August 28, 2020

The Chicago Mercantile Exchange (CME) proposes to establish the Live Cattle (LC) Initial daily trading limit at a base limit of $ 4.00 per cwt. and the Feeder Cattle (FC) initial daily trading limit at a base limit of $ 5.00/cwt. These proposed base limits for FC and LC establish a ratio of 1.25 (5/4). The proposal plans to use this 1.25 ratio to set the FC initial daily trading limit based on a variable LC initial daily trading limit. The LC initial daily trading limit will be set at the $ 4.00 base or 4.25 %, whichever is greater. The use of the 1.25 ratio is misguided. With the 1.25 ratio, constraints and price distortions are a near certainty. The 1.25 ratio must be corrected prior to this proposal being accepted.

The CME claimed “rationale” states that the ratio of the price of the front month FC futures contract to the third listed month Live Cattle contract is approximately 1.25. It is true that the ratio of these price series is approximately 1.25. Unfortunately, the 1.25 ratio demonstrated by these price series does not describe the relationship between a price change in LC and its’ influence on the price of FC. The correct ratio is approximately 1.80 and is determined by comparing an 800-pound feeder steer, as represented by the FC contract specifications to its expected finished pay weight of 1450 pounds. The finished steer pay weight divided by the steer placement weight (1450/800) yields a ratio of 1.81. FC values are dependent on the value of LC. Given an 800-pound feeder steer with a finished pay weight 1450 pounds, a $ 1.00 / cwt. change in the value of LC will support a $ 1.80 / cwt. change in the value of FC. Detailed analysis supporting the 1.80 ratio has been presented to the CME multiple times over the last several years. The CME has chosen not to accepted the research submitted, and has yet to provide a reasonable rebuttal to the use of the 1.80 ratio. The correct ratio is 1.80. The current ratio being utilized is 1.50 (4.50/3.00) yet, inexplicitly, the CME is proposing to move in the opposite direction by utilizing a ratio of 1.25.

With a $ 4.00 initial price limit for LC, and using the correct 1.80 ratio, the initial daily price limit for FC would be $ 7.25. If a $ 7.25 / cwt. initial limit for FC cannot be accepted, for some undocumented reason, then logic and common sense would dictate that the correct ratio be maintained while the current LC initial daily trading limit be adjusted as to not exceed the acceptable FC limit. In reality the 1.8 ratio and the resulting $ 7.25 initial daily price limit for FC are perfectly acceptable, as they represent the ratio established by the underlining cash markets.

The CME suggests, that if this proposal creates constraint and distorts prices, which clearly it will, they will move to make adjustments. Establishing trading limits such as these should not be, and clearly do not need to be, determined by trial and error. Furthermore, history suggests that the adjustments will not be quick, as the CME declines to take emergency action in an effort to avoid further embarrassment. After all, no exchange wants to take an emergency action to correct constraints and distortions, when the constraint and distortion were unnecessary and self-inflicted. Unfortunately, the damage to the contracts and its users will have already occurred.

These contracts are important management tools for the cattle industry and the users of these contracts deserve to have the correct ratio used with the initial proposal.

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