8 Day Intensive Course
Lesson 7

Fundamental Analysis -- Correlations Between the Markets

A) Crude Oil

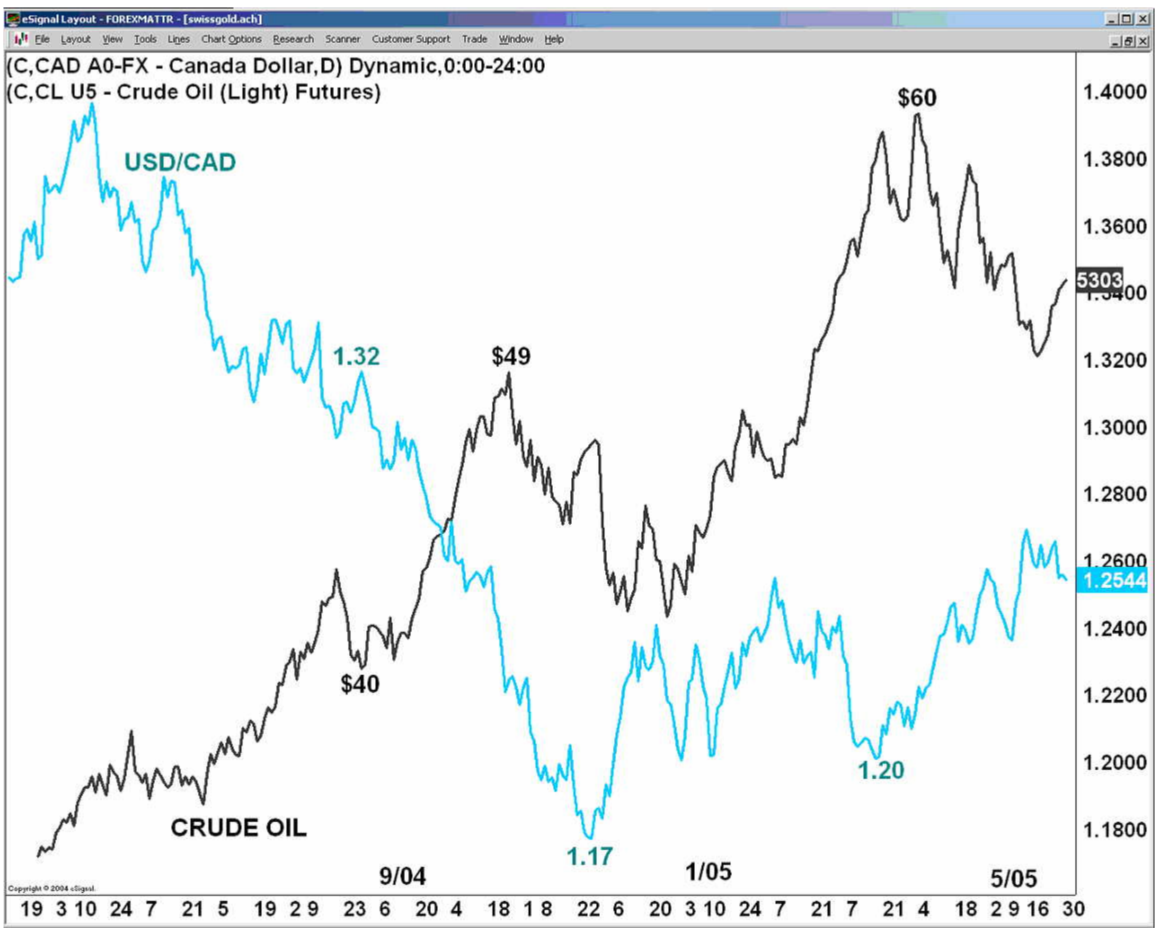
Oil: The price of light sweet crude oil can have a tremendous effect on the FX market, specifically affecting currencies such as the Canadian Dollar (CAD), U.S. Dollar (USD), as well as the Japanese Yen (JPY) for somewhat different reasons. In fact, as oil has broken above the $50 psychological level, the impact of high oil prices continues to have a severe impact on the global economy. The following daily chart illustrates the rally oil has enjoyed over the course of the past year. Note the price of oil as well as the corresponding price of the USD/CAD during the same period of time.

CAD: Oil represents around 8% of the Canadian economy, therefore for every dollar higher the price of oil moves, the Canadian economy tends to benefit. On the other hand, if oil moves to the downside, the Canadian economy tends to suffer. The Canadian economy depends on exports such as Lumber, Oil, as well as consumer staples such as wheat and other grains. Being the ninth largest producer of crude oil in the world, Canada's currency has a strong positive correlation with oil prices. In fact, over the past year (2004-2005), the weekly correlation has been close to 70%. This means that if oil prices rally, the Canadian dollar also has a high likelihood of rallying, but unfortunately the pitfall of this relationship is that the opposite scenario is true as well. When oil prices fall, the Canadian dollar will also fall. Higher commodity prices have benefited resource-rich Canada, but have hurt Canadian exports to countries such as the US, which accounts for two thirds of total exports from Canada.

USD: Canada is the number one supplier of oil to the US; in fact the US consumes more oil from Canada than from the Middle East. Due to the fact that the US and Japan are considered very industrialized nations, high oil prices tend to cut into the US's ability to stay productive. High oil prices can have a sever effect on such industries such as the Airlines, Chemical, Automotive, and Industrial Production. The price of oil has a very strong correlation or relationship to the USD/CAD.

USD/CAD: In fact the USD/CAD pair has a "double barrel" reaction to the change in the price of oil. As oil moves higher, it tends to benefit the CAD while putting a strain on the USD. For that reason, the USD/CAD tends to move with swift reactions as the price of oil moves higher or lower. As oil traded near the psychological $50/barrel, the USD/CAD traded near the 1.2500 large round figure. As oil crossed above $50, the USD/CAD sank below 1.2500. The opposite also holds true. As oil subsequently fell below $50, the USD/CAD broke above 1.2500. Traders who realize this inter market correlation can trade the FX market with a bias, depending on its respective commodity market.

JPY: Japan imports 99% of the oil they use, as they are also considered a highly industrialized economy. Their economy tends to benefit when oil prices decline, as their economy is usually put under strain during periods of higher oil prices. Most major industries such as the Auto and industrial production industries depend on oil on a day-to-day basis. As the price of oil has continued to rise over the course of the past few years, Japanese industries are not able to sustain the same level of growth over the long term due to this increased cost of production. Because oil can have such a severe impact to not only the JPY economy, but also the US and major European economies, it is one of the most widely watched commodities. We may not see this correlation on a day-to-day, minute-to-minute basis, however it is important to note these inter-market relationships and how they influence the long-term trends.

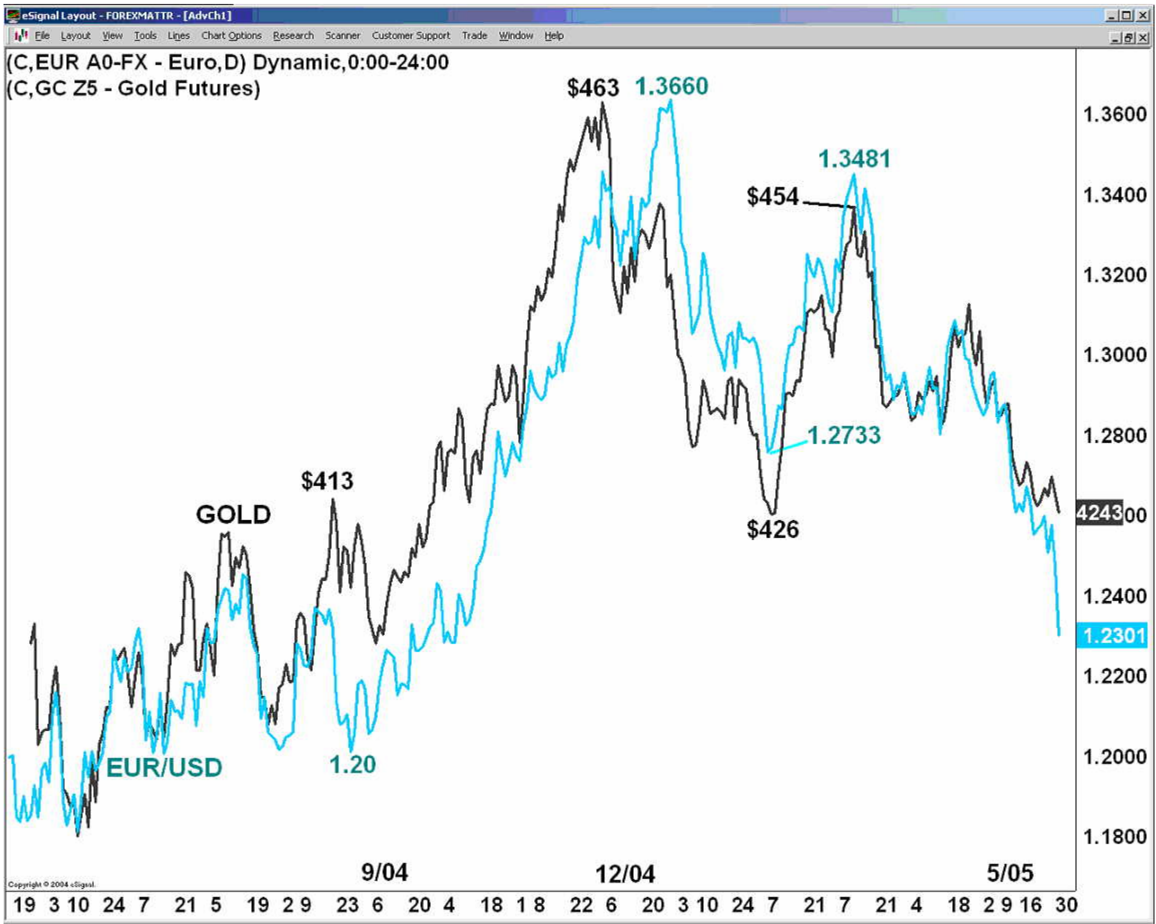


B) Gold

Gold: In addition to oil, the price of gold tends to have a very strong correlation or relationship with such currencies as the CHF, and an opposite or reverse correlation to the USD. Until recently, the CHF was backed by gold, in the same way the USD was a few decades ago. Gold is considered a 'safe haven' for capital during times of political and/or economic unrest. As capital flows out of the USD, Gold tends to benefit, as capital is attracted to tangible assets such as precious metals, primarily gold, in times of uncertainty. On the other hand, during prosperous times, capital will leave the safety of gold, and move into more speculative financial instruments such as the equity markets. Notice on the following daily charts, how gold and the USD/CHF are an almost perfect mirror image of each other, reflecting the flow of capital out of USD and into Gold or out of Gold and into the USD.

USD/CHF & EUR/USD: The price of gold also tends to have a double barrel effect on the USD/CHF. As the price of gold increases, the USD tends to decline in value while the CHF tends to benefit. Since both Gold and the CHF are considered very safe, conservative financial instruments, any movement in either one, tends to have a strong impact on the other. As the price of gold rises in value, capital tends to flow out of the USD, while the CHF tends to benefit. In addition, the EUR/USD pair tends to have a strong correlation to the price of gold, and a reverse relationship to the USD/CHF. Although the EUR currency itself is not back by gold, it is often times considered to have a strong correlation with this precious commodity.

In fact the EUR (EUR/USD) has been considered the "anti-dollar" due to the fact that as capital flows out of the USD, investors are constantly looking for a relatively safe financial instrument, at least for the short term. It is important to look at the reasons 'why' the US dollar may lose value. This could occur due to a high difference in interest rates such as the GBP/USD or AUD/USD. But more importantly, the USD tends to lose value during times of economic and/or political instability inside the US. When this occurs, capital tends to search for financial instruments that generally benefit as an "alternative investment" to the USD. If the US economy is put under strain, perhaps the EUR economy will be the recipient of capital as investors look for a more favorable 'risk to reward' investment.



C) Copper

Copper: Australia is the world's second largest producer of this precious metal, mining nearly 261 tons annually, trailing only South Africa's output of 345 tons. More than half of Australia's exports are metals creating a high correlation between metals and the Australian dollar. Gold and copper particularly have a large effect. The price of copper plays a very large role in not only in the Australian economy, but also in many different sectors. For example, the housing (homebuilder) sector uses a great deal of copper for plumbing and other fixtures. The Australian economy has also benefited from their very strong housing market over the past few years. All of these elements are related in terms long-term economic cycles.

With the US economy, and many other economies around the world falling under strain, the FOMC (US) and other central banks around the world lowered interest rates to encourage economic growth around the world. Lower interest rates made it easier for the average consumer to buy new homes or refinance existing properties. This alone has had a great benefit to the Australian dollar. However, due to poor returns in the equity markets such as the Dow Jones Industrial Average and NASDAQ, investors looked to other financial instruments and commodities such as gold, silver, and copper to hedge their equity portfolios. So one could say that low interest rates stimulated the housing market, which in turn drove up the demand for those products and components that are used in the manufacturing of homes; i.e. copper.

Traders tracking the AUD should also note the price action of copper as well as the fundamental reports released from Australia that relate to their housing markets. As copper, gold, and the Australian housing market soured, the Reserve Bank of Australia raised interest rates to combat the risk of inflation. As AUD interest rates climb quickly, capital from around the world looked to the AUD as it paid a significantly higher yield than other majors such as the USD, CHF, CAD, and JPY. In fact one of the only currencies that currently has a higher interest rate is the NZD, which benefits for some of the same reasons and macro economic forces.

Buying a currency with a higher interest rate, and selling another with a lower interest rate is known as a 'carry trade'. Looking down the road, those interested in the carry trade should not only study the current interest rates but as well the 'anticipation' of future interest rates. The FX market moves in anticipation of higher or lower interest rates based on what information we have at the present time. The FX market, like any market is a "forward looking mechanism".
Therefore, if an Australian economic number is released that indicates that the housing market and/or AUD economy is slowing, or at least, has failed to sustain previous growth, traders may anticipate the Reserve Bank of Australia to cease raising interest rates, and perhaps consider cutting them down the road. In other words, simply buying the AUD/USD (positive carry trade) is not sufficient in order to be a profitable trader. We must not only study interest rates, and the charts, but as well the market's anticipation for future price action and the future outlook of the economies around the world.

D) Quiz

Quiz: Correlations Between Different Markets

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 Correlations Between Different Market.

The quiz center is at the following link.

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