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To Each Its Own

FX Advantages And Alternative Opportunities

Technical analysis is well suited to forex trading, more so than other financial markets. Here's how you can combine technical setups with intermarket analysis to help unearth potential trading opportunities.

The foreign exchange market (forex or FX) has its unique characteristics, drivers, and advantages (and some disadvantages) over the stock and commodity markets. I will highlight a few of its attributes and explain why technical analysis is perhaps better suited to FX than the other financial markets. I will also share some insights into unique ways of looking for trading opportunities in FX by combining technical setups with intermarket analysis. But first, I will discuss the main fundamental drivers of the FX markets that determine long-term trend direction for currencies.

A QUICK INTRODUCTION TO FOREX

The forex market is one of the most exciting markets available for retail traders to speculate in. It is a global, over-the-counter (OTC) market for trading currencies, unlike stocks, which are mainly traded over an exchange. Currencies are always traded in pairs. So the FX market determines its relative value by setting the market price of one currency against another. Continuously in operation 24 hours a day, except at the weekends, trading with most forex brokers usually starts at 22:00 GMT on Sunday (or early Monday in Asia) until 22:00 GMT Friday. It is by far the largest market in terms of trading volume, making it extremely liquid and potentially less prone to manipulation. The Bank For International Settlements estimated in April

2016 that trading in FX markets averaged almost \$5.10 trillion per day. The main players are large banks, investment funds, hedge funds, and central banks. Retail traders and commercial companies can be thrown into the mix as well.

Unlike with equities and commodities, FX market fluctuations are usually very small, with a one cent (or 100-pip) daily change for most currency pairs representing a sizeable move. While this makes FX one of the least-volatile markets, the use of leverage allows speculators to sharply increase the value of the potential movements.

FUNDAMENTAL DRIVERS OF FX

From my almost 10 years of experience in the markets, I can confidently state that once you realize that it is the changes in interest rate expectations that move currencies, everything else will fall into place. Interest rate expectations can be impacted by a vast number of factors, including incoming economic data, geopolitical news, and unexpected fiscal policy announcements. Basically, it's anything that could influence the economic performance of a nation, or more specifically, anything that could impact inflation expectations. That's because most central banks have a mandate to keep price levels low and stable, using the only tools they have: interest rates and supply of money.

While these fundamental developments usually take from several months to several years to work through the economy, the markets usually react as if the change is happening right now. This is because of an economic assumption that market participants are

by Fawad Razaqzada



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rational investors and they discount the odds of future interest rate changes as and when new information is made public. Of course, market participants are not all rational investors—far from it—and that’s why trading actually exists and why technical analysis works. Nonetheless, it is the economic fundamentals that move the markets in a particular direction over the long term, regardless of any temporary change in sentiment or some short-term technical development.

Large institutional investors such as insurance and pension funds are always on the lookout for opportunities to invest their money in assets that pay the best yield at acceptable levels of risk. Their interest is in making a return on their capital. This so-called “smart money” tends to make its way to countries where government bond yields are at comparatively higher levels. Bond yields tend to be higher in economies that are growing, or expected to grow, at a faster clip. In part, this reflects investors’ belief that the faster-growing economy would be pushing up inflation, and therefore requiring monetary conditions to be tighter if the central bank of that nation’s mandate is to keep the annual change in the level of prices at a low and stable level, usually around 2%.

To illustrate this point, I have taken the yield differential between the German and US 10-year bonds and plotted this spread against the EUR/USD exchange rate. (I will come back to this in the section “Intermarket analysis: An alternative” later on in this article.)

One of the monetary policy tools central banks have at their disposal is the ability to change nominal interest rates. When the central bank decides to increase rates, this effectively helps to reduce borrowing from—and therefore spending on credit by—businesses and individuals. To give you a basic example of how this might impact the real economy, think about mortgages or home loan finances: Higher interest rates push up the debt costs for the holder. As a result, the level of disposable income from households falls, which squeezes their spending power. This in turn lowers company revenues and profits, potentially slowing down wage growth. And the cycle continues.

Another method central banks use to withdraw liquidity is to reduce their government debt holdings. Bond prices and bond yields have an inverse relationship. When central banks offload large amounts of government bonds in the market, it pushes up bond yields.

The higher bond yields and interest rates mean smart money will be attracted toward that particular economy. This raises demand for its currency as foreign funds must be converted to the domestic currency before they can be invested in the

country’s bond, stock, or housing markets. From basic economic theory, we know that when demand for anything rises, while everything else is held constant, price has to rise. So, in this case, it is the exchange rate that rises when demand for the currency rises.

From the above explanation, it is clear that anything that is deemed to be inflationary would be boosting expectations for tighter monetary conditions and that in turn would lead to inflow of foreign funds into the economy. For example, when the economy creates more jobs than expected or when retail sales unexpectedly jump, in theory this will lead to a rise in aggregate demand and, over time, inflation.

As mentioned earlier, the processes I just described will obviously take several months and in some cases years to work through the economy, but in the eyes of speculators, the impact will be instantaneous on the currency markets. This is because of an economic assumption that investors are rational and efficient in discounting future cash flows. As technical analysts, we know that this is not exactly true, otherwise, trading wouldn’t exist. Nonetheless, the process does take place over a number of months and sometimes years, as more and more people adjust to changing economic conditions, and that’s why we have trends in the markets.

That, in a nutshell, is one of the simplest ways I can explain why currencies tend to rise and fall. Now that we know what moves the FX markets, let’s turn our focus to trading.



FX TRADING VS. STOCKS AND COMMODITY FUTURES

The first point I would like to make here is that much like trading stocks and commodity futures, you don’t need to know much about the fundamentals if you have a good technical strategy that has a proven track record. Nonetheless, it is important to at least be aware of the fundamentals and know, for example, when a major central bank announcement is due. It is of course advantageous to be in sync with the fundamentals when making trading decisions based on technical levels, as this would most likely improve results.

FX trading is similar to trading stocks or futures, except you are buying or selling one country’s currency against another’s. Instead of shares or futures, you are buying or selling a number of currency units called lots. The standard size for a lot is 100,000 units of currency, but mini (10,000 units), micro (1,000), and even nano (100) are also available for those with smaller account sizes. A one-pip (or 100th of a cent) movement for a standard lot corresponds with a \$10.00 change; for a mini it is \$1.00, micro \$0.10, and nano \$0.01.

With smaller lot sizes, traders can perhaps manage their positions better, just as they can with inexpensive stock shares. For example, smaller lot sizes may allow the FX trader to take partial profits along the way, while keeping some in the market in order to ride the trend, if one emerges. With expensive stock shares, this isn’t an option for traders with small account sizes, and in most cases the higher margin requirements might be an additional factor preventing use of proper position management.

Moreover, since stocks have shorter trading hours than FX and more risk of the stock gapping, a stock trader may decide against holding (part of) their positions open to ride the trend.

FX trading opens up a vast number of markets, significantly increasing trading opportunities on a day-to-day basis. As well as the major pairs such as the EUR/USD and USD/CAD, speculators can trade exotic pairs such as the SGD/JPY. While stock market traders have the same advantage, equity markets tend to have a stronger positive correlation with one another, meaning that on any given day, a highly liquid stock such as Facebook (FB) or Morgan Stanley (MS) might go up and down with the wider stock markets, depending on sentiment on the day. In FX, while movements in some currencies will obviously be correlated, this isn't the case for all pairs. For example, the volatility in USD/JPY will have no obvious impact on the EUR/GBP or AUD/NZD.

So traders who have an eye for only spotting long opportunities may have a tough time finding opportunities when the stock market is in a correction phase. But the same trader, using the same technical tools at his disposal, can use his skills and knowledge to look for long opportunities in an FX market that is trending higher. Likewise, a trader whose specialty is trading the ranges may have a hard time when the stock markets are rallying or falling sharply. But in FX, you are bound to find a pair or cross that is range-bound even during periods of high volatility for most major pairs.

Another advantage of trading currencies over stocks is that traders can speculate on macro drivers of the economy such as data and geopolitical events. While macro events can also impact certain stocks and sectors the same way, the reaction may not always be straightforward, as stock investors also need to take company- or sector-specific news into consideration. With FX, therefore, you don't have to worry about micro and

company-specific news, arguably making it a less risky asset class to trade.

What's more, FX markets trade 24 hours, 5.5 days a week as opposed to only being open during exchange hours. This means more trading opportunities and it reduces the prospects of seeing large gaps, which are typical of stocks when some fundamental stimulus (either company-specific news like earnings or a macro event) causes a large void at the next day's open.

Because of its reduced risk profile, the margin requirements for FX tend to be lower over stocks and some other asset classes, meaning speculators can control more with less capital.

Trading stocks has its own advantages over FX. Among other things, typical retail investors can't see spot FX trade volume as they can when trading stocks and futures. Volume with price action can arguably provide more information about the market's next move, compared with price alone. Also, there won't be any ambiguity over the price of a stock since stocks are traded on exchanges. FX prices can be slightly different from broker to broker, or significantly different on Brexit-like events.



HOW TECHNICALLY FRIENDLY IS FX?

The slightly more opaqueness of FX over stocks (due to invisibility of volume for most retail investors) and that they are traded 24 hours arguably makes FX a more technical-friendly asset class compared to stocks. You could argue here that by utilizing the volume profile, trading stocks can provide more confirmation and therefore lead to better, more informed, decisions. While that may be the case, the counterargument by spot FX traders is that with no knowledge of volume, traders are more likely to treat key support & resistance levels with the same level of respect and therefore



FIGURE 1: GOVERNMENT BOND YIELDS. These are one of the fundamental drivers of forex. The yield spread between the 10-year German and US bonds has had a strong positive correlation with the EUR/USD exchange rate. One of the many ways speculators could use this type of correlation is by looking for signs of divergence.

more likely to act around such levels (by buying and selling). Their actions around such levels usually provide short-term tradable bounces, which could provide a profit even if price eventually breaks through that level. Also, that they are traded 24 hours a day reduces the risks of price gapping through such key technical levels.

INTERMARKET ANALYSIS: AN ALTERNATIVE

Intermarket analysis is a form of technical analysis that observes the relationship between various asset classes such as stocks, bonds, commodities, and currencies. This form of analysis can be especially useful to FX over other types of asset classes.

The most obvious example is in the utilization of government bond yields, which tend to be among the biggest fundamental drivers of FX, as explained earlier. When country A’s yields rise at a faster pace than B’s due, for example, to better economic performance, the exchange rate tends to rise in favor of A. To illustrate this point, refer to the chart in Figure 1, which shows the yield spread between 10-year German and US bonds. As can be seen, this spread has had a strong positive correlation with the EUR/USD exchange rate. One of the many ways that speculators could use this type of correlation is by looking for signs of divergence.

In this example, the EUR/USD made a higher high in early 2018 relative to its old high around September 2017. But at the same time, the German–US yield spread had made a lower high. This was a clear sign that the EUR/USD had risen above its fundamental value based on interest rate differentials. This should have put speculators on the lookout for bearish technical setups on the EUR/USD. One clear sell signal subsequently emerged when the EUR/USD broke below the support of its triangle pattern in April 2018 around the 1.2200 handle. Another similar setup with the yields spread showing a negative

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difference was made in September 2018. This time, the break of the trendline on the EUR/USD could have been a very good sell setup.

In addition, you have the likes of the Canadian dollar and Norwegian krone, which tend to correlate positively with oil prices given that crude makes up a large portion of these nations’ exports. What’s more, changes in prices of iron ore or copper tend to move the Australian dollar, while the New Zealand dollar tends to move along with unexpected changes in dairy prices. To illustrate this, take a look at Figure 2, showing the relationship between WTI oil and the CAD/JPY. Like the EUR/USD example, crude prices made a lower high while the CAD/JPY made a higher high and thus formed a negative divergence. Oil prices went on to fall sharply well before the CAD started to move. One straightforward entry on the CAD/JPY would have been to sell the rounded retest of the broken support level around the 103.60 area in January 2015. Another obvious entry would have been in June that year, when the CAD/JPY broke the short-term bullish trendline.

Furthermore, there are so-called “safe-haven” currencies such as the Japanese yen and Swiss franc that come into focus



FIGURE 2: RELATIONSHIP BETWEEN WTI AND CAD/JPY. Crude prices made a lower high while the CAD/JPY made a higher high and thus formed a negative divergence. Oil prices went on to fall sharply, well before the CAD started to move.



FIGURE 3: SAFE-HAVEN CURRENCIES VS. INDEXES. The USD/JPY and S&P 500 generally go up and down in unison. Speculators could have bought the dips back into support on the USD/JPY, based on the bullish behavior of the stock markets.

particularly during stock market rallies and turmoil. In Figure 3, this relationship is highlighted by the USD/JPY and S&P 500, both generally going up and down in unison. In this example, the S&P 500 made a double-bottom low in April while the USD/JPY made a lower low. A month later, the S&P formed a higher low and once again, the USD/JPY formed a lower low. Both cases were examples of positive divergence. Speculators could have bought the dips back into support on the USD/JPY, based on the bullish behavior of the stock markets, such as the areas highlighted on the chart.

Once you realize that it is the changes in interest rate expectations that move currencies, everything else will fall into place.





IT'S A UNIQUE MARKET

The FX markets are like no other. On a day-to-day basis, there can be a significant number of tradable opportunities, whether based on technicals or fundamentals. The trading week is longer than in the stock market and almost all other markets (with the exception of cryptocurrencies, which are open 24 hours a day, seven days a week). The FX market has many advantages over stocks for a typical retail trader, although it has some disadvantages too.

Fawad Razaqzada is an economist and market analyst who has been involved in the financial markets for almost 10 years. He has worked for several leading brokerages as a market analyst in London. Specializing in forex, commodities, and stock

indexes, Razaqzada has expertise in reading price action on the charts. He uses his knowledge of economics together with fundamental analysis to forecast short-term price fluctuations. He has also been trading his personal account for many years. You can follow him on Twitter at @Trader_F_R.

FURTHER READING

Triennial Central Bank survey of foreign exchange and OTC derivatives markets in 2016. Retrieved on Nov. 6, 2018 from <https://www.bis.org/publ/rpfx16.htm>.



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