19BAE710-FINANCIAL DERIVATIVES

Commodity and Currency markets have seen tremendous growth in India and the world over the past several years. While equity markets are the most talked about in India, the significance of commodity and currency markets is often understated. This is in contrast to global trends where currency and commodity markets see higher trading and turnover compared to equities. It is important and interesting to understand price behavior of commodities since they are so closely inter-linked to our daily life. From the petrol that drives our cars to the food grains we eat, we deal in deal in commodities every day in some form or the other. We use currencies to transact both locally and globally and therefore the currency markets are equally important.

When it comes to trading, the dynamics of every asset class differ and therefore it is imperative to understand the drivers behind price movements. In that sense, both commodities and currency markets are largely driven by macro-economic factors which drive demand and supply. Unlike equities which are predominantly driven by stock specific or sector specific fundamentals, commodities are driven by demand-supply, weather, geo-politics, trade policies and broader economic fundamentals. Currency markets are largely driven by macro-economics and geo-politics. Since both these markets are essentially global, they provide an opportunity for domestic traders and investors to play on global events. For example, an ordinary domestic investor would have no way to trade elections in France or participate in the China growth story. But through currency markets, he could take exposure to the Euro to trade the outcome of the French elections. Similarly, since base metals are most consumed by China, an exposure in metals could provide a proxy for trading the China story.

Currencies:

Currencies, in the context of trading and finance, refer to the money used by countries. Forex (foreign exchange) is the market where currencies are traded. Some key points:

1. **Major Pairs:** Currencies are traded in pairs, like EUR/USD (Euro/US Dollar) or USD/JPY (US Dollar/Japanese Yen). The first currency in the pair is the "base currency," and the second is the "quote currency."
2. **Exchange Rates:** The exchange rate tells you how much of the quote currency you need to buy one unit of the base currency. It's a measure of the value of one currency against another.
3. **Volatility:** Forex markets can be highly volatile, influenced by economic indicators, geopolitical events, and central bank policies.

Commodities:

Commodities are raw materials or primary agricultural products that can be bought and sold. There are two main types:

1. **Hard Commodities:** These are natural resources that must be mined or extracted, like gold, oil, or copper.
2. **Soft Commodities:** These are agricultural products, like wheat, coffee, or sugar.

Key Points:

1. **Futures Trading:** Both currencies and commodities often have futures contracts associated with them. These contracts allow for speculation on future price movements or serve as a risk management tool for businesses.
2. **Supply and Demand:** The prices of commodities are often influenced by supply and demand factors. Weather conditions, geopolitical events, and global economic trends can impact commodity prices.
3. **Diversification:** Traders and investors often include currencies and commodities in their portfolios to diversify risk. They might move inversely to other assets like stocks or bonds, providing a hedge against broader market movements.

Commodity markets :

There are currently about 50 major commodity markets worldwide that facilitate investment trade in approximately 100 primary commodities. While there are a lot of ways to invest in commodities, the most direct way of investing is by buying into a futures contract. A futures contract obligates the holder to buy or sell a commodity at a predetermined price on a delivery date in the future.

There are three different types of players in the commodity markets:

Commercials: The entities involved in the production, processing or merchandising of a commodity. For example, both a corn farmer and Kellogg's are commercials. Commercials account for most of the trading in commodity markets.

Large Speculators: A group of investors that pool their money together to reduce risk and increase gain. Like mutual funds in the stock market, large speculators have money managers that make investment decisions for the investors as a whole.

Small Speculators: Individual commodity traders who trade on their own accounts or through a commodity broker. Both small and large speculators are known for their ability to shake up the commodities market

Benefits of trading in commodity markets

Alternative investment opportunity

Less volatility as compared to equities

Lucid trends based on macro fundamentals

Exposure to global markets/commodities

Longer market hours allow sufficient time to react

No manipulation in global markets

Track able seasonal patterns for various commodities

Higher leverage

Low cost of transactions

Carry trades

Currency markets:

Foreign exchange markets are made up of banks, commercial companies, central banks, investment management firms, hedge funds, and retail forex brokers and investors. The forex market is the largest financial market in the world. A country's currency exchange rate is typically affected by the supply and demand for the country's currency in the international foreign exchange market. The demand and supply dynamics are principally influenced by factors like interest rates, inflation, trade balance and economic & political scenarios in the country. The level of confidence in the economy of a particular country also influences the currency of that country.

Benefits of trading in Currency Derivatives

Hedging: You can protect your foreign exchange exposure in business and hedge potential losses by taking appropriate positions in the same.

Speculation: You can speculate on the short term movement of the markets by using Currency Futures.

Arbitrage: You can make profits by taking advantage of the exchange rates of the currency in different markets and different exchanges.

Leverage: You can trade in the currency derivatives by just paying a % value called the margin amount instead of the full traded value.

Benefits of trading in currency markets

Highly Liquid

No manipulation in global markets

Open almost 24 Hours a Day, 5 Days a Week

Leverage

Diversification

Hedge Against Political and Event Risk