## Commodity Spread Trading

# Take Advantage of Seasonality

DAVID CARLI

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# About the Author

INTRODUCTION

My journey in the investment and trading world started shortly after I graduated from the University of Pisa, Italy. I then travelled to New York City USA., where I attended exclusive courses by Steve Nison who introduced the western world to the art of the Japanese candlestick as a tool for analysing market trends and investment decisions.

I have been working as a full-time trader and an independent financial analyst since 2007 hence I established Trading with David as a niche investment service with the primary focus on FX markets and commodities. During that time, I collaborated with reputable financial trading services and investment magazines. And from 2012 -2013 I worked as a hedge fund manager for an Italian Bank boutique. In 2018, I began providing market analysis and trading ideas for a major European commodity investment company up to this date.

I published several trading and investment books to pass on my knowledge and expertise on how to analyse the financial market correctly and have the odds on your side to become a profitable trader. My approach is based on low-risk investment strategies across all markets to achieve a balanced asset allocation through diversification and risk management.

I have several other books for those who wish to learn more about certain aspects of trading such as Forex, Commodities, Options, Spread Trading, and Stocks so you can see how I approach other markets. Through educational channels, I coach independent investors on my personal trading strategies and how to apply them in different market conditions.

You can find out more about my educational library on https://tradingwithdavid.com to develop an extraordinary edge to your trading and investments plan with a deep understanding of the macro environment, along with advanced technical analysis and risk management they are designed to build or improve your trading skills.

# About SpreadCharts

## INTRODUCTION

**SpreadCharts** is a complete analytical platform for commodity futures and spreads. Find out more on https://SpreadCharts.com.

Seasonality alone is no longer sufficient in today's financial markets. It is like a rear-view mirror: it tells you something about the past but very little about the present. You have to do better to be successful in today's ever-changing markets. You need additional tools that work independently from seasonality and reflect what is happening in the market right now. You need SpreadCharts.

SpreadCharts offers the widest range of functions, which gives you a unique insight into the markets. Technical analysis, seasonality studies, sentiment data, term structure dynamics... these are just a few of the many tools you will find in this app. And they are free for anybody to use, which is especially helpful for beginners. Moreover, all of this is served in a modern, user-friendly environment. You can run the app anywhere and anytime - on your PC, tablet, or phone if necessary.

While the free features are great, the premium features on SpreadCharts will blow your mind. A good example is the trading signals powered by artificial intelligence. The intelligent model generating the signals takes other types of data into account, not just seasonality. It makes predictions in real-time, continually learns from new data, and adapts to the ever-changing market environment.

For those who desire a more personal approach, there is premium research. It is world-class research of the best opportunities in the markets from people with a successful track record in the hedge fund industry.

Although the premium features are exciting, they will not make a successful trader out of you. Their purpose is to save you time analysing tens of markets, finding you only the best opportunities. The rest is, however, up to you. Only hard work and thorough study will bring you success. But you are lucky! This book is precisely the right source for the start of your journey in the markets...

# PREFACE

## INTRODUCTION

Everyone has seen the movie "Trading Places," at least once in their life; after all, it is a must during the Christmas holidays. The trade on pork bellies at the beginning; the orange juice report, with which the two starring actors, Dan Aykroyd and Eddie Murphy, take revenge on Duke cousins… priceless!

Wheat, coffee, orange juice… not only you can use them to prepare a delicious breakfast, but you can also trade them for profit. Trading with commodities is the most fascinating and intriguing way to trade, as it includes a characteristic uncommon to any other market: seasonality.

Spread trading is the best way to trade commodities and provides an excellent opportunity to diversify your portfolio, reducing the risks. Balancing, covering and protecting the portfolio have to be the trader's first goal.

"*Take Advantage of Seasonality*" is the first volume of the series "Commodity Spread Trading." This book is a real and complete course on commodities and spread trading. You will learn aspects that you will not find in any other book or course, and they come from over 25 years of experience in financial markets, even as a fund manager for a small Italian investment bank.

Inside this book, you will find explained not only the statistical databases and software for your analysis but also the main commodity reports, how to read the C.O.T., term structure, and why you have to be careful of the First Notice Day (FND) and Last Trading Day (LTD).

And again, the importance of a correct reading of contango and backwardation, understanding if a movement is driven by speculation or real reasons such as a drought or epidemic, and many other essential aspects.

With "*Take Advantage of Seasonality*" you will learn a new and exciting way to trade. With its modest price, this book is my gift for all those who aspire to become professional traders.

For any question, do not hesitate to contact me at the e-mail address info@tradingwithdavid.com, it will be my pleasure to answer all of you. Also, visit my website https://tradingwithdavid.com, where you will find free articles, analyses, and books.

# Birth of Commodity Market

CHAPTER 1

What is a commodity? It is a natural resource that can be subjected to transformation and sold. Commodities are essential elements for the creation of other goods. They are the building blocks on which food and industrial production are based.

The production and consumption of commodities depends on several factors, such the weather, with the seasons, but also by natural and artificial resources. The demand for commodities is influenced by several factors, such as economic, but also by consumer habits.

The Commodity market is the oldest in the world. It was born when ancient peoples began to barter: ten oil amphorae for five measures of wheat in ancient Rome.

In all the squares of the world, until the nineteenth century, the farmers (Producers) met the artisans and entrepreneurs (Hedgers) who bought the wheat for the mills, negotiating the price based on the quality and quantity offered.

Commodities now are traded on the physical market and, more frequently, through exchanges. The first financial contract dates back to around 1700, to the Dōjima Rice Exchange in Osaka, Japan. It was a necessity that began in the 1730s when the price of rice plummeted across Japan. Samurai, who were paid entirely in rice, needed a stable conversion into money.

Today's commodity markets have originated from agricultural trade in the 19th century (the first contract to the Chicago Stock Exchange dates back to 1864 with a contract on wheat).

Both buyers and sellers wanted to limit the risks to which they were subjected during the harvest. The buyers tried to defend themselves in case crops were scarce, and therefore the prices were high; while sellers wanted a guaranteed price to sell their goods, protecting themselves in case of oversupply and low prices. However, the level of standardisation concerning the quality and delivery of products was very scarce, and there was no centralised storage location.

It was founded rounded in 1848 by the Chicago Board of Trade (CBOT), who played an intermediary role between farmers and traders in the trade of grains. It determined procedures for weighing and grading of grains and was created a centralised market. It established in advance the prices of deliveries to be made in the future, and this allowed buyers and sellers to limit the risk of price changes.

### *The tulip mania*

However, trading in commodities has not always been undertaken solely with the intent of limiting risks, but has often had speculative connotations. At the end of the 16th century, Holland developed a market dedicated to the trade of tulips. Prices began to climb, attracting a wave of investors with little understanding of the horticulture sector.

The cultivation of tulips in the Netherlands began in the late 1500s, when bulbs, imported from Turkey, demonstrate toleration for Dutch weather conditions. The combination of a new investment available on the market and a particularly prosperous and flourishing era that allowed the continued expansion of the Dutch economy, very quickly propelling investors into entering this new market.

Very rapidly tulips became a real asset, so much so that they were traded on the exchanges of many Dutch cities and pushed investors towards this investment; the demand for tulips grew to such an extent that they began to be considered luxury goods, a status symbol that could not be renounced.

The speculative bubble, however, unlike what is commonly believed, did not actually start from the tulips, but their bulbs. The tulip bulbs began to be seen as safe future investments, and many investors started to sell properties to buy them, giving rise to a dramatic increase in their price (and, by default, even that of tulips). It was reported that an Utrecht brewer reached the point of exchanging his brewery for three tulip bulbs.

The so-called "futures" began to make their way in the financial world. Not being the tulips in themselves to arouse the greatest interest for investors, but their bulbs, the merchants began to sell the bulbs that had just been planted, and in this way the "right on the bulbs" was negotiated.

The buyer paid, therefore, a sum as an advance on the final price, paying the balance only upon delivery of the flowering bulb; this phenomenon did not go unnoticed, so much so that in 1610 a royal edict tried to prevent the trade of bulbs, but failed to stop it.

Their trade became, therefore, a "trade under-the-table" that took place mainly in taverns, where all that was required from traders was to pay a "wine money", a commission of 2.5% a trade, for a maximum of three florins.

All of this was, therefore, external to the exchange (precisely since they were considered non-legal) and took place between the individual counterparties. The trade in tulip bulbs continued to grow inexorably until 1636, a date that may be representative of the culmination of the bubble.

You can see in Figure 1 below the price chart of the tulips from November 1636 to February 1637.

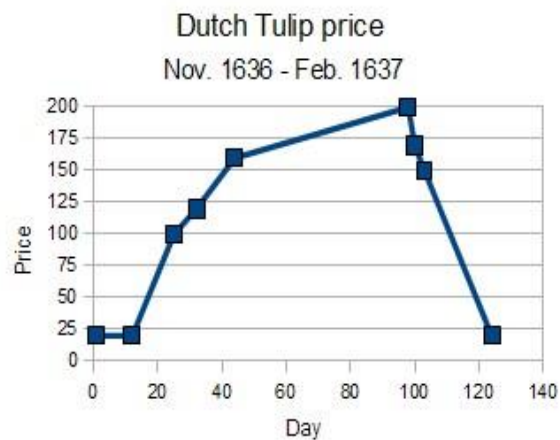


Figure 1 - Price chart of the tulips from November 1636 to February 1637

In 1636, an auction sold a tulip bulb at 6,000 florins (an unreasonable figure considering that the average income of a Dutch family at the time was about equal to 150 florins per year). Like any speculative bubble, the price increase was bound pretty soon to end with a wave of sales and a strong price fall.

The bubble of tulips burst at the start of 1637 and in this case the historical context also influenced a trend in the economy. The bubble burst, in fact, following an auction in Haarlem with no bids, probably due (although there are still numerous debates on this topic), to a possible outbreak of bubonic plague that frightened the population making it stay in their homes.

From that moment on, euphoria gave way to panic, and investors began to sell tulips for fear that they would no longer be required as before, thus trying to make profits before it was too late.

The wave of sales was such that the price of the bulbs and tulips collapsed dramatically, leading to the bankruptcy of numerous speculators. The busted bubble had left behind it a panorama of financial devastation and an economy now in ruins.

Buyers were forced to honour tulip purchase contracts at prices ten times greater than market ones, while sellers held rights on bulbs with the value of one-tenth of the original.

To avoid the worst, on February 24, 1637, the Dutch florist corporation decided to convert all futures contracts (i.e., futures regarding tulip bulbs) into options contracts. In this way, the buyer was no longer legally obligated to buy the bulbs but could also choose not to buy them by paying, in place of the final price, only a penalty.

No one knows today exactly how many people were involved in this market, but there is no doubt that a value well beyond the reasonable physical value was attributed to tulips, with this episode having a considerable impact on the local economy.

## *The commodity markets today*

Markets can be used to reduce the risk of price fluctuations to which you may be exposed, or, on the contrary, to exploit these price movements to your advantage. What was once considered coverage for suppliers and dealers in commodities, today enables more people to have access to these markets.

In recent decades, these markets have attracted pension funds, hedge funds, investment banks, other institutional investors and, increasingly, even private investors.

Commodities today play an important role in many investment portfolios. The growing investment in them throughout the years has led to the introduction of a broader range of tradable commodities and a greater variety of investment methods.

Moreover, in the XXI century, many commodities are also used in ways other than traditional ones. Corn, for example, has traditionally been used in the production of food and animal feed. But with the growing awareness of the possible adverse effects on the environment produced by the consumption of fossil fuels, the so-called "soft commodities" such as corn are increasingly used in the production of biofuels.

These new uses and decreases in the supply of some commodities can create interesting dynamics of supply and demand, influencing prices.

# INTRODUCTION TO COMMODITY

CHAPTER 2

You find commodities every day on your tables, and even when they are not food items, you use them daily. For this reason, the price of commodities will never drop to zero (which can happen, for a stock). That is because we would never deprive ourselves of certain goods such as corn or wheat that we eat every day and that feed the world.

The cost of production determines the first fascinating aspect of commodities. I will give an example. Let's take the wheat; it is a commodity widely spread all over the planet. You consume it every day; you find it, in the form of bread (stable food) and cereals. That means that there will always be someone willing to produce it for a profit.

Producing wheat, however, has a cost, and if the price of wheat is too low and fails to compensate for costs, the farmer would stop producing it. This would lead to a reduction in supply because there would be fewer farmers in the world willing to produce wheat. As a result, the price of wheat would begin to rise.

So, if you know the production cost of a commodity, you can purchase that commodity at a low price because you know that below a certain level, that particular commodity is no longer convenient to produce. All of this will affect the price, due to the decrease in supply which would lead to a price hike. And it would do so with very low risks - it is worth emphasising this point.

That is the first interesting aspect that only commodities can offer us. Let's see now what the reasons that underlie an investment in commodities are.

**1. Inflation**. Commodities have, by their nature, a role of hedging and they do it very well against inflation.

Generally, when the demand for goods and services grows, the prices of these goods and services also rise, and, of course, the prices of commodities that are used in the production tend to increase as well.

Since the commodity price increases during periods of prices rise, investment in this asset can provide the investor with coverage of the portfolio against the pressure of

inflation. In even more difficult situations, such as during the geopolitical and macroeconomic upheavals, commodities have often proved more robust than other instruments.

**2. Diversification**. To diversify, protect and balance the portfolio should be the first rules of every investor. Reduction of the risk always passes through the choice of instruments and different markets, and in this, the commodities play an important role.

It is well known that, very often, when the value of certain assets drops (e.g. equities or bonds), commodities provide very interesting returns for investors. That is why it is important to diversify.

**3. Seasonality**. Only with commodities can you exploit a seasonality, a cycle which repeats year after year. Just think about heating oil. It is clear that you will have much larger consumption of it in winter, while it will be used a lot less during the summer. This is also the case with the production cycle of the crops, with planting and harvesting occurring every year.

That is a statistical advantage that you only have in the commodity market: if you know in in advance the seasonality of a commodity, you can anticipate price movement. Just a few data are enough, some analysis, nothing complex and you can make very interesting profits from this market.

Let us now go and see which commodities are the most invested in the market and that you can trade every day. I start by saying that there are two types of commodities:

**1. Soft**, such as wheat, coffee, sugar and even livestock – those are commodities more easily influenced by external factors, such as climate or epidemics because they tend to deteriorate. The producers of soft commodities are often involved in this kind of market, with an interest to set the price of their products.

**2. Hard**, such as crude oil, gas, gold, and copper, are materials that are extracted from the ground or produced by other natural resources. Even the hard commodities may be affected by external factors, although to a lesser degree than soft commodities, such as strikes and wars.

More specifically, the principal commodities can be divided into five categories:

**Grains**: corn, wheat (in all its varieties: winter or spring, soft or hard, etc.), soybean, soybean meal, soybean oil, and oats.

**Softs**: cotton, cocoa, coffee, sugar, orange juice, and lumber.

**Meats**: live cattle, feeder cattle, and lean hogs.

**Metals**: gold, silver, platinum, palladium, and copper.

**Energy**: crude oil, gasoline, heating oil, and natural gas.

Even with the five categories listed above, you can diversify your portfolio, in

different sectors. You should not concentrate on one category, so you don't diminish the risk of a single investment, for example, in multilevel sectors such as energy and meat.

There are other categories and commodities that I have not listed because although investors expect a florid market in the coming years, all the classical instruments needed to invest in these products are not yet available. At the moment, they can be traded only by Funds. An example is the ETFs on water or hydrogen.

You are, therefore, coming to the general control of commodities through financial products.

Now, let's see what the different factors affecting commodity prices are.

**1. Supply and Demand**. The supply/demand relationship determines the price of the exchange of goods and services. The commodities price reflects exactly this law of the market.

If the supply increases, but demand does not change, (think, for example, the harvest of corn that has a higher-than-expected return and then, with a more considerable amount of corn in the market), the price will tend to fall. Many farmers will be willing to undercut the price of their corn to try to find a buyer.

If demand grows but producers are not able to fulfil it (think of the effects of an epidemic on cattle resulting in a sharp decrease of meat on the market), then the price will increase because buyers will be willing to pay a higher price for the amount of product needed.

**2. The weather**. It can influence the price of commodities and affect production a lot. It is, in fact, often the only thing responsible for very strong price movements due to imbalances in the supply/demand relationship.

Adverse weather conditions do not affect only crops such as wheat or coffee, but all commodities. Just think about the price of oil after the passage of a hurricane, or transportation blocked due to heavy snowfall and frost.

**3. Diseases and epidemic**. Some external factors can cause the price of a commodity to skyrocket, such as diseased crop or an epidemic that affects livestock. Same as with adverse weather conditions, diseases and epidemics create imbalances in the supply/demand relationship because of a reduction in supply which, therefore, results in a strong movement of prices.

The reason for this is that buyers predict that the future availability of a commodity could become scarce; thus, they increase the demand for that commodity. They are willing to pay more for it today than in the future.

**4. Economic and political factors**. Prices of commodities are also affected by the

economic and political events of the countries that are producing or using that commodity. For example, political unrest in the Middle East often causes fluctuations in the futures price of oil due to uncertainties on the supply side.

Think, also, of the strike in the gold mines in South Africa, or the duties in some South American countries on exports of grains. So, the political and economic instability of a country can influence the price of a commodity.

**5. Reports**. They are essential and give you a picture of the situation of commodities in their various phases: production, demand, supply, etc. Even just a change in the size of land cultivated can cause a rise or drop in the price of a crop.

The inventories and stocks showed by the reports affect the price of a commodity a lot. Like, for example, the Weekly Petroleum Status report that every Wednesday is released by the EIA (US Energy Information Administration) and that provides information about the petroleum supply situation. The new inventories can influence the crude oil price strongly.

**6. U.S. Dollar**. The prices of commodities are in dollars, so, the US dollar is their enemy. A rising dollar is anti-inflationary, so it applies downward pressure on commodity prices. Similarly, a falling dollar will usually apply upward pressure on commodity prices.

Investing in commodities is very different from investing in stocks and other financial assets. With commodities, you are dealing with a physical good, and managing that physical good requires effort that stock investors do not have to worry about.

Another aspect that you can deduce from the list above is that the commodity market is less easily manipulated than other financial markets because price is affected by the weather, diseases, epidemics, political factors, etc. that cannot be manipulated.

At this point, you are probably wondering: how can I invest in commodities? There are several ways to do it:

**1. Physical**. The most obvious way to invest in commodities is by buying the physical commodity itself. By owning a commodity, you will have direct exposure to increases and decreases in its value, and you can sell it when you want to convert it back to cash.

However, most physical commodities involve significant logistical problems. With commodities like gold or silver, it is relatively simple to find dealers to sell your coins or bars, albeit often at a slight profit margin. Instead, it is a lot harder to take possession of 1,000 barrels of crude oil or 5,000 bushels of soybean. Because of those problems, owning physical commodities works well only in limited situations with specific commodities.

**2. Futures**. They are derivatives. That is, their value derives precisely from an index, a commodity etc which are linked by something called an underlying asset. Investing in

commodities via futures offers investors a way to get exposure to changing prices of commodities without having to take physical possession of them.

Using futures contracts, you will never get to possess a commodity in which you are going to invest. A futures contract is an agreement to buy or sell a certain amount of a commodity in the future, with an established price that can fluctuate with market conditions.

**3. Spread Trading**. With spread trading, you no longer work on single futures, but on the difference between two or more correlated futures. You move from being directional on the market with the futures to non-directional with spread trading. That is a crucial aspect.

With spread trading, investors create a hedge of the position with a significant reduction of the risk. They get several other advantages that trading with futures cannot offer. I will not add anything else; you will see spread trading further in the next chapter.

**4. ETCs**. The Exchange Traded Commodity (ETC) gives investors exposure to commodities in the form of shares. Traded as a stock, i.e., bought and sold on a stock exchange, ETCs replicate the price movement of commodities, such as oil, gold, silver, etc. and then fluctuate on the basis of the value of those commodities.

An ETCs can invest in either one commodity or in a commodity basket. An example of a commodity basket ETC is one that is composed of multiple metals (not only one), like gold, palladium, copper, etc. In this way, you have invested in metals correlated with the growth of an economy (i.e., copper and aluminium) and, at the same time, you are covered with defensive assets like gold and silver.

**5. Equities**. With equities, you are going to invest in shares of companies linked to the world of commodities. Mining companies, oil and gas exploration and production companies have direct exposure to commodities prices. Affiliated businesses like heavy-equipment manufacturers and oilfield services companies tend to do better when the underlying asset is performing well.

Unlike an ETC or ETF, you will invest in companies that work as an individual commodity, and this implies substantial differences. Furthermore, often the price of a share of a company can undergo significant fluctuations due to external and economic factors. The price of a commodity cannot fall to zero; the price of a share, on the other hand, can.

**6. Options**. They are contracts that give the holder the right to buy (call option) or sell (put option) a given quantity of an underlying financial asset (equities, futures, ETFs, etc.) at a specific price (the strike) and a date (or within a date). If I buy an option, I pay a premium; if I sell it, I get a premium.

Just like the futures market, options are also derivatives. But unlike futures with

which you promised to fulfil the contract, when you buy options, if you feel that the operation is no longer convenient for us, you are not obliged to fulfil the contract, and you will only lose the premium you paid previously.

For the second time during the reading of this chapter, you are probably wondering: among all these, which is the better way to trade commodities? You can, of course, use all the ways seen above. The best ones to trade commodities, for many good reasons, is through the spread trading and options.

For options, I refer you to my books "*Options, from Theory to Practice – A Complete Guide for Beginners*" it will give you a complete knowledge about Options and a correct method to trade them.

While regarding the spread trading, you are going to see in the next chapter, a way to trade the commodities that will give you a lot of advantages.

# SPREAD TRADING

CHAPTER 3

At the end of the previous chapter, you saw that one of the best ways to trade commodities is through spread trading. I will now explain in more detail what spread trading is. Let me start by defining the term “spread.” The spread is the price or yield differential between two financial instruments correlated to each other.

An example of this is the difference in price between two equities belonging to the same industry (such as Goldman Sachs and JP Morgan both within the banking sector) or two indices (like S&P 500 and DJ30). But also, the difference between the yield of two interest rates (like German Bund and 10-year T-note).

In the commodity market, the spread is the price differential between two Futures of the same commodity with a different delivery, or between two commodities correlated to each other.

Now, let's take a look at a fundamental concept: correlation.

**Correlation** is defined as the ratio that describes, in trading, the degree of relationship between two markets. You talk about correlated markets when the first market increases and so the second one increases, and vice versa i.e., when the first market decreases and the second one decreases as well. Even the highs and lows of the two markets correspond, most of the time.

The correlation coefficient is a measure that determines the degree to which two markets' movements are associated. The range of values for the correlation coefficient is -1.0 to 1.0. If you get a correlation higher than 1.0 or lower than -1.0, there is a mistake in the calculation. A coefficient of -1.0 indicates a perfect negative correlation, while a coefficient of 1.0 indicates a perfect positive correlation.

You can see two correlated markets in the chart below (Figure 2) with Goldman Sachs and JPMorgan. It is easy to understand how the two stocks, both belonging to the banking sector, move in unison most of the time.

Figure 2 - Goldman Sachs and JPMorgan charts (TradingView.com)

You talk of inverse correlations when the first market ascends whilst the second descends, and vice versa, when the first market decreases and the second increases, most of the time.

You can see an example in Figure 3 with the S&P500 and VIX futures.

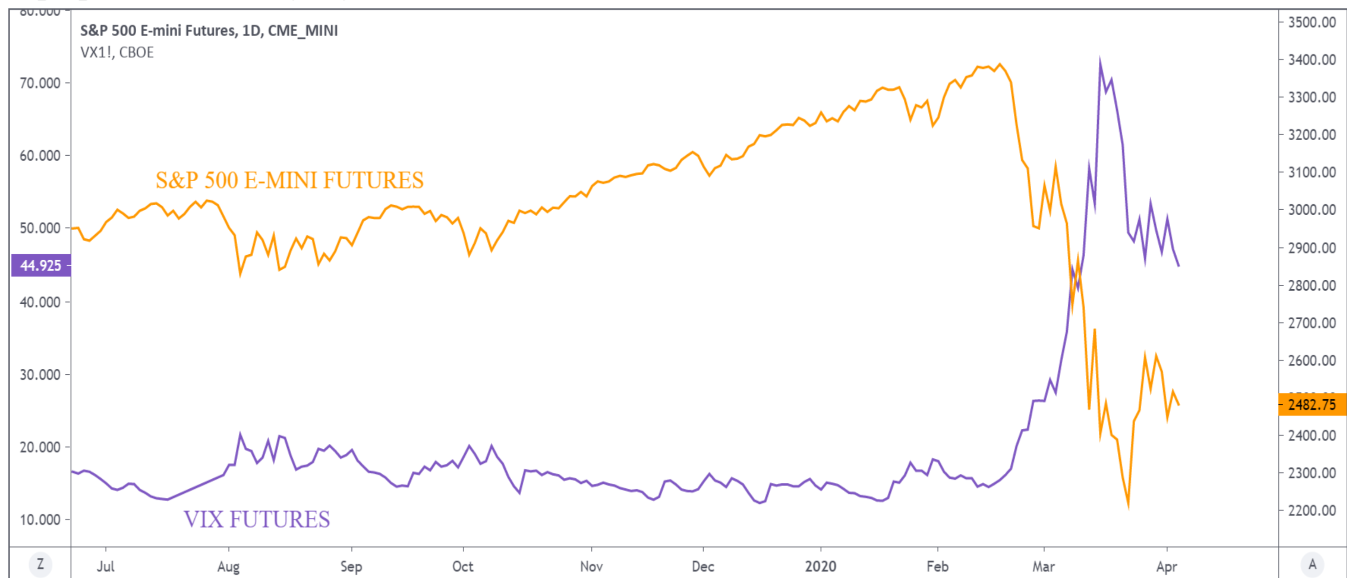


Figure 3 - S&P500 futures and VIX futures charts (TradingView.com)

You will talk about no correlation when two markets move in different ways: an example of uncorrelated markets in Figure 4 with Apple and coffee.

Figure 4 - Apple and coffee futures charts (TradingView.com)

In most cases, correlated markets belong to the same industry, which means that even the macroeconomic data that may influence them are the same.

What is Spread Trading, then? You use Spread Trading when you buy one or more futures contracts and, simultaneously, you sell one or more futures contracts, correlated with each other in order to have a balanced net position.

Figure 5 - Spread SBH18-SBK18 (SeasonAlgo.com)

An example of spread trading is SBH18-SBK18 (buy sugar futures delivery in March 2018 and sell sugar futures delivery in May 2018). This is a spread that you build by subtracting from the price of the first Futures (delivery in March) and the second one (delivery in May) as in Figure 5 above.

The two (or more) futures that make up a spread are called legs. You can decide to open the position at the same time, or with one leg at a time. It is possible to transform a trade with futures into one of spread trading and vice versa, depending on the time.

There are three types of Spreads.

**1. Intramarket**, when you are long and short on futures in the same market, but with different deliveries. This type of spread is a ***Calendar Spread***.

You can see an example of an Intramarket spread in Figure 6 below with the natural gas, and more precisely, with the spread NGN18-NGU18 (buy natural gas futures delivery July 2018 and sell natural gas futures delivery September 2018). In blue, the 15-year seasonal pattern.

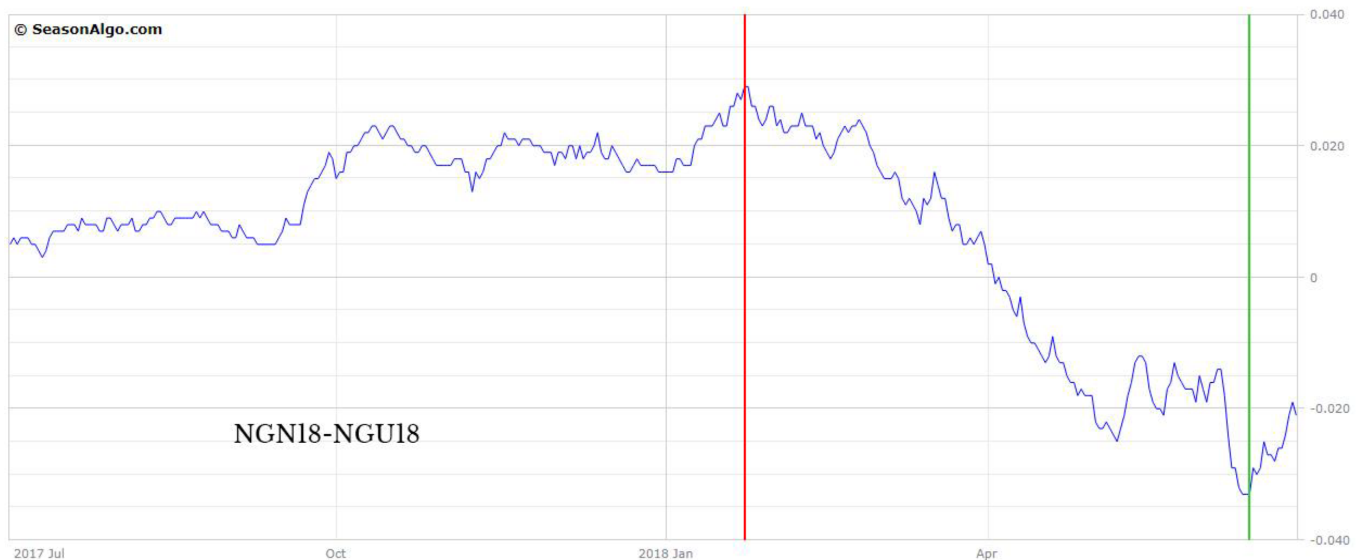


Figure 6 - Intramarket spread NGN18-NGU18 (SeasonAlgo.com)

**2. Intermarket**, is built by buying a futures contract on one market and selling simultaneously another futures contract on another market with the same delivery. Intermarket spreads can become Calendar Spreads by using futures with different deliveries.

An example of an Intermarket spread is ZCK18-ZWH18 (buy corn futures delivery in May 2018 and sell wheat futures delivery in March 2018) as shown in Figure 7.

Figure 7 - Intermarket spread ZCK18-ZWH18 (SeasonAlgo.com)

**3. Inter-exchange**, a less commonly known method of creating spreads is via the use of contracts in similar markets, but on different commodity exchanges. In this case too, if the two legs have different deliveries, it is called a Calendar Spread.

An example of an Inter-exchange spread in Figure 8 with the chart of MWZ18-ZWK18 (buy wheat futures delivery in December 2018 at the Minneapolis Grain Exchange and sell the wheat futures delivery in May 2018 at the Chicago Board of Trade).

Figure 8 - Inter-exchange spread MWZ18-ZWK18 (SeasonAlgo.com)

Spread trading has significant advantages. Firstly, it removes the directionality of markets. You do not care anymore if a futures contract rises or falls. The only thing that matters

to you is the spread; that is, the difference in price between the two legs. If you buy corn and you sell wheat, you will earn if the corn rises and wheat drops, if both go up, but the corn more than wheat, and if both descend, but the wheat more than corn.

Spread trading is not correlated to other financial markets and provides an excellent opportunity to diversify your portfolio, reducing risks.

You risk less than with simple futures. Entering in opposite directions on the market, in fact, creates a hedge in your position. Moreover, compared to the futures, spread trading reduces volatility, protecting you from macroeconomic news or particular events.

Another quality of spread trading is that you can make excellent gains even during phases of lateralisation of single futures. The spreads are much more often in trend, and this can last for a long time, which makes trading less stressful.

More importantly, when you trade a spread, you have no exit order (stop-loss), either for strategies or for two single futures. Your trade is anonymous; nobody has an idea of what your exact position and intentions are. No stop means no stop hunting, and you are also more protected against intraday noise.

There is, however, in recent years, large traders, as a result of the increased of spread trading by small traders, have begun to do a bit of stop hunting, but not as much when compared to the futures market.

You can filter spreads through seasonality, backwardation, and differential of the transport costs, in addition to the usual filters that you use in futures analysis. You will see these aspects more thoroughly in the next chapter.

Spread trading takes much less time; you are not forced to spend your days in front of a monitor watching the real-time market data. Working on EoD data (End of Day), it takes little time to organise the next day. So, it is ideal also for those for whom trading is a secondary activity. In this way, you do not use real data that would cost you, thus you save further on money.

Moreover, most brokers recognise the low volatility of the spreads, and they apply a discount on the margin. Especially for Intramarket trades compared to the single futures. In this way, you can also work with small accounts.

After all these advantages, now the very few disadvantages. When you trade Spread Trading, you do not work with a single futures contract, but on a differential between two or more futures. This means that you pay more commissions.

But nowadays, with online brokers offering low and competitive commissions, this is not as significant anymore, especially when considering the overall advantages that spread trading offers us.

There can be some confusion in spread creation and trading. Prices can be positive or negative, and you trade by narrowing or widening the spread. The same spread can be written in different notations. Some commodities are priced differently and have different units of measure and contract values.

Their spread cannot be calculated by a simple difference between the prices of the legs, rather you have to use equity spreads. Although spread trading is a little bit harder than simply buying some stocks, this can be easily overcome with experience.

Commodities and in particular Spread Trading gives you a lot of advantages that other markets do not. You can exploit unique aspects such as seasonality and correlation. They help a lot with your trading, and you will see it in the next chapter.

However, do not even think for a moment that the Spread Trading is easy. In trading, there is nothing easy, including the spread trading. As you have seen, with the spread trading you have a lot of advantages but, at the same time, there are several considerations you have to take into account such as the weather, economic decisions, political situation of a nation, etc.

I conclude by introducing an aspect that you will see better at the end of the book. Always follow your trading plan with proper money management, as it is easy to overtrade your account with the reduced margins that the spread trading offers, it has happened to me at the start of my trading with Spread trading.

# SEASONALITY & CORRELATION

CHAPTER 4

In this chapter, you are going to see an introduction to the “fundamental” aspects of commodities and how they affect your choices when trading. That is definitely the most exciting and interesting part. Throughout the various chapters that make up this book, I will go into detail in order to better clarify concepts that are basic to being able to properly analyse a spread.

First, you can see that each commodity has multiple futures contracts with different deliveries. They have different prices. Generally, a futures contract with a closer delivery has a lower price than a futures contract with a more distant delivery.

This is because the further away delivery is, the higher the costs that a producer incurs in storing, ensuring, etc. a commodity.

Summarised below, you have two different possible situations.

**1.** Supply and demand are balanced, the market is in a normal situation, so you say it is in **contango**. If the demand is weak, and the supply is excessive, the market tends to amplify the contango (Figure 9).

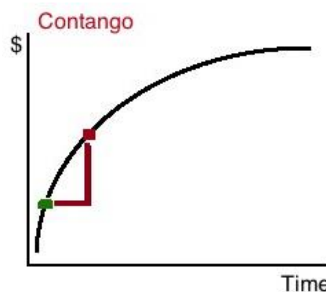


Figure 9 - Contango curve

**2.** In the case of excess of demand compared to supply, the market tends to reduce the contango and even to reverse the curve bringing it in **backwardation** (Figure 10).

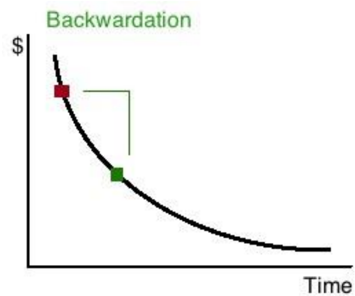


Figure 10 - Backwardation curve

You have a situation of backwardation when closer deliveries have higher prices than the ones furthest away, and this is because buyers are willing to pay more for a commodity now than however much they might pay in the future.

For this, buyers have predicted that the future availability of a commodity could become scarce for several reasons (a climate change such as drought that threatens crops, or an epidemic that can affect the livestock), thus increasing the demand for that commodity.

In this case, the supply and demand for a commodity, due to external factors, are unbalanced for periods that may have differing durations, depending on the severity of the event.

This is an important aspect that concerns commodities, and that can orient your trading. A contango gives you the green light to continue your analysis; if you are instead in backwardation, you should change your type of operation.

I turn now to the most exciting aspect of commodities, one that forms the basis of your analyses: **seasonality**.

Seasonality is a cyclical condition that happens every year, such as the classic changing of the four seasons. Similarly, you have a repetition of the sowing and harvesting of a crop in the same period every year; as well as industrial production cycles that recur every year. And so on.

Think about the heating oil, whose consumption will be significantly greater in Autumn and Winter, and lower during Spring and Summer.

All of this is also reflected in the chart. You can contemplate at certain times of the year, with the repetition of similar movements of a spread. That is an amazing advantage that you get only with commodities. Knowing in advance which is the seasonality of various commodities, you can anticipate price movements.

It is common to find spreads that, in the last 15 years (or even longer), if you had bought and sold them always on predetermined specific dates, you would get 100% of winning

trades.

You are now probably wondering: "how do I recognise these seasonal windows?" there are websites with statistical databases that will give you all the necessary information for a complete and accurate analysis. The main statistical databases are Moore Research, SeasonAlgo and SpreadCharts, and you will see them in detail in the next chapter.

Seasonality is extra ammunition to your analysis, and a great starting point for commodities trading but, of course, it should not be the only reason to open a trade. The spreads selected based on seasonality, subsequently, it must be filtered.

As you have seen, it is important that the futures contracts of a commodity are in a phase of contango. A situation of backwardation could undermine the seasonality. But not only that. Another significant aspect to consider in your fundamental analysis of a spread is **correlation**.

You have seen in the spread trading chapter, that correlation is defined as the ratio that describes the degree of relationship between two markets. We talk about correlated markets when the first market increases so as the second one increases, and vice versa when the first market decreases and the second one decreases as well. Even the highs and lows of the two markets correspond, most of the time.

Not only with two correlated commodities do you have the same movements most of the time, but also with macroeconomic news and data, which have the same impact on both. You have already seen this in the previous chapter, as this aspect is crucial because it reduces the risk of sudden losses in spread trading.

Finding a correlation with a past year is therefore significant. If you know, for example, that this year wheat is behaving exactly like in 2012 and that for 145 days it has followed the same trend, this provides you with further confirmations and advantages.

All you have to do is to look at the chart of wheat in 2012 to have reliable indications of what could be the future behaviour of wheat.

As you have seen more thoroughly in this chapter, seasonality and correlation are two amazing aspects that only commodities and spread trading can offer us. But when you go to analyse a spread, there are other aspects to take into account.

You will see everything I mentioned above in more detail in the next chapter devoted to statistical databases, where I will explain exactly how to use them properly, for a complete and correct fundamental analysis of a spread.

Hello, if what you have read has caught your interest, you can buy this book at the price of $ 22.99 (Paperback black and white) and $ 58.00 (Paperback in colour). Click on the link to proceed with the purchase Commodity Spread Trading - Take Advantage of the Seasonality.

Thank you!