



National Association of Wheat Growers

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NAWG Comments on Futures Markets

Prepared for:

1. Commodity Markets Council forum in Chicago, April 3, 2008
2. Commodity Futures Trading Commission forum in Washington, April 22, 2008

Thank you for the opportunity to provide a wheat producer perspective to the discussions about how commodity futures markets are functioning in the present environment. While enjoying the higher prices brought about by recent events, our members have serious concerns about the functioning of these markets. We believe that failure to apply appropriate limits to certain classes of speculative investors have interfered with the markets' function as risk management tools for grain producers and other hedgers.

Producer Impacts

The effects on producers from the gyrations in commodity futures markets have been significant. Producers who hedge their own price risks in the futures market face exposure to margin calls that may far exceed their credit lines. Farmers must produce the crop that's being traded, but even a brief time away from watching the market can result in large financial consequences. We understand the need for markets to clear, but they must also be orderly and disciplined.

Country elevators that are better positioned to take on this risk have had to dramatically increase their credit lines, and, in some cases, their lenders have drawn the line on additional expansion. The result of financial pressure on country elevators can be withdrawal of bids (no local market for cash grain), withdrawal of forward pricing opportunities (because the elevators can't hedge those forward prices) and wider basis levels. Basis levels have increased by more than 50 cents in recent weeks because of the increased cost and risk being borne by grain merchants as well as a perception that the futures price was in some cases overinflated.

One of our Montana directors commented that the biggest change he has seen at the local elevator is that he used to be able to lock in cash prices through the local elevator 18 months out and now can only sell one year in advance. After the futures market closes for the day there is no local bid until the market opens the next day. Producers are forced to pay the cost of the higher elevator margin calls in the form of wider basis.

There is also a strong possibility that severe financial pressure on the grain handling system will result in business failures or consolidation of local facilities and reduced competition for grain purchases. Some elevators in Kansas have already closed their doors. If those failed or distressed businesses are cooperatives, producer equity in them will evaporate. These costs associated with these increased risks will all come out of producers' pockets.

Causes

We believe the fundamental cause of the problems in the current marketplace is a failure of market discipline to force convergence. In other words, the futures market is not reflecting market fundamentals. The primary reason for this is the relatively new scale-up in participation by funds. While these funds were apparently not involved in the price run-up in Minneapolis, their influence elsewhere may have manipulated the entire wheat complex.

There are no position limits on index funds despite the fact that they are not hedging any business risk like producers, mills, elevators or end-users routinely do. These funds are purchasing assets to speculate on their future value. This single fact is the greatest problem that calls out for a remedy. According to one source, an estimated \$8 billion has flowed into the commodity markets since Jan. 1 – some \$600 million a week – primarily from funds. This influx of capital raises prices of commodities on the exchange and increases volatility, which then widens the trading ranges and creates a spiral. It also distorts or severs the link between futures and cash markets. In other words, a mob mentality overwhelms the fundamentals.

Speculators are important players in the market – the market essentially serves to transfer risk from hedgers to speculators and it couldn't function without them. Index funds now hold the equivalent of two years of Soft Red Winter Wheat production on the Chicago Board of Trade – an amount that would draw prosecution for cornering the market if held by commercial interests.

Just as the inflow of speculative money inflated and distorted the market on the way up, at some point the pendulum will swing the other way. If the funds decide that stocks or real estate are more attractive investments than commodities, money will flow back out, triggering limit-down locks, widening trading ranges going down and creating chaos in the marketplace for those who are trying to hedge genuine risk. Farmers do like some volatility in the market because it offers pricing opportunities, and we don't want to see contracts that don't fluctuate. But that volatility should be driven by market fundamentals and not by disproportionate speculative positions.

Recommendations

NAWG recommends the following for consideration by the Commodity Futures Trading Commission, the Commodity Markets Council and the exchanges:

1. Subject index funds to the same position limits applied to speculators and revisit the recent decision to expand speculative position limits. The market needs access to speculators, but they should not be allowed to manipulate the market. The primary function of the market as a risk management tool for legitimate hedgers must be restored. Applying limits to speculators and including index funds in that category should allow the fundamentals to reassert a dominant role, enabling the markets to clear without excessive volatility. In order to avoid creating immediate downward pressure on prices, imposition of the limits may need to be delayed for an appropriate length of time.
2. Revisit limits on daily trading ranges to see if adjustments can be made to reduce volatility while still allowing the markets to clear. The exchanges may want to adopt uniform maximum trading ranges or use the “collars” common in financial markets as ways to manage trading range flexibility. We’re not entirely sure what the right answer is to this question but we think it deserves another look.
3. Re-establish Toledo as a delivery point for Chicago and consider other ways to increase delivery opportunities against the contracts on all the exchanges. The threat of actual delivery will provide a much-needed dose of fundamental reality to speculators (including index funds).
4. Consider the recommendations of the National Grain and Feed Association to improve market convergence. These recommendations include, among others, adjusting load-out and storage rates at delivery elevators to more closely match market rates.
5. NAWG does not support the recent proposal by the Treasury Department to merge the Securities Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC). Commodity and capital markets serve different purposes, with the most important function of commodity markets being to transfer risk. The Treasury proposal identifies several changes that need to be made to SEC before a merger would take place, and perhaps SEC should implement those changes – but we see no justification for merging the two agencies in this volatile trading environment.

Futures markets are very important to wheat producers and other stakeholders in the wheat industry. We believe these steps will help restore the basic function of risk management to the markets and improve their performance.