SHORT COURSE ON COMMODATIES TRADING

Note:- All the words in blue colour are linked to web pages in Internet

Part 1: A Brief History

In the 1840s, Chicago had become a commercial center with railroad and telegraph lines connecting it with the East. Around this same time, the McCormick reaper was invented which eventually lead to higher wheat production. Midwest farmers came to Chicago to sell their wheat to dealers who, in turn, shipped it all over the country.

He brought his wheat to Chicago hoping to sell it at a good price. The city had few storage facilities and no established procedures either for weighing the grain or for grading it. In short, the farmer was often at the mercy of the dealer.

1848 saw the opening of a central place where farmers and dealers could meet to deal in "spot" grain - that is, to exchange cash for immediate delivery of wheat.

The futures contract, as we know it today, evolved as farmers (sellers) and dealers (buyers) began to commit to future exchanges of grain for cash. For instance, the farmer would agree with the dealer on a price to deliver to him 5,000 bushels of wheat at the end of June. The bargain suited both parties. The farmer knew how much he would be paid for his wheat, and the dealer knew his costs in advance. The two parties may have exchanged a written contract to this effect and even a small amount of money representing a "guarantee."

Such contracts became common and were even used as collateral for bank loans. They also began to change hands before the delivery date. If the dealer decided he didn't want the wheat, he would sell the contract to someone who did. Or, the farmer who didn't want to deliver his wheat might pass his obligation on to another farmer The price would go up and down depending on what was happening in the wheat market. If bad weather had come, the people who had contracted to sell wheat would hold more valuable contracts because the supply would be lower; if the harvest were bigger than expected, the seller's contract would become less valuable. It wasn't long before people who had no intention of ever buying or selling wheat began trading the contracts. They were speculators, hoping to buy low and sell high or sell high and buy low.

Part 2: What is traded?

A cash commodity must meet three basic conditions to be successfully traded in the futures market:

1. It has to be standardized and, for agricultural and industrial commodities, must be in a basic, raw, unprocessed state. There are futures contracts on wheat, but not on flour. Wheat is wheat (although different types of wheat have different futures contracts). The miller who needs a wheat futures to help him avoid losing money on his flour transactions with customers wouldn't need a flour futures. A given amount of wheat yields a given amount of flour and the cost of converting wheat to flour is fairly fixed. hence predictable.
2. Perishable commodities must have an adequate shelf life, because delivery on a futures contract is deferred.
3. The cash commodity's price must fluctuate enough to create uncertainty, which means both risk and potential profit.
4.

Part 3: Futures Exchanges - a look inside

Most exchange trading floors are divided into pits (or rings) where traders stand facing one another. These are more or less shallow octagonal areas with raised steps around the edge. Each pit is designated for trading one or more futures contracts. For instance, at the Chicago Board of Trade (CBOT) there are large pits for trading T-bonds, soybean, and corn futures among many others. The Commodities Exchange Center in New York houses more than one futures exchange. There you will find trading pits for such diverse commodities as coffee, sugar frozen orange juice, cocoa, gold, cotton, and heating oil.

Every futures exchange is set up in about the same way. Like the stock exchanges, the people trading on the floor must be members of the exchange itself. The members support the exchange by dues and assessments. Non-members - average investors, for instance trade through brokerage firms whose officers or partners hold memberships.

The exchange provides the place to trade and support facilities, such as phones and price-reporting and dissemination systems. It does not set prices or buy or sell for itself. However, its employees scrutinize operations and strictly enforce exchange rules

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Part 4: The Futures Contract

Unlike a stock, which represents equity in a company and can be held for a long time, if not indefinitely, futures contracts have finite lives. They are primarily used for hedging commodity price-fluctuation risks or for taking advantage of price movements, rather than for the buying or selling of the actual cash commodity. The word "contract" is used because a futures contract requires delivery of the commodity in a stated month in the future unless the contract is liquidated before it expires.

The buyer of the futures contract (the party with a long position) agrees on a fixed purchase price to buy the underlying commodity (wheat, gold or T-bills, for example) from the seller at the expiration of the contract. The seller of the futures contract (the party with a short position) agrees to sell the underlying commodity to the buyer at expiration at the fixed sales price. As time passes, the contract's price changes relative to the fixed price at which the trade was initiated. This creates profits or losses for the trader.

In most cases, delivery never takes place. Instead, both the buyer and the seller, acting independently of each other, usually liquidate their long and short positions before the contract expires; the buyer sells futures and the seller buys futures.

Arbitrageurs in the futures markets are constantly watching the relationship between cash and futures in order to exploit such mispricing. If, for example, an arbitrageur realized that gold futures in a certain month were overpriced in relation to the cash gold market and/or interest rates, he would immediately sell those contracts knowing that he could lock in a risk-free profit. Traders on the floor of the exchange would notice the heavy selling activity and react by quickly pushing down the futures price, thus bringing it back into line with the cash market. For this reason, such opportunities are rare and fleeting. Most arbitrage strategies are carried out by traders from large dealer firms. They monitor prices in the cash and futures markets from "upstairs" where they have electronic screens and direct phone lines to place orders on the exchange floor.

Part 5: Market Pressures

The cost of carry explains the basic relationship of cash to futures pricing, but it does not explain many less certain factors that can affect futures pricing such as seasonal influences and other unpredictable events.

As for Interest-rate and currency futures - those based on T-bonds, T-bills, Eurodollars and the five major currencies - the biggest influences are the policies and trading activities of the Federal Reserve, U.S. Treasury and foreign central banks, all of which affect interest rates.

Stock indexes are affected by whatever influences the stock market as a whole. Interest rates certainly play a major role - higher interest rates usually hurt the stock market. Other effects include the overall prospects for corporate earnings and corporate tax policies that help or hurt big business.

Futures trading provides a way to establish a form of price knowledge leading to continuous price discovery. Futures prices reflect not only current cash prices, but also expectations of future prices and general economic factors.

Part 6: Who Trades Futures and Why?

There are two basic categories of futures participants: hedgers (**hedge:** A sale of futures contracts to offset the ownership or purchase of the underlying cash commodity in order to protect it against adverse price moves; or, conversely, a purchase of futures contracts to offset the sale of the underlying cash commodity, again for protection against adverse price moves.)and speculators.(A trader who takes an outright long or short position in the market (opposite of "hedger"). Some speculators also trade spreads.)

In general, hedgers use futures for protection against adverse future price movements in the underlying cash commodity. The rationale of hedging is based upon the demonstrated tendency of cash prices and futures values to move in tandem.

Hedgers are very often businesses, or individuals, who at one point or another deal in the underlying cash commodity. Take, for instance, a major food processor who cans corn. If corn prices go up. he must pay the farmer or corn dealer more. For protection against higher corn prices, the processor can "hedge" his risk exposure by buying enough corn futures contracts to cover the amount of corn he expects to buy. Since cash and futures prices do tend to move in tandem, the futures position will profit if corn prices rise enough to offset cash corn losses.

Speculators are the second major group of futures players. These participants include independent floor traders and investors. Independent floor traders, also called "locals", trade for their own accounts. Floor brokers handle trades for their personal clients or brokerage firms.

For speculators, futures have important advantages over other investments:

a. If the trader's judgment is good. he can make more money in the futures market faster because futures prices tend, on average, to change more quickly than real estate or stock prices, for example. On the other hand, bad trading judgment in futures markets can cause greater losses than might be the case with other investments.
b. Futures are highly leveraged investments. The trader puts up a small fraction of the value of the underlying contract (usually 10%-15% and sometimes less) as margin, yet he can ride on the full value of the contract as it moves up and down. The money he puts up is not a down payment on the underlying contract, but a performance bond. The actual value of the contract is only exchanged on those rare occasions when delivery takes place. (Compare this to the stock investor who generally has to put up at least 50% of the value of his stocks.) Moreover the commodity futures investor is not charged interest on the difference between the margin and the full contract value.
c. In general, futures are harder to trade on inside information. After all, who can have the inside scoop on the weather or the Chairman of the Federal Reserve's next proclamation on the money supply? The open outcry method of trading - as opposed to a specialist system - insures a very public, fair and efficient market.

d. Commission charges on futures trades are small compared to other investments, and the investor pays them after the position is liquidated.

e. Most commodity markets are very broad and liquid. Transactions can be completed quickly, lowering the risk of adverse market moves between the time of the decision to trade and the trade's execution.

Part 7: The Clearing House

Each futures exchange has a clearing association which operates in conjunction with the exchange in a manner similar to a bank clearing house.

Membership in the clearing association is composed exclusively of well-capitalized members of the exchange and corporations or partnerships one of whose officials must be an exchange member Exchange members who do not join the clearing association must clear their trades through a member of the association.

Every clearing-house member must put up fixed original margins and maintain them with the clearing house in the event of adverse price fluctuations. In such instances, the clearing house may call for additional margins throughout the day without waiting for routine end-of-day settlement.

It is worth noting here that parties to a trade who disagree about the information they exchanged in the pit (such as the price, number of contracts or month of the trade) must settle their differences and clear the trade before they are allowed to return to the floor the next morning. Disputes rarely arise, but if they do, exchanges have steps to follow in helping to resolve them.

Part 8: Market News and Analysis

Keep in mind that futures prices are more volatile than stock prices. An established company that has enjoyed a long history of solid earnings will probably continue to do so. But a commodity that has trended up during one year, may turn around in the opposite direction the next year - and very quickly, too. For this reason, the commodity trader cannot sit back and relax knowing that his futures contract will bring in smooth returns. He must do his homework. In the futures market that means forecasting using fundamental analysis, technical analysis (charting), or both.

Information Sources for Fundamental Analysis

The fundamental approach to forecasting futures prices involves monitoring demand and supply. Traders gather this information from a number of sources trade organizations, private newsgathering and research firms, and the press. The most complete source of information is the U.S. government through the Departments of Agriculture, Treasury and Commerce and the

Federal Reserve Banks.

everal brokerage firms issue market letters, which are usually in the form of digests of market information with opinions on future price trends.

Also, a few private advisory services provide commodity market information. They analyze available information from government and other sources, and make their own market and price forecasts.

Technical Analysis - the Philosophy of Charting

The cornerstone of technical trading is the belief that fundamental information, political events, natural disasters and psychological factors will quickly show up in some form of price movement. The chartist, therefore, searches for certain formations or patterns which indicate bullish or bearish shifts in fundamentals. If his analysis is correct, he can quickly profit from the changes without necessarily knowing the specific reasons for them.

Fundamental traders can also use charting information. Since the market price itself may react before the fundamental information comes to light, chart action can alert the fundamental analyst that something is happening and encourage closer market analysis.

How Charting Works

Bar charts, one of the more popular tools of traders, include information on a particular futures market's price movements, volume and open interest. Such charts are produced daily, weekly and monthly. Studying historical patterns can help to provide a long-term perspective on the market.

In addition to studying chart patterns, traders also look at moving averages, oscillators and other devices in ascertaining how bullish or bearish a market may be growing. Computer models are also used to check trend direction.

Charting is not an exact science. Allowances must be made for errors, and unexpected events can disrupt forecasts made on chart patterns. Even so, many market participants - both fundamental and technical traders - find that charting helps them stay on the right side of the market as well as pin down entry and exit points.

Part 9: Taking a Position

Hedging

Hedging programs are used by individuals and companies who want protection against adverse price moves which would affect the cash commodities in which they deal.

The Short Hedge

In a short hedging program, futures are sold. This strategy is used by traders who either own the underlying commodity or are in some way subject to losses if its price declines.

The Long Hedge

Suppose the miller knows in July that in September he will buy 10,000 bushels of wheat from a grain elevator operator for grinding into flour. He worries that wheat prices will rise in the meantime because he has already guaranteed a price at which to sell flour to a baker in October.

Because he does not have the wheat now, he is considered to be "short the actuals" or "short the cash market." Therefore, to hedge this risk in the futures market, he can buy two wheat futures contracts (each represents 5.000 bushels). In September the cash price of wheat rises, the value of his futures contracts will rise too. The profit on the futures "leg" of his hedge will be earned by selling the futures at a higher price than he paid when he initiated the position, and will offset the extra money he must pay the grain elevator operator for the wheat.

The Relationship Between the Hedger and the Speculator

Unlike the hedger, the speculator usually has no contact with the underlying commodity; he has no natural long or short position as in the case of the hedger. He is in the market to make profits by buying low and selling high. Speculators are very important to a market. They make it more liquid and often take the opposite side of hedgers' trades. In this way, they act as a type of insurance underwriter by bearing the risk which hedgers seek to avoid.

Spreads

Much of the non-hedging activity in the futures markets involves spread trades (also called straddles). These strategies generally carry less risk than outright long or short positions; hence, they usually have lower margin requirements. Spreads involve the simultaneous buying and selling of futures contracts with different characteristics.

Compared to speculators, traders who put on spreads tend to make limited profits; they also suffer milder losses and likely enjoy a better night's sleep.

Part 10: Taking Delivery

You may wonder what happens if a trader forgets to close out a long position. If he bought live hog futures, will someone deliver 40,000 pounds worth of squealing porkers to his back door the morning after his contract expires?

Brokerage firms watch their open accounts and know who has long or short positions in contracts nearing maturity. Prior to delivery day, they inform customers who have open long positions that they must either close out the position or prepare to take delivery and pay the full value of the underlying contract. By the same token traders with short positions are informed that they must close out their trades or prepare to deliver the underlying commodity. In this case, they must have the required quantity and quality of the deliverable commodity on hand.

On the few occasions that a buyer accepts delivery against his futures contract, he is usually not given the underlying commodity itself (except in the case of financials), but rather a receipt entitling him to fetch the hogs, wheat, or corn from warehouses or distribution points.

Food processors or manufacturers who use futures to hedge rarely take delivery because the deliverable grade on the contract may not be exactly what they need. Hence, they will close out their futures position before delivery and buy in the cash market instead.

Sometimes merchants and dealers accept delivery because they can find buyers for many grades and types of the underlying commodity.

Part 11: Options on Futures

Options on futures began trading in 1983. Today, puts and calls on agricultural, metal, and financial (foreign currency, interest-rate and stock index) futures are traded by open outcry in designated pits. These options pits are usually located near those where the underlying futures trade. Many of the features that apply to stock options apply to futures options.

An option's price, its premium, tracks the price of its underlying futures contract which, in turn, tracks the price of the underlying cash. Therefore, the March T-bond option premium tracks the March T-bond futures price. The December S&P 500 index option follows the December S&P 500 index futures. The May soybean option tracks the May soybean futures contract. Because option prices track futures prices, speculators can use them to take advantage of price changes in the underlying commodity, and hedgers can protect their cash positions with them. Speculators can take outright positions in options. Options can also be used in hedging strategies with futures and cash positions.

Futures options have some unique features and a set of jargon all their own.

Puts, Calls, Strikes, etc.

Futures offer the trader two basic choices - buying or selling a contract. Options offer four choices - buying or writing (selling) a call or put. Whereas the futures buyer and seller both assume obligations, the option writer sells certain rights to the option buyer.

A call grants the buyer the right to buy the underlying futures contract at a fixed price the strike price. A put grants the buyer the right to sell the underlying futures contract at a particular strike price. The call and put writers grant the buyers these rights in return for premium payments which they receive up front.

The buyer of a call is bullish on the underlying futures; the buyer of a put is bearish. The call writer (the term used for the seller of options) feels the underlying futures' price will stay the same or fall; the put writer thinks it will stay the same or rise.

Both puts and calls have finite lives and expire prior to the underlying futures contract.

The price of the option, its premium, represents a small percentage of the underlying value of the futures contract. In a moment, we look at what determines premium values. For now, keep in mind that an option's premium moves along with the price of the underlying futures. This movement is the source of profits and losses for option traders.

Who wins? Who loses?

The buyer of an option can profit greatly if his view is correct and the market continues to rise or fall in the direction he expected. If he is wrong, he cannot lose any more money than the premium he paid up front to the option writer.

Most buyers never exercise their option positions, but liquidate them instead. First of all, they may not want to be in the futures market, since they risk losing a few points before reversing their futures position or putting on a spread. Second, It is often more profitable to reverse an option that still has some time before expiration.

Option Prices

An option's price, its premium, depends on three things: (1) the relationship and distance between the futures price and the strike price; (2) the time to maturity of the option; and (3) the volatility of

the underlying futures contract.

The Put

Puts are more or less the mirror image of calls. The put buyer expects the price to go down. Therefore, he pays a premium in the hope that the futures price will drop. If it does, he has two choices: (1) He can close out his long put position at a profit since it will be more valuable; or (2) he can exercise and obtain a profitable short position in the futures contract since the strike price will be higher than the prevailing futures price.

Part 12: A Safety Net (of sorts)

Through the control offered by the exchanges, and government regulation, trading in the commodities markets does offer some limited protection from manipulation. The use of prudent orders does also offer some protection from loss.

The Short Futures Position

This simply means taking a short position in the hope that the futures price will go down. There is nothing to borrow and return when you take a short position since delivery, if it ever takes place, doesn't become an issue until some time in the future

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Part 13 : Limit and Stop-Loss Orders

"Limit orders" are common in the futures markets. In such cases, the customer instructs the broker to buy or sell only if the price of the contract he is holding, or wishes to hold, reaches a certain point. Limit orders are usually considered good only during a specific trading session, but they may also be marked "G.T.C." good till canceled.

Maximum Daily Price Moves

Sometimes futures prices in certain markets will move sharply in one direction or the other following very important news extremely bad weather in a growing area or a political upheaval, for instance. To provide for more orderly markets, the exchanges have definite daily trading limits on most contracts.

Most futures exchanges use formulas to increase a contract's daily trading limit if that limit has

been reached for a specific number of consecutive trading days. Also. in some markets, trading limits are removed prior to expiration of the nearby futures contract. For other contracts, including stock index and foreign currency futures, no trading limits exist.

The Commodity Exchange Act

Trading in futures is regulated by the Commodity Futures Trading Commission, an independent agency of the United States government. The CFTC administers and enforces the Commodity Exchange Act.

The End