

Ignore the hype

Use data and probabilities, not opinions and emotions



DAVID DERWIN
Hedging your bets

COLUMN

There's a quote I really like by English poet, writer and broadcaster John Betjeman that says: "When you understand the past, the confusion of the present becomes clear."

This is very true of the commodity markets given they're in a constant state of change and uncertainty. These kinds of conditions can lead to decision-making under pressure that are highly emotionally charged. Especially if you've just read a market newsletter, watched traders on television or listened to an online commodity podcast. It's easy to react too quickly and not take the time to properly think it through; which isn't the best way to make decisions.

You might chase a market down by selling too much at a low price or fail to capture a high price because all the frenzy led you to believe it's going higher. These types of situations often surround the monthly USDA crop reports.

During the U.S. government shutdown in January this year, a Reuters article called "U.S. shutdown sends grain traders, farmers hunting for data" laments that "commodity traders, economists, grain merchants and farmers are anxious for crop updates as they work to project their financial balance sheets and make spring planting decisions." That got me thinking; while we didn't have USDA data for the past couple of months, there was still a lot of data out there but it takes the shape of market prices. So, does market price action and historical data give us better guidance than USDA data? What impact do USDA reports really have on grain prices? These are important questions to ask and to answer.

A 2008 study in the Journal of Agricultural and Applied Economics called "The Impact of Situation and Outlook Information in Corn and Soybean Futures Markets: Evidence from WASDE Reports," analyzed market activity the days before and after the release of the World Agricultural Supply and Demand Estimates (WASDE) reports over a 10-year period. Their results show that the return variance, or volatility, during the day of the reports is about seven times greater than normal daily volatility for corn and soybeans. The study also showed that this volatility effect of the WASDE reports has increased over time.

In practice, we have all seen that USDA release days bring more volatility, surrounded by a lot of emotions, opinions and guestimates. But, while previous studies show that volatility the day of a USDA release is greater than the days before or after, there are no studies that I could find that show whether the reports have any lasting impact on prices. Are there really any sustained practical implications that we can use to better market grain? To answer this question, I looked at the past five years of price data in the weeks before and after USDA, WASDE, and Crop Production reports.

The typical weekly price fluctuation, both up and down, for corn, wheat and soybeans combined for any given week is around two per cent. The average absolute price movement, either up or down, in the week following the release of USDA reports is essentially the same, just over two per cent. Overall, the average price change in the week following a USDA report was a rather insignificant negative 0.5 per

cent.

Some USDA reports can move markets, especially during the crucial summer growing months.

The top three weekly price moves following a USDA report were up nine per cent, down eight per cent and down six per cent. They all occurred in the summer months of June, July or August (see chart).

However, most USDA monthly reports had little more impact on the market compared to any other typical week.

This February was a case in point. It was the first USDA release since December due to the U.S. government shutdown. There is always a lot of hype and fanfare surrounding USDA reports, and this one more than usual because it had been two months since the last report. As is often the case, it was a whole lot of excitement for nothing. The trading range for the grain markets after the report was only five cents. In fact, I even double-checked the release details just to make sure I had the right day and time. This really shouldn't have come as a surprise especially when you refer back to historical price data following the monthly crop reports.

Bottom line, while it is good to review the USDA numbers and understand the implication of the reports, don't spend too much time trying to anticipate the results. In general, I find that a disproportionate amount of time is spent trying to predict prices. This can cost too much emotional and financial capital. Instead, invest your time developing and implementing hedging strategies that include options and futures, to proactively: 1) Manage risk; 2) Protect revenues; 3) Capture price opportunities.

A well-researched, disciplined marketing approach built on data and probabilities, not emotions and opinions, can help improve pricing decisions over the long run.

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