
Global Online Lecture Series by Dr. Glen Brown



GLOBAL ACCOUNTANCY
Institute Inc

2024



Understanding Backwardation and Contango in Commodity Markets

Instructor: Dr. Glen Brown

Introduction

In commodity futures markets, understanding the relationship between spot prices and futures prices is crucial for making informed trading and investment decisions. Two key market conditions that traders need to be aware of are backwardation and contango. These conditions can significantly impact trading strategies, hedging practices, and overall market behavior.

What is Backwardation?

Backwardation occurs when the current spot price of a commodity is higher than its futures price. This situation often arises due to immediate demand or supply shortages and reflects market expectations of declining prices over time.

Causes of Backwardation

1. **Supply Shortages:** Short-term supply constraints can lead to higher spot prices as buyers are willing to pay a premium for immediate delivery.
2. **High Storage Costs:** When it is expensive to store a commodity, market participants prefer to sell now rather than incur these costs, leading to lower futures prices.
3. **Convenience Yield:** The immediate availability of a commodity for use can be more valuable than holding a futures contract.
4. **Expectations of Price Declines:** If market participants expect prices to decrease, they may sell futures contracts at lower prices than the current spot price.

5. **Market Demand:** High current demand for a commodity, especially those with seasonal demand, can push spot prices above future prices.
6. **Risk Aversion:** In uncertain markets, investors might prefer holding physical commodities over futures contracts.

Effects of Backwardation

1. **Incentive to Sell:** Producers and holders may be incentivized to sell immediately, helping to alleviate supply shortages.
2. **Impact on Hedging:** Companies hedging price fluctuations may face challenges if future prices are lower than expected.
3. **Investor Behavior:** Investors might prefer commodities in backwardation to take advantage of higher spot prices.
4. **Arbitrage Opportunities:** Traders can exploit arbitrage opportunities by buying the physical commodity at a lower price and selling it at a higher spot price.

Strategies for Navigating Backwardation

1. **Physical Storage:** If storage costs are manageable, buying and storing the physical commodity can be beneficial.
2. **Long Futures Positions:** Profiting from rising prices towards the spot price as contracts approach maturity.
3. **Spread Trading:** Using strategies such as buying near-term futures and selling long-term futures to profit from price convergence.
4. **Diversification:** Spreading investments across different commodities and asset classes to mitigate risks.

What is Contango?

Contango is a market condition where futures prices are higher than the current spot price. This typically reflects expectations of rising prices due to costs associated with storage, insurance, and financing.

Causes of Contango

1. **Storage Costs:** Higher futures prices include the cost of storing the commodity until the delivery date.
2. **Financing Costs:** Borrowing costs to buy and hold the commodity are factored into futures prices.
3. **Insurance Costs:** Costs of insuring the commodity during storage contribute to higher futures prices.

4. **Market Expectations:** Anticipation of higher future spot prices due to increasing demand or supply constraints.

Effects of Contango

1. **Negative Roll Yield:** Investors rolling over expiring contracts to the next month incur higher costs, eroding returns.
2. **Hedging Costs:** Higher futures prices make hedging more expensive for producers and consumers.
3. **Investment Strategies:** Contango impacts the performance of commodity ETFs and other investment vehicles that roll futures contracts.

Strategies to Manage Contango

1. **Physical Commodities:** Holding physical commodities to avoid rolling futures contracts and incurring negative roll yield.
2. **ETFs and ETNs:** Using ETFs and ETNs that minimize contango impact by employing strategies like holding longer-dated contracts.
3. **Optimized Roll Timing:** Minimizing roll costs by rolling contracts when contango effects are less pronounced.
4. **Diversification:** Reducing exposure to any single market in contango by diversifying across commodities and asset classes.
5. **Hedging Instruments:** Using options and swaps to hedge against adverse price movements and contango effects.
6. **Long-Term Contracts:** Investing in long-dated futures contracts to reduce the cumulative impact of contango.
7. **Contango-Resistant Funds:** Choosing actively managed commodity funds that employ strategies to minimize the impact of contango.
8. **Technology and Analytics:** Using advanced data analytics and forecasting tools to predict market conditions and optimize roll timing.
9. **Selective Contract Choice:** Choosing contracts with lower contango or backwardation for better roll yields.

Trading Strategies in Contango and Backwardation

Using Contango and Backwardation for Trading Strategies

1. **Arbitrage Opportunities:**

- In backwardation, traders can buy the physical commodity at a lower futures price and sell at a higher spot price.

- In contango, traders can exploit the cost-of-carry arbitrage by selling futures at a higher price and buying the spot commodity.

2. Hedging Strategies:

- In backwardation, producers can lock in higher spot prices to secure immediate revenue.
- In contango, consumers can lock in lower futures prices to secure future supply at a known cost.

3. Spread Trading:

- In backwardation, traders can profit from the price convergence by buying near-term futures and selling long-term futures.
- In contango, traders can use calendar spreads to exploit the roll yield differentials between contracts.

4. Algorithmic Trading:

- Developing algorithms to automatically adjust positions based on contango or backwardation signals, optimizing entry and exit points.

5. Diversified Portfolios:

- Balancing investments across different asset classes and commodities to mitigate risks associated with specific market conditions.

Conclusion

Understanding and navigating the dynamics of contango and backwardation are crucial for traders, investors, and hedgers in the commodity markets. By employing effective strategies and staying informed about market conditions, participants can optimize their portfolios and manage risks more effectively.

About the Author:

Dr. Glen Brown is the President & CEO of Global Accountancy Institute, Inc., and Global Financial Engineering, Inc. With over 25 years of experience in the financial and accounting sectors, Dr. Brown holds a Ph.D. in Investments and Finance. He specializes in financial accounting, management accounting, finance, investments, strategic management, and risk management. Dr. Brown is dedicated to shaping the future of finance and investments with innovative solutions and nurturing the next generation of financial professionals.

Call to Action:

Stay informed and ahead of the curve by visiting the Global Online Lecture Series Course page at: [Global Online Lecture Series Course](#)

General Disclaimer:

The information provided in this lecture is for educational purposes only and should not be construed as financial advice. Investing in commodities involves risk, and you should consult with a qualified financial advisor before making any investment decisions.

Organizational Overview:

Global Accountancy Institute, Inc. and Global Financial Engineering, Inc. are established as Global Multi-Asset Class Professional Proprietary Trading Firms. We specialize in conducting extensive financial research and engaging in proprietary trading across multiple asset classes. Our efforts are dedicated to advancing the understanding of market dynamics and developing sophisticated trading strategies.

No Public Dealing:

We do not offer services or products to the general public. Our operations strictly involve internal activities and do not include client transactions or external fund management.

Research Purposes Only:

All trading activities are conducted solely for research and proprietary trading purposes, aimed at advancing financial market strategies.

General Disclaimer:

The information provided on this website is for educational purposes only and does not constitute investment advice or a solicitation to buy or sell any financial instruments. Trading in financial markets involves substantial risks, including the potential loss of principal. All trading strategies are used at your own risk.

Regulatory Compliance Notice:

Trading foreign exchange on margin carries a high level of risk and may not be suitable for all investors. The high degree of leverage can work against you as well as for you. Before deciding to invest, carefully consider your investment objectives, level of experience, and risk appetite. It is possible for you to sustain a loss of some or all of your initial investment; therefore, you should not invest money that you cannot afford to lose. You should be aware of all the risks associated with foreign exchange trading and seek advice from an independent financial advisor if you have any doubts.

Performance Disclaimer:

Past performance is not indicative of future results. The contents of this website are not to be construed as a promise, warranty, or guarantee of the profitability of transactions or that the trading strategies will not result in losses. No representation is being made that any account will or is likely to achieve profits or losses similar to those discussed.

Risk Warning:

High Risk Investment Warning: Trading foreign exchange and/or contracts for differences on margin carries a high level of risk and may not be suitable for all investors. The possibility exists that you could sustain a loss in excess of your deposited funds and therefore, you should not speculate with capital that you cannot afford to lose.

"Success is the harmonious blend of ambition, hard work, and the courage to embrace failure." - Dr. Glen

