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Fundamental Analysis

What is Fundamental Analysis?

Whilst this course is heavily orientated around technical analysis and creating technical analysts, it is important to understand a little bit about fundamental analysis because it has an impact on price action from both a short term and longer term point of view.

So, fundamental analysis, it is a method of analysing the market with the purpose of forecasting the future value of a currencies price based on macroeconomic indicators. Fundamental analysis doesn't focus on the short term impulses in price but rather looks at the market from a longer term perspective, which means it is not ideal to implement strategies around this from a day trading perspective. However where you can tie it in with technical analysis is if you know for example the USD has just announced a hike in interest rates which results in the currency being more attractive to investors therefore inflating the currencies value, you can capitalise on any buy setups for the USD with the technical strategies that you choose to use.

Stocks Vs FOREX

Whilst this course is heavily related around the Foreign Exchange Market I just want to use stocks to help illustrate the importance of understanding the bigger picture when considering the overall strength of an economy which in turn will reflect of the relative strength of the economies fiat currency.

When we are evaluating which stocks to buy we have various indicators that we can look at to help determine the value of that stock. Similarly, these indicators can be used to help forecast any the future valuations in the stock price. Indicators such as the earnings per share, price : earnings ratio, balance sheet analysis etc.. You would also want to look at the current growth in the specific industry, is it a contracting industry or a booming industry? Ideally you would be looking for stocks to buy and hold in industries you feel will experience continued and consistent growth. Identifying whether the company is undervalued or overvalued will be important when buying a stock.

The same works with FX when it comes to looking at the macroeconomic environment. In order to analyse a currency pair you need to understand the relative performance of the economy which will then give you clarity on the directional bias on a given trade.

Economic Indicators

Fundamental analysis looks at the macroeconomic environment as it has a huge influence on not just the currency market but all financial markets. So what is an economic indicator? Well economic indicators are macroeconomic data that includes a variety of facts and figures about a given economy such as employment data, unemployment data, inflation, interest rates, GDP growth, retail sales data, consumer confidence data, industrial production data etc.. This data can be used to explain past price movements as well as predict future movements and in times of data releases can vastly increase the level of liquidity and volatility in the market. Due to this it is extremely important that you are up to date with the latest economic news and how this may affect the markets in which you are trading. I would highly recommend you download an FX calendar app on your smart phone, or ensure you are looking at some kind of economic calendar online so you know the high impact new releases for the week ahead. This will keep you in tune with what is going on in the world and will allow you to trade around high impact news with sound levels of risk management to prevent any unnecessary losses.

Time	Currency	Event	Importance	Actual	Forecast	Previous
Monday, December 25, 2017						
23:30	JPY	JPY National Consumer Price Index (YoY) (NOV)	High	0.6%	0.5%	0.2%
Tuesday, December 26, 2017						
04:00	JPY	JPY BOJ Kuroda makes a speech in Kaidanren	High			
Wednesday, December 27, 2017						
15:00	USD	USD Consumer Confidence Index (DEC)	High	122.1	128	128.6
Thursday, December 28, 2017						
13:30	USD	USD Advance Goods Trade Balance (NOV)	High	-\$69.7b	-\$67.9b	-\$68.1b
Friday, December 29, 2017						
13:00	EUR	EUR German Consumer Price Index (YoY) (DEC P)	High	1.7%	1.5%	1.8%

Above: Economic Calendar

The image above is to highlight the importance of understanding and acknowledging economic data releases. at the time of writing this over the Christmas period, you can see there are a number of what i call 'high impact' news events across Japan, USA and Europe meaning these currency pairs are likely to see increased volatility. Essentially fundamentals offer a comparison of economic performance between countries.

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countries economy the higher the value of the fiat currency. For example if Japan's economy is weak, you will see the currency devalue against the USD when the U.S economy is booming. Let me explain some of the key data releases that can have a huge impact on the currency market to get a better understanding of what i mean.

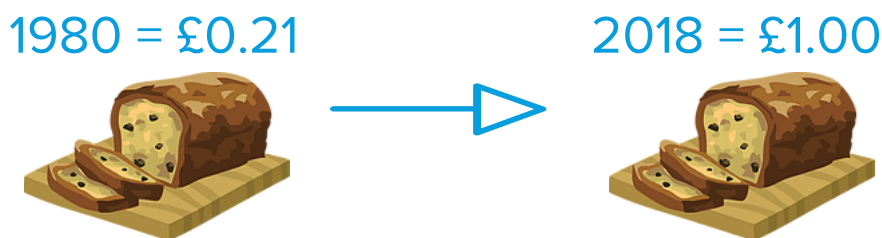
Interest Rates

What are interest rates and how do they effect a currency? Essentially interest rates are the cost of borrowing money and the revenue from lending money. Let's say Joe Bloggs needs a loan for his new start up business to the sum of £10,000. Luckily for Joe, right now interest rates are fairly low in the U.K. meaning he can borrow money cheaply at a rate of interest at just 2% from ABC Bank. Joe has decided he wants to take out this fixed interest rate loan out for 5 years with equal monthly repayments. In total over the 5 year period Joe will pay back £175.20 per calendar month for a total cost of £10,511.91 over the duration of the loan. This means that ABC Bank make £511.91 in revenue from lending to Joe Bloggs at 2%. Over the 5 years that Joe has been in business he has gone from making £0 to over £100,000 a year in revenue of which £55,000 is net profit. Due to interest rates being low it prompted Joe to spend money on his business, by doing so he now spends an additional £45,000 year in the economy. In a very basic and theoretical approach to economics, lower interest rates promotes more spending and with more spending promotes economic growth. As economic growth increases, so does the strength of a currency as investors look to pour money into a stronger performing economy which is more than likely going to increase interest rates in the near future.



Inflation

Taking our example above we have Joe Bloggs who is now contributing significantly more to the countries economic output through increased spending. If purchasing power is higher it means demand for goods and services increases, with increased demand means prices rise, and rising prices leads to inflation. Inflation is essentially the average price increase of a basket of specified goods, just to make some comparison, back in 1980 you could buy a loaf of bread for £0.21, today, to buy that same loaf of bread will cost you £1! That's inflation for you. Inflation is another key indicator that defines the relative strength of an economy. If inflation is increasing it shows consumers are spending and an increased level of economic activity is occurring, this resulting in investors ploughing money into a stronger performing economy to maximise from the economic growth the country is experiencing, this increasing the value of the countries currency.



Employment Data

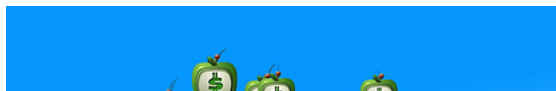
This one is pretty obvious, the more people that are in work means more people are paying taxes and more people are consuming goods. The result of this is that the currency increases in value. However if employment data is lower than expected, meaning less people are employed, this is negative for a countries currency valuation and will likely devalue the currency as it shows signs of economic weakness if jobs aren't being created and more people are out of work.

Manufacturing Data

This is another key indicator especially for those countries who obviously manufacture a lot of goods and is one of their larger contributions to economic output. Due to this if manufacturing data comes out as weaker than expected, it is likely you will see a sell off or devaluation of the currency, or conversely if the data comes out positive you will see price action react in a bullish fashion.

Quantitative Easing

The process where money really does grow on trees! Just kidding, but its not far off. Essentially its where central banks buy securities such as government bonds with digital money that did not exist before in order to help stimulate growth in the economy. It stimulates the economy because it increases the money supply meaning the banks reserves increase allowing them to lend more money, which in turn results in more spending. However this is why there is such a large and uncontrollable worldwide debt cycle. So how does QE effect an exchange rate? Well initially it can show signs of economic weakness and can devalue a currency, however as we have recently seen in the Eurozone, there QE stimulus has helped increase inflation in the Eurozone and the overall economic performance, resulting in the value of the Euro increasing. So in other words, know what different currencies are doing and how they are performing as it will help you determine the longer term directional bias of a market!



Above: The QE Money Tree!

Gross Domestic Product (GDP)

GDP is a measure of the total market value of all final goods and services produced quarterly or yearly. It is a measure used to help define economic growth, if GDP comes out positive it shows a growing economy and can be seen as bullish for a country's currency. However if GDP comes out negatively it highlights a contracting economy and may be an indicator highlighting a recession, this can cause a devaluation of a currency and can be seen as bearish.

Now you know a little more about the economic indicators you need to look out for, your next job is to find yourself a economic calendar so you can keep track of the key events occurring on a weekly basis. Having this awareness and understanding of a country's economy will help add an edge to your overall knowledge as a trader. You can find economic calendars your smartphone as an app or on the internet, there are plenty of them around! Make it your job to scan the key events for the week ahead to ensure you are fully prepared for any unexpected moves in the market. Let's now move on to talk about some of the key banking organisations that determine monetary policy and who have a say in the country's money supply which directly affects a country's economy and therefore the value of an exchange rate.



Above: Central Bank Depicted

Bank of England

The BoE is the United Kingdom's central bank who deliver monetary policy and financial stability for the British people. The BoE was established in 1964 to act as a banker to the Government. The BoE is still owned by the Government but they set monetary policy independently. The Monetary Policy Committee who as of the time of writing this is headed by Chairman Mark Carney who you will see in economic calendars like the one above making speeches on everything to do with the country's monetary policy, from inflation to interest rates to quantitative easing. It is important to be up to date with these announcements as some may come across as 'hawkish' which means that Carney is looking to increase interest rates, or 'dovish' which means there may be lower interest rates to push economic growth (although they couldn't be much lower than they are right now!)

European Central Bank

The ECB is the central bank of the 19 European Union countries that have adopted the euro. The ECB is tasked with maintaining price stability in the euro area and to preserve the purchasing power of the single currency. The ECB is run by President Mario Draghi who you will also need to be aware of as he is somebody who makes announcements based on the European Union's monetary policy and economic stability. As the ECB's policies reflect 19 different countries it can cause huge fluctuations in price action depending on the outcome of Draghi's speeches.

Federal Reserve

The central bank of the United States of America was established in 1913. The Federal Reserve System is made up of three key entities, the Federal Reserve, Board of Governors, 12 Federal Reserve Banks and the Federal Open Market Committee (FOMC). Its main purpose and functions are to provide financial stability, conduct monetary policy and regulate financial institutions and their activities. The Fed's Chair of the Board of Governors is Janet Yellen, another key name you will need to remember when you are looking at your economic calendar as she will hold FOMC meetings to discuss the outlook of the country's monetary policy.

How Fundamentals Affect the Market

Fundamentals affect price action in the market significantly as investors look to understand the information that the market is presenting them. If an economy is in a period of growth and has financial stability, investors will look to buy the currency. Signs of economic growth can be seen through a country's employment levels, CPI figures, PMI indexes, interest rate decisions, inflation, GDP and much more. However, there are a couple of key areas that I want to focus on as these variables have a huge impact on the market and can cause huge volatility within the market in a small time frame. I want to make you aware of how investors react so you understand why markets move in the way that they do when given news announcements and economic outlooks are delivered.

Political & Financial Instability

If a country is going through a period of political and/or financial instability, investors will look to shift their investments to safe haven currencies. Safe haven currencies are sought after by investors to limit their exposure to losses in the event of an economic downturn or an event that could affect the value of their investments. During these times investors will look to purchase safe haven currencies such as the Swiss Franc (CHF) and Japanese Yen (JPY). These are considered safe haven currencies as they are expected to retain their value or even increase in value in times of market turbulence.

A key example of this is when Donald Trump became President of the United States of America in January 2017. Shortly after Trump brought about a lot of political instability through tensions across borders with Russia after FBI investigations into collusion with Russia and more specifically North Korea and the threat of nuclear war. This results in the value of the USD to fall and the Japanese Yen (JPY) to increase in value as investors began to sell USD.

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Above: USD/JPY 550 PIP Fall in Price - 10th May - 18th May 2017

As you can see from the chart above the USD crashed 550 PIPs in just 7 trading days! This was a result of political instabilities within the US caused by the actions of President Trump. This chart highlights that if you are also aware of the fundamentals, you can use it to your advantage when trading. For example, a trader who was aware of the political instabilities in the US could've taken advantage of any technical setups that prompted a USD/JPY short position as the fundamentals back up the technical analysis! This gives you a HUGE edge in the market if you are aware of the macroeconomic environment.

Non-Farm Payroll (NFP)

Another variable that I want to make you aware of is Non-Farm Payroll (NFP). NFP is a key economic indicator in the US and represents the total number of paid workers in the United States minus farm employees, private household employees and employees of non-profit organisations. The NFP data is released on the first Friday of every month and is a key fundamental announcement that you need to be aware of as it can cause huge fluctuations in the market in the hour of release! Let me show you...



Above: NFP Data Release: EUR/USD - November 2017

The reason it causes such volatility is that it is key data that is used to assist policy makers and economists with determining the current state of the economy and predict future levels of economic activity. As you can see above a chart of EUR/USD on the 1-hour time frame showing the huge spike in volatility during the hour of data release, the range in price was just shy of 50 PIPs during this 1-hour window. These spikes in the market are designed to take smaller retail traders like you and me out of our positions for a loss also referred to as a 'stop hunt'. If you can imagine you're already short EUR/USD before the announcement, where are you most likely to place your stop? Probably just above the past previous high, well as you can see price ran straight past the previous high which probably would've taken a retail trader out with tighter stop losses for a full loss on their position. Furthermore with this level of high impact news we lose our technical edge in the market as we cannot predict or foresee the direction that the market will move in once the data has been released. Due to this it is with paramount importance that you look to protect your positions or simply avoid trading currency pairs linked to the USD during this specific high impact news release. Failure to take these pre-cautions and taking high-level risk traders could result in bigger losses than expected.

High Risk Fundamental Trading

Some traders or a better way to describe them is gamblers, like to hit buy or sell based on a likely forecast of a given event occurring in order to benefit from the huge fluctuations in the market after a high impact news announcement has been released. This 'get rich quick' mentality is unfortunately one of the biggest downfalls of retail traders and is more often than not destined to result in huge losses. Your odds are just as good as going to a casino and putting your account balance on red or black on roulette and as far as I'm aware I've never heard of a long term successful roulette player, have you? Hence, it's probably not a good idea. Let me show you some events that have occurred in the past which a reckless trader could have taken, and either hugely benefitted, or quite simply blown their account, let me explain.



Above: BREXIT: GBP/USD - June 2016

BREXIT - quite frankly one of the most astounding days that will go down in history in the FX market. Above you can see an image of the GBP lose 18% of its value in a single day after the U.K voted to leave the European Union. The threat that this proposed to the U.K economy and the political instability that would follow resulted in investors absolutely selling off the GBP by over 2,000 PIPs in a single day. Yep, price went from highs of 1.5030 down to just over 1.30 by the end of the day, and that was just the start of the decline of the GBP.

So, how does this effect the retail 'trader' with a gamblers 'get rich quick' mentality. Well, those with a wide enough stop loss who battled away the emotions of the initial bullish move as the votes were being released and the optimism grew that the U.K would stay in the EU and held their short positions, well they made a tidy bit of profit by the end of the trading day. However, if you decided to trade this event, and went long - as most people were anticipating the U.K to stay in the EU, despite having a stop loss in place, they will have no doubt blown there account, even if they did have a stop loss in place. I will explain why shortly. First let's take another look at the GBP taking another beating...



Above: Flash Crash: GBP/USD - October 2016

Following the BREXIT vote the Great British Pound (GBP) was already in free fall making new lows on nearly a daily basis. However on the 7th October 2016, the GBP crashed once again losing another 6% of its value in matter of minutes! Yes, not hours or days, minutes! Speculation from analysts suggested that it was a rogue algorithm that triggered a huge sell off. Due to the sell off happening during the Asian session and with US jobs data due out the following day, trading volume was fairly light, this exacerbated the impact of the sell off! Now whilst this is more of a freak occurrence than actually being off the back of trading a highly volatile news event, it does show the high risks involved in trading that could leave you massively exposed. This is why i put so much emphasis on strict risk management and to really try and steer you away from any kind of 'get rich quick' mentality, and i'm not done yet. Take a look at the chart below...



Above: The Swiss Franc Tsunami: USD/CHF - January 2015

Above is the daily chart from the day that the Swiss National Bank decided to end its peg against the Euro in a surprise announcement that took the currency market by storm! As the Swiss Franc rallied upon this news it resulted in an almost 29% intra-day move. This unexpected news announcement strengthened the Swiss Franc (CHF) against all currency pairs as the SNB removed their 1.20 market cap against the Euro. The chart above is the outcome against the USD, which given the usual strength of the USD, you can see the huge reaction of which a large proportion of the move took place within 30 minutes of the announcement.

Why Do These Market Moves Matter? - Slippage

As referred to before, trading fundamentals can be disastrous, however like some of the market moves above, they were also unexpected and happened in the space of a matter of minutes. These flash crashes can have severe consequences on any account that is in an open trade that it is positioned in the incorrect direction of there market bias. For example, if you were long when BREXIT happened but the market went short by 2000PIPs, you might be thinking well if i have a stop loss in place then my losses will be limited anyway. Well, the truth is, this assumption is incorrect. The reality is, when the markets move in such a violent manner with huge liquidity entering the market in such a short space of time, there is a term called 'slippage'.

Slippage is the end result when the broker cannot exit the trade and trigger your stop loss due to the level of volatility in the market. Therefore if you were long GBP/USD after BREXIT or the Flash Crash, or you were long USD/CHF after the SNB took away there peg against the Euro, well you would've lost a significant more of your planned to when entering the trade, if not losing your whole account even if you did have stop loss measures in place. Now whilst these trades occurred during the trading week, let me show

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happens when you hold trades when there is high impact fundamental's occurring over the weekend when the markets are closed...

Market Gaps

There are two dangers of holding trades over the weekend. Firstly, we don't know if there could be any unanticipated announcements that could occur over the weekend that could cause a gap in the market upon market open. Secondly, if an announcement comes out that is unfavourable to your trade, well theres nothing you can do about it because your broker will be closed, meaning the next possible opportunity for you to do something about it is after the market has already reacted. Which yeah, you've guessed it, could be bad for you and your account balance. So what does a gap look like?



Above: French Presidential Election: EUR/USD - Weekend in April 2017

Above shows a 200PIP gap in the market whereby polls suggested over the weekend that French President Emmanuel Macron was way ahead of his opposition Marine Le Pen. The reason for this is that Le Pen had extreme policies such as coming out of the European Union (we saw how that effected the GBP) as part of her 'FREXIT' campaign. However early polls suggested Macron had won the election, the result of this caused a 200PIP jump in the Euro on market open against the USD. Imagine being short EUR/USD? You're in a trade that you know on market open is going to be negative 200 PIPs which could potentially put you in a far greater loss than expected. Well the reality was that anyone who was short with a stop loss anywhere between where the price of where the market closed on Friday evening and opened on Sunday night would have been taken out of their position for a loss. Meaning you could've experienced a loss up to 200 PIPs larger than your initial stop loss.

Summary

To summarise I cannot emphasis enough how trading high impact news events can be highly costly to your account and could put you in very uncomfortable situations and I wouldn't wish that on anyone. So take care when you are trading, try to avoid these high impact events, it removes your technical edge in the market and could give you some massive set backs. The reality is brokers cannot simply pull you out of a position with such added liquidity and volatility. These moves can happen so fast they've probably happened before you've even had chance to check your trade. Therefore it is imperative that you trade fundamentals with extreme caution.

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