

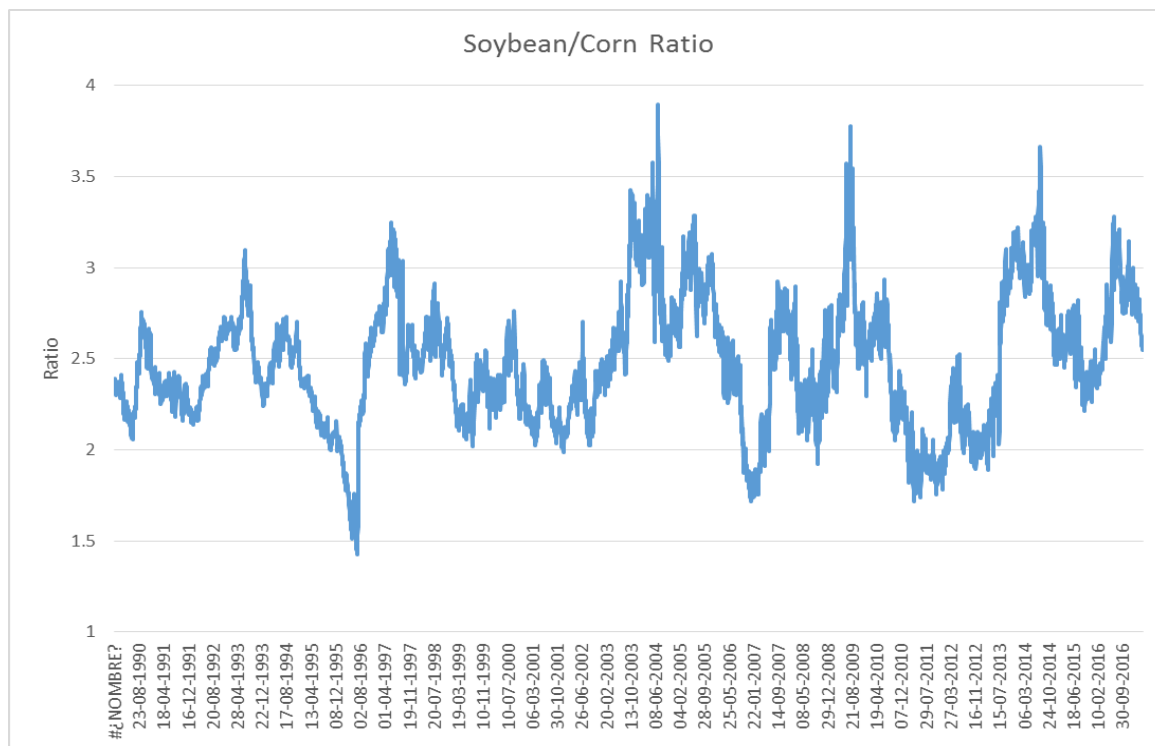
# Understanding The Corn/ Soybean Spread

The Corn to Soybeans Ratio is very important to American farmers. In normal conditions, it's a key factor that helps them decide how much Soybeans or Corn they'll put into the ground. Both crops compete for the same acreage area. I like to think of it like this:

Farmers have a **portfolio**, but instead of money, they have **acres**. There are two assets they can choose to invest in. Either Corn or Soybeans. This key decision is **ASSET ALLOCATION**. Whether they want more exposure to Corn prices, or prefer holding more Soybean bushels, depends on many factors, but price is a big one.

Farmers can check, even months prior to the harvest, how much money they'll receive for every bushel they pull from the ground. This is done by evaluating the relationship between the Corn and Soybean futures that'll be trading by harvest time.

Here's the long-term relationship for the front month futures:



The ratio is Soybeans over Corn. Whenever the ratio is over 3, farmers get 3 times more money for every Soybean bushel than Corn. Sometimes the ratio goes crazy due to weather risk and supply imbalances, but in normal conditions it shouldn't be over 3.

Whenever the ratio is over 3, farmers plant a heck of a lot more Soybeans than Corn. And by the laws of supply and demand, this will eventually cause the ratio to go down as Corn becomes scarcer relative to Soybeans.

The best way to play this relationship is through a spread trade. You can use one contract of Soybeans per two contracts of Corn. This means you'll have 5,000 bushels of soybeans and 10,000 bushels of corn on a notional basis.

If we're bearish on the Soybean/Corn spread, meaning we think corn prices will rise relative to soybean prices, we'll need to short one contract of Soybeans, and go long two contracts of Corn. If bullish, meaning we think soybean prices will rise relative to corn prices, we do the opposite — buy one contract of Soybeans and short two contracts of Corn.



You'll notice that this chart is very similar to the previous spreads chart, but the Y-axis is now quoted in points instead of in a ratio. Every point on the Y-axis is worth \$50 per the spread trade.

The reason we use a spread instead of playing the commodity straight up is to hedge weather risk. Weather is THE principal risk factor in grain commodities. Weather produces a largely asymmetric effect: while bad weather alone could completely destroy a crop yield, good weather by itself won't produce a bumper harvest. Good weather is just one factor involved in a successful growing process. By taking the spread we're strictly betting that Corn futures will do better than Soy futures no matter the other general conditions. Weather risk is partially hedged.