RMB Special Reports

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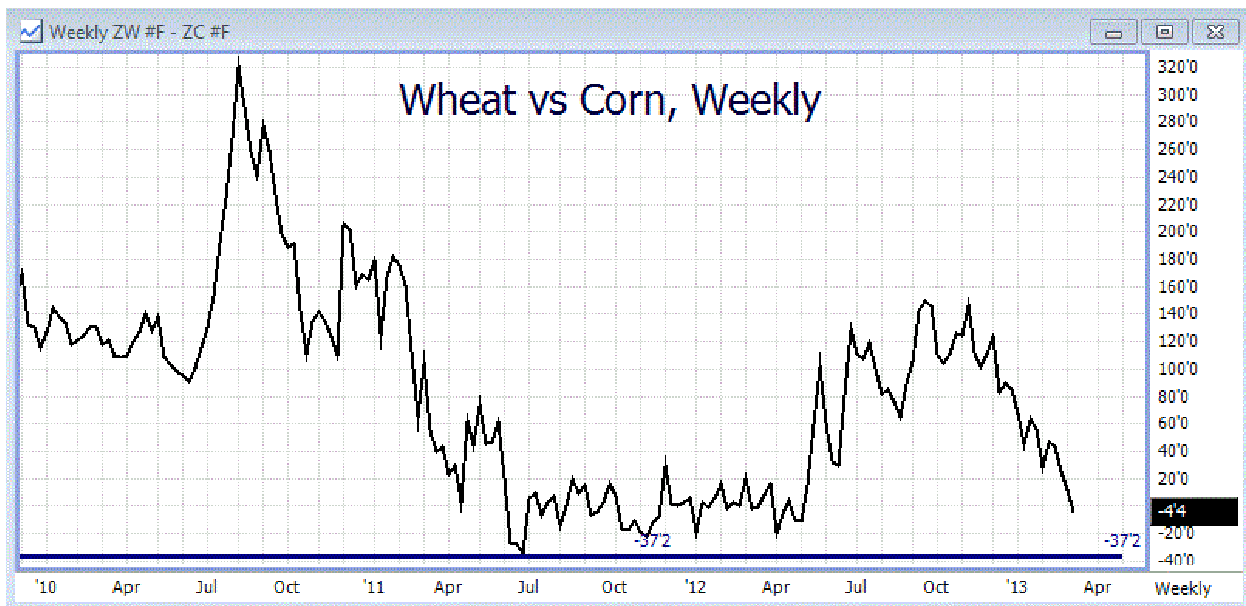
Wheat Is Cheap vs. Corn

How to play this market anomaly

Wheat and corn are not the same. Both are sources of energy and protein and can be eaten by humans and fed to livestock. However when it comes to bang for the kernel, wheat wins by a mile. A simple way to measure relative food value is to compare calories. Calories are a measure of heat which can be used to determine how much energy a given food will provide. At 339 calories per 100 grams versus corn's 86 calories, **wheat has nearly four times the stored energy of corn.**

Another way to measure relative nutritional value is to look at protein. CBOT wheat has roughly 11% protein versus CBOT corn at roughly 8%. If you were a cattle feeder or a hog farmer and you had the choice of paying $7.00 for either a bushel of corn or a bushel of wheat, which would you buy? This is a big reason why the price of wheat rarely drops below the price of corn. It's also why we pay attention when it does.

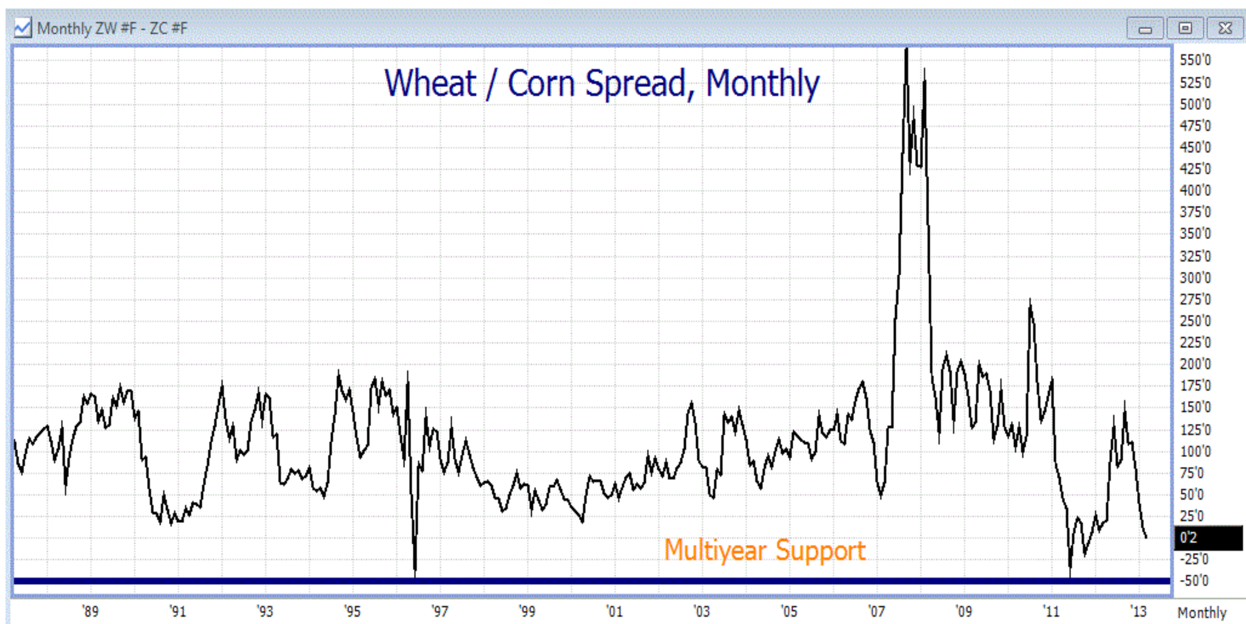


Data Source: CQG

The chart above shows the price of corn subtracted from the price of wheat on a weekly basis. In just the past two years wheat has fluctuated from a $3.20 premium to

corn to a 37.25 cent discount. A bushel of wheat is going for *4 cents less* than a bushel of corn as we write this. That means wheat is "on sale" in relation to the price of corn. One way to trade this anomaly is to buy wheat futures, simultaneously sell corn futures and use a spread of minus 40 as a "stop loss" level.

The blue line at the bottom of the monthly chart below shows the multi-year historical support for this spread at roughly *minus 40* cents. This level has proven to be tough to breach going all the way back to the late 1980s, making it a very workable risk parameter.



Data Source: CQG

Wheat / Corn Spread Dynamics

Winter wheat is harvested in July. Corn is harvested in the fall. That means the supply of wheat is greatest in mid-summer, just as "old crop" corn supplies are beginning to wear thin. As you can see from the chart, the price of wheat has dropped below corn during harvest in the past but it tends not to stay there for long.

Last year's drought hit the mid-summer wheat harvest hard, pushing prices above $9.00 per bushel and to more than $1.40 over the price of corn. Good snow cover over the wheat-growing "breadbasket" of North America this winter has helped alleviate some of the drought conditions that prevailed during last July's harvest, but not entirely. The Great Plains lost a lot of soil moisture last year making this year's wheat crop vulnerable to weather disruptions – especially late season dryness.

At the same time, the expectation of a better crop this year is forcing speculators to abandon their long positions. Better weather is also causing producers to hedge their

future production by selling it in the futures market. Combine this with tight supplies in corn due to last year's drought-damaged crop and you get the current situation. Given the caloric and protein advantages of wheat, we don't think the current discount to corn will last.

Buying the Wheat / Corn Spread

Buying the wheat / corn spread involves going long a 5,000 bushel contract of wheat while simultaneously selling a 5,000 bushel contract of corn, looking for the price of wheat to rise faster than the price of corn ***or*** for the price of corn to fall faster than the price of wheat.

When we enter this spread we are not betting that grain prices will rise or fall. Our bet is that, when the dust clears, market forces will win the day and wheat will cost more per bushel than corn, reflecting its higher caloric and protein content. The more wheat costs versus corn, the more we will make. The more corn costs versus wheat (making the spread more negative), the more we will lose.

Each 1 cent move in the spread is worth $50. Let's say we buy the spread with wheat costing 5 cents less per bushel than corn and that subsequently wheat rises to a premium of 20 cents over corn. Our gain will be 25 cents per bushel. Multiply 25 cents times the 5,000 bushel contract size to get a gain of $1,250. Should wheat drop versus corn and get as much as 30 cents per bushel cheaper than the yellow grain (a spread of *minus* 30 cents), we would be looking at a $1,250 loss.

Two Ways to Play

The way we see it, there are two ways to play the current anomaly: **1)** Purely with futures or **2)** combining futures and options to help reduce risk. The first is the most straightforward but potentially riskier. Because it is possible for wheat to drop lower than the negative 40 cent differential that has defined the historical bottom of this spread, a straight futures play requires dynamic stop loss strategy. A spread protected by options may not.

1) **Suggested Action – "classic" futures spread:** *consider placing an order to buy May CBOT wheat futures while simultaneously selling an equal number of May CBOT corn futures for* ***minus*** *5 cents or lower premium wheat, looking for the spread to widen out to $1.00 per bushel or more. Roll the position to July contracts prior to first notice day of the May contracts in late April. Exit the position should the spread close twice below minus 45 cents to the wheat.*

2) **Suggested Action – buy cheap protection using options**: *execute the spread listed above but augment it by doing the following:* ***a)*** *buy out-of-the-money wheat puts as protection for your long wheat position and* ***b)*** *buy out-of-the-money corn calls to protect your short corn positions. Quantity should equal the number of futures spreads you have on. Buying this protection will cost cash but it will also limit the maximum amount you can lose on the spread, making a stop loss order unnecessary.*

Note: prices will probably have changed by the time you read this, so work with your broker to determine the proper hedge strategy for you.

How the Option "Hedge" Works

As we write this, May corn futures are trading for 6.88 per bushel and May wheat futures are trading for 6.83 per bushel, which is a spread of *minus 5 cents* to the wheat. Let's say in addition to buying the wheat / corn spread at minus 5 cents we also buy a May $6.00 wheat put and a May $7.80 call and pay no more than 6 cents ($300) for both.

Buying the May $6.00 wheat puts gives us the right but not the obligation to sell our long wheat contract at $6.00 per bushel. We paid $6.83 for our long futures position, so owning the put means the most we can lose on our long futures position is $6.83 minus $6.00 or 83 cents ($4,150). Wheat could drop to zero and the maximum we could lose on the long wheat leg of our spread is this $4,150 plus transaction cost.

Buying the May $7.80 call gives us the right but not the obligation to buy back the corn futures we shorted at $6.88 per bushel for $7.80 which means the most we could lose on the short corn leg of our spread is $7.80 minus $6.88 or 92 cents ($4,600) plus transaction cost. Our maximum possible loss with the option hedge is the $4,150 max loss on the long wheat leg plus the $4,600 max loss on the short corn leg or $8,750.

However the odds of corn and wheat heading in different directions at the same time are slim – especially given the fact that wheat can be substituted for corn and vice versa. Having a limited downside on each leg of the trade means more earning power for the opposite leg should the grain market head sharply in one direction or another.

Let's say both wheat and corn drop $2.00 per bushel. Our downside risk on the long wheat leg of our trade is $4,150. The same $2.00 drop would result in a $10,000 gain on the short corn leg of our trade. Similarly, let's say both contracts rally $2.00 per bushel. The downside risk on the short corn leg of our trade is $4,600. The long wheat leg would gain $10,000. In either case, potential harm from the losing leg of the spread is sharply reduced.

Getting Started

You cannot trade grain futures and options in your stock account. You need a separate commodity account. The **RMB Group** has been helping their customers trade futures and options since 1984 and are intimately familiar with the strategy in this report. Call us toll-free at **800-345-7026** or **312-373-4970** direct. We'll send you everything you need to get started. Or visit us at www.rmbgroup.com to open an account online and see other "big move" trade suggestions.

If you are new to futures and options and would like to know more, give us a call at the phone numbers above or e-mail suerutsen@rmbgroup.com and we will send you the *RMB Short Course in Futures and Options* (a $14.99 value) absolutely free. You can also download the *"Short Course"* from our website and watch a brief, informative video at www.rmbgroup.com.

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