The US Dollar’s Impact on Current Commodities Markets

By Paul Kavanaugh

THROUGHOUT THE FIRST half of 2010, news of the various European nations experiencing debt crisis caused global speculators to flee to the safety and stability of the US dollar, as well as US Treasury investments and US stocks. We have referred to the first half of 2010 as the “flight to quality rally” in terms of the dollar’s value. From its November 26th, 2009 low of 74.17 to its June 7th, 2010 high of 88.70, the US$ Index rose 19.5%.

However, since mid-year, the US$ has seen a precipitous decline. I’ll outline some of the fundamental reasons behind that price drop, and look at some price charts to see what has happened in other commodity markets during – and after – dollar rallies. We will conclude this review with analysis about why I feel we are now seeing the beginnings of the next bull market in commodities.

Going back through the charts, we see previous “flight to quality” rallies in the US dollar occurred twice since mid-2008. Before that, for the seven-year period from 2001 to 2008, the dollar was weak and commodity prices benefitted from investors’ shift out of the US currency.

The following gives is a bit more detail on what was happening to cause commodity prices to strengthen while the dollar weakened at the beginning of this decade.
In 2001, the US$ peaked just above 12,100. In the years that followed, through mid 2008, the US$ spiralled down more than 41% from that level. At the same time, commodities enjoyed one of their biggest bull markets on record.

In the chart you will see the Reuters CRB Index (Continuous Commodity Index CCI) rallied more than 235% from 2001 to 2009 – from 18,425 to 61,800. This was spread over precious metals, grains, and a host of other physical commodities. Gold rallied some 300% from US$255/oz to US$1,033/oz; soybean futures rallied 294% from 421 to 1,663 cents per bushel; cotton futures rallied 224% from 2,820 to 9,138 cents/lb; copper futures rallied a whopping 588% from 62 to 427 cents/lb.

In the foreign exchange markets, the Australian dollar doubled in value against the US$, moving from 4,773 to 9,856 (106.49%) and the Canadian dollar rallied 78% from 6,170 to 11,043 – well above parity with the US$.

These moves were a result of increased allocations into commodities, as speculators shifted from the relative safety and security of the US$ and US Treasury securities to higher-yielding investments. This became known as the short US$ “carry trade”.

The US financial crisis that began in mid-2008 brought this run to an abrupt end, as the appetite for risk abated. Investors took profits in commodities and bubbles in energy futures, grains, and global stock index futures popped, giving back in a few short months a majority of the gains they had taken years to build. That was the first of the US$ “flight to quality” rallies, and it added 25% to the US$.

In the first quarter of 2009, the US Federal Reserve Board took action to stimulate the US economy by easing monetary policy. They lowered US interest rates to near zero and purchased mortgage backed securities to increase the money supply, a move that exerted downward pressure on the US$, allowing commodity prices to move higher again. We sometimes refer to those shifts into commodity investments as “risk trades”.

So, through the second and third quarters of 2009, it was once again in fashion to be short the US$ and long risk ... or risk/interest (meaning commodities).

Dubai, Greece, and other European sovereign debt concerns took the spotlight beginning in November 2009, and held the attention of the media and global speculators through June 2010 as the dollar regained nearly 20% in that second flight to quality rally. Investors perceived that in light of news that other nations were on the verge of economic collapse, and that the US$ was a better hold than the Euro.

In June and July of 2010, however, the US$ declined nearly 10%; it finished lower for nine consecutive weeks as the Euro recovered significantly, and the dollars found their way into risk trades. Weakness in the US economic data – particularly in the jobless claims, but also in manufacturing, exports and home sales appears (as we write)to be bringing continued downward pressure on the greenback.

However, I would make the argument that we are missing the point if we only look at the US$ versus the Euro, or the US$ versus risk appetite (commodity investments). My analysis shows more that speculators focus on BOTH the US$ AND the Euro is being shunned in favour of three markets in particular: gold, US Treasuries, and the Japanese yen. I think the reason is a lack of confidence in both the European and US currencies.
Global speculators are increasingly adding to their long Japanese yen holdings. We see this leading to economic chaos that could hit Japan, as that country’s manufacturers and exporters will find their goods and services less competitive on a global scale. With that result, the Japanese economy will suffer, and this is already becoming apparent as judged by recent weakness in the Nikkei stock index.

Continued global stock market weakness could attract more speculators to allocate more of their capital to commodity markets. The economies of the US and European nations continue to struggle with high unemployment and slow growth, and this requires that our central banks keep the Euro and the US$ lower to stimulate consumer spending. Keeping the US$ and Euro under pressure also causes real estate, bond, and equity investments to underperform.

As we approach 2011, it will not surprise me to see commodities trump all other asset classes as investors and speculators move to allocate larger percentages of their portfolios to risk trades. In line with that, basic world demand for commodities continues to increase, with China the source of fastest-growing demand.

I do not see any trend away from continued Fed and European central bank interventions to keep those currencies under pressure in order to continue the effort to stimulate economic growth in the western hemisphere.

Paul Kavanaugh is Senior Account Manager with PFGBEST in Chicago.

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