

2018 Agricultural Commodities Futures Conference

CME's LH Contract: Contract Design, Effectiveness and Transparency

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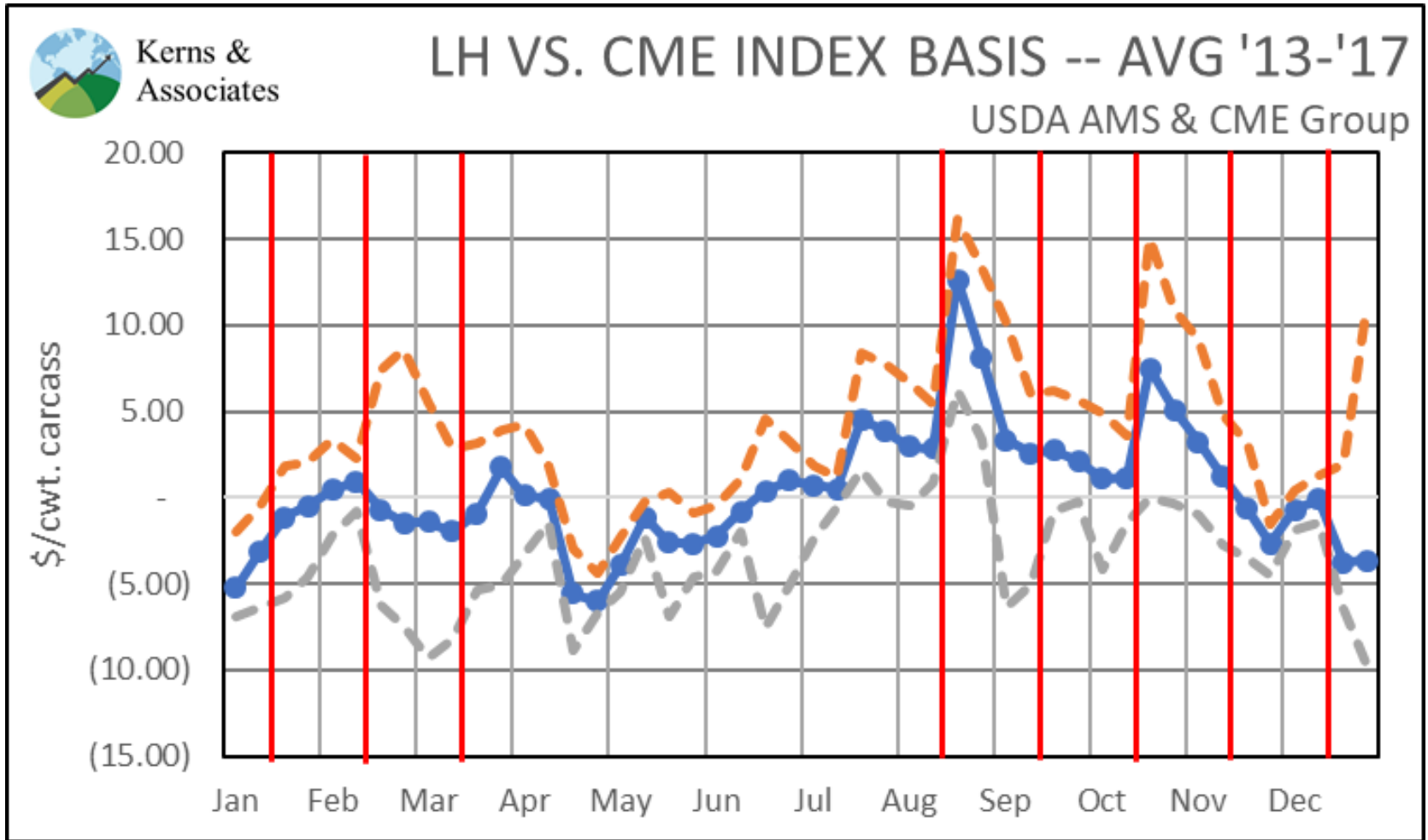
LH contract – some negative but many positives

- LH began with Feb '97 – A response to carcass weight pricing and gripes about basis
- MAJOR FEATURE: Cash settled
 - Has worked reasonably well – national/correlated market
 - Made the contract more attractive to speculators
 - Allows options to trade all the way to expiration date
- Not without concerns and faults
 - 40,000 lbs. carcass does not equal a load of hogs
 - Cash settlement => conversion on only the last 2 days
 - “Representativeness” of CME LH Index with dwindling spot market
 - Slowly becoming a cutout value contract?



There are still concerns about basis ...

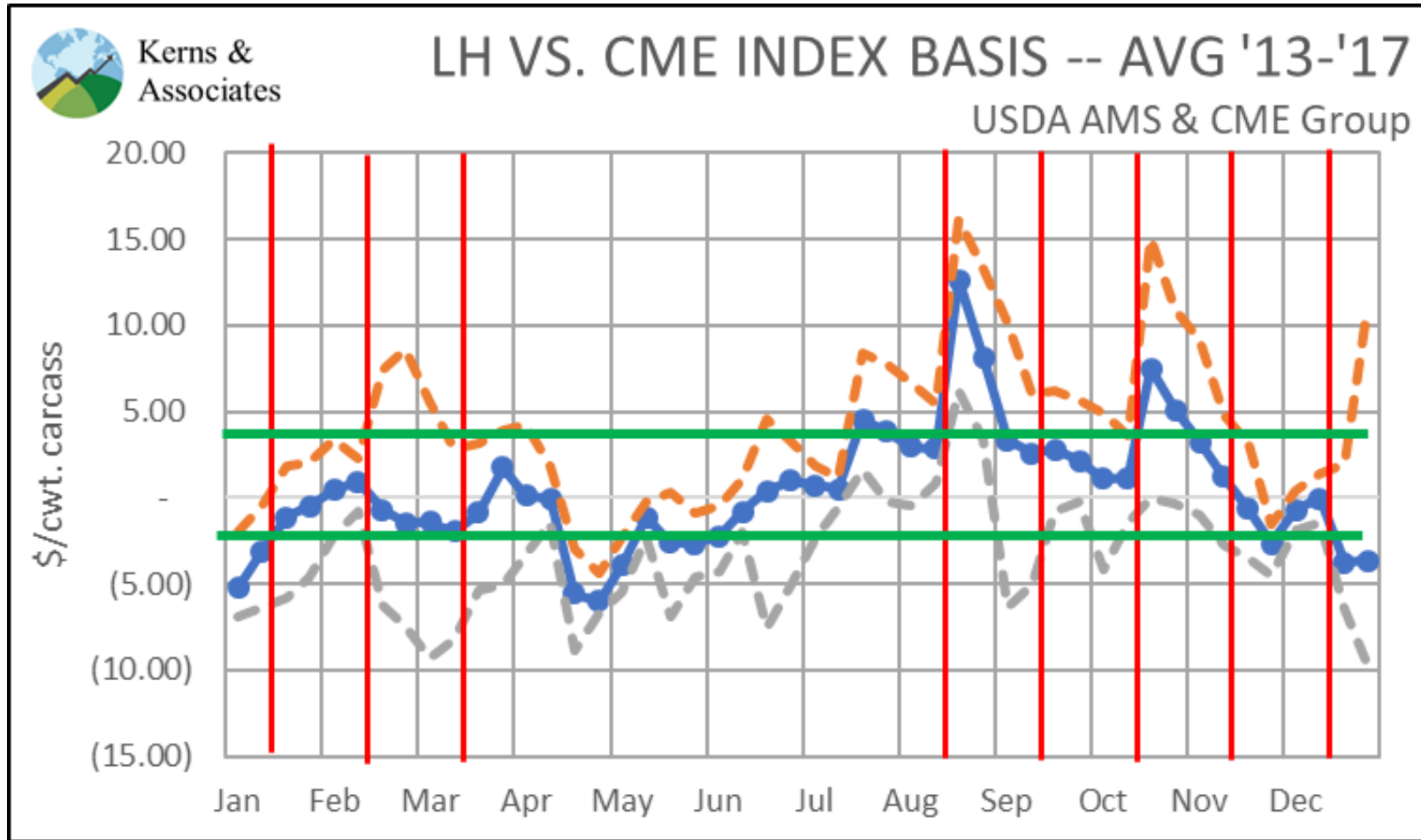
... Some based on “selective” memories of old basis



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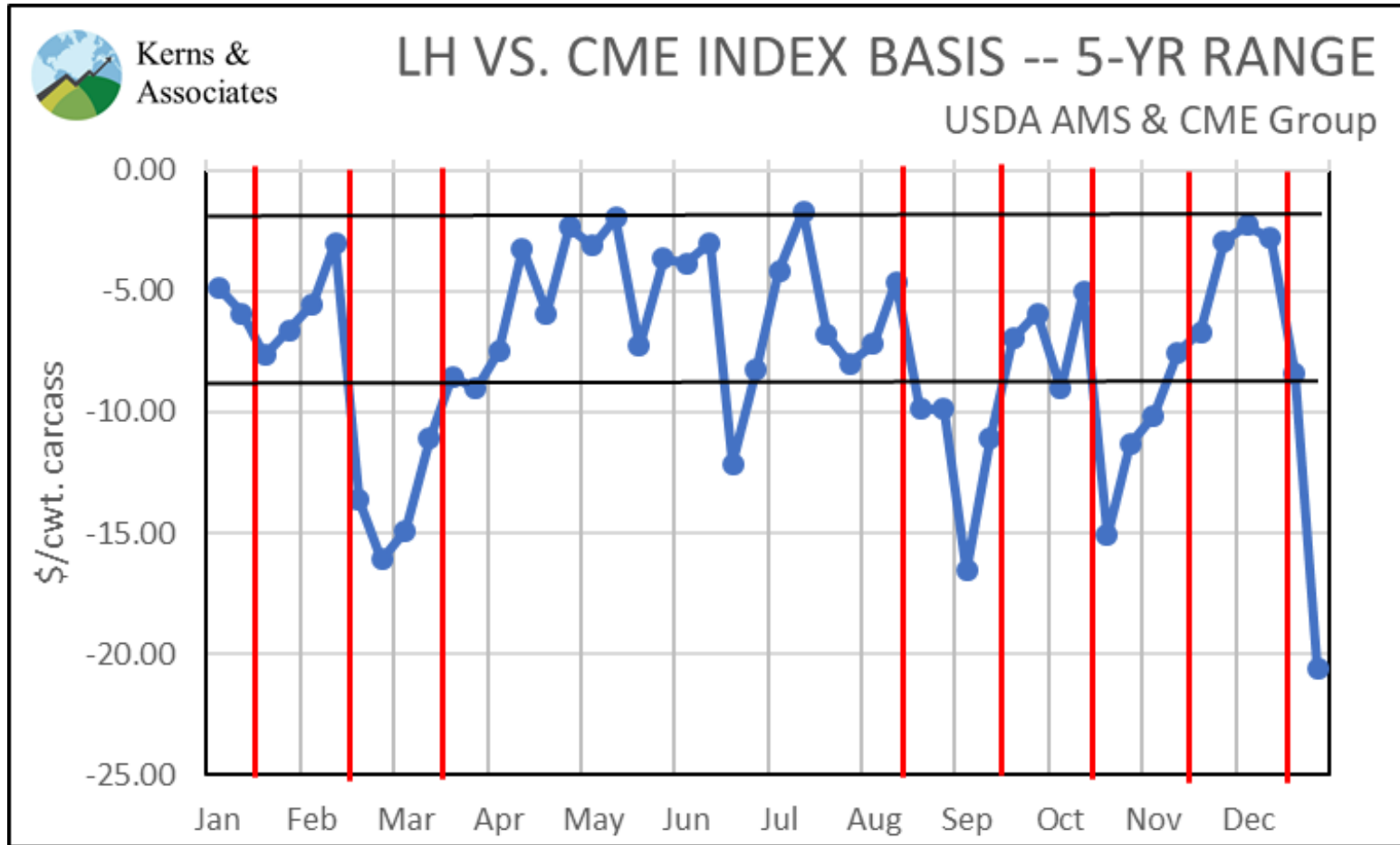
Is a range of -\$2 to +\$4 a “problem with basis”?

... Look more like a need for monthly contracts to me



Basis predictability is the key to hedging ...

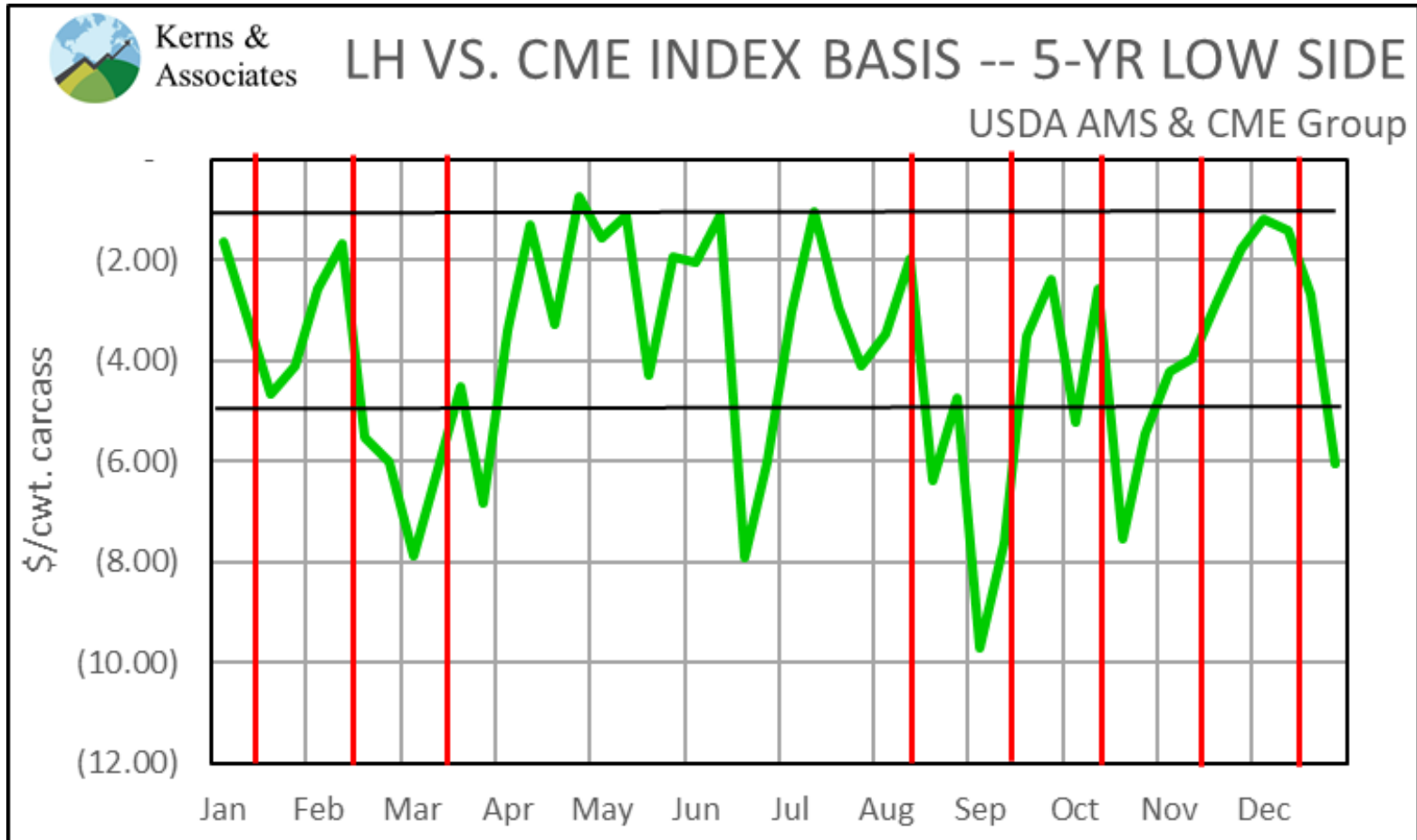
... Range: Still large but worst is in non-contract mos.



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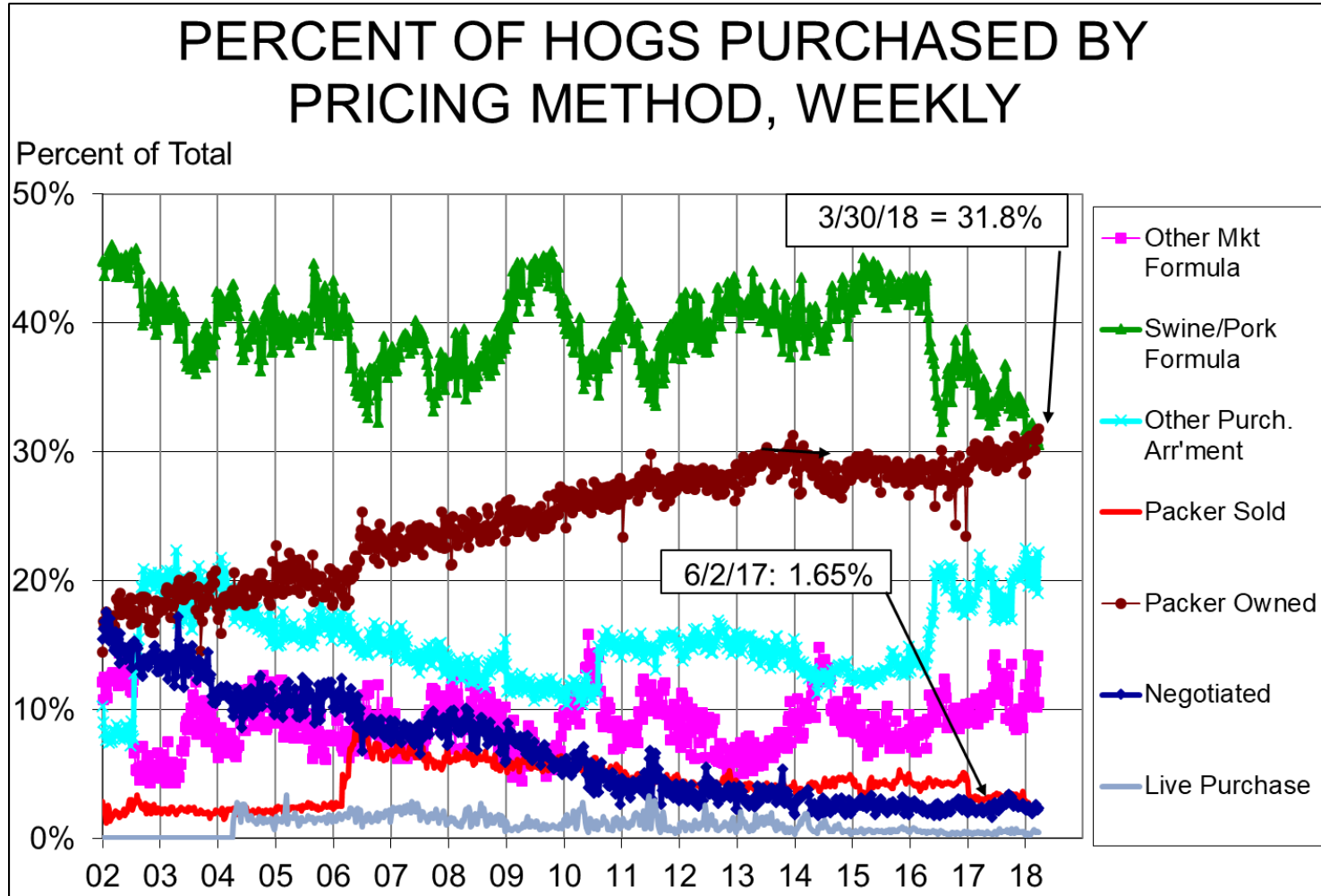
Low-side variation is much smaller ...

... But is also worse in non-contract months



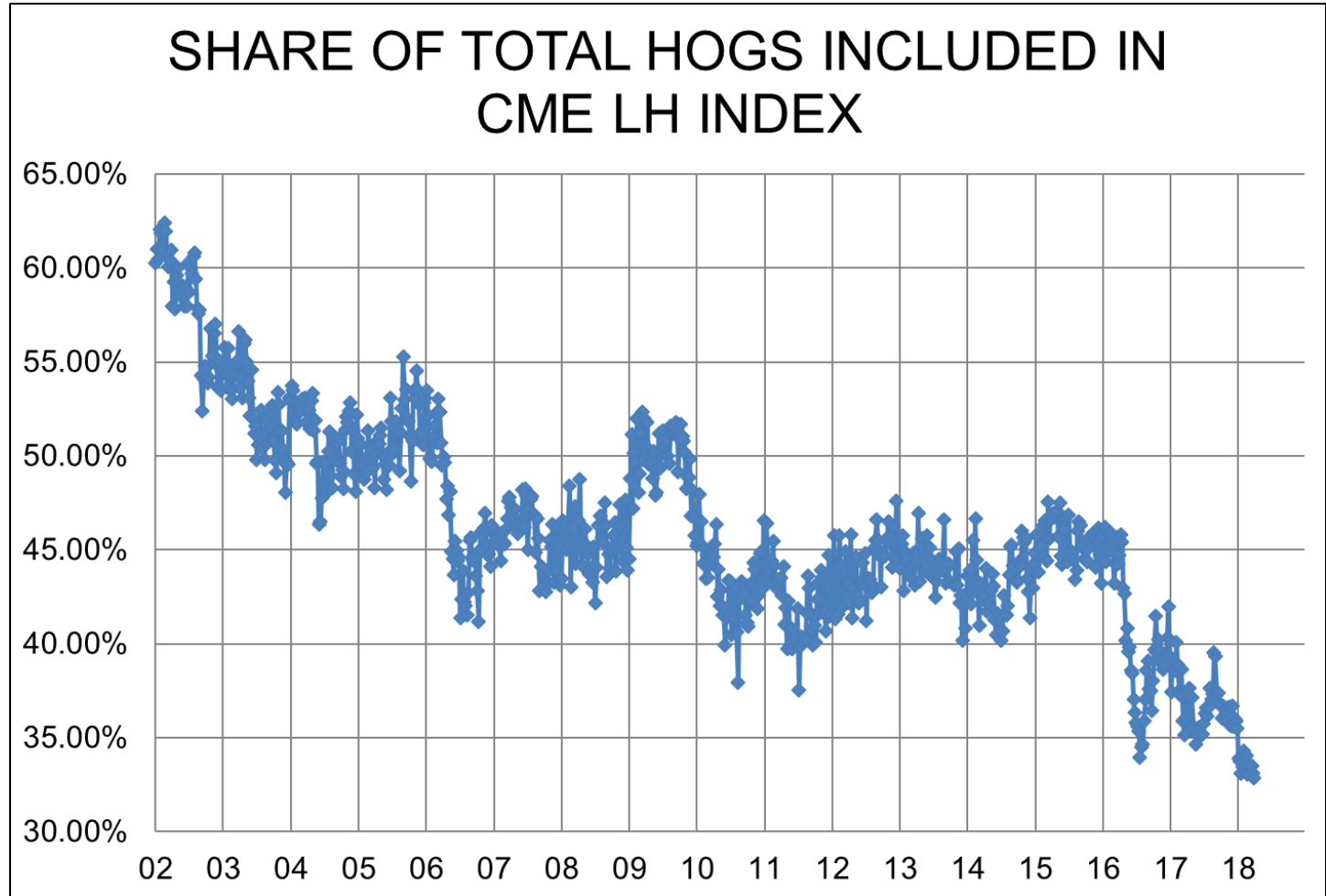
Concerns continue re. number/share of negotiated

... But we've been near 2% since '14 – Comfort?



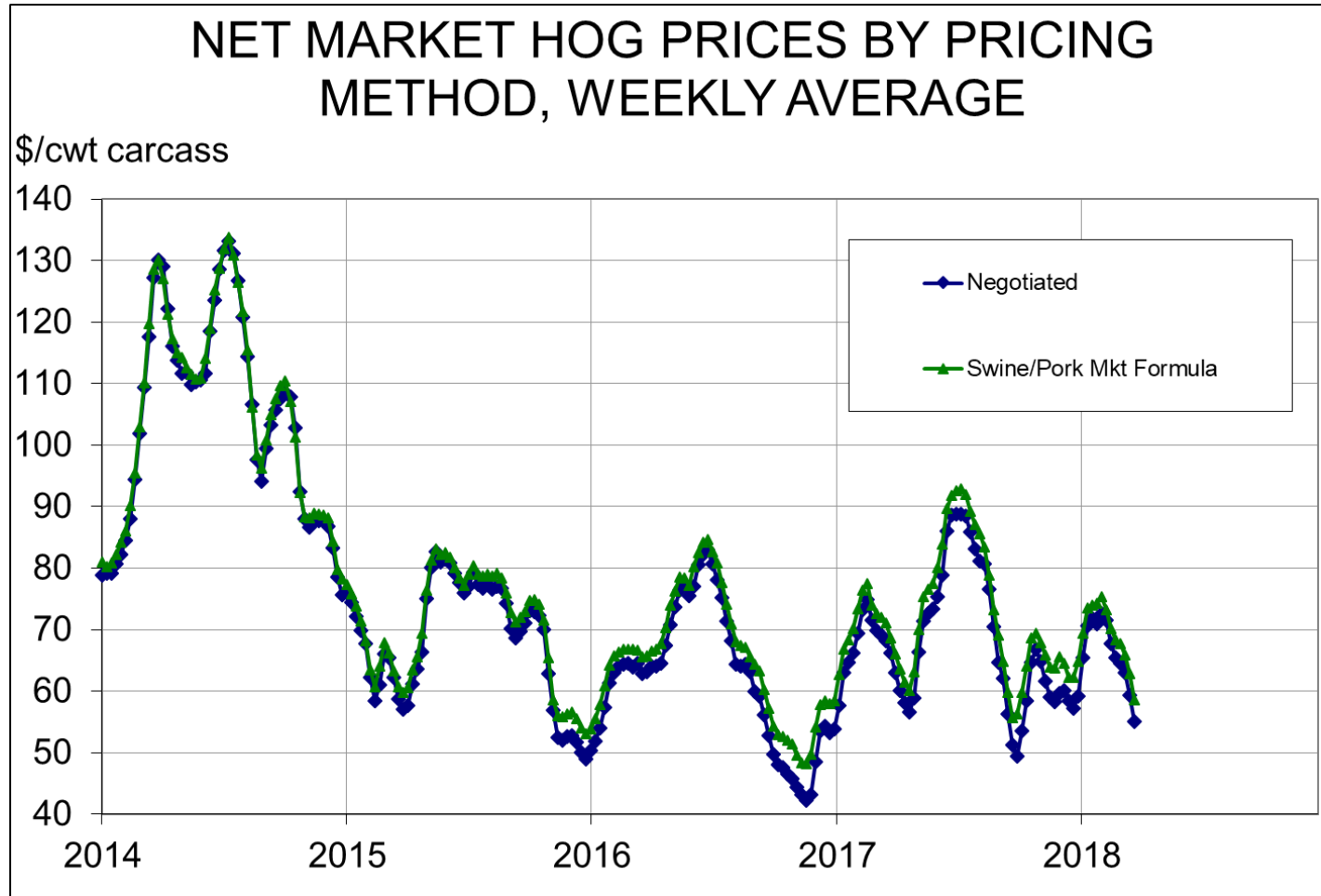
The share of hogs in the CME Index has dropped ...

... USDA could have prevented the 2016 decline



SPMF is diverging from neg'd due to cutout pricing...

... If it goes to 100% -- CME Index= Cutout



Summary...

- LH contract was a “modernization” that has by and large worked well
- Not without its challenges
 - Size
 - CME Index depends on a shrinking spot hog trade and a growing cutout component
- Cash settlement is relatively good in spot months
 - Non-spot months are a crapshoot
 - Other months??
 - » May is a bad example
 - » The challenge is volume and liquidity – specs & spreads?

