

Canola Futures

90% of the value of canola on any given day is derived from the futures market. Because of this, it's very important to understand how and why the futures work, and how the market can be used to your advantage.

Futures markets take a 'global' perspective on commodity values, absorbing all of the buying and selling interest at any given point in time. The function of netting out total world supply and demand into the values posted on the futures market board is called 'price discovery'.

In the case of Winnipeg Commodity Exchange (WCE) canola futures, there are western Canadian crushers, European rapeseed farmers, Japanese trading houses, Australians, domestic elevators, multinational grain companies, food manufacturers and many other players in the market. They don't trade futures with each other directly; this takes place in the 'pit' of the exchange, through brokers and floor traders.

Depending on their cash positions and/or their opinion about the outlook for prices, the various parties in the market buy or sell futures in order to protect against the risk of a change in the value of the underlying cash canola. Speculators also buy and sell canola futures, trading risk for profit potential.

Using Futures to Hedge

Trading futures can offset price risk in the underlying cash commodity, because cash and futures prices move together. For example, a farmer with canola in the bin is at risk that the price will drop before it is sold. Selling futures offsets that risk by creating a position in the market that will increase in value if prices fall.

Likewise, exporters sometimes sell canola to their end-user customers without having already bought it from farmers. This creates a risk that the price of canola will climb above the level it's been sold for, before the company is able to buy all the canola needed to fulfill the sale. Buying futures against a short cash sale protects against this risk, creating profits to offset losses the company would incur from purchasing canola at a higher equivalent price than what it had been sold for.

This illustrates the importance of a well-functioning futures contract. If the cash and futures prices of a particular commodity don't move together, there is no guarantee the profits will be there on one side to offset losses on the other, and the contract won't be a reliable tool for managing cash price risk.

Liquidity, Convergence, Delivery and Arbitrage

The main cause of cash and futures moving out of line is a lack of liquidity in the market, i.e. not enough buyers and sellers. Liquidity is measured by the volume of trade or the open interest in the futures market.

A critical mass of commercial players needs to use a futures contract for hedging and/or speculation in order for it to accurately reflect cash market dynamics. Otherwise there won't be enough interest to keep the futures price in line with actual market conditions.

Once the futures move out-of-line with the underlying cash market, commercial and speculative players become even less interested in the contract. They no longer trust the futures market to represent true value. Hedgers won't use illiquid contracts for hedging, and speculators – who need to enter and exit positions easily — find it too risky. The problem of too few players in the market is quickly compounded and usually results in a contract failing to trade.

A futures market must also converge with the cash market in the delivery month in order to work properly. This means that in the month denoted by the futures contract on the board, futures market prices come very close to cash bid prices for the same grade and quality of canola. This is achieved through the threat of delivery against futures.

Delivering grain against a futures market contract occurs when a long or short futures position is carried into the delivery month. Upon expiry, open 'longs' are matched with 'shorts' and the product changes hands, at the futures market price. Un-liquidated futures contracts thus become cash market contracts in the delivery month, and the physical product is delivered or owed to the two parties.

Because the futures prices on the board represent the market's actual valuation of the contract's specified grade of canola, cash and futures markets may be 'arbitraged'. Arbitrage opportunities arise when the cash market price is far different from the futures market price in the delivery month. For example if the cash price was far below the futures, companies could buy canola on the cash market, sell it to the futures market and pocket the difference.

Delivery of cash against futures when the two markets haven't yet converged is an example of arbitrage. 'Arbitraging' cash and futures markets drives the two prices together. In the example above, buying the cash for delivery against futures represents new demand, which drives up the price. Selling the futures against those cash purchases pushes the price down, and the spread collapses.

When cash and futures prices meet in the delivery month, the contract is said to 'converge.' Even if there are no arbitrage opportunities, the threat of delivery is usually enough to pressure cash and futures prices together.

In Summary:

Liquidity promotes an active trade in futures, which is supported by the threat of delivery. Delivery against futures facilitates arbitrage. Arbitrage will cause convergence.

Contract Specifications

The whole notion of delivery leads to the question of contract specifications. What type, grade and oil content of canola is the long going to acquire when taking delivery? All of these price-related details are factored into the specifications of the futures contract, along with transportation, storage and interest. Details on the 'contract deliverable grade' are very specific and critically important to traders.

These and other details about the canola futures contract are available on the WCE's web site at www.wce.ca.

Prepared by Brenda Tjaden Lepp, Mercantile Consulting, 947 3032.