SPECTRA MARKETS

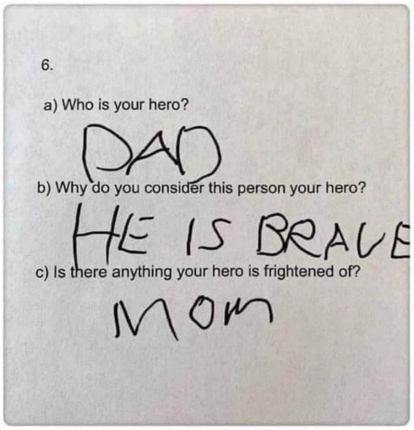
Monday, October 04, 2021

am

FX

Brent Donnelly

bdonnelly@spectramarkets.com
(212) 398-6230



Courtesy of CnD

Current Trades

Flat

Brent's crude thoughts

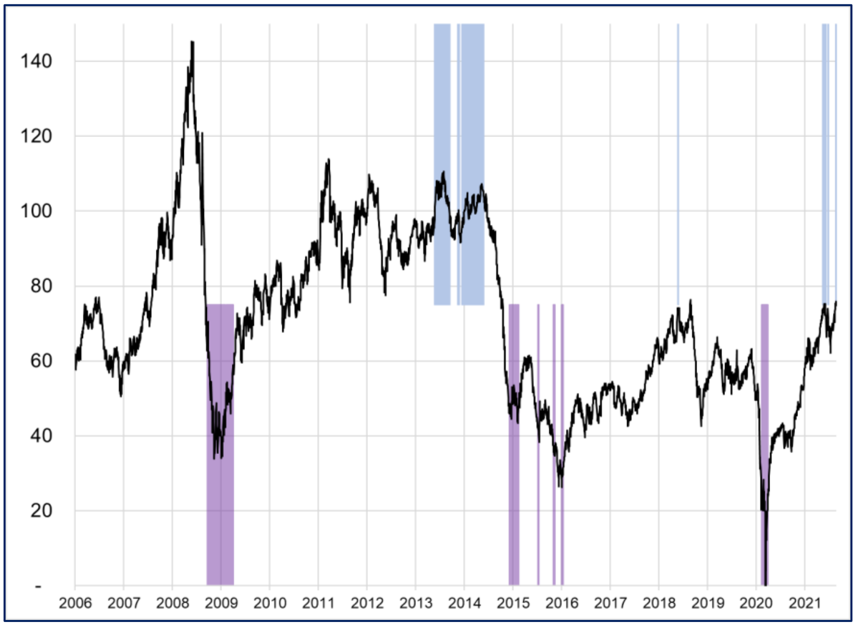
Backwardation and contango are confusing terms

I wrote a bit last week about the spike in UNG volumes and how tourist activity in natural gas can sometimes be an indicator of a top there. The fever pitch of the news coverage on energy is what has got me interested here, I think, as it reminds me so much of the lumber frenzy earlier this year and other supply-driven commodity surges. There are also quantitative reasons to think energy is stretched.

The most basic signal of supply tightness is the shape of the crude oil curve. When there is extreme backwardation or contango, that is often a sign of short-term supply issues (shortage or extreme oversupply). In contrast, during periods of strong demand, the entire curve tends to move (not just the front contracts).

Today's chart shows NYMEX crude oil marked with any time the front contract (CL1) was $16 or more away from the contract three years out (CL36), like it is now. You can do similar analysis with CL1 vs. CL12 or other contracts; the conclusion is not highly sensitive to your choice of parameters.

CL1 (black line) marked with extreme inversion and steepness



Just a note about back testing: When I test a hypothesis like this, I choose my parameters first, based on what I think is logical. I test my hypothesis, and then I look at the results and I analyze them. I do not change the parameters or look for a better fit or cooler / sexier result. If you start with a hypothesis then tweak parameters repeatedly, you can end up with the green jellybean problem. The more you play with the parameters, the greater chance your result will be the product of chance.

You can see that the shape of the crude oil futures curve is a decent indicator for whether you should be buying or selling oil. It is not a perfect indicator, but it's much better than following the trend. There is a strong mean reverting pull as the roll between the front and back contracts resolves over time—but it's not just about rolldown.

There is some signal when the curve goes wild like this. The signal is “WARNING: temporary supply imbalance—unlikely to persist”.

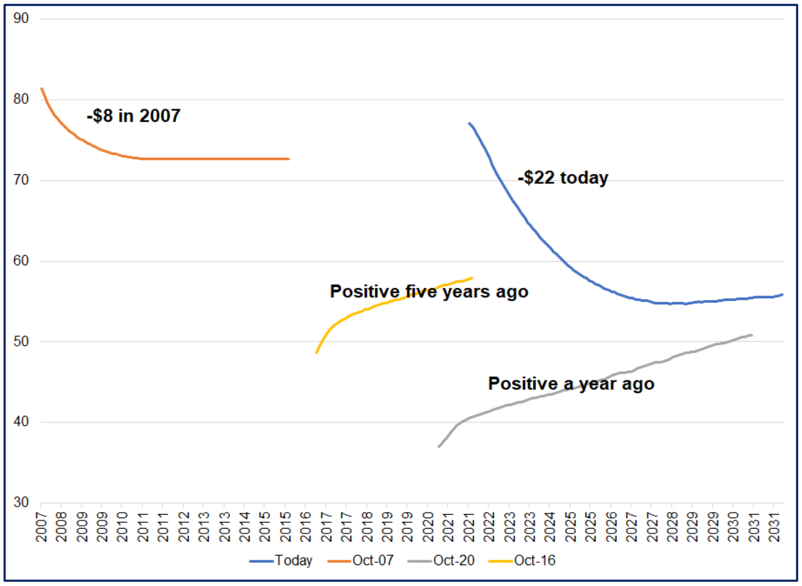
The main pushback to my UNG vs. NG analysis was that it didn’t include the 2006-2008 period. Today’s analysis shows that in 2006-2008, the entire crude oil curve was moving up, not just the front. As such, the rampant demand for commodities as an asset class in 2006/2008 is not in evidence today.

So what’s the takeaway? Avoid getting sucked into a persistent bullish energy narrative. This is much more likely to be a short-term story with a very attractive, multifaceted narrative about failing infrastructure, ESG woes, bad UK wind, etc. That doesn’t mean you need to go short oil right now. It just means you should treat this last rally more like the lumber rally of 2020 than the energy rally of 2007.

Context

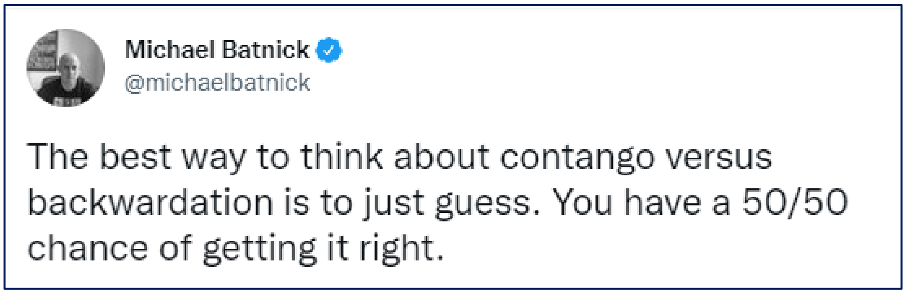
For context, here is a snapshot of the NYMEX crude curve at four arbitrary points in time.

Crude oil curve (NYMEX)
Today, one year ago, five years ago and October 2007



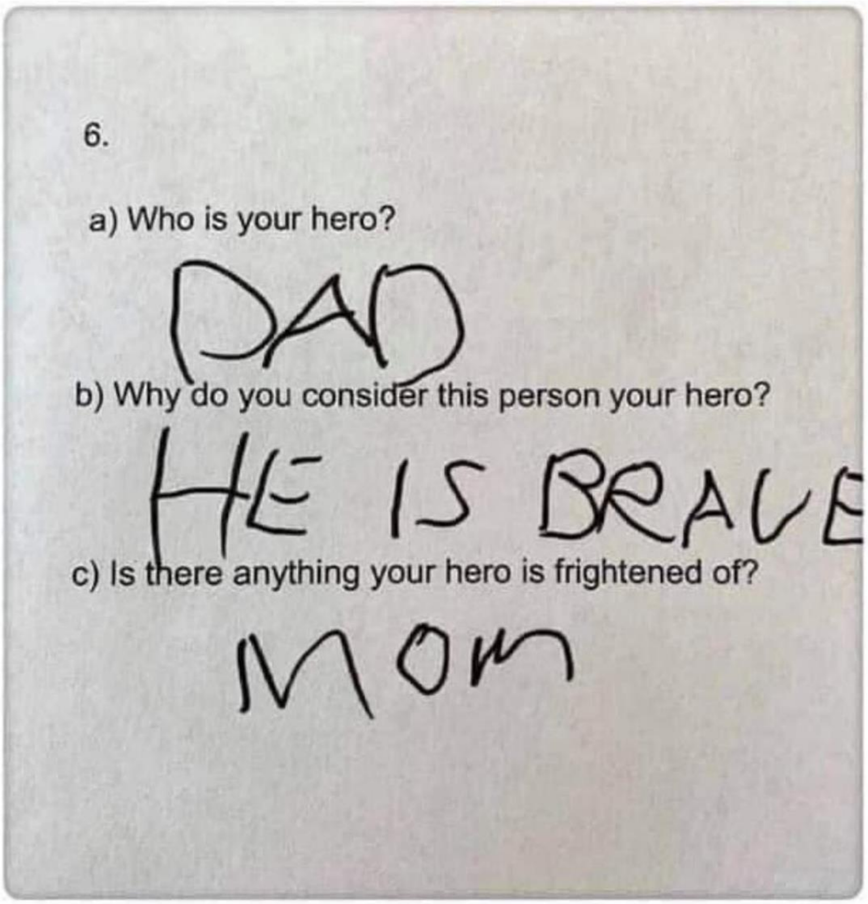
Niche humor

I am sure this tweet isn’t as funny as I think it is.



Have a brave day.

good luck ⇅ be nimble



6.

a) Who is your hero?

DAD

b) Why do you consider this person your hero?

HE IS BRAVE

c) Is there anything your hero is frightened of?

MOM

What is AM/FX?

AM/FX is Brent Donnelly's must-read daily macro letter, published since 2004.

It is a clear and concise daily look at one or two important topics related to global markets. Brent talks macro, narrative economics, trading strategy, tactics, positioning, technicals, and market psychology as he covers whatever markets are in play. Topics covered include FX, crypto, stocks, fixed income, commodities, and macroeconomics.

Brent's huge network of hedge fund, real money, central bank, and trading contacts give him unique insight into what's driving markets today, and what will move markets tomorrow.

Brent offers actionable analysis, clear directional views, and real trade ideas as he helps you surf the current narrative. He puts new themes on your radar before they hit the mainstream.

AM/FX is relevant, concise, and original. And not boring.

Subscribe to AM/FX here

What is Spectra Markets?

Spectra Markets is the shiny new digital media division of Spectra Holdings.

As President of Spectra Markets, my goal is to build a place where every trader and investor goes for smart, independent, and original financial markets content. The vision is to build a company that produces forward-thinking and mind-expanding financial markets coverage. Real-world market intelligence for every trader and investor.

Spectra Markets: Look Forward.

Markets and Trading Commentary Disclaimer

This material has been provided by Spectra Markets, LLC ("Spectra Markets"). This material is confidential and therefore intended for your sole use. You may not reproduce, distribute or transmit this material or any portion thereof to anyone without prior written permission from Spectra Markets.

This material is solely for informational and discussion purposes only. Spectra Markets is not a registered investment advisor or commodity trading advisor. This material should not be viewed as a current or past recommendation or an offer to sell or the solicitation to enter into a particular position or adopt a particular investment strategy. Spectra Markets does not provide, and has not provided, any investment advice or personal recommendation to you in relation to any transaction described in this material. Accordingly, Spectra Markets is under no obligation to, and shall not, determine the suitability for you of any transaction described in this material.

To be clear: Your individual circumstances have not been assessed. You must determine, on your own behalf or through independent professional advice, the merits, terms, conditions, risks and consequences of any transactions described in this material. Securities described in this material may not be eligible for sale in all jurisdictions or to certain categories of investors. This material may also contain information regarding derivatives and other complex financial products. Do not invest in such products unless you fully understand and are willing to assume the risks associated with such products. Neither Spectra Markets nor any of its directors, officers, employees, representatives or agents, accept any liability whatsoever for any direct, indirect or consequential losses (in contract, tort or otherwise) arising from the use of this material or reliance on information contained herein, to the fullest extent allowed by law.

The opinions expressed in this material represent the current, good faith views of the author at the time of publication. Any information contained in this material is not and should not be regarded as investment research or derivatives research as determined by the U.S. Securities and Exchange Commission ("SEC"), the U.S. Commodity Futures Trading Commission ("CFTC"), the Financial Industry Regulatory Authority ("FINRA"), the National Futures Association ("NFA") or any other relevant regulatory body. The author is currently employed at a trading desk. The opinions may not be objective or independent of the interests of the author. Additionally, the author may have consulted with various trading desks while preparing this material and a trading desk may have accumulated positions in the financial instruments or related derivatives products that are the subject of this material.

Spectra Markets does not guarantee the accuracy, adequacy or completeness of the information presented in this material. Past performance and simulation data do not necessarily indicate future performance. Predictions, opinions and other information contained in this material are subject to change continually and without notice of any kind and may no longer be true after the date indicated. Any forward-looking statements speak only as of the date they are made, and Spectra Markets assumes no duty to and does not undertake to update forward-looking statements. Forward-looking statements are subject to numerous assumptions, risks and uncertainties, which change over time. Actual results could differ materially from those anticipated in forward-looking statements. The value of any investment may also fluctuate as a result of market changes.

Spectra Markets is affiliated with Spectra FX Solutions LLC, an introducing broker that is registered with the NFA; Spectra FX Solutions LLP, which is a registered entity with the U.K.'s Financial Conduct Authority; and SpectrAxe, LLC, a swap execution facility that is currently in the process of registering with the CFTC. The disclosures for Spectra FX Solutions LLC and Spectra FX Solutions LLP related to the separate businesses of Spectra FX can be found at http://www.spectrafx.com/.