Pork Cutout Futures Provide New Risk Management Tool

By James Mintert

In recent years there has been a significant rise in the number of hog contracts that rely upon wholesale pork prices, instead of live hog prices, as a pricing mechanism. Fundamentally the change arose from a desire to price hogs in a way that more closely corresponds to values that consumers pay for pork. However, the change in pricing arrangements made managing hog price risk more challenging since the primary risk management tools available were lean hog futures and options on lean hog futures. Although lean hog futures prices and pork cutout values are correlated, they can diverge significantly at times leading to interest in developing a risk management tool that more closely matches the price series used in many cash contracts. Recently CME Group launched pork cutout futures and options in an attempt to address this challenge.

Like lean hog futures, pork cutout futures are a cash settled contract. The new pork cutout futures are settled to the *CME Pork Cutout Index*. The cutout index is a five-business day weighted average of prices available in USDA's *National Daily Pork Report FOB Plant-Negotiated Sales-Afternoon* report each day. The index is calculated by multiplying that day's carcass value by the number of loads traded to determine the daily total value. That process is repeated for five consecutive business days. The sum of five daily total values is then divided by the total number of loads across those same five business days and the result is the CME Pork Cutout Index. The next business day the process is repeated, substituting the new day's information for the oldest day's value and load count. The resulting index is quoted in cents per pound.

The pork cutout contract, which started trading in November 2020, is the same size, 40,000 pounds, as the lean hog contract which could ease a transition from use of the lean hog to the pork cutout contract. Contract expiration months are February, April, May, June, July, August, October, and December, the same as for lean hog futures.

CME Group began publishing the CME Pork Cutout Index in early 2013 which makes possible a comparison over time between the cutout index and the CME Lean Hog Index. Although the hog and pork product indices are correlated, the two indices do not move together in lockstep. This suggests that for risk managers interested in managing wholesale product price risk, using the new cutout contract could be advantageous since it will more closely correspond to the cash price risk they are exposed to.

Typical for a new futures contract, volume and open interest to date has been small relative to existing contracts, although the nearby contracts have been actively trading. For example, in mid-May, the June 2021 pork cutout contract had open interest of nearly 750 contracts and a daily volume of over 30 contracts traded. This is still a small fraction of the open interest and volume for the June 2021 lean hog contract which, on the same day, had open interest of over 50,000 contracts and a daily volume of more than 15,000 contracts. Ultimately, if the new pork

cutout futures contract is going to be successful, it will have to attract more volume and open interest to provide the liquidity hedgers need to effectively manage price risk.