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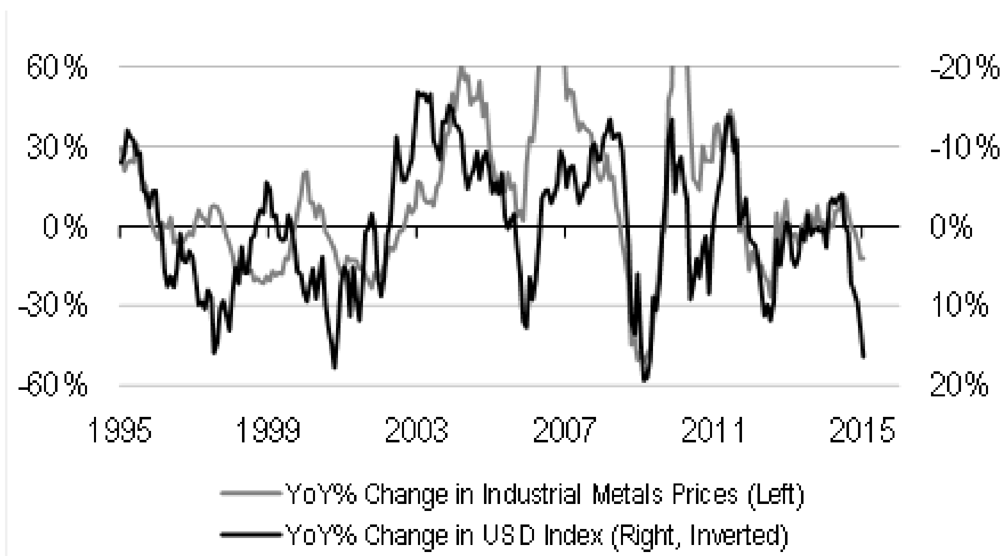
# Why ECB QE is Negative for Commodities

- **Recent ECB Quantitative Easing has led to a rally of risk assets globally**
- **EUR liquidity growth increasing, however USD liquidity growth is continuing to decrease**
- **Changes in liquidity conditions will be manifested in a weaker EUR and stronger USD, which will continue to weigh on Commodities**

**This view has Tactical Investment Implications for Country Allocation, Equities Sector Allocation and Currency Allocation.**

**ECB QE is not US Fed QE…**




*Sources: Bloomberg; Deltec International Group*

## European Central Bank Quantitative Easing:

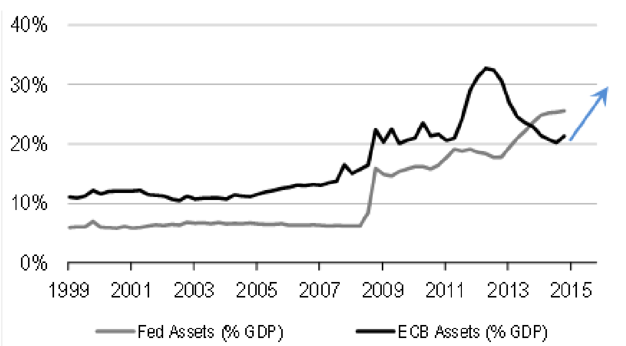
The recent European Central Bank (ECB) announcement of Quantitative Easing (QE), has led to a recovery in risk assets globally. Despite the rally in traditional risky assets, such as Developed Market Equities, Emerging Market Equities and selected Fixed Income sub-asset classes, we retain our negative view towards Commodities, as we see ECB QE as broadly negative for Commodities.

## The ECB Balance Sheet and EUR:

ECB QE has led to a decline in the EURUSD – a trend we expect will continue given the relative growth outcomes and relative monetary conditions between the US and Europe. Importantly, EUR liquidity has been increased, however USD liquidity has not, and has actually been declining progressively as US growth has been increasing and the US Federal Reserve has ended their QE program.

**Refer to Figure 1, showing the US Federal Reserve and ECB Balance Sheets as % GDP and; Figure 2, showing the EURUSD through time:**

**Figure 1:** US & European Central Bank Balance Sheets as % of GDP




*Sources: Bloomberg; Deltec International Group*

**Figure 2:** EURUSD


*Sources: Bloomberg; Deltec International Group*

## Liquidity, Currencies and Commodities:

Important for an understanding of the likely outcome for Commodities is an understanding of global liquidity conditions, and specifically, USD liquidity. As discussed in our recent research **The Clock is Ticking for Emerging Markets, Commodities and Commodity Currencies (Part 2 of 3: Commodities)**, **An Emerging Crisis** and the **Q1 2015 Deltec Quarterly Global Strategy Outlook: A World Apart**, declining USD liquidity growth has a significant negative impact on Commodities through:

1. Global industrial production growth - as liquidity fuels global growth, which impacts Commodities demand;

2. Global excess liquidity growth - as liquidity funds carry trades, including Commodities;

3. Emerging market growth - as USD liquidity funds emerging markets, and emerging markets have the greatest share of global Commodities consumption and;

4. USD - due to the pricing of Commodities.

Taking this as read, relatively tighter USD liquidity conditions manifest themselves in a stronger USD, however especially so in a declining EUR environment, due to Point 4, above.

We can broadly measure the relative tightness of USD liquidity conditions through tracking the USD relative to other currencies, using the USD Index, which measures the value of the USD relative to a basket of foreign currencies. Even if all other currencies were to remain equal (an unlikely scenario, given the growth and monetary policy dynamics currently occurring in these countries), the USD Index would rise, given the high weighting of the EUR within the USD Index.

Refer to Figure 3, showing the current basket weights of currencies in the USD Index:

**Figure 3:** USD Index Currency Basket Weights

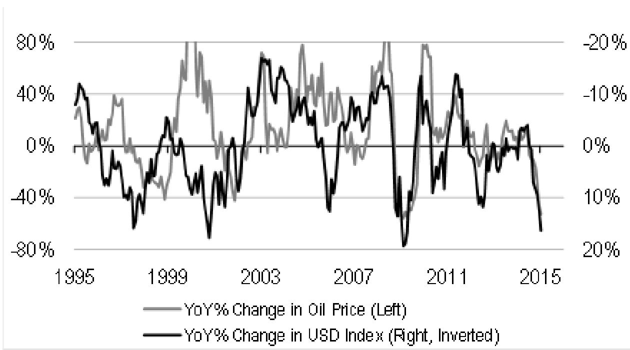
| Currency | Weight |
|---|---|
| EUR | 57.6% |
| JPY | 13.6% |
| GBP | 11.9% |
| CAD | 9.1% |
| SEK | 4.2% |
| CHF | 3.6% |

*Sources: Bloomberg; Deltec International Group*

There remains an inverse relationship between the USD Index and Commodities, both Industrial Metals and Oil. As the USD rises relative to the basket, Commodities prices fall, at times with a lag. At present, the increase in the USD Index is consistent with still weak Oil prices and significantly weaker Industrial Metals prices.

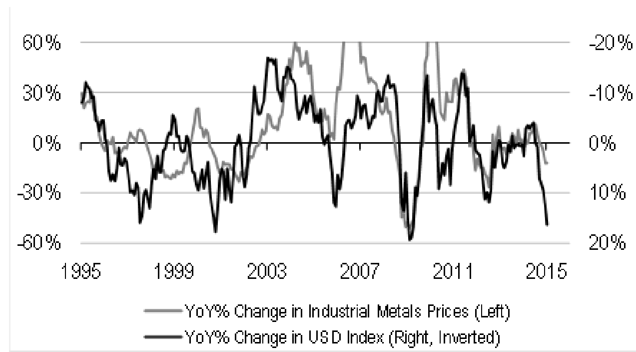
**Refer to Figure 4, showing the change in the USD Index (inverted relative) to Oil prices and; Figure 5, showing the Change in the USD Index inverted relative to Industrial Metals prices:**

**Figure 4:** Change in USD Index (inverted) vs Oil Prices




*Sources: Bloomberg; Deltec International Group*

**Figure 5:** Change in USD Index (inverted) vs Industrial Metals

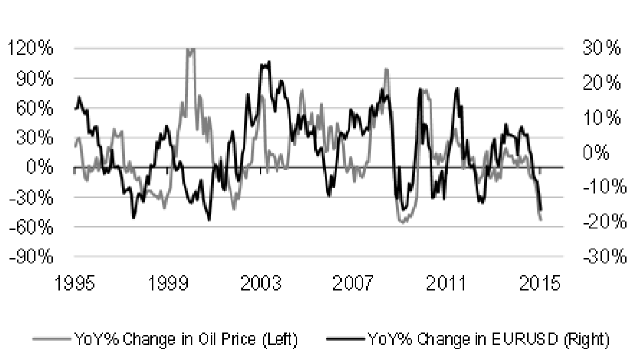



*Sources: Bloomberg; Deltec International Group*

Looking beyond this relationship of the weakness in a broader basket of currencies against the USD relative to Commodity prices, it is important to analyze the relationship of the weakness in EURUSD relative to Commodity prices, given the ECB QE announcement. At present, the decrease in EURUSD Index is consistent with still weak Oil prices and weaker Industrial Metals prices.

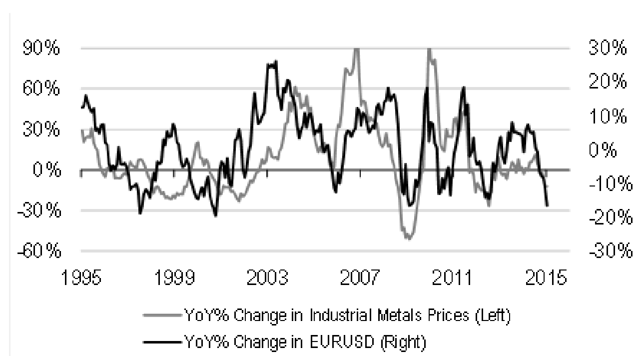
**Refer to Figure 6, showing the Change in the EURUSD relative to Oil prices and; Figure 7, showing the EURUSD relative to Industrial Metals prices:**

**Figure 6:** Change in EURUSD vs Oil Prices




*Sources: Bloomberg; Deltec International Group*

**Figure 7:** EURUSD vs Industrial Metals




*Sources: Bloomberg; Deltec International Group*

## Conclusions:

The recent ECB announcement of QE has led to a sharp rally in risky assets, such as Developed Market Equities, Emerging Market Equities and selected Fixed Income sub-asset classes. Whilst EUR liquidity is increasing due to the actions of the ECB, USD liquidity growth is declining due to the actions of the US Federal Reserve, with these changes in liquidity conditions having a negative impact on Commodity prices via the channels of global growth; global liquidity; emerging markets and the USD. At present, the resultant increase in the USD Index more broadly, and the resultant decrease in EURUSD Index specifically, are consistent with still weak Oil prices and weaker Industrial Metals prices.

As such, we retain our negative view towards Commodities, Commodity Economies and Commodity Currencies.

## Tactical Investment Implications and Opportunities

**This view has Tactical Investment Implications for Country Allocation, Equities Sector Allocation and Currency Allocation.**

- **Country Allocation: Preference for Developed Markets over Emerging Markets.** We continue to avoid those economies that are heavily exposed to Commodity prices, including Australia, Canada, Brazil and oil producing Emerging Markets.

- **Equities Sector Allocation: From an Equities Sector Allocation perspective, within Europe,** this environment is positive for yield exposed Consumer Staple and Interest Rate Sensitive sectors and as growth stabilizes, sectors that benefit from increased liquidity, economic stabilization, including Autos, and specific companies the benefit from a weaker EUR. **Across all markets,** we continue to avoid Energy, Metals & Mining, and ancillary sectors, including the Oil Services and Mining Services sectors. **Within those commodity economies that are later cycle,** where bond yields are only now beginning to decline (eg; Australia and Canada), we have a preference for those sectors that offer exposure to a rising USD over commodity exposed sectors, those sectors that have strong cash flows and those that are beneficiaries of lower longer dates interest rates (eg; Telecommunications, REITs, Infrastructure).

- **Currencies: Preference for USD and GBP over the EUR, JPY, EMFX, AUD and CAD. In isolation, ECB QE is likely to result in a declining EUR. In addition to this,** the USD is likely to continue to strengthen given the combination of the more attractive cyclical factors of growth and monetary policy, and the structural driver of a declining energy trade deficit, resulting in a shorter supply of USD globally. Weaker commodity prices will also continue to place downwards pressure on the currencies of Commodity economies such as AUD, CAD and BRL, and the currencies of oil producing nations, many of whom are yet undergo structural reform to attract capital inflows, and will need to cut interest rates further to stimulate economic growth.

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