Futures Market Exchanges

- 12 organized exchanges
- Two largest
  - Chicago Board of Trade (CBOT)
    » Grains, interest rates
  - Chicago Mercantile Exchange (CME)
    » Livestock, financial, currencies
  - Combined for 75% of futures volume
The futures contract

- A legally binding contract to make or take delivery of the commodity
  - Form (wt, grade, specifications)
  - Time (delivery date)
  - Place (delivery location)
  - Possession (seller delivers, buyer receives)
The futures contract

- Standardized contract
- No physical exchange takes place when the contract is traded.
- Deliveries are made when the contract expires (delivery time)
- Payment is based on the price established when the contract was initially traded.

Market Price
Standardized contract

- Certain delivery (contract) months
- Fixed size of contract
  - Grains 5,000 bushels
  - Livestock in pounds (40,000)
- Specified delivery points
  - Relatively few delivery points
Market position

- Objective: *Buy low, sell high*
- You can either *buy* or *sell* initially
  - Sell a December Corn contract
    » *Short the market*
  - Buy a February Live Cattle contract
    » *Long the market*
Futures trade on information

Why would buyers buy?
- They think that the price at delivery will be higher than it is currently.

Why would sellers sell?
- They think that the price at delivery will be lower than it is currently.
Relationship between futures and cash prices

- **Difference is call basis**
  
  \[ \text{Basis} = \text{Cash} - \text{Futures} \]

- **Grain**
  
  Typically quote the absolute value
  
  "30 cents under" = $.30 basis
  
  Cash is $.30 less than futures

- **Livestock**

  *The sign is important*
Fulfilling contract obligations

- Deliver or take delivery on commodity
- Offset initial futures transaction with a second, opposite transaction in the same contract
  - An initial “sell” is offset with a “buy”
  - An initial “buy” is offset with a “sell”

.Offset is most common
Market participants

- **Hedgers** are willing to make or take physical delivery because they are producers or users of commodity.
- **Speculators** buy or sell in an attempt to profit from price movements.
Hedgers

- Producers with a commodity to sell at some point in the future
- Short hedgers
  1. Sell the futures contract first
  2. Buy the futures contract (offset) when they sell the physical commodity
Hedgers

- Processors or feeders that plan to buy a commodity in the future

- *Long* hedgers
  1. *Buy* the futures first
  2. *Sell* the futures contract (offset) when they buy the physical commodity
Futures Speculators

- Do not have the commodity nor need the commodity
- They try to profit from price change
Trading futures

- Exchange provides the rules and enforcement
- Commodity Clearing Corporation
  - The bookkeeper and banker
- Licensed brokerage firms
  - Purchase the right to trade
  - Represent buyers and sellers
Futures Market Exchanges

- Trading pits
- Centralized pricing
  - Buyers and sellers represented
  - All information represented
- Perfectly competitive market
  - Open out-cry trading
<table>
<thead>
<tr>
<th>Brokers</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Licensed agent to trade contract</td>
</tr>
<tr>
<td>Local Broker</td>
</tr>
<tr>
<td>Seat on the exchange</td>
</tr>
<tr>
<td>- Contact with the Individual</td>
</tr>
<tr>
<td>- Receives a fee for services</td>
</tr>
<tr>
<td>$30-90 per contract</td>
</tr>
</tbody>
</table>
Commodity Clearing Corporation

- Makes good on every trade
- Settles every account at the close each day
- Notifies the brokerage firm of any changes in the individual account