1985 The Efficiency of the U.S. Cotton Futures Market (1986-2006)

Dr. John R. Robinson, PhD , Texas A&M University, College Station, TX
Ms. Marissa Chavez , Department of Agricultural Economics, College Station, TX
Ms. Mansoo Park , Department of Agricultural Economics, College Station, TX
Dr. Vicky Salin , Department of Agricultural Economics, College Station, TX

One of the most debated underlying principles regarding futures markets is whether or not these markets are efficient and whether participants can earn a return in these markets by forward pricing. The U.S. cotton futures market is no exception. Several studies have been conducted on the efficiency of the soybean and grain futures markets but there is a lack of research when looking at the cotton futures market. Following Fama's definition of efficiency and principles of modern finance, there may be a price bias present in the cotton futures market which is the compensation for risk. This price bias would then be displayed as either normal backwardation or a contango. Kolb (1992) takes this idea and analyzes several different commodity markets, testing for normal backwardation and/or contangos. Meanwhile, Zulauf and Irwin (1998) analyze the efficient market hypothesis and its application to commodity futures market. They identify different marketing strategies commonly used to generate income. One such strategy, the systematic strategy utilizes an indicator variable when deciding what position to take on in the market.

Focusing first on Kolb's work, we test the cotton futures market for normal backwardation (price bias). We then take a closer look at the underlying principle of systematic strategies and focus on economic indicators that may have some relation to the movement of cotton prices. By analyzing different indicator variables, we can gain a better understanding of external factors that may influence cotton prices; thereby, allowing market participants to better formulate strategies to implement in the cotton futures market.

Preliminary results indicate deviations from normal market behavior (normal backwardation) but also suggest significant relationships between certain economic indicator variables and cotton futures prices.