CHAPTER 1

COMMODITY MARKETS

YOU CAN'T AFFORD TO IGNORE THEM ANYMORE

The commodity market mystique is alive and well. Stellar successes and dismal failures in these markets are the stuff of legends. From an outsider's perspective, commodity markets can be intimidating, even scary. I'm here to dispel some of the common myths and misconceptions about these markets. I can with all authority tell you that these markets are some of the most liquid, well-ordered, and secure in the world today. And once you've read this book, you'll agree that adding commodities to your portfolio is a sure way to capitalize on some of the most rewarding, exciting investment opportunities ever. Even if you don't know preferred stock from livestock, this book will introduce you to an asset class that promises to be a vital part of your portfolio over the next 20 years, and beyond.

Some people call me the Maniac Trader. I'm flattered. Why? Well, to most people these fast-paced markets conjure up images of high-risk investing in an environment of absolute chaos. Actually, the images of chaos and high risk are two myths I will dispel in this book. I trade all commodities and I trade both sides of the market, switching from the bear camp to the bull camp and then back again, sometimes within only a few days. Some would call this a schizophrenic existence. But it definitely works for me, and it can work for you if you take the time to learn about and trade these highly liquid, exceedingly profitable markets. Read on . . .

A LITTLE HISTORY

Commodity markets in various forms have been around forever, or at least since the time of ancient Greece and Rome. They even survived the Dark Ages, and reemerged at local fairs in medieval times, arranged by trade associations formed by merchants, craftsmen, and promoters. Over the next few centuries, these markets evolved into exchanges, or *bourses,* in England and Europe, as well as in Japan and the New World. U.S. cash commodity exchanges first appeared in New York for trading in domestic produce.

Though none of these markets exist now, they were the foundation for the commodity markets as we know them today. Since 1848, when the Chicago Board of Trade was formed, commodity futures have given producers and consumers a way to even out price moves and protect against market risk, as well as giving investors a way to capitalize on market moves.

In their early days, futures markets were used primarily to make or take delivery of the actual commodity; today, fewer than 1 percent of all futures contracts actually result in delivery against the contract. So there's really no truth to the myth that you'll end up with 200 head of hungry cattle grazing on your front lawn, or 50,000 gallons of orange juice cooling in your fridge, or a boxcar of grain dumped in your backyard! Unless, of course, that's what you want.

RESOURCES, NATURALLY

Right now, the world is experiencing a commodities supercycle—a boom in resources that's likely to last for at least another decade. The market for raw resources is raging—because of China, because of

India, because of surging oil demand and plunging energy supplies and the crushing effect of hurricanes on offshore U.S. oil. It's time for you to get in on the profit cycle!

History is full of gear-turning, gut-churning events, each with its own importance. But each is connected to the others by an endless cycle of supply and demand. As the world scrambles for resources, the opportunities for the savvy investor to profit are endless. And because these products are finite, we can expect demand to continue to grow. At this moment, you're looking at one of the best times in history to make money by trading resources.

Let's face it—trading commodities is not for the meek or faint of heart. You need sound judgment, guts, and an appetite for risk, not to mention available capital. These markets move, and they move quickly. Just take a look at all the markets over the past few months—gold, oil, grains, stock indexes, tropical markets, all of them with wild swings in both directions. There are huge risks but incredible rewards for the savvy trader or investor.

Cycles in commodities can be very predictable. There are no CEOs on the inside cooking the books. There are no accounting firms puffing up profit reports. You just have the commodities on the move. Trading on those moves, you can make money no matter which way prices are headed.

Many times in this book I refer to commodities trading as "the last bastion of pure capitalism on earth." I mean, where else can you sell something you don't own, buy it back half an hour later, and walk away with 100 percent profit? Few investment vehicles offer the excitement, flexibility, and tremendous profit opportunities of commodities.

STORM OF PROFITS

It's unfortunate, but profit opportunities often are greatest when things go wrong. Look at the devastation from Hurricane Katrina. When hurricane season is in full swing it can be a very long summer indeed. Often, Gulf Coast residents have barely picked up the pieces from the previous year's debacle when it is time to batten down the hatches yet again.

In 2005, four Category 3 storms—Dennis, Katrina, Rita, and Wilma—left a trail of havoc and destruction through a large part of the United States. Hurricane Katrina's strong winds and heavy waves devastated the Gulf Coast in late August. The storm and resulting flooding caused more than 1,300 deaths and an estimated $100 billion in damage, making it the most expensive natural disaster in U.S. history.

Nobody can predict for sure what any storm season will hold, but some experts say we are in the beginning stages of a hurricane supercycle, which usually lasts 15 to 20 years.

Stockpiling positions in some of the key commodities that may be adversely affected can be a very profitable strategy. As certain industries brace for each new storm season, traders can hedge themselves by adding specific commodities to their portfolios on a limited basis, using options or even futures to some extent.

Don't feel guilty betting on a rough hurricane season; after all, like any type of hedging, it's insurance. When we purchase fire insurance on our houses, we don't hope they'll burn down, at least not usually. No, we take out insurance to protect our investment—that's all we're doing.

The vulnerable markets include everything from natural gas and sugar to orange juice and crude oil. Take sugar, for example. Sugar crops have sustained hard hits in Florida and elsewhere from recent years' hurricanes. Sugar has the added benefit of being a key ingredient in the production of ethanol and is already in high demand, so there's a double whammy here. Another market likely to be heavily impacted by a rough hurricane season is natural gas. Remember, natural gas is used for heating and cooling—again, a double-edged sword.

Another good risk/reward scenario heading into an active hurricane season would be adding some unleaded gasoline call options to your portfolio. Whoa! I know what you may be saying: "Oh, no! There he goes using all of that trader jargon—calls, puts, straddles, strangles, and so on." No worries; in this book it's all about speaking plain English. We will learn what calls are, and all the other trading terms, later.

All of these commodities and many more are almost certain to experience intense volatility heading into and during hurricane season. But keep in mind that volatility drives the commodity markets.

The fear of what *may* happen can be more of a factor than the actual storms, so it's best not to be greedy. Use a hedge for what it's for: protecting your overall portfolio from the losses other holdings in your portfolio and property may take as a result of the storms.

Another thing about hurricanes is that they do a lot of damage and leave a mess to clean up. In 2005, more than 113 oil platforms were destroyed and over 400 pipelines were damaged. Sometimes the best way to play resources is to buy equities related to the companies that harvest the resources as well as provide the drilling equipment and, eventually, the transportation of the finished goods. For example, while not a direct resource play, buying stocks related to transport of oil workers from oil platforms and terminals was a very good investment that year. Even heading into the 2006 hurricane season it proved fruitful. Smaller stocks in companies that transport workers to and from rigs and facilities—specifically, boat and helicopter companies—were a very good investment. This play was good globally, too. In the Scottish newspaper *The Scotsman,* Frank Urquhart wrote about it just prior to the hurricane season in 2006 ("Copter crisis threatens oil industry," 6/30/05):

> North Sea helicopter companies are struggling to meet a surge in demand for their services because of a shortage of aircraft and crews to fly them, it was revealed yesterday.
>
> The soaring price of oil has led to a sudden and major increase in helicopter operations in the offshore oil and gas industry.

Helicopters and transport are commodities in their own right in times of need. This is only one example of the many investment opportunities available that are simply associated with the commodities themselves. Shipping, rail, storage, you name it—if it hauls, plows, ships, builds, or refines, we can relate it to commodities and it can be a profitable addition to our portfolios.

BEYOND THE STORMS

It can be as important to understand the psychology of the markets as it is the mechanics. At the start of hurricane season nobody knows for sure just how bad it will be. One thing is certain, though—a lot of attention is being paid to it. This can often have the reverse effect on a trading market should the hurricane season be relatively light. The old adage "Buy the rumor, sell the news" certainly applies here.

In other words, put your positions on early and take early profits simply on the back of the fear of what might happen, not what actually does happen. Being married to a weather position is never fruitful for a portfolio. Simply get in and get out. A smart trading strategy would be to add one or all of the vulnerable commodities; then as you enter the season, with a bit of luck, grab fairly quick profits, even before the first winds start to really hit. There are many different scenarios—at least as many as there are weather patterns—and we will address them more thoroughly later. Remember, timing is everything. It's always important to be four to six months ahead of the regular calendar when trading commodities. Keep in mind that we're trading futures not "currents"; it's vital always to be looking forward and thinking about the impact of news, weather, and geopolitical events months in advance.

A VIEW FROM THE INSIDE

Another thing this book will do is give you an insider's view of what actually goes on in those trading pits and show you some of the tricks of the trade. The market's strange terminology can be a big hurdle to traders new to commodities. Words like *hedgers, speculators, locals, scalpers* all sound a lot more mysterious than they really are. Each commodity has its own particular jargon, and once you learn it you'll be well on your way to a better understanding of these markets. Here's an example: "The locals were short the Dec/Jan softs across the board. They used limit orders and GTCs before the commercials came in and the funds, too."

Huh? Don't worry; in this book I will always speak in plain English and teach you what much of that jargon means, demystifying it so you don't ever have to feel intimidated again. The language of the markets is very important to know, whether or not you ever actually use it. I'll help you learn, so that you will feel like a pro. By the way, here's the translation—let's break it down:

The locals in the pits. The "pits" refers to the trading pits where all the trading takes place—you know, that wild, frenzied place you sometimes see on TV. The "locals" are traders who usually trade only for their own accounts; they play a vital role in the markets by providing liquidity. Without locals, it would be much more difficult for the huge players—the major banks and institutions—to move into and out of the market efficiently. *Short the Dec/Jan softs across the board.* First of all, "softs," or "tropicals" as they are sometimes called, are commodities such as sugar, coffee, cocoa, cotton, orange juice, and even lumber; "Dec/Jan" just refers to a spread trade between the December and January contracts. "Across the board" is simply all the softs. "Limit orders" and "GTCs" also are called *contingency orders;* they simply place a limit on what you will pay or ask for a certain trade. GTC stands for "good till cancelled" orders. *Commercials came in and the funds, too.* Commercials and funds are institutional buyers or sellers and can often be a strong fundamental indicator of a market's direction. Is your head spinning yet? I know it all sounds confusing, but by the end of this book I guarantee it will all be a lot clearer and you'll be tossing those terms around with the best of them—and understanding them, too!

Once you've seen how these markets function, how locals in the pit work, what those strange-looking order acronyms and alphabet soup mean, which markets are thinly traded and tightly controlled, and so on, you'll feel much more confident and better able to jump right in and grab those profit opportunities that are just waiting for you.

FUNDAMENTAL TECHNICIANS AND TECHNICAL FUNDAMENTALISTS

Like stocks, commodity prices don't always go down or up. But the one thing you can practically guarantee about the commodities market is that somewhere prices are on the move. And predicting these prices is where fundamentals and technicals come in.

Technicals versus fundamentals, which is better? This is an ongoing argument among traders, but actually they're *both* necessary. I use both technicals and fundamentals, and I firmly believe it's vital to have a well-rounded knowledge of both in order to be a successful trader. The trick is to know when to rely more on one or the other, or sometimes even neither, and just go with your intuition—your gut. Sometimes, for some of us, this is the best indicator of all.

Certain commodities, such as crude oil, tend to make use of the fundamentals; others, such as financials, rely more heavily on technicals. As I talk about different commodities in this book, I'll show you how these two methods can be used to build your own trading system around these markets and make solid profits.

RULES OF THE GAME

My major rules regarding discipline and trading are a constant theme in this book; in fact, I can say that my success is due in many ways to discipline tempered with flexibility. I talk about trading rules and the pitfalls of breaking them. You'll see examples of how discipline paid off and not only kept my profits high and intact but allowed me to sleep at night. You'll also see how, in some instances, my lack of discipline burned me—a perfect opportunity for you to learn from my mistakes.

Human beings, I believe, are fundamentally morbid. (Ever notice how many gapers slow down or even stop when they see a car accident on the freeway?) Consequently, one of the most common questions I am asked is "What is the worst mistake you have ever made trading?" Now, most people are being polite when they ask that; what they mean to say is "What is the most money you've ever lost in one day?" The worst trading mistake I ever made was not necessarily the one that cost me the most money. It was in 1991, before the first Iraq war. To make a long story very short, I was long the U.S. dollar index futures, in a far bigger position than I should ever have had, but I knew it was going to go higher once the war started—I just knew it! Famous last words.

The night the missiles started flying over Baghdad, the dollar did just as I had predicted—it rallied big-time. So I went to bed thinking I was a genius and was all ready to cash in my millions the next day. Wrong! As the night progressed, it was obvious that there was not going to be a long, drawn-out battle, and that the United States was already in almost full control. The dollar did not just drop, it sank like a stone all night long. Without getting into all the horrific details, I had broken about 10 of my trading rules, and I paid a heavy price. Sure, the financial price was heavy, but it was more the psychological damage that was done to my trading psyche that bothered me. It took me months to recover and not to be overly cautious and second-guess myself. As traders, we all need rules and guidelines to be consistent; otherwise, we are all only one trade from oblivion. So heed that occasional wake-up call—you probably need it!

COMMODITIES BOOM

It's almost impossible to turn on the business channel or read the financial pages these days and not find a story about the next commodity that's breaking an all-time price record: crude oil surpassing the $74 mark for the first time ever, gold and silver at 25-year highs, copper surging to record levels, and sugar, too. It's enough to make a trader's head spin. Suddenly the technicians are all scrambling for more paper or a bigger screen so they can fit the chart on the page. We're seeing many of these commodities in truly uncharted territory.

In market conditions like these the most important thing an investor can do is remain focused and disciplined. One of the classic mistakes investors make in these types of volatile markets is to become greedy and lose sight of their objective. *Don't do it!* It's one thing to have a price objective and quite another to "talk your book" (floor terminology for a trader who speaks positively of a market based on his or her own trading position, regardless of what the market is actually doing; it's also known as *denial*). When I was in the Dollar Index pit a long time ago, one trader, whose name I will not mention, always talked his book. He was short U.S. dollars, and as more and more good economic numbers came out he talked more and more about how well he was doing. One day when I got to work he was gone and all his trading accounts had been seized. Now that's some serious denial.

Risk management in any trading strategy is one of the most important tools and the most often overlooked. Risk management falls right into the same category as discipline; without it, most traders lose money consistently. A solid basic risk management strategy encompasses clear entry and exit levels, using stop orders and limit orders and, most of all, never getting emotional about the trade. This can be the toughest challenge for many traders. Passion is different from emotion, in my opinion. When I get passionate I get energized; when I get emotional I can make bad decisions. So my advice is to detach yourself from your trades somewhat; when they go against you, don't take it so hard, and when they're in your favor, don't let your ego run away with you. The two "E"s, emotion and ego, can be a deadly combination.

It's also important not to go with the herd. "The trend is your friend" is an important and oft-used saying, but the motto traders use more often instead is "The trend is your friend, until it ends." Take a chance and look away from the crowd for an unpolished gem or a market that isn't as active—you may be surprised at what you find!

CONCLUSION

In this book I will show you what you need to learn to have a working understanding of what really goes on in those chaotic trading pits and how you can make it work to your extreme advantage. I will share with you my own pitfalls and successes so that you can build on them without having to endure all the pain. I will show you how to take huge profits from movements in markets you've only heard of but were afraid to trade, thereby succeeding beyond your wildest dreams. As I've said before, the commodities markets are the last bastion of pure capitalism on earth, and now you're invited to the party. Are you ready?