Western Beef Resource Committee *Third Edition*

Cattle Producer's Handbook

Marketing Section 840

Futures Market: Basics

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Cattle producers face a great deal of risk, not only in production but also in pricing. One technique that can be used to manage the price risk is the futures market. The focus of this article is on the basic concepts and definitions related to that market.

The Chicago Mercantile Exchange

The Chicago Mercantile Exchange (CME) was established in 1919. It is the primary livestock exchange. Cattle futures, both live (fed) and feeder cattle, are a part of the CME.

While anyone can buy or sell futures, all transactions for cattle are handled by a broker who then uses appropriate channels to carry out orders. Again, for livestock, the CME is a major player in those channels.

Futures Contract

A futures contract is a standardized agreement to buy or sell a commodity at a date in the future. It is an obligation. The contract specifies the commodity (live cattle, feeder cattle), the product quantity (40,000 or 50,000 pounds of live animals), product quality (specific U.S. grades and yields), delivery points (only for live cattle—there are no delivery points for feeder cattle), and the delivery date (within the month that a contract terminates).

The important concept to remember here is that the contract is standardized. Product descriptions are pre-set. If what you produce is different than the product described in the contract, the price quoted for the futures contract must be adjusted. That adjustment process involves basis. Both the process and basis are discussed later (also see 845, Evaluating Forward Prices with Basis).

Who Uses Futures?

Three major categories of people use futures: hedgers, speculators, and observers. The hedger uses the futures market to manage price risk for products they have or expect to have. Risk is transferred to the speculator. The speculator accepts the risk with the anticipation of earning profit. Speculators have no intentions of buying or selling actual commodities. The observer does not actively participate in the futures market (doesn't buy or sell futures) but uses the information provided in the futures market. Possible uses include establishing price outlook and evaluating other pricing alternatives.

What Is Hedging?

Hedging is buying or selling futures contracts as a protection against unfavorable price changes. A short, or selling, hedge is used when you plan to sell a commodity, such as a cattle producer with feeder cattle, at some future date. You are concerned that prices will go down. A long, or buying hedge, is used when you plan to buy a commodity, such as a feedlot needing feeder cattle, at a later date. You are concerned that prices will increase. In either case (short or long), the key is the use of "opposite" transactions. All that means is that as you are producing a product (feeder cattle), you are buying that product as you pay for inputs.

An opposite transaction on the futures market would be to sell futures. Then, when the feeder cattle are sold, do the opposite on the futures market (buy back the contract originally sold). The transaction of buying back a futures contract originally sold is called "offsetting." All transactions are made through a broker. That individual should be able to help those who are "in it for the first time."

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