Forex Fundamentals Simplified

Those trading in the foreign-exchange market (forex) rely on the same two basic forms of analysis that are used in the stock market: fundamental analysis and technical analysis. The uses of technical analysis in forex are much the same: price is assumed to reflect all news, and the charts are the objects of analysis. But unlike companies, countries have no balance sheets, so how can fundamental analysis be conducted on a currency?

Since fundamental analysis is about looking at the intrinsic value of an investment, its application in forex entails looking at the economic conditions that affect the valuation of a nation's currency. Here we look at some of the major fundamental factors that play a role in the movement of a currency.

The effects of these reports are comparable to how earnings reports, SEC filings and other releases may affect securities. In forex, as in the stock market, any deviation from the norm can cause large price and volume movements.

Economic Data

Economic theories may move currencies in the long term, but on a shorter-term, day-to-day or week-to-week basis, economic data has a more significant impact. It is often said the biggest companies in the world are actually countries and that their currency is essentially shares in that country. Economic data, such as the latest gross domestic product (GDP) numbers, are often considered to be like a company's latest earnings data. In the same way that financial news and current events can affect a company's stock price, news and information about a country can have a major impact on the direction of that country's currency. Changes in interest rates, inflation, unemployment, consumer confidence, GDP, political stability, housing stats etc. can all lead to extremely large gains/losses depending on the nature of the announcement and the current state of the country.

These reports are released by the government or a private organization at scheduled times, providing the market with an indication of whether a nation's economy has improved or declined. The number of economic announcements made each day from around the world can be intimidating, but as one spends more time learning about the forex market it becomes clear which announcements have the greatest influence. Listed below are a number of economic indicators that are generally considered to have the greatest influence - regardless of which country the announcement comes from.

Employment Data

Most countries release data about the number of people that currently are employed within that economy. In the U.S., this data is known as non-farm payrolls and is released the first Friday of the month by the Bureau of Labor Statistics. In most cases, strong increases in employment signal that a country enjoys a prosperous economy, while decreases are a sign of potential contraction. If a country has gone recently through economic troubles, strong employment data could send the currency higher because it is a sign of economic health and recovery. On the other hand, high employment can also lead to inflation, so this data could send the currency downward. In other words, economic data and the movement of currency will often depend on the circumstances that exist when the data is released.

Interest Rates

As was seen with some of the economic theories, interest rates are a major focus in the forex market. The most focus by market participants, in terms of interest rates, is placed on the country's central bank changes of its bank rate, which is used to adjust monetary supply and institute the country's monetary policy. In the U.S., the Federal Open Market Committee (FOMC) determines the bank rate, or the rate at which commercial banks can borrow and lend to the U.S. Treasury. The FOMC meets eight times a year to make decisions on whether to raise, lower or leave the bank rate the same; and each meeting, along with the minutes, is a point of focus. (For more on central banks read

Inflation

Inflation data measures the increases and decreases of price levels over a period of time. Due to the sheer amount of goods and services within an economy, a basket of goods and services is used to measure changes in prices. Price increases are a sign of inflation, which suggests that the country will see its currency depreciate. For example, if the inflation rate is 2%, then a $1 pack of gum will cost $1.02 in a year. Most countries' central banks will try to sustain an inflation rate of 2-3% In the U.S., inflation data is shown in the Consumer Price Index, which is released on a monthly basis by the Bureau of Labor Statistics.

Gross Domestic Product
The gross domestic product of a country is a measure of all of the finished goods and services that a country generated during a given period. The GDP calculation is split into four categories: private consumption, government spending, business spending and total net exports. GDP is considered the best overall measure of the health of a country's economy, with GDP increases signaling economic growth. The healthier a country's economy is, the more attractive it is to foreign investors, which in turn can often lead to increases in the value of its currency, as money moves into the country. Most traders focus on the two reports that are issued in the months before the final GDP figures: the advance report and the preliminary report. Significant revisions between these reports can cause considerable volatility. In the U.S., this data is released by the Bureau of Economic Analysis once a month in the third or fourth quarter of the month

Durable Goods
The data for durable goods (those with a lifespan of more than three years) measures the amount of manufactured goods that are ordered, shipped and unfilled for the time period. These goods include such things as cars and appliances, giving economists an idea of the amount of individual spending on these longer-term goods, along with an idea of the health of the factory sector. This measure again gives market participants insight into the health of the economy, with data being released around the 26th of the month by the Department of Commerce.

Retail Sales
The retail-sales report measures the total receipts of all retail stores in a given country, This measurement is derived from a diverse sample of retail stores throughout a nation. The report is particularly useful because it is a timely indicator of broad consumer spending patterns that is adjusted for seasonal variables. It can be used to predict the performance of more important lagging indicators, and to assess the immediate direction of an economy, increased spending signals a strong economy, Revisions to advanced reports of retail sales can cause significant volatility. The retail sales report can be compared to the sales activity of a publicly traded company. the Department of Commerce releases data on retail sales around the middle of the month.

Industrial Production
This report shows the change in the production of factories, mines and utilities within a nation. It also reports their 'capacity utilizations', the degree to which the capacity of each of these factories is being used. It is ideal for a nation to see an increase of production while being at its maximum or near maximum capacity utilization.
Traders using this indicator are usually concerned with utility production, which can be extremely volatile since the utilities industry, and in turn the trading of and demand for energy, is heavily affected by changes in weather. Significant revisions between reports can be caused by weather changes, which in turn, can cause volatility in the nation's currency.

Consumer Price Index (CPI)
The CPI is a measure of the change in the prices of consumer goods across over 200 different categories. This report, when compared to a nation's exports, can be used to see if a country is making or losing money on its products and services. Be careful, however, to monitor the exports - it is a focus that is popular with many traders because the prices of exports often change relative to a currency's strength or weakness.

Some of the other major indicators include the purchasing managers index (PMI), producer price index (PPI), durable goods report, employment cost index (ECI), and housing starts. And don't forget the many privately issued reports, the most famous of which is the Michigan Consumer Confidence Survey. All of these provide a valuable

Macroeconomic and Geopolitical Events
The biggest changes in the forex often come from macroeconomic and geopolitical events such as wars, elections, monetary policy changes and financial crises. These events have the ability to change or reshape the country, including its fundamentals. For example, wars can put a huge economic strain on a country and greatly increase the volatility in a region, which could impact the value of its currency. It is important to keep up to date on these macroeconomic and geopolitical events.

Trade and Capital Flows

Interactions between countries create huge monetary flows that can have a substantial impact on the value of currencies. As was mentioned before, a country that imports far more than it exports could see its currency decline due to its need to sell its own currency to purchase the currency of the exporting nation. Furthermore, increased investments in a country can lead to substantial increases in the value of its currency.

Trade flow data looks at the difference between a country's imports and exports, with a trade deficit occurring when imports are greater than exports. In the U.S., the Commerce Department releases balance of trade data on a monthly basis, which shows the amount of goods and services that the U.S. exported and imported during the past month. Capital flow data looks at the difference in the amount of currency being brought in through investment and/or exports to currency being sold for foreign investments and/or imports. A country that is seeing a lot of foreign investment, where outsiders are purchasing domestic assets such as stocks or real estate, will generally have a capital flow surplus.

Balance of payments data is the combined total of a country's trade and capital flow over a period of time. The balance of payments is split into three categories: the current account, the capital account and the financial account. The current account looks at the flow of goods and services between countries. The capital account looks at the exchange of money between countries for the purpose of purchasing capital assets. The financial account looks at the monetary flow between countries for investment purposes.

Real Interest Rate Differentiation Model

The Real Interest Rate Differential Model simply suggests that countries with higher real interest rates will see their currencies appreciate against countries with lower interest rates. The reason for this is that investors around the world will move their money to countries with higher real rates to earn higher returns, which bids up the price of the higher real rate currency.

Asset Market Model

The Asset Market Model looks at the inflow of money into a country by foreign investors for the purpose of purchasing assets such as stocks, bonds and other financial instruments. If a country is seeing large inflows by foreign investors, the price of its currency is expected to increase, as the domestic currency needs to be purchased by these foreign investors. This theory considers the capital account of the balance of trade compared to the current account in the prior theory. This model has gained more acceptance as the capital accounts of countries are starting to greatly outpace the current account as international money flow increases.

Monetary Model

The Monetary Model focuses on a country's monetary policy to help determine the exchange rate. A country's monetary policy deals with the money supply of that country, which is determined by both the interest rate set by central banks and the amount of money printed by the treasury. Countries that adopt a monetary policy that rapidly grows its monetary supply will see inflationary pressure due to the increased amount of money in circulation. This leads to a devaluation of the currency. These economic theories, which are based on assumptions and perfect situations, help to illustrate the basic fundamentals of currencies and how they are impacted by economic factors. However, the fact that there are so many conflicting theories indicates the difficulty in any one of them being 100% accurate in predicting currency fluctuations. Their importance will likely vary by the different market environment, but it is still important to know the fundamental basis behind each of the theories.

Employment Cost Index – ECI

A quarterly report from the U.S. Department of Labor that measures the growth of employees' compensation (wages and benefits). The index is based on a survey of employer payrolls in the final month of each quarter. The ECI tracks movement in the cost of labor, including wages, fringe benefits and bonuses for employees at all levels of a company.

The idea behind analyzing ECI is that as wage pressures increase, so does inflation because compensation tends to increase before companies increase prices for consumers. Thus, it is considered inflationary when the ECI has an increasing trend or exhibits a jump that is higher than expected for a given period. In addition, as inflation increases, yields and interest rates

Producer Price Index – PPI

A family of indexes that measures the average change in selling prices received by domestic producers of goods and services over time. PPIs measure price change from the perspective of the seller. The PPI looks at three areas of production: industry-based, commodity-based, and stage-of-processing-based companies

Purchasing Managers' Index – PMI

An indicator of the economic health of the manufacturing sector. The PMI index is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employmentenvironment.

A PMI of more than 50 represents expansion of the manufacturing sector, compared to the previous month. A reading under 50 represents a contraction, while a reading at 50 indicates no change. Prior to September 1, 2001, the acronym (PMI) stood for Purchasing Managers' Index. The Institute of Supply Management (ISM) now uses only the acronym, PMI. Although the ISM publishes several indexes, the PMI is the most widely followed and is sometimes referred to as the ISM index.

Earnings

The amount of profit that a company produces during a specific period, which is usually defined as a quarter (3 calendar months) or a year. Earnings typically refer to after-tax net income.Ultimately, a business's earnings are the main determinant of its share price, because earnings and the circumstances relating to them can indicate whether the business will be profitable & successful in the long run.

Earnings are perhaps the single most studied number in a company's financial statementsbecause they show a company's profitability. A business's quarterly and annual earnings are typically compared to analyst estimates and guidance provided by the business itself. In most situations, when earnings do not meet either of those estimates, a business's stock price will tend to drop. On the other hand, when actual earnings beat estimates by a significant amount, the share price will likely surge

So, How Are These Used?

Since economic indicators gauge a country's economic state, changes in the conditions reported will therefore directly affect the price and volume of a country's currency. It is important to keep in mind, however, that the indicators discussed above are not the only things that affect a currency's price. There are third-party reports, technical factors, and many other things that also can drastically affect a currency's valuation. Here are a few useful tips that may help you when conducting fundamental analysis in the foreign exchange market:

- Keep an economic calendar on hand that lists the indicators and when they are due to be released. Also, keep an eye on the future; often markets will move in anticipation of a certain indicator or report due to be released at a later time.
- Be informed about the economic indicators that are capturing most of the market's attention at any given time. Such indicators are catalysts for the largest price and volume movements. For example, when the U.S. dollar is weak, inflation is often one of the most watched indicators.
- Know the market expectations for the data, and then pay attention to whether or not the expectations are met. That is far more important than the data itself. Occasionally, there is a drastic difference between the expectations and actual results and, if there is, be aware of the possible justifications for this difference.
- Don't react too quickly to the news. Oftentimes, numbers are released and then revised, and things can change quickly. Pay attention to these revisions, as they may be a useful tool for seeing the trends and reacting more accurately to future reports.

Conclusion

There are many economic indicators, and even more private reports that can be used to evaluate the fundamentals of forex. It's important to take the time to not only look at the numbers, but also understand what they mean and how they affect a nation's economy. When properly used, these indicators can be an invaluable resource for any currency trader