



WEEKLY OUTLOOK



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SOYBEAN BASIS ISSUES PERSIST

The sharp run-up in cash and futures prices of soybeans since the harvest of the 2007 crop has at least partially diverted attention from an underlying issue of extremely weak basis. While basis levels have strengthened marginally since harvest, they remain very weak by historic standards.

The average cash price of soybeans in central Illinois was \$.85 to \$.90 under March 2008 futures at harvest time in 2007. On January 17, 2008, the average price was still \$.72 under March futures. In northern Illinois, the March basis only strengthened from about -\$1.05 at harvest time to -.86 on January 17. In southern Illinois, the average March basis strengthened from about -\$1.00 at harvest to -.61 on January 17.

The continuation of a weak basis means that short hedges have not earned a return to storage since harvest, particularly in northern and central Illinois. The strengthening of the basis has not covered the cost of owning and storing the crop. Conversely, long hedgers have been favorably impacted by the weak basis that has resulted in lower-than-expected buying prices for cash soybeans. Those who only buy or sell in the spot cash market have probably not been impacted by the weak basis. In theory, the cash price reflects fair market value for the commodity so traders in the cash market are receiving or paying what soybeans are worth.

The weak interior basis has been attributed to a combination of factors. These include higher transportation costs, higher storage and ownership costs associated with interest cost on high-priced soybeans, and a shortage of storage capacity at harvest time. Only about 65 million bushels of storage capacity were added in Illinois in 2007, while combined supplies (production plus September 1 stocks) of corn and soybeans in Illinois were up about 250 million bushels in 2007. A shortage of storage capacity, however, is not an issue at this time of year.

The issue of weak soybean basis appears to be broader than just increased transportation and storage costs and an increase in demand for storage space. The broader problem is revealed by the lack of convergence of cash and futures prices of soybeans at the futures delivery markets as futures contracts mature. Theory suggests that the opportunity to deliver and take delivery of soybeans (warehouse receipts or shipping certificates) at

contract maturity should insure that cash and futures prices come together at maturity of the futures. Historically, soybean contracts have generally performed well relative to that performance criterion. However, lack of convergence has been an issue since early 2006, continuing through the maturity of the January 2008 contract. Basis levels at delivery markets were especially weak at maturity of the July and September 2007 contracts. At maturity of the January 2008 contract, basis at the Illinois River was still about $-\$0.55$.

The lack of convergence in cash and futures prices at soybean delivery markets implies that the delivery mechanism is failing to some extent. Persistence of futures prices above cash value at maturity may indicate that the extremely large speculative activity in the futures markets is holding futures prices artificially high and that the delivery mechanism is not robust enough to force convergence of cash and futures prices. If this is the case, weak interior basis and issues with convergence may persist for the foreseeable future. Cash bids for harvest delivery of the 2008 soybean crop, for example, reveal a continuation of weak soybean basis. On January 18, average cash bids for harvest delivery ranged from about $\$0.70$ under November 2008 futures in central and southern Illinois to $\$0.84$ under in northern Illinois. Bids are $\$0.30$ to $\$0.40$ weaker than experienced at this time of year over the previous four years. Part of the weakness in new crop basis reflects the industry's response to increased basis risk that unfolded over the past year. Some of the weakness may also reflect the extreme margin risk associated with hedging soybeans. Aggressive new crop selling by producers has apparently created large short futures positions for some buyers, resulting in large futures margin requirements as November 2008 futures have increased nearly $\$4.00$ per bushel since the fall of 2007. Large margin requirements increase the interest cost of hedging and weak basis bids may help offset some of that increased cost.

Some grain buyers have taken steps to limit futures margin exposure by limiting new hedged-to-arrive (HTA) contracts for producers to the current marketing year and by not offering flat price bids beyond the 2008-09 marketing year. Reduced availability of HTAs and flat price contracts transfers some of the margin risk of forward pricing to the producer. Producers who want to forward price the 2009 or 2010 crops may have to sell futures directly. High prices for these crops entice producers to do some forward pricing, while the weak basis and margin risk of hedging discourage forward pricing.

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