December 2020

Grain Elevator Outlook: Accelerated Merchandising Margins Today, Potential Volatility Tomorrow

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Key Points:

- An explosive rally in grain prices – driven by a smaller-than-expected U.S. harvest, strong China export demand, dryness concerns due to La Niña, and resulting tight corn and soybean stocks – dramatically changed the complexion of the 2020-21 grain marketing season.

- The resulting effect was grain cooperatives accelerated merchandising as farmers rushed to sell and lock in gains. In doing so, elevators were able to capture strong margins on old crop, as well as on new crop which they bought and resold into a rising market.

- This activity has required elevators to increase borrowings under existing credit lines and/or to obtain large increases to their seasonal borrowing programs. CoBank has actively supported customers' funding needs, specifically the cash flow timing mismatch between current cash outflows (for grain purchases) and delayed capital inflows (payables from processors and exporters).

- Having already accelerated merchandising, elevator activities will be limited over the next three months until the market has greater visibility as to U.S. planting intentions for 2021-22 as well as the size and quality of the crops from the ABUR (Argentina, Brazil, Ukraine and Russia) growing regions.

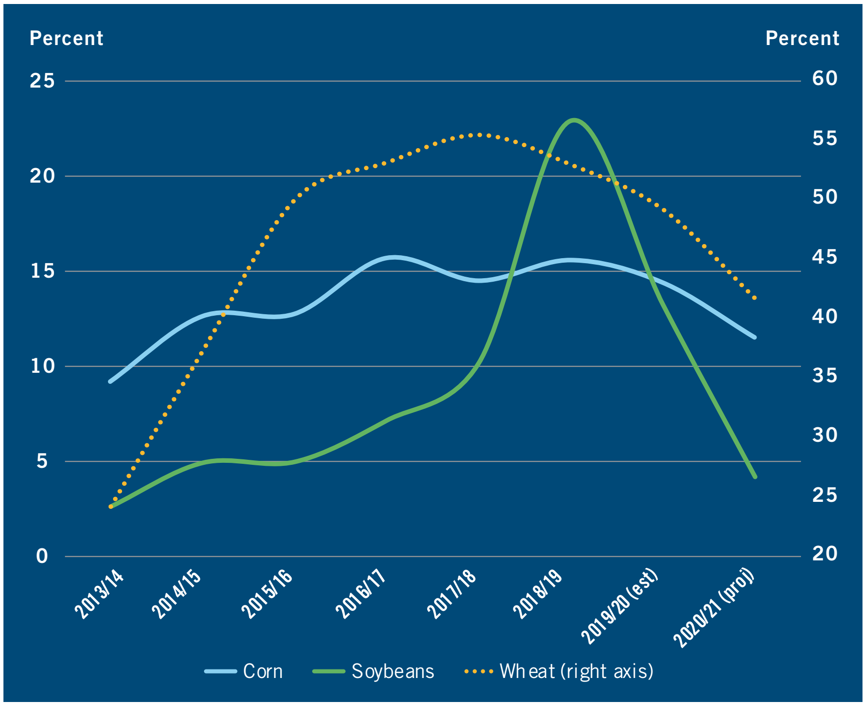
- Given the continued inversion in futures prices, we see volatility ahead that could limit opportunities for elevators to buy basis cheap and capture carry, at least during the near-term. However, grain cooperatives that also have farm supply divisions should benefit from a strong fall application season and what we believe will be an acceleration of farmer prepayments of spring crop inputs prior to year-end.

Introduction and Situational Overview

The year is concluding on a much different but substantially more profitable note for U.S. grain elevators than we had been expecting as recently as four months ago.

The 2020 growing season began with a dramatic COVID-19 driven economic recession, considerable trade uncertainty and, following the March 31, 2020 Prospective Plantings report, expectations for a very large U.S. corn and soybean crop. The season then got off to a very favorable start and crop progress for the three major grains were well above average for the past five years until late July 2020. Then came the Iowa derecho weather event that inflicted damage on crops and grain storage facilities, followed by hot weather, dryness and crop stress. Fast forward to November and WASDE's production estimates and ending stocks had tightened considerably, confirming the recent price rally in U.S. grain prices and setting up a very bullish picture heading into 2021 *(Exhibit 1).*

EXHIBIT 1: Major Grains Stocks-to-Use Ratios



Source: USDA-WASDE

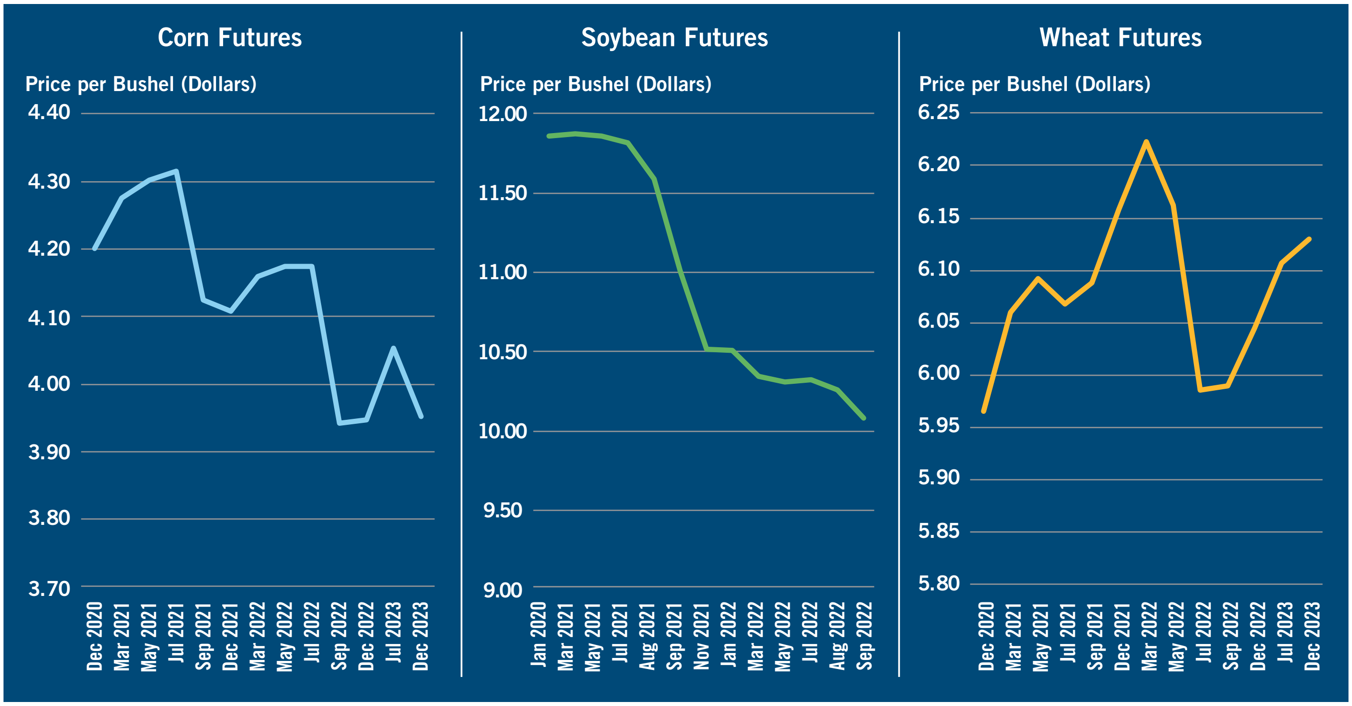
Amidst the commodity price rally, grain elevators found themselves in an ideal trading environment because of an intersection of factors:

- Early in the 2020 growing season, expectations for a large crop resulted in low estimates of average farm-gate prices at harvest, specifically $3.20/bu for corn and $8.40/bu for soybeans[1].
- As prices began rallying in the fall towards $3.75 and $10.25, respectively, growers began contracting with elevators in order to lock in what had previously been unobtainable profits for the 2020-21 crop.
- Then, as prices further strengthened, elevators were able to sell stronger basis after having already bought basis cheaper into a marketplace with robust demand from both local processors and export sales to China.

The aforementioned grain trading activities increased the need for borrowings by elevators to fund the mismatch between current cash outflows for grain purchases and delayed capital inflows such as payables from processors and exporters. While this has caused financial leverage to increase, CoBank views this as temporary and manageable by elevators.

In the near term, corn and soybean prices should continue to be supported by concerns about the size and quality of the Brazilian and Argentinian crops due to expected dry weather conditions related to La Niña, strong export demand by China, steady domestic feed demand, and stable U.S. ethanol production.

EXHIBIT 2: Corn, Soybean and Wheat Futures Curves



Source: BarChart.com as of November 30, 2020

While wheat prices had been on a bullish uptrend recently – driven by drought conditions in the western U.S., tighter U.S. supplies of soft red winter wheat and dry weather in key regions that compete with U.S. wheat exports such as Russia, Ukraine and Argentina – both cash and futures prices have pulled back recently. The relaxing of export quotas on exported Russian wheat and a return of Australian wheat production are additional bearish factors for wheat prices.

The inversion of forward price curves, especially for soybeans, will continue to result in a backwardation market environment during early 2021 *(Exhibit 2).* Looking out towards the start of next year's U.S. spring planting season, we expect the market to begin factoring in large planted soybean acres in 2021. Should acreage and yield expectations rise beyond current trade estimates, cash prices might correct and therefore the forward curves could flatten. However, as we discuss later, we see a high likelihood of futures price volatility and therefore lack a reasonable basis to make a call for normalization at this time.

The China Situation

In recent months, China contracted to import a considerable amount of grain which underpins USDA's 32% expected increase in total U.S. corn, soybean and wheat bushels exports during calendar year 2020 *(Exhibit 3).* China's appetite for U.S. grain is driven by:

- The need for animal feed (soybean meal and corn) as the country rebuilds its hog herd following the decimation caused by African Swine Fever (ASF);
- Local crop shortfalls due to flooding and COVID-19 production disruptions, which has driven up the price of local grain;
- An increase in purchasing power resulting from weakness in the U.S. dollar relative to China's yuan throughout 2020; and
- Apparent desire by China's government to satisfy some of its obligations agreed upon under implementation of phase one of the U.S. / China Trade Agreement signed during Q1 2020.

Looking forward, market signals appear very bullish for continued China purchases although we continue to vigilantly monitor the relationship with booked sales and accumulated exports. We would also point out that over the long-term, there is risk that China will contract for grain from sources other than the United States.

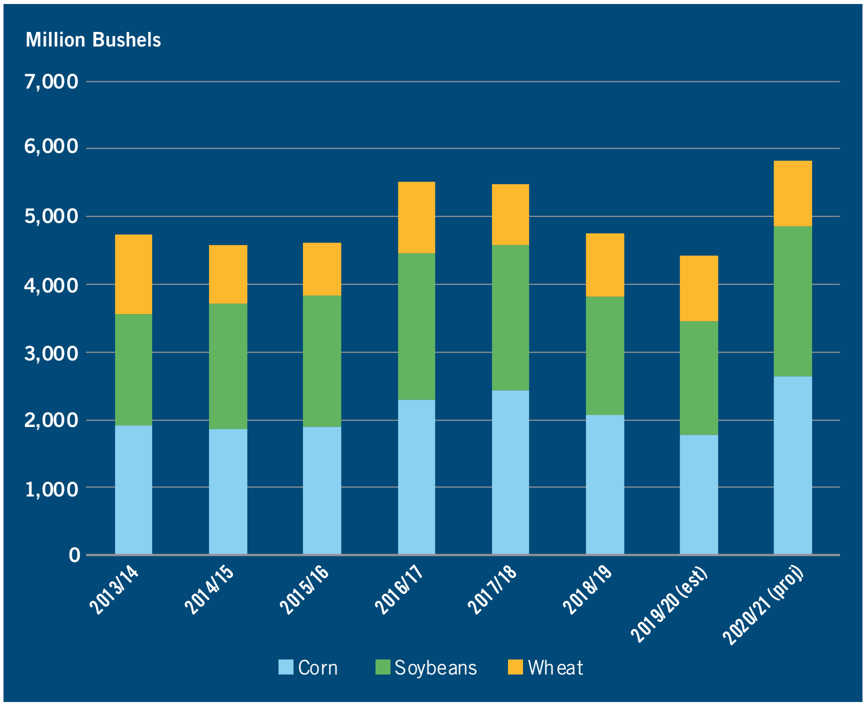
Our bullish opinion about continued grain purchases by China in the near- to intermediate-term stems from three variables: core demand, foreign exchange rate and economic growth.

- **Core Demand:** China needs to feed its people and will continue to expand its animal protein production capabilities, a positive demand driver for U.S. soybean, soybean meal and corn. Note that USDA's recent quarterly Outlook for U.S. Agricultural Trade – which projects that U.S. ag exports will reach $152 billion for fiscal 2021 – factors in an $8.5 billion increase (relative to its August 2020) report of ag exports to China primarily due to strong soybean and corn demand.[2]

- **Foreign Exchange Rates:** The U.S. dollar is forecasted to weaken further relative to the Chinese yuan over the next two years, as well as relative to the Brazilian real and the Russian ruble. The significance here is two-fold: First, U.S. grain will remain cheap to China in "absolute" terms due to favorable currency translation. Second, U.S. grain becomes increasingly attractive in "relative" terms to Brazil (for corn and soybeans) and Russia (for wheat.)

- **Economic Growth:** Although China's reported economic figures are often suspect, the country's post COVID-19 economic recovery seems to be gathering momentum based on several anecdotal channel checks. As vaccines become available and widely distributed, an uptick in global general economic activity would be positive for China's economy and incrementally positive for ag exports to the region.

EXHIBIT 3: Corn, Soybean and Wheat Exports



Source: USDA-WASDE

We are closely monitoring factors related to logistics, specifically container demand vs. supply. While U.S. railroad, barge, and trucking operators have managed the flow of grain exports quite well – with only minor bottlenecks arising nationwide – a shortage of containers in Asian ports due to growing global trading activity could be a risk factor in 2021.[3]

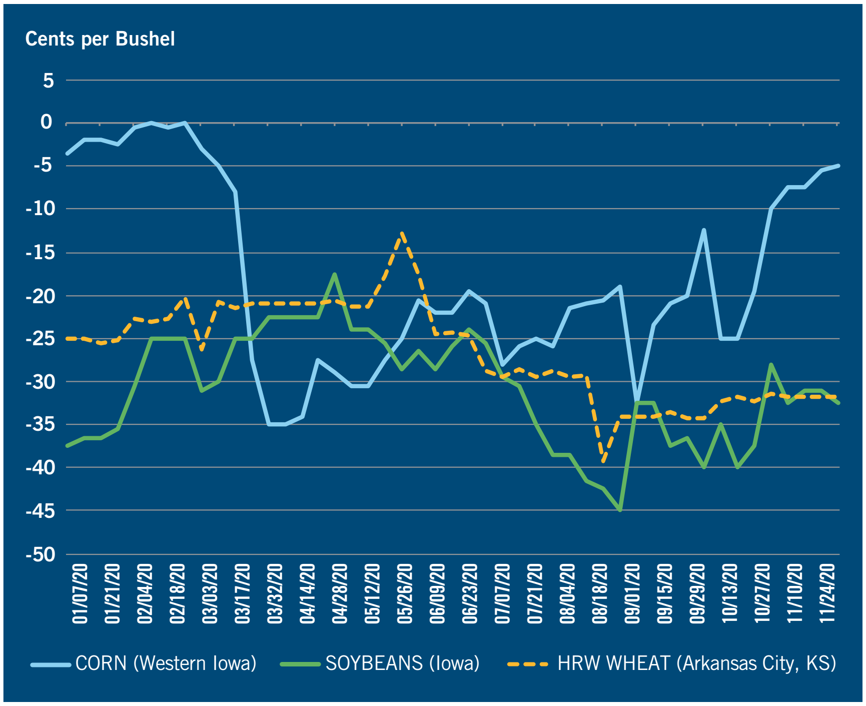
Another positive could come as a result of the change in U.S. political leadership. While the has indicated it will not change its position on tariffs with China for the foreseeable future, we expect a more favorable dialogue between President-elect Joe Biden's administration and China as well as other key ag export markets. At present, the weaker outlook for the U.S. dollar vs. the Chinese yuan, Brazilian real and the Russian ruble makes U.S. exports quite price competitive.

Outlook Scenarios

Balancing all factors, we envision two likely scenarios unfolding for U.S. grain elevators over the next six months:

- The optimistic scenario is that the backwardation in commodity future prices reverses, creating opportunities for elevators to buy cheaper basis and capture carry. This could occur in the event of a milder La Niña which would result in large Latin American crop production, a significant increase in planted U.S. soybean acres, and a temporary or more permanent reduction in U.S. grain purchases by China. The cumulative impact would exert downward pressure on cash prices.

EXHIBIT 4: Corn, Soybean, Wheat Basis



Source: USDA and KSU-AgManager.Info

- The pessimistic scenario and one we see as more likely, is that elevators could be forced to the sidelines amidst an uptick in commodity price and a limited ability to buy basis "right" to capture carry *(Exhibit 4)*. This situation could occur with volatile and/or dry weather and continued robust (but unsatisfied) soybean demand from both China and domestic processors. This would exacerbate already tight supplies.

Conclusion

Grain has been flowing with considerable momentum, following an orderly fall harvest and amidst a sharp, unexpected price rally. This has allowed elevators to capture exceptionally strong merchandising margins as the current marketing year has been pulled forward amidst backwardation in futures prices. The inversion of futures prices – especially for soybeans and corn which are more pronounced than wheat for 2021 contracts – will likely continue for the foreseeable future. As such, we see limited opportunities to buy cheap basis and capture carry. That being said, grain cooperatives that also have farm supply retailing operations should see a resurgence in input demand as growers spend money on off-season applications and prepayments for next season's inputs.

References

[1] WASDE Report, May 2020.

[2] USDA Agricultural Trade Outlook- FY 2021 U.S. Exports Forecast Up $11.5 Billion, Farmdoc Project Policy News, November 24, 2020. USDA Agricultural Trade Outlook- FY 2021 U.S. Exports Forecast Up $11.5 Billion • Farm Policy News (illinois.edu)

[3] Container shortages on the New Silk Road, and possible solutions, September 11, 2020, RailFreight.com https://www.railfreight.com/beltandroad/2020/11/09/container-shortage-and-price-increase-in-china-which-could-be-the-possible-solutions

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