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1992 Cotton Management Economic Notes

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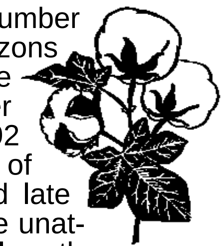
Introduction

Upland spot price quotations were down 164 points for the past two weeks ending August 7, according to statistics compiled by the Cotton Division, Agricultural Marketing Service, USDA. Domestic mill purchases were light with most of the purchases made for delivery during the fourth quarter through mid-1993 delivery. Most mills are perceived to have adequate supplies on hand until the new crop is available. Trading of Pima was light in the Desert Southwest with a small volume of grade 2 trading at 91.8 cents and grade 3 at 89.3 cents per pound. A few growers in the San Joaquin Valley contracted at 90 cents for grade 3, staple 44 or longer, and mike 35-49. The cotton crop continues to advance under warm weather conditions with good to excellent crop progress reported throughout much of the cotton belt.

Pros and Cons of Marketing Methods

Choosing a marketing strategy is a decision that all producers must come to grips with. Advantages and disadvantages of 1) cash marketing, 2) forward contracting, 3) marketing through a cooperative, 4) hedging with futures, and 5) hedging with options are discussed below.

Cash Marketing: Utilization of just a cash marketing strategy has appeal in that it is a simple approach with no "middle-men" involved and keeps transaction costs of marketing at a minimum. Also, a producer can take full advantage of any upward movement in price prior to sale. On the down side, a *producer takes full risk associated with price declines in a bearish market.* Because delivery must occur with cash marketing, the number of market opportunities or time horizons available for selling in the market are less with cash marketing than any other strategy. Thus far, the December 1992 Futures contract reached a peak price of around $.65/lb. in early January and late June. These market opportunities are unattainable to the strict cash marketer unless the market improves between now and December.



Forward Contracting: Forward contracting has a straightforward approach and simplicity with appeal similar to a cash marketing strategy. Contract specifications can be written so that a producer's net price received is known for certain when the contract is signed -- providing that quality standards are met. Pricing terms should include a schedule of discounts and premiums for quality grades, who pays for storage if contractor is unable to take delivery, a down payment, and final payment schedule after delivery. Also, a producer should insist on including an "Act of God" clause in the contract so that adverse weather events like detrimental hail would negate any obligation of requiring delivery. Making sure that a contractor is licensed and bonded is another critical checkpoint for forward contracting. If a suitable buyer and terms of trade can be agreed upon, forward contracting has great potential. However, *forward contracting is no better than the thoroughness of the contract* in covering all outcomes conceivable. Unexpected weather can result in quality and quantity shortfalls that make forward contracting very tenuous and risky for the producer unless a thorough contract is agreed upon. Forward contracting removes all risk associated with price decreases for the producer but also offers no upside price potential.

Cooperative Marketing: Marketing through a cooperative allows a producer to put all or most marketing decisions in the hands of the cooperative. Different pools allow flexibility for the amount of risk, price potential, and producer involvement in marketing decisions. The critical question each producer needs to answer is whether "the costs associated with marketing through a cooperative outweigh any benefits in the form of a higher net price received and producer time freed up from less intense marketing?" When comparing net price received, an after-tax price needs to be analyzed. A disadvantage of marketing through a cooperative is that a producer *may lose the ability to transfer income from one year to the next to effectively minimize tax*

Recent Prices **August 7, 1992**

	Upland (c/lb)	*Pima (ELS)* (c/lb)
Spot	60.41	89.50
Target Price	72.90	105.80
Loan Rate	51.15	88.15
December Futures	60.23	

Note: Upland Spot for Desert SW grade 31, staple 35;
Pima Spot for grade 03, staple 46 7/24/92; Phoenix LoanRates

Pro and Con Synopsis of Marketing Methods

Method	Advantages	Disadvantages
Cash Marketing	* Minimal selling costs. * Full benefit of price advances.	* Only sell when delivery is possible. * Full risk of price declines in market.
Forward Contracting	* Can be tailored to specific needs.	* No upside price potential.
Cooperative Marketing	* Frees time and worry. * Full time marketer may keep better in tune with market.	* May lose the flexibility to receive income in a manner that will effectively manage income tax liabilities.
Hedging With Futures	* Widely traded competitive market. * Hedging costs minimal.	* Limited upside price potential. * Basis risk. * Margin monies required.
Hedging With Options	* Allows for upside price potential. * No margin expenses.	* Premium may be costly. * Trading sometimes thin. * Basis risk.

liabilities. If cotton is sold at a marginal income tax rate of 15% instead of 0% or 28% instead of 15%, the before-tax selling price for the higher tax bracket will have to be about $.10/lb. more in order to have an equal after-tax price with the lower tax bracket. In many years the high and low price for the year will not exceed $.10/lb.

Hedging With Futures: Hedging with futures has an edge over all other hedging tools in liquidity. That is, futures contracts traded on the New York Cotton Exchange are utilized as the base point price for the world since they are so widely traded. Changes in world events and weather cause the futures market to change instantaneously. The homogeneous nature of contracts traded and equal access to market information characterize the exchange as a market close to “perfect competition.” Similar to forward contracting, hedging with futures protects a producer from decreases in the market but offers very limited upside price potential.

A decreasing basis (cash minus futures) will decrease the net price received from a futures hedge. For example, with December Futures trading at 60.25 cents/lb. and the Phoenix spot trading at 58.50 cents/lb. the current basis is -1.75 cents/lb. December Futures would be sold at 60.25 cents/lb. today and the price level is “locked in.” *The only factor that will change the final price netted after a price level is “locked in” is a change in the basis.* If the basis were to decrease to -3.00 cents/lb. in November when cotton is sold in the cash market and December Futures are bought back, the net price received would be 57.25 cents/lb. (58.5 original spot price - 1.25 decrease in basis) less about .5 cents/lb. for broker fees. However, an increase in the basis will increase the final price netted in a similar manner according to the amount of the basis increase.

Having a banker that thoroughly understands the hedging process is a must for hedging with futures. If the market increases after one has sold in the futures market, additional margin monies will need to be sent to the exchange. Because the spot price will also increase with the futures market, losses in the futures market will be made up by gains in the cash market and vice versa. Thus, both producer and banker need to understand the implications of “locking in a price.”

Hedging With a Put Option: The unique advantage of hedging with a put option is that one is protected from price declines in the market yet the opportunity to benefit from price increases is still available. Because a put option is the right to sell at a specified strike price rather than an obligation to sell, one can just let the option expire. For example, December Put Options with a strike price of 60 cents/lb. are currently bringing 2.3 cents/lb. For a “premium” of 2.3 cents/lb. (50,000 lb. contracts), an individual can purchase the right to sell cotton at 60.0 cents/lb. on the New York Cotton Exchange anytime between now and December. If December Futures drop below 57.7 cents/lb., a producer would get his premium back. If December Futures go above 60 cents/lb. the option wouldn’t be exercised, and as long as the price level increased at least 2.3 cents/lb. a producer would get his “premium” back. But if the price level jumped 10 cents/lb., a put option strategy would only perform second to a cash marketing approach--behind by 2.3 cents/lb. plus broker fees.

Because a put option is a right to sell and not an obligation to sell, no margin monies or expense are required. However, a decreasing basis will decrease the net price received with options like a futures hedge and vice versa. In a flat or stable market a put hedge will generally result in a lower net price received than any of the other strategies because of premium expenses. Also, trading of options is much thinner and for fewer time horizons than futures contracts.

Summary

Individuals have different risk preferences, financial structure, and marketing abilities so that no one marketing approach can be viewed as superior to another. However, understanding the advantages and disadvantages of all marketing tools available may be keen for survival in the 90s. Trends for *reducing government expenditures* in agriculture suggest that producers will have to *explore other means than a target price and deficiency payment for reducing the price risk* associated with growing cotton.