Cattle Futures: Simply or Not so Simply Explained

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The term "Futures Market" is sometimes daunting because not everyone is familiar with what it represents, how it works, and how it can be used. The purpose of this short article is to address the major questions and to help readers understand the basics of the futures market as it relates to cattle.

Starting with what most people know. A cattle producer can physically sell cattle any day of the week either through an auction market, private treaty, video sale, or other venue. In most cases, cattle physically move from one operation to another on the day of the sale or shortly after the sale (one to two weeks). In other instances, cattle may be sold today but physical ownership of the animals does not change for a few months which would be the makings of a forward contract.

An example of a forward contract would be a stocker cattle producer who has 650 pound steers the producer plans to grow to 800 pound steers. The producer may choose to sell them today as 800 pound steers, while they still weigh 650 pounds, with a physical delivery date 75 days in the future. Thus, in 75 days, 800 pound steers will physically change ownership even though the price and buyer were known 75 days prior to delivery. One reason a cattle seller would use a forward contract is to capture a price if he/she thinks prices may decline between today and when the cattle will be ready for market. Alternatively, a buyer would use a forward contract if he/she thought there was risk of cattle prices increasing. It is not always possible to forward contract cattle.

The primary purpose of futures contracts is to provide an efficient method of managing price risk with a standardized contract. Understanding the aforementioned cattle marketing basics will help with understanding futures markets for cattle. There are two types of cattle traded on the futures market, "live cattle" and "feeder cattle." The "live cattle" contract is a 40,000 pound contract representing cattle ready to be harvested and that will grade 55% Choice, 45% Select, and yield grade 3. The "feeder cattle" contract represents 50,000 pounds of steers weighing 700 to 900 pounds (800 pound average) and are medium to large frame number 1 and 2 muscled. There are more contract specifics, but they are not necessary for this discussion.

The futures market is an electronic market running parallel to the local cash market for the same commodity. In the instance of feeder cattle, a producer can sell feeder cattle any day of the week at an auction market. The producer's decision to market at a certain time is often influenced by the expected price in the weeks to come. Thus, if the producer thinks prices will increase in the next few weeks then the producer may wait to market the feeder cattle in the coming weeks. Similarly, feeder cattle futures can be traded Monday thru Friday by anyone. Persons trading in the futures market buy and sell contracts based on the expectations of prices. If a person trading futures believes prices are going up as time passes then the trader will buy the contract today and sell it at a later date when the price is expected to be higher. In essence, buy low and sell high. The primary difference between the auction market and the futures market is the auction market has a physical animal that changes ownership while the futures market is trading an electronic contract and no animal has to physically change ownership. (This may be the most difficult thing to understand!)

For producers, the futures market has several uses including insight on direction of cattle prices, expected price levels, and price transparency. However, the primary use is to provide a method of managing price risk.

The futures market can be used in place of forward contracts which are not always easy to establish. The way a producer uses the futures is by operating in two markets simultaneously, the futures market and the local cash market. Consider the stocker producer with 650 pound steers who intends to sell the steers as 800 pound steers 75 days from today. If the producer could not forward contract the cattle with an actual buyer then the producer could keep growing the cattle and sell a futures contract for the month that most closely aligns with 75 days in the future. Thus, the stocker producer would sell a feeder cattle futures contract today and continue growing the cattle as intended. In 75 days, the stocker producer would sell the 800 pound steers at the local auction, through a video sale, or the normal method of marketing and at the same time buy back the feeder cattle contract that was sold 75 days earlier. This method essentially locked in a price since the futures market and cash markets are expected to move in the same direction.