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Cornhusker Economics

Who Is Trading in the Futures Markets and Why It Matters Part 2

Market Report	Year Ago	4 Wks Ago	11-27-17
Livestock and Products,			
Weekly Average			
Nebraska Slaughter Steers, 35-65% Choice, Live Weight.	111.14	*	120.50
Nebraska Feeder Steers, Med. & Large Frame, 550-600 lb.	149.09	179.00	180.17
Nebraska Feeder Steers, Med. & Large Frame 750-800 lb.	138.12	162.62	165.83
Choice Boxed Beef, 600-750 lb. Carcass.	186.30	198.63	208.70
Western Corn Belt Base Hog Price Carcass, Negotiated	42.23	65.38	57.03
Pork Carcass Cutout, 185 lb. Carcass 51-52% Lean.	72.87	74.13	81.14
Slaughter Lambs, woolled and shorn, 135-165 lb. National.	NA	144.53	NA
National Carcass Lamb Cutout FOB.	357.09	396.62	388.34
Crops,			
Daily Spot Prices			
Wheat, No. 1, H.W. Imperial, bu.	2.81	3.21	3.14
Corn, No. 2, Yellow Columbus , bu.	3.08	3.10	3.11
Soybeans, No. 1, Yellow Columbus , bu.	9.43	8.85	9.03
Grain Sorghum, No.2, Yellow Dorchester, cwt.	4.78	5.65	5.42
Oats, No. 2, Heavy Minneapolis, Mn, bu.	2.76	2.99	2.83
Feed			
Alfalfa, Large Square Bales, Good to Premium, RFV 160-185 Northeast Nebraska, ton.	NA	147.50	162.50
Alfalfa, Large Rounds, Good Platte Valley, ton.	70.00	83.75	80.00
Grass Hay, Large Rounds, Good Nebraska, ton.	80.00	85.00	82.50
Dried Distillers Grains, 10% Moisture Nebraska Average.	107.50	122.50	142.00
Wet Distillers Grains, 65-70% Moisture Nebraska Average.	42.75	43.50	42.00
* No Market			

In a previous article (*Who Is Trading in the Futures Markets and Why It Matters – Part 1*, 12/14/2016), we discussed the importance of learning about different types of traders in commodity markets and how we can obtain and understand the Commitments of Traders (COT) report, which provides data on traders' positions in futures markets. Today 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.

Once we have the COT data and see the size of long (buy) and short (sell) positions held by different types of traders, there are several ways to explore them in order to gather a better understanding of what those traders are doing in the futures market and assess what their price outlook might be. We can look at how open positions change over time, i.e. how long and short positions get larger or smaller over time. When traders start buying more in the futures market, this means that long positions will become larger (when they buy to open new long positions) and/or short positions will become smaller (when they buy to offset an existing short position). Similarly, when traders start selling more in the futures market, this means that short positions will become larger (when they sell to open new short positions) and/or long positions will become smaller (when they sell to offset an existing long position).

In general, we can say that, when prices are going up, speculators go to the futures market to buy, such that they can later sell at a higher price and make a profit. And they will keep doing so until they believe the market will no longer go up. When we look at speculators' positions in the futures market, we should see larger long positions relative to short positions (i.e. long positions are becoming relatively larger compared to short positions). Note, however, that not all speculators are alike. They have different trading strategies, different trading horizons (short-run speculation or long-run speculation) and different expectations. When the market is going up, many speculators will go long (buy) as we described above. However, there can still be speculators who will choose not to buy due to their particular strategies, trading horizons and price outlook. In addition, some speculators who have short positions when the market starts going up may choose to reduce their short position instead of completely offsetting it, i.e. they may want to keep part of their short position. Therefore, there will be a growth in speculators' long positions, but there will still be some short positions as well. Further, when prices are going up, commodity producers will go to the futures market to sell (so they guarantee a "good" selling price). When we look at producers' positions in the futures market, we should see larger short positions relative to long positions (i.e. short positions are becoming relatively larger compared to long positions).

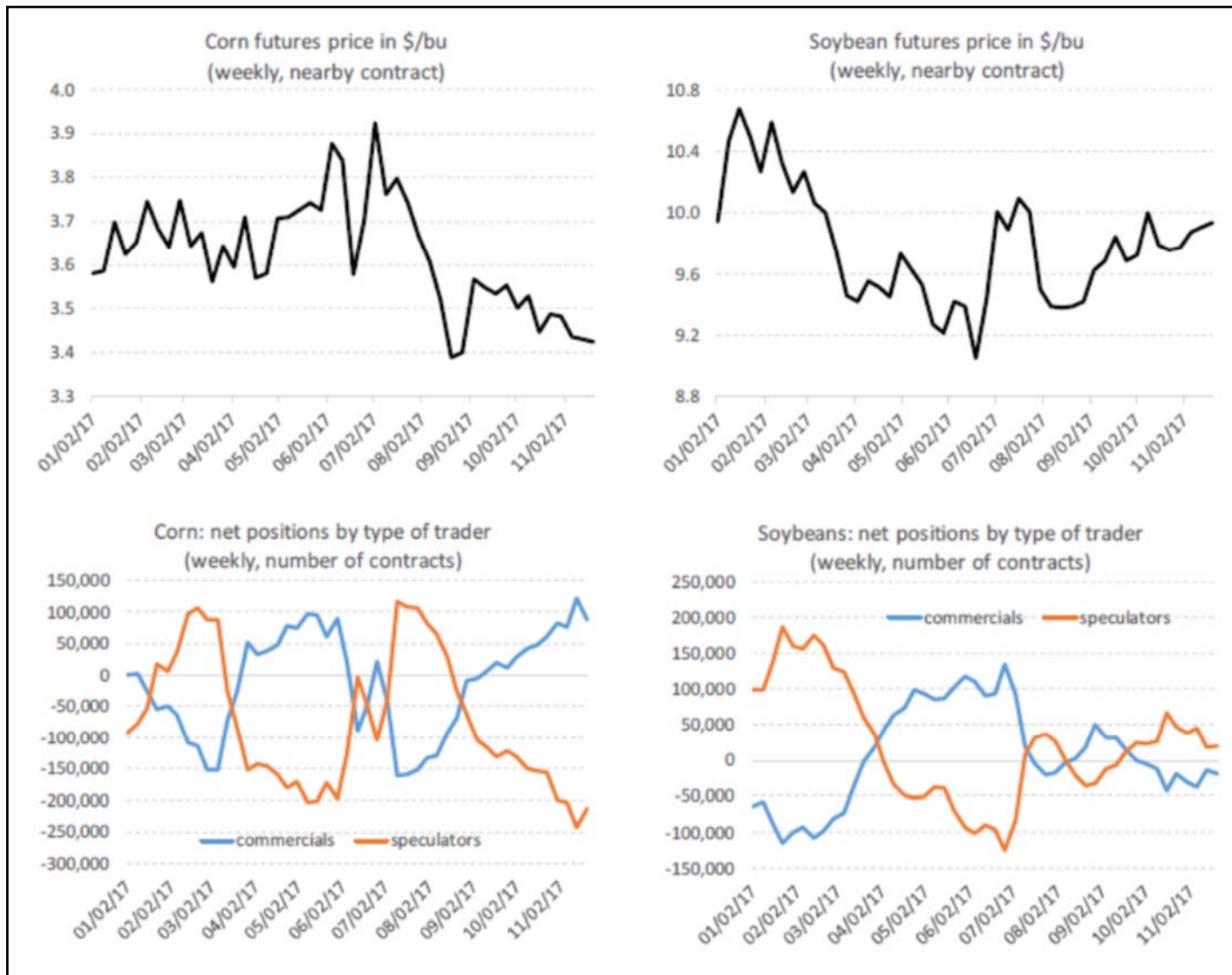
The same principle applies when prices are going down. Generally, speculators will then go to the futures market to sell (so they can later buy back at a lower price and make a profit) and they will keep doing so until they believe the market will no longer go down. When we look at speculators' positions, there should be larger short positions relative to long positions (i.e. short positions are becoming relatively larger compared to long positions). On the other hand, commodity processors who need to buy commodities to run their business will go to the futures market to buy (so they guarantee a "good" buying price). When we look at processors' positions, short positions should be getting relatively larger compared to long positions.

The figure below illustrates these ideas. The top part of the figure shows weekly futures prices for corn and soybeans since the beginning of 2017, while the bottom part shows "net positions" for commercials and speculators for the corn and soybean futures markets

during the same period. We use weekly data because COT data is only available on a weekly basis. "Net positions" refer to the difference between long and short positions. For example, if all speculators as a group hold a total of 100 contracts in long positions and a total of 80 contracts in short positions, speculators' net position is 20 contracts. Alternatively, if they hold a total of 150 contracts in long positions and a total of 190 contracts in short positions, their net position is 40 contracts. Hence, a positive net position means that there are more long (buy) contracts than short (sell) contracts for a given group of traders. If the net position is negative, there are more short (sell) contracts than long (buy) contracts. Further, the chart shows positions for commercials and speculators. Commercials are traders who have an active interest in the physical commodity (i.e. producers, merchants, processors and users) and use futures contracts to hedge their commitments in the cash market. Speculators, on the other hand, 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 themselves or their clients.

Comparing price movements and net positions by speculators and commercials (hedgers) can help us understand what is happening in the market. As we can see in the Figure, when corn prices are going down between July and November and soybean prices are going down between February and July, speculators' net positions change from positive to negative values, i.e. the number of short (sell) positions increase compared to the number of long (buy) positions. During those periods, this movement suggested that speculators believed that prices would continue going down as they chose to keep more short positions than long positions. As speculators stopped increasing their short positions, this could be an indication that their expectations changed. For example, between June and July in the soybean market, speculators' net position stayed around -100,000 contracts, after a large drop in previous months (Figure). This showed that speculators no longer wanted to increase their net short position during that time, suggesting that they were not as convinced that the price was going to keep going down. This is useful information as it may indicate possible changes in speculators' price expectations.

Figure: Futures prices for corn and soybeans (top) and net positions in the futures market for corn and soybeans by type of trader (bottom) between January 2, 2017 and November 20, 2017



Another useful information from COT data in this case is the magnitude of speculators' positions. If speculators have a net short position and they start believing that prices will go up, their strategy should be to offset their short positions and open new long positions. In order to offset their short positions, they need to buy in the futures market. And if they want to create new long positions, they need to buy even more in the futures market. Therefore, knowing the size of their short positions gives us an idea of how much buying there will be in the market as speculators start offsetting them. If they have large short positions to close out, there can be stronger buying in the market, generating extra upward pressure (even if temporary) on prices.

Similar ideas can be used to read COT data on "commercials" (our hedgers), but with an important distinction. In principle, "commercials" do not take long or short positions solely to make a profit in the futures market. Instead, they use the futures market to hedge, i.e. they trade futures contracts in combination with their trades in the cash market in order to obtain a profit for their business. Hence, it is a different mindset compared to speculators. For example, if the futures price is going up, producers will sell in the futures market in order to guarantee a "good" price for their product, and not necessarily because they believe the price will go down. One strategy followed by commercials is to average up when

prices increase and average down when prices decrease. When prices are going up, commodity producers (i.e. those who need to sell the commodities they produce) will sell at different points in time as the price continues rising. Hence, we should see commercials increasing their short positions relative to long positions when prices are going up, making their net positions become negative or less positive (see how commercials' net positions become less positive and then negative as prices go up in the Figure). On the other hand, when prices are going down, commodity processors and users (i.e. businesses that need to buy commodities to run their operation) will buy at different points in time as the price keeps falling. Therefore, commercials' net positions should become positive or less negative when prices are going down (which we can also see in the Figure).

These are some initial thoughts on how to interpret COT data to obtain a better understanding of what different types of traders might be thinking and try to assess what their price outlook might be. There are more nuances to the data that can be discussed in future articles, but one point needs to be kept in mind:

COT data on traders' positions in the futures market should be used as an instrument to help understand what is happening in commodity markets, and not as a definite signal of how prices are going to change. COT data was not designed to serve a trading tool, but rather to provide information for market participants. Besides, the four categories of traders in the report (swap dealers, producer/merchant/processor/user, managed money, and others) aggregate different individuals into broad groups of traders. We can think of producer/merchant/processor/user and swap dealers as commercials (hedgers), and managed money and others as speculators (see *Who Is Trading in the Futures Markets and Why It Matters - Part 1*, 12/14/2016). But it would be more informative to also have data for specific types of traders within each group. Still, once we combine COT data with other information available in the market, we are better equipped to understand market conditions and come up with our own assessment of future market movements .

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