Understanding the 'Fundamentals' behind Currency Moves

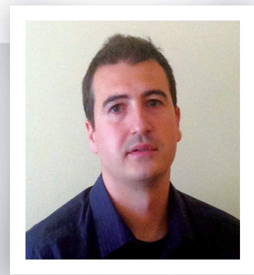
Fundamental Bias to Improve the Odds in Forex Trading

Traders often underestimate the importance of personal interpretation of economic data in order to come up with a forex trading strategy. Without undermining the potential effectiveness of trading signals and automated trading, a trader's personal intuitiveness and insight 'beyond the numbers' will ultimately make the difference between a successful and a bad forex trader. After all, if a particular trading strategy or a set of trading signals were absolutely effective, then everybody would be a successful trader. If such a successful trading strategy exists, it must be a very well-kept secret. Therefore, how do we improve our odds in forex trading?

» First, Understand the Market

To start, forex traders should take a good look at currency trading symbols. Unlike stock symbols, for instance, there is an inherent meaning in the way currencies are quoted. Let's take a look at the USD/JPY, where the US dollar is the base currency and the Japanese yen is the counter currency. The symbol helps traders realise that there is a bi-dimensional relationship in every transaction. This is not so obvious in any other market.

In all transactions, there is a purchase of one item and a simultaneous sale of another item. The 'USD/JPY' symbol shows that someone is buying US dollars and someone is selling Japanese yen or vice-versa. This relationship is not so evident when traders buy shares of Apple. The stock is not listed as APP/USD although traders are buying or selling Apple shares in exchange for US dollars.



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Jose M Piñeiro started in the forex industry in 2002 as an Operations Specialist and then Compliance Officer for FXCM in New York when the online retail forex market was still getting off the ground and expanding rapidly. He has spent the last seven years working for Web Financial Group (WFG), based in Madrid. He is now forex analyst for WFG's forex website, fxmania.com.

As a result, there is a dominating bias to buy a stock that will rise in value. Although stock traders have the option to 'short' a stock, usually that action is carried out under a different set of conditions. Stock trading tends to become more about stock picking rather than determining a stock's direction. On the other hand, forex traders may have their favourite currency pairs but their focus is on determining the right direction, regardless of the direction.

Forex traders should understand this bi-dimensional relationship in their trades. A trader will often buy the EUR/USD as a bet in favour of the euro but could overlook important factors that affect the US dollar. This may seem complicated but traders only need to keep in mind the relationship in order to determine general market direction and judge the driving forces in a currency pair. This understanding will give traders an advantage.

When traders decide to buy or sell shares of Apple, they will often ignore the other side of the equation. They will often ignore the direction of the US dollar or the US economy in general. After the asset class and market has already been picked, traders will at most consider how the company will fair despite the country's economic situation. For example, is the company geographically diversified? Will it lose market share? Most questions will revolve around the company, not the US economy.

Let's stress this point with a 'visual' example; it would not be strange for a trader to turn upside down a price chart of the EUR/USD. The result would be a chart of the US dollar trading in terms of euros; it would show how many euros it would take to equal one dollar. Currency conversion takes place all the time but no one will ask how many shares of Apple it would take to equal one dollar.

F1) Bi-Dimensional Relationship in EUR/USD

Forex traders should focus on both sides of a bi-dimensional relationship in a currency pair. They have no inconvenience in turning a chart upside down. Above, a price chart of the EUR/USD has been turned upside down to show the value of one dollar in terms of euros.

Source: www.fxcm.com

Second, Determine What Drives the Forex Market

Like in any other market, supply and demand will determine a currency's price except in countries that impose foreign exchange controls, such as bans on the use of foreign currency, currency exchange restrictions, and exchange rate fixing. Ideally, traders have the best chance of succeeding by trading in a free and highly liquid market.

Individual traders will have the odds against them and therefore should not be interested in a market

» What matters is the relationship between two currencies and not the consideration of every possible factor. «

controlled by government or other market manipulators, even though an argument can be made that there is no perfectly free market. It is difficult for a trader to make money in day-to-day trading operations on a restricted currency like the Chinese Yaun, which is only allowed to trade in a narrow margin around a fixed base rate.

Thus, traders should be familiar with the factors that move currencies that trade in a free and highly liquid market. Four main factors are economic growth, inflation, interest rates, and monetary policy. Also tied into this are a country's credit worthiness and status as a reserve currency, with the most revered currencies called 'safe-havens'.

While the above are major themes affecting currencies, there are many other factors that affect currency rates, making it very difficult to get proper valuations and to forecast future prices. For instance, events that often go unnoticed could have an impact. Social uprisings in a remote country could boost the US dollar as investors seek a 'safe' currency; a labour strike in Chile, the world's top copper producer, could boost commodity prices; and new bank regulations in a 'tax-haven' country could affect the local currency.

Going back to the bi-dimensional relationship discussed above, what matters is the relationship between two currencies and not the consideration of every possible factor. Traders should focus on that relationship using the major factors listed above. These factors – economic growth, interest rates, inflation, and monetary policy – are interrelated and affect each other.

Macroeconomic data on economic growth, interest rates, and inflation will suggest whether demand for a country's currency is likely to accelerate. A trader should then interpret whether the economic conditions of one currency is becoming more favourable than another. It is okay for traders to have different interpretations because even prestigious economists disagree.

A deeper analysis of how economic factors affect the forex market could be the subject of a much longer publication. Traders should mainly decide where a particular country fits in the economic growth cycle and trade accordingly. The main clue will usually come from monetary policy. In recent times, the global economy has been steered by monetary policy instead of government policy, perhaps because decision-making is easier and more effective at the central bank.

In theory, one of the best times to judge a currency pair's direction would be when both countries are at different turning points in their monetary policy. If country A prepares to increase interest rates while country B begins to lower them, all else being equal, currency pair A/B should rise. Thus, a trader may decide to have a bullish bias for A/B. Once this 'personal interpretation' of the data has been established, a trader should pick out trading strategies and use trading signals that call for being bullish on A/B.

By following the news and macroeconomic data, a trader will build arguments for a particular bias, and ignore what is only 'noise'. It will help traders establish criteria for making trade decisions and not enter blindly. Without a solid bias developed over time, an isolated data point such as a positive retail sales figure for country B could encourage a trader to get carried away and sell A/B even though country B is in a recession and country A is growing strongly. A trader with a bullish bias should be looking for reasons to buy and should let this data pass.

Since forex traders trade on high leverage and place frequent short-term trades to take advantage of small moves, a bias could help traders become more selective and prevent many unnecessary trades.

Conclusion

Forex trading has proven to be a very difficult activity for many people although there are only two primary decisions that can be taken for any currency pair, either buy in the hope that a currency will rise in value or sell in the hope it will fall. As such, we should realise that there is a 50-50 chance of correctly opening a successful trade. (For simplification purposes, we will not consider trading costs via the spread or the cost of carry.)

Surprisingly, an overwhelming number of forex traders are not successful. The odds of success could be improved greatly with tips on emotions, psychology, risk and leverage management, and technical analysis. However, understanding the 'fundamentals' behind currency moves gets traders started on the right foot by not trading aimlessly.«