Canola Oil Contracts

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Overview

Canola (named from ‘Canadian Oil, Low Acid’) is a type of crop that has been developed in Canada. The parent crop of Canola is rapeseed, and Canadian Scientists have used several breeding and selection techniques in its creation. The reason behind this research was to create a food crop that had very attractive nutritional qualities.

Canola has so many qualities including very low saturated fat while simultaneously being a source of omega 3, which is usually only found in appropriate quantities in oily fish. Canola is also rich in vitamin E. Canola itself is similar in many respects to other oilseeds, such as soybeans, and it is often separated into two products: oil and meal. It is estimated that 13 million acres of canola are planted every year, and the crop serves as an important source of income for Canada.

Canola futures are traded primarily on the Canadian branch of the Intercontinental Exchange (ICE), and this is under the ticker symbol of RS. Canola futures are also traded on a smaller scale at the Australian Securities Exchange, where it has the base contract code of ACM, with two additional characters denoting the specific contract.

The main consumer market for canola is the food market, mainly due to the abovementioned health benefits. This is not the only market for canola however, as the product also enjoys popularity as an ingredient for numerous items, including beauty products such as lipstick and domestic items such as candles. Part of the appeal of canola lies in the fact that it can serve as a replacement for many non-renewable resources: this is supported by its use in the production of bio-fuels such as ethanol.

We will outline in this report the Canola Industry by listing the main countries that produce, consume, import and export canola. Also we will represent the contract specifications for the ICE canola contract. In addition, we will talk about the factors that affect the canola prices with the risks in investing in the canola contracts. As well as, we will represent the correlation between canola and soybean contract prices and the relationship between currency exchanges with the canola contracts. Finally, we will look at the technical side of the canola contract.

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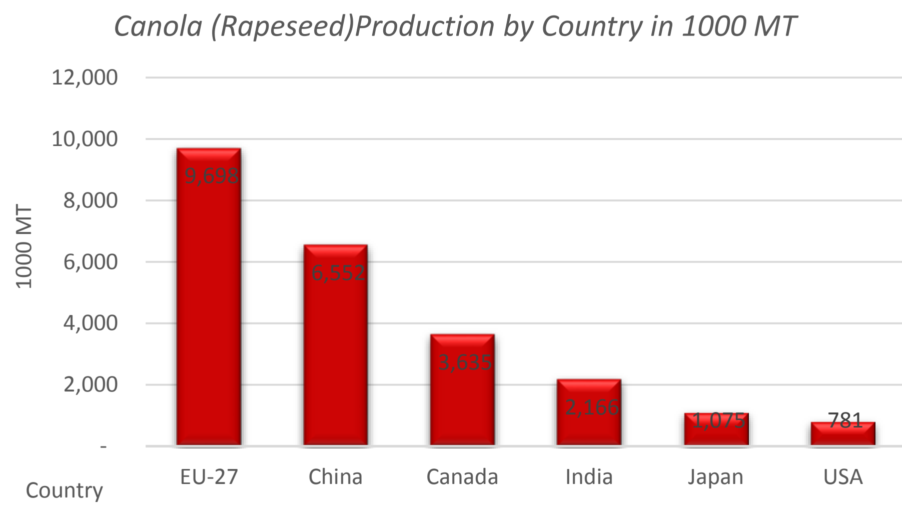
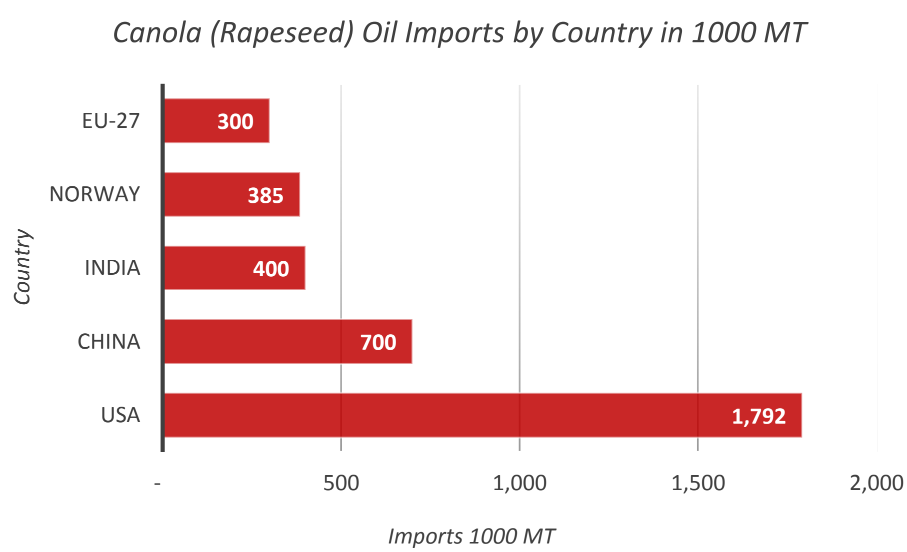
Canola Industry

Canola is a broadly grown, with global production at around 57.5 million metric tons. The below figure represents the main canola producing countries.



We can see from the above figure that canola is widely produced in the European Union, followed by china and Canada. In addition, it is worth mentioning that most of the Canola in the world is consumed by the USA, China, Japan, Mexico and Pakistan.

Now we will turn our attention to the exports and imports of the canola. Below is a graph that represents the main importing countries of the canola



We can see that the United States is the biggest importer of the canola. The country imports around 70% of Canada's canola. In addition, some fast food chains like KFC, Taco Bell and McDonalds have started using canola oil in preparing their food.

Finally, it is worth mentioning that Canada is the world's largest exporter of the canola oil mainly it exports 70% of the world canola. This is why the contracts are priced in Canadian Dollar (CAD).

Canola Contracts Specifications

The ICE Futures Canada canola futures contract is physically delivered. The below table represents the contract main specifications

Trading Screen Product Name	Canola Futures
Trading Screen Hub Name	WCE
Contract Symbol	RS
Contract Size	20 tonnes
Currency	Canadian Dollars
Pricing Basis	Free on Board value at points in the Par region.
Delivery Months	January, March, May, July, November.
Daily Price Limits	$30.00/tonne above or below previous settlement

A market participant who is not in the canola business may be classified as a non-commercial trader. A market participant active in the business may be classified as a hedger. For a non-commercial participant, trading is simple and straightforward: if you believe the price of canola will rise, you buy (go long) a futures contract; if you believe the price of canola will fall, you sell (go short) a futures contract.

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Factors that affect the canola prices

1. Weather conditions: as with all agriculture commodities, canola prices are driven by weather conditions. Current worries of canola are thought to be extremely resistant to both disease and drought.

2. Environment: The environment has a huge effect on oil. Of the various environmental factors, moisture generally has more of an influence on oil than temperature. In years with abundant moisture, canola tends to handle heat stress better, so oil content is generally higher in wet years. Drought stress, particularly during bolting and flowering, can lead to lower yield, higher protein, and lower oil content. Just like oil is favored by wetter years, it also benefits from cooler years. Canola performs best in relatively cooler temperatures (13-22 ºC), particularly during flowering.

3. Prices of Canola substitutes: The canola market is naturally linked to the market for all of the cooked oils, such as sunflower-seed oil and soybean oil. Fluctuating demand for these products will affect the canola price

4. Canada Economy: as we have mentioned previously Canada is the largest exporter of canola in the world, also the canola contract is priced in Canadian Dollars so any factor that could affect the CAD will affect the canola price such as (Inflation, Interest rates, GDP…etc.).

5. Consumer Taste: consumer taste of the canola oil will affect it’s demand and of course its prices.

Risks in investing in canola contracts

1. Liquidity Risk: canola’s overall share of the global vegetable oil market is still smaller by comparison to the consumption of palm oil and soybean oil, so markets consider it as a non-liquid asset and this can be viewed by the comparison of the small export numbers versus production number.

2. Currency Risk: investors are exposed to currency risks when they invest in canola contracts, as these contracts are priced in the Canadian Dollars. For example an investor who lives in Spain will face a risk because he will exchange his profits from CAD to EUR.

3. Market Risk: Investors are exposed to market risk because any factors that affect the Canadian economy will affect the canola prices

4. Default Risk: Canola contracts are derivative contracts that usually face counterparty default risk, because when the long profits from raising prices in canola the short should pay these profits, so the long may face the risk of not being paid by the short.

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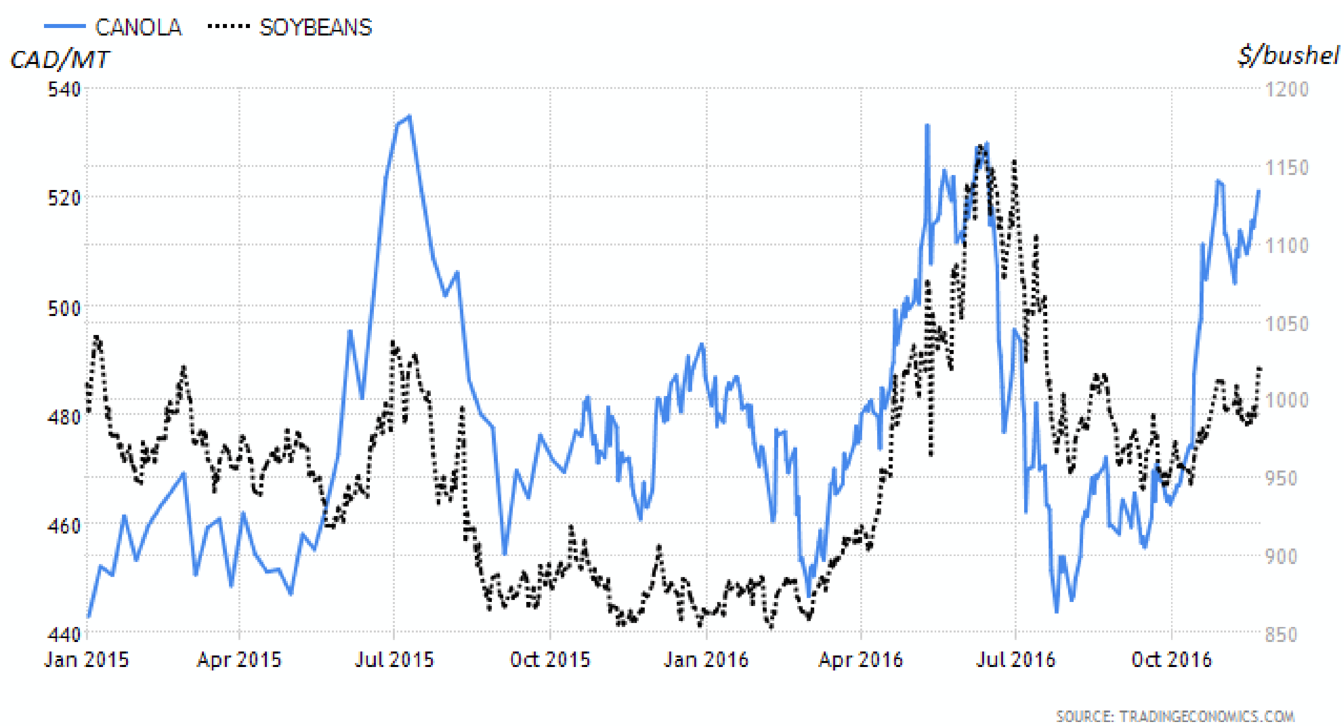
Canola vs Soybean

Soybeans are a minor crop in Canada, but are a direct competitor to canola. Soybeans have a higher meal content than canola, and, in years when the world's oilseed crushers are trying to meet meal demand, they prefer soybeans. When it is the opposite situation, canola is preferred. Crush margins are everything. With Brazil being the world's No. 1 soybean producer, a higher than two-to-one relationship with the U.S. dollar versus the real means the possibility of more Brazilian soybeans on world markets. This has the effect of lowering soybean prices, and increasing their competition with canola.



Soybean market is a direct competitor to the canola market and after making the regression analysis, we found that there is a positive 0.6674 correlation between the two, and we can witness this by looking at the above graph.

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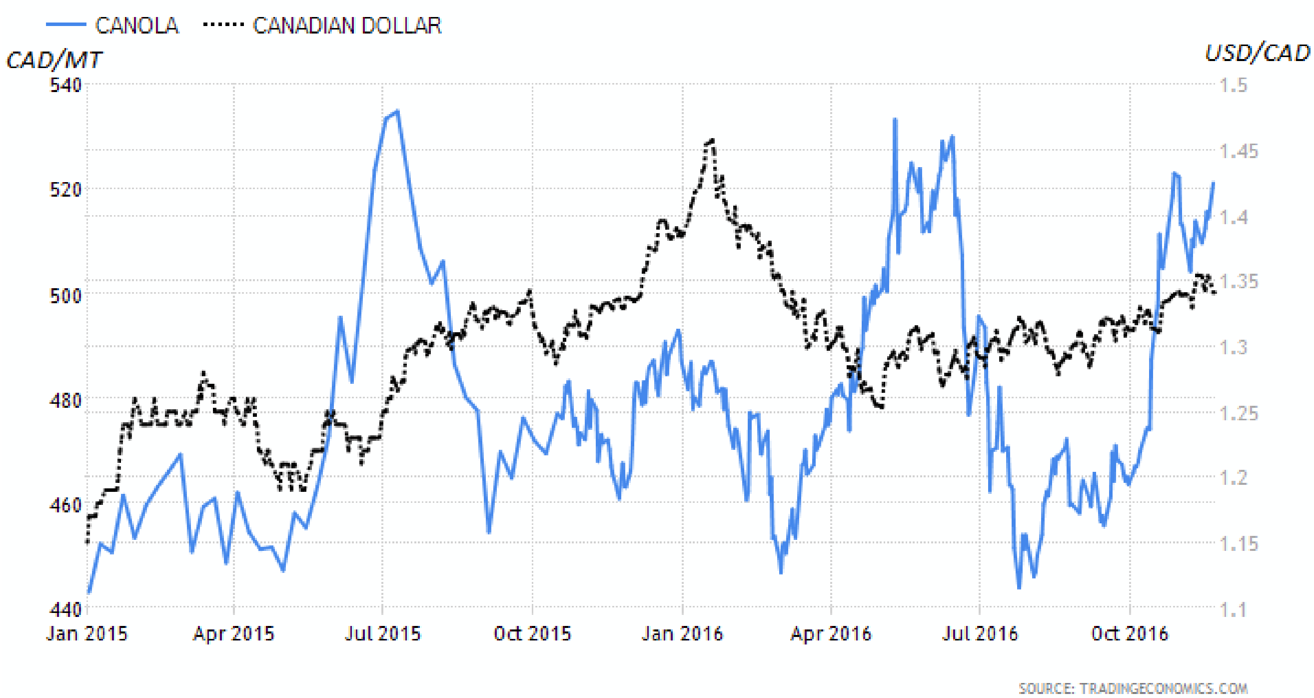
Currency Connections

As we have mentioned earlier that the canola contracts are priced in Canadian Dollar, so many people thinks that canola has a relationship with the USD/CAD exchange rate alone but the truth is that we found there is also interaction between other exchange currencies.

First we will look at the below graph to see that when the value of the U.S. dollar goes up, it becomes more expensive in non-U. S. currencies and therefore there will be a negative effect on demand, sending futures prices in that commodity down. It is also true for the inverse, when the U.S. dollar goes down there is a positive effect for the demand of that commodity in non-U. S. currencies, generally sending futures prices for that commodity up.



As for the other currencies, much of the Canadian canola is exported to Japan and China. Buyers in these countries use the U.S. dollar in purchase agreements for canola. That means the value of the Japanese yen and the Chinese yuan against the U.S. dollar are the important factors in pricing this canola.

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Technical Analysis

We can see in the above chart that Canola reached an all-time high of 651.60 in September of 2012 and a record low of 395.30 in September of 2014.

Conclusion

Canola traders should always analyze the factors that affect the price of the commodity and always understand that trading futures is risky.

We have mentioned previously in this report that much of the canola production and exports are concentrated in Canada, also the contracts are priced in the Canadian dollars, so investors should watch carefully any factors that may affect the Canadian economy. In addition, canola prices are affected by the demand of other competitors such as soybeans and soyoil.

Finally, we encourage investors to watch the Canadian dollar carefully, as expectations that the Federal Reserve will hike interest rate in its next meeting in December are rising and definitely, this decision will affect the USD/CAD prices and volumes.

Sources

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