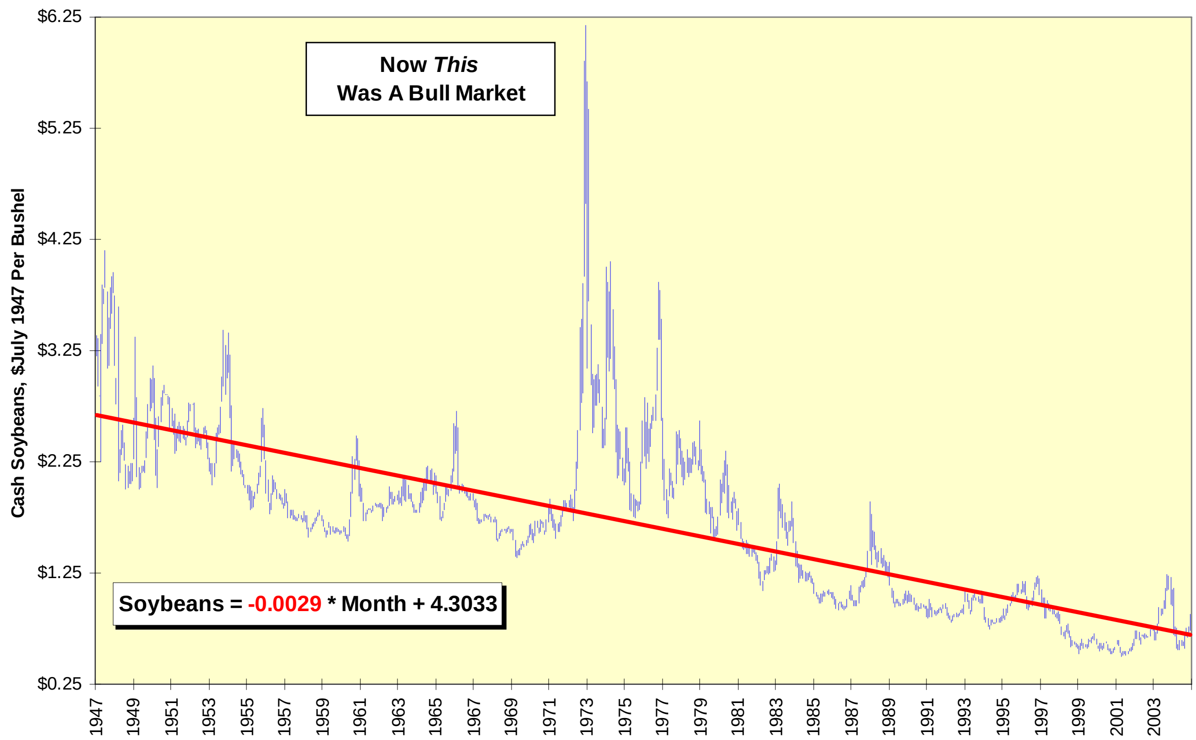
Will Inflation Sprout On The Farm?

"It's been a long time since I rock and rolled
It's been a long time since I did the Stroll" – Led Zeppelin

Were the lords of heavy metal singing about soybeans? Probably not, but they just as easily could have been in recent years. This commodity used to burn up several times a year under the summer sun, and then rise phoenix-like from its own ashes to dash the hopes and dreams of speculators who had fewer ways in the 1970s of losing a lot of money in a short period of time on pointless gambles.

But in recent years, soybeans have been tame, almost docile. The mechanization of agriculture in India and China has improved yields there, and both Brazil and Argentina have become major producers of the legume. These two Southern Hemisphere exporters were insignificant producers during the massive early-1970s rally. Their industry was created and financed by Japanese importers stunned by the U.S. embargo of soybean exports to Japan in 1973 by the Nixon administration. Trade restrictions have consequences, generally negative ones, for those imposing them, a lesson we all should heed today.

The Low Spark Of High-Yield Soys

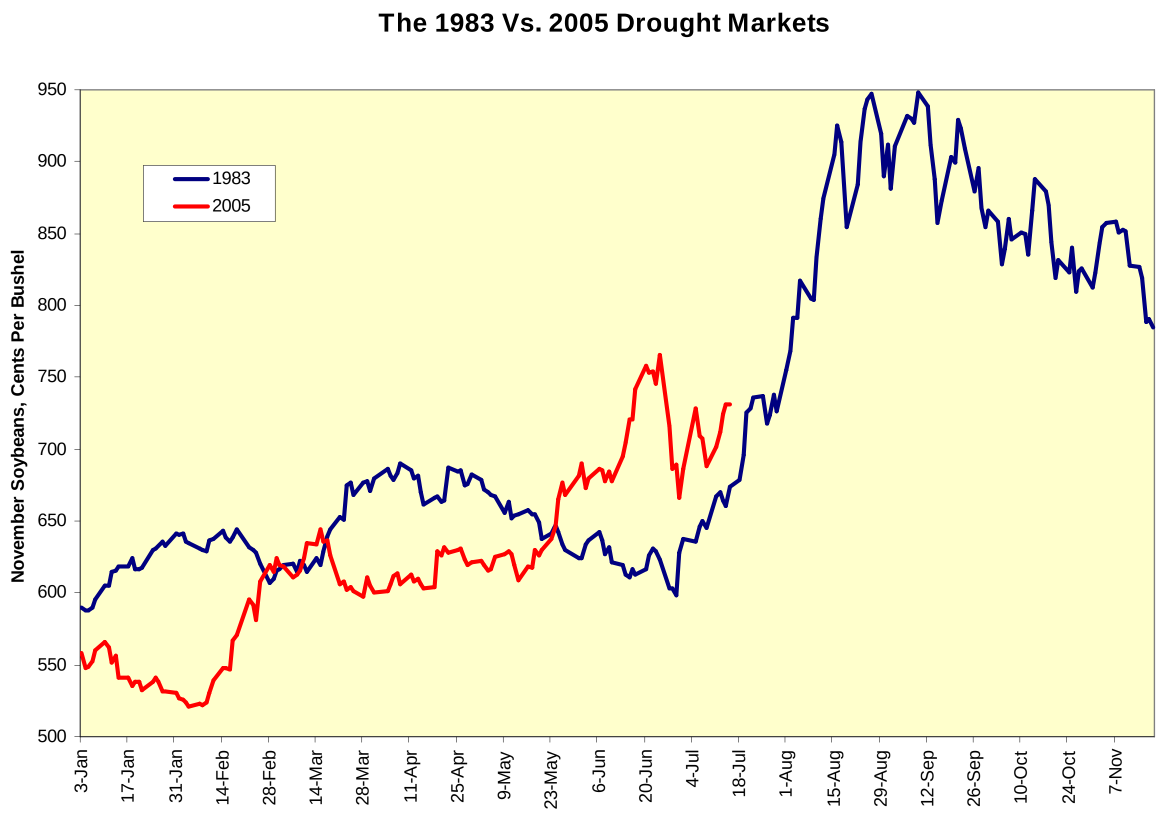


The dominant feature of the chart above is its persistent downtrend over the past 58 years. A secondary feature is the negative coefficient of the constant-dollar price against time. In a cold slap across the face of the hot-commodity crowd by the hairy-knuckled Hand of Facts, constant dollar soybean prices do not keep up with inflation. One shudders to think what this line could look line in the future if major food importers dropped their prohibitions against genetically modified soybeans.

But In The Short-Term

The long-term downtrend does not preclude a short-term trade. And here the parallel from the last time soybeans held a rally this long into the growing season, 1983, is instructive. Grain traders have a lingo all their own, and in the case of soybeans, you find yourself worrying about "setting the pods," the critical time in early July when the flowers are pollinated and beans start to form. The corn market has a parallel: There are only two times in life you should pay attention to tassels; one is when these strands facilitate the ears getting pollinated.

The rally in November soybeans, the harvest contract for North American soybeans, is ahead of where it was in 1983. And given the life of a soybean plant, rain from here on in will permit what's set in the pods to ripen, but it will not create more pods or more beans in the existing pods. It is 2005, not 2001, but the pod bay door has closed for the year.



Assorted Market Impact
For all of the visibility of soybean prices, soybeans account for only 1.736% of the Crude Materials component of the PPI, and corn contributes only another 2.321%. Still, these are highly visible prices and just as consumers have mental benchmarks for what they should be paying for gasoline, they have mental benchmarks for grocery products. Never mind that processing, marketing and transportation costs dwarf raw materials costs; those are indirect and largely invisible expenses.

And even though this is not an election year, no discussion of farm prices can be separated from the web of welfare payments involved. Here's an incredible-but-true personal story from 2001. I was in Manhattan, Kansas, to give a lecture on grain hedging at Kansas State University and was having dinner with one of the professors beforehand who dabbled as a trading consultant to farm groups. He told me he put his farmer clients in soybean calls when the price got down to the very low level of $4.25 per bushel. I nodded in congratulations, and then with a start blurted, "Wait a minute! Why are farmers buying calls; they're already long?"

He smiled as if to say, "You don't get it, do you?" I did not, but here it comes: When the price got down to that level, the farmers were taking in so much money in the form of price supports, deficiency payments and other giveaways that they would have been losing almost $2 in payments for every $1 the price would rise. They were not hedging their crops; they were hedging their government handouts. Is this a great country, or what?

While it might be logical to think that higher prices would reduce government payments, fear not: Our friends in the various farm lobbies and the politicians at all levels who cater to their interests will find a way to transfer tax dollars to the farmer. They always do.

How To Trade
If you want to trade soybeans by trading stocks, forget it. Just forget it: There are no soybean or corn ETFs, none of the grain processors like Archer-Daniels-Midland are plays on grain prices, and none of the big food processors like ConAgra or Kraft Foods have a pure exposure to grain prices. These firms have large exposures to other commodities, such as dairy and meat products. If you want to trade soybeans, you will have to open up a futures account to do so. And get ready to rock and roll: These markets are every bit as violent as crude oil when they move.