GETTING THE EDGE

COMMODITIES

CREATING OPPORTUNITY

CFDs AND FOREX TRADING

COMMODITIES OVERVIEW

Commodity trading requires an understanding of economics, central bank policy and what that all means for supply and demand or for the more speculative focused traders – the outlook for supply and demand. In their most simplistic form, currencies move around on the perception of inflation and how central banks may affect the price of money using monetary policy. Equities move on the predictions of future earnings and cash flow and bonds, where current and future inflation forces will cause yields to rise (prices to fall). Commodities have some similar drivers, but also hold some very key differences.

MARKET DRIVERS

Like currency trading, where each individual currency has its own unique characteristics and traders will play one against another, commodities have unique properties; although from time-to-time will see strong correlations between each other.

One of the key drivers of commodities is the USD. Commodities are priced in USD's; therefore any falls in the currency makes the underlying commodity more attractive to buyers. A fall in the USD will subsequently benefit a corresponding currency, such as EUR or AUD, which means foreign buyers of commodities will have increased purchasing power.

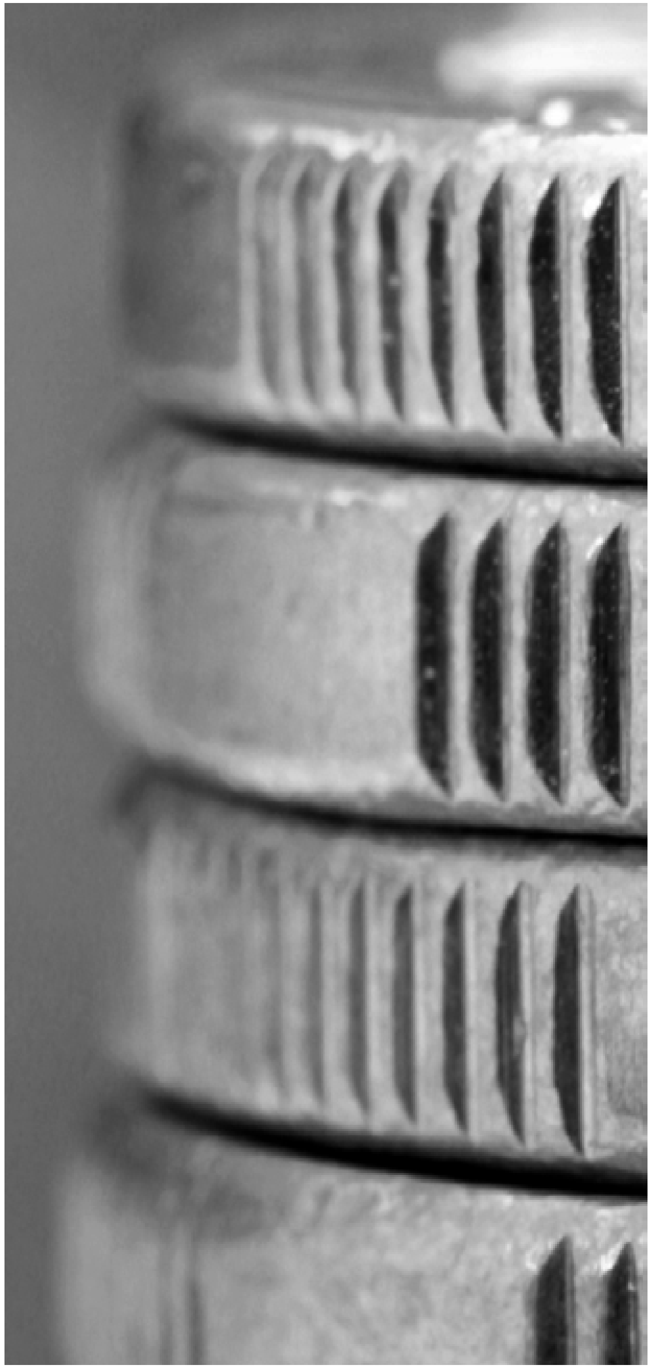
In these days of extremely accommodative central bank policy, a weaker USD has also been reflective of the Federal Reserve expanding its balance sheet and printing money – diluting the dollar and bringing down US bond yields. In this case, a lot of cheap money has not only trickled its way into equities and bonds, but also commodities such as gold and oil.

A weaker USD is not always going to have such a strong effect on commodities though, and as the Fed looks to cut back on its bond purchases, the start of a normalisation process will begin. The reason for this normalisation policy is increased signs of stability and real organic growth in the US. This carries negative short-term consequences for commodities.

Longer term, we feel that commodities will fully revert back to trading around growth of an economy rather than purely how much stimulus is being provided by central banks. In this regard, the cleanest measures of economic strength are copper, aluminium and other base metals as well as (to a lesser extent) the energy complex.

ONE OF THE KEY DRIVERS OF COMMONDITIES **IS THE USD**

THE CLEANEST MEASURES OF ECONOMIC STRENGTH ARE **COPPER, ALUMINIUM AND OTHER BASE METALS**



COPPER

Copper is generally seen as the best leading indicator of economic growth and has earned the nick name 'Dr Copper' by many people in the market.

Copper is used in so many industrial processes and is highly leveraged to housing, which plays a big influence on the perception of household wealth, and thus it must be looked at closely when trading commodities. It is also extremely leveraged to China and will often have the purest reaction to a Chinese manufacturing read. Supply and demand are key here, and traders will always try to source out the expected level of future surplus or deficit of a commodity when forecasting future prices.

COPPER IS GENERALLY SEEN AS **THE BEST LEADING INDICATOR OF ECONOMIC GROWTH**

GOLD IS PERHAPS THE MOST PECULIAR OF THE ACTIVELY TRADED COMMODITIES, MAINLY BECAUSE ITS **PRICE ACTION SEEMS TO FIT ANY RANGE OF OUTCOMES**

GOLD

Gold is perhaps the most peculiar of the actively traded commodities, mainly because its price action seems to fit any range of outcomes.

Traders and investors have traditionally bought gold as a store of wealth, given the limited amount of new supply seen over the last five years or so. On this basis, traders will often look to buy gold to hedge against inflationary forces and – especially during the last few years – as a hedge against currency debasement and the prospect of rampant inflation caused by over stimulus.

Some people have also bought gold in times of stress or as a safe-haven; however we don't buy this argument and feel there are much better places to hide when the world looks to be in a bad state, most notably being long on German bunds, USD, CHF and JPY. Longer term gold will not only be driven by central bank actions, but by physical buying; predominantly from China, India and emerging market central banks.

It is also important to understand that a move higher in US treasuries will have negative ramifications on gold longer term, given gold has no yield and can only provide capital growth; thus a rise in bond yields will put pressure on gold as fund managers and traders look at more compelling yields on offer in the bond market.

As well as the more popular precious metals and energy complex, IG also allows you to trade a vast range of soft commodities as CFDs such as Cocoa, Cattle (feeder), coffee, oats and many others.

TRADING STRATEGY

Here are some other points to consider when trading commodities:

- **As with any other product, a stringent risk management strategy is fundamental to making money** – always trade with a stop-loss in case your analysis proves incorrect
- **Have a thorough understanding** not just of the technicals, but also the volatility and variables that affect price movements
- **Keep an eye on positioning in the market.** Each week leveraged firms such as hedge funds and investment banks have to report the levels of futures contracts they are holding. This is then put into a detailed report by the CFTC and released every Saturday to the market. It can be found on the CFTC website or on Kitco.com
- **Understand market opening times and when traders are most active**; this could have large ramifications on liquidity
- **Listen to what CEOs are saying**, especially around earnings and productions reports, as they deal directly with the end customer and can often provide good insights on the actual underlying market
- **Many traders will look to trade commodities through a long/short strategy.** This simply involves playing one commodity against another by buying a commodity you feel will outperform, and selling another commodity you feel will underperform against it. The actual USD exposure (opening level multiplied by the contract size) needs to net off as close as possible and thus you are simply looking to net off the outperformance. This can be beneficial way to trade. One of the favourites in the market has been buying WTI and selling Brent crude and looking to play the spread between the two