HEDGING WITH MGEX SRWI FUTURES CONTRACTS

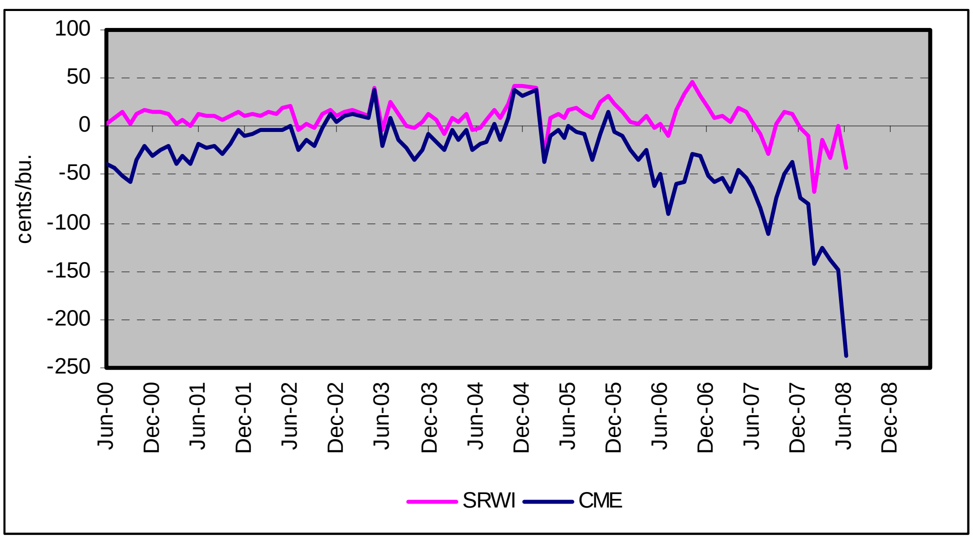
Introduction

MGEX (Minneapolis Grain Exchange) offers futures and options that settle financially to the Soft Red Winter Wheat Index (SRWI), calculated daily by DTN. Because the spot SRWI is comprised of bids collected from country elevators, it reflects country-level pricing for soft red winter wheat. Historical SRWI values are used in this analysis to evaluate potential basis levels and basis variability for hedges with MGEX SRWI futures contracts at alternative market locations.

Basis Variability

A stable and predictable basis is necessary for effective hedging. Because MGEX SRWI represents elevator-level pricing, it is expected to closely track elevator prices and demonstrate stable basis. Figure 1 illustrates how the SRWI contract provides a much more stable basis for the wheat growing regions of Illinois. Indeed, a hedge in the MGEX SRWI futures contract would have avoided much of the basis weakness that was experience with the CME contract in 2006-2008.

Figure 1. W. Southwest Illinois SRW Wheat Basis, 2000-2008



The weak soft wheat basis experienced by elevators and producers using the CME contract for short-hedging was endemic across both country-level markets and terminal markets. This is shown in Figure 2 for another country-level market in Northern Ohio and in Figure 3 for a terminal market at the U.S. Gulf. As shown in Figure 2, basis variability increased—along with market variability—across the board in the 2007-2008. Yet, MGEX SRWI basis tended to be more stable than that of the CME contract. Moreover, the MGEX SRWI basis avoided the dramatic weakness experienced by the CME's soft wheat contract.

Figure 2. Northwest Ohio SRW Wheat Basis Levels, 2000-2008

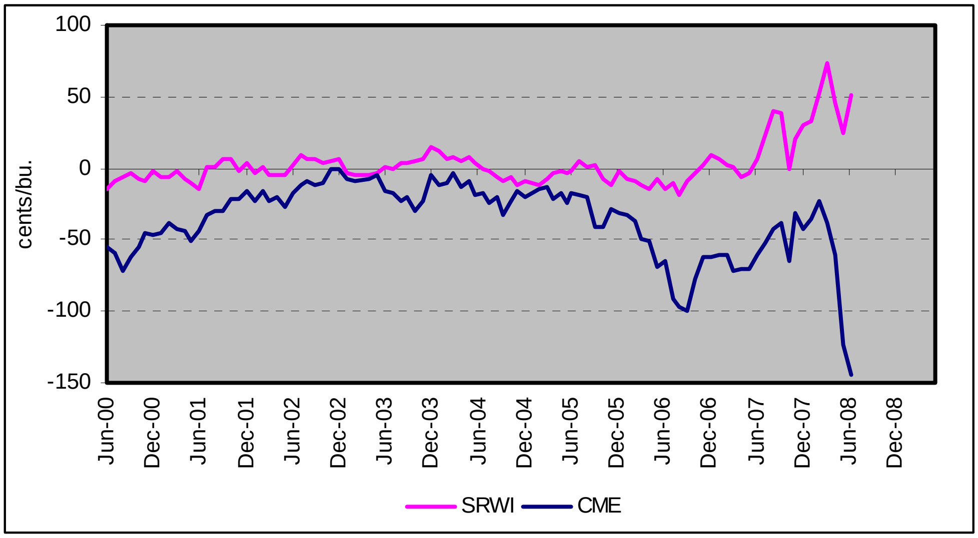
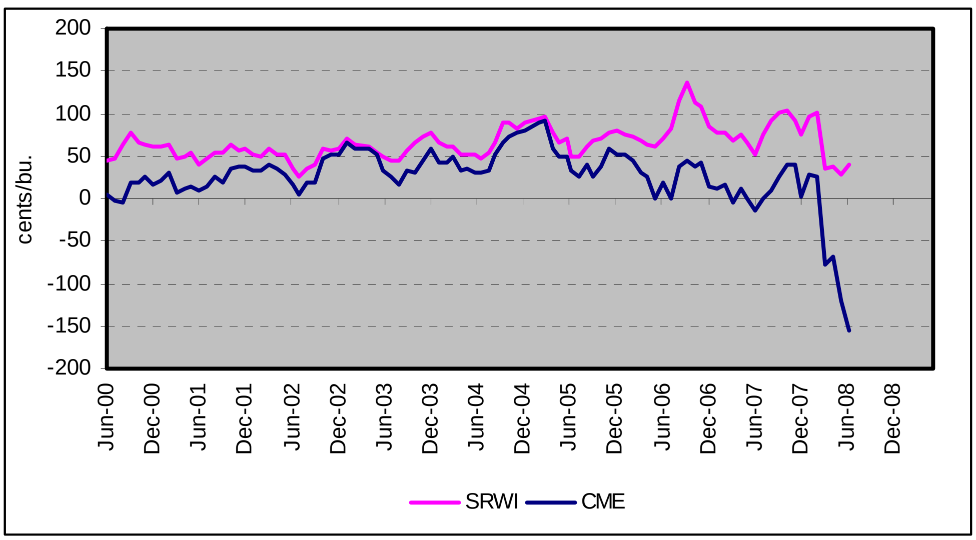


Figure 3. U.S. Gulf, SRW Wheat Basis Levels, 2000-2008



Conclusions

MGEX SRWI futures contracts have the potential to reduce basis variability and increase hedging effectiveness relative to the CME wheat futures. Across both country and terminal markets, the SRWI contract provides less basis variability than CME futures. Moreover, although basis variability increased in general over the 2006-2008 crop years, MGEX SRWI contracts showed much better performance than CME contracts—for which the basis weakened to historically low levels. This suggests that the MGEX SRWI futures contract provides an excellent hedging tool for producers, merchants, and end-users that are looking to reduce the basis risk in their hedging programs.