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11-28-2018

Do We Need More Futures Contracts in Commodity Markets?

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Cornhusker Economics

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Market Report	Year Ago	4 Wks Ago	11-24-18
<u>Livestock and Products.</u>			
<u>Weekly Average</u>			
Nebraska Slaughter Steers, 35-65% Choice, Live Weight.....	120.50	115.00	117.01
Nebraska Feeder Steers, Med. & Large Frame, 550-600 lb.....	180.17	172.62	172.26
Nebraska Feeder Steers, Med. & Large Frame 750-800 lb.....	165.83	160.01	150.03
Choice Boxed Beef, 600-750 lb. Carcass.....	208.70	211.50	213.76
Western Corn Belt Base Hog Price Carcass, Negotiated	57.03	58.38	49.32
Pork Carcass Cutout, 185 lb. Carcass 51-52% Lean.....	81.14	75.57	65.86
Slaughter Lambs, wooled and shorn, 135-165 lb. National.....	NA	135.62	NA
National Carcass Lamb Cutout FOB.....	388.34	378.61	376.40
<u>Crops.</u>			
<u>Daily Spot Prices</u>			
Wheat, No. 1, H.W. Imperial, bu.....	3.14	4.46	4.25
Corn, No. 2, Yellow Columbus , bu.....	3.11	3.34	3.34
Soybeans, No. 1, Yellow Columbus , bu.....	9.03	7.32	7.57
Grain Sorghum, No.2, Yellow Dorchester, cwt.....	5.42	5.30	5.25
Oats, No. 2, Heavy Minneapolis, Mn, bu.....	2.83	3.16	3.12
<u>Feed</u>			
Alfalfa, Large Square Bales, Good to Premium, RFV 160-185 Northeast Nebraska, ton.....	162.50	108.00	*
Alfalfa, Large Rounds, Good Platte Valley, ton.....	80.00	105.00	110.00
Grass Hay, Large Rounds, Good Nebraska, ton.....	80.50	87.50	87.50
Dried Distillers Grains, 10% Moisture Nebraska Average.....	142.00	135.00	160.00
Wet Distillers Grains, 65-70% Moisture Nebraska Average.....	42.00	48.50	49.75
* No Market			

In the last couple of months, there has been news about a new futures contract for soybeans. The Financial Times and Reuters, among others, reported that the CME Group, the world's largest futures exchange, is considering launching a futures contract based on Brazilian soybeans. The discussion seems to have started after trade issues between the United States and China resulted in a 25 percentage-point tariff on U.S. soybeans exported to China. As Chinese buyers try to avoid the tariff by purchasing grain from other suppliers, notably Brazil, a new price dynamics between U.S. and Brazilian soybeans could be emerging. This raises the question of whether there would still be enough price correlation between the two countries for Brazilian producers and merchandisers to use the Chicago futures contract to hedge their soybean transactions. If the soybean price in Brazil is really becoming less correlated with the soybean price in the U.S., the local basis in Brazil will be less predictable and hence the hedging with Chicago futures contracts will become relatively less effective.

A similar idea came out in the early 2000's, which resulted in the Chicago Board of Trade (which is now part of the CME Group) eventually launching its South American soybean futures contract in May 2005. The new futures contract had delivery points in Brazil and hence was expected to reduce basis risk for Brazilian hedgers compared to the traditional soybean futures contract at the Chicago Board of Trade. However, the contract never attracted many producers and merchandisers with commercial interests in Brazil, and neither had it attracted many speculators. Since this contract never gained much trading activity, it was terminated after a while.

One of the main issues with the South American soybean futures contract created in 2005 was the same that afflicted other new futures contracts in history, which is the inertia of liquidity. The success of futures markets in commodities, equities, currencies and other asset classes relies, among other things, on the fact that it concentrates in the same place a large number of buyers and sellers willing to do business. This is actually one of the main reasons why futures markets were created a long time ago, i.e. to offer buyers and sellers a centralized marketplace where it would be easier and faster to find someone to trade with at a price that was satisfactory for both sides of the trade.

However, when new futures contracts are created, traders are often cautious in the beginning, and they do not trade as heavily as they would in more established futures contracts. They still want to learn how the new contract works, who is trading there, how the prices for the new contract behave, how much they can trade without moving the market, and so on. But if nobody really starts trading more heavily until others do, trading activity will never pick up. This is what commonly happens with new futures contracts, and also one of the main reasons why many of them are eventually terminated.

Is it common to have more than one actively traded futures market for agricultural commodities?

In the world of agricultural commodities, there is typically one futures contract for each commodity. It is unusual to find more than one futures contract on the same commodity (except for commodities with different varieties, such as wheat and coffee), mostly because of the liquidity issue that we discussed above. Still, in 2012, the Intercontinental Exchange (ICE) tried to create more competition in the market by launching futures contracts on corn, wheat, soybeans, soybean meal and soybean oil, which had already been trading in the CME Group for several decades. All of the ICE new contracts resembled the futures contracts traded at the CME Group and were actually based on the CME Group's own prices. The ICE tried to gain some market share in the futures trading for grains and oilseeds by offering essentially the same futures contracts as the CME Group, but with extended trading hours and lower margin requirements. Again, traders chose to wait and see what others would do before they started trading and it turns out that these contracts never attracted much trading activity and were eventually terminated last summer.

An old adage in futures markets says, "Liquidity begets liquidity". Markets with high trading activity will often attract more traders, while markets with low trading activity will rarely attract more traders. For any new futures contract, the main challenge is how to attract enough traders to create sufficient activity that will encourage other traders to join the market. For example, if a new soybean futures contract is created, traders (both hedgers and speculators) will

essentially be asking the questions: "Can the new contract give me something that the existing contract cannot?" and "Will I benefit from the new contract even if it may not be as highly traded as the existing contract?" (Some interesting readings about this topic can be found in [1, 2, 3]).

New developments in different commodity markets may create more interest in new futures contracts over time. For example, a recent article about the wheat market discusses how the decline of U.S. share in production and exports and the emergence of former Soviet Union countries (specifically Russia, Ukraine and Kazakhstan) as large exporters may be changing the price dynamics in the world market [4]. The growing importance of wheat production in Europe would make local supply and demand relatively more relevant to determine wheat prices in Europe. Hence, European producers and merchandisers would naturally seek a futures contract based in Europe, which should better reflect their supply and demand conditions and should allow them to manage their local basis more effectively. The article argues that this is one of the main reasons behind the increase in trading activity for the futures contract on milling wheat offered by the Euronext exchange in Paris in recent years. The U.S. futures markets for wheat are still the central stage for wheat pricing in the world market, but the Europe-futures market for milling wheat has also become an important pricing platform.

Another example could be the futures contracts for agricultural commodities in China, such as the ones traded at the Dalian Commodity Exchange (DCE). The growing participation of China in the world market for commodities (such as corn and soybeans) resembles the case of wheat discussed above, although in much larger magnitude. However, there are restrictions for foreign traders who want to trade in futures markets in China, which limits the ability of these futures markets to become active pricing platforms for commodities in the world market.

Back to the idea of a South American soybean futures contract: Do we need another futures contract for soybeans?

The general notion that recent trade disputes have affected the price dynamics in the soybean world market and hence "destabilized" the relationship between U.S. and Brazilian prices would, in principle, justify looking into a new futures contract to hedge Brazilian soybeans. However, it is not yet clear what lies ahead. If trade disputes are resolved and we return to the "traditional" price dynamics between U.S. and Brazilian prices, there may be no need for a new futures con-

tact. If trade disputes persist, a new futures contract may be useful depending on how the new price dynamics develop.

Looking ahead: May there be room for a new futures contract for corn?

The discussion about the potential for a new South American soybean futures contract brings to mind the changes that have been taking place in the corn market. In the last 10-15 years, Brazil has emerged as a major producer and exporter, as has the Ukraine more recently. The growing participation of Brazil and Ukraine and relatively smaller share of the United States in the world market raises the question of whether U.S. markets are still the central stage for corn pricing in the world. Although the answer is still likely to be yes, this could be changing in coming years. Recent articles that looked into the price dynamics in the corn market suggest that Brazil and Ukraine are already becoming more influential in corn pricing in the world market [5, 6, 7, 8]. If this movement continues in the future, in a few years we may be reading about ideas to launch new futures contracts for corn based in South America and/or Europe (or about increasing trading activity in the corn futures contracts already offered by B3 in Brazil and Euronext in France).

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