



# Commodity Trading Strategies

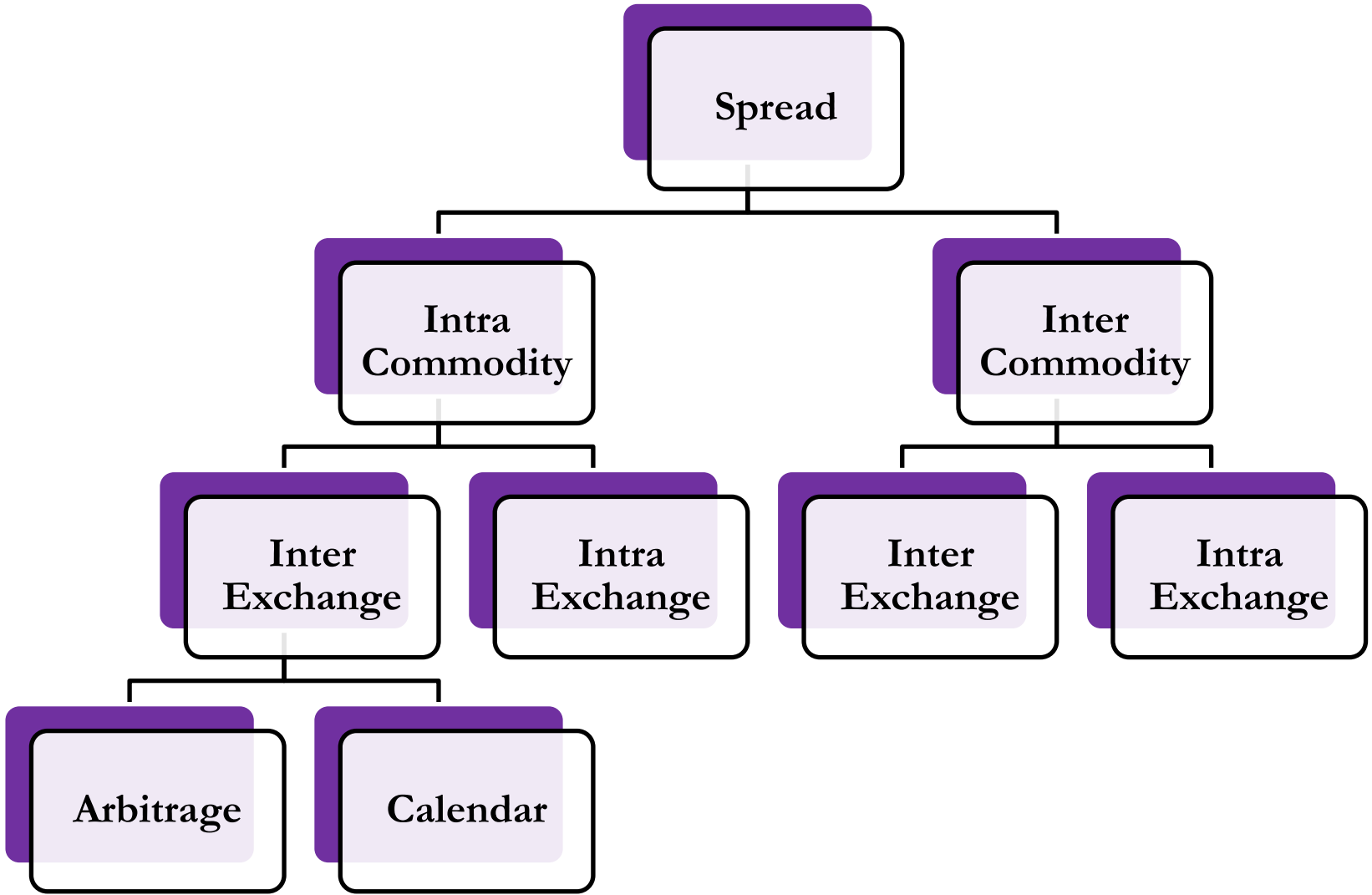


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# Spread

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- Spreads are strategies used by traders to profit from discrepancies in market price movements by taking a long and short position simultaneously in a single currency/commodity or between two different but correlated commodities/currencies
- To start with there are three different types of Commodity spreads. They are
  - Calendar or Intra commodity spreads
  - Inter commodity spreads
  - Inter exchange spreads



# Calendar or Intra commodity spreads

- This is the most common spread strategy used by today's traders. It is also known as Intramarket or interdelivery or horizontal or time futures spread. The spread is executed by a trader or investor by taking long and short positions in two future contracts with different maturities but within the same commodity

**For example** a calendar spread can be executed by going long in January 2010 wheat futures and short in March 2010 futures or vice versa. The short and long positions are taken simultaneously. Here again a question arises in a traders mind as to go long and short in which contract respectively

- The calendar spread is sub divided into two categories-
  - Bull Spread
  - Bear Spread

# Bull Spread

- When a trader believes that the spread between two futures contracts in a particular commodity market may rise he/she will sell the near month contract and buy the deferred month contract

**Example:** If the trader expects the spread between Feb-March Guar futures to rise then the trader can capitalize the price movement by executing the following strategy

1 Feb 2011		15 Feb 2011 (Trader's Forecast)	
	Prices (per quintal)	Contract	Prices (per quintal)
Feb- 2011	2870	Feb- 2011	2940
March- 2011	2930	March- 2011	3000

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- **Step 1:** The trader **sells** Feb 2011 Wheat future and **buys** March 2011 Wheat futures on 1<sup>st</sup> Feb 2011
  - **Step 2:** Holds the contracts for 15 days
  - **Step 3:** Squares off his positions in the respective contracts by going long and short in the Feb 2011 and March 2011 contracts respectively on 15<sup>th</sup> Feb 2010

Current spread between Feb & March contracts = Price of March 2010  
Futures - Price of Feb 2010 Futures  
Current spread = 2930-2870 = 60

Traders forecast for prices as on 15<sup>th</sup> Feb = Price of March 2010  
Futures - Price of Feb 2010 Futures  
=3030-2920 = 110

Profit realized from the strategy when spread rises:

	Feb 2011	March 2011	Change (March-Feb)
1 Feb 2011	Sell at 2870	Buy at 2930	60
15 March 2010	Buy at 2920	Sell at 3030	110
Profit	-50	100	
Net profit realized		50	50

- The strategy works as long as the spread between both the contracts rises

## **One should do Bull Spread- Why???**

- For intra commodity spread one have to pay less margin (60-70%) money while taking the positions
- Prices of any commodity depends on its demand –supply situation. So if trader has an idea that the supply will be more in March while less in April then higher supply will pressurize the prices in current month. However, till the far month contract will become active supply pressure will ease down.
- Vice versa if demand is expected to come in far month compared to near moth them prices in current month will remain down compared to far month

Thus, trader can make profit by buying far month and selling near month

# Bear Spread

- If the trader believes the spread between two contracts in a commodity will fall in the future he/she will buy the near month contract and sell the deferred month contract

**Example:** If the trader expects the spread between Feb- March wheat to fall in the future then the trader can capitalize the price movement by executing the following strategy

1 Feb 2011		15 Feb 2011 (Trader's Forecast)	
Contract	Prices (per quintal)	Contract	Prices (per quintal)
Feb- 2011	1355	Feb- 2011	1300
March- 2011	1295	March- 2011	1220

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- **Step 1:** The trader **buys** Feb 2011 Wheat future and **sells** March 2011 Wheat futures on 1<sup>st</sup> Feb 2010
  - **Step 2:** Holds the contracts for 15 days
  - **Step 3:** Squares off his positions in the respective contracts by going short and long in the Feb 2011 and March 2011 contracts respectively

Current spread between Feb & March contracts = Price of Feb 2011 Futures - Price of March 2011 Futures

$$\text{Current spread} = 1300 - 1215 = 85$$

Traders forecast for prices as on 15<sup>th</sup> Feb = Price of Feb 2011 Futures - Price of March 2011 Futures

$$= 1265 - 1160 = 105$$

Profit realized from the strategy when spread rises:

	Feb 2011	March 2011	Change (March-Feb)
1 Feb 2011	Buy at 1300	Sell at 1215	85
15 Feb 2011	Sell at 1265	Buy at 1160	105
Profit	-35	55	
Net profit realized	20		

- The strategy works as long as the spread between both the contracts falls

## One should do Bear Spread- Why???

- For intra commodity spread one have to pay less margin (60-70%) money while taking the positions
- Same as Bull spread prices of any commodity depends on its demand –supply situation. So for bear spread if trader has an idea that the supply will be less in March while more in April then higher supply will pressurize the prices in far month. However, till the far month contract will become active supply pressure will be more. Or
- If demand in current month will be more compared to far month then prices in near month will move up against far month.

Thus, trader can make profit by buying current month and selling far month

# Inter commodity spreads

- This strategy involves taking long and short positions in futures contracts in **different but correlated commodities**. The trading contract can be same or different for both the commodities

**Example:** If the trader expects the spread between Lead mini and Zinc mini futures to rise then the trader can capitalize the price movement by executing the following strategy

1 Feb 2011		15 Feb 2011 (Trader's Forecast)	
Contract	Prices (per quintal)	Contract	Prices (per quintal)
Feb- 2011 (Lead mini)	120.20	Feb- 2011(Lead mini)	121.50
Feb- 2011(Zinc mini)	211.20	Feb- 2011(Zinc)	110.50

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- **Step 1:** The trader **buys** Feb 2011 Lead mini futures and **sells** Feb 2011 Zinc mini futures on 1<sup>st</sup> Feb 2010
  - **Step 2:** Holds the contracts for 15 days
  - **Step 3:** Squares off his positions in the respective contracts by going short and long in Lead mini Feb 2011 and Zinc mini Feb 2011 contracts respectively

Current spread between Lead mini & Zinc mini Feb contracts = Price of Guar Feb 2011 Futures - Price of Chana Feb 2011 Futures

$$\text{Current spread} = 120.20 - 111.20 = 9$$

Traders forecast for prices as on 15<sup>th</sup> Feb = Price of Lead mini Feb 2011 Futures - Price of Zinc mini Feb 2011 Futures

$$= 121.50 - 110.50 = 11$$

Profit realized from the strategy when spread rises:

	Lead Mini Jan 2011	Zinc Mini Jan 2011	Change (Guar Gum- Guar Seed)
1 Feb 2011	Buy at 120.20	Sell at 211.20	9
15 Feb 2011	Sell at 121.50	Buy at 110.50	11
Profit	1.30	0.7	
Net profit realized		2	2

# Inter exchange spread

- Consider that a single commodity is being traded on two different exchanges. However there is a variation in the prices quotation of the commodity on both these exchanges. This strategy involves taking long and short positions in same commodity in same contracts but in two different exchanges

**Example:** Consider potato prices on NCDEX is at Rs 610 /quintal while the same on MCX is Rs 670/quintal. As result a trader can initiate an arbitrage by buying 1 contract of Potato on NCDEX and selling it on MCX. As a result the trader has earned a risk less profit of Rs 60/quintal. However, the price disparity will disappear as more arbitrage take place because with more buying the prices of the commodity on NCDEX will rise while at the same time as more sellers come to sell on MCX the prices will fall. As a result equilibrium will be established over a period of time.

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NCDEX	MCX
Buy at Rs.610/ quintal(Low price)	Sell at Rs 670/quintal (High price)

- However, the price disparity will disappear as more arbitrage take place because with more buying the prices of the commodity on NCDEX will rise while at the same time as more sellers come to sell on MCX the prices will fall. As a result equilibrium will be established over a period of time.

# Inter Commodity Ratio

- This a ratio between prices of commodities having good correlation or between the prices of commodity and its by-product / processed product derived from the supply-demand dynamics of that commodity

$$\text{Ratio} = \frac{\text{prices of one commodity}}{\text{Prices of other commodity or By product}}$$

**Example:** Price ratio between Guar Gum (a processed product ) and Gaur seed . If prices of guar gum moves up ratio moves up and vice versa

**Ratio moves up if:** Trader will buy Guar Gum and sell Guar seed

- Numerators (Guar Gum) increases while denominator (Guar Seed) remain stable
- Denominator (Guar seed) decreases while numerator (Guar Gum) remain stable
- If Numerators increases and denominator decreases at the same time

1 March 2011		15 March 2011 (Trader's Forecast)	
Contract	Prices (per quintal)	Contract	Prices (per quintal)
Mar- 2011 (Guar Gum)	2850	Mar- 2011(Guar Gum)	2750
Mar- 2011(Guar seed)	8150	Mar- 2011(Guar seed)	8250

- Ratio at 1 March =  $8150/2850 = 2.85$

	Guar Gum Mar 2011	Guar Seed Mar 2011	Change (Guar Gum- Guar Seed)
1 Mar 2011	Buy at 8150	Sell at 2850	5300
15 Mar 2011	Sell at 8250	Buy at 2750	5500
Profit	100	100	200
Net profit realized	200		

- Ratio at 15 March =  $8250/2750 = 3.0$

**Ratio moves down if:** Trader will sell Guar Gum and Buy Guar seed

- Numerators (Guar Gum) decreases while denominator (Guar Seed) remain stable
- Denominator (Guar seed) increases while numerator (Guar Gum) remain stable
- If Numerators decreases and denominator increases at the same time

1 March 2011		15 March 2011 (Trader's Forecast)	
Contract	Prices (per quintal)	Contract	Prices (per quintal)
Mar- 2011 (Guar Gum)	2850	Mar- 2011(Guar Gum)	2950
Mar- 2011(Guar seed)	8150	Mar- 2011(Guar seed)	8050

- Ratio at 1 March =  $8150/2850 = 2.85$

	Guar Gum March 2011	Guar Seed March 2011	Change (Guar Gum- Guar Seed)
1 Mar 2011	Sell at 8150	Buy at 2850	5300
15 Mar 2011	buy at 8050	Sell at 2950	5100
Profit	100	100	200
Net profit realized	200		

- Ratio at 15 March =  $8050/2950 = 2.70$

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*Thank You*