AG-ECO NEWS

Vol. 24, Issue 11

Jose G. Peña

Professor and Ext. Economist-Mgmt.

April 17, 2008

Volatility in the Futures Market Makes Forward Pricing Very Difficult

Jose G. Peña, Professor & Extension Economist-Management

Record high energy costs and the impact they have had on biofuel demand, along with tight grain supplies and speculative investments have all contributed to record high commodity prices and high market price volatility. This explosive volatility is making it difficult for producers and commodity users to utilize the futures market as a price risk management tool.

The potential for further price increases are attracting increased trade in the futures market. The sheer volume of speculative trading in the commodities market, especially by fund traders, is causing volatile market responses, beyond fundamental supply/demand relationships and making it very difficult to forward price/contract commodities. For example, December 2008 corn futures have traded from a low of about $2.60/bu. to, currently (4.15.08), around $6.28/bu. Dec '08 cotton contracts jumped to the mid-90's in early March '08 only to drop to the low 80's a few day days later. Other commodities have experienced similar volatility. This volatility is reducing the effective use of the commodities market to forward price/contract commodities. Merchants who contract commodities are hesitant to forward contract and the high cost of trading in the futures market is affecting basis.

Fund traders almost exclusively buy contracts (go long) in expectation of selling the contract later for a higher price. The large amount of buying generally drive prices up. The contracts can then be sold back for a higher price. Elevators and other actual users of the commodities normally sell contracts (go short) as they negotiate a forward contract with sellers of commodities to help manage risk associated with the price called for in the contract.

Daily Limit

In addition, the volatility has increased the frequency of grain futures markets trading the limit up or the limit down and make it more difficult for traders to enter and exit positions. As price levels and volatility have increased, the daily price movement limits have been increased. For example, grain futures trading limits can be expanded 50% in a trading session following a session when the price of two or more futures contracts traded the limit higher or lower.

Margin Calls

The futures exchange clearinghouse, which tracks the value of each futures market trader's position and ensures that sufficient funds are available to cover each trader's obligations, requires that traders deposit money (referred to as the initial margin deposit) to ensure contract performance when they buy/sell a contract. The volatility in the grain futures market has also led to increases in initial margin requirements. These margin increases have significantly increased the transaction costs associated with hedging. Each trader's required margin money deposit is adjusted daily to reflect the gain or loss in contract value that occurred that day. Account balances in excess of margin requirements may be withdrawn but deficit balances must be offset by additional deposits, called margin calls.

As the volatility in the commodities markets has resulted in higher margin requirements and more frequent and higher limit moves, elevators and other buyers who entered into forward contracts with producers and secured their position by selling (going short) contracts in the futures market, are facing huge margin calls. For example, with Dec. '08 corn futures contracts trading at about $6.28/bu., corn which was contracted in Dec. '07 for about $5.00/bu. (the contracting merchant sold a Dec. ‘08 futures contract for $5.00/bu. to hedge the contract) would have at least a $6,400 margin call requirement (5,000 bu. contract times $1.28), in addition to the initial margin deposit, to maintain each contract. Some commodity buyers are resorting to using the more expensive options market to manage commodity prick risk. This added cost will be passed on to producers in the form of a less favorable basis.

With regard to the recent market volatility, the Commodity Futures Trading Commission (CFTC) announced it will hold a public meeting on April 22, at 9:00 a.m. to discuss factors affecting the agricultural markets, including divergence between futures and cash prices, higher margin requirements and questioning the role of speculators’ and commodity index traders’ impact on market participants.