Tips for Traders | 11/2/2007

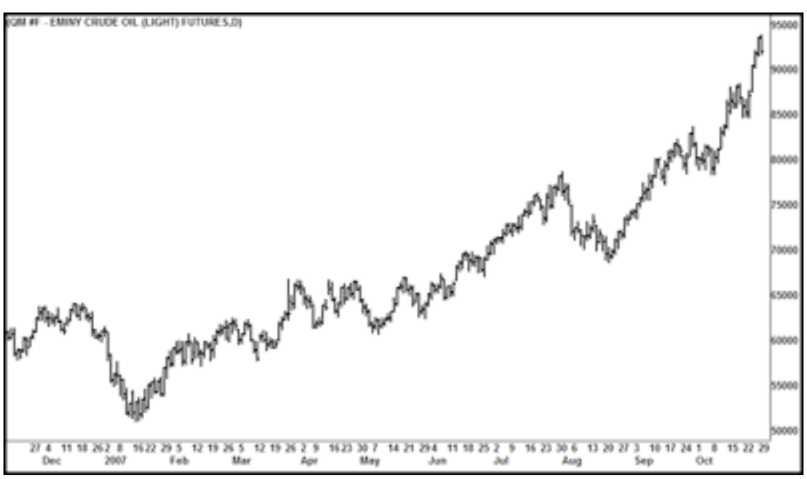
Profit From Moves in Oil and Gold by Trading Currency Futures!

You can't turn on the radio or open the newspaper these days without people talking about oil going to $100 a barrel. Everyone's got an opinion on oil and many have an opinion on gold and silver, because they are perceived as inflation hedges. And of course, with everyone holding their breath over the 'interest only' loan portfolios held by the large investment houses at huge losses, it's no wonder traders and investors have started to trade commodities like oil and gold much more actively.

But what if you have no experience in these markets? Or worse, what if the size of these contracts are too large for your trading account, or the lack of liquidity and open interest of their 'mini contract' versions worry you? Can you still make money when you see a trade set up in these markets? You bet you can! I am going to focus on the oil markets, because they are the most active as I write this article, but you can use these techniques to do the same thing in the metals markets. Let me show you how I use currency futures as 'proxy' trades for these markets.

Here are two facts to keep in the back of your mind: Canada produces more than three times the energy it uses and that means it is a huge seller of oil and natural gas [at a great profit these days, I might add]. Japan, on the other hand, produces literally no energy and uses a tremendous amount of it [and it costs them a great deal of money these days, obviously]. These are fundamental facts and besides the knowledge of the natural resources of these countries and the associated profits and losses nationally that help or hurt their economies, there is another reason to know these two facts: if Japan wants to use oil, they have to buy it. And they have to pay for it with the currency of the country that produces it [or they can deliver Yen and the producing country can then change the currency into their own currency]. To make things easy, let's assume the Japanese deal direct with Canadians. If they buy oil from a Canadian producer, the Japanese buyer has to sell Yen and then buy Canadian dollars to pay for the oil. And the Canadian dollar gets a double boost from this transaction: The immediate effect is that a huge amount of Canadian dollars are bought in the market for this particular transaction. And the long-term effect is that traders look at the natural resource situation and know that capital is continually flowing from countries like Japan directly into Canada-so the Canadian dollar benefits from further appreciation as traders position themselves to be on the 'right side' of this capital flow. Can the movement in these currencies be anywhere near as profitable as the recent movement in oil prices? After all, oil ran from $70 a barrel in early September to well over $90 a barrel as I write this article on November 1, 2007. That's a huge move!

Let's look at an oil chart, so you can see the recent run up in the price of crude oil:



This is a chart of the NYMEX Mini Crude futures and unless you are a very active and well-capitalized trader, you'd probably be trading this futures contract if you wanted to take a position in oil. The daily volume is about twelve to thirteen thousand contracts and the open interest is roughly thirteen thousand contracts. These numbers are pretty small compared to most futures contracts. For instance, the E Mini S&P futures contract trades well over one million contracts a day, every day. And the euro currency and the Japanese yen futures on the Chicago Mercantile Exchange trade well over 200,000 contracts a day, and the Canadian dollar trades fifty to seventy thousand contracts a day as well. So the currency futures are much more liquid, which means less slippage and a much lower probability that you'll see price spikes.

Now how would you position yourself to take advantage of a large upward movement in the price of crude oil by taking a currency futures position? Here is a spread trade that I follow regularly and have been trading in and out of regularly for the past four or five years, since oil and gold started moving actively. I look at the price of the Canadian dollar versus the Japanese yen. Let's take a look at that chart, during the same time period as the oil chart above:

You can see that over the same period, this currency spread has made a huge move! And looking at the chart, you can see that once I added in an up sloping Median Line [or pitchfork], I simply waited for price to come back down to touch the up sloping Lower Median Line, where I was able to get long this spread. This means I bought one Canadian dollar future and sold one Japanese yen future that day for each currency future spread I wanted to put on. There is an actual Canada/yen spread contract that trades on the Chicago Mercantile Exchange and you can simply take a position in that futures contract but I prefer to take a position in each individual currency future. There is more liquidity in the individual contracts and less slippage on entries and exits and I tend to trade large amounts of contracts when I take currency positions.

Now what about the profit opportunities? Can you make anywhere near as much trading these spreads, as you would have if you had simply bought oil futures? The Canada yen spread trade was taken on September 7, 2007, so we'll use oil prices on that day as well to calculate a quick profit and loss comparison. Here's the math:

Crude oil futures closed at 76 ? dollars per barrel on September 7, 2007. And yesterday, they were at 92 ? a barrel when I took profits on the currency spread trade. Each mini crude contract controls 500 barrels of oil, so 76 ? - 92 ? = 15 1/2 dollars per barrel times 500 barrels. That means I would have made $7,750 per contract before commissions on a long oil position taken on September 7, 2007 and exited yesterday.

The Canadian dollar futures closed at 94.80 on September 7, 2007 and when I took profits on the currency spread position yesterday, they were at 104.67, for a total gain of 987 ticks. At $10 per tick, I made $9,870 per contract before commissions. But I can't forget about my short Japanese yen futures position. Yen futures closed at 8941 on September 7, 2007 and I closed them out yesterday at 8767, for a gain of 174 ticks at $12.50 per tick-which means I made an additional $2,175 per contract because the yen went down in value as the Canadian dollar went up in value. My total gain on the currency spread was $12,045 per spread, which is quite a bit more than I would have made from a long oil position!

Although many of you have probably never made a futures spread trade, just as many have probably never taken a position in oil futures. It's as simple as an outright futures trade and in currency futures; the actual spread is almost always traded as its own futures contract on the Chicago Mercantile Exchange. Just call your broker and they'll be glad to help you out with charts and execution if you need help.

The old saying is: 'there's more than one way to skin a cat'! I've never skinned a cat, but I can assure you, there are always ways to make money from movement in one market by taking a position in other markets. You just have to think a bit and do a little homework. And sometimes, you make more by taking the position in a different but correlated market. And of course, that's a very good thing!

I wish you all good trading.

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