

Seasonal Spread Trading - A Viable Alternative

At a time when equities markets have lost significant value the clear trend is over, and a cloud hangs over interest rate and property markets, then maybe it is time for traders to consider some alternatives.

One viable alternative is trading seasonal spreads. This article explains how and why this strategy provides a higher probability of success, longer trends, less volatility, lower margin requirements, anonymity, and a hedge.

Seasonal trading has been around for many years, the old time veterans pre 1975 relied on seasonal patterns, and their predictability to trade and be profitable before the introduction of computers. Professional traders and large commercial interests are well aware of seasonal trading patterns, and seasonal spread trading is part of their arsenal. The annual supply and demand characteristics of commodities still apply today, yet most traders overlook this strategy.

Seasonal patterns exist in most all markets because of the production cycles, weather cycles, and planting and harvest cycles. These patterns have been entrenched for decades and are easily understood. Heating oil consumption is heavy during winter; gasoline consumption is strong during summer. Red meat is consumed more during the colder months and lean meat is consumed during warmer months. Soy meal is consumed in cold months and gold is usually in demand during the gift-giving season towards year's end, through to Chinese New Year. Prices are low when supply is plentiful and prices are high when supplies decline. These seasonal patterns become stable and reliable.

What is a spread?

A spread is the sale of a futures contract and the purchase of an offsetting futures contract. Spreads can be done with options, but for this article we will stay with futures. Generally the direction of the underlying futures market is of no concern because we are trading the differential of the sold (short) contract and the purchased (long) contract or vice versa.

Seasonal Spread Example

As winter nears its end in the United States and temperatures start to increase, consumption of natural gas starts to decline. This decline usually starts to drive near month (April) contract prices down while the back month contract (June) holds its premium.

We enter this trade, for example only, on approximately 9 February 2008:

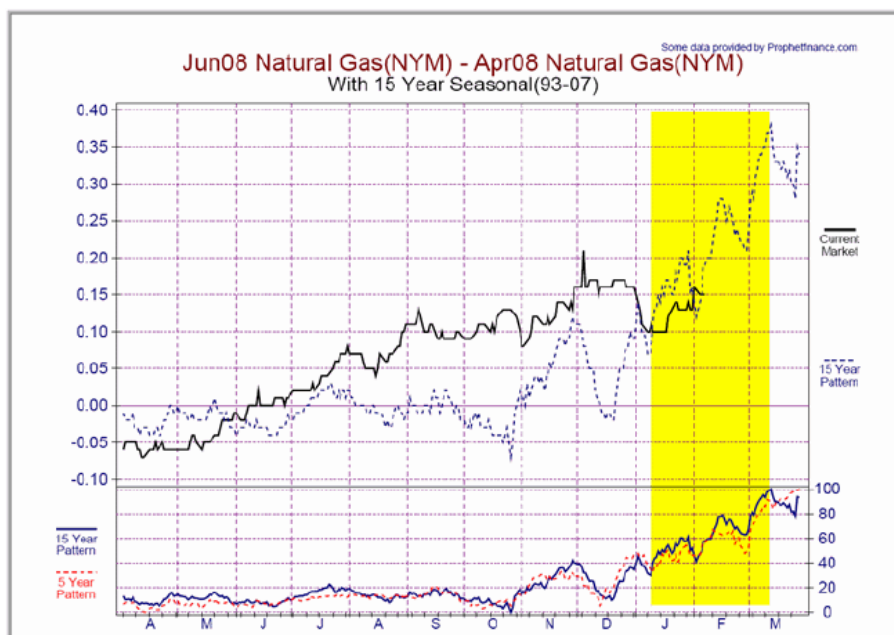
- Buy June Natural Gas (long)
- Sell April Natural Gas (short)

The simultaneous purchase of these two Natural Gas (NG) futures contracts in different months creates the spread. The characteristics of the intra-market spread are you are now long and short

NG and have a natural hedge. Exchanges and brokers recognize that spreads carry less risk and therefore require less margin deposit. No one knows your opinion as you are long and short at the same time and you don't care if natural gas goes up, down, or sideways, as long as the difference in the spread moves in your favor. In this instance we want to see the spread widen.

Long June NG/short April NG has been profitable 13 years out of the last 15 with the average profit on this trade being \$2000 . This trade's last losing year was in 2002 when it suffered a drawdown of \$480 and the only other losing year was in 1993 when it lost \$1100. As with nearly all trading on US exchanges, all numbers quoted are in US dollars.

Below is a 15 year seasonal chart tracking the performance of this spread. The broken line in blue is the past performance and the hard black line is this year's performance. The yellow area is the optimal entry and exit time for trade.



Looking at the seasonal chart you can see that optimal entry is early January when the spread price was at 10 cents, the difference in price of June NG (long) and April NG (short). At the time of entry the individual price of June NG was at \$8.15 and April NG was \$8.05. As at 8 February 2008, the spread was trading June NG at \$8.35 and April NG at \$8.20, a 15 cent differential, a profit of 5 cents, a \$500 profit.

The NG or minimum price movement, or "tick size", is \$0.001. A movement of \$0.001 in the natural gas commodity price equates to a \$10 move in the futures contract price, so a 1 cent move in natural gas equates to \$100 in the futures contract.

There are just as many opportunities trading seasonal spreads as there are trading outright futures positions, once you understand the concept. Placing spread trades is as easy as placing outright futures positions. You open and close positions with your broker as a spread (usually recommended) or, if preferred, you can open or close them individually.

Seasonal spread trades exist in nearly all commodity markets, such as:

Meats: Lean Hogs, Live Cattle and Feeder Cattle

Softs: Orange Juice and Cotton

Grains and Soy: Soy Beans, Soy Oil, Soy Meal, Wheat - Chicago Board of Trade (CBOT) and Wheat - Kansas City Board of Trade (Kansas City) and corn

Energy: Crude Oil, Natural Gas, Heating Oil and Unleaded Gasoline.

With so many seasonal spreads to trade, one has to ask why traders are not considering this strategy. With the assistance of computers you are able to spot seasonal trends and get information faster.

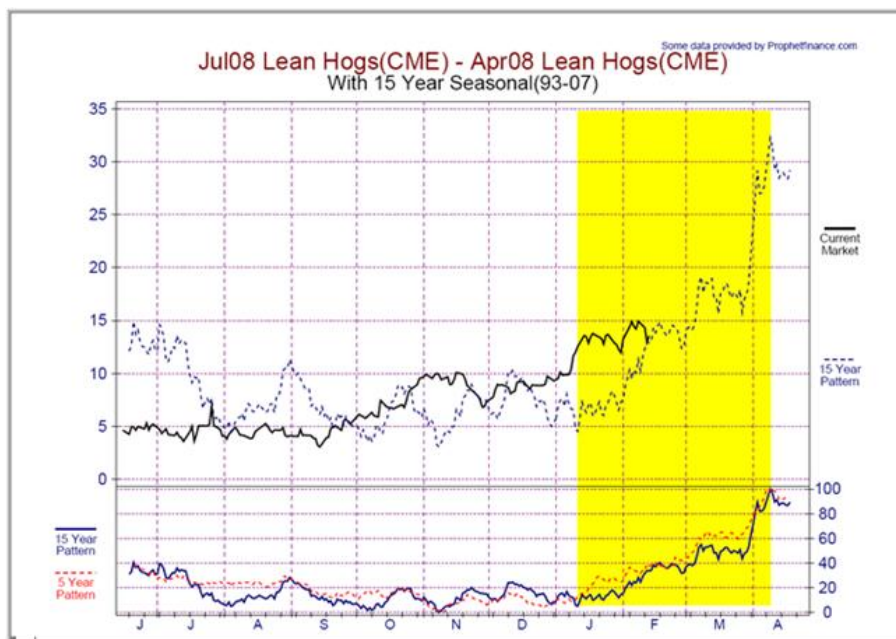
Here are a few examples of current seasonal trades.

Lean Hog Spread - Buy July Lean hogs/Sell April Lean hogs

Demand for Lean Hogs increases into warmer months (US summer), so prices for the "back month" (July) usually carry a premium over the "front month" (April) as the US consumes more lean meat over summer.

We enter on 11 January 2008 and exit around early April

This trade has closed with the spread moving in favour of July Lean Hogs in 14 of the last 15 years, with an average return of \$1800. The only losing year was 1996 when this trade lost \$1800.



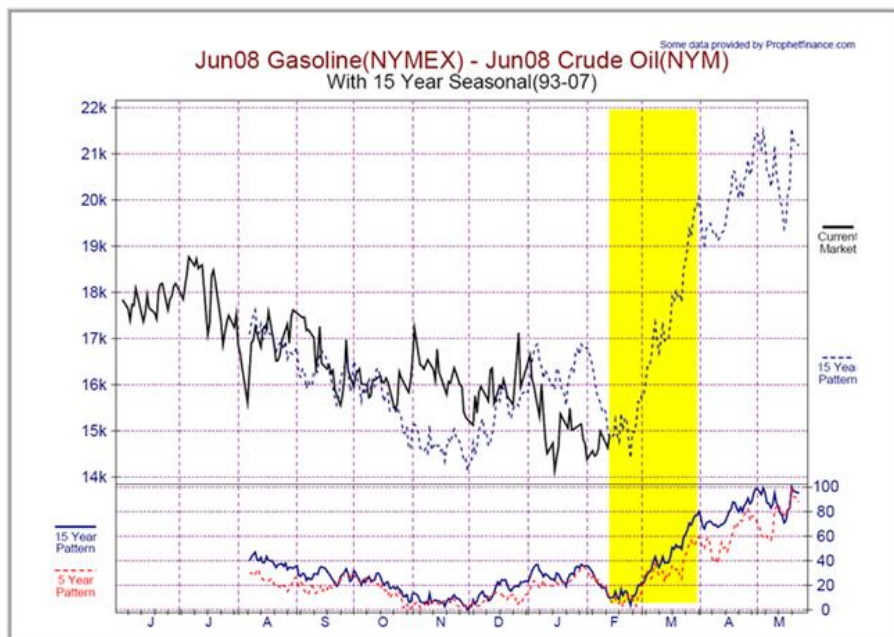
Crude Oil Spread - Buy June Unleaded Gasoline/Sell June Crude Oil

As winter nears its end in the US Crude Oil supplies usually start to build as the thaw opens roads, seaways and river ways used for crude delivery. Heating Oil demand also usually starts to decline

assisting the build of crude oil stocks as the weather gets better and the snow melts. US drivers then start taking to the roads increasing demand for Unleaded Gasoline.

We enter this trade on 30 February 2008 and exit around late March.

This trade has closed with the spread moving in favour of June Unleaded Gasoline in 15 of the last 15 years. Its average return has been \$1500. The lowest return was \$200 in 1993 and the best return was \$5600 in 2006.



Traders should further investigate spread trading as it utilises reliable trends that are easily identified and in most cases don't suffer from extreme volatility. Spreads recognised by exchanges require lower margin deposits, allowing traders to utilise their trading funds more effectively. Trades are anonymous because you are simultaneously long and short the market. Don't forget there is also a natural hedge in the trade.

Spread trading is time efficient as it does not require constant monitoring, unlike outright futures positions. The majority of spread trades take place at the end of the day near the close, so you track your position at the end of the day using the settlement price, avoiding the need for watching real-time data.

Steve Britt and **Warren Lum** are principals of Option1 AFSL 225380 (www.option1.com.au) a spread trading education and advisory service, dedicated to making sophisticated strategies simple. They can be contacted on info@option1.com.au.

This information is in no way is to be considered advice. The examples above should not be considered trading recommendations. Before undertaking any trading seek professional advice. Any type of trading involves risk of loss and therefore risk capital should only be used. A trade is not an investment and requires training, knowledge and experience. The guidance of a licensed adviser is recommended.

