

Farming's Futures

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How and Why Does the Basis Fluctuate?

On any given day, the cash price of grain in Chicago is determined by active competition between large numbers of buyers and sellers. Processors, merchandisers, exporters and retailers are continuously bidding (in cents per bushel under or over the nearby futures price) for grain for immediate delivery.

If the demand for grain is strong and/or the available supply is small, buyers may become eager bidders and elevators (which make money by storing grain) may become reluctant sellers. The resulting strong cash market (often called the "spot" market) may result in high cash prices (relative to futures prices) and a narrowing of the basis.

Example: On a particular day, the March futures price is \$2.10; the Chicago cash price is \$2.04; and the Localville cash price is \$1.80. The Localville basis is thus 30 cents under March. The following day witnesses a sudden surge in demand for grain for immediate delivery and the Chicago cash price rises from 6 cents under the March futures to only 4 cents under the March futures.

If the March futures price has remained at \$2.10, the Chicago

cash price will be \$2.06 and the Localville cash price may increase to \$1.82 (a basis of 28 cents). Conversely, if the demand for grain for immediate delivery weakens—such as might be due to a decline in processing or export requirements of a large supply of cash grain seeking a limited supply of available storage space—cash prices in Chicago may fall relative to the futures price. The result: A widening of the basis.

For example, assume the March futures price remains unchanged at \$2.10 but a weak cash market causes the Chicago cash price to decline from 6 cents under to 8 cents under. The Localville basis may thus widen from 30 cents to 32 cents, resulting in a decline in price from \$1.80 to \$1.78.

Local price changes are by no means due to Chicago price changes. A widening of the local basis (and a decline in local prices) may, for example, be triggered by higher transportation costs. Or by a weakening of local and nearby demand for grain. Or by a larger local supply than there is storage available for. Or by a shortage of railroad cars.

By the reverse arithmetic, a local supply short-fall, or strong demand by local buyers for grain

to use or accumulate in inventory, or a favorable change in freight rates could result in a narrowing of the basis and higher local prices relative to the futures price.

How important is it to have information about local basis?

For reasons that will soon be seen, it is extremely important. Without a knowledge of the usual basis and basis patterns for your particular community, it is impossible to make fully-informed decisions about, for example, whether to accept or reject a given price; whether and when to store your crop; whether, when and in what delivery month to hedge; when to close (or "lift") a hedge; or when and how to turn an unusual basis situation into a possible profit opportunity.

What records of basis are necessary?

At the very least, it is useful to have a weekly record of cash and futures prices—and the basis difference—during those months in which you normally market your crop. Thus, if you sometimes market corn in December and sometimes not until the following spring or summer, begin keeping price records in December and continue to keep them through July.

Nothing elaborate is necessary. A table created by dividing a sheet of lined notebook paper into vertical columns is satisfactory. Then select a particular day of the week (midweek might be best) and begin keeping a record of the local cash prices, the nearby futures price and the difference (the basis). One such set of records is illustrated here:

Is the local basis the same, or similar, from year to year?

Similar is a more accurate description than same. This is why records of local basis during past years provide a useful starting point in attempting to estimate what the basis may be at various

times during the current market year.

Even so, just as the basis can vary from week to week and from month to month—and for much the same reasons—the basis can, and often does, vary from one year to the next. Whenever possible, it can be well worthwhile to attempt to determine the reasons responsible for a change in the basis compared with previous years.

Whether they indicate a permanent shift in the relationship between local and futures prices or merely a temporary price aberration that is likely to be soon corrected can be useful to know in planning your marketing strategy.

A change from the normal basis level might be permanent or semi-permanent if, for example, it was due to a change in local grain demand, such as the opening or closing down of a processing plant in a nearby community. Or the basis and local prices could be affected adversely if the railroad

were to suddenly abandon or restrict service in your area, or if freight rates were to be increased.

The basis can also be affected by the size of the crop and the availability of storage space. In years of large crops and storage shortages, the basis is likely to be wider—particularly during the harvest months—than during years of small crops and ample storage.

Such variations notwithstanding, the basis is normally much more predictable than the level of grain prices—a fact which, for reasons soon to be shown, enables hedgers to substitute basis risk for price level risk. Moreover, buyers and sellers who are familiar with the normal basis in their area are often able to earn profits or reduce risks by reacting properly to short-term basis fluctuations.

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



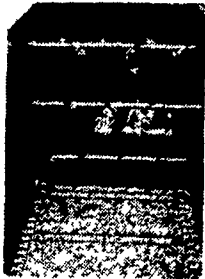
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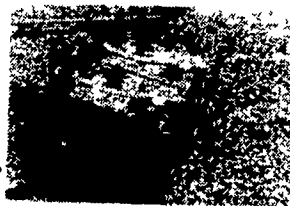
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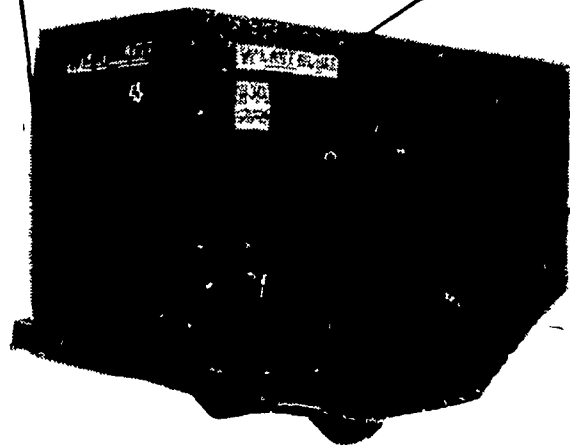
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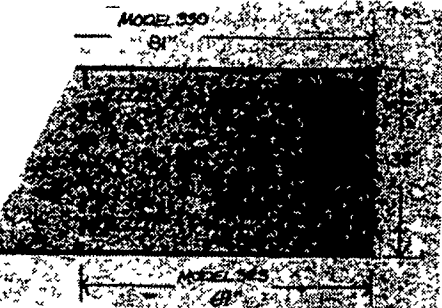
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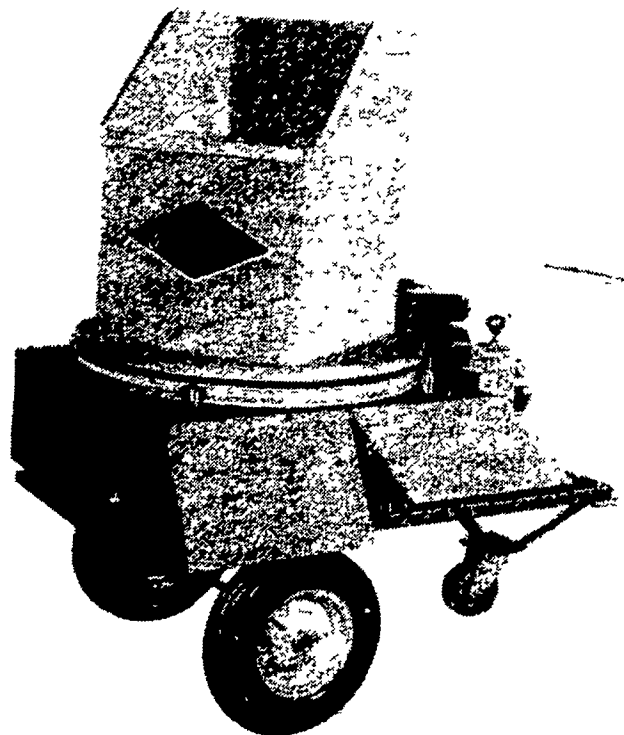
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