



Commodity and Currency Correlations

The correlations between many of the most heavily traded commodities and the most major currencies are often confused and their importance is often overlooked. Many times people wonder why sometimes the forex markets “just happen” to follow some commodities such as oil, gold and silver. One commonly traded currency pair is the USDCAD (US Dollar vs. Canadian Dollar.) This pair is correlated to oil due to the exportation of oil. The Japanese markets import most of their oil so Japan is susceptible to oil prices as well. On the other hand while oil prices affect New Zealand and Australia, both of those countries are more affected by the fluctuation in the prices of gold. Whether the price action is bullish or bearish knowing such information can aid a trader if their timing of these price movements is done properly. There will be times when a relationship can break down; these are the times when traders will need to adhere to strict risk management rules. On the other hand being aware of these correlations, timing them and monitoring commodity correlation prices, traders can be much more successful in their analysis.

Which Currency and Commodity relationships to trade:

Many traders think they know what to trade, but not all of these correlations are even worth a trader's time of day. Most of the time the typical commissions, spreads, fees, liquidity and other fundamentals come into play and need to be accounted for along with the correlation. Just like trading “odd pairs” the pairs and commodities that are most heavily traded will be easier to find information on their movements and will also be more lucrative in their spreads and liquidity.

Since we used Canada earlier as an oil example, Canada is a major exporter of oil, as a result their economy is greatly affected by the price of oil and the amount it must import affects the Japanese economy. Because of this correlation between Japan's and Canada's oil relationship, the CADJPY correlates positively with the fluctuation in oil prices. This is a perfect example of being careful though, the CADJPY typically has a higher spread than say for example the USDCAD. So in this case we will watch the USDCAD, since oil is priced in Dollars throughout most of the world. Trading the USDCAD in correlation to oil prices can be productive since both countries are major oil importers and exporters.

On the other hand since gold is also a major commodity, we can use Australia as a prime example as well. Australia is and has been a major producer of gold for a long long time. Just like Canada, Australia's economy is greatly affected by the price of gold and how much gets

exported. Since New Zealand is such a major trader and partner with Australia, New Zealand is highly vulnerable to the economic conditions of Australia. Some great examples of how this all correlates to forex; in 2008, Australia was the 4th largest producer of gold in the world. In 2009 the US was the 3rd largest buyer of gold in the world. This means that the AUDUSD and the NZDUSD are great to trade in correlation to gold prices.

Over time the relationships between commodities and currencies may change. Other currency commodity relationships can be found by looking for major producers of any exports as well as on the other side as importers of the same commodity. Once interesting way to look at all of this is by taking a glance at the pairs where one is an importer of a commodity and another is an exporter of the same. Those sorts of correlations are great to watch their movements to see how they interact with whatever their common commodity is.

Deciding which and what to trade:

Once you find out which currencies and commodities have strong enough relationships to pay attention to, your next objective is to decide if those pairs are even tradable or worth your time. What this means is taking a look at spreads, if your broker even offers the pairs, times of day when that particular market is open for trading according to when you personally are able to trade; those factors make a big difference. Many times traders opt to have more than one broker for this reason. One broker may have a currency pair that another broker does not offer, the same may apply with the spreads; one broker may offer a lower spread on a pair making that trade with that broker more feasible and profitable.

Commodity and Currency “Tests of Time”

A crucial mistake is made when traders assume that these correlations will last the test of time. This is simply not the case. Just because a correlation is there today does not mean it will certainly be there for every trade. Many of these pairs that have correlations are certainly worth watching and knowing how they work. Different market events whether political, economical, speculative or whatever, may cause the pairs to make irregular movements for an unknown period of time.

This type of change is typically not on the short term of a few hours to a few days. A pair that is highly correlated to a commodity may change from one year to the next; this is also why knowing both the currency and the commodity. The crosses or changes are so important because this type of trading signal can be used for substantial long term gains and may result in large profits or losses depending on the position.

This type of monitoring is not difficult at all. What you will need is a correlation indicator or knowledge of how to decipher good and bad correlations by researching the moves on those pairs. Many times, traders look at grabbing small divergences during highly correlated periods. When divergences continue to and the correlation weakens, this is a good time to step back and look at the possibility of a correlation change. This is one of those times where having a different

trading strategy would come into play. Just like having one indicator to use as your “Holy Grail” doesn’t really work, neither does have strictly one system of trading.

Entry and exit of Currency/Commodity trades:

This section is true no matter if you are trading currency/commodity style trades or any other trading system out there. There are several factors that may have effect on the trade and the entry price and time. Every trader is different in their trading strategy so every entry and exit will be determined more by how that trader trades and what their focus is. In any system there should be a few basic questions the traders asks him or herself before the entry or exit.

1. Are the currencies and commodities still correlating? Is there an “end” in sight?
2. Is there a leader? Does the currency movement or the commodity movement seem to come before or after the other?
3. Divergence or Convergence in price? Is one making higher highs or lower lows while the other is having a hard time following? If this is the case, time to step aside or find another strategy to use.

Commodity and Currency correlation summary:

Like any other trading system out there, these correlations may be extremely profitable when being careful and taking your time. Also like any other trading system this type of trading is NOT a guaranteed win. There may be news factors or other things that come into play that are unexpected. The indicators we mentioned above and chart monitoring are just two of the ways that this type of trading style may be done. Many times this type of trade may become long term; therefore the traders must know how to manage their risk before entering these trades. Keep in mind stops and limit levels before entering any positions. Do not be afraid to close out a position early in profit or in loss if you become uncomfortable with the position.

Lastly, Pinnacle Forex Group is posting this as a suggestion of trading; this method is simply one way of looking at the market. We are in no way making any claims that this trading style will work for everyone as everyone’s trading habits differ. This method of trading is one that Pinnacle Forex Group does use and has made successful trades using. This is also a method of trading that we teach in our educational coaching.