

Le dernier mot

Jean-François Lambert looks at how uncertainty is becoming the 'new normal' in dollar/commodity relationships



When teaching commodity dynamics to students I strive to ingrain a few simple ideas about a complicated world. One of them is about the relationship between the US dollar and commodities markets. Commodity prices, mostly denominated and quoted in dollar, have an inverted correlation with the value of the US dollar.

When the dollar strengthens, commodity prices tend to get cheaper. When it weakens, they tend to appreciate. The rationale is rather simple: with a rising dollar, consumers in non-dollar countries, with revenues (largely generated in local currencies), struggle to pay the bill for more pricey commodities and this ends up dampening overall demand. The producers, thanks to a stronger dollar and cheaper production cost (denominated in local currencies), have more flexibility to adjust their prices downwards to foster the demand for their products. With a weakening dollar, conversely, producers struggle and endeavour to raise their prices. Consumers benefiting from a stronger parity can afford more expensive commodities. A rather convincing story which is evidenced by facts over the last 20 years – the pattern is obvious.

The problem is that it is no longer like this. Since the end of last year, we have a perfect correlation, but a positive one: commodity prices keep rising with a stronger dollar. One could simply dismiss this as a non-issue. After all, what is a five-month-old alignment of stars worth, against 20 years of empirical evidence? Merely a blip? Maybe so. The past few years, however, have taught us that one should think twice before discarding any hint of change without pondering the potential consequences.

So what is going on?

Clearly the dollar's strength reflects the health of the US economy. The US has put the great crisis behind it, faster than has Europe or Japan. Employment is robust, wages are fostering inflation and the Fed logically has started to raise interest rates, and is likely to continue doing so this year. The election of Donald Trump provided a further boost to the dollar. The US economy is going to grow if the president triggers a much-needed infrastructure initiative, maybe boosting growth to above 2.5% this year. It remains to be seen how far such an initiative can go, but for the moment, it does the trick.

On the commodity front, potential large infrastructure spending provides the first explanation for stronger prices this year. In 2016, China pulled iron ore and metals back from the 2015 lows thanks to a robust 6.7% growth (probably largely through debt stimulus but this is another story). This year and while China is likely to remain on a strong course (see Philippe Chalmin's November 2016 column), the US rebuilding its bridges, roads and tracks is rather an attractive proposition. Can it fulfil its promises? Notwithstanding the poor track record of any US administration when trying to engage in such a programme, which relies more than most think on states and local governments' decisions, it is worth keeping in mind that the US represents less than 10% of the world's consumption for copper, steel, aluminium zinc and nickel, versus around 50% for China (according to Capital Economics). Not so much leverage there, in fact.

The main reason for commodity indices to climb (despite a strong dollar environment) lies with the OPEC's (and NOPEC) decision to cut oil production to

boost prices buffer stocks. So far so good, but the question is how high can oil go? Shale producers in the US are ramping up to take advantage of the cuts. Week after week, more rigs get in production especially in the Permian basin where the production costs are the lowest. As rigs are getting more productive thanks to significant technology breakthroughs, it is highly possible that the OPEC/NOPEC cuts merely set the scene for the shale producers' longs to take over the vacated space. Should this transpire, then the oil price's upward move would be short-lived. Other factors are fuelling the commodity price indices rise such as robust commodity imports in China in January or strikes in a copper mine in Chile, but they are merely underpinning the trend.

The question is therefore whether a mix of attempts to control the market (OPEC's initiative), political ambition (President Trump's policy) and Xi Jinping's endeavours to keep the Chinese engine roaring, are strong enough to drive a new cycle of bull market for commodities when the dollar is likely to get more attractive. Arguably, this trend benefits emerging market commodity producing countries, but it also starts hurting Europe and other large commodity buyers.

A positive correlation between commodities and the dollar is not the 'new normal' and cannot last. Uncertainty is prevailing, and will prevail. A rising dollar, firmer commodity prices: which of them is going to flinch first? This is certainly something that many traders – and some students – will be wary of in 2017.

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