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Trading Forex Interventions

How to Make the Central Banks of Japan & Switzerland Work for You

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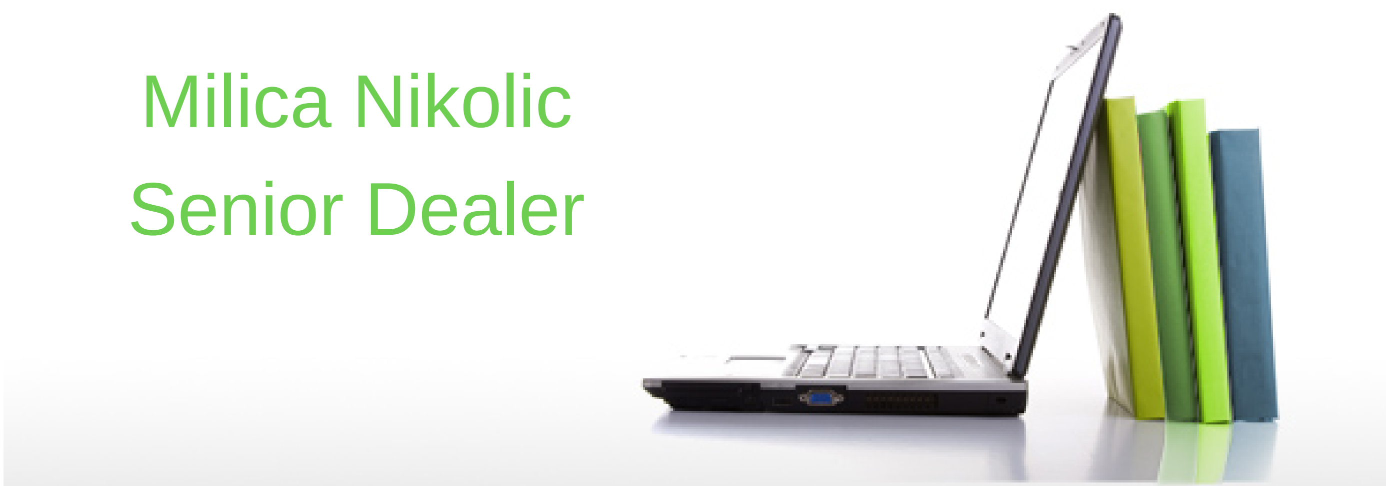

Outline

- What are interventions and why do they happen?
- What do interventions mean for forex traders?
- How to identify when an intervention might occur
- How to trade an intervention
- Key differences between Switzerland and Japan & what they mean to us
- The bottom line

How would you like to make $49,547 in 2h?

If you had bought $1,000,000 of USDJPY on Oct. 31, 2011 at 75.58 and sold 2 hours later at 79.52, you could have.

It would have worked like this:

1. First buy $1,000,000 and sell 75,580,000 yen (100,000*75.58)
2. In 2 hours, USDJPY increases to 79.52
3. Then sell $1,000,000 and buy 79,520,000 yen, to realize a gain of 3,940,000 yen
4. In dollar terms, the profit would be 3,940,000/79.52 = $49,547

Who was on the other end taking the huge loss?

The Central Bank of Japan!

But…Why would they do this?

They were carrying out an **‘intervention’**

Before we discover why they do it, let’s review the economics of the currency markets

A Brief Economics Lesson

- Forex revolves around **currencies** and their **value** against one another – i.e. the ‘exchange rate’
- They play a big role in domestic & global economics – for example, exchange rates set the prices of Imports & Exports

So..how are exchange rates determined?

In one of 2 ways:

1. By the market, through supply & demand forces
2. By Governments, i.e. Central Banks – this is known as ‘pegging’ a country’s currency to another major currency

A Brief Economics Lesson

A country can influence the exchange rate through:

1. Adjusting Interest Rates – this is gradual
2. Buying or Selling its currency in the forex market – very fast – **THIS IS KNOWN AS INTERVENTION**

If the country cannot reduce its interest rates further, or needs to react to an exchange rate fluctuation quickly, option 1 is not possible, so they have to **intervene.**

Take USDJPY for example. In 2011, the Bank of Japan intervened 3 times to keep the Yen from getting stronger than the Dollar. Why?

Strong JPY

- Makes exports more expensive
- Hinders Economic Growth

On 31 Oct 2011, Japan sold a record **¥7.5 trillion** in an intervention!

Trading Interventions

- Interventions present an interesting opportunity
- A negative catalyst like a big recession or national debt, can indicate that a country’s currency should be weaker
- Recent U.S. & EuroZone recessions caused the EUR & USD to fall rapidly in relation to CHF, whose value rose fast
- Traders could speculate an intervention was likely, which would cause sharp price moves in the short term
- There’s an opportunity for traders to profit by taking a position **before** the intervention, and **exiting** after the intervention
- Trading against the trend & looking for an intervention, especially when leveraged, can be extremely dangerous – a lot of capital can be lost in short time - should be reserved for speculation traders only

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Interventions on a Graph – USDJPY Daily

Interventions on a Graph – EURCHF Daily

When Will an Intervention Occur?

- Interventions usually occur around the same price level as previous interventions – e.g. around 75.60-76 for USDJPY, and 1.2000 for EURCHF
- Sometimes there are verbal clues prior to interventions
  - Before Japan's last intervention on 31 October, Japan's prime minister Noda repeatedly suggested action needed to be taken
  - Switzerland has committed to keep EURCHF above 1.2000
  - Words alone are not always enough to move the markets. The more often traders hear these threats with no action, the less impact they have
- Analysts often give good estimates of intervention levels. Keep an eye on foreign exchange analysts from popular banks and investment firms

How to Trade the Intervention?

- There are 2 possible strategies
- **1. Open before the intervention and wait for the intervention. Exit right after.**
- **2. Open right after the intervention, anticipating the trend to resume.**
- Let’s take a closer look at each strategy.

1. Open before intervention and wait for it

- Gauge the expected intervention start & end prices by looking at previous intervention moves
- Always use stop loss & take profit to lock in gains & limit losses
  - Set the stop-loss at a reasonable level but leave enough room for pre-intervention downside
  - Take-profits should be set at previously attained intervention highs
  - Use sms price alerts to get instant notification of rapid price moves
- In case your take profit isn't reached, watch the charts to get out at the right moment before the inevitable drop
- Use as little margin as possible. Since you're trading against the long-term trend, margin calls become a significant risk if an intervention doesn't occur when planned
- Instead of opening a trade & waiting, you can set a buy limit order expecting the price to go there, fill it, and then change direction. However, there's a risk of the limit order not being captured.

2. Open after intervention expecting trend to hold

- Great opportunity to open positions in the same direction as the recent trend
- The effects of interventions are usually short-lived, especially uncoordinated interventions from Japan
- Switzerland has committed to an exchange rate floor so better to use this strategy on the JPY
- After an intervention, one can enter a trade anticipating the long-term trend to continue, getting in at a good price
- Choose a reasonable stop loss, and target a take profit several times the margin
- Strategy is good in case the chance to trade during the intervention is missed

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USDJPY Daily Downtrend

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Important differences between Japan & Switzerland

Switzerland	Japan
Small economy, population 8 million	Third largest world economy, member of G7, 10th largest world population (over 125 million)
Free to control its exchange rate without major objections/interferences	Any exchange rate target would attract intense criticism from Europe & North America – would also make it harder to push China to appreciate the Yuan faster
CHF recently reached record highs against both EUR & USD	JPY not trading at extreme levels in real, trade-weighted terms
Imposed EURCHF peg above 1.2000 soon after	Unlikely to impose a peg due to G7 pressure
Swiss gov't & corporate bond markets limited in size. Switzerland must print money & sell CHF to buy foreign bonds	More policy options available - Japan can print money & buy domestic gov't bonds – don't need to use exchange rate to loosen monetary policy

The Bottom Line

- Interventions occur when Central Banks use their reserves to quickly adjust the value of their currency
- Trading Interventions can be extremely profitable, but is mostly for speculators
- Watch price levels, listen to finance ministers & read market research to spot potential interventions
- Use low leverage & smart money management
- Open a trade and wait for an intervention with an appropriate stop loss and take profit, or
- Open a trade in the opposite direction post intervention, following the long term trend.

Questions?

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