NDSU Extension Service North Dakota State University | MISSISSIPPI STATE UNIVERSITY | KANSAS STATE UNIVERSITY | SDSU Extension

July 16, 2014

In The Cattle Markets

John Michael Riley, Extension Agricultural Economist
Department of Agricultural Economics, Mississippi State University

Price Risk Protection Tools for this Uncertain Market

Last week's drop in cattle futures markets were largely unsupported by the cash markets. Granted cash fed (live and dressed) prices declined an average of $2.02 and $2.43, respectively for steers and heifers. The bulk of other cash prices either held steady or moved higher with boxed beef breaking previous records on the week. Still, the occurrence created quite a stir, at least on my radar as calls were received in regard to marketing options. Many were asking if it was time to sell.

So, based on this market event and the reaction to it, a review of price risk management alternatives is warranted. Of course, managing risks does not mean eliminating all risks. The most common methods of managing price risks are: (1) futures market hedge, (2) option on futures, (3) forward contract, and (4) livestock risk protection insurance.

The first two of these involve using products offered through futures market exchanges. In agriculture, the CME Group's Chicago Mercantile Exchange or Chicago Board of Trade are the most likely establishments. Hedging with futures provides a known contract price with the risk trade-off coming in the form of an unknown final basis value (where basis is the actual cash price minus the final futures price). Hedging with futures does carry certain cash flow, or liquidity, issues with respect to potential margin requirements (a.k.a. margin calls). For instance, in the current market environment where cattle prices have increased over the past few months, a short hedge where the futures contract was originally sold, the price increase has caused the futures position to incur losses. Once the losses reach an exchange-determined threshold, more margin money is required.

An option on futures hedge can be more complicated and expensive at the onset, but once the hedge is in place (in its simplest form) it does not bring with it the potential cash flow problems of a futures hedge. Options provide an assurance of a minimum or maximum price, respectively for sellers or buyers, with the added ability to obtain a more favorable price. This flexibility carries costs, the option premium, and in a volatile market environment the premium will typically be higher relative to a more calm market. The premium is also affected by the duration of the option contract. The longer the time period of the option, the higher the premium since the market has more time to change. However, once the option is purchased, there are no margin requirements for the option buyer and therefore the potential cash flow issues are not present.

A forward contract is very similar to a futures contract hedge, but instead of utilizing a futures market exchange to handle all the contract details, the buyer and seller form their own personalized contract. This provides much more flexibility than a futures contract, whose location, quantity, and quality specifications are quite rigid. However, the two parties are

responsible for contract fulfillment and this has the potential to require legal professionals either before or after the contract is agreed upon.

Livestock risk protection is an insurance product available from the USDA Risk Management Agency via approved insurance providers. This product is available for both feeder cattle and fed cattle. The insurance is very similar to a put option (an option that provides a minimum price). These insurance products carry a 13 percent subsidy and are more flexible than an option on futures given that the number of head can vary (and the cattle type can vary for the feeder cattle product). The premium is often similar to an exchange traded option premium. However, these insurance products can only be purchased in the evening through early morning hours and the cattle must be sold within a given time frame, which can limit their attractiveness.

The Markets

Fed steers were $1.72 and $2.31 per hundredweight lower for live and dressed, respectively. Wholesale boxed beef prices reached record levels for the third consecutive week, with Choice boxes at $250.54 and Select at $242.89. However, the spread between Choice and Select is moving counter-seasonally lower. Heavy feeders were higher in the Plains with Nebraska steers showing tremendous week-over-week gains of $25.96 following sales during the July 4th week. Feedgrains continue to be pulled down by favorable conditions being reported. Corn in Omaha was 31 cents per bushel lower compared to the previous week.

Data Source: USDA-AMS Market News		**Week of 7/11/14**	**Week of 7/4/14**	**Week of 7/12/13**
5-Area Fed Steer Price	all grades, live weight, $/cwt	$155.89	$157.61	$119.75
	all grades, dressed weight, $/cwt	$247.13	$249.44	$192.70
Boxed Beef	Choice Price, 600-900 lb., $/cwt	$250.54	$247.80	$193.30
	Choice-Select Spread, $/cwt	$7.64	$7.89	$8.22
700-800 lb. Feeder Steer	Nebraska 7-market average, $/cwt	$238.85	$212.89	$154.83
	Oklahoma 8-market average, $/cwt	$221.24	$216.48	$146.60
500-600 lb. Feeder Steer	Nebraska 7-market average, $/cwt	$282.75	$262.50	$176.12
	Oklahoma 8-market average, $/cwt	$250.39	$255.13	$159.56
Feed Grains	Corn, Omaha, NE, $/bu (Thursday)	$3.74	$4.05	$7.14
	DDGS Price, Nebraska, $/ton	$135.50	$136.88	$224.10