

# 8 Day Intensive Course

## Lesson 6

Fundamental Analysis -- Who and What Moves the Market

### A) FX Market Structure

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#### FX Market Structure

- The FX market is an over-the-counter market with no centralized exchange.
- Traders have a choice between firms that offer trade-clearing services.

Unlike many major equities and futures markets, the structure of the FX market is highly decentralized. This means that there is no central location where trades occur. The New York Stock Exchange, for example, is a totally centralized exchange. All orders pertaining to the purchase or sale of a stock listed on the NYSE are routed to the same dealer and pass through the hands of a single clearing firm. This structure requires buyers and sellers to meet at the NYSE in order to trade a stock that is listed on this exchange. It is for this reason that there is one universally quoted price for a stock at any given time.

In the FX market there are multiple dealers whose business is to unite buyers and sellers. Each dealer has the ability and the authority to execute trades independently of each other. This structure is inherently competitive as traders are faced with a choice between a variety of firms with an equal ability to execute their trades. The firm that offers the best services and execution will capitalize on this market efficiency by attracting the most traders. In the equities markets, the execution of trades is monopolized and there is no incentive for a clearing firm to offer competitive prices, to innovate, or to improve the quality of their service.

#### DISCUSSION

The FX market has clear advantages over the equities markets in terms of efficiencies created by decentralization and competition. How does the nature of this market structure effect a trader's profitability?

### B) Key Market Participants

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#### FX Market Participants

While the foreign exchange market was traditionally exclusive to all but a select group of large banks, advances in technology and reductions to capital flow barriers have brought in a variety of new participants. Because all of these participants affect the supply of and demand for currencies, it is important to understand the role each plays in the market.

#### Commercial and Investment Banks

- Commercial and Investment banks make up the "Interbank" market and trade on electronic brokerage systems (EBS).

- These banks trade among themselves via strong credit relationships, and account for the largest portion of FX trading.
- These banks trade on a proprietary basis (they trade for themselves) and through customer flow (they fill orders for clients outside of the Interbank market).

The Interbank market consists of the world's largest Commercial and Investment banks and caters to the majority of commercial turnover as well as enormous amounts of speculative day-trading volume. These banks will trade among themselves via credit relationships they have established with one another as part of a system of balancing accounts.

- Large Corporations, Hedge Funds, Central Banks are all customers on the Interbank market.

Aside from trading exclusively amongst themselves, these banks also trade with large corporations, hedge funds, central banks, or specialized dealers that cater to smaller retail traders. For example, when a large international corporation based in Japan needs to pay its employees in the United States, they must buy USD with JPY. To buy USD, this corporation will go to a bank to make the transaction.

- This trading amounts to billions of dollars daily, or about  $\frac{3}{4}$  of daily FX volume.

Due to their size and the large volume that they trade, these banks have unique access to:

- Important information on direction and size of capital flows. This means they may be able to make reasonable short-term predictions on FX movements based on the large positions they hold and trade.
- Significant capital power they might use to defend their proprietary positions at significant technical levels. This is often what creates support and resistance.
- Large research departments that offer fundamental and technical analysis to prop traders.

All of these factors make it requisite for a good trader to take advantage of all the resources these banks provide. Possible trading opportunities as well as information on the particular interests of banks is disclosed in much of the research these banks create. Many of these reports can be accessed at [www.dailyfx.com](http://www.dailyfx.com)

### **Central banks**

- Central banks have access to huge capital reserves.
- Central banks have specific economic goals.
- Central banks regulate money supply and interest rates.

Central banks are large players with access to significant capital reserves. They enter the FX market primarily in a supervisory capacity in order to stabilize money supply and interest rates. Central banks closely monitor economic activity, and have many options available to them to regulate their economies. Many of these options relate to specific policies that greatly impact the FX market.

- Central banks set the overnight lending rates to change the rate of interest paid on their domestic currency.
- They buy and sell government securities to increase or reduce the supply of

money.

- They buy and sell their domestic currency in the open market to influence exchange rates.

Knowing the policy of a central bank and its opinion of the domestic economy will allow a trader to anticipate what actions the central bank is most likely to take in future policy meetings.

### **Corporations**

- Corporations primarily use FX to hedge against currency depreciation.
- Corporations also buy and sell currencies in order to meet payroll for international offices.

Foreign exchange plays an increasingly important role in the daily business of corporations as globalization forces them to make and receive payments in foreign currencies. When international transactions of goods are made, a transaction of currency is also necessary. Whether it is to pay employees abroad or to pay for products coming from a foreign nation, corporations must exchange their local currency for the domestic currency of the nation they are trading with.

- When a corporation agrees to buy or sell goods to a client in foreign nation at a future date, it runs the risk of its local currency depreciating in the meantime.

If a corporation believes that its local currency is expected to depreciate, and as a result the outstanding position is at risk, it would most likely enter the FX market and buy the domestic currency of the country with which it is trading.

### **Global Managed Funds**

- Many profit-seeking managed funds invest in foreign financial instruments.
- When they purchase and sell these instruments, an FX conversion is always necessary.

Global fund managers (large mutual, pension, and arbitrage funds) invest in foreign securities and other foreign financial instruments. These investments can have substantial impacts on spot price movements because these firms constantly re-balance and adjust their international equity and fixed income portfolios. These portfolio decisions can be influential because they often involve sizable capital transactions.

- Major changes in equity or bond markets of respective countries dictate the roles of Global Managed Funds in the FX market.
- When equity markets are performing well they will attract substantial global capital, which will drive a domestic currency higher.
- To purchase stocks or bonds in a foreign nation, managed funds must exchange their local currency for the domestic currency of the country in which they are purchasing financial instruments.

Many of these funds implement currency-hedging strategies. When they wish to hedge existing investments so they don't incur the risks of depreciating currencies, they can also generate significant selling flows.

Under the umbrella of Global Managed Funds are pure FX funds (Global Macro Funds).

- FX Funds trade in FX for speculative purposes.
- Many large funds tend to take large carry trade positions exploiting global interest rate differentials (see next lesson).
- They also watch for misguided economic policy and over/undervalued currencies to take large spot positions (assuming a natural return to equilibrium).

Ultimately, these funds gauge global events and take a longer-term view on which currencies will strengthen/weaken in the next six to eight months. Fund participation in the FX market has risen sharply in recent years and its total trading market share is now around 20%. While relatively small compared to other market participants, they can have a profound effect on the currency spot movements when acting together.

### **Individuals**

- With the advent of online currency trading, retail investors now have total access to the spot FX market.
- Retail clients trade in FX for both speculative and hedging purposes.
- Retail participation is growing rapidly and is having a tremendous impact on the foreign exchange market.

Retail spot currency trading is the new frontier of the trading around the world. Up until 1996, foreign exchange trading was only available to banks, institutions and extremely high net-worth individuals. Prior to online retail FX dealers, individuals could not realistically participate in the foreign exchange market from a speculative standpoint. The Interbank market operated as a tight circle and it managed transactions with Corporations and Managed Funds to accommodate its own needs. Online foreign exchange trading offers retail clients access to trading functionalities similar to those of the Interbank market. Spreads are slightly wider - 5 pips on most currency pairs as opposed to the Interbank standard of 3 - but execution is unsurpassed; additionally, many of these firms maintain fixed spreads, as opposed to fluctuating spreads in the interbank market. Now retail clients and multinational institutions can participate in the FX market on a highly equitable playing field.

### **Question**

While there are numerous market participants, each one plays a unique role in the market. Each role brings with it a varying degree of influence on the market. One of the common roles that influences exchange rates is that of speculation. Of the market participants discussed above, which ones do not speculate on exchange rates? What is it about the nature and purpose of these participants that would prevent them from speculating on exchange rates?

## **C) Intervention- The Bank of Japan**

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### **Intervention: The Bank of Japan in Action**

*What is intervention?*

- *An attempt by a central bank to intentionally move the exchange rate.*

Essentially, interventions are attempts by central banks -- banks that govern the value of respective currencies -- to manipulate the currency's value. Interventions serve as a prime example of how key market participants -- like central banks -- need to be watched by all traders, as their actions can substantially affect exchange rate movement.

The most prolific example of interventions can be seen in the actions of the Bank of Japan. Japan's economy is dependent upon exports -- meaning its economy relies on selling its products internationally. Because of this, Japan's economy benefits from a weaker yen, as a lowly valued yen easily allows other nations to purchase Japanese products (and hence facilitates exports).

Since Japan's economy benefits from a weak yen, the central bank has a vested interest in ensuring that the value of the yen remains low. As a result, the Bank of Japan has intervened on numerous occasions in the currency markets, selling literally trillions of yen to drive the exchange rate down. For savvy traders, this presents an interesting and lucrative opportunity.

Let's take a closer look at how the Bank of Japan has recently intervened in the FX markets to drive the exchange rates downward.

### **Bank of Japan Attempts to Put a Floor Under USDJPY**

The Bank of Japan (BoJ) intervened numerous times throughout 2003, in an attempt to ensure that the USDJPY rate would fall as little as possible. The pair had been falling rapidly, as U.S. dollar weakness coupled with yen strength led to a sliding USDJPY exchange rate. As a result, emergency meetings were held at all major export firms to assess their plans for handling the rapid appreciation in the JPY. By the end of the year, the Bank of Japan would spend over Y13 trillion (or \$115bn) to sell the yen in the FX market to prevent its value from rising excessively.

The Bank of Japan started its new intervention policy in 2003 by intervening between the 115 and 116 levels. While their attempts at keeping the USDJPY above 115 were successful for some time, market forces eventually won out, and the pair made a sustained break through the 115 level in September of 2003. With the "invisible floor" of 115 cleared, traders felt comfortable that the Bank of Japan could not maintain a weak yen, and hence entered the market as buyers of yen and sellers of USD (or sellers of the USDJPY pair). The result was a sharp fall: the USDJPY pair fell about 600 pips in less than two weeks.

Prior to the sustained break below 115, participants experienced a few months of trading where they could legitimately expect the BoJ to intervene in the market around that level. As a result, many traders purchased USDJPY around the 115 level -- and reaped profits in doing so.



More recently, in early 2004 the Bank of Japan intervened in the currency market to keep the exchange rate of USDJPY above 105.00. This massive intervention pushed the USDJPY from just above 105.00 to above 112.00, a 700 pip gain in just a few weeks. The intervention coincided with the end of the Japanese fiscal year. The Bank of Japan drew a "line in the sand" just above 105.00, and intervened on a massive scale.



## Risks to Intervention-Based Trades

Clearly, intervention, or even failed interventions, can have a big impact on the FX market -- and hence should be something that traders keep an eye out for. Before seeing intervention as a quick way to easily profit, though, there are certain factors that traders should bear in mind before placing trades focusing on interventions.

### •Timing

The biggest risk of intervention-based trades is the timing of when intervention will occur. In the past year, the BoJ has intervened between 116-118. Although this level is known, 200 pips can be significant risk. Also, the exact timing is always unknown, so traders will typically need to hold their position for weeks -- with potentially large floating losses -- as they wait for intervention. Therefore unless traders have sufficient margin in their accounts to sustain losses, they could easily get a margin call prior to the BoJ stepping into market.

### •Sustainability

An additional risk is that, as we've seen, the BOJ cannot sustain intervention indefinitely. At some point, the artificial level the intervention is meant to uphold will have to fall. When exactly this will happen, though, is anyone's guess. A trader who had expected the intervention level to hold strong on September 17 of 2003, and thus had bought USDJPY, clearly would have experienced the downside of unsustainable interventions; the market fell strongly in the opposite direction, falling through the level and creating enormous potential losses for any trader who was counting on an intervention.

## Key Points for Traders

There is no denying that intervention-based trades worked very well in 2003, as the

Bank of Japan has spent over ¥13trln to aggressively combat Yen strength. However, as we have seen, traders cannot take their presence for granted and assume that interventions will last indefinitely, nor can they know precisely when they will occur. Ultimately, traders will have to follow the news to help them determine whether or not an intervention will occur, and need to react accordingly based on their analysis.

**DISCUSSION:** Is it too risky to make trading decisions based on potential interventions? Or does the potential reward justify the risk? Share your thoughts on the topic with the class by replying to this thread.

### D) Bank of Japan Intervention: How Traders Reacted

On May 19, 2003, USD/JPY reached a low of 115.07. The Bank of Japan, knowing that there was a "head and shoulders" formation with a neckline at 115, intervened to support the exchange rate. The BoJ knew that 115 was a significant level, and that a break of that level may have induced traders to sell USD/JPY. Traders, using both the fundamental knowledge and technical levels, may have had a very profitable trade.



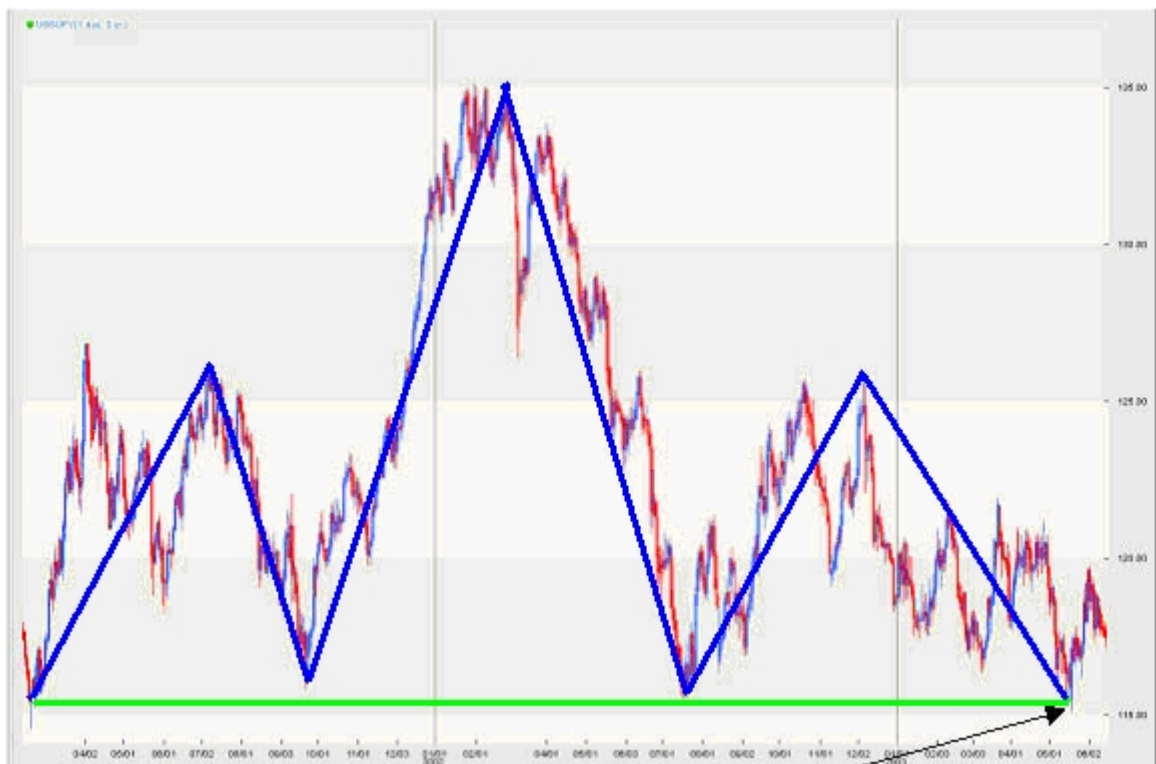
Price reaches low of 115.07 before jumping over 250 pips in a few hours. BOJ later confirmed intervention



The head and shoulders formation is a chart pattern that includes a peak that returns to support (the shoulder), followed by a higher peak, which again returns to support (the head). The second shoulder occurs when the exchange rate fails to reach the peak of the head, and instead reaches the approximate peak of the left shoulder before falling once again to support.

The neckline is established as the common level of support, the low point reached by the exchange rate after the creation of each part of the formation. Once the price breaks below the neckline on the right side of the second shoulder, this is a signal to sell.

Below, the head and shoulders pattern is outlined. The trading signal in such a pattern is to sell when the price breaks below the neckline, outlined in green.



## E) Market Participants in Action: How Speculators Beat the Bank of England

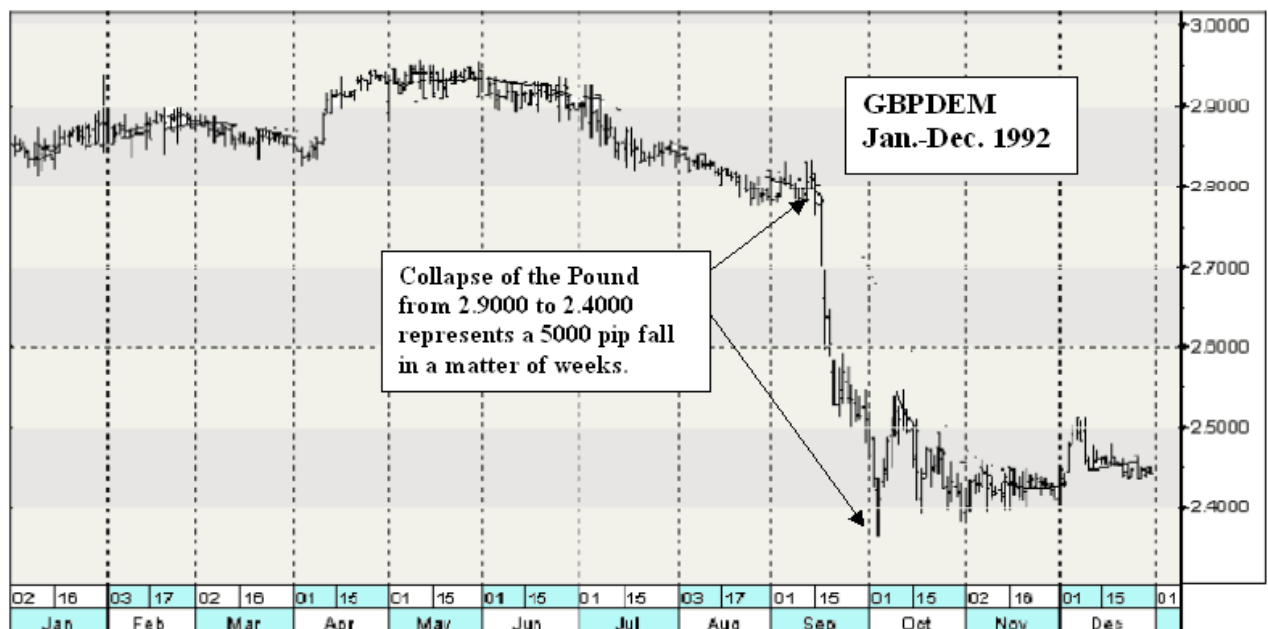
### 1992: Bank of England Fails to Support GBP

The purpose of this article is to show one of the most famous examples of central bank intervention in an attempt to keep an exchange rate at a fixed level, and subsequent failure to do so. The Bank of England in September 1992 used its reserves to support the British Pound in an effort to stay within the confines of the European Exchange Rate Mechanism, but it ultimately ran out of funds to do so and could not oppose speculators indefinitely.

The European exchange rate mechanism (ERM) was introduced by the European Community in early 1979. It was a major part of the European Monetary System (EMS), which aimed to reduce exchange-rate variability and achieve monetary stability in Europe before the introduction of the Euro as a single common currency.

The ERM was based on fixed currency exchange rates with a small margin of just over 2% allowed for the rates to fluctuate in either direction. Individual currencies were compared against a weighted basket of the other currencies. The ERM did not allow exchange rates to fluctuate outside of these margins and because of this the system was inflexible. If a country wanted to stay in the ERM and stay on course to becoming part of the common European currency, its individual currency had to remain within the inflexible thresholds designated by the ERM.

In order to remain within the limits established for the British pound, the Bank of England was forced to use its reserves to buy the GBP against the German Mark (DEM), the other major currency within the ERM. As rumors circulated that the BoE would not be able to maintain the required level indefinitely, speculation against the GBPDEM increased. In September, the weight of the speculative selling pressure finally overwhelmed the BoE, and GBPDEM fell dramatically overnight and in the next few days.



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Most famous among the speculators against the BoE was George Soros, who borrowed massive amounts of British pounds in order to convert them into DM's. When the exchange rate collapsed, he simply bought back the pound and repaid his borrowed funds for a tremendous profit. Soros, in fact, made a reported \$1 billion overnight. Certainly one individual does not have the resources to trade against the BoE, but this is also an excellent example of how a central bank can not trade against the rest of the market indefinitely if the fundamentals are against the bank and there are enough speculators aligned on the opposite side of the trade.

The ERM has, of course, since been replaced by the common Euro currency. At the end of 1998, rates between Eurozone countries were frozen in place, but the failure of the BoE to keep the GBP within its allotted margin has been one of the major milestones preventing the U.K. from adopting the common currency.

### **Discussion Point**

Prior to currencies being pegged to each other at a set date, such as the EMU before the creation of the Euro, what would be an incentive for a country to make intervene and make its currency weaker against the others? What would be an incentive to keep it strong against the other currencies?

### **F) Quiz**

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#### **Quiz: Market Participants**

If you are unsure about the rationale for the answers to the quiz questions, please reply to this thread with any questions you have.

A few further notes on the quizzes:

The quizzes are for your benefit only. It is not necessary to share your results with the class if you do not wish to do so.

Some of the material on the quiz is not found in the lessons. Feel free to use any outside resource you'd like in order to research the answers, including but not limited to the resources we have listed already. A simple web search will yield some answers.

Go to the Quiz Center and take the Market Participants Quiz.

The quiz center is at the following link.

<http://www.learncurrencytrading.com/main/>

#### **How would you rate your understanding of fundamentals?**

- No understanding of why the market moves
- Basic understanding of how the market relies on capital flowing between countries
- Understanding of the fundamentals of capital flows and trade flows, as well as what causes them
- I should be a central banker