Farming's Futures

By David K. Sauder
Commodity Advisor
Trade Tech, Lancaster

Why does the basis differ from one location to another?

Saying that the basis differs from one location to another is the same as saying that prices differ from one location to another. On the same day the cash price is Localville is $1.80, it may be $1.76 in some other location. And $1.845 in another, and $1.91 in still another.

In each of these communities, there is obviously a different basis. One reason is that locations with lower-cost transportation to the primary areas of grain demand generally enjoy a price advantage over less favorable locations.

The excent to which a local price happens to be below the current Chicago cash price at a particular time may — nor may not — be the same as the current cost of transportation to Chicago. While local prices for grain of comparable quality are not usually below the Chicago price by more than the cost of available transportation, they may be below the Chicago price by less than this amount.

Reason: Elevators and other owners of grain sell to whoever offers them the highest net price. Thus, if a bidder from some other location offers a higher price than buyers from Chicago are currently willing to pay, the local price is likely to be higher than the Chicago price minus transportation cost.

How is the basis affected by the passage of time?

The most predictable feature of the basis is the tendency to narrow—by the amount of reduced storage costs—as the delivery month is approached. Thus, if storage costs of 4 cents a month are included in the basis, the likelihood is that the basis will narrow at the rate of 4 cents a month. This, of course, assumes that the other basis components remain unchanged.

Example: In January, the Localville price of $1.80 is under the March futures price of $2.10 by 30 cents. That is, the basis (which includes storage costs) is 30 cents. By February, all else remaining unchanged, the basis should narrow to 26 cents. By March, all else remaining unchanged, it should narrow to 22 cents.

The tendency of the basis to become narrower as the delivery month is approached is known as convergence. Indeed, at the time and place of delivery, the cash price and futures price are normally the same. This convergence is assured by the fact that if prices were higher in the futures market than in the cash market, or vice versa, traders would buy or take delivery in the low-priced market and sell or make delivery in the high-priced market, thereby quickly minimizing any price difference.

The drawing below illustrates the "normal" relationship between cash prices and futures prices as the delivery month is approached.

In the real world of continuously fluctuating prices, of course, the cash-futures price relationship is seldom as exact as depicted in the drawing. Much more typical is the chart of actual cash and futures prices over a several month period.

How do futures differ from one marketing year to next?

Each harvest begins a new marketing year with its own supply and demand arthmetic. Simply put, the start of a new marketing year is the start of a "new ball game." Price levels may be higher or lower than during the previous year.

As a result, the futures price for the last delivery month of one marketing year may differ sharply from the futures price for the first delivery month of the next marketing year. For example, if the remaining supply of "old crop" corn is expected to be roughly equal to the needs of feeders, processors and exporters during the summer and fall months but a bumper "new crop" is expected to be harvested in December, the stair-stepping of futures prices might be as shown on the chart.

This is not to say "old crop" and "new crop" prices are always or totally unrelated. Such is not the case. If there is an over-abundance of old crop supplies as the marketing year draws to a close and a big new crop is in the offing, the large impending harvest will almost certainly have some depressing effect on old crop prices. Conversely, if old crop supplies are barely adequate for the remainder of the year and a small new crop is in prospect, the possibility of a potential shortage is likely to lend strength both to old and new crop prices.

Send questions on futures trading to Farming's Futures, Lancaster Farming Newspaper, Box 366, Lititz, PA 17543.