Price Movement reasons:

- Economic Outlook
- LME stock levels
- Demand Outlook (from healthcare and anti corrosion equipment making industry
- Supply Outlook (Mines Closer, Zinc producing country situation)
- Demand from China as it is the largest consumer of metals due to rapid development
- Demand from developing countries/ emerging economies

Due to this price movement risk arises for the traders. So for that they look for the ways to reduce it. Below are the details for mitigating price risk.

Price Mitigation Methods

Hedging:

Hedging means reducing or controlling risk. This is done by taking a position in the futures market that is opposite to the one in the physical market with the objective of reducing or limiting risks associated with price changes.

Hedging is a two-step process. A gain or loss in the cash position due to changes in price levels will be countered by changes in the value of a futures position.

Buying/Long hedge

A buying hedge is also called a long hedge. Buying hedge means buying a futures contract to hedge a cash position. Dealers, consumers, fabricators, etc, who have taken or intend to take an exposure in the physical market and want to lock- in prices, use the buying hedge strategy. Benefits of buying hedge strategy:

- To replace inventory at a lower prevailing cost.
- To protect uncovered forward sale of finished products.

The purpose of entering into a buying hedge is to protect the buyer against price increase of a commodity in the spot market that has already been sold at a specific price but not purchased as yet. It is very common among exporters and importers to sell commodities at an agreed-upon price for forward delivery. If the commodity is not yet in possession, the forward delivery is considered uncovered.

Long hedgers are traders and processors who have made formal commitments to deliver a specified quantity of raw material or processed goods at a later date, at a price currently agreed upon and who do not have the stocks of the raw material necessary to fulfill their forward commitment.

Selling/Short hedge

A selling hedge is also called a short hedge. Selling hedge means selling a futures contract to hedge.

Uses of selling hedge strategy:

- To cover the price of finished products.
- To protect inventory not covered by forward sales.
- To cover the prices of estimated production of finished products.

Short hedgers are merchants and processors who acquire inventories of the commodity in the spot market and who simultaneously sell an equivalent amount or less in the futures market. The hedgers in this case are said to be long in their spot transactions and short in the futures transactions.

Understanding the basis:

Usually, in the business of buying or selling a commodity, the spot price is different from the price quoted in the futures market. The futures price is the spot price adjusted for costs like freight, handling, storage and quality, along with the impact of supply and demand factors.

The price difference between the spot and futures keeps on changing regularly. This price difference (spot - futures price) is known as the basis and the risk arising out of the difference is defined as basis risk. A situation in which the difference between spot and futures prices reduces (either negative or positive) is defined as narrowing of the basis.

A narrowing of the basis benefits the short hedger and a widening of the basis benefits the long hedger in a market characterized by contango - when futures price is higher than spot price. In a market characterized by backwardation - when futures quote at a discount to spot price - a narrowing of the basis benefits the long hedger and a widening of the basis benefits the short hedger.
However, if the difference between spot and futures prices increases (either on negative or positive side) it is defined as widening of the basis. The impact of this movement is opposite to that as in the case of narrowing.

Hedging Instruments

Derivatives: it is a contract whose value is derived from an underlying asset. Assets may be stocks/bonds/commodities/currencies/interest rates/market indexes

TYPES OF DERIVATIVES

Derivative contracts can be differentiated into several types. All the derivative contracts are created and traded in two distinct financial markets, and hence are categorized as following based on the markets:

- **Exchange Traded Contract:** Exchange traded contracts trade on a derivatives facility that is organized and referred to as an exchange. These contracts have standard features and terms, with no customization allowed and are backed by a clearinghouse.
- **Over The Counter Contract:** Over the counter (OTC) contracts are those transactions that are created by both buyers and sellers anywhere else. Such contracts are unregulated and may carry the default risk for the contract owner.

OVER THE COUNTER CONTRACTS

Over the counter contracts are of two types:

- **FORWARD**

In this type of contract, one party commits to buy and the other commits to sell an underlying asset at a certain price on a certain future date. The underlying can either be a physical asset or a stock. The loss or gain of a particular party is determined by the price movement of the asset. If the price increases, the buyer incurs a gain as he still gets to buy the asset at the older and lower price. On the other hand, the seller incurs a loss in the same scenario.

- **SWAP**

Swap can be defined as a series of forward derivatives. It is essentially a contract between two parties where they exchange a series of cash flows in the future. One party will consent to pay the floating interest rate on a principal amount while the other party will pay a fixed interest rate on the same amount in return. Currency and equity returns swaps are the most commonly used swaps in the markets.

EXCHANGE TRADED CONTRACTS

Exchange traded forward commitments are called futures. A future contract is another version of a forward contract, which is exchange-traded and standardized. Unlike forward contracts, future contracts are actively traded in the secondary market, have the backing of the clearinghouse, follow regulations and involve a daily settlement cycle of gains and losses.

Futures Contract: it is a contact which obligates the buyer and seller to sell or purchase the commodity at predefined future date and price. This is standard and regulated instrument.

Options: A contract that gives the right but not the obligation to buy or sell a security or other financial asset.

a) Call Option (Option to Buy): it is a contract between 2 parties to exchange a stock at a strike price by a predetermined date. One party, the buyer of the call has the right but not an obligation to buy the stock at a strike price by the future date, while the other party, the seller of the call has the obligation to sell the stock to the buyer at the strike price if the buyer exercises the option.

b) Put option (Option to Sell): it is a contract between 2 parties to exchange a stock at a strike price by a predetermined date. One party the buyer of the Put has the right but not and obligation to sell the stock at the strike price by the future date while the other party the seller of the put has the obligation to but the stock from the buyer at the price if the buyer exercises the option.

Stop loss: To reduce the further risk of price fall, investor put a limit and exit the trade once price fall in this limit.

Use of derivatives:

a) To hedge risk
b) Used by speculators and arbitrageurs to make profit which includes heavy risk if analysis not done properly.

Disclaimer:

This content has been compiled from various sources from internet. The purpose of this document is to give knowledge of various Commodities to the user.