Grains: Still The Portfolio Diversifier Of Champions

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Given this year's bumper harvest of global crop headlines, will rising uncertainty about trade deals and ag yields spark new interest in agricultural exchange-traded funds (ETFs), similar to the flows seen in funds tied to scarce commodities like oil and gold?

On this week's podcast, Investable Universe spoke with Sal Gilbertie of Teucrium Trading LLC, the firm that brought listed, single-commodity agricultural ETFs (CORN, WEAT, SOYB, CANE and TAGS) to the floor of the New York Stock Exchange, on the slowly rising popularity of ETFs tied to staple crops, and why even the unpredictable effects of the U.S./China trade war likely won't be enough to diminish the diversification case for staple commodities.

"Grains trade on supply and demand. They don't care what the latest iPhone is, who the President is, or what the S&P 500 is doing," he said.

Uncorrelated returns

To investors, the fundamental supply/demand dynamics of farm production suggest an allocation to grains as a potential hedge against exposure to stock market returns. Among acolytes of modern portfolio theory, farm commodities' appeal as a portfolio diversifier is twofold: low historic correlations to risk assets like stocks, and relatively inelastic demand for grains as dietary staples and product inputs.

A feature this month on ValueWalk revealed that agricultural commodities have outperformed equities during 11 of the last 12 market downturns.

Meanwhile, Teucrium's analysis of Bloomberg data revealed that gold — the traditional hedge against portfolio volatility — had a correlation coefficient of .48 against the S&P 500 from 1999–2018 (indicating a weakly positive correlation between gold prices and stocks). The same data series identified even lower positive coefficients of .12 to .15 for wheat, corn and sugar compared to the S&P 500.

While price discovery for many traded agricultural commodities occurs in the futures market, most investors don't dabble in these markets, which involve actual physical delivery of the underlying commodity. They can and increasingly do, however, use ETFs that are based on futures prices, in order to gain exposure to price movements in these products through a more liquid vehicle that can be bought and sold in a regular securities account.

The emergence of agricultural commodity funds is perhaps a natural outgrowth of the billions of dollars in inflows to ETFs indexed to precious metals and oil in recent years. Volume in the ag funds remains comparatively light, however. Average daily volume in CORN is just under 110,000 transactions, compared to around 12 million daily trades in GLD, which tracks the price of gold.

Headlines: What?

It has by most accounts been a lousy year for the American grain harvest, with August reports from the U.S. Department of Agriculture revealing that farmers were unable to plant crops on more than 19.4 million acres of farmland due to rains and flooding this year — the severest prevented planting since such reporting began in 2007.

Despite this, the U.S. Department of Agriculture in its August crop report forecast a larger-than-expected U.S. corn harvest, driving corn futures prices sharply lower.

An outbreak of African swine fever in Asia has disrupted feed grain exports all year long, amid massive livestock culls related to the disease, primarily in China.

There remains also the certain but as-yet-unclear ramifications of China trade tariffs on U.S. agricultural exports.

Some market participants — among them agco giants Cargill and Archer-Daniels Midland — are anticipating a base-case scenario in which trade war tensions have lasting effects on the global soybean trade regime due to trade diversion effects.

A limited U.S. trade deal signed last week with Japan focused on the reduction or elimination of tariffs for over 90% of U.S. food and agricultural products imported into Japan, a gesture meant to mitigate some of the effects of Chinese trade barriers on U.S. goods.

Yet China itself has reportedly bought an estimated 1.6 million metric tons of U.S. soybeans in just the last 10 days, and granted tariff exemptions on another 6 million metric tons ahead of the anticipated resumption of trade talks next month — despite tense exchanges in the ongoing trade war.

Amid this mixed bag of headlines, ag prices have remained soft. WEAT is down 12% for the year-to-date, CORN is down 8%, and SOYB is down 6%.

Weight / wait / drought / out

According to Gilbertie, extended periods of low prices present an opportunity for traders to layer long positions into their portfolio.

Grain prices normally hover around the cost of production due to the consistency and ubiquity of farm subsidies and consistency of demand — for corn, this has hovered around $3.50–4.00 per bushel.

But prices have spiked to the $8.00 per bushel level, effectively double the cost of production, twice since the adoption of the U.S. ethanol mandate, first in 2008 when prices rose 147% due to extensive flooding across the U.S. corn belt, and again in 2012 amid the worst U.S. drought in 50 years, before quickly reverting to breakeven price levels.

This longer-term, mostly sideways price action in grains, alternating with rapid, weather-related price spikes every 5–7 years, followed by rapid price normalization, has given rise to a market truism.

”Investors tell us that they ‘weight’ some grains into their portfolio, ‘wait’ for a ‘drought,’ and when there’s a drought, they get ‘out,’” Gilbertie said.

Prices for the NYSE Arca-listed grain ETFs are primarily based on U.S. and North American markets because the ETF is derived from U.S.-based futures prices (two, three and four calendar months ahead — the front, or spot, month is not included in the ETF). Underlying corn, soybeans and wheat prices are affected by a variety of factors.

Wheat prices are affected by weather in multiple areas. The U.S. is a global breadbasket, but so too are Western Canada, Australia, and the Ukrainian and Black Sea regions of Eastern Europe. India, too, is a top wheat harvester, but uses most of what it produces. Rain in a dozen different areas can affect wheat prices, whereas generally only weather patterns in the U.S. and South American markets (which dominate production) affect the global price of corn and soybeans. Corn and soybean prices are closely related because they are planted on the same acreage, with price action in corn — the core staple — leading the rest of the complex.

So about this trade war…

As to the effects of the trade war on soybean prices, he notes that three countries export soybeans to a meaningful degree: the U.S., Brazil and (to a lesser extent) Argentina. Per Gilbertie, China imports so many beans that they could theoretically buy Brazil's and Argentina's entire, combined bean harvest and still need U.S. product to meet their needs, even in a prolonged trade war scenario.

"No country — particularly China — can get away with buying only from Brazil and Argentina, but not the U.S," he said, adding that the economics of crop trading mean that everything grown will ultimately be sold somewhere, and that in this respect the possible reconfiguration of trade partnerships due to U.S./China tensions could actually have positive secondary effects.

"In terms of logistics there's no question that [as a result of the trade war] supply chains will become more reliable around the world. In that regard, the trade war is a good thing for supplies and food reliability around the world."

Risks and Disclosure