Intercontinental Exchange® (ICE®) became the center of global trading in “soft” commodities with its acquisition of the New York Board of Trade (NYBOT) in 2007. Now known as ICE Futures U.S.®, the exchange offers futures and options on futures on soft commodities including coffee, cocoa, frozen concentrated orange juice, sugar and cotton.

Cotton futures have traded in New York since 1870, first on the New York Cotton Exchange, then on the New York Board of Trade and now on ICE Futures U.S. Options on cotton futures were introduced in 1984. Futures and options on futures are used by both the domestic and global cotton industries to price and hedge transactions. Because cotton is at the center of the global textiles industry, it is a preferred contract among commodity trading advisors and hedge funds. ICE Futures U.S. is the exclusive global market for Cotton No. 2 futures and options.

A BRIEF HISTORY OF COTTON IN COMMERCE
Cotton is grown widely around the world and has been used for at least 7,000 years. While the oldest archaeological fragments have been found in Mexico, the Indus valley in modern Pakistan was the first commercial cotton-growing center. Alexander the Great brought cotton back from the Indus Valley into the Hellenistic world. Europeans’ unfamiliarity with cotton led to the legend of “the Vegetable Lamb of Tartary” as the fiber’s source.

Cotton’s impact on history has been considerable. It was imported into England by the East India Company in the 17th century and began to compete with English wool in the textile industry. However, it was the introduction of cotton into the British colonies in North America, and the development of steam-powered textile machinery in the United Kingdom, that led to cotton textiles’ central role in the 18th century British industrial revolution. Later Eli Whitney’s invention of the cotton gin in 1794, and the opening of cotton plantations in what is now Mississippi and Alabama, led to cotton’s dominance of the economy in the American south, the perpetuation of slavery and ultimately the American Civil War.

Cotton was so critical to British and French industries at the time that both countries contemplated intervening on behalf of the Confederacy during the Civil War, their opposition to slavery notwithstanding. Many Confederate bonds sold in Europe were backed by cotton.

The European dependence on American cotton exports led to the financing of cotton plantations in Egypt, India, various African colonies and Australia. Tsarist Russia expanded cotton plantings in what are now Uzbekistan, Kazakhstan and Turkmenistan. Later, the diversion of the Amu Darya and Syr Darya rivers under the Soviets to irrigate cotton led to the desiccation of the Aral Sea.

Textile manufacturing is always among the first steps of industrialization. In India, for example, Gandhi protested the British
Raj’s restrictions on textile manufacture by advocating home spinning, and the chakra, or spinning wheel, became the symbol of the Indian National Congress party. Today China and India, two rapidly growing industrial powers, are the largest consumers of cotton, respectively. They also are the largest two producers of cotton, respectively.

USDA 2011 CONSUMPTION ESTIMATES (1,000 BALES)

Source: U.S. Department of Agriculture

USDA 2011 PRODUCTION ESTIMATES (1,000 BALES)

Source: U.S. Department of Agriculture

Just as cotton is important to developing industry, it is also important to developing agriculture. Cotton has been a very contentious issue in global trade liberalization talks. The United States is the third largest producer of cotton, but it is the world’s largest cotton exporter, and its production efficiencies give it a formidable advantage over smaller growers, especially those in Africa.

USDA 2011 EXPORT ESTIMATES (1,000 BALES)

Source: U.S. Department of Agriculture

USDA 2011 IMPORT ESTIMATES (1,000 BALES)

Source: U.S. Department of Agriculture

While cotton has few direct price competitors in the final textile market — wool is used for different products and polyester reflects petrochemical feedstock prices more than demand considerations in the final market — U.S. cotton does have an interesting battle with soybeans. The two crops can be grown on many of the same acres in the American South, the Mississippi Delta in particular, so when soybean prices rise or fall, acreage shifts into and out of soybeans, respectively. This affects the planting intentions for cotton; the average lead time is about four months.
U.S. cotton production is also affected by the battle for acres between corn and soybeans in the Midwest. As the U.S. corn crop is diverted to ethanol distillation, fewer acres in the Midwest produce soybeans. This makes soybeans more attractive in the U.S. South and diverts acres away from cotton.

**Long-term cotton prices**

Even with the growing global demand for cotton and the increasing competition for acreage with soybeans, cotton farmers have done an extraordinary job in keeping the constant-dollar price of cotton low. However, traders do not trade the long-term constant-dollar price of cotton; they trade the short-term current-dollar price of cotton. That price has put in some major trends and sharp reversals over the past half-century, including a price surge to all-time highs in current dollars in 2010-2011 before markets adjusted.

**Real price of cotton reflects increased productivity**

Source: CRB-Infotech CD-ROM

Commodity trading advisor or commodity-based hedge fund can ignore the cotton market — not just for its trading opportunities, but for its diversifying properties vis-à-vis other commodity futures as well.

**Long-term success of Cotton No. 2 contract**

The ICE Futures U.S. Cotton No. 2 futures contract is for the physical delivery of strict low middling quality cotton, 1 2/32nd inch staple length, to one of five U.S. locations.

**Contract specifications including fees, margins and delivery standards**

Options on the Cotton No. 2 futures contract are also available. Each futures contract has options that settle into that contract along with serial options for the months of January, September and November. These serial options settle to the March, December and December futures, respectively. Option strikes are spaced 1 cent apart. The last trading day for regular options is the last Friday preceding the first notice day for the underlying futures by at least five business days; for the serial options it is the third Friday of the month in which the option expires.

Options trading volume on the Cotton No. 2 futures contract has grown significantly since the late 1990s. Options tend to be used by two groups of sophisticated traders. The first is commercial participants hedging their physical positions. The second is experienced speculative traders. The growing use of these markets by both groups is an important indicator of the Cotton No. 2 futures contract’s success.
TRADING ICE FUTURES U.S. COTTON FUTURES AND OPTIONS

Futures markets exist for the purposes of price discovery and risk transfer. Price discovery requires buyers and sellers to meet in a competitive marketplace; prices resulting from each transaction signal to other traders what a given commodity might be worth.

Anyone approved by a clearing member or futures commission merchant can participate in the price discovery process, regardless of their participation in the cotton business. A market participant who is not in the cotton or textiles business will be classified as a non-commercial or speculative trader. A market participant active in the cotton or textiles business will be classified as a commercial trader or hedging trader. For a speculator, the price discovery trade is simple and straightforward; if you believe the price of cotton will rise, you “go long” a futures contract; if you believe the price of cotton will fall, you “go short” a futures contract.

These same market views can be expressed in options as well. If you believe prices will rise, you can buy a call option, sell a put option or engage in a large number of spread trades tailored to your specific price view and risk acceptance. If you believe prices will fall, you can buy a put option, sell a call option or engage in a different set of spread trades. A long call (put) option is the right, but not the obligation, to go long (short) the underlying future at the strike price at or by expiration. A short call (put) option is the obligation to deliver (take delivery) of the underlying future at or by the expiration if that option is exercised.

Hedgers use Cotton No. 2 options frequently. Producers can set a floor beneath a selling price with long put options, and buyers can establish a ceiling over costs with long call options, among other strategies. In a futures trade, you and the counterparty to your trade will post initial or original margin with your futures commission merchant or clearing member. Minimum margins are set by ICE Futures U.S., and your futures commission merchant may require additional funds.

There are no margin requirements for long option positions. Margin requirements for short option positions vary according to the relationship between the option strike price and the futures price.

If the market moves in your favor — higher for a long position (or commitment to take delivery of cotton or to offset the contract by selling it prior to delivery), or lower for a short position (or commitment to deliver cotton or to offset the contract by buying it prior to delivery) — the equity in your account will increase. You may withdraw these funds down to the “maintenance margin” level, depending on your account agreement.

If the market moves adversely — lower for a long position or higher for a short position — your futures commission merchant will require you to post additional funds, called variation margin, to sustain your maintenance margin level. These “margin calls” assure both your futures commission merchant and ICE Clear U.S.®, the exchange clearing house, that you can perform according to your contractual commitment. All futures accounts are marked-to-market daily, and participants deficient in margin obligations may have positions liquidated involuntarily.

As the designated clearing house, ICE Clear U.S. serves as the counterparty to every futures contract traded on ICE Futures U.S. The clearinghouse clears trades matched by ICE Futures U.S. and guarantees performance in delivery even if a trader defaults.

What do the financial flows look like in a futures trade? Let’s say a five-contract futures position is initiated at 89.65¢ per pound and the market rises to 91.30¢ per pound on the following trading day.

- For the long position, the gain is:
  5 contracts x \([91.30 - 89.65]/\text{contract}\ x 5.00\ \text{per .01\$} = 4,125\]
- For the short position, the loss is equal and opposite:
  5 contracts x \([89.65 - 91.30]/\text{contract}\ x 5.00\ \text{per .01\$} = -4,125\]

If we reverse the price path, we reverse the gains and losses.

Let’s change the starting price to 89.83¢ per pound and have the market decline to 88.91¢ per pound the next day.

- For the long position, the loss is:
  5 contracts x \([88.91 - 89.83]/\text{contract}\ x 5.00\ \text{per .01\$} = -2,300\]
- For the short position, the gain is equal and opposite:
5 contracts x \([89.83 - 88.91]\) / contract x $5.00 per .01¢ = $2,300

Options traders see the same directional profit and loss profiles relative to price, but the actual profit and loss is subject to a range of additional factors, including market volatility, time to expiration, interest rates and the relationship between the current futures price and the option’s strike price.

**RISK TRANSFER**

Risk transfer is the second purpose of a futures market. Any grower of cotton, any holder of cotton inventories, or any party at risk of the price of cotton declining can seek protection in the futures markets. These participants are long the market and can offset risk by going short a futures contract. Any textile mill or user at risk of the price of cotton increasing is short the market and can offset risk by going long a futures contract.

The mechanics and financial flows are identical to those outlined above. A cotton grower at risk to prices falling can acquire a financial asset, the short futures position, which will rise in value as the market declines. The opposite is true for a textile mill at risk to prices rising; there a long futures position will rise in value as the market rises.

While the financial flows should offset the economic gains and losses of the physical cotton position, there are two important things to remember. First, even though futures prices converge to cash prices at expiration, the convergence process is subject to what is called “basis risk” or differences resulting from changes in hedging demand, location of the cotton and grade differentials.

**Daily premium and discount of various grades**

Second, while the economic gains on, for example, a warehouse full of cotton are real, they are not realized until the cotton is sold. If this inventory is hedged with a short futures position and the market rises, the beneficial owner will have to keep posting additional funds in the margin account.

Nothing in the above discussion of hedging tells you when or at what price to hedge. This is one of the reasons options are valuable to hedgers. While the cotton grower may wish to have downside protection or a price floor, that same grower probably wants to participate in any future price increases. The grower concerned about a decline in the value of cotton between now and the time he expects to be able to sell his cash crop at harvest in the fourth quarter could buy a December 89¢ put option, which is the right, but not the obligation, to receive a short position in a December future at 89¢ for 4.27¢, or approximately $2,135. The purchased put guarantees the grower the right to sell the December future for an effective price of 84.73¢ per pound (the 89¢ strike price less the premium paid of 4.27¢). This right gives him protection if cotton prices have fallen by the expiry of the December option, but at the same time preserves his ability to profit should the price of cotton move higher over the period.

The textile mill wishing to cap the price of cotton, but not be exposed to margin calls if the price continues to rise, can do an opposite trade and buy a December 90¢ call option, which is the right, but not the obligation, to receive a long position in a December future at 90¢ for 4.44¢, or approximately $2,220. The purchased call gives the textile mill the right to buy the December future at an effective price of 94.44¢ per pound (again, the strike price of 90¢ cents plus the premium paid of 4.44¢), offering protection against an unfavorable rise in the price of cotton while preserving the ability to take advantage if prices decline.

It should be noted that the risk profile for sellers of options is dramatically different than for buyers of options. For buyers, the risk of an option is limited to the premium or purchase price paid to buy the option. For sellers, the risk profile is unknown and can be potentially quite large. Options can become complex very quickly, with trading influenced by variables including time remaining to contract expiration, underlying commodity volatility, short-term interest rates and a range of expected movements collectively called “the Greeks.”
GLOBAL MARKETS IN CLEAR VIEW™

ICE delivers fast, secure trade technology and risk management solutions through a customer-driven, innovation-focused culture.

IntercontinentalExchange (NYSE: ICE) is a leading operator of regulated futures exchanges and over-the-counter markets for agricultural, credit, currency, emissions, energy and equity index contracts. ICE Futures Europe hosts trade in half of the world’s crude and refined oil futures. ICE Futures U.S. and ICE Futures Canada list agricultural, currencies and Russell Index markets. ICE is also a leading operator of central clearing services for the futures and over-the-counter markets, with five regulated clearing houses across North America and Europe. ICE serves customers in more than 70 countries: theice.com/about

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