For many traders, foreign exchange is all about technical analysis, but regardless of what technical studies you use to signal a trade, a solid understanding of the fundamental drivers is necessary for long-term successful trading.

Forex fundamentals: moving the markets

BY CHRIS McMAHON

Because of higher housing prices and increased consumer confidence, the Bank of England was widely expected to temper rejuvenated economic growth with an interest rate hike at its meeting on Nov. 9. And it did, boosting the bank rate 25-basis points to 5.0%. That same week, the Reserve Bank of Australia was meeting as well. The consensus was that it too would raise interest rates, and that it would be the last hike of the year, as rates were already high at 6%. And it did, lifting the cash rate by 25-basis points to 6.25%.

"For the Aussie, it became: buy the rumor, sell the fact," says Brian F. Dolan, director of research at Forex.com. "And for the pound, it became: buy the pound and keep buying the pound." In that period, the GBP/AUS cross pair moved from 2.4600 to just shy of 2.500, a nice score based on knowledge of forex fundamentals. "It worked out very well in a short period," Dolan says. "This was one where it struck me that they were at different junctures on monetary policy and it suggested a trade to me."

Trading forex is all about betting on the value of one currency against the value of another, a pretty simple concept that lends itself very well to technical analysis. But the foreign exchange market also is a reflection of our changing global economy, which is dependent on complex relationships between producers and consumers of goods and services world wide. So even technical traders, who make their buy and sell decisions based primarily on price action, need an understanding of fundamental factors. For the trader who wants to go beyond "buy on green, sell on red," here is a look at the fundamental factors that affect the value of currencies and drive the forex market.

GROWTH DATA

The broadest measure of a country's economic growth is described by its gross domestic product (GDP), which is the total value of all the goods and services created internally and externally by that nation's producers. The U.S. GDP is tracked by the U.S. Bureau of Economic Analysis and is released on a quarterly basis. For the second quarter of 2006, U.S. GDP increased by 2.6% and is at 2.2% for the year.

Other measures of growth are the monthly non-farm payroll report, issued by the U.S. Department of Labor, and the real earnings report. Both of these reports and many others are available on the U.S. Department of Labor's Web site (see "Forex Fundamental Sources," right).

Growing production and payrolls are good indicators of a healthy economy. However, if unchecked, rapid growth can lead to inflation, which devalues a currency relative to others and which consumers experience as rising prices and decreased purchasing power.

The constant challenge for central banks, such as the Federal Reserve Bank, the European Central Bank and the Bank of England, is to promote growth while keeping inflation in check. They do this through the managing of interest rates. When inflation threatens, they increase rates to slow down growth. The Bank of Japan has the opposite problem. Japan is suffering from long-term deflation, which consumers experience as increased purchasing power and which the Bank of Japan had been fighting by lowering interest rates. Recently the Bank of Japan raised interest rates to 0.25%.

INFLATION

One of the best ways to track inflation is to watch its affect on production and consumption. Forex traders will watch the producer price index (PPI), which tracks the average change through time in the selling prices received by domestic producers; the consumer price index (CPI), which tracks a basket of items commonly consumed by urban shoppers; and the personal consumption expenditures (PCE), which measures price changes at the consumer level for durable and non-durable goods and services. Another important measure is the Institute for Supply Management Manufacturing and Non Manufacturing Report on Business.

"During periods when inflation is not on the radar screen, these reports will have less of an impact, and the market will focus on them for what they suggest about the growth outlook," Dolan says, adding that in an inflationary environment, however, those reports are heavily scrutinized for what they suggest about prices paid and the inflation outlook.

Understanding the mandate of central banks is a primary concern for forex traders.

"The central bankers are very concerned about inflation," says Kathy Lien, chief currency strategist for FXCM. "They say that oil prices are going to rise once again. And that's going to force them to consider raising interest rates. But at the same time, growth is beginning to falter," she says, adding that the U.S. housing market is softening as sale prices fall, houses stay on the market for longer periods and new housing starts decline. "It's really a tug of war between growth and inflation at the moment."

MONETARY POLICY

The primary responsibility of central banks is managing monetary policy, and the three most influential central bankers are Ben S. Bernanke, chairman of the U.S. Federal Reserve Bank, Jean-Claude Trichet, president of the European Central Bank and Bank of Japan Governor Toshihiko Fukui.

FOREX FUNDAMENTAL SOURCES

While many forex brokers and platform providers offer analysis and trade recommendations, you should know where to find the original data sources.

Treasury International Capital System (TICS data): Release dates: Jan. 17, Feb. 15, March 15, April 16, May 15, June 15, July 17, Aug. 15, Sept. 18, Oct. 16, Nov. 16 and Dec. 17. www.treas.gov/tic

Coordinated Portfolio Investment Survey (CPIS): Non-U.S. trade flow report. www.imf.org/external/np/sta/pi/cpis.htm

Institute for Supply Management (ISM): www.ism.ws

U.S. Department of Labor: Non-farm payroll, the employment situation. www.bls.gov/ces

U.S. Bureau of Economic Analysis: Gross domestic product and balance of payments reports. http://bea.gov/bea/dn/home/gdp.htm

The International Monetary Fund Dissemination Standards Bulletin Board: A searchable database of economic releases and calendars. http://dsbb.imf.org/Applications/web/calmultiarccountry

Group of 7 (G-7) and Group of 8 (G-8):
The world's economic powers, including the United States, Japan, Germany, United Kingdom, France, Italy and Canada regularly meet to discuss and create economic policy. When Russia is included in policy-making, the body is referred to as the G-8.

Source: *Futures*

Professional forex traders follow the central bankers' official statements, minutes from meetings and press releases. These official releases are extremely valuable because they frequently contain the bank's official inflation targets and descriptions of how the banks intend to hit those targets, typically through raising or lowering interest rates, which have long been the driver of currency market fluctuations.

"If you didn't know anything at all about fundamentals and just wanted to focus on one aspect, interest rates and where they are headed is the thing to watch," Lien says.

Dolan agrees. "The interest rate outlook is critical," Dolan says, stressing that forex traders have to catch up to the market's own view. "I liken it to boarding a moving train," he says, adding that new traders should scour the news to understand what the professional traders are thinking about and to determine what, if any, official stand is operative in the market at the moment. He says some of the forex market's biggest moves have come as a result of G-7 meetings, such as the Plaza Accord of 1985, where the central banks planned to lower the value of the U.S. dollar against the Japanese yen and German mark to alleviate recession in the United States; the Louvre Accord in 1987, which attempted to stabilize the devaluation of the dollar that the Plaza Accord initiated; and the April 2006 G-7 meeting, which created the impression that the world's economic powers were eager for Asian currency appreciation and prepared for a weakening U.S. dollar. "These moves come out of the official statements and official views on where currencies should go."

The machinations of the world's central banks can seem slow to materialize in terms of international trade but they can have huge impact on relative growth rates and drive intraday trading.

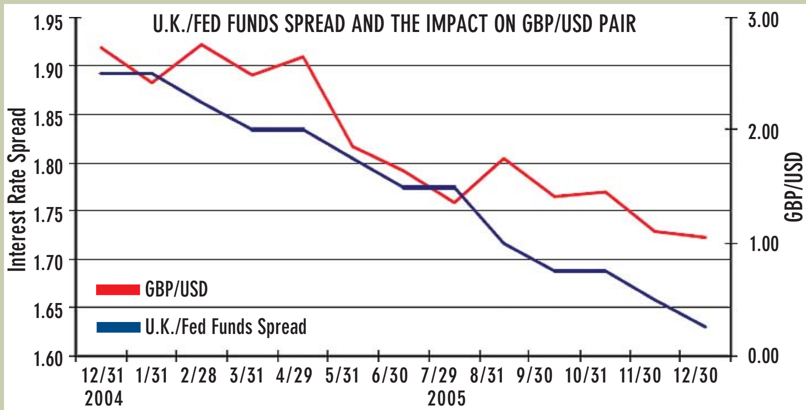
TRADE

Trade flows, usually expressed as surpluses and deficits, measure whether there is foreign demand for a country's currency, treasuries and goods. The best places to get that data are from the current account balance, or the Treasury International Capital System report, typically referred to as TICS data.

A positive current account balance measures U.S. investments overseas. A negative account balance measures foreign investment in the United States. In the second quarter of 2006, the United States was running an account

DOLLARS TO THE POUND

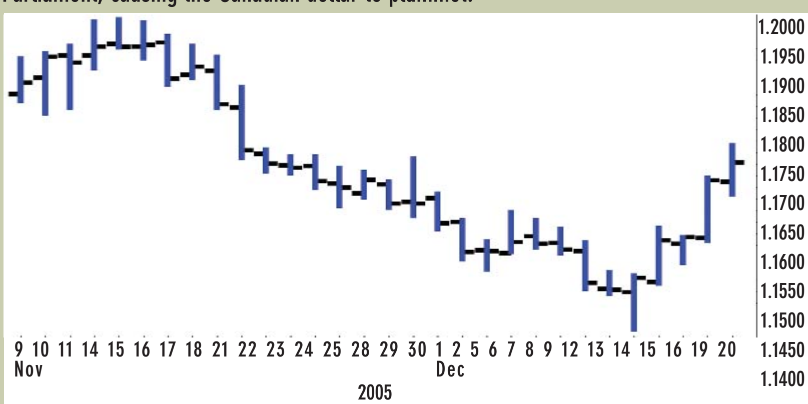
The relationship between the values of the U.S. dollar and the British pound sterling move in parallel with interest rate differentials.



Source: FXCM

LACK OF CONFIDENCE

On Nov. 28, 2005, Canada's Liberal government lost a no-confidence vote in the House of Parliament, causing the Canadian dollar to plummet.



Source: CSI Unfair Advantage

deficit of $218.4 billion (preliminary), up from $213.2 billion (revised) in the first quarter.

The U.S. Treasury tracks the sources of money flowing into and out of U.S. government and corporate securities and reports on a monthly basis in the TICS data. It also reports on U.S. holdings of foreign government and corporate securities and these numbers can be used to gauge the relative confidence that the world's investors have in a country and its economy.

If foreign money is flowing into U.S. corporate securities, it implies confidence in the U.S. economy and available capital for corporate expansion; and investors may infer the potential for an increase in the Federal funds rate. Conversely, it may show that foreign investors are divesting of U.S. stocks and bonds, which could imply a lower Fed funds rate. The International Monetary Fund consolidates and publishes similar data for other nations.

"Right now we have sufficient foreign inflow to fund our deficit, so the trade deficit and the balance of payments are not that important," Lien says. "But it's cyclical. When we do have a deficiency of funding, and we could if the U.S. dollar starts to fall, foreign investors see the possibility of lowering yields or a lower notional value of their investment. Then that will become more important." Right now, she says the most important factors on the U.S. dollar are threats of recession and political events. "The trade picture has fallen to the sidelines," she adds.

OTHER FACTORS

When analyzing forex fundamentals, there are also several intangibles to consider, including politics, technical traders and market sentiment.

"Politics always trumps economics," Lien says, because political risks are almost impossible to handicap. "You could have a fantastically booming economy, but if there is an internal war or if the government gets outvoted, like we saw in Canada with the no-confidence vote last year, it can have a very significant impact on the currency." The no-confidence vote in the minority Liberal party sank the Canadian dollar in November 2005 (see "Lack of confidence," left). "The same thing happened during the Eurozone constitutional crisis in June 2005, which caused people to start talking about reserve diversification for a good few months."

Because forex has historically been the domain of systematic traders, such as hedge funds and institutional traders, a significant number of trades are initiated by breaks at technical levels, especially when the market is quiet.

Sentiment and market psychology are also real factors, Dolan says. "The market is intent on taking the dollar lower. Any data that comes out suggesting that the economy is expanding or something good is happening is discounted and disregarded. It can be very confusing to newcomers who will look at a report, read it correctly and decide it is dollar positive and then the dollar fails to rally or even declines."

The best way to counter these effects is to follow the central banks' decisions and comments and the market commentary through time and go straight to the sources of the data — and then you can really understand what is moving the market. FM