Changing Emphases in Futures Markets and Ways and Means to Improve Them

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Cattle, hogs, and fresh egg futures markets are new departures in the field of futures trading. Two of these new markets established by the Chicago Mercantile Exchange are working and the third is not. I wish to look at some of the new concepts and at the things that may be needed to assist in the success of the new markets.

At the outset, I should like to commend the Chicago Mercantile Exchange for the innovations made in recent years. These have been forward-looking steps that have already enhanced the position of the exchange (and the value of the memberships). You should continue to look ahead, to change, and to improve.

New Concepts. Although we have long looked at futures markets as risk shifting and pricing arrangements, they are, in the final analysis, financial institutions. Their business is furnishing equity capital. Historically, futures markets have been mainly concerned with furnishing capital for carrying inventories of stored commodities. This has been accomplished by hedging in which risks of price change associated with stored commodities have been shifted from hedger to speculator. This shifting has enabled the hedgers to borrow from the banks at prime rates of interest. The equity capital with which price changes are absorbed is furnished by the speculators who buy the hedges.

The new game, recently started, is the equity financing of production. It has been brought about by the increasing commercialization of agricultural production that has greatly reduced the abiltiy of primary producers to carry the risks of price change.

FUTURES TRADING IN LIVESTOCK

Agriculture is changing rapidly. Production is becoming more specialized, concentrated and commercialized. Out-of-pocket costs are becoming a higher proportion of total costs. Producers are using an increasing proportion of total costs. Producers are using an increasing proportion of borrowed capital. Farms, those engaged in poultry and livestock production in particular, are becoming factories that buy a high proportion of their inputs. They are operating on increasingly thin margins. Thus, change in the selling price has a major effect on net return. A moderate change in the price can easily halve or double the net profit. Because of these changes, primary producers are losing their ability to carry risks of price change in advance of the production process and are looking for ways to produce at firm contracted prices.

This method of – reducing producer risks – is coming to the forefront, is forward pricing through futures trading. As this system grows and expands, products will be produced at firm prices for delivery on completion of production. As this occurs the capital to finance production will be forthcoming at minimum interest rates.

The equity capital necessary to carry the risks of price uncertainty and variability is furnished by speculators. Studies of the older futures markets indicate that speculators furnished this capital at very low or even negative rates of return. It appears that speculators, as a group, lose money or at best break even minus the cost of commissions. They do this because of the leverage that minimum margin requirements makes possible. They hazard a small amount of money in exchange for the chance to make a large amount.

As capital to finance producers is furnished at minimum rates, the competitiveness of producers is increased. They are freed to concentrate on efficiency of production. A workable system of forward pricing of production will lower cost just as a hedging system for stored commodities has increased marketing efficiency. This is economic progress and contributes to the welfare of the nation.

The most important single problem in agriculture is the expansion of markets. As markets for products expand, more resources, especially people, can be retained to carry on agricultural production. Our agricultural markets are no longer based on the necessity to consume food; rather they are based on the desire to eat better food. The markets in which we sell no longer need to consume only those foods that can be produced efficiently. Our productive capacity, can direct the marketing production system to furnish the products that are most wanted. Agriculture now responds to orders from consumers. At such a time, market growth is dependent upon good merchandising and new product development.

Price stability is essential to good merchandising programs. One problem that we have had in the past in increasing consumer expenditures is variable prices. This has been, and is, particularly true of the livestock and poultry sectors. Price stability should be maximized. It is not possible to totally stabilize price. There are vagaries of nature, changes in technology, changes in consumer behavior, and inadequacies of knowledge that make some price variation inevitable if prices are to direct the production-consumption system. Yet maximum price stability must be our goal. The fundamental goal of futures trading must be a set of prices that so effectively guides production and consumption that prices remain stable. Futures markets live on price variability. Their goal must be to put themselves out of business.

Speculators. The equity capital for production is furnished by speculators to the extent that producers forward contract through futures markets. By doing this the speculators gain control of production. The forward prices that are established by trading between producers and speculators order and direct production. As the distant futures prices are bid up by the speculators, production is increased. And as they are lower, production is retarded. Speculators control prices to the extent that producers and buyers contract forward.

The responsibility for price stability rests on speculators in futures markets. The quality of the job that they do will ultimately determine the success or failure of the markets in achieving the broader objective of price stability.

It is true that speculators will carry the risks of the price variation, sometimes profiting and sometimes losing, whether they do a good job of pricing or not. But this only partially improves the performance of the system. Major attention must be paid to improving the quality of the job that speculators do.

The intention of every speculator is to make money. The success of the speculator depends upon his ability to forecast prices. There are other considerations in successful speculation, but the forecasting of equilibrium prices is fundamental and determining in a fully competitive market. They must analyze the quantities that will be consumed at a series of prices at specified times in the future – specifically the delivery months. They must analyze the quantities that will be furnished at a series of prices at the same times in the future. The intercept of these two schedules, demand and supply, is the resultant forecast. They must not be unduly influenced to the extent that they project the current supply, demand, and price situation into forecasts of prices at future times, however. In contrast to the inventory hedging markets, these new markets are truly forward contracts markets; they are supply determining.

To the victor belongs the spoils; to the more skilled forecasters will go the profits and to the less skilled will go the losses. As the speculators, as a group, become more skilled, the less it will be necessary to adjust prices as the forward contracts mature and the more stable prices will become; and less will be the remaining profit opportunities.

What the market must do. All of this is by way of a preface to what the market must do to achieve its full potential. I shall list two principal things. First, it should teach forward contracting through futures trading to producers, buyers, processors, and distributors. The history of most futures markets is that they are built on forward contracting – hedging; that the need to shift risks comes first and where there is risk and price variability speculation follows.

This is a big teaching job and requires a large and continuing effort. Producers in particular must be taught to contract forward, the way in which their trading activities are related to their production operations, the relationship of *their* cash prices to futures prices, and how to account and relate profits and losses. This is what this study conference has been about. More importantly, they must be taught not to speculate. The exchange and such public agencies as the Cooperative Extension Service can do some of this teaching, but the bulk of the effort must be made by the commission merchants. They are the only ones who can do the job because they are the ones who directly profit from the generation of new business.

Second, the market must help speculators make money. Speculators must be furnished a flow of information that can be used in forecasting and they must be taught to use the information in making forecasts. Unfortunately, before these things can be accomplished someone must learn what information is pertinent and how to use it. Then the speculators must be taught to avoid mistakes in capital management, from letting mistakes in forecasting become too expansive, and from over-trading. (This) latter is necessary if the lives of the speculators are to be preserved long enough for them to learn to forecast; keep them alive first and then teach them to forecast.

What the market offers. The development of the new livestock futures offers opportunities for improvement and profit to many segments of the livestock and meat production, processing; and distribution industry.

First, the market offers producers an opportunity to contract forward at firm prices; an opportunity to produce at profitable rates of return, or to refuse to produce. It takes the age old uncertainty of gross revenue out of production. In the past, studies of factors affecting the profitability of livestock enterprises have indicated selling price or feeding margin as the single most important consideration. The ability of the producer to speculate has been a major factor in success or failure. Price uncertainty can now be substantially reduced and nearly ended by the use of futures markets. Producers can now turn full attention to increasing efficiency of production. This particularly includes the opportunities to expand production units without restriction by risk bearing ability and capital rationing. Second, the futures markets offer producers as a group an opportunity to stabilize production variations and increase the size of their markets. Increased production efficiency will lead to lower cost which in turn leads to lower prices and larger markets.

Livestock production has been notorious in the past for seasonal and cyclical variation. Production responses have been based on *current* market prices, and feeding ratios. As producers learn to respond to forward prices, expanding as profitable forward prices are offered and contracting as forwards prices are not profitable, the cobweb cycles should be reduced. The complete elimination of cycles will depend upon the skill that speculators achieve in forecasting supply and consumption responses to prices. Experience with the older markets suggests that as the speculative base is broadened through futures trading the quality of the speculative job will be improved.

Reduction in cyclical variation in production will result in increased efficiency in production and processing. It will be possible to use facilities at a higher percentage of capacity; with cyclical variation, some processing capacity is idle much of the time.

Reduction in cyclical variation will result in increased market size. As noted, consumers do not really need much of the livestock products that we are able to sell them. Merchandising programs to increase sales are more effective as supplies and prices are stable.

Third, futures markets offer money lenders — bankers — security for loans to a much greater extent than has been the case in the past. The producer who sells futures contracts has much greater income security than the one who does not. I think that the strongest influence in getting producers to use futures markets will be the requirements of bankers in financing production.

Fourth, futures markets offer processors stable supplies. It will, indeed, be unfortunate if meat packers buy futures with the intention of taking delivery. More likely and better, they will contract for cash supplies on fixed delivery schedules, and hedge these forward purchases in futures. This appears to be the way that the hog market is developing.

Fifth, futures markets offer distributors an opportunity to develop merchandising programs without the risk of price increases. I should expect this use of futures to be limited because it leaves distributors vulnerable to the risks of price declines.

Sixth, futures markets offer speculators new opportunities for profit. By the same token they offer speculators new opportunities for losses. But this is the kind of world in which speculators live and thrive.

There has been a great deal of effort put into forecasting the supply, demand, and price of livestock and meat. Much useful work has been done, but the results are far from accurate. There is room for improvement and the opportunity for speculative profits will provide the incentive. During the past two years, much new information and analysis of beef cattle prices has come into being. We will see more as speculators increasingly tackle the job.

In this discussion, I have tried to emphasize the role of the speculator and his needs. For altogether too long we have sold futures trading on the basis of risk shifting and treated the speculator as a necessary evil. If these new futures markets simply serve as a means of shifting risks, only a part of their potential will have been achieved. I think that the greater contribution of futures trading is toward more stable prices. And this is the role of the speculator.

Concern with growth. I think that my concern with the future of futures trading is readily apparent. I trust that I have made my enthusiasm for the new developments equally apparent. It is incumbent on all of us who work in this area to promote widespread use by producers, processors, and distributors as well as to assist in the development of a large group of competent speculators.

There are three routes that we can go in the pricing of agricultural products in the increasingly commercial agricultural world; three routes in the search for greater price stability. First, toward governmental price establishment, second, toward vertical integration and dominance by a small number of large firms, and third, toward larger futures markets. I think that in the third direction lies the maximum competitive efficiency and maximum individual opportunity and freedom.

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