FOREX SIMPLIFIED

Behind the Scenes of Currency Trading

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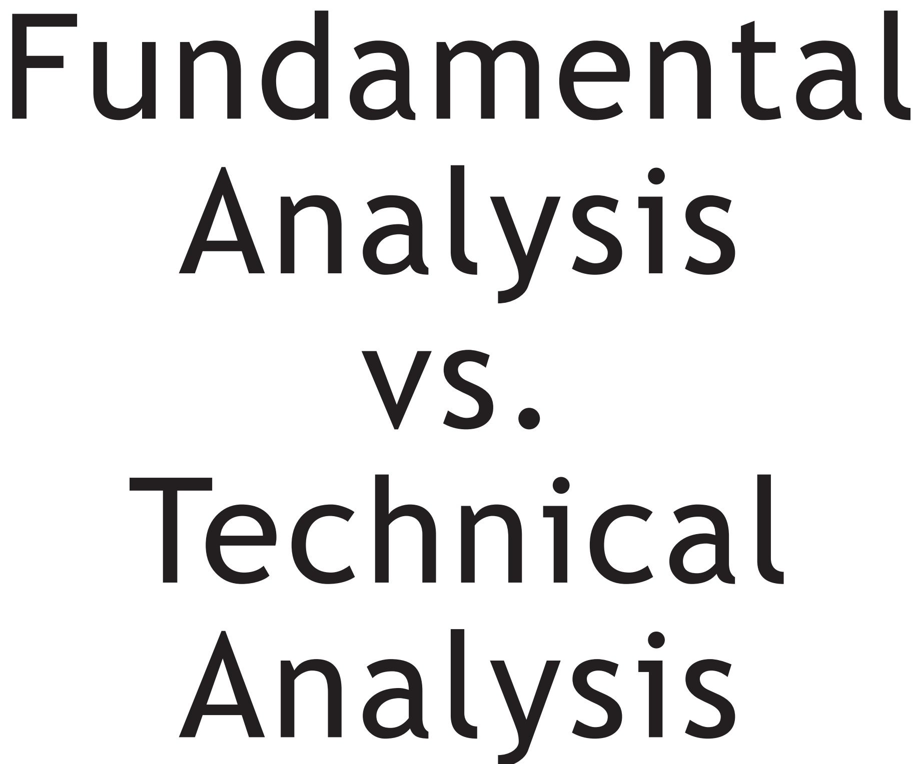
FREE PREVIEW CHAPTER

Chapter 4



Chapter Four: Fundamental Analysis vs. Technical Analysis

I am sure you have heard about both Fundamental and Technical Analysis, and now you are left pondering, "Which one works for me?" Everyone has their own opinion and will vehemently defend their view. My suggestion is to consider both in your daily trading. Technical analysts can point to example after example of why this type of analysis is the one you should use; but, if you have ever watched what happens to the markets on Non Farm Payroll Friday, then you cannot deny the power of Fundamental Analysis. See why I recommend that you consider both?

Let's take a closer look. You are trading on the first Friday of the month. Your chosen currency pair is in an uptrend, all your indicators say buy and the economic data comes in positive. You should feel confident about going long during the new announcement. You may even feel confident staying in your trade through the weekend and into the next week.

Now, if the trend is short, and the indicators are saying sell, but the economic data comes in positive, you may choose to go long during the news announcement, but will likely get out of this trade as soon as you make your desired profit. According to your technical analysis, the price is heading down, so you really shouldn't stay in over the weekend.

Limiting yourself to one style of analysis is a mistake. The more information you can gather regarding your currency pair, the better equipped you will be to trade in this highly volatile market.

Fundamental Analysis

Every time you hear someone talking about fundamental analysis in the Forex market you may notice that there is often very little information informing you how to perform your own fundamental analysis. Most traders (including myself) are left with questions like, "I don't get it, is there a PE ration of Japan?" Well, sort of. Fundamental analysis differs for the Forex market just a little bit, but some of the basic principles apply.

Fundamental analysis for the Forex market examines the macroeconomic indicators, asset markets, and political considerations of one nation's currency as opposed to another. Macroeconomic indicators include things such as: growth rates (Gross Domestic Product), interest rates, inflation, unemployment, money supply, foreign exchange reserves, and productivity. Other macroeconomic indicators include the CPI, a measurement of the cost of living, and the PPI, a measurement of the cost of producing goods. Asset markets are made up of stocks, bonds, and real estate. Political considerations influence the level of confidence in a nation's government, the climate of stability, and level of certainty.

There is a basic rule of thumb that says a currency can become more valuable in two main ways: when the amount of currency available in the world market place is reduced (for example, when the U.S. government raises the interest rates and causes a reduction in spending), or when there is an increase in the demand for that particular currency. But there are also many little things that can nudge the currency's value enough for the retail Forex trader to make (or lose) a substantial amount.

Let's take a moment to examine some of the fundamental information that has the potential to move the Forex market.

Getting a Bird's Eye View

If you want a solid view of the economy driving the currency pair you are trading, it is helpful to get a good overview of both currencies. One way to perform a more complete fundamental breakdown of a currency pair is to compile the following information:

Daily range (past x days):	Average:	Median:
Weekly range (past x weeks):	Average:	Median:

For each pair list:	Daily range	Weekly range
52 week high/low:		
Next Central Bank Meeting Date:		
GDP (annualized growth):		
Short term interest rate expectations:		
How are inflation rates?		
Unemployment rates:		

Filling out this form may help you examine the health of your chosen currency pair.

Checking Out the Macros

An interesting number to watch when you are checking out the macroeconomics of a country is the interest rate. Be careful not to jump to any premature decisions because, interest rates work like a split personality and can have both a strengthening and a weakening effect on your currency. On the negative side, investors will often sell off their holdings as

interest rates increase because they believe that higher borrowing rates will adversely affect stock prices. This can cause a downturn in the stock market as well as in the national economy. High interest rates, however, tend to attract foreign investments, which strengthen the local currency.

Another thing to keep your eye on is the International Trade Balance. A trade balance that shows a deficit (more imports than exports) is usually a bad sign. Deficits mean that money is flowing out of the country to purchase foreign-made goods and this can have a devaluing effect on the currency. It is important to remember that the markets will generally dictate whether a trade deficit is bad news or not. If the country routinely operates with a deficit, it has probably already been factored into the currency price. Trade deficits will generally only affect a currency when they are reported higher than the market consensus.

The Asset Markets

The asset markets have an interesting tie to the value of a country's currency. For instance, in the past, the USD has moved in line with the stock markets. In fact, everywhere you look people are still touting that relationship. However, if you look at the charts, you will find that this doesn't really hold anymore. The trend lately has been if the stock markets are up, then the USD is usually down. This is possibly due to the fact that U.S. companies have increasingly derived their revenues from outside the U.S. You can also see the same sort of influences between the Japanese yen and the Nikkei.

Some currencies, however, are more closely aligned with the commodity prices. The four major currencies that are usually mentioned in conjunction with commodity prices are the Australian dollar, the Canadian dollar, the New Zealand dollar, and the Swiss franc. Gold and oil in particular, are the commodities that have the greatest influence on the Forex market and some tout them as leading indicators for Forex trading.

Watching the price of gold can be very beneficial for Forex traders, especially if you bear in mind that gold tends to move on inflationary scares. If you know how your chosen currency pair reacts to gold, you may have an interesting predictor of price movement.

For instance, the U.S. is the world's second largest producer of gold after South Africa. So, the price of gold can have a strong impact on the USD. It is important to remember, though, that gold doesn't normally move in line with the USD; they tend to have an inverse relationship to each other. The Australian dollar also has strong correlations with gold because Australia is the world's third largest exporter of gold. Bearing these facts in mind, it is easy to see why the AUD/USD pair tends to follow gold's price.

The other 800-pound commodity gorilla in the Forex market is oil. The Canadian dollar is the currency most influenced by rising or falling oil prices. If you have an eye for the USD/CAD, then it is interesting to watch oil-related news. For instance, several months ago, there was a spike in oil prices due to the death of a former Iraqi ruler. This spike translated into movements in the Forex markets. This was a classic example of using the price of oil as a leading indicator for Forex prices.

It's All About Politics

Politics can play a strong role in the value of a currency. Several misspoken words by a political leader can boost or drop that currency's value in a matter of seconds. A general rule of thumb is the more volatile the politics, the more volatile the currency. The political neutrality of the Swiss and the fact that a large amount of its currency reserves have traditionally been backed by gold is why the Swiss franc has been hailed as a safe haven during periods of uncertainty. This means that the CHF/USD ends up having a strong positive correlation with gold prices.

Technical Analysis: A Beginners Guide

Most people have heard of technical analysis. It has been around for well over 100 years and has been used heavily and touted by securities and commodity traders for decades. Many of us have been to a sales presentation advertising technical analysis. The charts flash up on the screen, the presenter points out perfect buy and sell signals, and at the end of the presentation, you are expected to shell out for a software program that will tell you exactly how to trade.

The fact is that you do not need to pay the big bucks to learn how to trade. Technical analysis is not hard or scary. Once you understand the basics, you will realize that there is a lot of information to be learned from your charts, and it is all free for the taking. Most of us have done a little technical analysis whether we know it or not. Just looking at a price chart is a rudimentary form of technical analysis.

Before we get started, however, I want to remind you that trading well is a skill that takes years of practice, a little training, and a lot of learning from past mistakes. I am not going to offer you a posy-lined path to market wisdom and success. To use a common analogy, there are many ways to build a house. You need to decide what kind of house suits you.

The Definition

The official definition of technical analysis is the analysis of past price data to determine future price movements. It is the study of prices in order to make better trades. The basis of modern-day technical analysis can be traced back to the Dow Theory, developed around 1900 by Charles Dow. It includes principles such as the trending nature of prices, confirmation and divergence, and support and resistance. Technical analysts, or chartists, use a number of tools to help them identify potential trades, some of which I will attempt to cover in this book.

Why Technical Analysis Works (Or Not)

Technical analysis uses past and current behavior to predict future behavior. Think of it like weather forecasting. The weatherman (or weatherperson, if you will) looks at the weather patterns that are currently emerging and compares them to similar weather patterns that have appeared in the past. If eight of the last ten instances of this weather pattern have produced rain, then the weatherperson can confidently predict rain.

Technical analysis works because humans are predictable. People often behave in predictable ways. They will consistently repeat their behavior under similar circumstances.

Technical analysis is the art and science of identifying crowd behavior in order to join the crowd and take advantage of its momentum. This is where the often-overused phrase "control your emotions" comes into play. You will want to be sensitive to what the market is doing without succumbing to crowd mentality. Technical traders work hard to avoid political and analyst chatter because they believe that all the information they need to know is already embedded in the price.

However, remember not to overanalyze; every action causes a reaction. There are millions of traders analyzing the same charts as you are and that leads to a cat-and-mouse sort of game playing that can be incredibly complex, riddled with bluffing, cheating feints, and double crosses. Traders can be a crafty bunch.

Components of Technical Analysis

Charts

Most technical analysts use charts as their primary tool. Charts are the heart and soul of the technical analysts tools, and they come in all shapes and sizes. The most commonly used types of charts are line, bar, candlestick, point and figure, and renko. Each price style has different interpretations and uses, and everyone has their favorites.

Trends

If I hear one more person say, "The trend is your friend," I will probably scream. Unfortunately, it is fairly apt, and you would be wise to remember that the trend does rule. There are countless books and articles out there that will tell you to trade with the trend. So we nod and smile and think, "Yes, I will always trade with the trend. That is completely logical." And they look so logical when you see someone else draw one on a chart. If you are like me, you think, "Of course! I would have to be a blithering idiot not to see the trend!" Then I go home and look at the chart and think, "Hmmm, is that an uptrend? Or perhaps it is a downtrend? Do I look at the one-hour chart or the 5-minute chart? What if they are different? Which low points do I use? And what about that weird spike?"

Identifying trends is a critical tool for the technical trader. The problem is figuring out how you will define a trend. I did a search on the Internet and found the following definitions for trend:

1. The general drift or tendency in a set of data;
2. The general direction, either upward or downward, in which prices have been moving;
3. The direction (either up, down or sideways) in which price and trading volume are moving over a short term or a long term basis;
4. The change in a series of data over a period of years that remains after the data has been adjusted to remove seasonal and cyclical fluctuations.

It seems to me that the definition of a trend is a little blurry. Even after you define trend, what type of trend are you talking about? Is it a major trend, a secular trend, a trend micro? For the sake of my sanity, let's define a trend as a series of higher highs or lower lows over a period of time, or the direction that the price is moving.

But charts don't always move in a nice smooth line in one direction or another. In fact, I have never seen a nice, smooth angled line. Price charts

tend to zigzag back and forth along a general trend line. Trends have three basic directions: up, down, and sideways. Most of the tools on the market today have been designed for markets that are either moving up or down and tend to fail miserably when the market decides to move sideways; so, it is important to be able to monitor when the market has stagnated.

Trend Lines

Do you know how to draw your own trend lines? Do you know the definition? A trend line is defined as a straight line that starts at the beginning of the trend and stops at the end of the trend. Clear as mud, right? Pick the lowest lows in a move and draw a straight line connecting both the bottoms. Congratulations, there is your first trend line! The reason that you would want to draw a trend line is to help you identify places on your chart where the trend may change. That change isn't necessarily up to down. It can mean up to sideways, sideways to down, or any number of variations on the theme. So don't jump to conclusions if the price bars break the trend line. It could just mean a pause in the action before resuming the same trend path.

Drawing trend lines takes practice and confidence. First, look for the larger trend. If the chart is all over the place, then you will not be able to easily identify a solid trend, and while you are getting your feet wet, don't make yourself crazy. You will need two or three identifiable lows. Remember, it takes at least two points to draw a line. If you have only two points, don't count it as a firm trend line. Wait for the third bounce before you decide that it is truly a trend line. Once it has touched three times, you have a nice little trend line. This should hark back to your college physics classes and the old adage that a body in motion tends to stay in motion until acted upon by another force. The more times your price bounces off your trend line, the more significant you can consider your trend line to be.

Also, be realistic about whether a trend line is there or not. Often, you won't be able to draw trend lines on your chart. Remember, a valid trend

line is a line that helps you identify the direction of a price move. Once you start drawing trend lines on your chart, you will be unable to stop. It is fascinating to watch a price move up and along the trend line, bouncing along like a rubber ball.

Once you get comfortable with your trend lines, start looking for breakouts. A breakout is any part of the price bar that penetrates a line that you drew on the chart. You will want to beware of false breakouts, though. False breakouts can be especially damaging because you may automatically want to assume that a breakout means a reversal. That is not necessarily true. But it is tempting to jump into a breakout because the first few periods after a breakout are often the best time to get in on the market move. In my experience, it seems to be that a breakout that occurs in the course of a low volatility trend is more likely to be meaningful than a breakout that occurs in a highly volatile trend.

You will need to experiment with your reactions to price penetrations of your trend lines. Some traders prefer to wait for the candle after the penetrating candle to make decisions regarding the validity of the penetration. You don't want to make a knee jerk decision and have the market return to its original path.

Check Appendix B for the Trend Line Workbook, complete with before and after charts. What I want you to do is break out your pencil and a straight edge and draw some trend lines.

Support and Resistance

Support and resistance lines are another valid concept that all technical traders respect. Think of prices as a head to head battle between the currencies in the pair you are trading. For instance, in the case of the EUR/USD, imagine the euro traders pulling one way and the USD trader pulling the other. The direction the price actually moves reveals who is winning the battle. Each time the price reaches a certain level, the euro traders will pull the euros' value back up and prevent it from

falling further. This type of price action is called support because the euro traders are supporting the price. Similar to support, a resistance level is the point at which the sellers take control of the price and prevent them from rising higher. Support levels indicate the price where the majority of the investors believe prices will move higher, and resistance levels indicate the price at which the majority of investors feel prices will move lower.

You can identify support and resistance lines by drawing horizontal lines on your charts. It is always a good idea to know the support and resistance levels of the currency pair you are trading. The development of support and resistance levels is probably the most noticeable and recurring event on a price chart, and there may be places where you would want to put potential a stop-loss or take-profit. Penetration of these support and resistance levels leads to the formation of new support and resistance levels. The longer that the price remains at a support or resistance level, the more significant that level becomes.

Resistance Becomes Support and Vice Versa

When a resistance level is successfully penetrated, that level usually becomes a new support level. Similarly, when a support level fails, that level usually becomes a new resistance level.

Indicators

An indicator is a mathematical calculation that is applied to a security's price. The result is a value that is plotted on a chart and used to anticipate price changes. Or, in other words, lines and graphs that you can plot on your price charts to help you figure out what is happening.

There are literally thousands of indicators and many, many books that have been published about different indicators. I am not going to go into all the different indicators here, but I would advise you to keep it simple. There are four basic types of indicators: those that measure velocity,

momentum, volatility, and volume. Volume doesn't hold in the Forex market because there isn't a central exchange that measures volume, but choosing one indicator from the remaining three categories should give you a balanced view of what is going on with your charts.

The heart of your chart watching and analysis should be your indicators. Everyone has their favorite indicators. I have seen many people sell their indicators for a pile of money. My opinion is that with a little perseverance, you can find pretty much any indicator you need on the Internet. So if you are willing to put in a little work, then you may find what you are looking for without shelling out hard earned cash. Remember that most "new and fabulous" indicators are really just regular indicators with a few tweaked settings that someone has changed the name on in order to solicit a bunch of sales. You are better off doing a little homework and understanding what your charts are trying to tell you.

For a quick review of common indicators see Appendix A.

Convergence and Divergence

You will hear these two terms often when you listen to the market analysts. Convergence refers to two indicator lines coming closer to one another and divergence refers to two indicator lines moving farther apart. Convergence is most often seen in indicators on the price chart, and generally means that the price action is starting to go sideways or has a narrower high-low range.

Benchmark Levels

Benchmark levels refer to the historic highs and lows on a price chart. These aren't indicators that can be applied to a chart but may serve to indicate future price action. When a price makes a new historic high or low and then retraces, it can be quite some time before the benchmark is surpassed. Historic levels can cause some strange indicator behavior. If an uptrending indicator flattens out mysteriously, widen the timeframe

on your chart to see whether the price is near a historical level. The market will test these historical levels. If the test fails, then you might expect a retracement and perhaps a reversal.

Retracements

Admitting that no one can forecast a retracement hasn't stopped many people from trying. The following guidelines are helpful but don't statistically sound, so proceed with caution.

- A retracement won't usually exceed a significant prior high or low.
- Watch for round numbers. Traders are human and as people we tend to like nice round numbers. Think about it, would you set a stop at 1.2527 or 1.2530?
- The 30 percent rule: you can assume that a majority of traders will place stops to avoid losing more than a certain percentage, like 30%. The only issue with this is that you don't know where the majority of traders got into the market.

Noted technician, W.D. Gann used to say that the best retracement was a 50 percent retracement. It is the best place to re-enter an existing trend. If the trend resumes, it will then exceed the previous high, which identifies an immediate minimum profit target.

Fibonacci

Fibonacci numbers were named after Leonardo of Pisa, also known as Fibonacci, even though they had already been described earlier in India. The best-known Fibonacci numbers are a simple series of numbers that form a sequence. After two starting values, zero and one, each number is the sum of the two preceding numbers. The Fibonacci numbers are studied as part of number theory and have applications in the counting of mathematical objects such as sets, permutations, and sequences. Fibonacci levels are commonly placed on charts to predict potential retracement levels.

Market scholar, Ralph Nelson Elliot, believed that those Fibonacci numbers could also be found in man's behavior and could therefore be charted to predict future behavior. Elliott observed that securities prices appear in a wave like form on charts, hence the name Elliott Waves. Elliott wave adherents often use Fibonacci levels, with special attention to the 38 percent and 62 percent levels, to predict the extension of the retracements.