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Russian Wheat Exports Remain Biggest Risk to U.S. Wheat Elevators

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Inside…

Key Points:

- Following an extended period of inverted futures markets, the outlook for elevators storing wheat has improved. Carry in the futures markets has returned and the buy basis has widened after a bigger U.S. wheat harvest.
- While elevators storing soft red winter (SRW) wheat plan to pocket sizable carries, high costs of carry will erode the smaller margins in hard red winter (HRW) and hard red spring (HRS) wheat futures. The eroding futures margins increases the importance of making margin on basis.
- The strong U.S. dollar and record exports of cheap Russian wheat continue to be headwinds for the U.S. wheat export program.
- For millers, the high variability in HRW quality and the high protein content will create blending challenges.
- The greatest margin risk to storing wheat is the shrinking world wheat crop outside of Russia and China, which leaves the market vulnerable to supply shocks and extreme volatility in wheat prices.

Introduction

Following a historic run of inverted futures markets that sapped profitability in storing wheat, grain elevators' situation has improved for the 2023/24 wheat crop. Carries (also called spreads, the difference in price bids for two different delivery months) have improved for all three major classes of wheat: Chicago soft red winter (SRW), Kansas City hard red winter (HRW), and Minneapolis hard red spring (HRS).

However, with high interest rates pushing the cost of carry to historic highs, elevators will still struggle to pencil in a profit on the wider carries. This is particularly true for the hard wheats where the December-March spreads are notably slimmer compared to SRW. Elevators struggling to make margin on carries will instead look to benefit from rising basis (the difference between the local cash price and the futures market price) on company-owned grain through the marketing year.

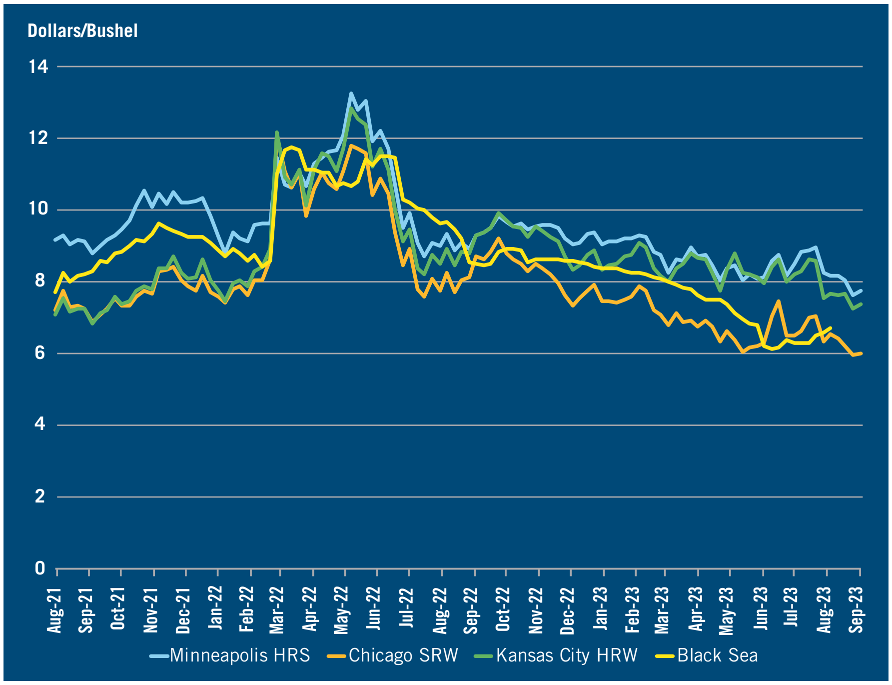
The major risk to elevators in the year ahead is a sharp rally in wheat prices *(Exhibit 1)*. With the global wheat stocks/use ratio outside of China and Russia historically low and stocks in major wheat exporting countries historically tight, potential disruptions to Russian exports in the Black Sea could result in extreme market volatility. Substantial liquidity will be needed to cover short hedges on company-owned grain. Wheat futures markets could also invert, erasing carries on stored grain.

U.S. wheat

The U.S. wheat harvest made a modest recovery this year following two years of anemic production, largely led by a substantial increase in SRW in the Midwest where farmers produced the biggest crop in nine years with record yields *(Exhibit 2)*.

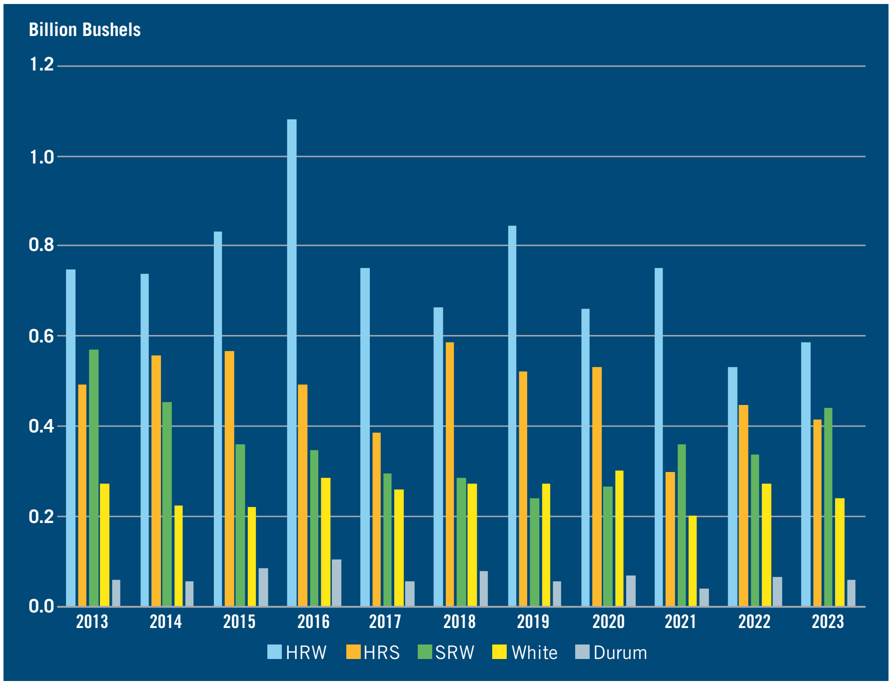
This year's SRW harvest rose 31% YoY to 440 million bushels, based on USDA's latest estimates. With the ample supply of SRW, elevators will not only benefit from exceptionally wide carries in the futures market, but also from the variable storage rate (VSR) that will add about 3 cents/bushel to the futures spread, thereby further incentivizing storage. SRW is a low-protein wheat grown mostly in the eastern Midwest states of Illinois, Ohio and Kentucky and is typically used for snack food products like crackers and pastries.

EXHIBIT 1: World Wheat Prices



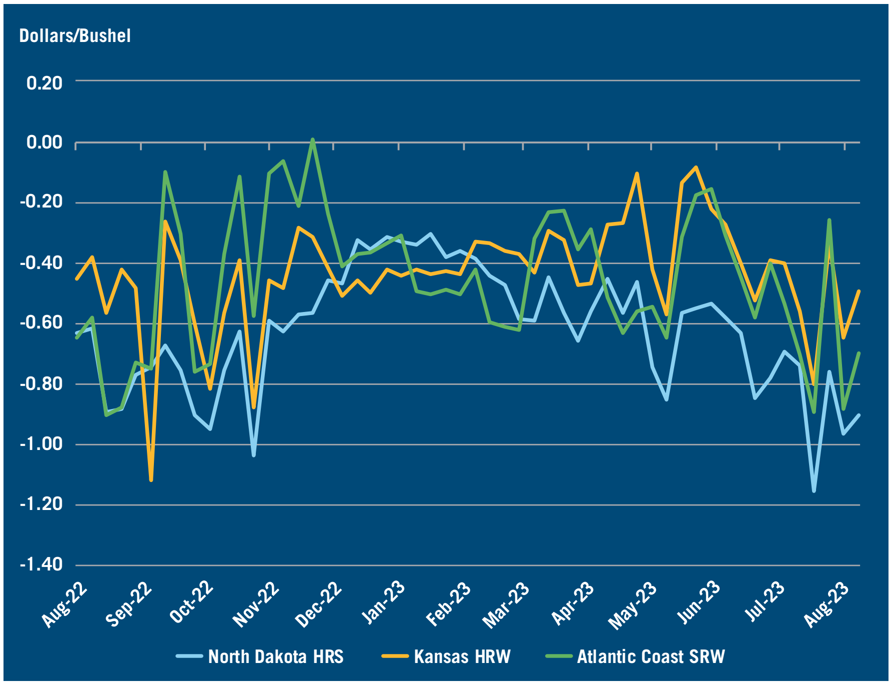
Source: CME Group; MGEX; CoBank

EXHIBIT 2: U.S. Wheat Production



Source: USDA-NASS

EXHIBIT 3: Elevator Basis for Wheat



Source: USDA-AMS

In the Central and Southern Plains, production of HRW, which is typically used for bread, buns and rolls, lost significant yield under ongoing drought; production rose only due to expanded acreage. The HRW crop struggled with drought early on, resulting in higher protein levels. On the heels of two prior crops that were also high protein, the abundance of protein in the HRW crop has resulted in protein premiums falling and being penalized with discounts. Late-season rains at harvest also lowered test weights and milling quality, while problems with sprouting in the head and higher weed contamination caused issues with storing and blending. HRW is typically 10%-12% protein and grown mainly in the Central and Southern Plains states of Kansas, Texas, Colorado, Oklahoma and Nebraska. HRW production rose 10% YoY to 585 million bushels, according to USDA.

The HRS harvest in the Northern Plains is figured to fall 7% YoY to 413 million bushels, according to USDA, despite expanded acreage. HRS is a high-protein wheat used for products like bagels and pizza crust. Late planting of the crop was followed by persistent drought conditions that cut yields. The smaller HRS harvest is compounded by a drop in Canadian HRS production that is expected to hold HRS prices at a significant premium to the other wheat classes in the year ahead.

Blending this year's wheat crop will be a tightrope for elevators, millers and bakers that are challenged to find low- to medium- protein hard wheat in a market saturated with high protein. With the hard wheats trading at a sizable premium to SRW, millers and bakers will be motivated to blend more SRW with hard wheat. Blending SRW, though, will be limited due to stark differences in mixing and baking performance. With the additional quality issues of this year's HRW crop, millers will be challenged to create blends that are cost effective for their customers while still meeting quality specifications and consistency of product.

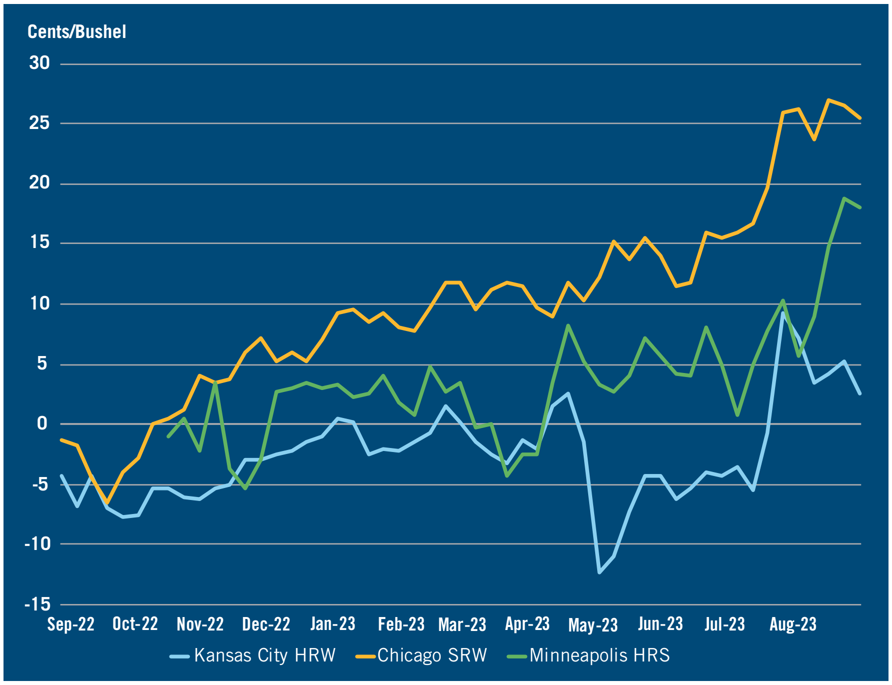
The U.S. white wheat harvest is estimated at 239 million bushels, down 12% YoY, while durum production is figured at 57 million bushels, down 11% YoY. Even with smaller HRS, white and durum harvests, the all-wheat harvest rose 5% YoY to 1.734 billion bushels.

World wheat

The flood of cheap Russian wheat and a strong U.S. dollar continue to be major headwinds to the U.S. wheat export program, which is contributing to the widening of basis in the U.S. Russia is currently harvesting a near-record wheat crop as the U.S. harvest comes to market. With substantial carryover inventories from last year's record-sized harvest, Russia is exporting a record-large volume of wheat. Russia's currency has also fallen sharply, down 30% YTD, putting Russian exports on sale in the global market and pushing down world wheat prices.

EXHIBIT 4: Wheat Futures Carries

December 2023 - March 2024



Source: CME Group; MGEX

The combined headwinds of cheap Russian wheat and a strong U.S. dollar has stalled U.S. wheat exports. As of Sept. 7, outstanding export sales for all U.S. wheat classes combined are down 15% YoY with HRW and white wheat sales being exceptionally slow. Outstanding export sales for HRW were down 52% YoY, while white wheat outstanding sales were down 35% YoY. SRW outstanding sales were up 1.5% YoY, HRS led last year by 23%, while durum sales exceeded last year by 130%.

The flood of Russian wheat, though, has created a false sense of security in the world wheat market. Outside of Russia – and China, which is excluded from global stocks estimates since China's wheat stockpile is non-tradable – the world's wheat stocks/use ratio is nearly the tightest on record. Wheat stocks among the major wheat exporters outside of Russia are also historically tight.

Drought has substantially reduced wheat supply in Argentina, Canada, and Australia, while delivery of Ukraine's wheat harvest to the world market faces numerous obstacles due to the ongoing Russia-Ukraine war. In China, wet weather during harvest damaged a substantial portion of the Chinese wheat crop, which reduced the quality of the crop. As a result, China will likely feed more domestic supplies to livestock and raise wheat imports. Weak performance with the North African wheat crop this year will also translate into a bigger demand for imports. And in a rare move, India has lifted import restrictions on wheat and is negotiating with Russia to import wheat at discounted prices to curb food inflation.

The loss of rice exports out of India is also a factor in increased global wheat demand. In July, India banned non-basmati rice exports, then followed with more rice export restrictions. The loss of Indian rice exports is shifting food demand from rice to wheat in major importing regions like Southeast Asia and Africa.

Wheat basis and carry

Profits for elevators carrying SRW wheat will be much improved over prior years, as they benefit from buying cheaper basis *(Exhibit 3),* pocketing bigger carries on stored wheat, and gaining additional profit from the VSR.

Carries have also returned to hard wheat futures, but the bigger carries do not necessarily translate into profitability on storage, especially with cost of carry historically high *(Exhibit 4).* Elevators carrying hard wheat instead will rely on basis rising through the marketing year or storing for shorter periods, if possible. January through April will be an important period for basis to appreciate when no new major wheat harvest is being brought to the global market.

Protein premiums could also return later in the marketing year due to the smaller Canadian HRS harvest. A short Canadian crop, combined with a smaller U.S. HRS crop, will result in a tighter supply of high-protein wheat later in the market year and lift protein premiums.

With the wheat stocks among major exporters historically tight, any disruption to the flow of Russian wheat exports through the Black Sea risks a sharp price runup. This risk would cause elevators to cover short hedges in the futures market on company-owned grain. Futures markets could also revert to an inverse, further erasing profitability on stored grain. Elevators and their CoBank relationship managers should stress test scenarios of rapidly rising futures and basis, and a potential return to an inverted futures market.

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