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Research on Issues Related to Cotton Futures and Options

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Abstract

Cotton is the largest economic crop in China, with the attribute of being a "natural commodity" and an important raw material for the textile industry. Cotton futures is the first commodity futures variety in China, which has gone through more than ten years of development since its listing. In the cotton futures market, Zhengzhou Commodity Exchange and Dalian Commodity Exchange occupy an absolute dominant position. On September 16, 2020, cotton futures and options contracts were officially listed for trading. As an important new variety in the commodity futures market, cotton options, like other commodity options, have their own characteristics. This article is based on the practical experience and challenges faced in the operation of cotton futures options, as well as a basic overview of the cotton futures market. It explores hedging strategies and other risk management strategies, such as speculation and arbitrage strategies, option trading, and technical and basic analysis. Finally, the risk control and future development trends were analyzed, such as the impact of technological innovation and digitization on the futures market, as well as the impact of international trade and policy changes on the cotton futures market. In order to provide experience and reference for the next step of improving cotton futures and options, and promote the development of the cotton industry.

Keywords

Cotton futures market; Hedging and hedging; Futures contracts; Speculation and arbitrage strategies; Option trading.

1. Introduction

In today's increasingly integrated global economy, the agricultural product market, as an important component of the world economy, its price fluctuations and supply-demand relationship have a profound impact on the stability and development of the global economy. Cotton, as an important economic crop, its price fluctuations not only affect the production and operation of related industries such as textiles and clothing, but also relate to the income of farmers and the stability of the national agricultural economy. Therefore, studying issues related to cotton futures and options is of great theoretical and practical significance for improving the agricultural product market mechanism, optimizing resource allocation, enhancing agricultural production efficiency, and preventing and resolving agricultural product market risks.

As an important derivative tool in the financial market, futures and options have functions such as price discovery, risk transfer, and resource allocation. Through futures and options trading, investors can lock in future prices, reduce the risk of price fluctuations, and achieve stable returns. At the same time, the futures and options market also provides producers with price references, helping them to arrange production reasonably and improve economic efficiency. Therefore, in-depth research on issues related to cotton futures and options is of great significance for promoting the healthy development of the cotton industry.

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However, there are still some problems and challenges in the current cotton futures and options market. Asymmetric market information, imperfect regulatory systems, and unreasonable trading rules may all affect the fairness and effectiveness of the market. Therefore, this article aims to conduct in-depth research on issues related to cotton futures and options, explore hedging strategies and other risk management strategies, such as speculation and arbitrage strategies, option trading, technical analysis and basic analysis, in order to provide theoretical support and practical guidance for the healthy development of China's cotton futures and options market.

Studying issues related to cotton futures and options not only helps deepen our understanding of the agricultural product market mechanism, but also provides strong support for optimizing resource allocation, improving agricultural production efficiency, and preventing and resolving agricultural product market risks. This article will conduct an in-depth analysis of the cotton futures and options market from multiple perspectives, in order to contribute to the sustainable and healthy development of China's cotton industry.

2. Overview of Cotton Futures Market

2.1. Purpose and Function of Cotton Futures Trading

2.1.1. Hedging

Hedging is a common risk management strategy, where participants can reduce risk by engaging in both spot and futures trading simultaneously. For example, cotton producers can sell cotton in the spot market and buy corresponding quantities of futures contracts to protect themselves from price fluctuations [1].

2.1.2. Liquidity Provision

The futures market provides a highly liquid trading environment, where participants can buy and sell futures contracts at any time, thereby increasing market liquidity and trading efficiency. This allows participants to quickly enter and exit the market and make adjustments or liquidate positions as needed.

2.1.3. Speculation and Arbitrage

In addition to risk management, the futures market also attracts speculators and arbitrageurs. Speculators make profits by predicting price trends, while arbitrageurs use price differences to trade for risk-free profits. The activities of these participants have increased market liquidity and trading activity.

2.2. Participants and Exchanges in the Cotton Futures Market

2.2.1. Cotton Traders

Traders play an important role in the cotton futures market. They are responsible for purchasing and selling cotton, and conducting hedging operations in the market. Traders manage the fluctuation risk of cotton prices through futures trading, ensuring that they can still make profits during market fluctuations [2].

2.2.2. Cotton Processors

Cotton processors are enterprises that convert cotton into textiles or other end products. They participate in the futures market mainly to manage the risk of cotton prices, ensure stable supply of raw materials, and control costs.

2.2.3. Investors

Investors refer to individuals and institutions who participate in the cotton futures market for investment purposes. They may be fund managers, individual investors, or professional

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investment institutions. Investors obtain investment returns through futures trading and engage in speculative activities using market price fluctuations.

2.2.4. Arbitrageurs

Arbitrageurs are participants who trade using price differences to obtain risk-free profits. They engage in arbitrage operations by simultaneously trading spot and futures, utilizing price differences.

3. Fundamentals of Cotton Futures Trading

3.1. Characteristics and Specifications of Cotton Futures Contracts

3.1.1. Delivery Month

The cotton futures contract specifies a specific delivery month, which is the month when the contract expires. Different contracts may have different delivery months to choose from, typically including near month, far month, and quarter month contracts [3].

3.1.2. Price Calculation

The price of cotton futures contracts is determined based on the price index or price calculation method specified by the exchange. Price indices are usually based on actual trading price data in the market, such as spot market price indices or futures trading.

3.2. Differences between Exchange Trading and Over-the-counter Trading

3.2.1. Exchange Trading

Participants: Exchange trading is conducted on the exchange platform, and participants include registered members, brokers, investors, etc. As a trading platform, exchanges provide a fair and transparent market environment, and require participants to meet specific qualifications and requirements. Regulation: Exchange trading is subject to supervision and regulation by regulatory agencies. Exchanges need to comply with specific laws, regulations, and regulatory requirements to ensure the fair, transparent, and orderly operation of the market. Regulatory authorities are responsible for supervising the operation of exchanges and regulating the behavior of participants [4].

3.2.2. Off Exchange Trading

Participants: Off exchange trading is a direct transaction between participants, without going through an exchange. Participants can be institutional investors, large corporations, or individual investors. Off exchange trading usually requires the use of brokers or trading platforms. Trading process: The process and terms of over-the-counter trading can be determined based on negotiations between participants. Transactions can be conducted through telephone, electronic trading platforms, or other means. Off exchange trading usually has greater flexibility and customization, and trading terms can be adjusted according to the needs of participants. Regulation: There is relatively less regulation on over-the-counter transactions. Regulatory authorities usually impose a certain degree of regulation on over-the-counter trading, but the level of regulation may not be as strict as exchange trading. This may lead to some risks in over-the-counter trading, such as counterparty risk and market opacity.

4. Hedging Strategy

4.1. Basic Principles and Objectives of Hedging

4.1.1. Price Discovery

The futures market, as a platform for price discovery, provides opportunities for trading among participants. By participating in the futures market, participants can observe and analyze the

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supply and demand situation and price trends in the market, thereby better predicting and managing future price fluctuations [5].

4.1.2. Hedging

The main purpose of hedging is to protect the existing positions of participants from the impact of price fluctuations. For example, a farmer can hedge the price risk of their agricultural products by selling futures contracts in the futures market, ensuring that they can sell products at predetermined prices regardless of market price fluctuations.

4.1.3. Liquidity Provision

Hedging activities provide more liquidity to the market and attract more participants. The increase in liquidity can reduce transaction costs, improve market efficiency, and provide better trading opportunities for participants.

4.1.4. Speculation and Arbitrage

The hedging market has also attracted speculators and arbitrageurs. Speculators attempt to profit by predicting price directions, while arbitrageurs use price differences to trade between different markets for risk-free profits.

4.2. Advantages and Disadvantages of Hedging

4.2.1. Advantages

Liquidity provision: Hedging activities provide more liquidity to the market and attract more participants. The increase in liquidity can reduce transaction costs, improve market efficiency, and provide better trading opportunities for participants [6]. Speculation and arbitrage opportunities: The hedging market attracts speculators and arbitrageurs who seek profit opportunities by predicting price directions and trading between different markets using price differences. Hedge price fluctuation risk: For enterprises that are greatly affected by changes in commodity prices, hedging can lock in costs or sales prices, thereby avoiding the uncertainty of market price fluctuations on business operations. In addition, hedging also helps improve the efficiency of a company's fund utilization. By arranging hedging operations reasonably, enterprises can more effectively utilize idle funds and increase investment returns.

4.2.2. Disadvantages

Cost: Hedging may involve some costs, such as transaction fees, margin requirements, and market data subscription fees. Risk cannot be completely eliminated: Hedging cannot completely eliminate price risk, and if market prices are opposite to expectations, participants may suffer losses in hedging transactions. Complexity: Hedging involves complex financial instruments and trading strategies, requiring participants to possess certain professional knowledge and skills. Professionalism: Hedging operations require a certain level of professional knowledge and experience. Incorrect operations may cause losses to the enterprise and even lead to more serious financial risks. Therefore, when conducting hedging, enterprises need to choose teams or institutions with rich experience and professional knowledge for operation. Secondly, hedging may be affected by market liquidity. In some cases, insufficient market liquidity may lead to unsuccessful hedging operations, thereby affecting the risk management effectiveness of the enterprise. Restrictive: Some markets or products may not have suitable futures contracts available for hedging, or participants may face restrictions on the number, term, or price of contracts.

Market risk: The hedging market is still affected by market risks, such as liquidity risk, operational risk, and market manipulation risk [7].

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4.3. How to Achieve Hedging

4.3.1. Identifying Risks

Identifying risks is crucial in the first step of risk management. Clarifying the types of risks to be managed can help develop more targeted risk management strategies. Taking cotton producers as an example, they may face various risks, but one of the most critical risks is the fluctuation risk of cotton prices. This risk can arise from various factors such as changes in market supply and demand, policy changes, and natural disasters. Therefore, cotton producers need to closely monitor market trends and conduct in-depth analysis of potential risk factors in order to timely identify and manage these risks. To more accurately identify risks, cotton producers can use various methods. Firstly, they can collect and analyze historical data to understand the fluctuation patterns and trends of cotton prices. Secondly, they can communicate with industry experts, analysts, or research institutions to obtain more information about market trends and potential risks. In addition, they can also use modern technological means such as big data analysis, artificial intelligence, etc. to monitor and predict the market in real time, in order to timely discover potential risk factors.

4.3.2. Determine Hedging Instruments

After identifying the risks, the next step is to determine the appropriate hedging tool based on demand and available markets. Hedging tools are financial instruments used to hedge risks and reduce uncertainty losses. For cotton producers, futures contracts are a commonly used hedging tool. A futures contract is a standardized contract that specifies the buying and selling of a certain quantity of cotton at a specific time and price in the future. By purchasing or selling futures contracts, cotton producers can lock in future cotton prices and hedge against the risk of actual cotton price fluctuations. In addition, the futures market also has characteristics such as strong liquidity and price transparency, providing effective risk management tools for cotton producers. When choosing hedging tools, cotton producers need to consider multiple factors comprehensively. Firstly, they need to understand the characteristics and applicable scenarios of different hedging tools in order to choose the most suitable tool for themselves. Secondly, they also need to consider the actual market situation and their own risk tolerance to ensure that the selected tools can effectively hedge risks and avoid excessive exposure.

4.3.3. Establishing Opposite Positions

After determining the hedging instrument, the next step is to establish a position opposite to the actual asset or liability by purchasing or selling futures contracts. The purpose of doing so is to reduce actual risk through hedging operations. Taking cotton producers as an example, they may be concerned that the future decline in cotton prices will lead to a decrease in income. To hedge against this risk, they can sell a corresponding quantity of cotton futures contracts. In this way, if cotton prices really fall in the future, their profits in the futures market can compensate for the losses incurred in actual cotton sales. On the contrary, if cotton prices rise, although their returns in the futures market will decrease, the actual revenue from selling cotton will increase. Through this approach, cotton producers can effectively hedge against price volatility risks. When establishing opposite positions, cotton producers need to carefully choose the quantity and timing of contracts. Excessive number of contracts may lead to excessive hedging and increase unnecessary costs. However, a small number of contracts may not be able to effectively hedge risks. In addition, they also need to closely monitor market dynamics in order to conduct buying and selling operations at the appropriate time.

4.3.4. Monitoring and Adjustment

After establishing the opposite position, it does not mean that risk management work is over. On the contrary, regular monitoring of market and position changes and making adjustments as needed is an indispensable part of risk management. Cotton producers need to closely

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monitor market trends, understand changes in cotton prices, supply-demand relationships, and the impact of relevant policies. At the same time, they also need to regularly evaluate their position, including the quantity, price, and expiration date of futures contracts. If there are changes in the market situation or unfavorable changes in the position, it is necessary to make timely adjustments. There are various ways to adjust, and you can choose according to the actual situation. For example, if cotton prices rise too quickly and exceed the expected range, cotton producers can choose to close some futures contracts to lock in profits; If there are new risk factors or changes in expectations in the market, they can also roll contracts or adjust their position size to cope with the new risks. In summary, when conducting risk management, cotton producers need to comprehensively use steps such as identifying risks, determining hedging tools, establishing opposite positions, and monitoring and adjusting to develop and execute risk management strategies. Through these measures, they can effectively hedge risks, reduce uncertainty losses, and ensure the stable development of the enterprise.

5. Risk Management Practices and Risk Control

5.1. Selection and Implementation of Risk Management Strategies

5.1.1. Evaluate Adaptability

Assessing the adaptability of various risk management tools is a crucial step in the process of risk management. According to risk management objectives and specific business or investment needs, it is necessary to conduct in-depth analysis and comparison of various risk management tools. In this process, factors that need to be considered include but are not limited to the cost, complexity, feasibility, and market availability of the tools.

5.1.2. Develop Strategies

Based on the assessment of the adaptability of risk management tools, the next step is to develop suitable risk management strategies. This process requires comprehensive consideration of factors such as business or investment characteristics, risk tolerance, and goals. In the selection process, it is necessary to weigh and make choices based on the evaluation results and your actual needs. By developing clear application methods and emergency plans, ensure the effectiveness and sustainability of risk management strategies, thereby providing more robust and reliable guarantees for business or investment.

5.2. Risk Control Tools and Methods

5.2.1. Stop Loss Orders

Set orders triggered at specific price levels to limit losses. When the market price reaches or falls below the set stop loss price, stop loss orders will be automatically triggered to avoid further losses [8]. Its core purpose is to automatically execute transactions when market prices reach a predetermined specific level, thereby limiting potential losses for investors. This type of order is crucial for risk management and capital protection, as it allows investors to quickly take action in adverse market changes and avoid further losses. In practical applications, investors will set stop loss prices based on their risk tolerance and market conditions. Once the market price reaches or falls below this preset stop loss price, stop loss orders will automatically trigger and execute corresponding trading operations, such as selling held assets. Through this approach, investors can exit in a timely manner when market volatility intensifies or prediction errors occur, avoiding further losses.

Stop loss orders are widely used, not only for stock trading, but also for other financial derivative markets such as foreign exchange and futures. In addition, with the advancement of technology and the continuous improvement of trading platforms, investors can now more flexibly set the conditions and parameters of stop loss orders to adapt to different market environments and trading strategies. It should be noted that although stop loss orders can help

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limit losses, they cannot completely eliminate investment risks. In extreme market fluctuations or insufficient liquidity, stop loss orders may not be executed in a timely manner or cannot be executed at the expected price. Therefore, investors still need to carefully evaluate risks when using stop loss orders and combine them with other risk management tools for comprehensive application.

5.2.2. Option Trading Rights

Option trading rights are an important derivative tool that grants investors the right to buy or sell a certain asset at an agreed price on or before a specific date in the future. This right can be used to manage risks and provide investors with flexible investment strategies. Buying call options is a reflection of investors' optimistic attitude towards future market trends. When investors expect asset prices to rise, they can purchase call options to buy the asset at a lower price in the future. In this way, even if the market price rises more than expected, investors can still purchase assets at a lower price by exercising their option rights, thereby protecting them from the risk of asset price increases. On the contrary, buying put options is a pessimistic choice for investors regarding future market trends. When investors expect asset prices to fall, they can purchase put options to sell the asset at a higher price in the future. Through this approach, investors can lock in the selling price and avoid losses caused by market price declines.

5.2.3. Futures Trading

Future trading is an important way to manage price volatility risk by buying and selling futures contracts. Futures contracts are essentially standardized contracts that stipulate the delivery of a certain quantity of a commodity or financial asset at a specific price on a specific date in the future. By participating in futures trading, investors can lock in future prices, thereby reducing the risk caused by price fluctuations. In futures trading, investors can choose to buy or sell futures contracts. If investors expect the price of a certain commodity or financial asset to rise, they can buy futures contracts; If the expected price will fall, futures contracts can be sold. Through this approach, investors can utilize the price discovery function of the futures market to predict future price trends and formulate corresponding investment strategies accordingly.

6. Future Development Trends of Cotton Futures Market

6.1. The Impact of Technological Innovation and Digitization on the Futures Market

6.1.1. Increased Market Transparency

Digital technology provides more market data and information, enabling investors to better understand market conditions. The accessibility of real-time quotes, deep market trends, and trading data enhances market transparency and helps investors make wiser decisions. [9].

6.1.2. Automated and Algorithmic Trading

In the futures market, the application of automated trading and algorithmic trading has gradually taken an important position. These two trading methods achieve automated execution of transactions through pre programmed trading strategies and algorithms, effectively reducing the impact of human errors and emotional factors on trading results. In addition, they significantly improve the execution speed and accuracy of transactions, bringing investors a more stable and efficient trading experience. Automated trading relies on advanced trading systems and algorithms that can monitor market dynamics in real-time and automatically execute buying and selling operations based on preset trading strategies. This trading method greatly reduces the need for human intervention and reduces errors and biases caused by human factors. Meanwhile, as trading decisions are based on algorithms and data analysis, they are also more objective and scientific. Algorithmic trading is a more complex automated trading method. It utilizes complex mathematical models and algorithms to conduct

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in-depth analysis of the market in order to find the best trading opportunities and prices. This trading method can quickly respond to market changes, capture short-term trading opportunities, and achieve higher investment returns. However, algorithmic trading also carries certain risks, such as algorithmic errors, abnormal market fluctuations, and other factors that may lead to trading losses.

6.1.3. High Frequency Trading

High frequency trading is a new trading strategy that has emerged in the futures market in recent years. It utilizes high-speed computers and advanced algorithms for a large number of fast trading operations to capture small price changes in the market and obtain profits. High frequency traders typically have a strong technical team and financial support, able to continuously monitor market dynamics and respond quickly. The advantages of high-frequency trading lie in its fast trading speed, high execution efficiency, and ability to capture small price changes. This enables high-frequency traders to have higher competitiveness and profitability in the market. However, high-frequency trading has also sparked a series of discussions about market fairness and liquidity. On the one hand, high-frequency traders utilizing their technological advantages to quickly obtain market information and execute trades may lead to other investors being at a disadvantage in the market. This information asymmetry phenomenon may trigger unfair competition and manipulation risks in the market. On the other hand, high-frequency trading may lead to temporary imbalances in market liquidity, as a large number of trading operations may have an impact on the market and affect its stable operation. Therefore, for high-frequency trading, regulatory authorities need to closely monitor its potential risks and take corresponding regulatory measures to maintain market fairness and stability. At the same time, investors also need to fully understand the operating principles and potential risks of high-frequency trading in order to make reasonable investment decisions.

6.1.4. Innovation in Financial Derivatives

Technological innovation has driven the development and innovation of financial derivatives. The introduction of new futures contracts, options contracts, and other derivative products provides investors with more investment choices and risk management tools. With the increasing maturity of financial markets and the continuous progress of technology, the development and innovation of financial derivatives are also showing a more diversified trend. These new derivatives not only provide investors with more flexible and diverse investment methods, but also provide more effective tools for risk management.

6.2. The Impact of International Trade and Policy Changes on the Cotton Futures Market

6.2.1. Trade Barriers

Changes in trade policies, such as tariffs, quotas, and modifications to trade agreements, may have an impact on international trade of cotton. The increase or decrease of trade barriers may lead to fluctuations in cotton prices and affect participants and trading strategies in the cotton futures market [10]. As the core of international economic exchange, changes in trade policies undoubtedly have a profound impact on global commodity flows. Specifically for the cotton industry, adjustments to tariffs, quotas, and trade agreements may have a significant impact on the international trade pattern of cotton. Trade agreements between countries play a crucial role in the global cotton market. For example, when two countries sign free trade agreements or expand trade cooperation, the barriers to cotton trade may decrease, thereby stimulating the growth of trade volume between the two sides. However, once trade relations become tense or trade agreements break down, trade barriers may be rebuilt, leading to obstacles in cotton trade and intensified price fluctuations.

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6.2.2. Exchange Rate Fluctuations

International trade and policy changes may lead to fluctuations in exchange rates, which in turn can affect the export and import costs of cotton. Exchange rate fluctuations can directly affect the price of cotton and the volatility of futures markets, as exchange rate risk in international trade is one of the important factors that futures traders need to consider. When the domestic currency depreciates, the export cost relatively decreases, which helps to improve the international competitiveness of cotton and increase export volume. Meanwhile, import costs have relatively increased, which may suppress import demand. On the contrary, an appreciation of the domestic currency may lead to an increase in export costs and a decrease in import costs. The impact of exchange rate fluctuations on the cotton futures market is equally significant. Due to the involvement of future price trading in the futures market, exchange rate risk has become one of the important factors that futures traders must consider. The fluctuation of exchange rates may lead to intensified fluctuations in cotton futures prices, increasing market uncertainty.

6.2.3. Government Subsidies and Support Policies

The government's subsidies and support policies in cotton production and trade have a significant impact on the cotton futures market. Subsidy policies usually aim to increase the profits of cotton producers and stimulate an increase in cotton supply. This may lead to oversupply in the cotton market, thereby exerting downward pressure on cotton prices. However, when subsidy policies are reduced or cancelled, cotton producers may face the risk of declining profits, thereby reducing production volume, leading to tight market supply and rising prices. In addition, government support policies for cotton trade may also affect the cotton futures market. For example, the government may support cotton exports by providing export tax rebates, reducing tariffs, and other measures. These policies help to enhance the competitiveness of cotton in the international market, expand export volume, and have a positive impact on cotton prices.

6.2.4. Trade Disputes and Strained Relationships

Trade disputes and strained relationships are common phenomena in international trade, and their impact on the cotton futures market cannot be ignored. Trade wars or frictions may lead to both sides taking restrictive measures on cotton trade, such as raising tariffs, setting quotas, etc., thereby hindering the normal progress of cotton trade. This uncertainty may lead participants in the cotton market to have doubts about future market trends, thereby affecting their trading strategies and decisions. Against the backdrop of trade disputes and strained relationships, the volatility of the cotton futures market may intensify. Due to the increased uncertainty of future market trends among market participants, they may be more inclined to adopt conservative trading strategies, such as reducing trading volume and increasing margin. This market reaction may further exacerbate the volatility of cotton prices and increase market risks.

7. Conclusion

Hedging, as a risk management tool, has broad application value in the cotton futures market. By identifying risks, selecting suitable hedging tools, establishing opposite positions, and monitoring adjustments, participants can effectively manage the risk of cotton price fluctuations. However, hedging also has drawbacks in terms of cost, complexity, limitations, and market risk, which require participants to consider and operate cautiously. With the development of technological innovation and digitization, the cotton futures market will face more opportunities and challenges. The increase in market transparency, the popularization of automated and algorithmic trading, the development of high-frequency trading, and innovation in financial derivatives will provide investors with more choices and risk management tools. At

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the same time, international trade and policy changes will also have a significant impact on the cotton futures market, and participants need to closely monitor market dynamics and policy changes to develop reasonable risk management strategies.

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