Trading KC Hard Red Winter (HRW) Wheat Futures

Outright Trades and the KC HRW-Chicago Soft Red Winter (SRW) Wheat Spread

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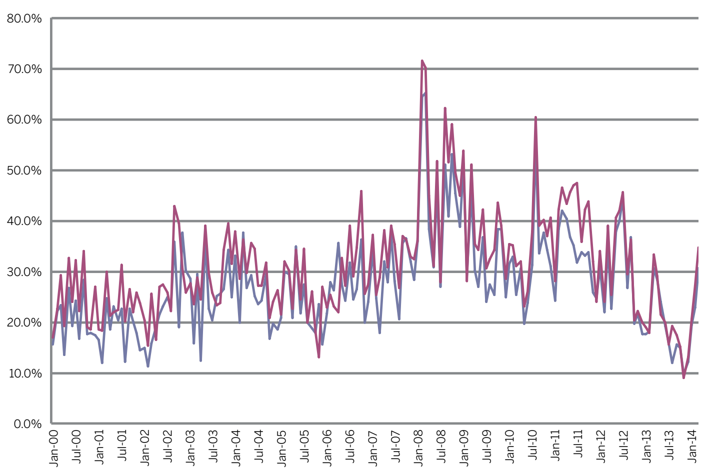
July 2014

Bullish Fundamentals and Geopolitical Risk

The KC HRW Wheat contract has seen a significant rise in open interest, traded volume and speculative participation in 2014, primarily due to one of the worst droughts in the history of the US and the involvement by newer participants such as commodity funds. Helping this trend has been supportive supply-side fundamentals from prior years as the market came off of the 2013/14 crop year with ending stocks at 189 million bushels, the lowest since 2007. Strong demand influences also played a supportive role, which took the July KC HRW Wheat contract from a 2014 low of $5.99 to a 2014 high of $8.55 ½, although the price trajectory since the beginning of May has been lower and the market has now retraced over 62% of the rally in less than a month. The geopolitical risk in Ukraine and Russia between March and April was a major contributor of the positive price movements as well.

Historical Monthly Volatility: KC HRW vs. Chicago SRW



Source: Bloomberg

Historical Daily Price: KC HRW vs. Chicago SRW

Source: Bloomberg

Off the Highs as Price Rations HRW Cash Wheat Demand

Like anything else in the agricultural commodity marketplace, the tectonic fundamental plates can shift without notice, which creates bursts of volatility and opportunity for speculative and fund traders.
More specifically, in the short term, HRW wheat cash demand is already slowing and this is expected to continue into the summer due to the substantial price premium it holds to other international exports. Harvest has begun in Texas, Oklahoma and Kansas and when factoring in these key market indicators it's not hard to see why the market has fallen close to 15% since May 6th. The demand rationing process can move very quickly and this seems to be the case this year. Currently, KC HRW Wheat is trading around $50 per tonne premium to Russian wheat. As a result of this rally, the July KC HRW Wheat contract recently traded in the area of $1.50 over the July Chicago Soft Red Winter (SRW) Wheat contract, after having fallen back down below $1.00 as of June 2nd.

The strong move in this spread is a direct result of the fundamentals between the two wheat classes but more specifically, a result of the contrasting weather and supply concerns facing the two in 2014. Volatility generally softens as crops begin to be harvested and the pattern of high volatility during the pre-harvest weather market for HRW cash wheat seems to have passed, which means the market may be faced with a period of lower volatility until the next major harvest approaches in the Southern Hemisphere.

KC HRW Wheat Managed Money Positions Net Long/Short

Source: CFTC Commitment of Traders Report

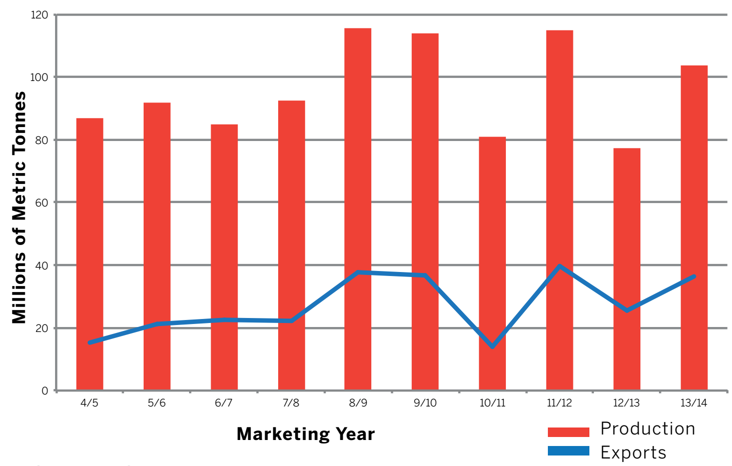
Europe and the Black Sea Region are the Next Focal Points

Looking ahead, traders and risk managers should be keenly aware that while harvest is upon us in the US, Europe and Black Sea, there are still obstacles and various supply-side scenarios that could develop which may trigger new waves of volatility within the KC HRW Wheat market and in the KC HRW vs. Chicago SRW Wheat spread. First and probably the most prevalent at this point in time are the warm and dry conditions prevailing in the Volga Region of Russia. This is a heavily planted wheat growing region and the hard wheat class specification might leave the KC HRW Wheat market at risk of some sporadic price swings if conditions continue this way, or get worse.

This supportive market scenario does not appear to be unfolding at the moment, mostly due to the fact that current production and export estimates for Russia and Ukraine are near year ago levels and world cash offers for exports from the Black Sea are the cheapest in the world. Furthermore, the EU is estimated to produce a 147.88 million tonne wheat crop, which is the largest since 2008 (and third largest since 1984), and exports will be at the second highest pace in the last 20 years.

Bottom line, world supply and export potential in the short term may be an overwhelming force for those bullish, despite some dryness in one specific region of Russia. The world market looks very competitive for the foreseeable future, which should be a negative force for the KC HRW Wheat market and should keep the lower price trajectory intact short term.

Former Soviet Union (FSU) Wheat Production



Source: USDA

Shifting to Southern Hemisphere Production and Price Impact on HRW and the HRW/SRW Spread

Argentina

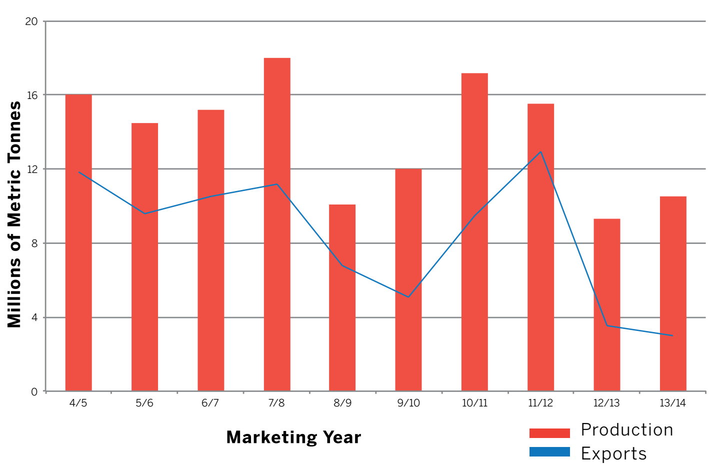
Traders will begin to focus more on the Southern Hemisphere wheat conditions, and Argentina, Brazil and Australia will be the primary countries in the spotlight, given their importance to the global export market. Argentina will be important to watch as it is typically the top exporter to Brazil for its milling wheat needs. Due to lower production the last two years in Argentina and Brazil, the US HRW wheat cash crop has been exported into Brazil and this is one reason why HRW wheat cash demand has been so strong until recently.

Weather and growing conditions for South America will be important to watch this fall when trading the KC HRW Wheat market because of the ability for US wheat to trade into this region. Planting is underway for South American wheat and up to this point, weather conditions have been rather favorable. Given the early stage of the crop and negative supply and demand factors in the northern half of the world, it may be difficult for the July KC HRW Wheat contract to find strong upside.

Fund traders still hold long positions in the KC HRW Wheat market, but liquidation remains the primary risk which could spill over to the KC HRW vs. Chicago SRW Wheat spread, triggering a move back down to the +40-55 1/4 level, which is about 20-30 cents above the historical premium.

Speculative support may be found here as the market won't be willing to discount the favorable supply expectations too much this early on, since the US will be a prime candidate to resume exports into South America if another production threat develops. Another year of production for Argentina near 10-10.5 million tonnes could boost the spread back near the +88 ¾ - 100 level, just on demand expectations for the US cash HRW wheat market alone.

Argentina Wheat Production/Exports



Source: USDA

Australia

Moving onto Australia, many professional weather forecasters now see a 70% chance of an El Nino year and the impact of the weather phenomenon may coincide with the maturing stage of Australian crops. The USDA is currently forecasting Australian wheat production at 26.00 million tonnes and exports at 19.00 million tonnes, both of which are down from year ago levels. If we were to assume that El Nino develops and production is cut by 8.5 million tonnes, the supply revision will trickle down to their export forecast which basically means the supply void needs to be filled elsewhere. Total production of 17 million tonnes would be the lowest since 2007.

The importance of this crop is due to the fact that it supplies high protein milling wheat to many of the major importers in the Middle East and Asia. The major suppliers that will be left to fill this gap will be Canada, the Black Sea, Europe and the US. US cash HRW wheat may be the last option for buyers given abundant supplies elsewhere, but the risk alone may be strong enough to see a supportive trend develop in the market again or at the very least carve strong support in the spread near +30-40.

While harvest is moving forward in the US, the crops in the Southern Hemisphere will go dormant for their winter. Of course, winterkill risk is always something to keep an eye on but if a weather story doesn't develop, the market will be left with slow demand-side news out of the US until the Southern Hemisphere crops break dormancy and begin maturing.

Wheat crops in both regions will begin heading in August-October, which could be the most volatile time for the spread as well as the HRW Wheat futures flat price market. A rally for December KC HRW Wheat back into the $7.55-8.00 range seems plausible if production were to fall near 10 million tonnes in Argentina and 17 million in Australia. These hypothetical forecasts would be down from the current USDA forecasts of 12.50 and 26.00 respectively, but again, these are extreme circumstances.

In any case, near term weakness in the HRW Wheat futures market and the KC HRW vs. Chicago SRW Wheat spread seems to be the likely outcome short term. Traders might look for a move below $6.93 for December KC HRW Wheat, but as the market edges closer to the fall season, bottoming action might develop if weather issues arise and risk premium is factored back into the market for the Southern Hemisphere. Overall, downside risk appears to be more of a near-term outcome while upside risk develops in September through October.

Summing Up the KC HRW Wheat Story

Collectively, it should be noted that world wheat ending stocks are at a comfortable 189.54 million tonnes, but weather patterns and production fluctuations for other major exporters around the globe can have a widespread impact on the market, particularly when issues arise in food-grade (milling quality) wheat classes. While the KC HRW Wheat futures market has taken a lower price trend since the beginning of May, wheat harvest occurs twice a year around the world, once in the Northern Hemisphere and once in the Southern Hemisphere. World feed grains and low protein milling wheat remain abundant, but traders should be mindful that some very important harvests are on the horizon and the volatility in the market will not stop just because combines are rolling across the US and Europe. Big gyrations in the KC HRW vs. Chicago SRW Wheat spread are likely to continue and an above average amount of premium may still exist throughout the crop year in order to keep HRW Wheat cash demand rationed until the US can produce a healthier crop, or until the market has a better understanding of the supply for hard wheat production countries in the Southern Hemisphere.

Ken Smithmier is an independent futures and options trader in the grain and soft commodity markets. He is a contributor to The Hightower Report daily commodity research and a frequent contributor to Reuters and Bloomberg, and has issued special reports on hedging and trading strategies for CME Group.