# ECON 6: Introduction to Futures and Commodity Trading

Course Notes

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# 1 Commodity Futures

Commidities are raw materials that came right out of the ground, like gold, corn, crude oil, etc. There are two major participants in the futures market:

- The **hedges**: produces the commodity
- The **speculators**: businesses who use the commodity

**Example:** A tomato grower can either sell his tomatoes by taking them directly to a market, or they can guarantee delivery of tomatoes at some price in thirty days' time. Such a price is agreed upon by the parties and they enter into a futures contract, knowing that in thirty days' time, a fixed sales price is paid in exchange for some specific quantity and grade of tomatoes. This agreement works well for both parties to guarantee a fixed price, which allows for them to structure their cash flow and know what their profits will be.

However, only 1-2% of futures contracts go to delivery. Most of the futures positions are closed before the delivery date specified in the contract.

## 1.1 Hedging

Hedging is a risk management strategy used by producers to offset the probability of loss from fluctuations in the prices of commodities. They enter into a futures contract to secure a fixed price.

**Example:** Suppose there is an oil driller who sells oil and an oil refinery who needs to buy oil for operations. The oil driller has a production cost of $30 per barrel, so it chooses to buy into the futures market at $50 per barrel to lock in a $20 profit. The oil refinery knows they will need a certain number of barrels in 3 months and that at a price of $50 per barrel, they would profit. Thus, the oil refinery buys into the futures market at $50 per barrel to lock in the guaranteed price.

## 1.2 Speculating

The speculators are the ones taking the risk from the hedgers by betting that the price in the futures market will rise or fall. As futures traders, we are the speculators in this case.

# 2 Strategy

The trader's curse is being prepared and patiently waiting but ultimately failing to take action. It is crucial to have a trading plan and a target profit. Such a trading plan may involve one or two markets consistently being watched everyday and being prepared to not make a trade on some days. Patience and consistency in sticking to the trading plan is key.

The markets repeat themselves, and one of the most profitable places on the market trends to trade is the shoulder-head-shoulder scenario on the graphs. Another recurring trend is when the market breaks through the moving averages on a rise or fall, then pulls back towards the moving averages. Lastly, the market will continue on its original movement path of a rise or fall.

These are only very basic strategies.

# 3 Exercises

1. Which of the following is not a commodity? (Choose one.)
    - Crude oil
    - Gold
    - Aluminum
    - Silver
2. True or False: A futures contract has known quality and quantity specifications.

3. True or False: Hedgers are looking to eliminate risk.
4. True or False: Speculators are looking to take risk.
5. The futures markets are traded on a global marketplace. What entity do we need to access the markets? (Choose one.)
   - Futures dealers
   - Clearing house
   - Futures broker
   - Pit trader
6. True or False: When trading we can see before we buy.
7. Who are the two parties involved in futures trading transactions, hedgers and? (Choose one.)
   - Stock broker
   - Speculators
   - Gamblers
   - Accountants
8. Which quality is not ideal to be a successful trader? (Choose one.)
   - Patience
   - Persistence
   - Discipline
   - Desperation
   - Organization
9. Which of the following is not a by product of crude oil? (Choose one.)
   - Asphalt
   - Fuel oil
   - Petroleum products
   - Cooking oil
   - LPG
10. True or False: It is not important to have a stop loss with a trade as it's best to maximize profits.

### 3.1 Solutions

1. Aluminum
2. True
3. True
4. True
5. Futures broker
6. True
7. Speculators
8. Desperation
9. Cooking oil
10. False

## 4 Acknowledgements

This course is based off of Udemy's "Futures/Commodity Trading (Basics)" by G. Scott Martin.