Commodity Prices And Currency Movements

Cory Mitchell, CMT

Professional forex traders have long known that trading currencies requires looking beyond the world of FX. Currencies are moved by many factors, including supply and demand, politics, interest rates, speculation, and economic growth. More specifically, since economic growth and exports are directly related to a country's domestic industry, it is natural for some currencies to be heavily correlated with commodity prices.

The top three currencies that have the tightest correlations with commodities are the Australian dollar, the Canadian dollar, and the New Zealand dollar. Other currencies that are also impacted by commodity prices but have a weaker correlation than the above three are the Swiss franc and the Japanese yen. Knowing which currency is correlated with what commodity can help traders understand and predict certain market movements. Here we look at currencies correlated with oil and gold, and show you how you can use this information in your trading. (For background reading, see *The Most Popular Forex Currencies*.)

Oil and the Canadian Dollar

Oil is one of the world's basic necessities. At least for now, most people in developed countries cannot live without it. . As a net oil exporter, Canada is severely hurt by declines in the price of oil, while Japan—a major net oil importer—tends to benefit from oil declines.

On a day-to-day basis, the correlation between oil and the Canadian dollar may break, but over the long term it has been strong, because the value of the Canadian dollar has good reason to be sensitive to the price of oil. Canada is the firth-largest producer of crude oil in the world. The size of

Canada's oil reserves is third in the world.

The geographical proximity to the U.S., as well as the political uncertainty in the Middle East and South America, makes Canada one of the more desirable places from which the U.S. can import oil.

The chart below shows the positive relationship between oil (blue line) and the CAD/USD (inverted USD/CAD, as shown by "1/USDCAD" on chart). The price of oil actually acts as a leading indicator for the price action of the CAD/USD in some cases.

Since the traded instrument in forex is the USD/CAD, when oil prices go up the USD/CAD falls, and when oil prices go down the USD/CAD rises.

An Attractive Oil Play: CAD/JPY

At the other end of the spectrum is Japan, which imports nearly all of its oil. Japan's lack of domestic sources of energy, and its need to import vast amounts of crude oil, natural gas, and other energy resources, make it particularly sensitive to changes in oil prices.

Looking at this from a net oil exporter/importer perspective, the currency pair that tops the list of currencies to trade to express a view on oil prices is the Canadian dollar against the Japanese yen. The chart below illustrates the tight correlation between oil prices and CAD/JPY. Oil prices tend to be the leading indicator for CAD/JPY price action, often with a delay.

While the correlation is not perfect, major up moves in oil (blue) are typically followed by a rise in the CAD/JPY, and declines in oil are typically followed by declines in the CAD/JPY.

Going for Gold

Trading the Australian dollar (AUD) is just like trading gold in many ways. As the world's second-largest producer of gold (third largest some years), the Australian dollar has a high positive correlation with the precious metal.

Generally speaking, this means that when gold prices rise, the Australian dollar appreciates as well.

The proximity of New Zealand to Australia makes Australia a preferred destination for exported New Zealand goods. Therefore, the health of New Zealand's economy is closely tied to that of the Australian economy, which explains why the NZD/USD and the AUD/USD also share a high positive correlation.

A weaker, but still important correlation is that of gold prices and the Swiss franc (CHF). The country''s political neutrality and the fact that its currency used to be backed by gold have made the franc the currency of choice in times of political uncertainty. While the relationship has broken down at times, the CHF tends rise when gold rises, and fall when gold falls.

The follow chart shows the inverted USD/CHF (CHF/USD) to the price of gold.

Trading Currencies as a Supplement to Trading Oil or Gold

For seasoned commodity traders, it may also be worthwhile to look at trading currencies as an alternative or supplement to trading commodities. In addition to being able to capitalize on a similar outlook (higher oil, for example), traders may also be able to earn interest by holding higher interest rate currencies.

When trading currencies, we are dealing with countries, and countries have interest rates. For example, between 2016 and 2018, the Australian interest rate was higher than the US interest rate. Therefore, buying the AUD/USD after gold bottomed in late 2015 would have not only produced a capital again as gold and the AUD/USD rose in value, but the trader would have collected interest for every day the long AUD/USD position was held.

Along the same lines, if you shorted AUD/USD to express a short gold view, you would end up paying interest each day.

If you're a commodity trader looking for a bit of a change, commodity currencies such as the AUD/USD and CAD/JPY provide opportunities worth looking into.

The Bottom Line

If you want to trade commodity currencies, the best way to use commodity prices in your trading is to always keep one eye on movements in the oil or gold markets and the other eye on the currency market. Due to the slightly delayed impact of these movements on the currency market, there is generally an opportunity to overlay a broader movement that is happening in the commodity market onto that of the currency market. It never hurts to be more informed about commodity prices, and how they drive currency movements. (For more insight, read *Forex: Wading Into The Currency Market*.)