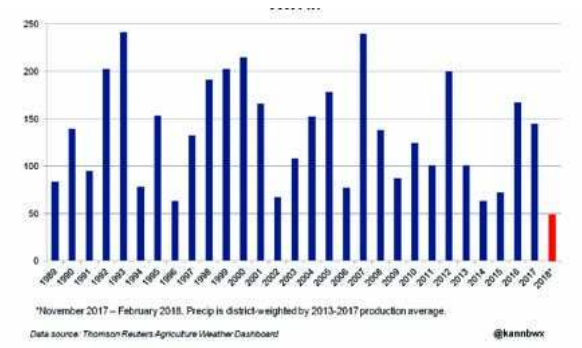
Does drought send crop prices soaring? It depends

The impact differs for wheat and canola but the bottom line is don’t let weather dictate marketing decisions



BY DAVID DERWIN PI FINANCIAL

E veryone has an opinion about markets, especially during a potential drought year.

Opinions and experiences about how much rain and precipitation is needed, when it is needed, how much is enough, how much is not enough and how much is too much are varied as there are regions across Canada.

I’ve heard comments over the years ‘that wheat is like a weed, you can spit on and it will grow,’ or, ‘one good rain is all it takes,’ and, ‘you can kill a wheat crop two or three times.’ Everyone watches weather which makes sense from an operational point of view. But if you are dealing with price, don’t just look at weather — you need to follow prices as well. This seems selfexplanatory but sometimes we can forget when we get caught up in the media frenzy surrounding dry conditions or a potential drought. Of course weather will have an impact on price, but it is just one of many factors. As I said in last month’s article, the best indicator of price is price.

So I was fascinated when I recently read some interesting research by Reuters market analyst Karen Braun, which for the first time in a long time, provided some objective data-driven analysis of the impact of dry conditions on hard red winter wheat yields.

This article will carry her analysis one step further to shed some light on how dry periods actually affect grain prices.

Between November 2017 and March, winter wheat in lead producer state Kansas received the lowest precipitation total in at least 30 years. Also in the last three decades, U.S. winter wheat during the first week of April 2018 only had a worse national good/ excellent rating twice (in 1996 and in 2002).

The years 1996, 2002, 2014, and 2018 all had very low levels of precipitation with extremely low good/excellent ratings and this had an impact on Kansas City hard red wheat futures. The more important question is just how much compared to all the other years.

In any given four- to six-month period in the past 30 years, the 90th percentile price increase has been 20 per cent to 25 per cent. Using this 20 to 25 per cent range as a baseline and looking back at the data, we can see that low-precipitation periods do indeed have a significant and meaningful impact compared to other years: • 1996, hard red winter prices increased 56 per cent from the bottom to the top; • 2002, it increased 83 per cent; • 2014, it was up 41 per cent; and • 2018, hard red winter wheat futures have increased about 37 per cent so far.

Also interesting is that in most of these dry years, prices would still tend to reach their highs during the seasonally strong months of May and June, with Canada Day and the 4th of July fireworks sometimes representing a symbolic high.

Although in 2002, prices kept going up until the fall when they almost doubled from their yearly low.

The weather story for canola, an important crop for almost all farmers across the Prairies, — whether you are in durum country, the Barley Belt, or produce a lot of pulse crops — is different.

Looking at historical Agriculture Canada precipitation maps for the past 12 years, even when there was a lot of dryness across large portions of the Prairies, it doesn't seem to have any consistent abnormal impact on canola prices.

In the particularly dry periods in 2003 across the Prairies, in 2006 throughout northern Alberta and Manitoba, in 2009 across most of Alberta, almost all of Alberta in 2015, and the southern Prairies in 2017, canola only moved up around 25 per cent, from low to high.

Since canola prices range on average 40 per cent in any given year, these drier years are not correlated or associated with any extreme price action.

Perhaps because canola production is spread across the vast Canadian Prairies, even big pockets of dryness aren't enough to impact the overall crop. This becomes evident speaking with farmers around the Prairies; you understand just how varied the conditions can be.

Our Prairies are so diverse that drought in one area can be offset by ideal growing conditions in another.

Also, since we export 90 per cent of canola into the massive global oilseed market, worldwide supply/ demand and other pricing factors likely temper any abnormal weather impact on canola prices.

Bottom line, based on this analysis, is that extreme dry conditions can have a significant impact on hard red winter wheat in the U.S.

However, the story is a bit different with canola, since historical numbers show that dryness doesn't necessarily translate into dramatically higher prices. So if canola prices do rally as a result of a perceived drought you might not want to wait too long before taking advantage of any weatherdriven rally.

Regardless, don't get too carried away by weather to make your marketing decisions.

Every year and every 'drought' year will be different depending on existing growing conditions, price patterns, and market trends.

History is a guide, not a guarantee.

Just because it happened in the past doesn't mean it will happen again, or in the same way, in the future.

However, having access to all the hedging tools and marketing strategies to capture these price moves should be part of the game plan every year. This is especially true in a dry year since options and futures allow you to separate pricing and delivery decisions to still take advantage of weather pricing without worrying too much about production.

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