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.
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*
  Basis = Cash - 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 outcry trading
Brokers

- Licensed agent to trade contract
  - Local Broker
  - Seat on the exchange
- Contact with the Individual
- Receives a fee for services
  - $30-90 per contract
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