

Dollar's Commodity Impact

On any day that commodities prices move materially, the financial media is quick to ascribe their action to the US dollar. And this oft-discussed causal relationship is certainly logical. With commodities priced in dollars, a stronger dollar will buy more units of any given commodity while a weaker dollar buys less.

But countless times as I've seen CNBC reporting on this important relationship, I've gotten the impression that the talking heads think the US dollar is the primary or only driver of commodities prices. Neither is true of course. Each commodity has its own unique global supply-and-demand profile, the true fundamentals that drive its price. Nevertheless, the fortunes of the US dollar are often a significant *secondary* driver.

The long-term data readily reveals the secondary nature of the dollar's role in commodities prices. During its secular bear between July 2001 and April 2008, the key US Dollar Index (USDX) lost a staggering 41% of its value! And if the dollar was the main driver of commodities prices they shouldn't have rallied significantly more than the 40% weaker currency demanded. Yet between October 2001 and July 2008, the Continuous Commodity Index (CCI) soared 235%. Supply and demand far outweighed the dollar!

Still, the US dollar has a disproportionate impact on commodities-trader *psychology*. The all-important worldwide supply-and-demand data for most commodities is usually merely estimated, is released piecemeal in a haphazard fashion on differing schedules by many unrelated organizations, and is very difficult to synthesize into a tradable whole. Meanwhile, the dollar's levels are always available in real-time. Thus it is far easier watching the dollar to game commodities rather than delving into their fundamentals.

And with the recent stock panic driving the most extreme market psychology we'll see in our lifetimes, the dollar's psychological impact on commodities has temporarily ballooned to monstrous proportions. A panic is a bubble in fear, and fear drives highly emotional trading that is totally divorced from underlying fundamental realities. The dollar's extreme fear-driven panic behavior, despite being irrational, really drove an unprecedented commodities bloodbath. The carnage was truly epic in scope.

Even today, 5 months after the stock panic gave up its ghost, we are still dealing with the commodities aftermath spawned by the dollar's behavior within the panic. While extreme market episodes are traumatic, extreme opportunities emerge out of them. Today we are seeing a young commodities trend just starting to unfold, a recovery from the irrational panic prices, that will ultimately lead to massive profits.

To understand why, we first need to gain perspective on what actually happened with the dollar and commodities during the stock panic. I am using the industry-standard [USDX](#) to represent the former and the venerable [CCI](#) for the latter. The USDX is a trade-weighted basket of the US dollar versus other major currencies. And the CCI is a broad geometrically-averaged index that tracks the prices of 17 equally-weighted major commodities. They are the best measures available today of the US dollar and commodities in general.



In early July 2008, the CCI hit a bull high. Commodities were doing fantastically well, as you probably remember thanks to the endless attention the media gave oil in the \$140s last summer. But with so much capital flooding into commodities, they were definitely getting overbought. As in all secular bulls, a CCI correction was expected and inevitable to bleed off the greed and return prices to more reasonable levels.

This correction started in early July and was quite steep. In its initial 3 weeks alone, the CCI plunged 11.7%. It was the [biggest and fastest correction](#) of this commodities bull, which was fitting considering the biggest and fastest upleg led to it. During that initial correction, the USDX was dead flat. In fact on July 15th after the CCI had already fallen 4.6%, the USDX ground down to close within 0.5% of its *all-time low* achieved just 3 months earlier in April. The dollar's fundamentals were horrible, as its price reflected.

Normal corrections in ongoing secular bulls usually end at or just under their [200-day moving averages](#). And in most of August the CCI's 200dma, despite being inflated from the massive preceding upleg, looked like it would hold. But then

some of the most peculiar events in all of market history started to unfold which radically altered the course of commodities from normal bull-market correction to something far worse.

While the stock panic didn't formally start until early October when the VIX implied-volatility fear gauge rocketed over 50 and stayed there, the bond panic began much earlier. Back in July, the giant GSEs Fannie Mae and Freddie Mac teetered on the verge of insolvency. Large investors worldwide, institutions and governments, feared their GSE bonds were getting much too risky. So they started selling GSEs and flooding into US Treasuries, long considered the least-risky bonds in the world.

With the massive American mortgage-securitization market imploding, foreign investors worried about the fallout in their local mortgage markets. They sold local mortgage-backed bonds and also wanted to park their capital in Treasuries to weather the storm. But before buying US Treasuries, they had to buy US dollars first. So the USDX surged 5.6% in August. For the usually glacially-slow currency markets, this was a stupendous spike higher.

Of course futures traders saw this incredible dollar action, and wrongly assumed it was fundamental. Dollar bulls argued aggressively that the dollar was rallying because it was a great currency and things were worse in the rest of the world, particularly Europe (the euro is 58% of the USDX's weight). And if this was fundamentally true, commodities prices would probably decline on the dollar strength. So futures guys sold. Unfortunately this happened right above the CCI 500 level where the correction probably would have ended without the bond panic.

When this dollar-safe-haven bond trade started to unwind in September, commodities rallied rapidly. But no one knew that the first full-blown stock panic [in 101 years](#) loomed right around the corner. After the stock markets sold off sharply into mid-September, the USDX started surging again. Stock traders around the world were getting scared, so they dumped everything. And many wanted to park this capital in US Treasuries even though their yields were terribly low. At least they wouldn't lose their capital in Treasuries.

But in order to buy safe-haven Treasuries, once again the foreign investors had to first buy US dollars. So the USDX again surged to new rally highs, and again the Wall Street consensus declared this was fundamentally righteous rather than a fleeting fear-driven anomaly. Futures traders saw the continuing amazing dollar strength so they accelerated their commodities selling. This was compounded by the general desire to flee risky assets of all kinds, including commodities, regardless of their fundamentals.

By the time the dust settled in late November, the USDX had rocketed 22.6% higher in just over 4 months! This rally was mindboggling. It was easily the

biggest move the USDX has *ever* made over such a short span in this index's [entire history](#)! And that goes all the way back to 1971 and includes the legendary dollar bull of the early 1980s! Nothing like that autumn 2008 dollar rally had ever happened before.

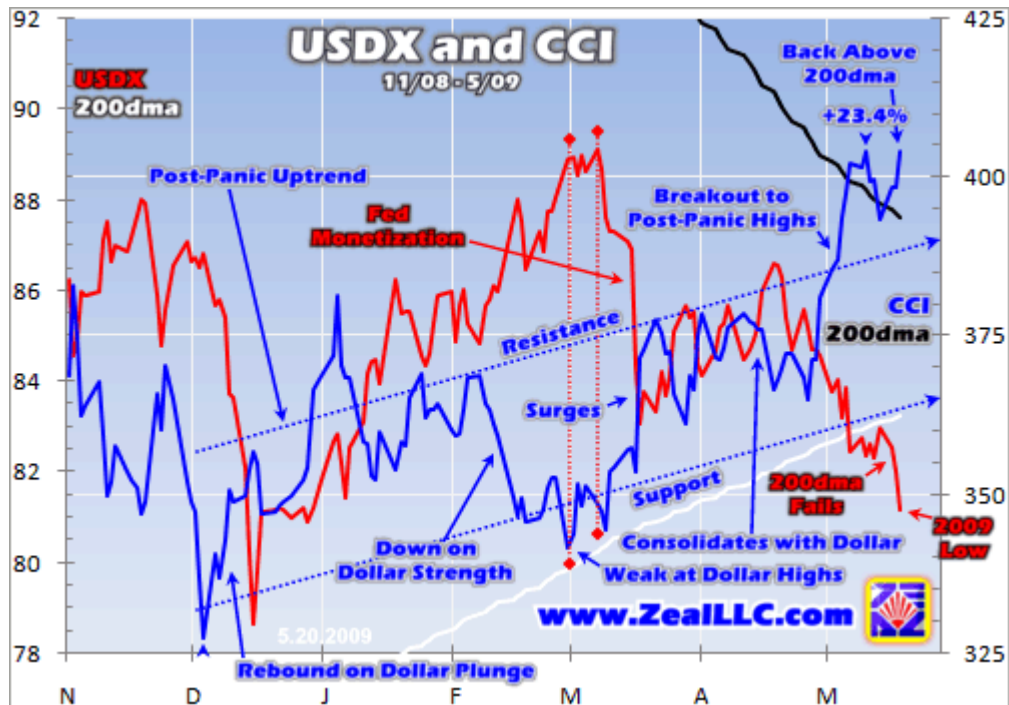
With commodities traders already scared anyway, as nearly everyone was terrified in the panic, the mighty dollar rally was a great excuse to sell. Over the rough span of this fear-driven dollar super-rally, the CCI lost 46.7% of its value. This index too is generally slow to move due to its construction (geometric averaging), so this large of swing was unprecedented. Not even over *the entire duration* of the Great Depression did commodities prices fall as far as they did in just 5 short months last year! It was a bloodbath.

Looking at the chart above, technically about 4/10ths of the CCI's correction was probably righteous and driven by overbought conditions in early July. But when the bond panic followed by the stock panic slammed into commodities just when they were trying to bottom, these titanic forces contributed to the other 6/10ths of the CCI's total loss. The fear-driven dollar buying slaughtered commodities.

Global commodities fundamentals prior to the panic probably justified the 500 to 525 CCI levels we saw in August after the expected and healthy commodities correction. But realize it was the flight capital deluging into the US dollar that drove the CCI down under 350, not imploding fundamentals. Commodities fundamentals evolve very slowly, over many years, and couldn't possibly change fast enough to justify such a massive move in such a short period of time. It was sentiment-driven.

Technically it is crystal clear the unprecedented dollar rally is what drove the lion's share of commodities' unprecedented decline. Note above the giant X formed between the USDX and CCI last year. Their overall inverse correlation over this panic timeframe is nearly perfect. The dollar was indeed the primary driver of commodities prices over this peculiar span of time. The talking heads were right in this case.

With the dollar exerting such great psychological influence over commodity prices during the panic, the dollar could continue to have an outsized (yet moderating) effect on where commodities are heading from here. Actually we are already seeing some of this moderation in the USDX and CCI behavior since the panic. This next chart zooms in to the past 6 months or so and offers insights into this evolving inverse correlation.



Since bottoming in early December, the CCI has actually been carving a nice post-panic uptrend despite the USDX largely remaining up in the 80s near its panic-climax levels. Commodities' higher lows and higher highs have led to a 23.4% gain in the CCI as of this week. But while the dollar's fear-driven influence on commodities prices is gradually waning, it is still a key factor in their short-term performance.

The CCI's initial rebound out of its panic lows in early December was driven by a USDX plunge. And in February the CCI fell sharply on USDX strength, although commodities remained in their uptrend. Provocatively the CCI's lows in late February and early March matched the dollar's highs almost perfectly. When the stock markets sold off again into early March, this panic aftershock ramped futures traders' fears and they reverted back to their sell-commodities-buy-dollars trade from the panic.

But still the CCI largely held near support despite the dollar strength in early March, evidence the latter's influence is waning a bit from its panic heights. In mid-March the goofy US Fed announced it was going to start monetizing \$1750b of debt, including \$300b in Treasuries. When investors buy bonds, they have to pay with cash. But when central banks buy their own sovereign bonds, they create this cash out of thin air. Thus this monetization is pure inflation, evidence the Fed is going to trash its currency. The dollar plummeted.

The 2.9% plunge in the USDX that day was the third largest daily selloff in this index's entire history. The first was in 1973 and the second in 1985, so the Fed's inflationism drove the biggest dollar selloff in nearly a quarter century! Naturally

on such a gigantic down day, the futures guys rushed in to buy commodities. The CCI surged and was back up to resistance in a matter of days. That was a fun rally to ride, and one of the reasons commodities stocks have been the best-performing sector since the March stock-market lows.

After that both the CCI and USDX largely flatlined in late March and April, consolidating as traders got comfortable with their new levels. But starting in late April, the CCI surged again. Interestingly this rally initially emerged when the dollar was fairly flat. The causality was subtly shifting, currency traders started selling the dollar because commodities were strong instead of the other way around as usual.

These latest CCI and USDX moves have important technical implications, as both indexes have finally crossed their 200dmAs again. For commodities, seeing the CCI move back above its 200dma is very bullish. In secular bulls, the 200dma is often the strongest long-term support. But for the dollar, seeing its 200dma fail is very bearish. In secular bears, the 200dma is often the strongest long-term resistance. These key 200dma crosses will encourage technically-oriented traders to continue buying commodities and selling the dollar.

So since the panic ended, the CCI's behavior has already greatly improved technically. While the USDX fell to its lowest levels of 2009 this week, it was still merely back to mid-December levels where the CCI struggled near 350. Yet today despite similar dollar levels the CCI is hovering around 400. This not only shows that the dollar's outsized panic influence is moderating, but that commodities fundamentals never justified their ridiculously low prices seen in the panic.

With the epic dollar strength driving the commodities selloff during the panic, it is interesting to consider what drove *the dollar itself*. The answer is the daily trading action in the US stock markets! It blew my mind throughout the panic that dollar bulls were claiming the dollar's fundamentals were improving, yet the dollar was generally only rising when the S&P 500 (SPX) was falling. *Stock fear* fueled the dollar rally!



Out of the many thousands of charts I've built as a student of the markets, this USDX versus SPX one across the panic is one of the most stunning. Since the stock panic ignited, the USDX's behavior has been a *mirror image* of the SPX's! The aggressive dollar buying wasn't because it was fundamentally better than the euro, but simply because stock investors were terrified and desperately sought dollars and Treasuries as a temporary safe haven.

The general symmetry of this relationship is very striking, the dollar was only strong while the SPX was weak and vice versa. The only times the USDX hit new highs over this entire span was when stocks were falling to new lows. And this panic relationship is not just skin deep, but actually very precise technically.

In October, the first month of the stock panic where the SPX plummeted 27.1% in less than 4 weeks, no fewer than 5 of the days that the USDX made new rally highs happened on the very days where the SPX made new bear lows. On October 27th when the SPX initially bottomed at 849, the USDX topped that very day. The dollar wouldn't make any new highs until the SPX again started falling. Stock flight capital, not fundamentals, was driving the dollar buying.

In November this behavior continued. The USDX hit new highs on the only 2 days where the SPX hit new panic lows. And the only other days that month where the USDX hit new highs happened to be ones where the SPX was very weak and slashing through key technical levels on its way to lows. And then when the SPX bottomed again at 752 on November 20th, the USDX magically topped that very day. It wouldn't see another new high until the end of February when the SPX first decisively closed at a new low under November's.

In late February and early March, the only days the USDX made new rally highs was when the SPX hit new panic lows. This happened 5 times! And on the days when the SPX rallied within this span, the USDX sold off. Honestly this relationship could not have been any more precise and clear. The dollar buying, throughout the entire panic, *was a direct response to stock-market weakness*. So indirectly via its USDX impact, the stock panic affected commodities on a mirror-like day-by-day basis.

Of course since the SPX started rallying out of its [final bear bottom](#) in early March, the dollar has sold off considerably. Capital that was hiding in dollars and Treasuries is leaving, unwinding this anomalous trade. The dollar wasn't suddenly fundamentally sound as Wall Street argued, it was just a convenient refuge in a storm. Given this abnormally tight inverse relationship between the USDX and SPX, commodities' near-term potential could still be heavily influenced by stock-market performance going forward.

Back in early January when fears ran high, I did some fascinating research on stock-market history. Thanks to the panic, 2008 was one of the worst stock-market years ever. But it turns out in history that the best stock market years *immediately follow* the worst. That [must-read essay](#) I wrote 4 months ago explained why in depth. The parallel unwinding of extreme fear and extreme-low-price anomalies leads to *huge* post-panic gains.

Its controversial conclusion, which I still believe today, was that 2009 should be a massive up year. We are talking 25% up to maybe even 50% in the S&P 500! And considering the SPX started 2009 near 900, such levels would be much higher *from here*. If this history holds, which it should, the stock markets will rally on balance for much of the rest of this year. And that means the dollar-safe-haven trade will continue to unwind. Stronger stock markets help portend a weaker dollar, much like we saw between early 2003 and late 2007.

The dollar's fundamentals also point to lower levels. In a time when investors and central banks around the world are trying to divest dollars, the Fed is printing new ones at record rates. Over the past year, the Fed has grown the US monetary base by a scandalous 111.0%! [Big inflation](#) is coming, there is no doubt. A multiplying dollar supply coupled with waning global demand ensures that lower dollar levels are inevitable. Of course a weaker dollar is especially [bullish for gold](#), the ultimate anti-dollar play.

At Zeal we've been telling our [newsletter](#) subscribers about the great opportunities the anomalous dollar rally was creating in commodities since the very heart of the panic. We've been aggressively buying elite commodities stocks ever since, and our unrealized profits are getting pretty hefty. Nevertheless, this commodities run is young and probably just getting started.

[Subscribe today](#) and get deployed ahead of the mainstream investors, because once they start buying again prices will blast higher.

The bottom line is most of last autumn's epic commodities selloff was driven by the biggest and fastest US dollar rally ever witnessed. And it was stock-panic fear, not fundamentals, that drove both the dollar buying and resulting commodities selling. Because of this anomaly, the dollar remains overpriced while commodities remain far too cheap relative to their underlying global supply-and-demand fundamentals.

As fear from the stock panic continues to fade, the flight-capital dollar trade will continue to unwind. The resulting lower dollar will be very bullish for commodities, primarily because it will get futures traders buying again. In the wake of their sharp panic interruptions, the dollar's secular bear and commodities' secular bull will continue. And in commodities' case, there is still much catching up that needs to be done.

Adam Hamilton, CPA

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