Section 1

Introduction to Futures and Options Markets

Chapter 2: Cash and futures markets

Learning objectives

- The difference between a cash and futures markets, contracts and trading
- The difference between futures and forward contracts
- Types of orders

Key terms

Cash market: Anywhere that buyers and sellers meet to agree to terms of a contract.

Nearby market (aka "spot" market): The trading of cash contracts that call for immediate delivery.

Deferred market: The trading of cash contracts that call for later delivery (often months later), often called forward or "to-arrive" contracts.

Futures market: A commodity exchange where futures contracts are traded.

Market order: An order to buy or sell promptly, at the first available bid or offer.

Limit order: An order placed to buy or sell a commodity at a specific price (or better).

The evolution of futures trading is a great story that started in a developing frontier that would eventually be known as the Corn Belt. To appreciate the development of futures trading, we need to understand the difference between cash and futures markets.

Cash vs. Futures Trading

There are two types of grain markets where the trading of contracts occurs; cash and futures markets. A cash market is where the trading of cash contracts occurs, which involve the purchase or sale of the actual commodity for immediate or later delivery. A typical cash contract calls for immediate delivery in the nearby or "spot" market. A cash contract that calls for forward delivery is often called a forward or "to-arrive" contract.

Cash markets are informal and exist wherever a buyer and seller can agree to terms on a contract. This can be in the manager's office at a local grain elevator or over the phone. Today, there are also a number of electronic cash trading platforms, where grain producers can make offers and grain buyers submit bids. Negotiated by buyers and sellers, the terms of a cash contract – amount, quality and timing – are unique to each contract. Cash contracts are nearly always completed with the physical delivery of grain. This can be delivery from the farm to an elevator, from an elevator to a processing facility, or from an export elevator to a country overseas.

While cash markets and trading occurs everywhere, the trading of grain futures contracts is limited to a handful of organized exchanges, often called futures markets. Unlike a cash contract, the terms of a futures contract are standardized. The only aspect of a futures contract open to negotiation is price. Possibly the biggest distinction between cash and futures trading is in delivery. While a cash trade nearly always ends with physical delivery, most futures contracts are offset before delivery, and do not result in physical delivery.

Futures trading in grain markets is very active, yet rarely ends in delivery. Is it possible that futures trading occurs for reasons other than physical delivery? Yes! Cash markets and the trading of cash contracts exist to move grain from sellers to buyers. Futures markets and the trading of futures contracts are there for price discovery. Futures markets are often the central pricing mechanism for commodities, and cash prices are often quoted in relation to the futures market. Futures contracts also provide for risk management.

Know the difference between futures and forward contracts

Terms can be confusing, and many people confuse a "futures" contract with a "forward" contract. While they sound similar, these are distinctly different contracts. Differences include....

1. Futures contracts are traded on a limited number of organized exchanges. Forward contracts - cash contracts for delivery in the future - are traded wherever a buyer and seller can agree to terms.
2. The terms of a futures contract are standardized, while the terms of a forward contract (like all cash contracts) are negotiated between buyer and seller, and unique to each transaction.
3. Futures contracts are usually not satisfied by delivery (about 1% of grain futures contracts end in delivery). Forward contracts end in delivery.

Types of Orders

To trade futures contracts, and for many cash contracts, you need to place an order to buy or sell. Commodity Challenge offers you the chance to place market or limit orders. A market order is an order to buy or sell promptly, at the first available bid or offer. Verbally, a buyer would place a market order by saying, "buy 2 contracts of March corn futures at the market." When trading is active in a futures market, orders are often filled at a price very close to the most recent quote. However, there is a risk of getting an order filled at a less than satisfactory price when markets are moving fast or are not actively trading.

Limit orders specify a price for executing a contract (in CC, this is noted as the "Set Price" option when placing orders). While it offers the trader more control, they run the risk of not getting the order filled. All limit orders placed in Commodity Challenge are active until they are filled or cancelled.

Which contract should you buy?

When placing an order to buy futures contracts (buying futures is a way to hedge the cost of grain to be purchased for feed), you must choose the delivery month and contract year to buy. In the "Select Market" tab, you will be presented with many choices. In the corn market, for example, there are five delivery months for each year; March, May, July, September and December (we will discuss the reason for these months in a later segment).

If you are placing an order to buy corn futures in April 2015, you will see the following contract choices…

- May'15
- Jul'15
- Sep'15
- Dec'15
- Mar'16
- May'16
- etc., etc.

Which contract should you select? While there is no hard and fast rule on the contract delivery month to select, hedgers typically select the contract that most closely aligns with final grain use. For example, if you buy futures contracts to price corn that you expect to feed in during the summer of 2015, you would hedge in the September 2015 contract (Sep'15). If this were a purchase to lock-in the cost of corn to be fed in the first quarter of 2016, then you would hedge in the March 2016 contract (Mar'16).

Further readings and resources

Self-Study Guide to Hedging with Grain and Oilseed Futures and Options (handbook), CME Group, April 2012 http://www.cmegroup.com/trading/agricultural/self-study-guide-to-hedging-with-grain-and-oilseed-futures-and-options.html

Exercise #2

Place a market order and a limit order in the market.

Log into a feed buyers game and place a market order to buy cash grain “At the market” (you choose the quantity). Note the cash price quote at the time you placed the order (cash and futures price quotes are on the lower let-hand side of your game dashboard). When the order is filled, compare your “fill” price to the price quote when you placed the order. Are they the same or slightly different?

Place a limit order to buy futures contracts (again, you choose the quantity). In CC, you will see this as the “Set Price” option. Note the futures price quote at the time you placed the order. The price set is your choice, but understand that you take a risk of not getting your order filled. If December corn futures are currently trading at $4.85/bu., you have a much better chance of getting filled if your “Set Price” is $4.84, rather than $4.75.

Check back later. Did you order get filled? If it did not get filled, what should you do about it? Will you wait and hope that the market rallies to reach your price, or will you cancel the order and place a new one with a set price closer to the market?