Archer Financial Services, Inc.

Is It Time to Buy Corn and Soybean Call Options?

By Chris Lehner (Nov 3)

To support a bullish outlook there are traders, speculators and hedgers that believe the slow harvest and grain not coming to the market is friendly for prices. But, buyers in the country tell another story with the extremely wide cash basis and the carry, showing that cash buyers are trying hard to push cash sales into 2018. Presently, farmers are accommodating what buyers want and are going to store more corn and soybeans than they did for the 2016/2017 crop year and stored for 2015/2016 crops. Where China has government grain stocks, the U.S. farmer holds the stockpiles either on the farm or pays storage month after month at a buyer's facilities.

There are also bulls that believe grains are going to rally, and farmers that have sold or forward contracted their crops will re-own them with call options. At this time, I don't want to re-own. First, I don't see a rally, other than speculative bounces and then re-owning with buying options is a way to fill the seller's pockets.

When the carry is wide, the price of the carry will be reflected in the option premium. Option prices are made up of time value, extrinsic value and where the price of the underlying commodity maybe, the intrinsic value. Time value for corn is around 3 cents/month, wheat, 4 cents/month and soybeans, 5 cents/month. Intrinsic value is a price value made of external conditions. Volatility is a factor traders calculate using various components such as the degree of market movement. A seller establishes a value depending upon a market moving sideways, fast or slow over a period of time and how big or small are the moves over a period of time. If a market moves sideways, the volatility won't be a big factor.

When a seller decides how to price an option, if markets are moving fast, the seller is going to add enough volatility value to the premium to shave off part of the risk of selling it. Like an insurance premium, if a home owner in Oklahoma, or Kansas, wants to buy home insurance in March because he or she was concerned about extreme weather risks, the actuary at the insurance company will use a measurement based on the number of tornadoes that occur from March through the tornado season and have an extrinsic value for it. If a person in Oregon in March wanted to buy tornado insurance, the extrinsic value would be likely less. Maybe now with climate change a person in Oregon does have to pay more for tornado insurance. But as you can see from the example, volatility has a price value.

For example; as I write on November 2, 2017 at 10:30AM central time, the carry between November soybeans and May 2018 soybeans is 30 cents. From November to May there are six

months and at 5 cents a month it is a normal futures carry. The price is 10.17, up 6.5 cents. November soybeans are 9.871/2. A May soybean 10.20 call is priced at 37 cents. When May options expire, May soybeans need to be 10.57 just to break even or 70 cents higher. If you feel soybeans are going to rally 70 cents, buy the call. However, as each month ticks away, the call will lose the 5 cents time value. Fortunately, there is only about 7 cents of extrinsic value. Essentially the seller is risking the 7 cents, but time is on the seller's side and the seller knows they will take in 5 cents a month even if the market moves at expiration to 10.20 from 9.871/2.

For corn, July is a good month for example. Often farmers that store corn, hold to July hoping for a winter/spring rally and for problems in South America. December corn is currently trading at 3.511/2. At 3 cents a month the carry between December and July is 7 months or 21 cents. July corn is 3.81, 291/2 cents over December. Grain buyers essentially are saying, don't sell at harvest; store it and make 9 or 10 cents more. Actually, in many areas of the Midwest, a farmer gets an added incentive with a narrower basis to sell in July. This says, the buyer really doesn't want it at harvest and this year with the extra wide cash basis at harvest, it is saying it even louder. This is also called a bear spread. A July 3.80 corn call is 20 cents. But many farmers need to sell at harvest because they don't have room on the farm and mostly because they need the cash. So, they sell at harvest and decide to buy the call for 20 cents on a 3.80 call. To break even, the market needs to rally to $4.00 or 50 cents during the winter and spring.

Buying calls in a bear spread market sometimes can work. It did a year ago and the year before. Of course, both reasons for the rally proved untrue. Could buying options work again this year? As the boy who cried wolf found out, after crying a wolf was coming over and over, nobody believed when the wolf finally came. The world is full of grain now. Unless the Southern Hemisphere has big proven problems, will enough traders fall for another year of rumored weather problems? There are analysts now touting problems and maybe they will catch on, but grain buyers, the companies that write the checks to the farmers are very clearly saying, they don't want it now and are paying a little extra, so they don't have to buy it now. Another way to put it, who do you think are writing the calls?

Call to discuss your trading and what you need from a broker. I can be contacted at 312 242 7942 or email at chris.lehner@archerfinancials.com.

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