Kathleen Brooks on FOREX

A simple approach to trading foreign exchange using fundamental and technical analysis

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By Kathleen Brooks

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About the author

Kathleen Brooks is a research director for **Forex.com**, a retail FX broker based in London. She uses both fundamental and technical methods in her analysis and fuses the two to get a complete picture of the market.

She is a regular contributor to Yahoo Finance and Reuters Great Debate, and she is often quoted in international publications including the *Wall Street Journal* and the *Financial Times*. She can be seen regularly on business TV including CNBC, Bloomberg, CNBC Arabia, Sky News Australia and the BBC. She started her career in finance at BP where she worked first as a business analyst in its trading division and then as a trading analyst in its foreign exchange dealing room. Prior to joining **Forex.com** she was a financial features writer for *City A.M.*

Kathleen holds an undergraduate degree in English Literature and Classical Civilisation from Trinity College Dublin, and a Master of Science from the Graduate School of Journalism at Columbia University in New York City.

Preface

What this book covers

Since you opened this book then I guess you are interested in foreign exchange, have traded it and want to hone your skills and increase your chances of making a profit. I have been working, learning and trading in foreign exchange for the bulk of my career and over the years I have developed my own philosophy for understanding the largest asset market in the world. It's not your standard approach, but I think that it will strike a chord with traders and that is why I want to share it with you in this book.

There are two main ways of analysing foreign exchange:

1. Using fundamental analysis; and
2. Using technical analysis.

Most people in the markets either look at fundamental analysis *or* technical analysis. But when I first started out in FX, restricting myself to looking at only one of either fundamental and technical factors didn't seem right to me. I always felt that something was missing. These approaches were either way too complex or they were too prescriptive. I wanted something that I could grasp and that made sense to me.

That was when I decided to ditch the dogmatic strategies that pervade the FX market and forge an approach of my own. In the course of my learning about FX I found that I understood the markets best by using neither technical analysis nor fundamental analysis in isolation, but by using them together.

I believe that fundamental factors – politics, economics and even society – cause currency prices to move the way they do (and sometimes in the strangest ways), but throughout the day the smallest price movements are usually based upon technical factors. So you'll get no fundamental or technical purist rhetoric here: my approach is to combine the two. It works for me and I hope by reading about it you'll pick up some ideas for your own trading.

My aim in this book is to teach you my approach to trading the FX market. I assume you already have some knowledge of trading this market – I won't go over the basics, such as giving you an intricate history of a pip, or explaining what a currency cross is. Plenty of pages (both in print and on the web) can give you this information and help you to take your first steps into trading. The website Baby Pips (**www.babypips.com**) is one of my favourites; it provides a great overview for the novice FX trader. Investopedia (**www.investopedia.com**) is another useful resource for an early introduction to the foreign exchange market.

So, rather than presenting you with another *FX 101* I hope to provide a fresh way to view the FX market. This should help you with setting up and executing your trades.

I am a firm believer in learning from observation so this book is packed full of real-life examples and trading set-ups from my recent analysis of the foreign exchange market. Some things deserve a little context or explanation, but I have tried to show more than tell.

The first two parts of this book will look at fundamental and then technical analysis separately before I show you how I combine the two in part C. Part D shows you how I execute my trading strategy in the market using my tried and tested risk management techniques.

Introduction

It was 2006 and I had just joined the forex trading desk at BP as a junior trading analyst. I was a novice, in fact extremely novice, probably the least experienced person that had ever walked on to the BP trading floor. Hence I was not only a young female on a desk full of men but I didn't even have a finance or economics degree. In sum I was totally clueless.

The patience of the traders, the chief dealer and my direct boss, the head of the analytics desk, was amazing. They got me up to scratch on bids and offers, what a pip was and how to trade. They also taught me how fundamentals impact the market. The crossover between central banks, economic data and even politics gripped my imagination and has determined my career path ever since.

In spite of this valuable tuition, when I started out there were a few things I just couldn't understand. Firstly, why was the dollar in such a steep decline? It had been heading south for years against the pound, the yen and the euro. I didn't understand why the dollar would always falter – what about the mean-reversion and efficient markets I had spent months learning about? Also, why did the dollar always seem to fall on *good* economic news out of the US?

If the currency was a reflection of the state of the economy then the US must be in deep economic trouble. But back then growth in America was quite strong and the financial crisis was still ahead of us.

Hence I would write long treatises about how oversold the dollar was, but I could never make a winning trade. I grasped economics and the markets fairly quickly, but something wasn't right. The dollar continued to go against me and I wanted to know why. That was when I learned a bit more theory about the importance of central banks, relative interest rate strategies, changing global growth dynamics and the concept of the safe haven.

As intelligent as I thought all of this new knowledge made me sound, I quickly realised that every time I thought the signals pointed to a stronger dollar, it weakened, and vice versa. Was this market nuts, or should I just give up the challenge of trying to teach myself something I knew nothing about and go and work in something more suited to my academic background?

Luckily I stuck with it and after some time I started to grasp that although you could be *fundamentally* right, you could be *technically* wrong. That was when it clicked; you need to use technical analysis too.

Back to my desk at BP, the guy I sat next to was always trying to show off his technical analysis skills and used fancy words that he knew would confuse me. I kept looking over his shoulder and eventually picked up a few terms the technicians like to throw about: support, resistance, MACD (and no, it's not a burger), RSI and Fibonacci. This last point solidified my affection for the FX market. Fibonacci numbers may have been *discovered* by man but they are derived from nature and this resonated with me. There is a magical, almost mystical, side to how financial markets move, hence price movements tend to follow patterns in nature, and that was a major comfort to me.

Try as I might though, I could only get interested in a few of the elements of technical analysis. Too many lines on the chart, with bull and bear flags popping up every few minutes, left me blurry eyed. While I started to appreciate the benefits of technical analysis I needed something more. That was when it came to me – you can't trade just on the fundamentals or the technicals, you need to fuse them. It seemed to me that the medium-term direction of a cross was down to the fundamentals but the day-to-day price moves, or intra-daily price moves, were all down to technicals.

I decided to stop trying to do what I thought I should do and start doing what I enjoy. I decided to concentrate on the fundamentals and combine them with my favourite technical indicators. That was a match made in heaven for me. That's not to say that I became the most profitable trader in the world, but instead I started to enjoy what I was doing and felt more in control. Hence the birth of my forex philosophy.

After a spell away from foreign exchange and back at graduate school (still not economics, instead journalism) I re-entered the retail FX market a few years back. This has given me the chance to further refine my forex trading approach, which is what I will share with you.

Thank you for reading.

Kathleen Brooks, London, 2013

PART A

Fundamental Analysis

INTRODUCTION

The term *fundamental analysis* is very widely used, but what does it actually mean? The definition of *fundamental* includes:

The foundation or base, forming an essential component of a system and something of great importance.

There are also musical, religious and scientific definitions of fundamental but its definition in relation to the FX market is quite specific – it is the study of the underlying factors that drive a currency's price. In the FX market these underlying factors include the economy, central banks and politics.

We use fundamental analysis in the forex market to help us answer a few basic questions related to these factors, for example:

1. Which economies in the world are growing?
2. Is the growth healthy and sustainable?
3. What are governments and central banks doing to manage their economies?
4. What is the political situation?

The forex trader making use of fundamental analysis takes the answers to these questions and applies them to the decisions they make when placing a trade in the forex market. To explain how this is done I will work through some real-life examples of how to trade using fundamental analysis later in the book.

TRADING USING ECONOMIC DATA

The way to get the information needed for fundamental analysis is to look at the official economic data releases. For most of the world's major economies, economic data is released regularly and it gives a glimpse of the overall economy and how fast it is growing. The key thing for me is that economic growth means future prosperity, which should then equate to a strengthening currency. Traders seek out growth because that is usually where the best opportunities lie to jump on an uptrend. Alternatively, economic data showing weakness in a country's economy has the effect of weakening the currency.

The markets have a tendency to *price in* future growth and prosperity. The forex market, like the stock market, is thought to price in future growth expectations up to six months in advance. Hence markets don't wait for the GDP release that comes out every three months before deciding on the direction of a currency; they react to the incremental flow of data from economic indicators throughout the month in anticipation of what that means for GDP and the overall health of the economy.

In addition to GDP the other indicators include inflation data, retail sales, industrial and manufacturing data, and data on consumer confidence. These are a timely update on the state of the economy and the occasions of their release can be major market-moving events.

In fact, there are thousands of economic indicators and it could make you dizzy if you tried to analyse them all and determine what they mean for growth. As an example of some of the kookier ways of measuring economic growth, some people may look at the hog market to try and detect Chinese consumption of pork and use that to deduce the strength of the Chinese economy. Others have been known to search out demand for a certain chemical found in paint and then try to apply that to demand for housing in the US.

Thankfully there are more accessible ways to understand what is going on from an economic perspective and for some people it is most effective to narrow the list down to a few key indicators. It is also possible to prioritise the indicators so that you can organise your analysis and know which to pay most attention to. I will now move on to introduce the economic indicators that I have found to be of most use in my own fundamental analysis. Before I do, a couple of words on finding economic data.

Use of an economic calendar

It is important to know when economic data is released and the easiest way to get this information is by using a calendar. You can get reliable up-to-date calendars on economic news websites like Bloomberg (**www.bloomberg.com/markets/economic-calendar**), some blogs have them – like Forex Factory (**www.forexfactory.com**), and the financial press often prints economic calendars at the start of each week. Also, ask your FX broker as they may provide you with a free calendar. Some even contain widgets that let you place orders or trade directly from the calendar.

Consensus

The key thing for traders to remember is that the actual data that comes out is only relevant based on whether it hits, misses or exceeds *consensus*. Consensus is an important word for the markets. Usually economic data calendars include the market's expectation of the data release. The *expected* number is the mean of estimates from a number of economists who have been polled prior to the event and asked to give their views on what the number will be. Reuters and Bloomberg are some of the most popular data providers that measure the *street's* expectations prior to major data releases.

As a general rule, a data miss (the figures released are worse than the forecasts) can be currency negative, a number around expectations usually has a negligible effect, and if the reading exceeds expectations this tends to be currency positive.

ECONOMIC INDICATORS

In this section I introduce the four major fundamental indicators that I use to assess the forex market. These are:

1. Labour market surveys
2. Purchasing Managers Index (PMI) surveys and Institute for Supply Management (ISM) surveys
3. Inflation data
4. Quarterly GDP

For each I explain what the indicator is, when it is released, why it is significant and give examples of how it can be used.

1. Labour market surveys

What is it?

Without a shadow of a doubt the most important economic statistic for me is the US nonfarm payrolls (NFP) report. It is published by The Bureau of Labor Statistics and measures the number of jobs created in the nonfarm sector of the US economy each month.

When is NFP data released?

The first Friday of every month.

Why is NFP data significant?

American labour market statistics are important because they give an idea about the confidence of American businesses for the future. If a company believes growth will be strong for their product or service going forward they will hire more workers to meet the expected increase in demand. If they think demand is going to contract they will reduce their employee numbers.

Hiring by firms also has an impact on consumer confidence. If people have stable jobs then consumer confidence should be high and they will spend money, whereas if people are losing their jobs the first thing they usually do

is cut their spending. Since consumption makes up 70% of the US economy (a level that is far from unique in the West) and jobs are a key component of whether or not consumers are spending, you can understand why the market is so obsessed by this indicator.

NFP data has an enormous impact on all financial markets. Currencies can move more than they customarily would on any normal day and it's not unusual for the major dollar crosses to move a couple of hundred pips in either direction. Stock markets across the globe are also on high alert. Due to the huge amount of volatility that this data can generate, many traders in Asia and Australia stay awake or get up in the middle of the night to place a trade.

FX MARKET EXAMPLE

Lots of people trade before, during and after nonfarm payrolls, and for some of the major FX brokers it can be their busiest day of the month. But I will let you in on my secret: I don't trade the NFP release.

A colleague of mine used to sit patiently looking at his Bloomberg terminal on NFP Friday, as the payrolls report is called by the *street*, and when the number was released he looked at it, digested it and went about doing something else. He chose not to trade the actual figure itself.

This is an important lesson to all traders – economic data like the NFP can produce extremely volatile movement in the markets so some people prefer to wait for the dust to settle and trade when they have a better idea of what effect the NFP data has had. I follow this strategy (or non-strategy) over an NFP release.

Figure 1.1 shows you how volatile the immediate aftermath of an NFP release can be. I have chosen to show the impact the August 2012 data (released on 6 September) had on EURUSD, but it has a similar effect on USDJPY, AUDUSD, GBPUSD, etc. This was the EURUSD's initial reaction to a disappointing payrolls number; the forecast was for a 130k gain in the number of jobs created, but the reality was that only 96k were created and this was considered a disappointment.

The data was released at 13.30 BST and the initial reaction was that the euro sold off sharply, dropping from 1.2650 to 1.2590 in a matter of seconds. It then meandered lower to 1.2570 before rebounding strongly to 1.2650 – back to where it started! – before the end of the London session. This shows you how erratic the market can be during this data release.

There are many reasons why the market can be so erratic on NFP Friday. Firstly, NFPs are one of the earliest releases each month and they are a bit like a new piece of the US economic jigsaw. Since the economy in the US is a complex beast, new information about its strength or weakness can cause shock waves in the financial markets, particularly the FX market. Secondly, hundreds of billions, if not trillions, are being traded during the release, which also causes excess volatility.

Figure 1.1: EURUSD on NFP Friday (6 September 2012)

In the above example it would have been so easy to get caught on the wrong side of that trade. NFP data can be particularly hard to predict so rather than take a bet on whether the number will beat or miss expectations, I wait it out.

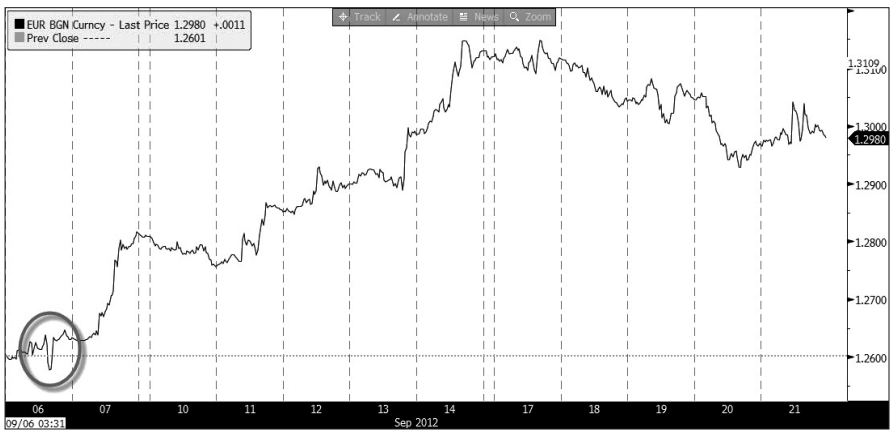
Instead my trading strategy for NFPs is more long term. I do two things immediately after the NFP release:

1. Digest what the data is showing; and
2. Decide if that is good or bad for the future trajectory of EURUSD.

On this occasion the data miss was extremely significant as it rounded off a week of bad economic data from the US. This data added to the body of evidence that the US economy was slowing down and would need some help from the US central bank to get going again (see the interest rate section for more).

Since central bank stimulus in the past has been dollar negative, I decided to put on a long EURUSD trade at 1.2650. Some may argue that I bought at the high of the day – how can that be a good trade!? – but in Figure 1.2 you will see that EURUSD rallied a staggering 400 points in the week after the NFP data was released. The circled area shows where I entered the trade, on 6 September 2012.

Figure 1.2: EURUSD (6 September to 21 September 2012)



2. Purchasing Managers Index (PMI) and Institute of Supply Management (ISM) surveys

What is it?

Purchasing Managers Index (PMI) surveys in Europe and China, and Institute of Supply Management (ISM) surveys in the US, are arguably the second most important pieces of economic data after NFPs.

They are useful for the currency trader for a couple of reasons. Firstly, they are used around the world and are not just US centric like payrolls, thus they can be a good gauge of global growth. Secondly, they are a snapshot of business sentiment in a wide variety of areas like exports, new orders and inventory levels. The results can be used to predict hiring patterns and also the strength of consumer demand.

PMI and ISM surveys originally focused on the manufacturing sector but as the manufacturing surveys evolved and grew in popularity they have expanded to the services and construction sectors. Each country's PMI survey polls hundreds of domestic businesses on the level of new orders they have received, order backlogs, shipment orders, the prices they pay for materials, employment, new export orders and imports.

In the euro zone the fusion PMI Composite index is an important indicator of the overall performance of the currency bloc's economy.

These surveys are conducted around the middle of the month before the data is released. The result is a diffusion index that measures expansion or contraction in service and manufacturing businesses. These indexes have values between 0 and 100, with 50 acting as the line between expansion and contraction. A strong release is above 50, a weak result is below 50.

When is the data released?

Usually the first week of every month (the exact day depends on each country). China and Europe do things differently and release first and second readings of their PMI surveys. The first reading is usually the third week of the survey month; the second reading usually takes place the first week of the next month. However, check your economic calendar as sometimes the timings can differ.

Why are they significant?

These surveys tend to have a close relationship with GDP data and are a timely signal of the growth (or lack of) in an economy. As I mentioned at the start of the chapter, the currency trader is always looking for where growth is strong and also where it is weak in order to find the best opportunities to go long or short a currency. ISM and PMI surveys provide this information.

FX market example

The actual PMI and ISM data releases can be good economic data to trade, in contrast to payrolls. For my part, I find it easier to read them. The index is either strong (above 50) or weak (below 50). Revisions are only relevant for the euro zone and China and they tend to be small, thus this is a well-respected and reliable gauge of economic strength or weakness.

When I trade the actual data release I tend to follow these steps:

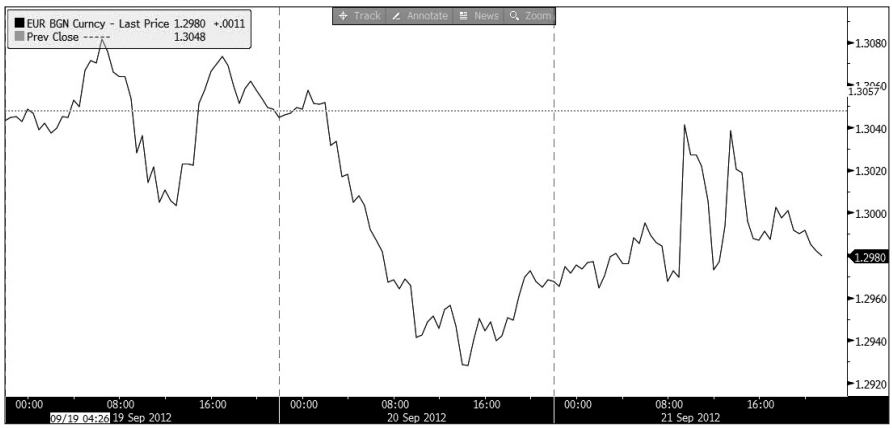
1. I know what day and time the data is being released.
2. I find out what the market consensus is – does the market expect a strong or weak release?
3. I come up with a trade plan. A number around consensus may only have a limited impact on the market; it's the outliers that tend to have the capacity to change trend. I find out the current trading range and look for support and resistance levels (see technical analysis chapter) that could double up as breakout zones. I may leave a buy order at the top of the range and a sell order at the bottom of the range just in case an outlier causes the cross to change trend.
4. At the time of the release I digest the number and make changes to my orders if necessary. Your broker should allow you to change orders without a charge.

A negative surprise in euro zone PMI data

Figure 1.3 shows EURUSD after the release of a weak preliminary reading of the September 2012 PMI data. The survey was below 50, which dashed hopes that the euro zone's struggling economy was starting to recover. This weighed heavily on EURUSD. As you can see this cross fell from 1.3040 all the way to 1.2920 in the aftermath of the news.

Although the euro recovered some of the losses during the next day's trading, this data is significant for the direction of the euro in the long term. The continued weakness in the euro zone economy could make some traders think twice before they put on a long euro trade in the coming weeks as the economic fundamentals look too weak to support the currency at a higher level.

Figure 1.3: EURUSD (20 September 2012)



GBP is also sensitive to PMI data releases. Let's take a closer look at the UK's October manufacturing PMI release on 1 November 2012. There are two ways to trade this piece of data:

1. Trade the data release itself, or

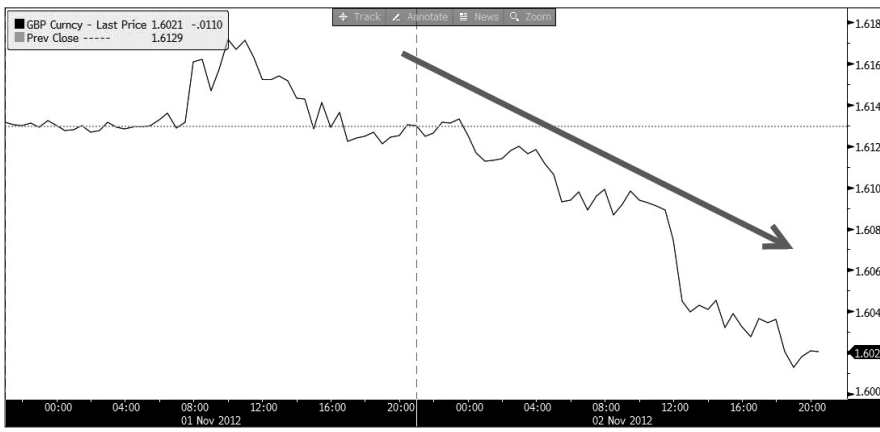
2. Wait to digest the data and then make your move.

Here is a trade set-up for trading the actual data release.

1. Homework: growth had been strong in the third quarter but the signs suggested that October had been weak and the strong performance could not be matched. Thus, there was a growing fear that the data may be even lower than broad expectations. Indeed, as it happened the data was weaker than expected for October as it came in at 48.4, whereas the market had expected a reading of 49.0. Also important to bear in mind was that GBPUSD had traded higher in the second half of October.

2. A data miss is likely to weigh on GBPUSD, so a sell order could be left around 1.6100 to benefit from this. As you can see in Figure 1.4, GBPUSD sold off sharply in the immediate days after the October PMI data miss.

Figure 1.4: GBPUSD short-term chart



Remember that trading around the data release can be volatile and extra risky, so this is usually a short-term strategy. A longer-term trader may prefer to trade once they have digested the release. However, in this example that would have only been profitable for a couple of weeks. In mid-November market sentiment shifted as risky currencies like the pound started to rally and the trend changed (see Figure 1.5).

Figure 1.5: GBPUSD 1-month chart

3. Inflation data

What is inflation data?

Inflation is an important part of a country's economic picture. Fundamental traders should always know what direction inflation data is moving and the pace of change for the economies of the currencies they are trading.

There are two types of inflation to look out for: *CPI (consumer price index)* data and also *PPI (producer price index)* data. The CPI data measures price changes paid by the consumer at the supermarket, shopping centre, etc. The PPI data measures the change in prices of items as they leave the factory gate.

There are also two components to the inflation picture to be aware of: headline and core prices. Headline inflation includes the price of food and energy, while core inflation strips food and energy prices out. Some central banks prefer to focus on the core measure as it is considered more stable. This is because energy and food prices can be extremely volatile – for example, the price of corn or vegetables can be impacted by a freak weather pattern that causes their price to soar one month over the next. This could cause a big spike in headline inflation, but it is likely to be a temporary phenomenon (hence the volatility).

Central banks don't want to change the direction of monetary policy based on a single factor affecting the price of corn, or any lone item, so they look at the core inflation rate instead, which is considered to be a smoother measure of price changes and trends in the economy.

When is inflation data released?

Inflation data is usually released in the middle of each month, but it does depend on the country. The euro zone, UK, US and China tend to release inflation data monthly, while Australia and New Zealand release it quarterly.

Be sure to consult an economic data calendar so that you know the date and time of these releases.

Why is inflation data significant?

Changes in price data are an important way to determine the state of the economy. Usually falling prices mean that activity is slowing, which can be

currency negative, while rising prices can mean that the economy is expanding, which can be good news for a currency.

Inflation data becomes interesting when it gets to extreme levels. So if a country's prices are deemed to be rising too fast it may cause the central bank of that country to adapt its policy to try to get the prices back under control. Central banks like steady increases in prices, and if prices rise or fall too quickly they usually react. This can have implications for the direction of currencies (see the section on interest rates to find out more).

FX MARKET EXAMPLES

EXAMPLE 1: US INFLATION AND USDJPY

While a single inflation data point may not be a major market moving event, its change over time can have huge implications for monetary policy and thus the direction of a currency. Figure 1.6 for the period late 2010 to summer 2012 shows core inflation in the US and also USDJPY. As you can see, as inflation rises it tends to mean a strong USDJPY rate. In contrast, when inflation started to fall in spring 2012 it dragged USDJPY down with it.

The trend in inflation does not follow the currency cross perfectly, as you can see in this chart, so this data point is better for the long-term trader with a multi-month view. If you are a short-term trader, make sure you keep up to speed with inflation data and which direction it is going, but it will be harder (if not impossible) for you to trade off inflation data alone.

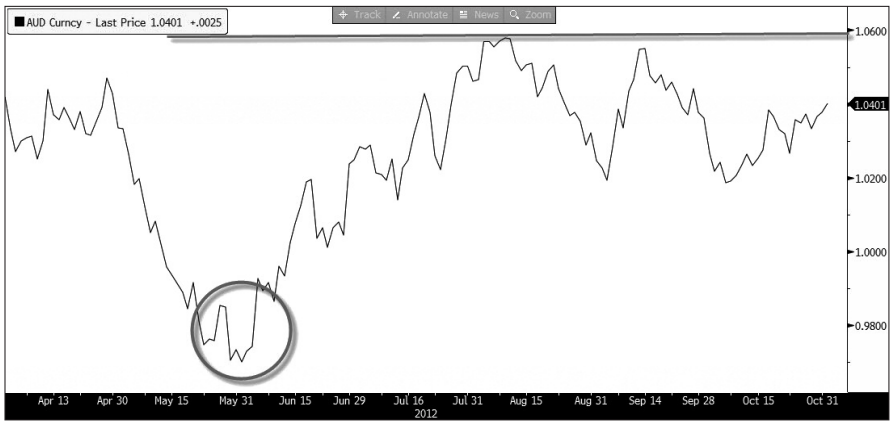
Figure 1.6: US inflation and USDJPY (late 2010 to summer 2012)

Example 2: Chinese inflation and AUDUSD

From April 2012 to November 2012 the Chinese inflation rate started to decline. This decline accelerated from July 2012. Declining inflation can be bad for a currency as it can suggest that the economy is slowing down. China does not have a free-floating exchange rate, so domestic economic data does not have a huge impact on the renminbi. However, the Aussie dollar has close trade links with China, and signs that growth and inflation were slowing in its important trade partner initially weighed on the AUDUSD, as you can see in Figure 1.7.

The Aussie sold off sharply from April to the end of May as the market digested signs of a Chinese slowdown. However, after that the Aussie recovered, but it didn't manage to break above a key resistance level of 1.06. Thus, although the relationship between AUDUSD and Chinese data is not perfect, Aussie gains were capped while Chinese data remained subdued.

Figure 1.7: AUDUSD daily chart (April to November 2012)



Inflation data is also useful for trading other fundamental events including central bank meetings and GDP releases. This means that even if I don't want to trade the inflation release itself I usually make a point of keeping an eye on the latest inflation release for currencies I am interested in.

4. Quarterly GDP

What is it?

This data is the ultimate snapshot of an economy's health. The technical definition of GDP is the market value of all goods and services produced by a country. It is also considered to be a measure of a country's standard of living.

The measurement of GDP was developed in the US in 1934 and the most common formula is:

GDP = private sector consumption + gross investment + government spending + (exports – imports)

Although it is reported quarterly, the data in the major economies usually includes an annual growth rate, so you can see how the economy performed in the past 12 months.

When is GDP data released?

GDP is reported quarterly for most countries in the world. Usually a GDP report is released in the first month of a new quarter, but consult an economic calendar to get the exact date and time. Also, there are usually a couple of subsequent revisions to GDP data after the main release, especially in the major economies.

Why is GDP significant?

GDP data tells the story of how an economy performed over a period of time – its change relative to previous quarters gives a good indication of which direction the economy is moving and where it may go in the future. A strong positive reading is good news for an economy, while the opposite is bad news. The annualised data is extremely useful for detecting changes in the economic cycle, which can have big implications for FX markets.

Since GDP data is used to determine a country's position in the economic cycle, it is of use for a longer-term trader. Like inflation data, GDP data is of more limited use for the short-term trader – they would be watching to see if the actual figure exceeds or misses the consensus estimate by a large margin. Usually if GDP data is in line with estimates then it barely moves the FX market.

FX MARKET EXAMPLE

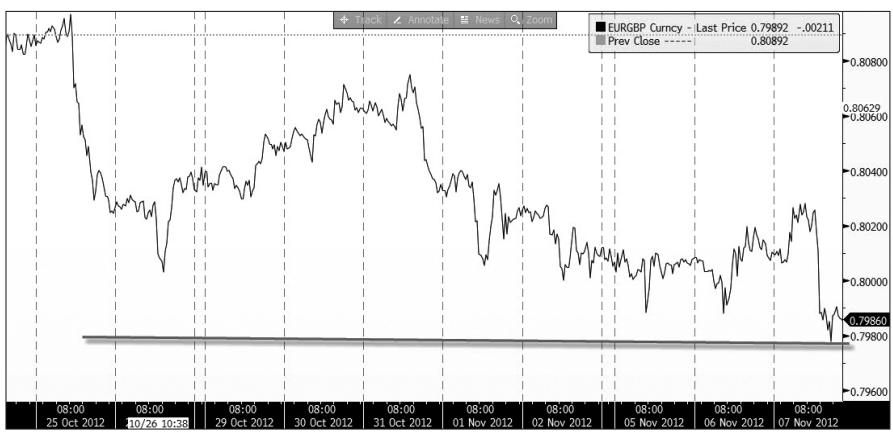
GDP can cause volatility in the FX market if it is wildly different to consensus estimates. Let's look at two examples of data surprises and see how it impacted FX.

EXAMPLE 1: UK

Third quarter UK GDP in 2012 was much stronger than expected, rising 1% versus expectations of a 0.6% rise. This data was even more important than usual since it meant that the UK had exited recession for the first time in 2012. This was difficult to predict, so the better trading strategy, in my view, would be to digest the data and then make your move. This was my strategy:

1. I asked myself what caused the UK to grow so strongly (it ended up being one-off factors like the Olympics and the Jubilee bank holiday, which weren't expected to contribute to growth later in the year).
2. This made me think that GBP strength on the back of this report may be short lived.
3. I wanted to trade the pound, but I had to be clever about it. A long GBP position would most likely only work against a currency where growth is weak. The euro was an obvious candidate. As you can see in Figure 1.8, EURGBP declined 190 basis points in the two weeks after the data release.

Figure 1.8: EURGBP in the immediate aftermath of the UK's Q3 2012 GDP



Example 2: Japan

Japan's economy contracted sharply in the third quarter of 2012, in contrast to the UK. It contracted by 3.5% on an annualised basis in Q3, a sharp slowdown relative to the 0.3% expansion in the second quarter.

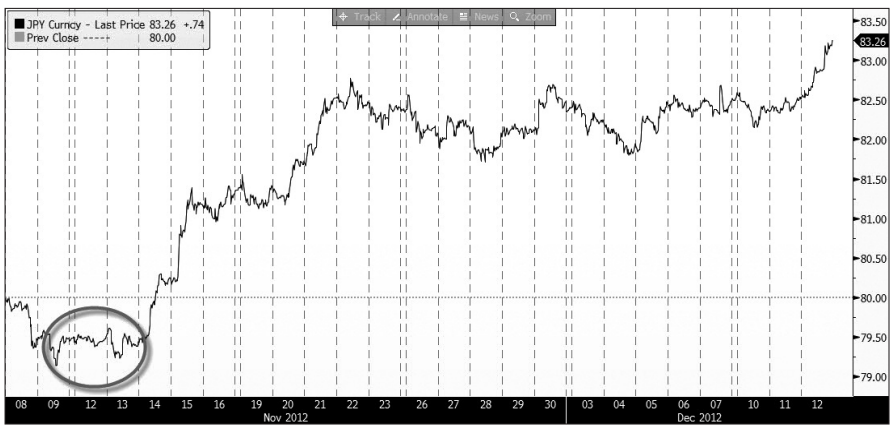
Japan's economy was weaker than expected, but rather than cause the yen to sell off, it actually caused the yen to strengthen by 100 pips versus the USD in the immediate aftermath.

How so?

The yen is a safe haven currency and even when there is a negative domestic economic shock it can cause a flight to its perceived safety. However, it would not have paid to remain short USDJPY for long, as you can see in Figure 1.9.

The price action after the data release is circled, but in the following three weeks USDJPY rallied 300 pips. Thus, the rush to the safety of the yen was only temporary, and once the market digested the news the yen reacted as you would expect, and started to weaken.

Figure 1.9: USDJPY – 30-day chart



How currencies are affected by the various economic data

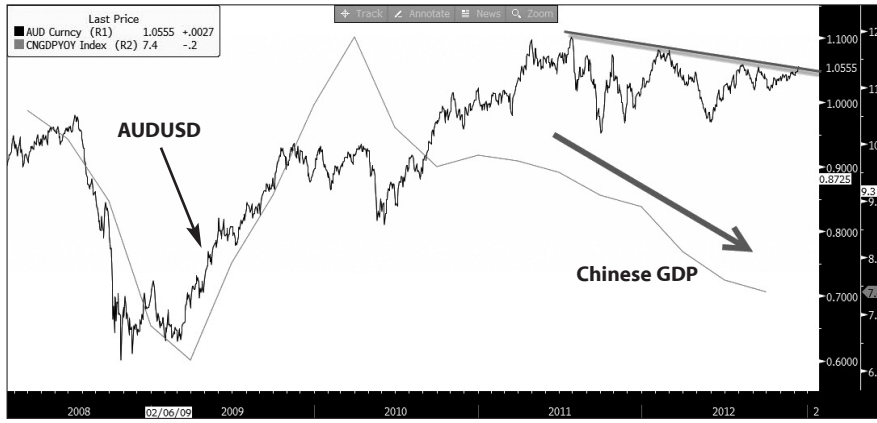
Some currencies are more sensitive to particular economic indicators than they are to others. Here is my very quick guide to which major economic data releases affect particular currencies.

- **Euro**: PMI data for the euro zone, inflation data, German factory orders, retail sales and sovereign debt auctions
- **Sterling**: PMI surveys, public sector borrowing figures, retail sales, GDP and GDP revisions. For example, the August 2012 manufacturing PMI survey (released 3 September 2012) beat expectations, causing a sharp jump higher in GBPUSD, as you can see in Figure 1.10. The arrow indicates the point of the data release.

Figure 1.10: GBPUSD (3 September 2012)

- **Australian dollar**: Chinese PMI survey, Chinese GDP projections, domestic terms of trade data and quarterly inflation report (Australia is unusual in that it only releases inflation data every three months). For example, the Australian dollar is extremely sensitive to developments in China because of the close trade links between the two economies. When important Chinese data is released – like GDP – it can have a big impact on the direction of AUDUSD. Figure 1.11 shows how Chinese GDP growth in 2009 came at the same time as a rise in AUDUSD, while moderation in Chinese GDP growth coincided with a slowing rise in AUDUSD in the period from late 2010 to 2012.

Figure 1.11: AUDUSD and Chinese GDP (late 2007 to 2012)



- **US dollar**: NFP, ISM surveys, consumer confidence, retail sales and CPI.
- **Yen**: US NFP, domestic inflation data, the Tenkan survey of manufacturing activity (a quarterly version of the ISM and PMI surveys) and central bank meetings in the US and Japan.

* * *

I have covered the most important indicators that I believe you need for effective fundamental analysis. Of course there are second, third and even fourth tier indicators that some traders follow avidly; such as terms of trade, factory orders and inventories. However, the purpose of this book is not to give you a step-by-step guide to all economic data because there are plenty of other books that will do that for you.

These include Richard Yamarone's *The Trader's Guide to Key Economic Indicators*, which is an easy to use and comprehensive look at most US economic indicators (but it can be applied to indicators used in other parts of the world).

You may have noticed that I did not include interest rates – and the central banks that set them – in the list of four economic indicators above. I like to think of these as a cousin of the monthly economic data statistics and use them in combination with all of the other indicators. Interest rates have a big impact on the direction of currencies and they are worth looking at in detail, so I will move on to this next.

Kathleen Brooks on Forex

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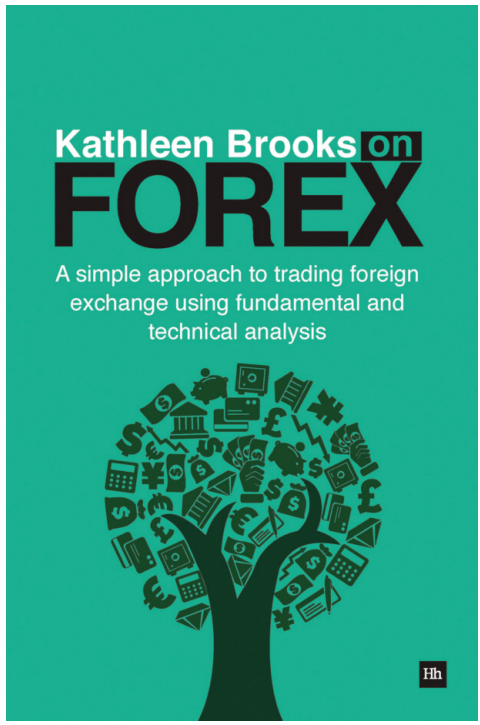
Kathleen Brooks



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