Chapter 1

What Is a Commodity?

While this book covers a multitude of issues, it is designed to answer one central question: What is a commodity? This may seem like a difficult question to some people, but it's really quite simple. If you can touch it, see it, feel it, or eat it, it's a commodity. If you are driving through Texas and you see an oil field, there's a commodity being pumped out: oil. If you are cruising through miles of wheat fields in Kansas, then you are passing an agricultural commodity: wheat. If you are vacationing in Florida, you're sure to see fields filled with orange groves; once again, you are looking at a commodity: orange juice. Even when you find yourself in a jewelry store eyeing a beautiful gold chain, you are checking out a traded commodity: gold. Commodities are all around you, but not all commodities are traded.

Smart Trader Tip

The process of trading a commodity is done typically in a trading pit located at one of the major commodity exchanges or by computerized trading, one of the predominant means to trade commodities today. A trade occurs when a *buyer* of the commodity and the *seller* of the commodity agree on a price for that commodity based upon a standardized unit for the commodity being bought or sold.

Lumber, wheat, crude oil, heating oil, natural gas, corn, copper, gold, sugar, and coffee are just a few of the commodities you may come across every day of your life. You probably just never looked at them that way. Each time you buy a pound of coffee, the price you pay is based on the commodity price established for a pound of coffee beans. But as strange as it may sound, the future price of coffee is being traded right now, and that price can have wide fluctuations today, tomorrow, and over the many months to follow.

The next time you drive up to the gas pump to inspect the price of a gallon of regular gas, keep in mind that the price you pay is directly related to how gasoline is trading as a commodity. Today's volatile world means that this price will keep changing on a daily basis; hence, as oil is traded, prices fluctuate. These prices eventually translate to a change in the price of a traded gallon of gas, which will ultimately be filtered into what you pay at the pump.

Smart Trader Tip

The prices of commodities change frequently throughout the day. You can watch prices fluctuate by observing how they change at the commodity exchanges. For example, if you want to scrutinize how gasoline prices change throughout the day, surf the Internet to the New York Mercantile Exchange website (www.NYMEX.com).

What Is a Commodity Market?

offer
an indication by an investor or trader of willingness to sell a security or commodity. The offer, or asking price, is the price at which an investor can buy the security from another investor in the market.

As we have already explored, commodities are all around us. The prices we pay each day for just about everything have been established, in most cases, by the trading of commodities at exchanges. A commodity market is a place where buyers and sellers of commodities gather to buy and sell the raw materials used in products bought and sold in the open markets. Sellers *offer* their commodities to buyers at a certain price, while buyers *bid* for a commodity until a seller agrees to a price; a trade is then established. This is the process of trading in its simplest form.

Let's take a real-world example in a market most of us are acquainted with: shopping for an automobile. Suppose you live in a small town in the middle of Texas and you would like to buy a new hybrid minivan to save money on gas and do your part to contribute less to global warming. You go to the one dealer in town who specializes in hybrids to negotiate a good deal. You want to buy the minivan for $26,000 (buyer's bid), but the dealer wants to sell it for $32,000 (seller's offer). Since there's only one dealership within a 100-mile radius, this dealer refuses to negotiate. Basically, the dealer doesn't have to compromise because there isn't any competition for many, many miles. Since you (the buyer) and the car dealer (the seller) cannot agree on a price, there is no transaction. In the trading world, this means there is no trade.

bid

an indication that an investor or trader is willing to buy a security or commodity at a specific price. The current bid price is the price at which an investor can sell the security or commodity to another investor.

So, instead, you decide to try a bigger town that hosts two hybrid dealers. Now you have three potential sellers—the original dealer in your hometown and the two new dealers—who may be a little more willing to negotiate. The competition among these dealerships means you have a little more negotiating power.

Since more dealers means better prices, you decide to drive all the way to Dallas because a bigger city will have a multitude of hybrid dealers (making it a little more difficult to decide) including Toyota, Honda, Chevrolet, Dodge, Nissan, Ford, and Saturn. Since they all want your business, the deals are not only getting better in terms of price, they are throwing in incentives. This scenario is superior thanks to the diversity of the offers from the many dealers.

But not so fast! There's another way to find the best price available: the Internet. By surfing the Net, you can look at offers from dealers all over the world. Now that's a *liquid market!* You've gone from one local dealer and no price competition to a multitude of options. This means you can adjust your bid or just leave it as is until you get the price you want. When you finally make the purchase, you have made a *trade*—that is, the buyer (you) and the seller (the dealer) have agreed to a price and terms, and now you have formally completed a trade.

Smart Trader Tip

A *liquid market* is one in which there are a large number of buyers and sellers willing to buy and sell at various price points. For a commodity trader, a liquid market is usually a better market to trade, as you will be able to get better prices since more people are willing to make a market. *Market making* is the process of bidding (as a buyer) and offering (as a seller). The more people willing to make a market, the easier it will be to find someone to take the other side of your trade.

This is exactly how the commodity markets work. There will be a *market* in which there are buyers and sellers going back and forth—bidding (as a buyer) and offering (as a seller)—until the price and terms are agreed upon. When there is an agreement on the price and terms, a trade is made. Once a trade is completed, the details of the transaction are reported to a central reporting party who is responsible for the transmission of price of the transaction around the world. In today's highly computerized environment, this process moves extremely fast. Not too long ago, traders would have been stuck waiting for tomorrow's newspaper to get a price or have to call their broker. These days, computers enable us to get this information instantaneously!

Let's now take a look at a real commodity market: oil. Crude oil is one of the most liquid and volatile commodities and is traded at the New York Mercantile Exchange (NYMEX)—the primary open outcry exchange. Traders have either purchased or leased a seat to have the right to buy and sell the specific commodity on that exchange. The term *seat* is a bit of a misnomer. It actually provides the individual with the right to stand in a small area of the trading pit and yell and scream orders to buy and sell (in this case) oil futures. What are they trading? They are trading a standardized unit of a commodity. The standardization of the contract ensures that everyone knows exactly what is being traded.

Smart Trader Tip

Open outcry is the term used to describe the process of trading whereby traders stand eye to eye and toe to toe in a trading pit and make trades by interacting with other traders who want to take the opposite side of the trade. (Just think of the trading scenes in Eddie Murphy's movie *Trading Places* and you'll get the visual picture on this one.) They signal with their hands, and when a trade is made they signal back acknowledgment and write their trades down on a card for record keeping. Today, computers do most of this work.

Using our previous auto example, if everyone was trading a hybrid minivan with exactly the same options, color, and so on, then it would be a *standardized* unit. If you were trading a silver Toyota Prius but everyone else had a different model, no trading would occur, as no one would be on the same page. Standardized units mean that everyone knows and agrees on exactly what is being traded. For example, if traders are trading light sweet crude oil, then they are actually trading 1,000 U.S. barrels of light sweet crude oil during the hours of 9 A.M. and 2:30 P.M. (eastern standard time). That's a lot of oil for one futures contract, which is why it's so important to make sure you know exactly what you're trading.

Smart Trader Tip

Over the many years that I've been teaching people how to trade, I've learned that specializing in the study of just a couple of markets is the easiest way to attain success. The trick is to avoid analyzing too many commodities at one time. So start by picking one or two favorite commodities and then investigate them very carefully. It may take a few months until you understand the specifics and rhythms of these commodities, but after a while that knowledge will guide you to the right strategies to take advantage of specific market scenarios. Start by going to the NYMEX website (www.NYMEX.com) and take a look at everything you can trade. There's a lot to be learned simply by looking at the contract specifications of each commodity. Your success depends on your ability to do your homework on any commodity you are considering trading—the more in-depth your study, the easier it is to plan your trade.

Let's get back to our traders. At the end of the day, the traders and their assistants hand over their trades to their clearinghouse. All the accounting of the buys and sells are then tallied and the next-day profit-and-loss statements are issued for the previous day's activities. This is how the trader in a pit works day in and day out. It looks like a stressful job and it is, but it's one of the most exciting jobs I can imagine.

But to quote Bob Dylan, "The times they are a changing . . ." As the world changes thanks to the rapid integration of computer and online technologies into every possible human endeavor, the information flow at home and work continues to advance as well. In the markets, the emergence of computers have given birth to a whole slew of opportunities in the exciting world of commodity trading.

What Is the Difference between a Commodity and a Futures Contract?

The answer to this question is not as precise as I would like it to be. At first look, a commodity is a physical product (wheat, oil, lumber, soybeans, etc.) that can be touched, eaten, processed, or delivered—whether it is today, tomorrow, or next year. In contrast, a futures contract is a commodity that (as was explained in the example of the oil traders at the NYMEX) is standardized in its unit of measurement (i.e., 1,000 barrels of oil) to be delivered at some future date. For example, a light sweet crude oil futures contract can be traded in all months of many years to come. So if people want to trade oil futures contracts for December 2008 or oil futures contracts for March 2009, they are able to do so, as there is a market of traders looking to buy and sell those contracts.

Why would anyone do that? Well, the market is made up of a large number of people with diverse views and many different desires. For example, in the oil industry, a big oil company might want to sell a certain portion of what it produces next year. For example, Exxon Mobil (XOM) produces countless barrels of oil. If it sees oil prices at what it considers a good level, it may sell a certain number of barrels at that price for delivery next year. This way, the company knows specifically how much it will make on those barrels of oil. This process is known as hedging and, in this example, the oil company is considered a hedger.

Who would buy that oil? Well, let's say you are Southwest Airlines (LUV). The cost to fuel your fleet of planes is a major problem, as airplanes use a massive amount of oil every day. Airlines may choose to offset any potential rise in the cost of fuel by locking in today's prices. Hence, a futures oil contract can help Southwest Airlines avoid the risk of having to pay higher oil prices if the price of oil rises in the future. For example, if the price of oil fluctuates between $60 and $90 a barrel, it would behoove Southwest Airlines to lock in the $60 price and save a huge amount of money over the next year. It's easy to see why the airline would want to hedge its fuel risk by going to the oil futures market and buying oil contracts for delivery next year that guarantee a specific price. In this example, the airline company is also a hedger. They are turning to the futures market to lock in prices and hedge themselves against an adverse price move in the oil market.

Hopefully, this process is starting to make more sense. The buyer and the seller make a trade in order to achieve an objective that makes economic sense for both of them. In the previous example:

- Exxon Mobil, the seller, wants to lock in profits for next year by selling oil in the future at today's trading price.
- Southwest Airlines, the buyer, wants to hedge its risk so it buys oil in the future at today's trading price.

Do Southwest Airlines and Exxon Mobil call each other up to discuss their deal over the phone? Of course not; they go to the oil futures market and buy and sell from traders on the floor who act as intermediaries. This is the fastest and most liquid way to achieve the objective they both want to achieve; this kind of trading happens day in and day out.

The next party in the futures market is the *speculator*. The speculator is an individual trader (like me or you) who wants to trade a futures contract and make a profit on the price fluctuations of the oil futures contract. Let's say you believe oil prices are likely to go up. As an oil futures speculator, you can buy an oil futures contract. If you are right and oil futures rise, you can profit from being right on the move up. If the price of the oil futures contract goes from $70 to $71, you would make $1,000. If you are wrong, and the price of the oil futures contract goes from $70 to $69, then you lose $1,000. There are many speculators buying and selling futures contracts who are making money trading commodities to be delivered someday in the future. Speculators are the ones who create a great deal of the liquidity that exists in the daily trading of

speculator
a trader who hopes to benefit from a directional move in the underlying instrument, attempts to anticipate price changes, and, through buying and selling futures contracts, aims to make a profit. The speculator does not use the futures market in connection with the production, processing, marketing, or handling of a product, and thus has no interest in making or taking delivery. So, while speculators attempt to bank profits from moves in the futures contract on a short-term basis, *hedgers* turn to the commodities market to protect themselves from adverse moves in prices. Taken together, the hedgers and speculators are responsible for the buying and selling in the commodities and futures markets.

hedger
an investor who uses the futures market to minimize the risk in his or her business. Hedgers may be manufacturers, portfolio managers, bankers, farmers, and so on. Hedging can help lock in existing profits and/or reduce the overall risk of loss due to fluctuating prices.

the futures market. Unlike Southwest Airlines, speculators are not interested in receiving the actual physical commodity someday in the future. They are just speculating to make profit; hence, the name.

Back to Commodities

All over the world, farmers grow and sell a vast array of agricultural products. Regardless of the product they are farming, they are all trying to make money on their crops. Wheat farmers in Kansas are trying to maximize their yield on their many acres of farmland. Coffee growers in Colombia are trying to maximize the yield on their families' coffee plantations. Sugar growers in Brazil are working hard to harvest as much sugarcane as possible from the land. Additionally, traders of agricultural products are wise to monitor weather conditions and assess how they may affect certain markets. Even your neighborhood contractors have to assess how much they can ask for a house in order to pay for all the commodities necessary to build it. They are dependent on a variety of commodities including lumber and oil—both for their roof shingles and for the cost of transporting the materials it takes to build the house.

Day in and day out, 24 hours a day, seven days a week, commodities are affecting your life in every way. In fact, it can be asserted that the consumption of commodities makes the world go 'round. Now that you are more aware of this, you might look at the world a little differently. Next time you find yourself shopping at the local grocery, you may notice that just about everything there is a commodity. They just happen to be commodities that have now been delivered (no longer futures contracts) and now are available to you as an individual shopper. The grocer is making an *offer* to purchase; so when you buy something, you have made the trade. Advancing your knowledge of how the world revolves around commodities is one of the keys to understanding how they work. It's important to open your eyes to the big picture as well as to study the details of specific markets that make it a very profitable and exciting business.

How Can a Stock Trader Use This Information for Financial Gain?

We have already established that commodities affect your everyday life. Those who study them can make a very good living as commodity speculators or as longer-term commodities investors. If you only trade stocks, you may be wondering why you should even care about commodities. Bottom line, you can also use the knowledge you gain by studying commodities to make money in the stock market.

Since global economic cycles are very much driven by commodity prices, stock investors need to pay attention to the commodity markets. Commodity prices filter themselves into the earnings of virtually every business. For example, rising oil prices can directly increase Exxon Mobil's earnings. In contrast, rising oil prices hurt the airlines (such as Southwest, American, and Delta) and the cruise lines (like Carnival and Royal Caribbean), unless they hedge their oil price risk. If lumber prices go up, it hurts the homebuilders such as KB Homes. If coffee prices go up, it hurts Starbucks but helps the producer. If cocoa prices go up, it hurts the candy makers. This kind of trickle-down progression goes on and on. In fact, most of these companies are affected by multiple commodity prices. In essence, they can be helped (or hurt) by a variety of different commodities. As a stock trader, you must recognize the importance of investigating the commodities that affect the share price of any company you are interested in trading. As the prices of these commodities fluctuate, keep an eye on them, as company earnings may be affected as well.

On a broader scale, commodity prices affect the entire economy and the stock market. Just listen closely to what they are talking about on television regarding economic catalysts (i.e., factors that can affect the overall economy). First and foremost, the talking heads and pundits on television are constantly talking about oil. If oil prices are too high, then many companies are affected and not just because of the way this affects the price of a gallon of gas. Oil and oil by-products are used in a whole host of products. In addition, if oil prices increase too much and the price of a gallon of gas rises too high, this pinches the pockets of the average consumer, and spending patterns could shift accordingly. When consumers reduce spending, every company and the economy in general are affected.

Let's go one level higher and evaluate how commodity prices affect the global economy. Once again, let's use oil as an example. Table 1.1 shows the world's top oil producers, exporters, consumers, and importers in 2004, providing clues to international production and consumption.

TABLE 1.1 Top World Oil Producers, Exporters, Consumers, and Importers, 2004 (millions of barrels per day)

Producers	*Total Oil Production*	*Exporters*	*Net Oil Exports*	*Consumers*	*Total Oil Consumption*	*Importers*	*Net Oil Imports*
1. Saudi Arabia	10.37	1. Saudi Arabia	8.73	1. United States	20.5	1. United States	11.8
2. Russia	9.27	2. Russia	6.67	2. China	6.5	2. Japan	5.3
3. United States	8.69	3. Norway	2.91	3. Japan	5.4	3. China	2.9
4. Iran	4.09	4. Iran	2.55	4. Germany	2.6	4. Germany	2.5
5. Mexico	3.83	5. Venezuela	2.36	5. Russia	2.6	5. South Korea	2.1
6. China	3.62	6. United Arab Emirates	2.33	6. India	2.3	6. France	2.0
7. Norway	3.18	7. Kuwait	2.20	7. Canada	2.3	7. Italy	1.7
8. Canada	3.14	8. Nigeria	2.19	8. Brazil	2.2	8. Spain	1.6
9. Venezuela	2.86	9. Mexico	1.80	9. South Korea	2.1	9. India	1.5
10. United Arab Emirates	2.76	10. Algeria	1.68	10. France	2.0	10. Taiwan	1.0
11. Kuwait	2.51	11. Iraq	1.48	11. Mexico	2.0		
12. Nigeria	2.51	12. Libya	1.34				
13. United Kingdom	2.08	13. Kazakhstan	1.06				
14. Iraq	2.03	14. Qatar	1.02				

Source: Energy Information Administration (www.eia.doe.gov/emeu/cabs/).

Much of the run-up in oil prices is attributed to recent growth in the Chinese economy. Oil prices have been driven up as the once stagnant communist economy experiences massive economic growth, driving China to thirst for more and more oil. China needs virtually every type of commodity to fuel this growth, so commodity prices will most likely be affected for many years to come. Now when you drive up to the gas station pump and look at what you are paying for that gallon of gasoline, remember that this price is closely tied to what is happening in China and other countries around the world—not to mention the volatile ramifications of looming *peak oil* declines.

As you can see, commodity prices affect everything. For astute investors or traders, understanding how commodities work, locally and globally, is essential to being able to develop an edge against competing traders and investors.

peak oil
an idea originally sparked by Shell Oil geologist M. King Hubbard back in 1956 that the world will reach a peak in the rate at which it can extract oil from the ground. Once this peak is reached, production rates will decline and will not be able to keep up with demand. When demand outpaces production, the world economy will no doubt receive a major shock. The ramifications of peak oil continue to be a hot topic of discussion, but unlike global warming, the forces underlying peak oil are generally not disputed. (See Figure 1.1.)

Summary

Commodities are everywhere; the world depends on them. Every person on this planet comes in contact with commodities every day. Since commodities affect important parts of your life, this information can be used to generate profits in the commodities and futures markets. For example, do you buy coffee? Do you notice the price changes from one day to the next? What about when you are filling your gas tank? We all feel the effects from rising and falling gasoline prices. So the first step in becoming a successful commodities trader is easy: Pay attention to what is going on around you.

This book is designed as a guide to trading success in the commodity markets. It will show you how to get started in the diverse world of commodities trading and how to make a profit using this knowledge. The book is written with the novice reader in mind and starts at a very basic level, with an explanation of the different types of investments or trading vehicles that can be used to generate profits in the commodity

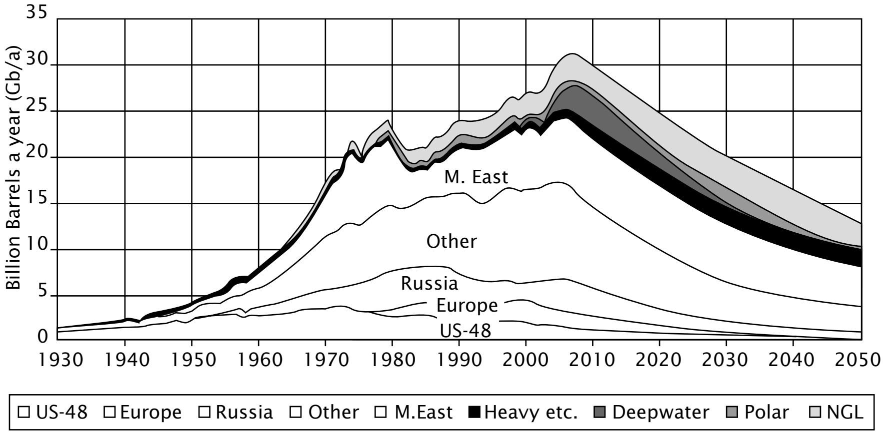

FIGURE 1.1 Peak oil timeline.
Courtesy the Association for the Study of Peak Oil & Gas.

markets. The reader is also introduced to various types of analysis tools, trading strategies, and risk management techniques. The book also explores finding the right broker, which is an extremely important part of becoming a successful trader in the commodity markets.

So get ready to learn how commodities work, how to analyze these markets and identify profitable opportunities, and how to structure trades to maximize rewards while managing risk.

Key Summary Points

1. Commodities are all around us. Lumber, oil, wheat, gold, coffee, and sugar are a few examples.
2. Not all commodities are traded in the financial markets, but many are.
3. The first step in becoming a successful trader in the commodity markets is to understand which commodities are traded and which ones are not.
4. Some of the actively traded commodities today include metals such as gold and silver, agricultural goods like wheat and coffee, energy such as oil and natural gas, as well as livestock such as cattle and pork bellies.

5. The commodities exchanges offer a central place for buyers and sellers to meet and trade the various commodities.
6. The New York Mercantile Exchange (NYMEX), the Chicago Board of Trade (CBOT), and the Chicago Mercantile Exchange (CME) are examples of active commodities exchanges.
7. Once buyers and sellers meet and agree on a price for a commodity, a trade is made.
8. For most investors, the buying and selling of commodities does not take place on the exchange but is handled by a licensed commodities broker (additional discussion in Chapter 13).
9. Many traders prefer to trade futures on commodities rather than the physical commodities themselves.
10. A futures contract is an agreement between two parties to buy or sell a commodity at a specific price sometime in the future.
11. The futures market consists of two principal players: hedgers and speculators. Hedgers, such as farmers and oil companies, turn to the futures market to lock in set prices and protect themselves from adverse moves in the market. Speculators use futures to speculate on possible moves in commodity prices.
12. While hedgers and speculators are the most active players in the futures market, commodities are all around us. Whether you are filling up the gas tank, going through the aisles at the grocery store, or buying a cup of coffee at your local Bohemian cafe, commodity prices will affect you.
13. Commodity prices have an important impact on the overall economy. Being aware of the importance of commodities not only makes you a better shopper and smarter investor, but also serves as the appropriate starting point for your journey to becoming a successful commodities trader.