TWO MARKET CONDITION: CONTANGO AND BACKWARDATION

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Before investing in the future market, traders have to encounter various technicalities that may hassle their mind. As the armed soldiers target the goal before battle, like wise traders must have the assurance of winning the trade. During the commodity trading, traders encounter two market situations, i.e. contango and backwardation. Pricing of the future market is the main aspect to be understood by each and every trader. Generally we can see the future price to be higher than the cash price. The higher price is due to the various factor like demand and supply in cash market, interest rates, sentiment, dividend yield and transportation cost. Let's take the example of gold in cash future price, let's assume gold is Rs 32900 in cash market and the interest rate is 9% per annum and insurance and interest rates are 5% per annum. In this market situation the future price will be 34051.5 assuming this is three months contracts.

Under normal conditions, the future prices of the commodity are always higher than the cash or spot price due to the cost of carry incurred in it. When the future prices are higher than cash price then this type of market situation is known as contango.

If any market indicates that is in contango situation then it means there are surplus in the supply of commodity. When the future price is below the spot price then the situation is backwardation, for e.g. if there is very little lentil available for delivery, the price demanded for what little is available can be very high.

Some commodity experts believe that the backwardation is entirely abnormal and seldom exists. But it may happen especially in the case of perishable commodity. According to a report, gold went to backwardation, in 2nd December 2008, at the COMEX in New York, December gold future (last delivery: December 31) were quoted at 1.98% discount to spot, while February gold future (last delivery: February 27th 2009) were quoted at 0.17% discount to spot. This means that the gold basis had turned negative, and the condition of backwardation persisted for at least 48 hours. Some experts believe that gold is going to stable backwardation which means that gold is no longer for sale at any price due to the lack of supply.

Contango indicates the existence of a good or surplus supply of the commodity in the warehouse for immediate delivery where as backwardation indicates shortages of supply of commodity. Here the term basis is used to describe the numerical difference between cash price and future price, the negative basis is called under future and positive is over future and at the time of expiry of contract the basis will be zero. In a contango market where the future price is higher than the spot price this narrow of basis benefits the short hedgers, who sells the future price and buys the

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underlying commodity. If the basis widens it benefits the long hedger, who buys future and sells underlying physical commodity. The frequent change in basis is not good for the short selling because short selling is the selling of a commodity that the seller doesn't own, selling a commodity or equity by borrowing from other traders or brokers and after given time trader close the short by buying back the same number of commodity or equity and return them. So in changing basis price short selling is very thorny.

Normally the future price of gold is valued at premium. Which means the future price of gold is greater than spot price in aspect of supply. This is very good for the economy because the supply of gold is limited and the higher price trend leads people to hold less of physical gold. Backwardation of gold means shut down of the free flow in economic system and this type of backwardation affects dollar a lot because there is inverse relationship between gold and dollar, so if the gold price turns towards backwardation then the present price of gold rise by decreasing the value of dollar which is not very good for US economy. Despite to this crude oil remains in backwardation in some case which means the price of future crude oil seem lower than the spot price, because the holding or storage cost is high. The future or forward premium will usually be quoted as a percentage of the underlying price. Gold is nearly always in a contango, but the backwardation may exist during price compress, but it rarely happens.

The two market condition contango Vs backwardation is very important for the commodity hedgers and speculators. The fact in the year 1993, the German company Metallgesellschaft lost 1 billon dollar because there expert team developed the hedging system under backwardation but they didn't anticipate a shift to contango situation.

In agro products like corn, wheat or oil, backwardation effect can be seen. Backwardation occurs in agro because the farmers or the commodity producer always try to lock their price from uncertainty of price movement. These people are not willing to sell their crops in uncertainty and always try to accept the current price assuming it as a high price to lock a sure profit. This is why the backwardation exist because there is low probability of supply of commodity in future, so the price of spot trend high than in near future. Let's take an example of Nepalese farmer of black cardamom, they have been observing prices of it, say the present spot price for immediate delivery is Rs 5000 per kg, but the farmers are not having much confidence of future increase in price of this commodity. Therefore, they lock the present spot price, in this situation the spot price is higher than future price, and this is one of the way how market turns contango to backwardation.

Therefore, the suggestion to the traders is to consider both the market condition, i.e. contango and backwardation before doing commodity spot and/or future trading.