

## 1994 Cotton Management Economic Notes

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### Forward Pricing

Upland cotton growers have forward priced about 16% of their expected production as of the end of April. This compares with only 4% booked last year at this time. All regions have followed a similar pattern of forward pricing more this year than last, except for the Western states. Western states have only forward priced 3% of their crop this year, compared to 7% at this time in 1993.

Table 1 compares hedging 100% of expected production in the first week of May with December Futures, versus a cash sale in December for recent years. As shown in the first price column, the recent December Futures price of 74.47 ¢/lb. is the highest it has ever been in the 1st week of May for recent years, not accounting for inflation. In 1987, hedging in May would have yielded .78¢/lb. more than just selling in the spot in December. But in 1991, hedging with December Futures resulted in a whopping 14.86¢/lb. more than the spot. Price levels dropped almost 15¢/lb. between May and December in 1991. On average, hedging comes out 1.99¢/lb. ahead of just cash sales. But if one takes 1991 out of the sample, cash sales in December are actually .15¢/lb. above hedging the 1st week in May.

### Developing a Market Plan

An individual's financial position, risk aversion, market outlook, and other personal preferences

Recent Prices	May 6, 1994	
	Upland Pima (ELS)	
	(¢/lb)	(¢/lb)
Spot - uncompressed	76.62	94.00
Target Price	72.90	102.00
Loan Rate	50.00	85.03
Dec '94 Futures	74.47	

Note: Upland Spot for Desert SW grade 31-3, staple 35, add 300 points for compressed bales, Pima Spot for grade 03, staple 46, 4/22/94, 1994. Phoenix Base loan rates without discounts or premiums for quality.

ences need to be accounted for in developing a marketing plan. The figure on the next page illustrates how market strategy and tools utilized will differ depending on a producer's market outlook.



**Table 1. Hedging in May vs. Cash Sale in December**

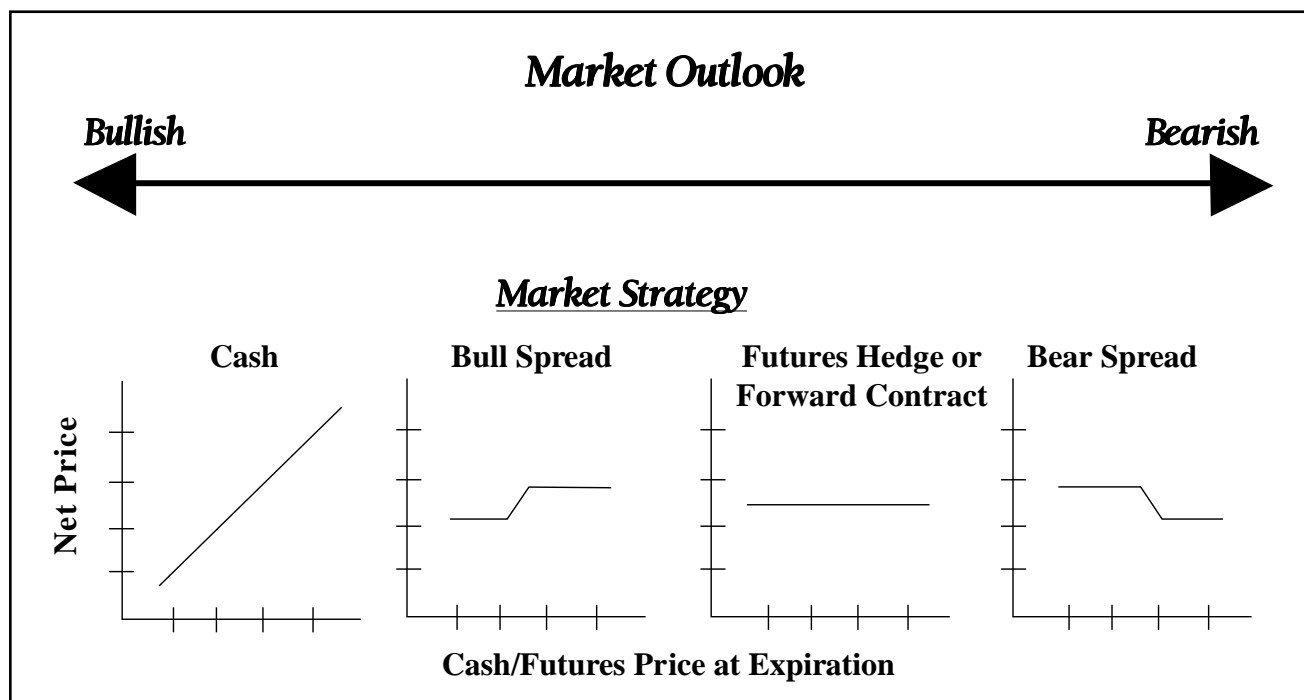
	Dec. Futures 1st Week in May	Cash Sale Price in December	Net Price from 100% Hedge in May	+ or - from Hedging
	----- (¢/lb. for 41/34) -----			
1987	66.85	67.50	68.28	0.78
1988	56.70	56.36	54.93	-1.43
1989	67.85	66.62	69.05	2.43
1990	68.37	75.49	71.15	-4.34
1991	72.05	57.19	72.05	14.86
1992	61.22	50.62	53.18	2.55
1993	61.55	53.53	52.64	-0.89
1994	74.47	?	?	?
	average 1987 to 1993 =			<b>1.99</b>

**Cash Marketing:** A bullish market outlook is consistent with the cash marketer, fully absorbing any price advances or declines. If a grower markets cotton throughout the year, the method is diversified in that an average price somewhere between the high and low price for the year is realized. But many growers are strapped for cash and pay high interest rates on borrowed funds so that they are "forced" to sell after harvest.

**Bull and Bear Spreads:** Bull and bear spreads are common market positions taken by future traders and equivalent positions are available to cotton growers. A bull spread is appealing in that a grower is protected from large price drops but can still benefit from higher prices, albeit less than the cash marketer. A grower can take a bull spread position by: 1) writing a call option (right to buy at a specified

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strike price) for say December with a strike price that is above current December Futures; and 2) buying a December put option (right to sell at a specified strike price) that is below the prevailing futures price. A bear spread is the same except that the call's strike price is specified below the prevailing market price and the put option's strike price is above the market price. Both spreads will be determined by how much the strike prices and premiums of the call and put options differ. In writing a call option, one receives a premium for taking the risk that December Futures will increase. **The premium received from writing the call option can offset all or most of the premium required for purchasing the put option.** But when writing a call option, margin monies will be required if December Futures advance above the strike price. Losses incurred when the market advances above the call option's strike price are offset by advances made from cotton that will be sold in the spot market. The put option purchased increases in value as the market declines, offsetting losses incurred from selling cotton in the spot market at a lower price and making a net price floor.

**Forward Pricing:** Forward contracting or hedging with futures are two common ways to "lock in a price." Forward contracting has a simple and straightforward approach with appeal similar to cash marketing. But contracts are no better than the reliability of the contractor and terms specified. Hedging with futures has an edge over forward contracting in liquidity. Numerous buyers and sellers trade in a competitive environment on the Exchange, insuring that a fair market price is

obtained whenever buy and sell decisions are made.

### **Precautions**

When using futures or options, a grower's net price can fluctuate from changes in the basis (cash minus futures). If the basis declines (increases) over the growing season, the net price received by the grower will decrease (increase). However, a cash marketing strategy will also feel the full brunt of a local price discount or premium.

Margin calls may be required for hedging with futures or writing a call option. Thus, it is important that your source of financing understands your hedging strategy. Also, some option contracts are thinly traded and the hedging legitimacy of writing a call option and receiving a premium may be under question by the IRS. Consultation with a tax advisor and futures broker may be necessary. Many other market tools and strategies are available than the few briefly described. The range and number of strategies available are only limited by the understanding and creativity of every marketer.

### **ERS AutoFAX**

Timely production and crop information, such as the May 10, 94/95 crop estimate, is available right from your fax machine. Using the handset attached to your fax machine, place a call to 202-219-1107 and answer voice prompts with your handset. Request document ID no. 0411 for a general directory of information available.