

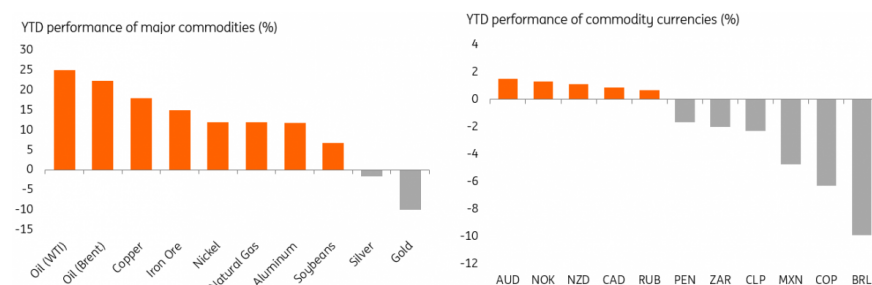
Re-assessing the commodity-FX relation

The rally in commodities has benefited G10 commodity FX more than EM FX so far, due in part to the UST sell-off. Looking ahead, long term undervaluation may help RUB reap more benefits from a 2H oil rally and help BRL weather a decline in iron ore, which should hit AUD harder. A continued rally in copper should support CLP, while coal's FX impact should stay low



Booming commodity prices have accompanied the market's recent bets on the global recovery. As shown in Fig 1, almost all major commodities saw a sharp increase in the first two months of 2021, led by the well-sustained recovery in oil prices.

Fig. 1 & 2 - YTD performance of commodities and commodity currencies



Source: ING, Refinitiv

We look at the main commodities that normally have an FX impact (oil, iron ore, coal and copper) and their near-term outlook, and then go on to analyse how commodity currencies are positioned to either benefit or be negatively impacted from future commodity dynamics.

As shown in Fig. 1, the two mostly traded precious metals, gold and silver, have been the key laggards, but for the purpose of the analysis of FX impact, we will not discuss those as they rarely have a clear impact on the currencies of those countries that are heavy exporters of those commodities.

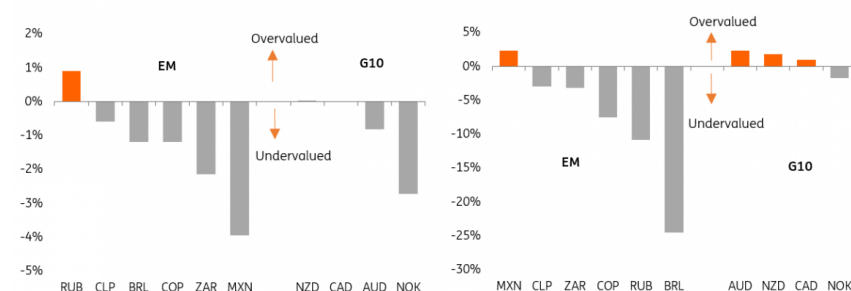
What currencies can still benefit from a commodity rally?

So far in 2021, G10 commodity currencies have performed better than EM commodity currencies (Fig. 2). This doesn't come as a surprise as EM commodity currencies were the vulnerable high yielding segment during the latest UST sell-off (which spilled over into the decline in local bonds).

From a valuation perspective, EM commodity currencies are generally more undervalued than the G10 commodity bloc, as shown in Figures 3 and 4 below. That is particularly evident from the longer term valuation prospective. All EM commodity currencies except MXN present a marked undervaluation to its average real effective exchange rate of the past 5 years (Fig. 4). As discussed in "[Timing the Tantrum: The market implications of a big Treasury sell-off](#)", the relatively attractive valuation is one of the factors that makes EM currencies (including the commodity segment) less vulnerable to the rise in UST yields compared to the pre 2013 taper tantrum state of affairs.

We will discuss each currency's outlook in the sections below, after highlighting our views on major commodities.

Fig. 3 & 4 - Misvaluation of commodity currencies



Source: ING

Oil (CAD, NOK, RUB, MXN, COP) – Further rallies more likely to materialize in 2H21

Additional supply cuts from Saudi Arabia, growing demand hopes, rising inflation expectations and the broader USD weakness have all proved bullish for the oil market. We expect ICE Brent to average US\$65/bbl over 2021, although believe further upside will be limited in the first half of this year. It is over the second half of this year where we see more upside, given the expectation of a stronger demand recovery over this period, and as a result expect Brent to end the year at US\$70/bbl.

However, there are still clear downside risks. Firstly, while we are seeing the rollout of vaccines, there is the risk that we still see further waves of Covid-19, which would weigh on demand. Secondly, any signs of tapering from the US Federal Reserve with regards to its bond buying program could put pressure on risk assets including oil. Thirdly, a swift return of Iranian barrels could slow the market rebalancing process. For now, though, we do not see a significant return of Iranian supply until later this year at the earliest. We think any short-term correction in crude may be contained to the US\$57/bbl level, where we could see some technical support coming into play.

Looking at the G10 FX space, NOK is undervalued both in a short-term perspective and in a longer-term perspective, and appears to be looking at more potential benefits from additional oil gains than CAD, which displays no sign of undervaluation. Nonetheless, some idiosyncratic factors – such as the faster recovery of neighbouring US economy or rising speculation around Bank of Canada tapering – suggest CAD could maintain a similar appreciation rate in the remainder of the year. We expect EUR/NOK to move below 10.00 in 2H21, when USD/CAD may trade in the 1.20/1.25 range.

In EM, COP is undervalued under both measures mentioned above and may be looking at a wider room for appreciation on the back of stronger oil prices, possibly moving back below 3,500 vs USD in the second half of the year

RUB appears slightly overvalued vs USD in the short term, but its REER undervaluation is very material. Country specific factors such as capital account volatility (related to actual or expected sanctions) are set to retain a stronger influence on RUB than oil prices, but an extension of the oil rally in 2H21 should contribute (also considering the over-mentioned real undervaluation) to limit RUB downside risk by helping the macro stability narrative. We maintain our year-end forecast at 73.00 for USD/RUB.

MXN appears to be facing a more contained upside potential if oil keeps rising: despite a short-

term undervaluation, MXN is overvalued in real terms. Incidentally, the Banxico's dovish bias and the likely further rate cuts should also limit MXN upside potential. We expect USD/MXN can remain supported into 21.00 in the coming weeks. Some MXN recovery in 2Q may be limited to the 20.50 level.

Iron ore (AUD, BRL) – Prices look unsustainable

While the iron ore market is set to remain in deficit this year, with Brazilian supply struggling to get back to pre-dam disaster levels, we do think that current price levels are unsustainable. We believe the market is pricing in a risk premium as a result of Australian/China tensions, with the potential that this could spill over into the iron ore market. However, we think this is unlikely, given China's strong dependency on Australian iron ore, and the lack of alternative sources.

We expect that as we move through the year, the supply situation will improve, and so expect prices to trend lower. We are currently forecasting that prices will average a little over US\$130/t this year.

AUD has leaned on the strong performance of iron ore lately as its carry profile took a hit from additional stimulus deployed by the RBA in February. We discussed this topic in detail in "[AUD: In balance between doves and iron ore](#)" and our view remains that an ultra-dovish RBA (which was reiterated at the March meeting) would suggest a weaker AUD. If iron ore prices start to decline as per our forecast, AUD appears vulnerable – especially in the crosses, such as AUD/NZD, where we expect a move to the 1.04 area in the coming months. In addition, AUD has the largest overvaluation to its 5-year average REER among all commodity currencies.

The opposite is true for BRL, which has the most material REER undervaluation, and is also moderately undervalued vs USD according to our short-term fair value model. Incidentally, BRL has been the worst performing commodity currency in 2021, also in large part caused by the rise in perceived political risk premium (following the replacement of the Petrobras CEO). All this may suggest a somewhat contained negative impact from a downtrend in iron ore prices, especially if such trend is the result of higher production/shipments from Brazil.

Coal (AUD, ZAR) – Some weakness could materialize after the winter

Newcastle coal prices remain well supported for now, however as we move out of the winter months we would expect prices to come under pressure. Meanwhile, domestic thermal coal prices in China have fallen, and so these weaker prices should weigh on the seaborne market.

Our view is that Newcastle coal will average US\$70/t over 2021, although we suspect the highs are behind us for the year already, with the much colder weather seen this winter having proved supportive for demand. The key risk for the coal market remains the tensions between China and Australia, and price action will also depend on how this situation develops.

AUD has been impacted more by iron ore prices than by coal prices, and this should continue to be the case moving on. As highlighted above, dynamics in the coal market will be heavily dependent on the China-Australia tensions (China moved to ban Australian coal in 2020). Any developments in the trade relationship between the two countries would likely impact AUD sentiment directly, and only partially through the coal channel.

Despite South Africa's coal rents amounting to approximately 2.4% of GDP (the third highest in the world), coal prices have not had a significant correlation with ZAR recently. This may suggest that only wide moves in coal prices may have a tangible impact on the currency, which is by the way showing some nominal and real undervaluation. We see ZAR as one of the most vulnerable EM currencies to rising UST yields given as its fundamentals not show material improvement vs most of its EM peers.

Copper (CLP) – Room for more short-term upside

Copper appears to be an ideal candidate to ride the globally supportive environment for commodities further. As highlighted in our recent publication: "[Copper: Red hot enthusiasm](#)", a combination of good fundamentals and the global green narrative on the demand side may continue to offer support to copper prices.

CLP shows some moderate undervaluation in the short term and a wider undervaluation in its REER, and has so far depreciated in 2021, in line with other commodity EM FX. All this should allow CLP to reap at least some of the benefits of an extension of the rally in copper prices.

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