Facing Reality:

Feed Price Volatility

How are you preparing?

by ***Kindra Gordon***

How high could the corn price possibly go? $9? $12? $24? By when? These are the questions on producers' minds — and grabbing headlines — in the ag industry. We all want to know if the high is in or if it is yet to come.

Scott Stewart, CEO and president of the commodity marketing firm Stewart-Peterson Inc., notes that no one really knows where the price will land. Instead price predictions are couched around words like "could possibly," "more than likely" or "potentially."

Rather than focus on the possible price predictions, Stewart, who has 30 years of tenure working with ag commodities, advises there is one certainty to bank on and for which to prepare: Volatility will continue, and it can be managed by preparing for the "likely," "potential" and "possible" events.

Winds of change

In fact, Stewart has been trying to get the ag community to prepare for volatility the past six years. In 2006, he wrote a paper titled the *$12 Corn Special Report.* Stewart says, "I wrote the report with that provocative title in order to get people's attention — everyone wants an adviser to pinpoint a price."

The report's overall message was not "prepare for $12 corn." It was "prepare for the volatility that could bring us $12 corn." He notes that sometimes that message gets lost in the desire to pinpoint a price level.

In 2006, when the report was released, corn prices hovered around $2.50 to $3. At that time the word "volatile" historically only referred to the weather. However, change loomed on the horizon. The effects of freedom to farm, stepped-up world demand, ethanol production and a just-in-time delivery mind-set lowered year-to-year carryover stocks and began shaking up what had been relatively stable markets.

As an example, Stewart recalls June 2008 when corn rallied 37.5% past its previous high and went to $7.625, with some deferred contracts eclipsing the $8 mark. It stopped climbing there; however, it also swung all the way back down to $2.90 in a period of six months.

Anticipate future scenarios

Corn has not hit the $12 mark; however, Stewart notes volatility is more prevalent than it has ever been and those who have not prepared will struggle as it continues. Tight supplies of corn continue, and the USDA has predicted an average corn price for 2012 between $7.50 and $8.90.

As this scenario unfolds, Stewart says producers' focus should not be solely on what might happen with prices — rather it should be in preparing for volatility.

Stewart's recommended approach, which he calls market-scenario planning, includes these essential steps:

1. Survey the data and expert opinions.
2. Develop scenarios of what could possibly happen to the price. He emphasizes including all the possibilities, and says, "For this exercise, don't get caught thinking: 'That could never happen.'"
3. Imagine how your operation will fare in each scenario, thus determining your greatest risks and opportunities.
4. Create strategies that manage risk and maximize opportunity in each scenario (Plan A, B, C, D and so on).
5. Implement the best strategies and continue to develop new strategies as scenarios unfold and new market conditions evolve. "In other words, continuously repeat steps 1 through 5," Stewart says.

Stewart emphasizes that the key in this approach is to keep an open mind and avoid the temptation to follow one single "marketing plan" based on someone's price predictions or bias.

He says, "In this new world of price volatility, an adviser's role should be to paint possible price scenarios, not predict price levels. It's so important to look at all the possibilities. Otherwise, you will be scrambling to adjust when a price level you hadn't envisioned comes along."

Stewart also says it is important to become familiar with risk marketing strategies and tools before decisions are needed.

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CONTINUED ON PAGE 92

Feed Price Volatility CONTINUED FROM PAGE 91

More extremes ahead

Looking ahead, Stewart is cautious, saying, "I still believe that more of the extreme price scenarios described in the *$12 Corn Special Report* I wrote in 2006 are coming our way. When we look at the conditions that have led to the volatility we have today, we see that they haven't changed. If anything, the risks have become more pronounced."

Among the risks he foresees continuing to influence corn price volatility are:

►**Weather data:** Climatologists have observed that serious Corn Belt drought has an apparent 19-year cycle (also called the Benner Cycle). Two hundred years of weather data and 800 years of tree-ring analysis indicate an average of 19 years between major droughts. Probability of this drought was high if you put stock in data patterns.

►**Yield patterns:** Additional analysis indicates there is a pattern to consistent vs. variable yields attributable to growing conditions. According to Iowa State Climatologist Elwynn Taylor, we are coming to the end of an 18-year stable period of production, which typically is followed by 25 years of high variability, Stewart shares.

►**Just-in-time mentality:** "The world has come to rely on supplies of crops and commodities being readily available," Stewart says. "No one wants inventory in advance of need. The most recent economic collapse has accelerated this thinking. Almost no one has stockpiles of agricultural commodities."

He surmises, "As a result of all this, the cost of protecting prices has jumped. Options that used to cost pennies to buy are now many times that, increasing the importance of good decision-making. When markets move fast, you can lose money so quickly if you do not know what you are doing."

He adds, "In this kind of high-price, high-risk environment, advanced option strategies or combinations of both futures and options will be necessary to keep marketing costs low while protecting a price range."

Going forward, Stewart says, when he describes the extremely volatile new world, reactions usually fall into two camps:

- There are those who believe the world "is what it is," and occasional random events come along to mess things up. They feel little, if any, control over their destiny.
- There are those who believe that catastrophic events will happen with some regularity, and you can anticipate them and position yourself to weather them vs. accept a devastating equity drain.

Stewart says, "If you haven't guessed, I am in the second camp. I believe that the complacent will be overwhelmed and swallowed up."

He concludes, "I also know from experience that volatile prices will bring out many analysts with opinions and reasons why their opinions are right. The wise marketer will listen to expert opinions and then use them to paint possibilities of what could happen. Imagine how your operation will fare in each scenario. Then you can begin to create the strategies that will have you fully prepared and confident in the age of uncertainty." AJ