Commodities And Currencies Are Not What You Think

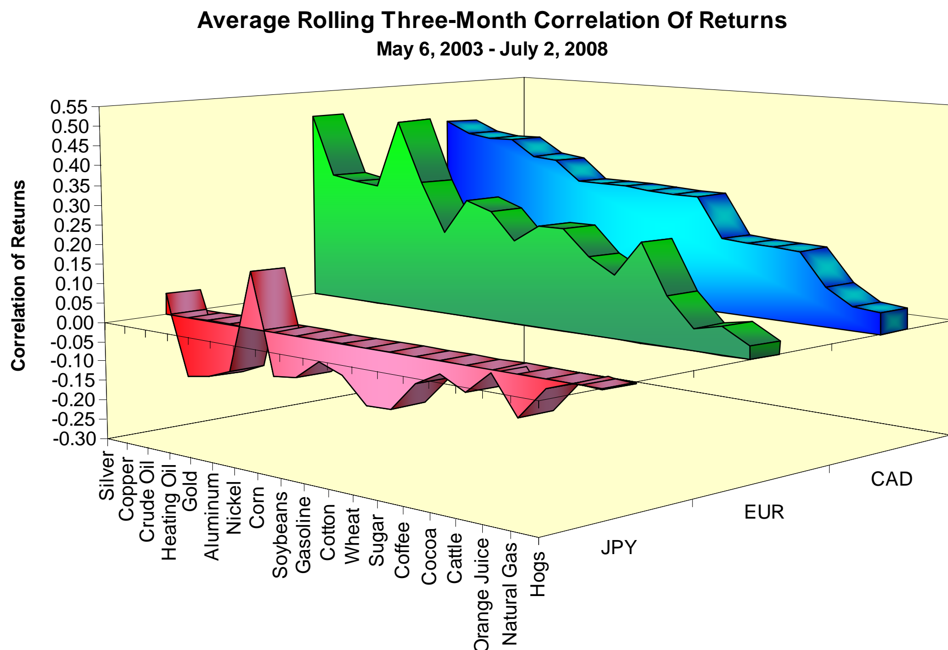
One of the comments to an article from last week, "There's No Such Things As Commodities," invited me to continue on the theme that different commodity markets had very different responses to primal factors such as currencies and interest rates. No problem other than trying to compress what could be a distressingly large pile of data into something interesting to read.

Let's narrow down the list of currencies to three just to keep the problem from getting out of hand. These will be the euro, the Japanese yen and the Canadian dollar. These three are selected for their weight in the dollar index (57.6%, 13.6% and 9.1%, respectively) and for their different roles in the world. As we will see at other times and in other places, there are some distinct commodity-currency pairs of interest, such as the Chilean peso and copper or the South African rand and gold, and the Australian dollar is just as linked to the global raw materials trade as is the Canadian dollar, but these three should do. Incidentally, the euro's weight in the dollar index and its linkages to the remaining members thereof, the British pound, Swiss franc and Swedish krona are such that when I hear someone say, "the dollar" I know they really mean the dollar-euro rate.

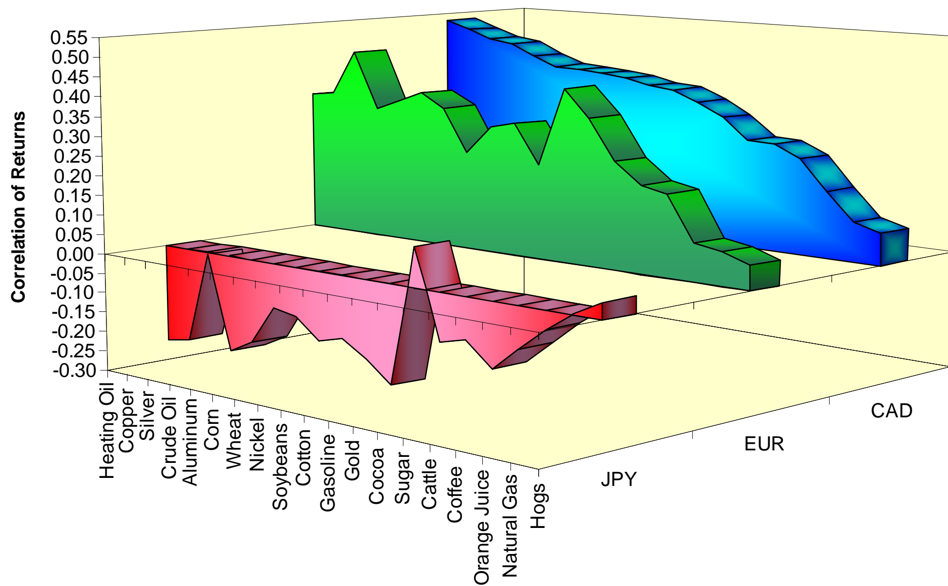
For the commodity universe, I have chosen a set of 19 different markets. With one exception, frozen concentrated orange juice, all of them are cash markets so as to sidestep the problems associated with forward curves. The exception is frozen concentrated orange juice; here a continuous front-month futures contract is used.

Now let's take two periods, May 6, 2003 – July 2, 2008 and July 3, 2008 – March 18, 2009. The May 6th and March 18th dates mark the first and second Wars on Deflation fought by the Federal Reserve (no Archdukes were harmed in the writing of this article, and while I did try to invade Poland, absolutely no one took me seriously); July 2008 dates marked the peak of the Dow Jones-UBS commodity index. Thus we have a period when strong economic growth and excess financial liquidity propelled all manner of commodity prices higher and another period when a financial crisis propelled all manner of commodity prices lower.

Now let's map the correlations of returns for these commodities against these currencies over the two different periods. Over the 2003-2008 boom period, none of the average rolling three-month correlations of returns against either the euro or the Canadian dollar exceeded 0.50. Most of the correlations of returns against the yen were negative; gold and silver proved prominent exceptions here.



If we move to the shorter and much more violent 2008-2009 bust period, the results remain similarly dreary. Once again, the yen does not bother to demonstrate positive correlations of returns save for cocoa and hogs (not even Wolfgang Puck could salvage that combination). None of the readings for the euro are over 0.50, and only heating oil and copper demonstrate correlations of returns greater than 0.50 against the Canadian dollar.



No amount of playing around with the data changes the answer: The impulse to say, "dollar-down / commodities-up" fails across a wide range of time periods, currencies and commodities. You have separate commodities, separate currencies and unstable relationships. And while there have been some strong pair-wise correlations in recent years, such as the one between the euro and crude oil, which was a singular affair and one that is not intrinsic. To make that very long story short, both markets rose and fell by the action of a common factor, excess liquidity, over the time period in question.

The best way to trade these individual markets is to trade them as individual markets and forget about the intermarket relationship. When you trade a sympathetic market, all you will get is sympathy.