WHAT MOVES the currency market?

What makes currencies tick? Find out which economic factors help shape the short-term and long-term forex landscape.

BY KATHY LIEN

The stock market has traditionally received the lion's share of attention in the trading industry, but foreign currency (forex) trading has surged in recent years. Forex's 24-hour access, liquidity and high leverage has attracted many active traders. Intraday traders can respond immediately to breaking news and events, thus avoiding having to wait for the market to open and risk "paying the gap."

Because of regulations, capital requirements and technology, access to the forex market was traditionally restricted to hedge funds, large commodity trading advisors (CTAs) and institutional investors. However, in recent years many firms have sprung up to offer forex trading to retail traders.

The growth in this area of the trading industry has been very rapid, especially as equity and futures traders realize the approaches they've been using for years in their respective markets — particularly price-based techniques based on technical and quantitative analysis — are equally applicable to forex.

From a price-action perspective, currencies rarely spend much time in tight trading ranges and tend to develop strong trends. More than 80 percent of currency trading volume is speculative in nature and, as a result, the market frequently overshoots and then corrects.

Also, many of the macroeconomic catalysts and events traders use in the equity or futures markets — including gauging interest-rate changes and economic releases — are also integral to forex trading. In addition, price moves in many commodities or indices are highly correlated to currency moves. For example, Australia is the world's third-largest gold producer, which explains the Australian dollar's 80-percent positive correlation with gold prices. As a result, many commodity traders can trade forex to spread their risk or leverage certain positions.

The most actively traded currency pairs are, in order, the eurocurrency/U.S. dollar (EUR/USD), British pound/U.S. dollar (GBP/USD), U.S. dollar/Japanese yen (USD/JPY) and the U.S. dollar/Swiss franc (USD/CHF). Table 1 shows the historical trading ranges of these and other currency pairs over the past one and five years.

Fundamentals for long-term trading

Fundamental analysis focuses on the economic, social and political forces that drive supply and demand. More so than other markets, currencies tend to develop strong trends, and one of the key roles of fundamental analysis is forecasting long-term trends. Analysts consider various macroeconomic indicators, such as economic growth rates, interest rates, inflation and employment when forecasting the markets. Fundamental drivers of currency moves include economic data releases, interest rate decisions, news and announcements, all of which can indicate potential changes in the economic, social and political environment.

Fundamental analysis helps determine whether currencies are undervalued or overvalued. A classic example is the eurocurrency/dollar rate (EUR/USD), which has been in a

Currency pair	Ticker	Average ranges (in points) Past five years	Past 12 months
$U.S./Swiss franc	USD/CHF	162	154
Euro/Japanese yen	EUR/JPY	139	136
British pound/$U.S.	GBP/USD	121	153
$U.S./Japanese yen	USD/JPY	113	95
Euro/$U.S.	EUR/USD	103	125
$U.S./$Canadian	USD/CAD	93	131
Euro/Swiss franc	EUR/CHF	71	66
$Australian/$U.S.	AUD/USD	64	77
$New Zealand/$U.S.	NZD/USD	59	74
Euro/British pound	EUR/GBP	55	52

TABLE 1 — HISTORICAL TRADING RANGES

long-term uptrend since 2002 (see Figure 1). This trend can be explained by the ballooning U.S. account deficit, the U.S. government's flagging commitment to a strong dollar and the fragile nature of the labor market recovery.

An example of a popular fundamental-based trading strategy is the "carry trade," which exploits the interest rate differential between currencies. This was a primary driver of exchange rate movements in 2002 and 2003. The strategy consists of going long a currency with a high interest rate while simultaneously going short a currency with a low interest rate with the goal of earning both the yield differential (the difference between the interest rates of the two countries), as well as capital appreciation. This type of strategy rewarded currency traders who went long the Australian dollar against the U.S. dollar in 2003 with a 30-percent gain.

Fundamentals for short-term trading: Trading off economic releases

While many participants in the forex market are pure technicians, a 1999 study ("Macroeconomic Implications of the Beliefs and Behavior of Foreign Exchange Traders," www.nber.org/papers/w7417) involving U.S. foreign exchange dealers revealed a significant number of traders also used a fundamental-based approach. Nearly one-fourth of dealers surveyed claimed they primarily used fundamental methods to trade, vs. 30 percent who used technical analysis. It should not be surprising, then, that fundamental data releases impact currency rates in the near term.

What is more interesting is the speed with which exchange rates adjust to news. Based on responses from foreign exchange dealers, the same study found the time it takes for exchange rates to adjust after data releases, such as unemployment, trade balances, inflation, GDP and interest rates, is generally less than one minute, and in many instances less than 10 seconds. The one economic report that stood apart was money supply, which was estimated to have a longer exchange rate adjustment time.

The changing importance of different economic statistics

Because of their strong link to currency value, interest rates consistently rank among the highest in importance with foreign exchange dealers. Other data, such as unemployment, trade balances and inflation, tend to vary in their importance to dealers over time (see Table 2, p. 58).

Intuitively, this finding makes sense as the market shifts its attention to different economic sectors and data — for example, trade balances may take precedence when a country is thought to be running unsustainable deficits. Similarly, in an economy that has difficulty creating jobs, the market will place greater emphasis on employment data. The top four entries from 1992 and 1997 shown in Table 2 still head the list today, with the unemployment/payrolls being the leading market mover.

Interestingly, according to the survey, some of the least relevant data to foreign exchange dealers was GDP. One possible explanation is GDP releases are less frequent than other data

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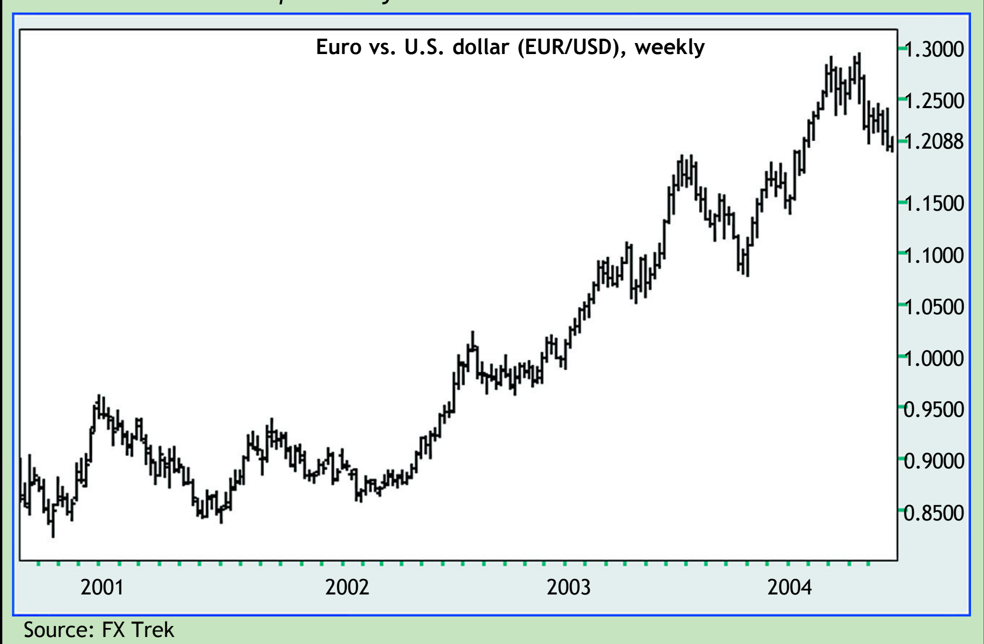
FIGURE 1 — LONG-TERM TREND

Currencies often embark on lengthy trends, as evidenced by the Eurocurrency's rally vs. the U.S. dollar over the past two years.



Source: FX Trek

used in the study (quarterly vs. monthly). Also, GDP data is more prone to ambiguity and misinterpretation. For example, surging GDP brought about by rising exports will be positive for the home currency; however, if GDP growth is a result of inventory buildup, the effect on the currency may actually be negative.

The implication of these findings is twofold. First, because the currency exchange rate adjustment to economic news tends to be so swift, any reaction beyond a 15-30 minute window after data is released may be the result of investor over-reaction or trading related to customer flow rather than news alone. Second, it is critical to stay abreast of which data the market deems important at any point in time. Because the market's focus changes from period to period, previously relevant data may end up having less (or more) of an effect on currency values.

TABLE 2 — FX DEALER RANKING OF IMPORTANCE OF ECONOMIC DATA: 1992 VS. 1997

The importance of different economic data to forex dealers can change over time, but interest rates and employment consistently rank near the top. GDP is typically near the bottom of the list. Employment data tops the list today.

1992	1997
1. Trade balance	1. Unemployment
2. Interest rates	2. Interest rates
3. Unemployment	3. Inflation
4. Inflation	4. Trade balance
5. Money supply	5. GDP
6. GDP	6. Money supply

Source: "Macroeconomic Implications of the Beliefs and Behavior of Foreign Exchange Traders" (www.georgetown.edu/faculty/evansm1/New%20Micro/chinn.pdf)

The price side of the coin

In a way, fundamental factors supply the road map of what happens in the forex market. Navigating that map — that is, actually trading — is usually a matter of analyzing price action, especially for short-term traders.

The FX market is well-suited to price-based techniques such as technical and quantitative analysis. In terms of trading with technical analysis, as long as you use charts and indicators, trading the euro currency/dollar currency pair is just like trading shares of Microsoft or E-mini futures.

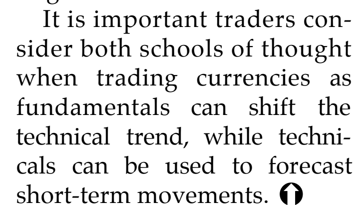
One of the most common gripes about technical analysis is that it fails to consider the very factors that result in the movement of exchange rates; it only looks at statistics and patterns, which are derivatives of market activity, not causes of it. As a result, some argue technical analysis is an ineffective forecasting tool.

Although this is undeniably true, it is also misleading. The advantage of technical analysis and other price-based techniques is they do not involve forecasting or predicting — they consider only what is actually going on in the market regarding who is buying and who is selling. This is the true information in the market, and it is the only information that matters. The market is simply a battle between buyers and sellers — and thus, technical analysis reasons, looking at the statistics behind this "battle" is all that is really needed to determine what really is going on in the market, and how to profit accordingly.

Implications for currency trading

Ultimately, the most successful trading scenarios tend to be the ones supported by both technical/quantitative and fundamental arguments. A great example of this is the breakdown of the dollar against the yen in October 2003 — the pair declined 6 percent between October 2003 and February 2004 (see Figure 2).

At that time, both technicals and fundamentals called for gains in the yen against the dollar. Technically, the dollar/yen had broken below longer-term support (a price level that has acted as a floor to past price declines), while fundamentally, Japan was finally showing economic growth after 10 years of stagnation.

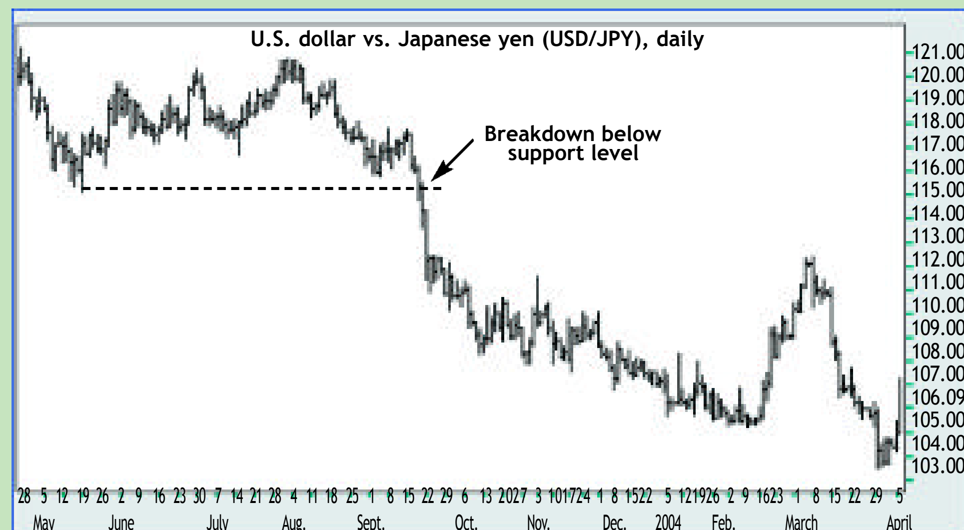


It is important traders consider both schools of thought when trading currencies as fundamentals can shift the technical trend, while technicals can be used to forecast short-term movements.

For information on the author see p. 8.

FIGURE 2 — TECHNICAL AND FUNDAMENTAL ALIGNMENT

When the U.S. dollar/Japanese yen rate fell below a support level in September 2003, it did so as Japan was showing evidence of renewed economic growth.



Source: FX Trek

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