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Five Key Factors that move the Forex Market

To profit from the fascinating world of international trade, we 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

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%. We 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 well as the US dollar's capital appreciation.

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 lead to a **700-point rally** in the GBP/JPY over the next three weeks.

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.

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.

Key Factor 3. Geo-Politics.

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**.

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.

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.

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*.