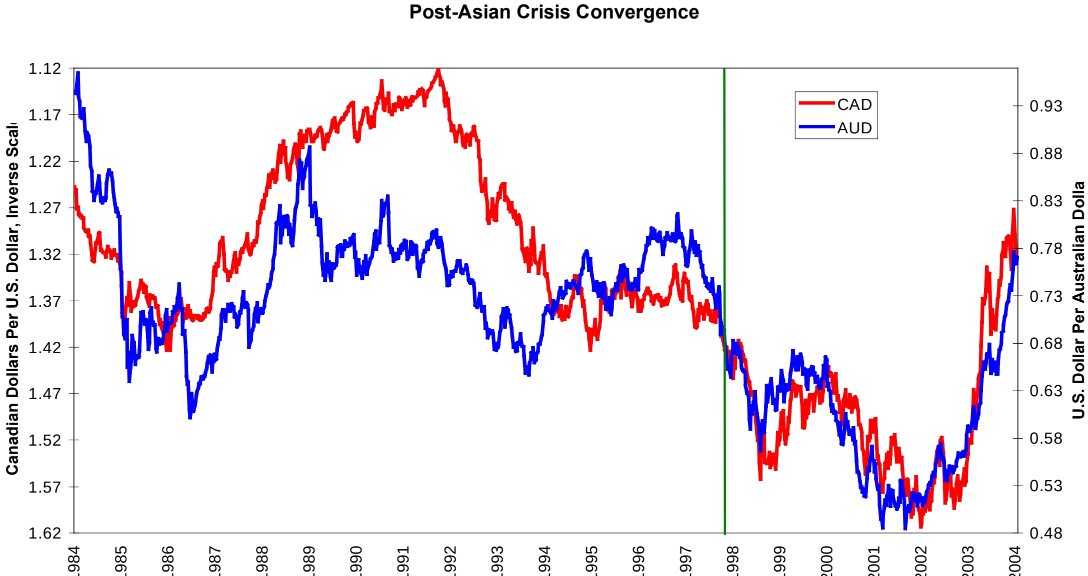
Commodities + Currencies ≠ Commodity Currencies

A keen grasp of the obvious is a prerequisite for success in most fields, but it often does you no good whatsoever in market analysis. Take the supposition that the strength or weakness of a nation's currency reflects the underlying economy. This line of thinking, intuitively appealing, leads to the conclusion that if an important sector or group of sectors in an economy start to do well that the currency ought to follow along for the ride, especially if those sectors are export-oriented. The logic is that the stronger import sectors will affect the current account balance positively and increase demand for the currency.

Certain currencies, such as the Canadian and Australian dollars (CAD and AUD) and the South African rand (ZAR) have been dubbed "resource currencies" in honor of this alleged connection. Many other currencies, such as the Russian ruble or the various riyals and dinars of the Middle East would qualify for this appellation if only they were convertible and traded freely on world markets.

Canada And Australia

The actual linkages between these two countries, both former dominions of Her Majesty the Queen and both countries wherein a form of English is spoken, are fairly sparse. Australia's economy is linked closely to those of South and East Asia, while Canada's economy is linked very tightly to that of the United States. But both economies do ride the commodity price cycles higher and lower, and both political systems are closer to the social democracies of Western Europe than they are to the American system. But for all of the similarities and differences we could catalog, the recent parallels between the two currencies are there for all to see.

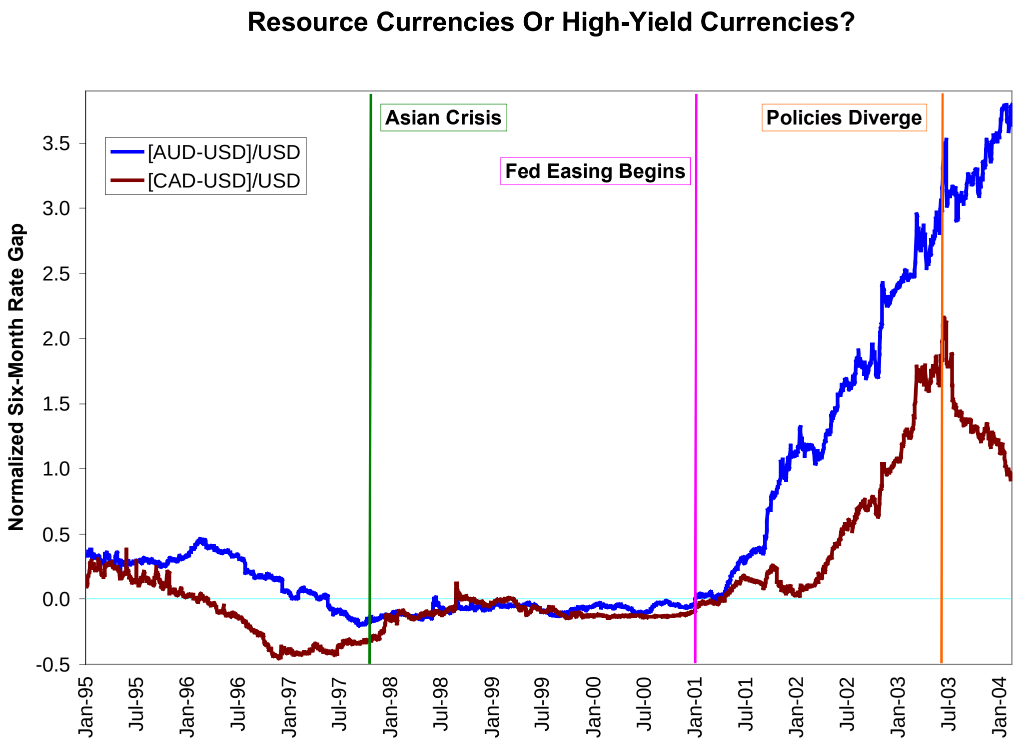


The operative word here is "recent." Prior to the onset of the Asian crisis in late 1997, the two dollars paralleled each other for periods such as 1988-1989, and diverged in periods such as 1990-1992. The Asian crisis led to a major shift in American monetary policy from a domestic focus to more of a global focus as the U.S. assumed the role of both lender and consumer of last resort. The Federal Reserve's swings from easy credit in late 1998 to a tightening in 1999-2000 to a historic easing in 2001-2003 so affected both global monetary and commodity markets that any currency remotely affected by either interest rate differentials or commodity prices got swept up in the tides.

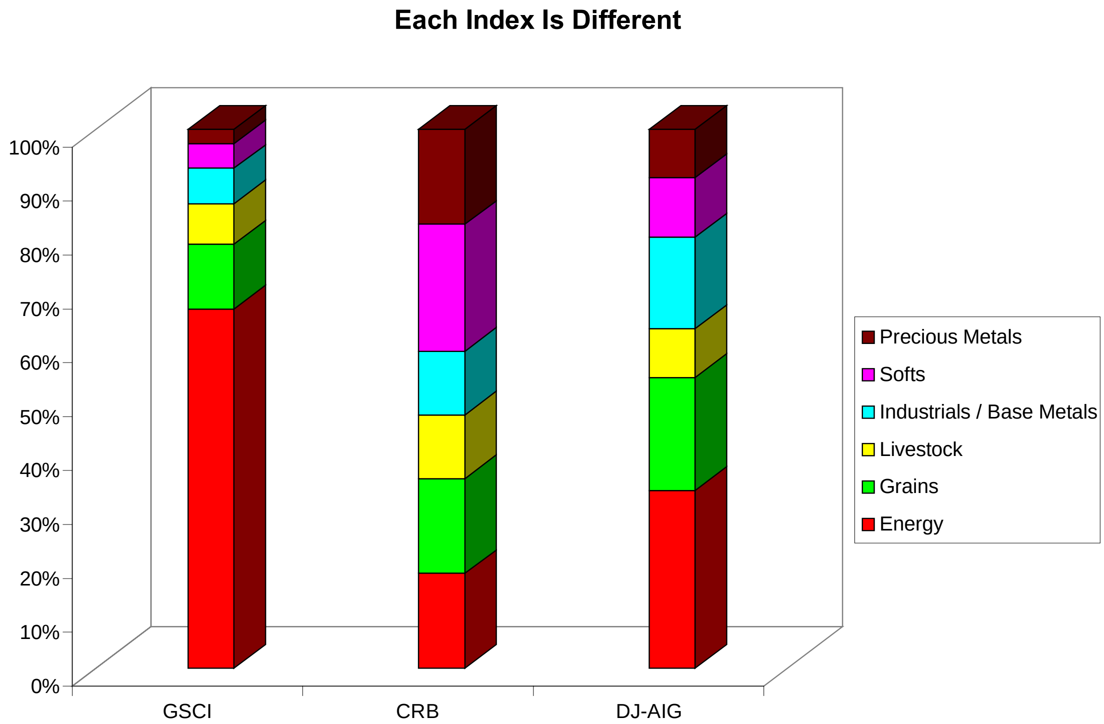
Commodities And Rates

How much of the strong rally in the CAD and AUD can be attributed to interest rate differentials and how much to commodity prices? The answer here appears to be surprisingly direct. If we take the six-month

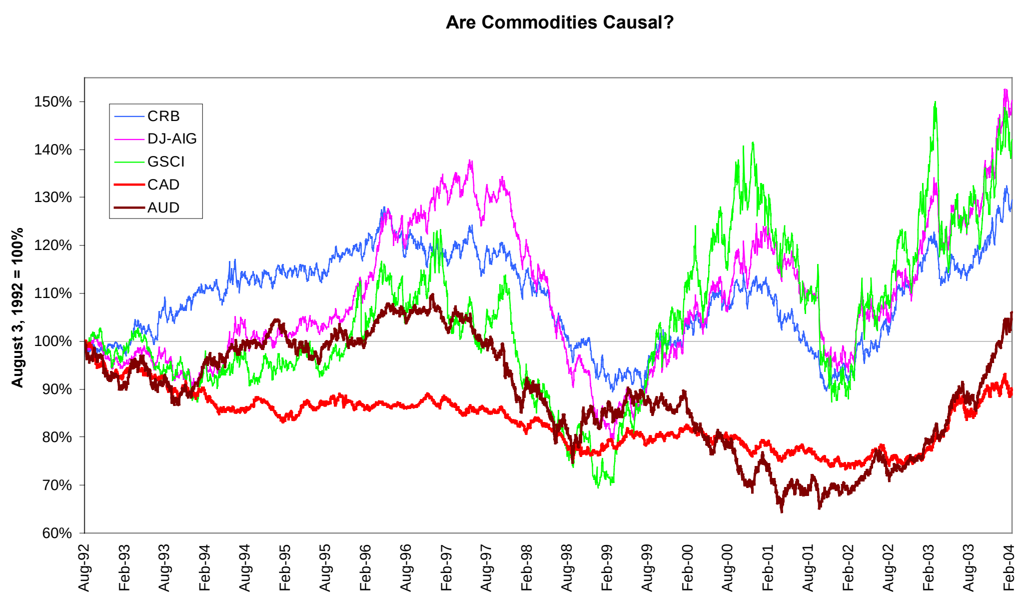
LIBOR rates in all three currencies and normalize the rate gap of both to the U.S. dollar, we can see both the post-Asian crisis convergence of interest rates and the post-Fed easing divergence. After July 2003, the Bank of Canada began to move its rates more in convergence with American rates - given the importance of bilateral trade between the two countries, it had little choice - while the Reserve Bank of Australia raised its rates in response to a significant expansion of bank credit.



The 1984 cinema classic *Trading Places* posed the rhetorical question, "What are commodities?" A similar question could be asked about commodity indexes. The three major indexes supporting derivatives, the Goldman Sachs commodity index, the Commodity Research Bureau index and the Dow Jones - AIG index all have significantly different weighting. Moreover, the sub-indexes do not have a particularly high degree of covariance with each other nor are the correlations between unrelated commodities particularly stable over time. A simplistic reference to "commodities" is unlikely to yield a very refined answer in regard to their contributions to currency movements, no pun intended.



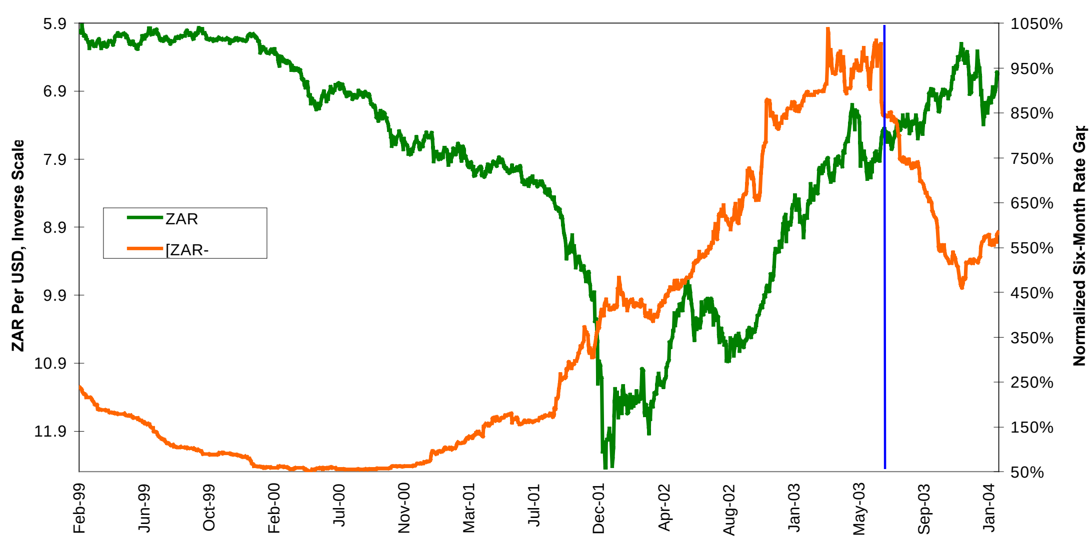
Regardless of the index used, their contributions to the movements of the CAD and AUD appear both tenuous and sporadic, especially for the CAD. The AUD has a few episodes of strong correlation to the GSCI, the late 1990s and again after early 2002, but if a relationship truly is causal it must be causal throughout the data sample.



The ZAR And Its Ministers

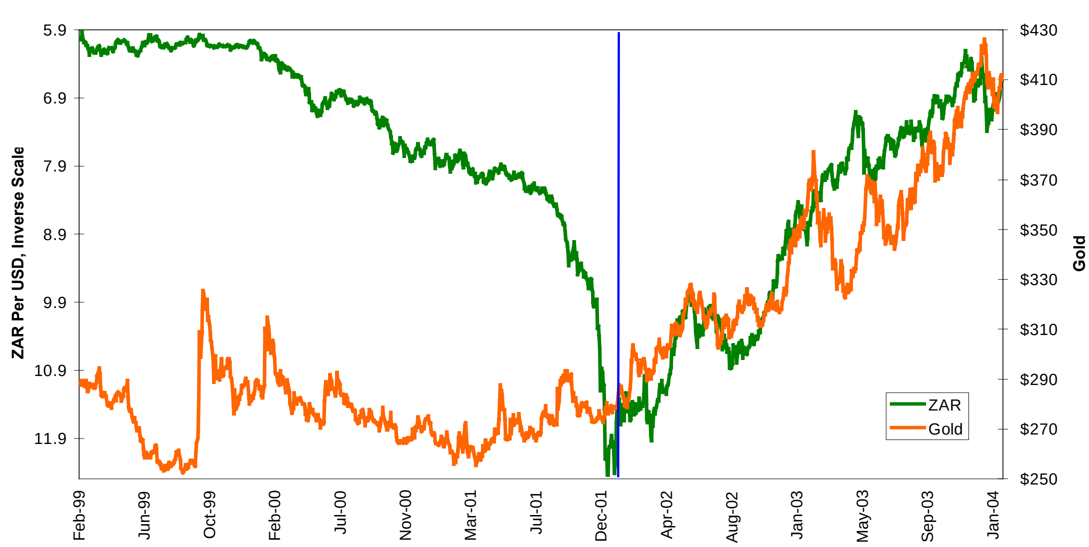
A similar lack of a permanent, stable and causal relationship can be seen in the ZAR, but with a twist. A combination of low metals prices, a narrow interest rate gap and sociopolitical problems in South Africa led to a collapse of the ZAR by the end of 2001. The rate gap expanded in the ZAR's favor, and by mid-2003 the currency was nearly back at pre-collapse levels. In fact, the ZAR managed to strengthen even in the face of a subsequent narrowing of the rate gap, a move that is consistent with declining inflationary expectations in that country.

A Rand(y) Walk Down Wall Street



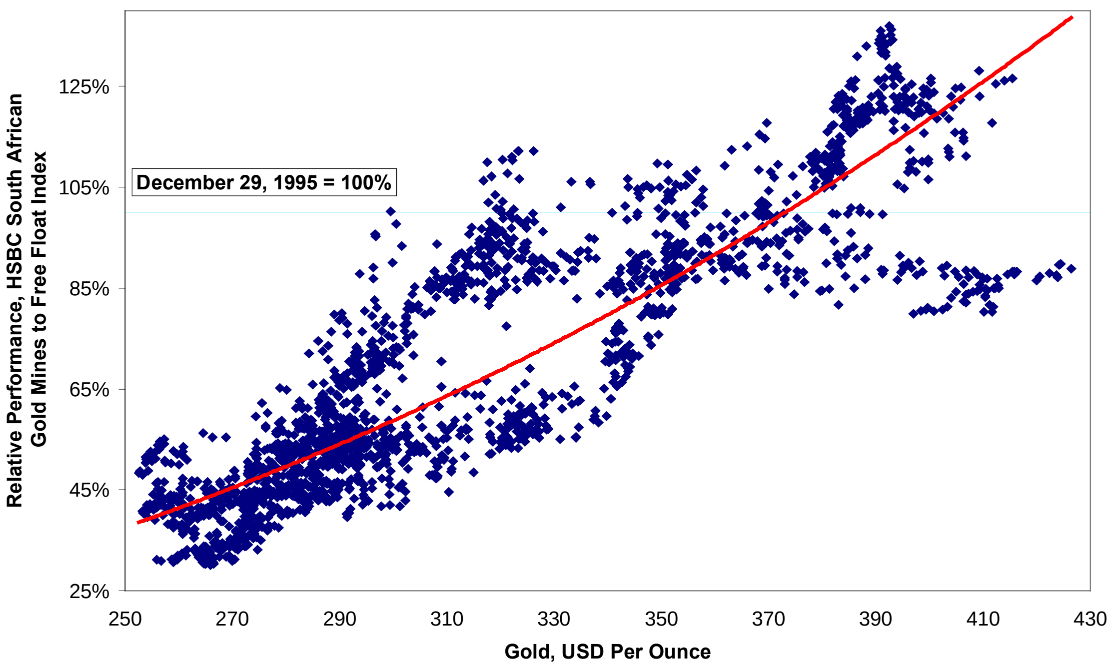
The ZAR's rebound after 2001 coincided with the first sustained rally in gold prices in more than two decades. Once gold started its climb, it reinforced the effects of a wider interest rate gap, and the continued strong price of gold helped support the ZAR in the aftermath of the rate gap's narrowing.

The Relationship Works In One Direction



Any attempt to explain the ZAR's rise by gold prices alone would have to contend with the weak or non-existent relationship between the two during 1999-2000. It is common for the stock price of a commodity producer to move as a call option on the underlying commodity, as we can see below, but there is no reason for a currency to do so. If anything, the currency of any economy so linked to a commodity's price should have a linear relationship, not an option-like relationship, to that commodity.

As Good As (Or Better Than) Gold



The Misnomer

In the end, currencies trade on a wide variety of underlying factors, including trade balances, interest rate differentials, political uncertainties, government interference and portfolio investments. All attempts to construct logical econometric models based on these factors have failed due to the instability of the relationships. This is why currencies, more than any other market, are best traded technically: The so-called fundamentals simply cannot be applied consistently.

To call any currency a "resource" currency as opposed to an "interest rate" currency reflects a poor and incomplete understanding of the dynamics of these markets. The periods in which key commodities in their export mix are rising in price simultaneously with the currency's exchange rate are incomplete enough to qualify for spurious correlation and little more.