Profit from the relationship existing between commodities, foreign bonds, and the dollar

Since 2000, investors learned that strategies based on buy-and-hold, averaging down, or indexation have been disastrous. They are valid when the market goes up year after year. But then, even throwing darts at the stock page would work during such times.

Since 2000, the investment environment has been like the 1970s – sharp moves in all asset classes. For this reason I am going to explore a relationship that, in my view, has substantial value in today's financial environment.

Business activity and movement in various asset classes are all connected. Investors who do not recognize this connection are bound to make costly mistakes.

For instance, the business cycle drives inventory policies, commodities, short-term interest rates, and finally impacts the stock market.

Another relationship to be kept in mind when setting your investment strategies, especially when inflationary pressures begin to mount, concerns the relative movement of **the dollar, commodities, and foreign bonds**.

Weakness in the dollar reflects loss of US competitiveness *vis-à-vis* our trading partners. The reason why the dollar declines is because we sell dollars and buy foreign currencies to purchase foreign goods which we find appealing and less expensive than those made in the US.

We act in this way because the cost structure of our local business is higher than that of our trading partners, who can sell at a lower price. Or, to put it in a different way, the dollar weakens when our inflationary bias is higher than those of our trading partners.

In economic parlance, this is the reason why currencies reflect inflation or productivity differentials between two countries. They always did and always will.

Inflationary pressures are visible when commodity prices rise, as we have been experiencing since 2002.

The sharp 24% decline of the dollar against major currencies should therefore come as no surprise at a time when commodities (CRB spot raw industrials) soared 43%.

For the Europeans, even if we stereotype them as "old Europe" or "sclerotic," things are much different. The euro appreciated from 0.8480 dollar per euro, to 1.2798 dollars per euro, a gain of roughly 50%. The appreciation of the euro offset the rise in commodities, which are expressed in dollar terms.

As far as the Europeans are concerned, they do not have a problem with soaring oil prices and all the other commodities, because these commodities showed little or no change when measured in euros.

How can you use all this to guide your investment strategy?

- Buy **commodities**. Reasons: the Fed is following an inflationary monetary policy by keeping short-term interest rates below inflation. Furthermore, the economy is still growing at well above potential. The time to be cautious about commodities is when business activity slows down to a crawl and the ISM index falls to about 53. There are no-load mutual funds investing in commodities.

- Buy **commodity driven stocks**. Reason: companies selling commodities can raise prices and show solid earnings growth.

- Go short **the dollar**. Reason: rising commodities imply strong inflationary pressures and a weak dollar.

- Go short **US bonds** only when spreads between BAA bonds and 10-year Treasuries are low and within their historical range. Reason: if spreads are high there is weak demand for money, yields are stable, and one should not short US bonds.

- Buy **short-term European bonds**. Reason: this strategy is equivalent to shorting the dollar because your capital is long a foreign currency. By doing so you eliminate the risk of capital losses caused by a possible rise in European bond yields. When foreign economies are slowing down however, as they are now, investors should buy bonds with longer duration.

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