Commodities and Currencies

Commodities and Currencies are Linked

Commodities and currencies are deeply interconnected in the global financial system. Historically, commodities were used to back currencies directly. In the modern world, although most currencies are fiat currencies, commodities still strongly influence currency values through trade, exports, inflation, and geopolitics.

Understanding this relationship helps explain:

- Why some currencies strengthen when commodity prices rise
- Why oil prices affect exchange rates
- How global economic power is shaped

Historical Perspective: Commodity-Backed Currencies

What Is a Commodity-Backed Currency?

A commodity-backed currency is a system where money derives its value from a **physical commodity**, most commonly:

- Gold
- Silver

In such systems, currency could be **exchanged for a fixed amount of the commodity**.

The Gold Standard

Under the gold standard:

- Each unit of currency represented a specific quantity of gold
- Governments held gold reserves to back the money they issued
- Exchange rates between countries were relatively stable

Advantages

- Controlled inflation
- High trust in currency value
- Limited excessive money printing

Disadvantages

- Restricted economic growth
- Governments could not respond flexibly to crises
- Money supply depended on gold availability

By the mid-20th century, most countries **abandoned the gold standard** to gain monetary flexibility.

Transition to Fiat Money

Modern currencies are **fiat currencies**, meaning:

- They are not backed by physical commodities
- Their value comes from **government authority and public trust**

Examples:

- US Dollar
- Indian Rupee
- Euro

Although fiat currencies are not commodity-backed, commodities still play a **critical indirect role** in determining their value.

Modern Relationship: Commodity-Influenced Currencies

What Are Commodity Currencies?

Commodity currencies belong to countries whose economies rely heavily on **exporting natural resources** such as:

- Oil
- Natural gas
- Metals
- Agricultural products

When commodity prices rise:

- Export revenues increase
- Foreign demand for the currency rises
- Currency tends to appreciate

When commodity prices fall:

- Export income declines
- Currency often depreciates

Examples

- Oil-exporting countries ---> currency linked to oil prices
- Metal-exporting countries --->currency linked to global industrial demand
- Agricultural exporters ---> currency influenced by global food prices

These currencies are **not officially backed** by commodities but are **economically linked** to them.

Basics of Investing

Investing is the process of allocating money to assets with the expectation of generating **future returns**. Unlike saving, which focuses on safety, investing focuses on **growth over time**.

Why Do People Invest?

- To beat inflation
- To grow wealth over time
- To achieve long-term goals (education, retirement, financial independence)
- To generate passive income

Major Asset Classes

1.Equities (Stocks)

- Ownership in a company
- Returns come from:
  - Price appreciation
  - Dividends
- High risk, high return

2. Debt (Bonds)

- Lending money to governments or companies
- Fixed interest income
- Lower risk than stocks

3. Mutual Funds & ETFs

- Pool money from many investors
- Invest in diversified portfolios
- Suitable for beginners

4.Cash & Cash Equivalents

- Savings accounts, fixed deposits
- High liquidity, low return

Risk and Return

Risk: The possibility that actual returns differ from expected returns.

Return: The gain or loss from an investment over time.

Key principle: Higher expected return → higher risk

Diversification

Diversification means **spreading investments across assets** to reduce risk.

Example:

- Instead of investing all money in one stock
- Invest across multiple stocks, bonds, and funds

Result: Losses in one asset may be offset by gains in another.

Time Horizon and Compounding

Time Horizon

- Short-term: 1–3 years
- Medium-term: 3–7 years
- Long-term: 7+ years

Longer time horizons allow:

- Higher risk-taking
- Greater benefit from compounding

Power of Compounding

Returns earned on both:

- Original investment
- Previously earned returns

Corporate Financing

Corporate financing refers to how companies **raise, allocate, and manage funds** to run and grow their business.

Companies need financing to:

- Start operations
- Expand into new markets
- Buy machinery or technology
- Manage day-to-day expenses
- Repay existing obligations

Sources of Corporate Finance

Companies mainly raise money through:

1. Equity Financing
2. Debt Financing

Equity Financing

What Is Equity Financing?

Equity financing is the process of raising capital by **selling ownership stakes** in a company to investors.
Investors who provide equity become **shareholders** and gain a claim on:

- Future profits
- Assets (after debt holders, in case of liquidation)

Equity does **not require fixed repayment**, but investors expect returns.

Sources of Equity Financing

1. Founders' Capital

- Initial capital invested by founders
- Highest risk capital
- No guaranteed return

2. Angel Investors

- High-net-worth individuals
- Invest early-stage capital
- Provide mentorship and industry connections

3. Venture Capital (VC)

- Institutional investors
- Invest in high-growth startups
- Expect high returns and partial control

4. Public Equity (IPO & Follow-on Issues)

- Shares sold to the public via stock markets
- Suitable for mature companies
- Highly regulated

Returns to Equity Investors

Equity investors earn returns through:

1. **Capital Appreciation** – rise in share price
2. **Dividends** – share of profits distributed periodically

Returns are **uncertain**, making equity the **riskiest form of capital**.

Advantages of Equity Financing

- No mandatory repayment
- Reduces bankruptcy risk
- Improves balance sheet strength
- Suitable for high-growth, uncertain businesses

Disadvantages of Equity Financing

- Ownership dilution
- Loss of control and voting power
- Higher long-term cost than debt
- Pressure to deliver growth and profits

When Do Companies Prefer Equity?

- Early-stage startups
- High uncertainty or volatile cash flows
- Expansion into new or risky markets
- When debt is expensive or unavailable

Debt Financing

What Is Debt Financing?

Debt financing involves borrowing money that must be:

- Repaid at a specified maturity
- Serviced with regular interest payments

Debt holders **do not own the company** but have priority over shareholders.

Types of Debt Financing

1. Bank Loans

- Fixed or floating interest rates
- Secured or unsecured
- Common for small and medium firms

2. Corporate Bonds

- Debt securities issued to investors
- Traded in financial markets
- Suitable for large corporations

3. Debentures

- Long-term unsecured debt
- Backed by company reputation and creditworthiness

Cost of Debt

The cost of debt is the **interest rate**, adjusted for:

- Credit risk
- Interest rate environment
- Company financial health

Important:
Interest payments are **tax-deductible**, making debt cheaper than equity in many cases.

Advantages of Debt Financing

- No ownership dilution
- Lower cost due to tax benefits
- Predictable cash outflows
- Enhances return on equity (leverage effect)

Disadvantages of Debt Financing

- Fixed repayment obligation
- Increases default risk
- Restricts financial flexibility
- Can lead to bankruptcy if mismanaged

When Do Companies Prefer Debt?

- Stable and predictable cash flows
- Mature businesses
- Low interest rate environments
- When maintaining ownership control is important

Capital Structure

What Is Capital Structure?

Capital structure refers to the **combination of debt and equity** a company uses to finance its operations and growth.

It answers the question: *How much should a company borrow, and how much should it raise from owners?*

Financial Leverage

Using debt increases ***financial leverage***.

- Leverage amplifies returns when profits are high
- Leverage amplifies losses when profits fall

This creates a ***risk–return tradeoff***.

Factors Influencing Capital Structure

Companies consider:

- Business risk
- Stability of earnings
- Cost of debt vs equity

- Tax benefits
- Industry norms
- Market conditions
- Management's risk appetite

There is **no universal optimal structure** , it is firm-specific.

Trade-Off Theory

- Debt provides tax benefits
- Excessive debt increases financial distress costs
- Firms balance both to choose a suitable structure

Example: A company needs 500 crores for expansion.

- **Option A:** 100% equity
  --> Safe, but founders lose control
- **Option B:** 100% debt
  -->No dilution, but high repayment risk
- **Option C:** Balanced mix
  -->Moderate risk, optimized returns

Most real-world companies choose **Option C**.

Key Takeaways

- Historically, currencies were **backed by commodities** such as gold, which provided stability but limited flexibility.
- Modern currencies are **fiat currencies**, not backed by physical commodities.
- Even today, commodities strongly **influence currency values** through trade, exports, inflation, and geopolitics.
- Commodity-exporting countries often have **commodity-linked currencies**.
- Oil plays a unique role in global finance, shaping exchange rates and global currency demand.
- "Backed by" and "influenced by" are different, but both matter for understanding currency movements.
- Investing is about **long-term wealth creation**, not short-term speculation.
- All investments involve a **risk–return tradeoff**.
- Higher potential returns come with higher risk.
- **Diversification** reduces risk without sacrificing long-term returns.
- Time horizon and **compounding** are more important than market timing.
- Asset allocation matters more than individual asset selection.
- Companies raise capital primarily through **equity and debt financing**.
- Equity provides flexibility but leads to ownership dilution.
- Debt is cheaper due to tax benefits but increases financial risk.
- **Capital structure** is the strategic mix of debt and equity.
- Financial leverage amplifies both returns and losses.

- There is no universal optimal capital structure — it depends on business risk, cash flows, and market conditions.