Will Dollar's Rise Favor Commodity Markets?
By Maureen Nevin Duffy

In general, consumers benefit from a stronger dollar, because it makes imports cheaper. And, exporters get hurt by a rising dollar, since most U.S. commodities are exported. But the investor story lies in the details between the two.

First, there's the matter of perception. Reactions to a stronger dollar only matter if the dollar's rise is seen as sustainable, says David Stallings, an agricultural economist with the US Department of Agriculture (USDA). The dollar has only recently shown signs of stabilizing.

The US Dollar Index closed down .06 for the day at 73.469, on May 8, compared with a 52-week low 71.329 (and a high of 83.128). The JPM Index was unchanged on May 8, closing at 80, compared to a 52-week low of 78.5, and a high of 87.2. Today (May 9) at noon the dollar was slightly down on the Dollar Index at 73.10 and trading at 1.5462 against the Euro. So these observers really are thinking ahead. But better to be prepared.

"In commodity markets that are fairly liquid, like grain or metals, you do see a pretty quick reaction (to changes in the dollar)," says Stallings. "But a lot depends on whether people believe any change in direction of the dollar is going to be sustained. If people have reason to believe that the dollar is going to continue to increase over time you'll see a larger reaction than otherwise."

Stallings notes that oil prices tend to settle out a bit when the dollar rises. "Although," he adds, "we'll never go back to $30 oil." Provided the dollar appreciates steadily, Stalling would expect increasing demand for US commodities from countries in Southeast Asia.

Changes in the dollar may be largely mitigated by tariffs, quotas and import restrictions. Sugar is one example. We already have quotas on sugar imports, so a stronger dollar would probably not make an impact.

But a stronger dollar may make even those with tariffs, say ethanol, cheaper, because "if ethanol were cheaper to import it might lessen our demand for corn," reasons Dr. Eugene Kunda, Visiting Director of the Office for Futures and Options Research, Futures and Options Markets, at the University of Illinois at Urbana-Champaign. A stronger dollar might also reduce the cost of fertilizers, since we import ureas and dimonium phosphates from the Middle East to make fertilizer.

Kunda doesn't see much impact from a dollar rise on commodity futures trading, since even money managers using systems that trade on price trends would probably just reverse their positions. "It wouldn't affect their activity," he says. But a rise in the dollar "might divert investment from commodities into stocks" if the prices of equities drop. In that case, he says, the climate would favor companies that import goods and punish those who export.

There is some disagreement in the marketplace as to the effect of a stronger dollar on oil prices. One source close to the CFTC told us that our inflation rate matters much more than our dollar. "My expectation is that if they change their rate and it causes a change in the exchange rate, it's still going to matter as to who has the higher rate of inflation – the US or Europe. If the European rate of inflation stays the same and ours continues at where it is now, I would expect the oil prices to continue to increase. And that's the kind of proof I'd like to see happen, but we'll see."

Bob Greer, manager of Real Return Products at PIMCO, a large fixed income investment house in Newport Beach, Calif., tells us a rise in the dollar will have more of a perceptional than real affect on commodity prices. "Over a very short term – a day, a week, or even a month - market perceptions of the value of the dollar can in fact affect in the short term futures prices," says Greer. "But over any reasonable investment time period, it's the fundamentals that would determine price levels."

As of 31 March 2008, PIMCO has more than $16bn of commodities exposure in tracking various long only commodity indexes.

The impacts of the changing value of the dollar on market participants, says Greer, are secondary in importance, because the primary factor in rising commodity prices "has and will continue to be the fundamentals of supply, demand and inventory levels."

"Whether the dollar rises or falls will not affect how much wheat or corn this world plants or harvests…or whether a typhoon destroys the rice crop in Myanmar, or whether a senior Russian official says they expect to produce less oil this year than last," says Greer. "Whether the dollar rises or falls will not affect whether or not we have a hurricane in the Gulf coast. All of these are the primary factors affecting commodities prices. The value of the dollar is always secondary to those bigger issues."

And, unfortunately for the grain elevators, Greer sees little relief in their current credit dilemma coming from a rising dollar. "Certainly I understand and have sympathy for those who hedged their inventories at lower levels, but their lack of margin financing is really more a factor of the liquidity problems we have in the US, and in fact in the global banking system itself," says Greer, who in the 1970s pioneered the first investible commodity index.

"It is not a function of whether the dollar is stronger or weaker, but the lack of liquidity and banks being reluctant to lend to grain elevators or to other businesses." And the cause of that lack of liquidity Greer places squarely on last summer's credit crunch, "sparked by the subprime debacle, but then extending to other areas of the financial landscape."