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Who Is Trading in the Futures Markets and Why It Matters – Part 1

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Cornhusker Economics

Who Is Trading in the Futures Markets and Why It Matters – Part 1

Market Report	Year Ago	4 Wks Ago	12-14-16
Livestock and Products,			
Weekly Average			
Nebraska Slaughter Steers, 35-65% Choice, Live Weight.	123.59	103.10	110.00
Nebraska Feeder Steers, Med. & Large Frame, 550-600 lb.	192.67	137.86	147.30
Nebraska Feeder Steers, Med. & Large Frame 750-800 lb.	155.17	128.01	134.63
Choice Boxed Beef, 600-750 lb. Carcass.	204.13	185.47	189.85
Western Corn Belt Base Hog Price Carcass, Negotiated	52.22	40.83	53.45
Pork Carcass Cutout, 185 lb. Carcass 51-52% Lean.	72.81	73.82	74.98
Slaughter Lambs, woolled and shorn, 135-165 lb. National.	146.14	142.05	138.97
National Carcass Lamb Cutout FOB.	362.72	352.40	352.19
Crops,			
Daily Spot Prices			
Wheat, No. 1, H.W. Imperial, bu.	3.96	2.66	2.73
Corn, No. 2, Yellow Columbus, bu.	3.44	2.94	3.13
Soybeans, No. 1, Yellow Columbus, bu.	8.39	8.91	9.38
Grain Sorghum, No.2, Yellow Dorchester, cwt.	5.86	4.50	4.83
Oats, No. 2, Heavy Minneapolis, Mn, bu.	2.74	2.85	3.02
Feed			
Alfalfa, Large Square Bales, Good to Premium, RFV 160-185 Northeast Nebraska, ton.	182.50	145.00	160.00
Alfalfa, Large Rounds, Good Platte Valley, ton.	77.50	67.50	67.50
Grass Hay, Large Rounds, Good Nebraska, ton.	87.50	65.00	65.00
Dried Distillers Grains, 10% Moisture Nebraska Average.	131.50	107.50	107.50
Wet Distillers Grains, 65-70% Moisture Nebraska Average.	50.50	41.75	43.34
* No Market			

When futures markets were created in the U.S. in the mid-1800's, market participants were mostly farmers and grain buyers looking for a tool to reduce uncertainty in their business operations. Futures contracts can be used to establish today a price for a commodity that will be delivered in the future (hedging), hence helping reduce price risk for commodity buyers and sellers. In addition, market participants can use futures prices as a reference for what the price of the commodity is expected to be in the future, thus futures markets can also be used as a price discovery tool.

Over the years, futures markets have been through several changes, generally making them more efficient and effective for hedging and price discovery. Those changes also attracted a larger and more diverse group of participants to the market, i.e. speculators who do not have any interest in actually selling or purchasing the physical commodity. Speculators see the futures market as a piece of the broader financial market and trade futures contracts as part of their investment strategy, which includes other assets as well (such as bonds, equities, and currencies). With the continuous development of financial markets, new players with different strategies emerged and also started trading in the futures markets.

For example, in the last few years we have witnessed the growth of exchange-traded funds

(ETFs) and high-frequency traders, who currently trade a sizable number of futures contracts in commodity markets. ETFs and high-frequency traders have different strategies, which affect how they trade in the market (i.e. how often they trade, how much they trade, how long they hold their positions in the market, and so on). The same idea applies to other market participants, such as farmers, grain buyers (e.g. grain elevators and grain processors), hedge funds, trading houses, and investment banks. The strategy that a grain farmer will use to trade in the futures market is very different from the strategy that a high-frequency trader will use to trade in the same futures market. Since different strategies to trade futures contracts determine buying and selling decisions, they will also influence how the futures price changes as it is affected by those decisions.

Therefore, if we want to gather a better understanding of how futures prices change over time, it is useful to understand what types of traders are in the market and how they are trading. Now we will discuss an important source of information in this matter, which is the Commitments of Traders (COT) report, and then explain how to read this report.

The COT report is released every Friday by the U.S. Commodity Futures Trading Commission (CFTC) and provides information on open interest by different types of traders in futures markets at the end of the trading session on Tuesdays. Open interest is the quantity of “open” futures contracts held by a trader. For example, if I trade a futures contract today and then close it before the end of the day, I am out of the futures market and my contract does not count as open interest. On the other hand, if I trade a futures contract today and hold it for several days, my contract will count as open interest during those days (and until I decide to close it). In other words, open interest shows how traders are positioned in the futures market and how big their positions are.

COT reports are available in two formats: short and long. As explained on the CFTC website, “The short report shows open interest separately by reportable and nonreportable positions. For reportable positions, additional data is provided for commercial and non-commercial holdings, spreading, changes from the previous report, percents of open interest by category, and numbers of traders. [...] The long report, in addition to the information in the short report, groups the data by crop year, where appropriate, and shows the concen-

tration of positions held by the largest four and eight traders”. Further, the long report shows open interest for “nonreportable” traders, who are those who trade ‘small’ quantities of futures contracts and hence are not required to report their trading activity to the CFTC.

Let us use an example from the short report to illustrate the kind of data we can obtain from the COT. Figure 1 shows a snapshot of the December 6 report for the corn futures market. The table and numbers were taken from the CFTC website, and I split it into different numbered sections by colors in order to help explain what the report is showing. Section 1 (in red, at the top of the table) presents the four categories into which traders are classified. Producer/merchant/processor/user represents traders who have an active interest in the physical commodity (e.g. producers and grain processors) and use futures contract to hedge their commitments in the cash market. This group is commonly referred to as “commercials”. Swap dealers are traders who deal mostly with swaps for commodities and use futures contracts to hedge their risk in those operations.¹ Managed money are traders that hold large positions in the futures market for speculative purposes. They engage in futures trading with the objective to make a profit for their clients. Finally, ‘other reportables’ represents all other traders outside the three previous categories. Overall, “commercials” and swap dealers are considered hedgers in the futures market, while managed money traders are considered speculators. Still in Section 1, the denominations ‘long’ and ‘short’ refer to whether traders are buying or selling in the futures market, respectively, while ‘spreading’ refers to the amount of offsetting long and short positions held by the same trader. For example, if a speculator in the corn futures market is long for March delivery and short for May delivery, these two contracts count as a spread position.

¹Generally speaking, commodity swaps are contracts where two individuals/entities agree to exchange payments (cash flows) over time. One side of the swap makes a payment to the other side depending on how the price of the commodity changes compared to a reference price specified in the contract. Swaps are typically used to hedge against a cash flow of risky payments, where the risk comes from price fluctuations of a commodity.

Section 2 (blue) shows the quantities of open futures contracts held by each type of trader in each position (long, short, spreading). In Section 3 (orange) we can see the change in open interest (measured by quantity of futures contracts) for each type of trader compared to the previous week. For example, in Figure 1 we see that managed money had 170,687 open contracts in a long position on December 6, which is 12,355 contracts less than what they held in the previous week (November 29). Section 4 (green) gives us the proportion of open interest held by each type of trader relative to the total. On December 6, total open interest in the corn futures market was 1,221,274 contracts (section 1). “Commercials” held 273,003 contracts in long positions (section 1), which represented 22.4% of

the total open interest in the market (section 4). Finally, Part 5 (purple) shows the number of traders in each category, e.g. there were 213 “commercial” traders with long positions and 304 “commercial” traders with short positions in the corn futures market on December 6.

In this article, we discussed the importance of learning about different types of traders in the futures market, and how we can obtain and understand data about that. In a subsequent article, we will discuss some approaches to interpret COT reports trying to assess the reasoning behind trading decisions from different traders, which can reflect their price outlook and provide insights on how futures prices might change.

Figure 1: Snapshot from COT report based on open interest from December 6 for the corn futures market (Source: CFTC website)

Disaggregated Commitments of Traders-All Futures Combined Positions as of December 6, 2016												
Reportable Positions												
Producer/Merchant : Processor/User : Swap Dealers : Managed Money : Other Reportables Long : Short : Long : Short : Spreading: Long : Short : Spreading: Long : Short : Spreading											1	
CORN - CHICAGO BOARD OF TRADE (CONTRACTS OF 5,000 BUSHEL)												
CFTC Code #002602											Open Interest is 1,221,274	2
: Positions												
: 273,003	574,556	271,746	4,518	13,611	170,687	236,115	52,289	190,828	53,787	113,046		
: Changes from: November 29, 2016												3
-10,285	-13,868	-5,231	-871	1,584	-12,355	-12,038	16,452	-971	7,055	-6,408		
: Percent of Open Interest Represented by Each Category of Trader												4
22.4	47.0	22.3	0.4	1.1	14.0	19.3	4.3	15.6	4.4	9.3		
: Number of Traders in Each Category											5	
213	304	23	4	17	59	61	49	96	78	105	Total Traders: 719	

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