“The UK could be facing currently unknown barriers to trade with the EU.”

Brace yourself for Brexit

Features
Markets

With the date now set for Britain leaving the EU, arable farmers may be among the first to feel the effect it may have on markets. *CPM* assesses the likely impact.

By Tom Allen-Stevens

Before you pick up the phone to your seed merchant, consider this: the seed you’re about to buy will form the crop you may be selling after Britain has exited the EU. For the first time since the second world war, no one knows what the trading terms will be for UK arable crops as the seed for those crops is being planted, and in theory, there may not be a market for them at all.

“Brexit is the biggest unknown everyone’s coming across — we still have uncertainty as to what will happen,” says Cecilia Pryce, senior market analyst at Openfield. “Realistically, by April 2019, the UK could be facing currently unknown barriers to trade with the EU, while also facing full exposure to global grain prices.”

Uncertainty

On the plus side, agriculture isn’t the only industry affected, she notes. “Farmers face just as much uncertainty as those who are buying their grain, so as 2019 approaches, a good knowledge of your market and a good relationship with your merchant will become more valuable.”

So what do growers know about their market and how Brexit will affect it? AHDB has put in some work here and produced a series of ‘Bitesize’ Horizon documents, one of which summarises what Brexit may mean for cereals and oilseeds producers.

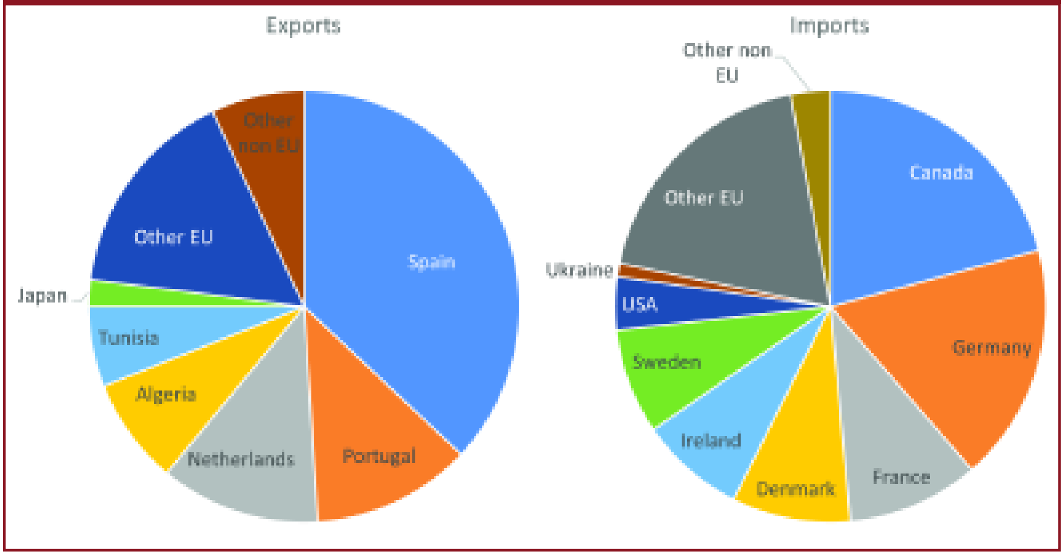
Around 80% of cereals and 94% of oilseeds exports are traded with the EU. If the UK finds itself outside a free-trade agreement, tariff rate quotas (TRQs) allow a specified quantity to be imported into the EU at a low tariff, which for wheat is currently €12/t. Once the quota’s reached, the tariff’s jacked up to €95/t for wheat. Oilseeds are tariff-free.

There’s been a reduction in the area of wheat such that in the current trading year, and for harvest 2017, the UK is likely to import as much as it exports. This should put the market as a whole into a position of some stability, although much depends on individual trade agreements.

The other unknown is maize, notes AHDB senior analyst Helen Plant. “In the feed grain market, wheat will compete directly with maize, and that’s a challenge.” Maize is the world’s most widely grown cereal, and annual consumption has just topped 1bn tonnes. UK wheat would struggle to compete with maize on the feed grain market as maize is inherently more efficient.

Imported maize into the EU must meet strict criteria on GM crops and there’s a TRQ of 280,000t. UK imports come almost exclusively from France, but increasing volumes are coming from Ukraine and Eastern EU countries. The effect of maize

UK wheat and barley imports and exports



Source: HMRC

on feed grains post Brexit will depend heavily on trade deals done with maize-exporting countries and the stand the Government takes on GM crops.

"If we go for a free market, we could be vulnerable to large imports of maize if price and quality allow," notes Cecilia Pryce. "We'd have to take the rough with the smooth — it would hit the feed grain prices for arable producers while allowing for exports of better quality wheats, but could also result in cheaper feed for livestock farmers."

Wheat imports vary from 7-20% of domestic demand and are predominantly from Germany, Canada and France, much of which is high protein wheat, which is not largely produced in the UK. These countries also act as a source quality and feed wheat in years when yields come up short or weather reduces quality. Lifting import restrictions may have little direct effect on the milling wheat market, but some processed cereal imports into the EU carry a higher tariff. So if Brexit resulted in a change in trade flows, this may have a knock-on effect on the domestic cerealst market.

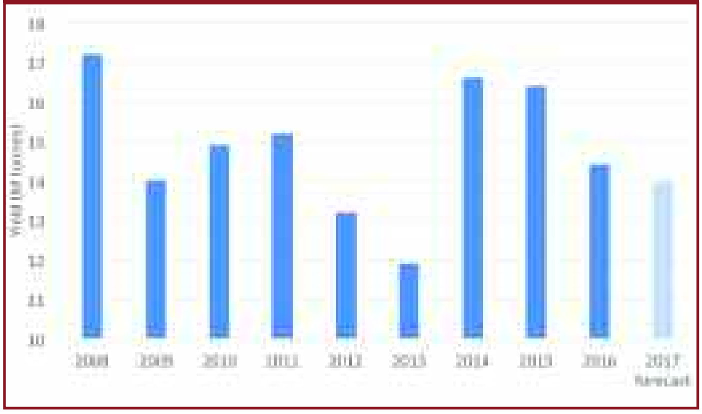
"If you have a domestic market for your grain, it's worth thinking about how dependent that end user is on the export market, and how vulnerable that market might be post Brexit," points out Cecilia Pryce.

Two thirds of barley exports go to the EU, and both feed and malting barley are exported. There's a thriving domestic demand for malting barley, especially for distilling malt, although much of this is exported — whisky is the UK's single largest food and drink export.

"If there's a strong market for a commodity, traders will soon learn how to embrace any trade barriers that are put in place," says Cecilia Pryce. "There'll be a market or price adjustment, but trade will recover if it's commercially viable for all parties."

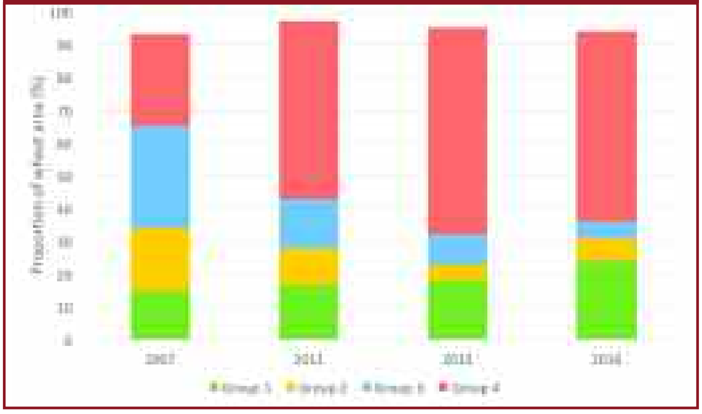
Oilseeds trade at world market levels, but there are always invisible barriers in every sector,she notes. "These can come in the form of GM and phytosanitary restrictions, that could limit our exports to the EU while also affecting imports. The amount of paperwork and justification needed shouldn't be underestimated — anyone thinking regulation will be relaxed is sorely mistaken. If anything, the requirements to prove low chemical residues, toxins and similar justifications could increase if the UK is to continue to trade goods with the EU." ▸

UK wheat production



Source: Defra and AHDB early bird survey

UK wheat variety profile



Source: AHDB planting and variety survey

Quality call in wheat markets

The domestic soft wheat supply is on a knife edge, says George Mason.

Wheat growers should aim for a premium market, according to traders and processors who gathered in London recently for the KWS Industry Forum. Premiums may currently be low, but growing quality wheat opens up far greater marketing options.

For George Mason of Heygates, the biggest area of concern is for the Group 3 and 4 soft wheats. "The domestic soft wheat supply is on a knife edge," he says.

"If we run out of milling wheat, we can import. But if we run out of soft wheat, what can we do? Not a lot."

The nervousness comes over what he calls a "nasty" drop in the wheat area grown in recent years. "It's almost as low as it was in 2001, and there's a great variability in yield. I put that down to blackgrass," he says.

He estimates the total available soft wheat supply from the 2017 harvest will be about 1.58M tonnes. UK demand for cakes, biscuits, food ingredients and breakfast cereal runs to about 1.15M tonnes, leaving a balance of just 430,000t. "Compare this with 2011 when the net balance was 2,550,000t," he notes.

There's been a "massive drop" in the area grown to soft wheats he points out from 50% of the wheat area in 2001 (all Group 3) to 19% now, with just 5% growing Group 3s.

But according to Beds grower Andrew Robinson there's good reason. "There isn't enough soft wheat because the market isn't offering a decent premium. From a grower's perspective, if you're going to put the time and effort into growing a consistent, quality crop, you need the support of a good contract with a consistent premium."

Glencore trader Tom Eaton believes the export market has been the driver this year. "We fulfilled the export opportunity because we had the right crop in the barn."

Going forward, he highlights Morocco, Algeria and Tunisia as good export prospects for the right quality wheat. "These countries want to buy milling wheat, and that's a real opportunity. We should continue to focus on Algeria in particular."

The premium has dropped to just £5-8/t, he notes. "But you can go for buyback contracts or trade your premium. The point is, you don't have the opportunity of a premium unless you grow wheats with quality potential."

It's not just quality, but the right kind of quality that Hovis technical director Shaun Taylor is after. "I'm not looking to buy on protein content, but on functionality. I'm really intrigued to see what will happen to some of these newer wheats in a low protein year," he says.

The bakery market is changing, he says — the overall value of the market is declining year on year. But while wrapped bread is down 9%, sales of wrapped bakery snacks and breads of the world (such as bagels and croissants) are up 3.8% and 4.1% respectively.

He's been carrying out tests on new Group 1 entrant on the AHDB Recommended List KWS Zyatt. "It has the closest texture of any variety we tested, which means something to a baker. Bagel flour undergoes a real ordeal in its process and KWS Zyatt has a very high tolerance — that's unique which is good."

A cross of Quartz with Hereford, Quartz makes KWS Zyatt short and stiff, brings in rust resistance and the quality from its parent Cordiale. Hereford brings in the high yield — an RL score of 102% of controls, says breeder Mark Dodds of KWS. With a septoria rating of 6.4, early maturity and good performance as a second wheat, he reckons it's a variety growers will warm to.

Shaun Taylor looks for protein functionality rather than content.

Are you open to options?

One way to take the risk and uncertainty out of the market is through options, while financial and commodity exchanges can reduce your business' exposure to fertiliser, fuel and currency fluctuations.

Tom Barclay is a broker with Berkeley Futures and believes a greater focus by farmers on price sensitivity and risk management will help the strong and informed to prosper once the protection of CAP and the EU falls away.

"Farmers who have traditionally hedged their grain price by forward selling to a merchant understand they need to spread their counterparty risk and attain the keenest price available. In the same way that global businesses hedge their risk through the financial and commodity exchanges, we're finding that many farmers are now looking to the same markets to help manage price risk within their own business."

The exchanges offer liquidity, transparency and security, he says, and brokers are regulated by the Financial Conduct Authority, so have an obligation to provide best execution, the keenest price, and security of client funds.

Unlike forward trading, options give you the right, but not the obligation to trade, he explains. "When purchased for grain sales, in effect, you're buying insurance cover in case the market goes against you. You've secured your right to sell at a particular price and a particular time, but still have the ability to sell your crop at a higher price if achieved when that time arises."

There are put options for when you're looking to sell, and call options if you're buying. What's more, you can buy 'out of the money' options if you want to secure a different price to what the futures market may be offering.

Here's how it works: The current price of Nov wheat is trading at around £140/t. You may not feel that the price has reached its optimum level but you worry the market may fall back to the lows of last year. In this situation, it may be wise to put a floor on the downside risk, while remaining open to further upside potential. So you buy a put option for each 100t of wheat you have to sell.


Tom Barclay believes a greater focus on price sensitivity and risk management will help the strong and informed to prosper.

'At the money' put options at £139 cost £5.75/t. You decide to go for an 'out of the money' option at £135, costing £3.95/t.

Nov comes around and the market's slumped back to £120. You exercise your option and sell your wheat at £135/t, netting £131.05.

Alternatively, an attractive offer turns up to sell your grain forward at £140/t. You sign the contract but worry the market may improve. 'At the money' call options at £140 cost £6.50. You decide to go for an 'out of the money' option at £144, costing £4.80/t.

Nov comes around and the market's soared to £160/t. You sell your grain at £140/t, but exercise your option to buy it back at £144, and then sell again at £160.

The net receipt is £151.20/t (£140-£144+£160-£4.80).

"Unlike a futures contract, the buyer of an option pays an initial premium, not dissimilar to the premium you would pay for an insurance policy," notes Tom Barclay. "There would be no further calls for funds on such a position, whatever happened in the market — if you don't want to exercise your option you just let it lapse."

With Brexit potentially exposing farmers to greater volatility with less protection, he feels more growers will turn to such mechanisms to manage the returns from their crops. "Price risk is a fact of life, however open-ended risk is unacceptable," he says.

Processed cereal imports into the EU carry a higher tariff, so changes in trade flows may result in a knock-on effect on the domestic cereals market.

► But for the most part, the effect of the majority of market mechanisms will have little overall impact on the market in the medium to long term, she believes. "If you want to limit your exposure, grow for a local market and get to understand that market better. If the main destination for your grain is a port then it may become more complicated — what size ships can it accommodate and what are their main destinations? Proximity to the EU won't change but trade routes and quality requirements may.

"But the reality is that commodities trade on price and quality, and Brexit won't change that — we have been trading at world market prices for many years. There may be potential added costs, although this could affect EU businesses we currently deal with, just as much as farmers in the UK. What we need to prepare for more than anything are some years of uncertainty, extra work and delays, but we should embrace the changes that come our way." ■