AgriLIFE EXTENSION
Texas A&M System

Introduction to Futures Markets

History

- The first U.S. futures exchange was the Chicago Board of Trade (CBOT), formed in 1848.
- Other U.S. exchanges also began in the last half of the 1800s.
  - Kansas City Board of Trade (KCBT) traces its roots to January 1876.
  - Chicago Mercantile Exchange (CME) was formed in 1874 when the Chicago Product Exchange was organized to trade butter.
- Sellers wanted to rid themselves of the price risk associated with owning inventories of grain or butter and buyers wanted to establish prices for these products in advance of delivery.

What is a Futures Contract?

- A futures contract is a binding agreement between a seller and a buyer to make (seller) and to take (buyer) delivery of the underlying commodity (or financial instrument) at a specified future date with agreed upon payment terms. Most futures contracts don't actually result in delivery of the underlying commodity.
- Futures contracts are standardized with respect to the delivery month; the commodity's quantity, quality, and delivery location; and the payment terms.

Futures Exchanges Provide

- Rules of conduct that traders must follow or risk expulsion.
- An organized market place with established trading hours by which traders must abide.
- Standardized trading through rigid contract specifications, which ensure that the commodity being traded in every contract is virtually identical.
- A focal point for the collection and dissemination of information about the commodity's supply and demand, which helps ensure all traders have equal access to information.
- A mechanism for settling disputes among traders without resorting to the costly and often slow U.S. court system.
- Guaranteed settlement of contractual and financial obligations via the exchange clearinghouse.

The Purpose of Futures Markets

- Price discovery
  - Futures markets provide a central market place where buyers and sellers from all over the world can interact to determine prices.
- Transfer price risk
  - Futures give buyers and sellers of commodities the opportunity to establish prices for future delivery. This price risk transfer process is called hedging.

Changes in a Futures Contact's Value

- A futures contract's value is simply the number of units (bushels, hundredweight, etc.) in each contract times the current price.
- Each contract specifies the volume of grain or livestock it covers.
  - Trade grain and oilseed futures contracts cover 5,000 bushels.
  - Live cattle futures contract covers 40,000 pounds (400 hundredweight).
  - Lean hog futures contract covers 40,000 pounds (400 hundredweight).
  - Feeder cattle futures contract covers 50,000 pounds (500 hundredweight).
- The effect of a change in contract value depends on whether you previously sold or purchased a futures contract.
  - A decrease in contract value (a price decline) is a loss to anyone who previously purchased a futures contract, but a gain for a trader who previously sold a futures contract.
  - An increase in contract value (a price increase) is a gain to anyone who previously purchased a futures contract (i.e., is long), but is a loss for a trader who previously sold a futures contract (i.e., is short).

Figure 1. Marking-to-Market Buyer and Seller Accounts at Exchange Clearinghouse.

Buyer (Long)		
Date	Action	Price
Day 1	Buy at	$6.00/bushel
Day 2	No action (but price increases)	$6.10/bushel
		$0.10/bushel gain x 5,000 bushels
		$500 gain from day 1
Seller (Short)		
Date	Action	Price
Day 1	Sell at	$6.00/bushel
Day 2	No action (but price increases)	$6.10/bushel
		$0.10/bushel loss x 5,000 bushels
		$500 loss from day 1

Futures Trading Terminology

- *Long* – A buyer of a futures contract. Someone who buys a futures contract is often referred to as being long that particular contract.
- *Short* – A seller of a futures contract. Someone who sells a futures contract is often referred to as being short that particular contract.
- *Bull* – A person who expects a commodity's price to increase. If you are bullish about wheat prices you expect them to increase.
- *Bear* – A person who expects a commodity's price to decline. If you are bearish about wheat prices you expect them to decline.
- *Market Order* – An order to buy or sell a futures contract at the best available price . A market order is executed by the broker immediately. "Sell one July KCBT wheat, at the market" is an example of a market order.
- *Limit Order* – An order to buy or sell a futures contract at a specific price, or at a price that is more favorable than the price specified. For example, "Buy one March KCBT wheat at $6.30 limit" means buy one March KCBT wheat contract at $6.30 or less. In this example, the order will not be executed at a price higher than $6.30.
- *Stop Order* – An order which becomes a market order if the market reaches a specified price. A stop order to buy a futures contract would be placed with the stop price set above the current futures price. Conversely, a stop order to sell a futures contract would be placed with the stop price set below the current futures price.

Using Futures Contracts in a Farm Marketing Program

- Futures contracts can be useful when marketing grain or livestock because they can be a temporary substitute for an intended transaction in the cash market that will occur at a later date.
- Futures contract prices can be used as a source of price forecasts. A futures contract price represents today's opinion of what a commodity's value will be when the futures contract expires. If a history of the difference between a commodity's futures contract and cash prices, for a particular grade and specific location of interest (known as the basis) is available, it can be used to estimate a futures market-based cash price forecast.