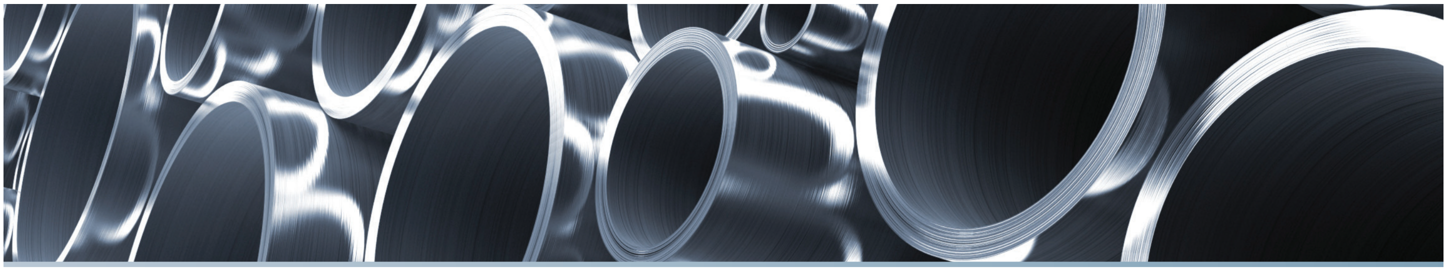

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Hot Rolled Futures & Commodity Derivatives: Hedging vs. Speculating

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Recently the trading of commodity derivatives has made news, particularly in regards to a how Chesapeake Energy used derivatives to both hedge and speculate in energy markets. As is often the case when discussion of derivatives comes up, many misconceptions arise.

It must be noted that the use of commodities derivatives for both hedging and speculative purposes has been around for hundreds of years and is an ingrained tool of doing business in many commodities markets. The rise of derivatives markets originally gained footing in the US in the 1800s when farmers were looking for ways to protect themselves from the volatile swings in prices that weather related events had on their crops. This ingrained volatility in agricultural markets led to the development of financial derivative instruments that allowed users of the underlying market (farmers, consumers) to offset their risk onto speculators who took on the price risk. This symbiotic relationship between those who have natural exposure to price risk due to their underlying business and those who are looking to gain exposure to volatile price movement's lead to the development of commodity futures exchanges such as the Chicago Board of trade, NY Board of trade etc…

After the early success of the agricultural industries adoption of derivatives as a hedging tool other markets such as metals and energy and financial markets where volatility has become more of the norm have adopted derivatives markets of their own. Today futures and options contracts are actively traded for products as diverse as weather derivatives to oil, copper, sugar, coffee, freight and many more. In fact the US steel market is one of the last commodities markets that does not have an active futures market associated with it. The US HRC futures market is still very much in its infancy with many common misconceptions associated with it.

One of the most common misconceptions amongst many new to or on the outside of futures markets is that they are inherently risky. This is a logical fallacy. If a business is engaged in either producing or consuming a physical commodity they have natural risk to the market and by using a derivatives contract to offset this natural exposure they would actually be decreasing their market risk. For instance if an OEM has an annual steel buy in order to produce their products they are naturally exposed to the price of steel going up. The have a risk inherent in their business. If they buy a HRC futures contract they would then be mitigating their risk to the price of steel. The futures contract is not a gamble on price, the gamble on price came first by the very rasion d'etre of their business. Therefore in this example the derivatives product is a 'hedge' for them.

Alternatively, if a company does not have natural exposure to a commodity market but feels they have information that leads them to have a view a certain commodities price will either move up or down they may enter into a 'speculative' futures contract. Starting at a natural exposureless position selling a futures contract would then be adding risk to the company thus speculative. If the market fall in line with that companies belief and they decide to purchase the actual physical product to offset their short futures position the 'hedge' in this case would be the physical position as that was the 'de-risking' trade of the two positions they ended up having.

To muddle the waters further, many commodities producers, traders and consumers will use futures to both hedge as well as speculate. This is only natural as businesses that have a deep knowledge of a particular commodities market may use futures to hedge their physical exposure as normal course of doing business and as a prudent risk management practice. However, at times these same companies may develop a strong view on market price direction and decide to express that view through futures or options contracts rather than through their physical business as futures and options are more leveraged products and involve considerably less counter-party risk when they are cleared on exchanges.

In summary, commodities markets have used derivatives products for over 2 hundred years. There are two primary types of uses for derivatives, hedging and speculating. Hedging is when the derivatives contract offsets physical exposure to a market where as speculating adds market exposure. At any given time the same company may enter into derivatives contracts as hedges and/or speculative trades. The bottom line is that derivatives are not inherently risky and often are tools for inherently risky physical businesses to decrease their risk. Both hedgers and speculators are necessary to provide the liquidity needed to create a robust futures market.

The US HRC futures market while small is growing in terms of volumes and participants as the underlying price movement of steel in the US is becoming increasingly volatile. Producers, distributors and consumers are increasingly seeing ways to utilize derivative products to decrease risk and/or maximize profit.