Five Key Factors that Move the Forex Markets -- and How to Profit from Them

Hi! We're Boris Schlossberg and Kathy Lien, and we've been making people money in Forex for over a decade. As senior analysts at FXCM and long-time Investopedia.com contributors, we've seen our share of wins and losses. Thankfully, over the years, we've also been able to learn from our less glamorous predictions and come up with a currency trading system that has earned us a very respectable success rate on Forex trades.

Today, we're sharing our Forex trading system with you. We're going to show you how to analyze the movements of any currency pair using a simple checklist of **five key currency-moving factors**. These are the same factors that we use to analyze our own Forex picks.

Why Forex?

Although trading currencies originated as a way to purchase foreign goods and services, investors soon learned that there are **huge speculative returns** to be made by predicting the value of international currencies. Today, those who use the Forex market as an investment vehicle outnumber those who trade currencies to expedite world trade. In fact, as of December 2006, 80% of all trades in the currency market are made by investors or investment entities out to make a **quick return** on their extra cash.

The Forex market is the **most prolific** market in the world, attracting trillions of dollars per day from central banks, corporations, hedge funds, and individual speculators. This **fast-paced** market operates 24/7, 5 days a week, beginning with trade in Wellington, New Zealand, and continuing on to Sydney, Australia; Tokyo, Japan; London, England; and New York, New York before the whole cycle begins again.

Forex is exciting, and with the right guidance and a bit of luck you can earn 500%, 600%, even 2000% returns. *But Forex is not for everyone*. If you prefer the penny slots to the high roller tables, then the **high-stakes** world of Forex trading is probably not for you. Forex is best traded with money you have allocated as risk capital -- money you don't need for day to day expenses.

So, if you'd like to spice up your more secure investments with a pinch of adrenalin and a dash of risk, try a few Forex trades. But first, let us show you how you can gain an edge in the market with the...

Five Keys to Predicting Forex Market Movements

To profit from the fascinating world of international trade, you must have a firm grip on the key factors that affect a currency's value. When making our trades, we analyze five key factors. In order of importance, they are:

- Interest Rates
- Economic Growth
- Geo-Politics
- Trade and Capital Flows
- Merger and Acquisition Activity

If you can predict how each of these factors affect your currency trades, you have the foundation to make **serious returns**.

Key Factor 1. Interest Rates.
We use two methods to profit from the difference in countries' interest rates:

- interest income
- capital appreciation

Generating interest income.

Every currency in the world comes attached with an interest rate that is set by its country's central bank. All things being equal, you should always **buy currencies from countries with high-interest rates and finance these purchases with currency from countries with low-interest rates.**

For example, as of the fall of 2006, interest rates in the United States stood at 5.25%, while rates in Japan were set at .25%. You could have taken advantage of this rate difference by borrowing a large sum of Japanese yen, exchanging it for US dollars, and using the US dollars to purchase bonds or CDs at the US 5.25% rate. In other words, you could have borrowed money at .25%, lent it out at 5.25%, and made a 5% return. Or you could save yourself all the hassle of becoming a money lender by simply **trading the currency pair** to affect the same transaction.

Generating income from capital appreciation.

As **a country's interest rate rises, the value of the country's currency also tends to rise --** this phenomenon gives you a chance to profit from your currency's increased value, or capital appreciation.

In the case of the USD/JPY spread in 2005 and 2006, as the US interest rates stayed higher than Japan's, the dollar continued to increase in value. Investors who traded yen for dollars gained from interest income (as explained in the section above) as well as the US dollar's capital appreciation.

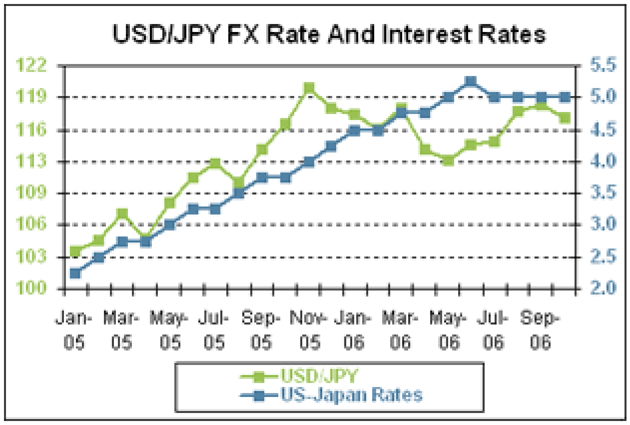

Figure 1-1
Source: FXCM

Figure 1-1. Between January 2005 and November 2006, as the spread between US and Japanese interest rates widened, so did the spread between the currency values. A wide spread in currency values provides investors with a ripe opportunity to earn income through both interest income and capital appreciation.

Interest Rates Spark a 700 Point Rally

Another great example of the power of interest rates in the currency market occurred in August of 2006. At that time, the Bank of England surprised the market by raising its short-term rates from 4.5% to 4.75%. Interest rates for Japan were still at a low .25%.

The rise in England's interest rates widened the interest rate differential on the popular GBP/JPY cross from 425 basis points to 450 basis points. Investment money flowed into Great Britain as traders bought up pounds to take advantage of the new spread. As the demand for the GBP increased, the value of the GBP increased, and the spread between the currencies increased. This domino effect leads to a **700-point rally** in the GBP/JPY over the next three weeks.

Figure 1-2
Source: FFXTrek by Intellicharts

Figure 1-2. When the Bank of England raised short-term interest rates in August 2006, it lead to a 700-point rally in the GBP/JPY over the next three weeks.

80 Points in Less than 24 Hours

More recently, we have used interest rate differentials to successfully predict several profitable trades for *Forex Advisor* members.

The concept of interest rates can be used to trade currencies using both long- and short-term perspectives. On a long-term basis, we look for major themes. On a short-term basis, we look for **surprises in the news** that shift the market's interest rate expectations. We were able to make **two winning trades** based on short-term interest rate flows in the Australian dollar/Japanese yen (AUD/JPY) currency pair on January 24, 2007.

The trigger for our trade was the surprise drop in Australian consumer prices during the fourth quarter. The market was looking for hot inflation numbers but instead they received cold ones. Low inflation numbers meant the central bank of Australia was not likely to raise interest rates as expected. This news sent the Australian dollar tumbling hard against the Japanese yen, as traders speculated that the **interest rate differential** between the two currencies would no longer grow.

The first trade we made on January 24 banked us 45 points. We took profit before the currency pair retraced and then sold it again when it showed further signs of weakness. The second January 24 trade produced an additional 35 points for a total of **80 points**.

Source: FFXTrek by Intellicharts

Key Factor 2. Economic Growth.

The next factor you need to consider when predicting a country's currency movements is its economic growth. The stronger the economy, the greater the possibility that the central bank will raise its interest rates to tame the growth of inflation. And **the higher a country's interest rates, the bigger the likelihood that foreign investors will invest in a country's financial markets.** More foreign investors means a greater demand for the country's currency. A greater demand results in an increase in a currency's value.

Hence, a ripple effect: economic growth inspires higher interest rates inspires more foreign investment inspires greater currency demand which inspires an increase in the currency's value.

How Anemic Economic Growth Crashed EUR/USD 2,000 Points

For a good example of the impact of economic growth on the direction of currency rates, let's look at the EUR/USD from 2005 to 2006. Economic growth is best measured by a country's Gross Domestic Product, or GDP. The United States and Eurozone represent two of the most prosperous regions in the world with GDPs running at $13 trillion and $11 trillion respectively.

In 2005 and 2006, the **difference in growth rates** between the two major economic powers was clearly reflected in currency movements. In 2005, the Eurozone lagged significantly behind the United States in economic growth, averaging an anemic 1.5% rate throughout the year while the US expanded at a healthy 3% rate. Consequently, investment capital flowed **from Europe to the US** and the EUR/USD dropped by nearly 2,000 basis points by the end of 2005. In 2006, however, Eurozone growth perked up while US growth began to slow. At the end of 2006, Eurozone GDP actually overtook US growth rates, causing the EUR/USD to rally.

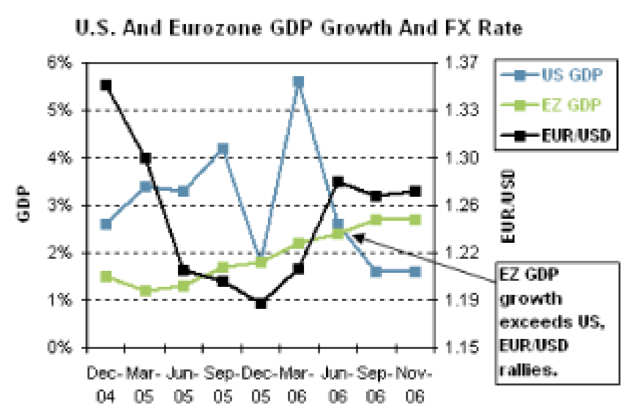

Figure 1-3
Source: FXCM

In 2005, The EUR/USD plummeted as Euro zone showed little economic growth compared to the US GDP. In 2006, as the EZ GDP rallied, so did the EUR/USD.

We've used GDP's to forecast trends on several more Forex trades in the past. One great example is our November 14, 2006; United States dollar/ Japanese yen trade (USD/JPY).

67 Points in Four Hours

In the middle of November 2006, hurt by the contraction in its housing sector, the US economic data began to deteriorate. Rumor had it that the US might **lower interest rates** in the first quarter of 2007, which would encourage foreign investors to look elsewhere.

Meanwhile, the Japanese economy was buoyed by the weak yen that made Japanese products affordable internationally and helped spur double digit growth in exports. On November 14, 2006, the Japanese GDP printed at much better than expected -- 2% versus the 1% forecast. We decided to take advantage of the **strength of the Japanese economic growth** vs. the relatively weak economic outlook in the US, so we went short USD/JPY at 117.82. As we hoped, that morning, in sharp contrast to Japan, US retail sales produced very weak numbers and the USD/JPY pair collapsed. We were able to collect **67 points** on the trade in less than four hours.

Source: FFXTrek by Intellicharts

Key Factor 3. Geo-Politics.

Do you hate the business section? Do your eyes glaze over at the mere mention of economic data and mind-numbing accounting numbers? Fear not. The currency market is the only market in the world that can be successfully traded on political news as well as economic releases. Because currencies represent **countries rather than companies**, they are political as well as economic assets and are therefore very responsive to any disturbance in the political landscape.

The key to understanding speculative behavior with respect to any geopolitical unrest is that speculators run first and ask questions later. In other words, whenever investors fear any threat to their capital, they will quickly retreat to the sidelines until they are certain that the political risk has disappeared. Therefore, the general rule of thumb in the currency market is that **politics almost always trumps economics**. The history of FX is littered with examples of political trades. Let’s take a look at some examples over the past few years.

No-Confidence Vote Depresses Loonie

The end of May 2005 was not a happy time for the Liberal Party government of Canada’s Prime Minister, Paul Martin. After having guided the country to its best economic performance in 30 years, Martin was facing the fight of his life as his party prepared for a no-confidence vote stemming from accusations of past Liberal Party corruption.

Meanwhile, Canada’s economy was becoming a star performer, spurred by the massive rises in the price of oil. As the number one exporter of crude to the US, Canada was benefiting mightily from this newfound wealth. Yet despite the great economic news, the Canadian dollar **remained weak** against the greenback as traders worried about the implications of the fall of the Liberals.

On May 26, 2005, Martin’s government survived the no-confidence vote and the **Canadian dollar rallied**, causing the USD/CAD* to plunge 200 points in less than a week as the market once again focused on Canada’s stellar economic fundamentals.

*The USD/CAD pair trades inversely.

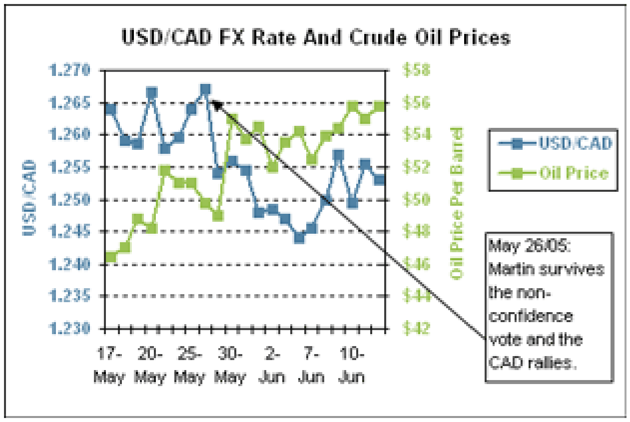

Figure 1-4
Source: FXCM

> Despite strong economic performance, the Canadian dollar remained weak until Martin survived the no-confidence vote and the Canadian political climate settled.

BoJ Governor Fukui Responsible for Floundering Yen

At the beginning of June 2006, Bank of Japan Governor Fukui revealed to the Diet that he had invested 10 million yen in 1999 in a fund founded by financier Yoshiaki Murakami. Murakami was later indicted on charges of insider trading and although Fukui was not involved in any illegal activity, the mere appearance of impropriety in image-conscious Japan greatly damaged his reputation.

As the principal of Japan's monetary policy during its recovery from a decade-long battle with deflation, Fukui was considered one of the most powerful men in the currency markets. His forced resignation would do **great damage** to the prospects of further recovery in Japan.

Meanwhile, Japanese economic data continued to show **stellar economic performance** as exports and business investment continued to grow, unemployment reached decade-long lows, and consumer sentiment improved. Talk spread through the markets that Japan would soon abandon its zero-interest rate policy and would actually have positive interest rates for the first time this century.

Despite all the positive speculation, the **yen floundered**, continuing to decline against the dollar as traders feared that Fukui would have to step down. Fukui stolidly refused, and as the furor passed and the market realized that he would stay on, the yen's strength returned, showing once again that when it comes to currencies, politics can often be more important than economics.

Figure 1-5
Source: FFXTrek by Intellicharts

Despite positive speculation and strong economic reports, the Japanese yen did not regain strength until investors realized that Fukui would not resign.

If you enjoy predicting changes to the political landscape, your talents could be well utilized as a Forex trader. Recently, we predicted a strengthening of the Canadian dollar and earned close to 70 points in less than 24 hours. At 10 to 1 leverage you could have profited along with us, making a **7% return or $700 on a $10,000 trade**.

How OPEC Made Us 70 Points

Geopolitical risk can mean wars, terrorist attacks, or missile launches, but it can also relate to milder yet still politically powerful events such as G7 meetings and OPEC announcements. In October 2006, Saudi Arabia announced that they would back OPEC's plans to **cut oil production** by one million barrels a day after oil prices dropped more than 10% in just seven trading days. The cuts were to take effect on November 1, 2006, with more to come in December.

As Canada is a major exporter and producer of oil, we believed that this policy change would be **very positive** for the Canadian dollar. Therefore we went short the US dollar and long the Canadian on October 19, 2006. Over the next 24 hours, based upon the geopolitical theme, we earned close to **70 points** on the trade.

Source: FFXTrek by Intellicharts

Key Factor 4. Trade and Capital Flows

Before you make your final prediction about the trend of a country's currency, you should take a moment to **categorize the country** as dependent on either trade flow or capital flow. Trade flow refers to how much income a country earns through trade. Capital flow refers to how much investment a country attracts from abroad. Some countries are sensitive to trade flows, while others are far more dependent on capital flows.

Countries whose currency strength depends on their **trade flows** include:

- Canada
- Australia
- New Zealand
- Japan
- Germany

These countries achieve a large portion of their growth through the export of various commodities. In the case of Canada, oil is the primary source of revenue. For Australia, industrial and precious metals dominate trade, and in New Zealand, agricultural goods are a crucial source of income. Trade flows are also important for other export-dependent countries such as Japan and Germany.

For countries such as the US and UK, which have large liquid investment markets, **capital flows** are of far greater importance. In these countries, financial services are paramount. In fact, in the US, financial services represented 40% of the total profits of the S&P 500.

The United States also serves as a perfect example of why it is crucial to understand which flows affect which country in order to effectively analyze the direction of currencies. On the surface, the US currency, with its record multi-billion dollar trade deficit and near $1 trillion current account deficit should depreciate significantly. However, that has not been the case. As the chart below illustrates, the US has been able to attract more than enough surplus capital from the rest of the world to offset the negative effects of its massive trade deficits.

Figure 1-6
Source: Gary Dorsch

> The US has massive trade deficits. However, its currency remains strong because it consistently attracts large amounts of investment capital (capital flow).

For the time being, trade-flow deficits do not matter to the dollar. However, should the US become unable to attract enough capital flow to offset its deficits, the currency may weaken.

Understanding the influence of trade and capital flows has been important to a number of our trades, including our New Zealand dollar/United States dollar (NZD/USD) trade on January 22, 2007.

Uridashi Bond Prediction Returns 40 Pips

New Zealand has one of the highest interest rates in the developed world (as of January 2007 it was 7.25%), and because of that fact, it is a major destination for capital flow. On January 22, 2007, there was talk of **Uridashi bonds** being issued to the benefit of the NZD. Uridashi bonds are issued when companies want to denominate their debt in a higher yielding currency and then offer it to Japanese investors. These are popular because the yield offered is far higher than the yield that Japanese investors can earn at home, which is less than 1%.

We anticipated that the week's Uridashi issuances would inspire capital flow into New Zealand as investors purchased the bonds in New Zealand dollars. Once we made this prediction, we had to decide which New Zealand currency pair we would trade to best take advantage of the movement of the New Zealand dollar. We considered both the NZD/USD pair and the NZD/JPY.

We decided to go long the New Zealand dollar against the US dollar instead of against the Japanese yen. The risk/reward ratio to go long NZD/JPY versus NZD/USD was not as attractive. Our stop in the NZD/USD was more conservative than the risk we would have assumed in NZD/JPY. Therefore, we went long NZD/USD and banked **40 points over the next 24 hours**.

Source: FFXTrek by Intellicharts

New Zealand dollar vs. United States dollar, January 22, 2007. We traded the New Zealand dollar / United States dollar on January 22. The trade returned 40 points in 24 hours.

Key Factor 5. Mergers and Acquisitions

While merger and acquisition activity is the least important factor in determining the long-term direction of currencies, it can be the most powerful force in staging **near-term currency moves**. Merger and acquisition activity occurs when a company from one economic region wants to make a transnational transaction and buy a corporation from another country.

If, for example, a European company wants to buy a Canadian asset for $20 billion, it would have to go into the currency market and acquire the currency to affect this transaction. Typically, these deals are not price sensitive, but **time sensitive** because the acquirer may have a date by which the transaction is to be completed. Because of this underlying dynamic, merger and acquisition flow can exert a very strong temporary force on FX trading, sometimes skewing the natural course of currency flow for days or weeks.

If you keep abreast of international merger and acquisitions, you may be able to predict short-term fluctuations in FX. In late 2006, for example, Canadian economic data showed a great deal of weakness. Yet large demand for Canadian corporate assets from the Asia, Middle East, and Europe overrode the financial reports and kept the USD/CAD at all-time lows*.

*USD/CAD trades inversely

Figure 1-7
Source: FFXTrek by Intellicharts

Although economic data indicated USD/CAD should rally, the pair stayed at all-time lows due to a large number of foreign investors acquiring Canadian dollars to purchase Canadian equities.

In November of 2006, we made a healthy profit by predicting a backward acquisition effect: After a surprising government announcement, money that had been used to purchase equities in Canada, reversed flow and headed out of the country.

Canada Loses Investors, Inspires Big Forex Gains

Merger and acquisition activity can be a powerful but sometimes stealthy driver of demand in the currency market. When a country's capital assets such as equities, suddenly find favor from the rest of the world, they indirectly affect pricing in the foreign exchange market as dealmakers first have to **buy the country's currency** before they can buy the stock. However, woe unto any currency when this situation reverses. Such was the case with USD/CAD in November 2006.

In the fall of 2006, Stephen Harper's newly elected conservative government made a **shocking announcement** that the very popular Canadian income trusts which enjoyed certain tax advantages would be taxed just like other Canadian securities. The Harper government exacerbated the situation by not grandfathering any of the long-term investors who already held positions in income trusts.

We thought the impact of this news would be highly negative to the Canadian dollar as foreign capital would quickly **flow out** of the country. Despite lackluster US economic news at the time, we thought a USD/CAD trade would be profitable because news that affects immediate investment flows typically overwhelms any day to day economic data. Therefore, on November 1, 2006 we went long USD/CAD at 1.1290 and were able to bank **45 points** in just a few hours.

Source: FFXTrek by Intellicharts

United States dollar vs. Canadian dollar, November, 2006. As investment dollars flowed out of Canada, the USD/CAD trade earned us 45 points.

At 10 to 1 leverage you could have profited $450 on a $10,000 investment on the November USD/CAD trade -- that's a 4.5% profit in a matter of hours.

The basic building blocks of Forex analysis are relatively simple to understand. Interest rates, economic growth, politics, trade and capital flows, and merger and acquisition activity are the five primary forces that move prices in the currency market. However, while the factors that drive trade are straightforward, actual currency trading can be **very tricky**.

To forecast the Forex market, you must be able to predict the **endless interplay** of each of the five forces affecting a currency pair. A currency pair typically driven by economic growth may suddenly be overtaken by influences in trade flows or short-term acquisitions. A pair that seems sure to fluctuate with interest rates may unexpectedly be held back by investors' response to political unrest.

Some investors enjoy solving the puzzle themselves -- spending hours and years analyzing the complex cause and effect relationships between a country's economics, politics, and currency strengths. Others are more interested in reaping the potential rewards, without all the hard work. If you are one of the latter, it makes sense for you to find a **qualified Forex analyst** and follow their lead.

(http://www.bkforexadvisor.com, Five Key Factors that Move the Forex Markets, 2008).

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