimited amounts available at all times. Your banker needs to understand why this money is necessary and that in the long term you will

likely be far ahead. Your banker needs to know that the 2-3 year price level you are protecting will give you a very high average price relative to history and relative to your production costs. This strategy will allow you to insure profitability for several years at a high price even if the futures go above your strategy price for some unforeseen reason.

George Flaskerud of North Dakota State University conducted research to evaluate this strategy for spring wheat. A continuous rolling hedge placed in July of 1980 for 1981 crop yielded \$1.23/bu. more than a 1981 harvest time sale on the cash market. He further analyzed a continuous rolling hedge placed in July of 1980 for the 1982 crop and found a \$1.44/bu. advantage over cash sales. Also, he found that a continuous rolling hedge placed in June of 1988 yielded \$2.15/bu. more than cash sales of the 1990 crop. All commissions and interest on margin accounts were included in the analysis.

Bill Tierney at Kansas State University analyzed continuous rolling hedges for winter wheat using the Kansas City Board of Trade. For the eight major price peaks from 1973 to 1992, he found a \$1.06/bu. average advantage for the rolling hedge over harvest prices.

These two studies build a strong case for multiple year hedges for wheat producers. If a producer is uneasy about selling 300 percent of a year's production, these studies at least suggest that any crop that must be sold at harvest should be sold using these multiple year strategies. Both Tierney and Flaskerud compared continuous rolling hedge strategies with selective rolling methods and found that the continuous rolling hedge outperformed the selective strategy.

The author of this article evaluated the selective rolling hedge method for soybeans using the CBOT. The three year hedge was placed in August of 1988 for 300 percent of one year's expected production. The actual price realized each year varied due to basis differences and gains and losses on rolls. The strategy was initiated by selling Nov futures at \$8.90 for the 1988 crop and May 89 futures at \$8.70 for the



SOUTH DAKOTA STATE UNIVERSITY
Economics Department
Box 504A
Brookings, SD 57007

Address Correction Requested

Non-Profit Org.
U. S. Postage
PAID
Brookings, S. D.
Permit 24

1989 and 1990 crop. The 1988 crop hedge was lifted (futures bought back and cash sold) at harvest for a net price of \$8.30. In April of 1989, the 1989 and 1990 crop hedges were rolled to the Nov 89 contract. The 1989 hedge was lifted at harvest for a net price of \$8.10/bu. The 1990 hedge was rolled in August of 1989 to July of 1990 (buy back Nov 89 contract and sell July 90 contract). It was rolled again in Nov 1989 to Nov 1990 (buy back Nov 89 and sell Nov 90). The 1990 hedge was lifted at harvest 1990 for a net price of \$8.40/bu. Commission and margin interest were \$.015, \$.03 and \$.06 per bushel for the 1988, 1989, and 1990 strategies, respectively. If income tax consequences were considered, net prices would still be much above harvest prices of \$7.20 in 1988, \$5.50 in 1989 and \$5.25 in 1990. For soybeans, this strategy should be evaluated when futures price reaches \$8.00. This price level does not hold into the harvest period, according to the long term charts.

An analysis of this strategy was not completed for corn. However, inspection of the long term charts leads me to believe that early in the crop year (before July), a futures price of \$3.50 to \$3.75 would be a safe level to initiate the strategy. Later in the crop year (say in August) a price of \$3.25 or above looks relatively safe from a margining point of view. Of course, each

hedger must select a price level that is right for their own business.

Multiple year or rolling hedge opportunities occur every three to five years, depending on the commodity. Opportunities historically last for only a few days at best. So, if you wish to consider such a strategy, have an account open with a broker or visit with your local elevator manager about cash contract rolling opportunities so you can initiate the strategy on short notice. Also, make sure you have included your lender.

Current 1995 price levels have provided an opportunity for rolling hedge strategies in winter and spring wheat. Corn prices on rallies are nearing a level to begin considering a multiple year strategy. And, soybean price is still \$1.50 per bushel below the price needed to seriously consider a *rolling, multiple year hedge*.

ECONOMICS COMMENTATOR

EDITOR: Donald C. Taylor

ECONOMICS DEPARTMENT
 South Dakota State University
 Box 504A
 Brookings, SD 57007-0895
 Phone: (605) 688-4141
 Fax: (605) 688-6386

400 copies of this newsletter were produced at a cost of less than \$100

