TRADING GROUP UBC

Weekly Educational Topics

The Basics of Commodities

"COMMODITIES ARE BASIC RAW OR UNPROCESSED MATERIALS THAT ARE USED AS INPUTS TO MAKE SOMETHING THAT WILL EVENTUALLY BE CONSUMED"

"THE COMMODITIES MARKET IS PRIMARILY MOVED BY UNCERTAINTIES SUCH AS WEATHER AND GEOPOLITICAL EVENTS THAT WOULD AFFECT PRODUCTION."

BY:
MEHTAAB CHANDI

Commodities are basic raw or unprocessed materials that are used as inputs to make something that will eventually be consumed, such as barrels of oil or bushels of wheat. The commodities space goes beyond just precious metals, foods and fuels - some exotic derivatives allow traders to trade foreign currencies, indexes, and even cell phone minutes/bandwidth.

The basic idea is that a commodity from one producer and the same commodity from another producer are considered interchangeable since there is very little differentiation between their quality. Although the quality of a commodity is essentially uniform across producers, however, they must meet specified minimum standards when traded on an exchange, known as the “basis grade”.

The commodities market is primarily moved by uncertainties such as weather and geopolitical events that would affect production. For example: natural disasters flooding farmland, oil embargoes, etc. There are two broad commodity market participants:

- Commercials: These traders are the ones that mean to use the commodity for what was actually intended for. They (ie. farmers) use commodity trading to hedge against the risk of losing money on their commodity if the price falls before the commodity is harvested/obtained.
- Speculators: These are the traders who trade on the commodities markets for the sole purpose for profiteering from volatile price movements.

Traders typically buy and sell commodities directly on the market or via derivatives such as futures and options.