Written by Maureen Nevin Duffy | April 25, 2008

Two Rainy Weeks From Armageddon

A CFTC roundtable on agriculture brings up some scary prospects for the future of the farming economy.

- Watch the grain elevators
- The influence of index funds
- The need for 1-for-1 margining

Are we heading into a "Silent Tsunami," the sheer mass of which could starve - rather than drown - most of the planet? Are we "two rainy weeks" away from a severe global food crisis?

These are the doomsday scenarios experts like Diana Klemme, a risk management specialist on global food prices for the Grain Service Corp., warned about at this week's Roundtable, hosted by the Commodity Futures Trading Commission (CFTC), in Washington, D.C.

Klemme's and others' observations were supported by tables and charts of data and testimony by members of commodity boards, associations, financial entities, investors and regulators, all pointing to the world food market's position being so precarious as to be at the mercy of any market-shaking event - be it weather, war or economic forces.

At the very least, the evidence makes a case for immediate action. But which act will restore the delicate balance that has come apart? This was the dilemma facing nearly 40 representatives as they gathered for six hours on April 23.

Watch The Grain Elevators

The current canary in the agricultural commodity coal mine are the grain elevators, which are caught up in a tangled web of rising prices, margin calls and the emerging credit crunch.

Grain elevators are the grease in the wheels of the American agricultural economy. They buy crops from farmers either for cash or on fixed contracts, allowing those farmers to lock in prices for their goods. That's critical, as farmers can't plan for the long term (invest in new tractors, buy increasingly expensive fertilizer, etc.) without knowing they can get X dollars for their crop. Ag prices are too volatile otherwise.

The grain elevators profit by selling futures contracts on the crops that are a little bit more expensive than the amount they pay their farmers. The contracts aren't speculative, just enough to cover operators' costs and a little extra, Don Sullivan, senior examiner and portfolio manager for the Farm Credit Administration, tells HAI.

And here comes the challenge. As the price of basic foods has risen all over the world for myriad reasons - from climate-change-induced drought in Australia destroying two back-to-back crop seasons to developing economies becoming rich enough to buy meat (it takes seven pounds of grain to produce one pound of meat) - futures exchanges have been issuing margin calls on the grain elevators' contracts.

It makes sense. Typically, you only put up a fraction of the value of the contracts in cash to buy them.

But with the price of rice up 118%, wheat 95%, soybeans 88%, corn 66%, cotton and oats 47%, those fractions are getting a lot bigger. In some cases, they are more than the grain elevators are worth themselves.

The problems are exacerbated by the credit crisis, which has made new cash harder to come by for the elevators.

In some cases, grain elevators have stopped hedging prices altogether. And that's where it gets ugly. "If a farmer can't put forward prices on commodities, then we're at greater risk than ever before," declared Tom Coyle, chairman of the National Grain and Feed Association. "If he can't market that crop at the prices, we've got a train wreck coming."

There's no hard-and-fast numbers about how grain elevators are pulling back, but the consensus at the meeting was that this was a real threat to farmers' productivity in the year to come.

Participants pointed to the 25% run-up in price that some say "broke" the cotton market in early March, an event some speakers attributed to margin calls going unmet and some farmers allowing contracts to run out.

No Elevators, No Convergence
The failure of the grain elevators may have something to do with the disappearance of price convergence in the ag market, something we've covered in depth here.

Jeffrey H. Harris, the CFTC's chief economist, describes convergence as where the spot and futures markets meet. "Identical items in the same time and place must be equal to one another," he notes, quoting the Law of One Price. We aren't seeing this. Harris quoted from a letter the commission received: "The less that futures serve as an accurate pay for cash, the greater the risk for elevators and others involved in the grain business."

Perhaps, as Dr. Eugene Kunda, a University of Illinois senior economist, suggests, there should be "a zone of convergence."

Harris contends that convergence consists of four variables and one activity: "spot price at that instant, the cost of storing the commodity, the value of having immediate access to the commodity and the cost of delivering the commodity according to the contract. The activity is arbitrage."

Blame The Index Funds: Full Collateralization
"We do believe [speculation is] having an impact on the market, that it is creating an imbalance," said Coyle, who ran a task force last summer to look at contract terms. It's not increasing liquidity, it's actually reducing liquidity. If you look at wheat at the long open interest - take out the spread trades and just look at the longs and shorts - 60% of the current market is owned by an index fund. If you look at the net positions, it's 50% Dr. Eugene Kunda, a University of Illinois economist the longs and shorts. Clearly that's having an impact on the market."

Institutional investors from the California Public Employees' Retirement System (CalPERS) and other pension funds, which are required to be fully collateralized, expressed their desire for volatility reduction.

"We would recommend 100% margining," said Coyle. "If in fact ... there's going to be more money coming into our markets - and that's not a bad thing; however, if it's supposed to be a notional value and it's in a long-term passive investment, then it should be margined dollar for dollar." He added: "But if it's coming through a swaps dealer, then you don't have one-for-one margining. We think that might actually create some balance in the market."

Yet, Coyle said the association is also calling for a moratorium, similar to the one suggested by the Chicago Mercantile Exchange, on the speculative limits. "The idea of a moratorium on hedge exemptions for this new capital is something that should be considered, because for right now, the market is out of balance."

Coyle said analysis shows that, "We have 10 times more index fund shorts than two years ago." But, he noted, it also shows that the market is adapting. He singled out Deutsche Bank's plans for a short-only fund as typical of efforts among these participants to provide some balance as well.