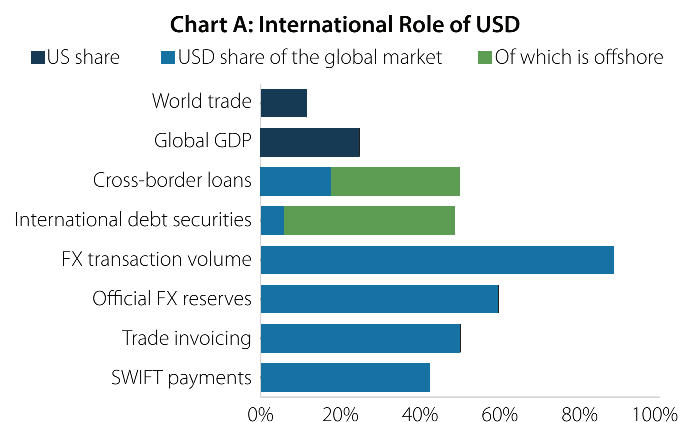
ALPS | CoreCommodity Management CompleteCommodities® Strategy Fund

Is King Dollar Under Siege? | May 2023

An honest review of the US dollar and how it may influence commodity prices

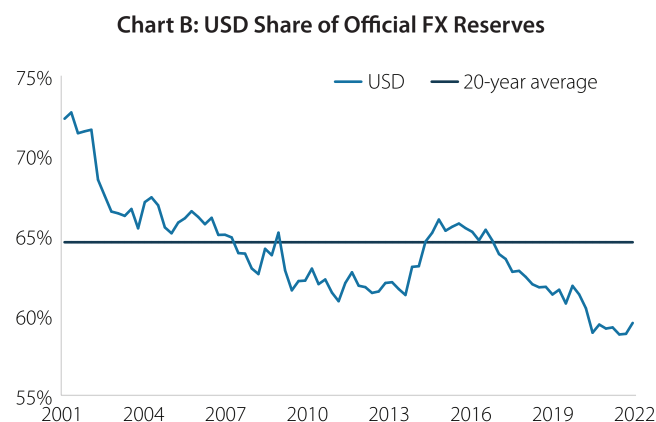
Among the handful of reasons behind our positive outlook for commodity prices over the next several years is the potential shift to a weaker dollar environment. Although less sexy than the energy transition and less frightening than Russian imperialism, an extended decline of the American currency is no minor affair. At 58% of global reserves and nearly 90% of foreign exchange (FX) transaction volume, the dollar is still very much king (Chart A). The question is, what kind of influence would the global reserve currency have on the commodity markets should its value diminish? After all, commodity prices and the dollar have displayed a strong inverse relationship for the better part of 50 years. The bond they share has fluctuated over time, sometimes meaningfully, but rest assured the two are inextricably linked. Here we consider the nature of the relationship, its predictive power and the primary determinants of the dollar's future trajectory.

Chart A: International Role of USD



Source: Bank for International Settlements, Dec. 2022

Chart B: USD Share of Official FX Reserves



Source: Bank for International Settlements, Dec. 2022

Why are commodity prices and the dollar linked?

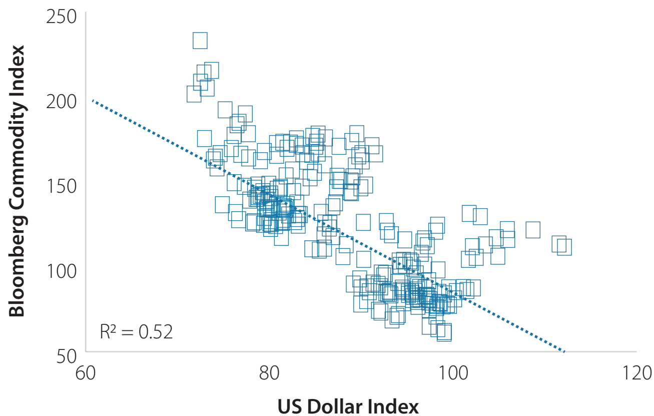
There are several possible explanations as to why changes in the value of the dollar tend to coincide (inversely) with changes in the value of natural resources. Most importantly, nearly all exchange-traded commodities are priced and settled in USD. In fact, several key oil producers (including Saudi Arabia and the U.A.E.) peg their local currencies to the dollar. Some yuan-denominated liquidity exists in bespoke Chinese markets for materials like steel and petrochemicals, but the lion's share of commodity trades are still transacted in greenbacks. For that reason, as the value of the dollar falls, more currency is required to buy the same unit of goods (i.e., commodity prices rise). Similarly, as the dollar falls, commodities become more affordable to holders of foreign currency, thereby lifting demand from trade partners and shortly thereafter, lifting prices.

How strong is the connection?

While the two aren't necessarily joined at the hip, commodities and the dollar tend to move in opposite directions, as quantified by the trailing 20-year correlation coefficient of -0.53.[1] Chart C illustrates this relationship nicely and provides grounds for the existence of a moderate linear relationship. Disseminated further, we find the strength of the coefficient varies by sector and by individual commodity (Chart D). A stronger inverse relationship tends to favor those resources that are (i) easiest to transport, (ii) unimpeded by seasonality and (iii) global in nature. Gold is a prime example of all three features. On the other end of the spectrum, a commodity like cattle is difficult to export, varies tremendously by the time of year and represents a highly regional marketplace. In general, the metals and energy sectors have offered the most stable and most significant correlation to the dollar in the past.

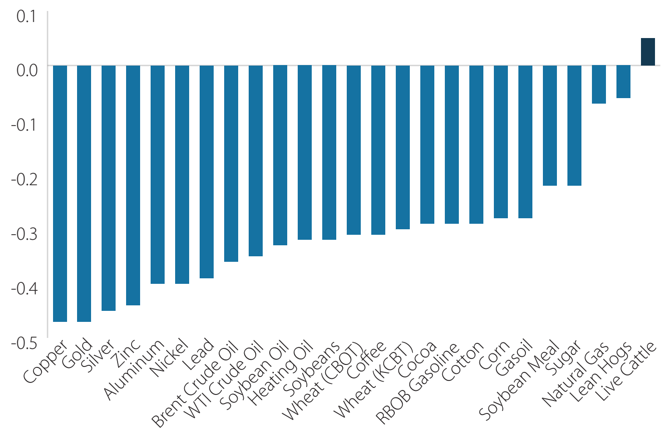
[1] *Calculated using 20 years of monthly returns for the Bloomberg Commodity Index and US Dollar Index as of April 2023.*

Chart C: Correlation Between the Dollar and a Basket of Diversified Commodities



Source: Bloomberg, April 2003 - April 2023

Chart D: Correlation Between the Dollar and Individual Commodities



Source: Bloomberg, April 2003 - April 2023

How has the dollar performed in recent years?

As of the writing of this piece, the US Dollar Index is unchanged on the year but has fallen nearly 10% since the highs established last September. The US Dollar Index, our proxy of choice, is a basket of six leading dollar-currency pairs established in the wake of the Bretton Woods dissolution of 1973. Unlike most other indices, it has only rebalanced once in its history when in 1999 the basket added the newly established euro, replacing several European currencies of the time.

What's telling is the performance of the index in two distinct periods: 1999 - 2008 and 2008 - 2022 (Chart E). In the former, the dollar fell 27% as China joined the World Trade Organization and most emerging economies enjoyed synchronized growth. Almost in unison, commodities underwent an incredible bull market, rising nearly 330%. Contrast that to the second period in which the global economy faced a series of cataclysmic events, the dollar advanced 55%, and commodities lost nearly half their value. As we'll discuss in the following section, we believe the right pieces are aligning today that may indicate the US Dollar Index is entering another period of extended depreciation.

Chart E: The History of the Dollar and Commodities

Source: Bloomberg, Feb. 1999 - April 2023

Where does the dollar go from here?

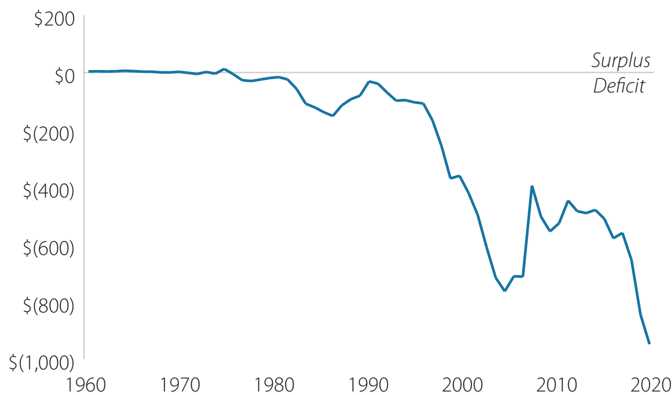
While recent weakness in the greenback is significant, some may argue it doesn't necessarily signal a protracted downturn. Here we list just three trends that may suggest otherwise.

1) Interest Rate Convergence: If there is one lever that influences currency values the most, it is the change in interest rates. The policy rate in the US has risen 500 basis points in just 14 months (the fastest pace since the early 1980s), propelling the dollar to new cyclical highs in 2022. But, now that inflation is steadily declining and financial conditions are sufficiently tight, an argument is being made within the Federal Reserve to end (or at least pause) the rate hike cycle.

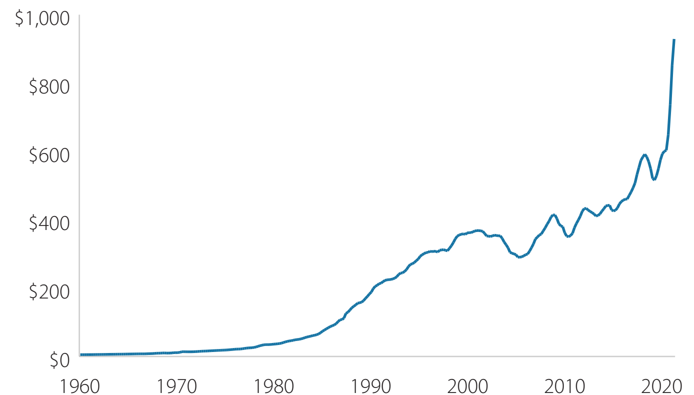
Importantly, that conversation is far different at the Bank of England, European Central Bank, Bank of Japan (BOJ) and other top monetary institutions. Whereas the Consumer Price Index (CPI) is relatively under control stateside, it continues to run above 7% in Australia, 7% in the Eurozone and nearly 9% in the United Kingdom.[2]

Greater inflation beyond US borders is, to some extent, an indication of greater economic activity. Estimates from the International Monetary Fund call for real gross domestic product (GDP) growth of 1.6% in the US for 2023, which pales in comparison to 3.9% for emerging economies and 2.8% for the world writ large.[3] In Japan, where a new governor has taken the helm of the BOJ, activity is finally accelerating after decades of economic stagnation. If monetary policy normalization is to occur inside the BOJ, the last remaining vestige of the "easy money" era, that would represent a powerful signal to the market. Regardless of the BOJ decision, it would seem the US is keen to disengage from the inflation fight before international counterparts. That would leave room for non-US interest rates to converge on the federal funds rate, potentially weakening the dollar.

2) Debt Overload: In addition to possible rate convergence, US fiscal health poses a threat to dollar dominance. Admittedly, raising concerns over America's twin deficits is a common scapegoat for the dollar bears of the world; however, the velocity at which debt has accumulated in recent years demands attention. In one sign that US indebtedness has reached critical mass, interest expense now resembles one of the largest obligations within the government budget (Chart G). According to Bloomberg, the US spent more in 2022 servicing its massive debt burden than it did on national defense.[4]



Source: US Census Bureau, 1960 - 2022



Source: Federal Reserve Bank of St. Louis, Jan 1960 - Jan 2023

Possibly an even greater sign of financial instability is the latest flirtations with the infamous debt ceiling. Whereas some view a possible resolution as just that, more than likely the debt debate will become an increasingly contentious event in the years ahead. Many believe this to be a short-term headache for the US economy when in fact it's a symptom of a longer-term disease. When the first aggregate debt limit was set by Congress in 1939, government borrowing was capped at $45 billion. Since then, it has been suspended 7 times and increased 89 times to its current level of $31.4 trillion. The cap increase is staggering but so too are the political failings to keep the US government operating efficiently and decisively.

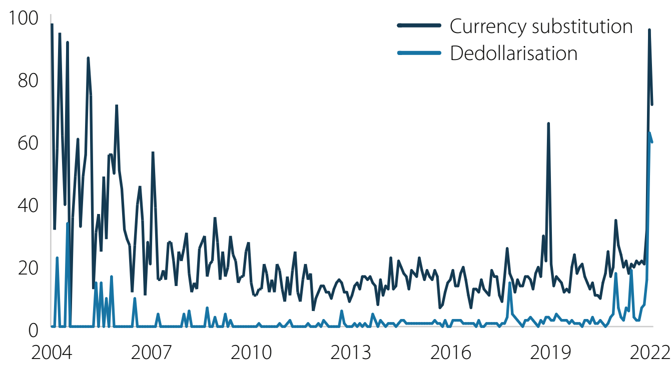
In recollecting the series of events that led to the US downgrade in 2011 (from AAA to AA+), the Former Head of Sovereign Credit Ratings at S&P claims it was the rising trajectory of public debt and increased political polarization that drove the downgrade decision, not necessarily the government's near-default moment.[5] So yes, the rising debt burden is a reason to question dollar strength, but political brinkmanship should also raise a red flag for investors.

3) Sanctions Backlash: The last trend, and one that is most unique to today's environment, is the threat posed by the US government's abuse of sanctions. Sanctions are often used to defend human rights, prevent war, stop terrorism – all universally-accepted justifications. However, they have also been used to destabilize regimes and impose political willpower. As Jeremy Shapiro of the European Council on Foreign Relations has stated, "sanctions contain the seeds of their own destruction."[6] In other words, once the world has witnessed the effectiveness of these penalties on pariahs like North Korea, Iran and Russia, nations will increasingly maneuver to avoid the same fate.

---

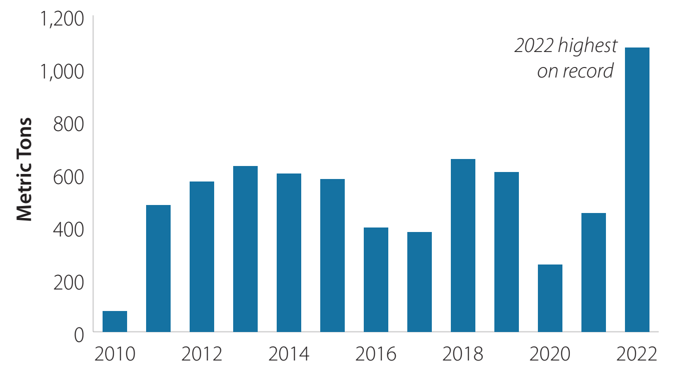
[2] *Source: Bloomberg, as of April 2023 for the Eurozone and United Kingdom and March 2023 for Australia*
[3] *"World Economic Outlook", International Monetary Fund, 4/2023*
[4] *"Souring Mood: The Bloomberg Open, Americas Edition", Bloomberg, 5/16/2023*
[5] *"Daunting Debt Limit Dynamics", Goldman Sachs, 5/22/2023*
[6] *"Commodities in a Deglobalizing World with Jeremy Shapiro", HC Insider Podcast, 5/9/2023*

Chart H: Google Search Interest, 0-100



Source: Google Trends, Jan 2004 - May 2023

Chart I: Central Bank Gold Purchases



Source: World Gold Council, May 2023

For that reason, we have seen a tremendous uptick in de-dollarization rhetoric (Chart H) and a reshuffling of FX reserves. As was depicted in Chart B, USD as a share of official reserves has fallen from 72% at the turn of the century to just under 60% today. Not coincidentally, gold purchases among central banks have also exploded since Russia's invasion (Chart I).

For those weary of the dollar being used as a weapon, it only makes sense to diversify into something less mainstream like gold bullion, Japanese yen or even the Chinese yuan. China in particular has made a very public effort to encroach on dollar territory. Russia, Saudi Arabia, Argentina, Pakistan, Brazil and others have already made arrangements to conduct trade in yuan.[7] In fact, China has developed its own international payment platform (CIPS) to rival the prevailing SWIFT network. The arrival of CIPS and growing popularity of non-USD denominated trade speaks to the waning status of the dollar in geopolitical circles. There have been many reasons in the past for governments to park cash either in the US Treasury market or directly in US bills. To the dollar's dismay, there are now a growing number of reasons for governments to hedge their exposure and consider other viable alternatives.

Final Thoughts

As a last remark, before selling the farm and shifting your assets to bitcoin, let us be clear that currency depreciation does not equal currency demise. There is a very good reason the dollar overtook the British pound all those years ago as the dominant reserve currency, and there is a very good reason it will maintain that status for many more years to come. The Chinese yuan has grown in popularity as a medium of exchange between authoritarian states, but as long as the Chinese Communist Party plays puppeteer with the financial system, it will never garner the following necessary to claim reserve status. There does exist a scenario in which multiple currencies share prominence on the global stage, steadily chipping away at the USD foothold, but for now the dollar is secure for lack of a better alternative.

It is our view that most signs point to a period of dollar neutrality, if not downside, for the foreseeable future. That is a stark juxtaposition to the last 14 years in which dollar-prominence posed a serious threat to commodity performance. If the US currency is to falter, energy, metals and diversified commodities more broadly may benefit from the added tailwind.

Nick Schwartz, CFA
CoreCommodity Management, LLC

[7] *"Which 8 countries are using China's yuan more, and what does it mean for the US dollar?", South China Morning Post, 5/10/2023*

Disclaimer

All expressions of opinion are subject to change without notice in reaction to shifting market conditions. Data contained herein from third-party providers is obtained from what are considered reliable sources. However, its accuracy, completeness or reliability cannot be guaranteed. The economic statistics presented herein are subject to revision by the agencies that issue them. CoreCommodity Management assumes no obligation to provide this information in the future or to advise of changes in this information. Any indices and other financial benchmarks shown are provided for illustrative purposes only, are unmanaged, reflect reinvestment of income and do not reflect the impact of advisory fees. Investors cannot invest directly in an index. All investments are subject to risk.

Important Disclosures & Definitions

An investor should consider the investment objectives, risks, charges and expenses carefully before investing. To obtain a prospectus containing this and other information, call 1-866-759-5679 or visit www.alpsfunds.com. Read the prospectus carefully before investing.

Performance data quoted represents past performance. Past performance is no guarantee of future results; current performance may be higher or lower than performance quoted.

All investments are subject to risks, including the loss of money and the possible loss of the entire principal amount invested. Additional information regarding the risks of this investment is available in the prospectus.

The commodities markets and the prices of various commodities may fluctuate widely based on a variety of factors. Because the Fund's performance is linked to the performance of highly volatile commodities, investors should consider purchasing shares of the Fund only as part of an overall diversified portfolio and should be willing to assume the risks of potentially significant fluctuations in the value of the Fund. The Fund invests in commodity futures related investments, which are derivative instruments that allow access to a diversified portfolio of commodities without committing substantial amounts of capital. Additional risks of commodity futures related investments include liquidity risk and counterparty credit risk. Liquidity risk is the risk stemming from the lack of marketability of an investment that cannot be bought or sold quickly enough to prevent or minimize a loss. Counterparty risk is the risk that a party to a transaction will fail to fulfill its obligations. The term is often applied specifically to swap agreements in which no clearinghouse guarantees the performance of the contract.

Another principal risk of investing in the Fund is equity risk, which is the risk that the value of the securities held by the Fund will fall due to general market and economic conditions, perceptions regarding the industries in which the issuers of securities held by the Fund participate or factors relating to specific companies in which the Fund invests. The Fund's investments in non-US issuers may be even more volatile and may present more risks than investments in US issuers. Equity investments in commodity related companies may not move in the same direction and to the same extent as the underlying commodities.

AAA: a rating issued by Standard & Poor's and is similar to the Aaa rating issued by Moody's. This rating is the highest possible rating that may be assigned to an issuer's bonds. AAA-rated bonds have a high degree of creditworthiness because their issuers are easily able to meet financial commitments and have the lowest risk of default.

AA+: a rating issued by Standard & Poor's and is similar to the Aa1 rating issued by Moody's. This rating is of high quality and falls below the AAA ranking. It comes with very low credit risk, even though long-term risks may affect these investments. Because they are financially strong, investments that are rated with an AA+ rating have a strong likelihood of repaying their debts, making the chance of default very low.

Basis Point (bps): a unit that is equal to 1/100th of 1% and is used to denote the change in a financial instrument.

Bond Rating: a letter-based credit scoring scheme used to judge the quality and creditworthiness of a bond. Investment grade bonds are assigned "AAA" to "BBB-" ratings from Standard & Poor's, and Aaa to Baa3 ratings from Moody's. Junk bonds have lower ratings. The higher a bond's rating, the lower the interest rate it will carry, all else equal.

R-squared (R2): the percentage of a security's movements that can be explained by movements in a benchmark index.

Bloomberg Commodity Index: an unmanaged index used as a measurement of change in commodity market conditions based on the performance of a basket of different commodities.

Consumer Price Index (CPI): a measure of the average change over time in the prices paid by urban consumers for a representative basket of consumer goods and services.

US Dollar Index: measures the value of the US dollar relative to a basket of foreign currencies.

One may not invest directly in an index.

ALPS Advisors, Inc. and CoreCommodity Management, LLC are registered with the CFTC as the Commodity Pool Operator and, respectively, as the Commodity Trading Advisor. Both ALPS Advisors, Inc. and CoreCommodity Management, LLC are NFA members.

ALPS Advisors, Inc. is the investment adviser to the Fund and CoreCommodity Management, LLC is the investment sub-adviser to the Fund. ALPS Advisors, Inc. and ALPS Portfolio Solutions Distributor, Inc., affiliated entities, are unaffiliated with CoreCommodity Management, LLC. CoreCommodity Management, LLC serves as investment adviser to the Fund's Cayman Islands subsidiary.

"CompleteCommodities" is a service mark of CoreCommodity Management, LLC.

ALPS Portfolio Solutions Distributor, Inc. is the distributor for the Fund.

Not FDIC Insured • No Bank Guarantee • May Lose Value

JCI000998 12/31/2023