Contango

Contango is situation where the futures price of a commodity is above the expected future spot price. Why would this happen? Why would an investor pay a futures price that is above what the future spot price is expected to be?

Contango usually occurs when there are carrying costs to holding a commodity. By buying a futures contract, the investor can avoid these carrying costs. And the futures price is usually above the future spot price by this difference.

A market in contango will usually see the futures price of the commodity fall so that it converges with its future spot price.

Related to contango is backwardation. Backwardation is a situation where the futures price of a commodity is lower than its market price today. Backwardation does not happen frequently or last very long. It usually occurs after a shock of some kind that causes the market price of a commodity to spike upward. The immediate need to have the commodity is so great that the spot price rises above the futures price.

Contango and backwardation are sometimes referred to as “opposites” of one another. They are opposites in the sense that contango is the situation that normally prevails and backwardation is the abnormal situation.