December 2004 • Strategies, News and Analysis for Forex Traders

CURRENCY TRADER

Volume 1, No. 3

GLOBAL IMBALANCE

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carry trade

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with macro factors

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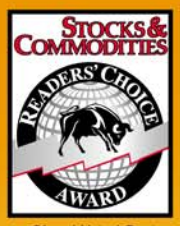

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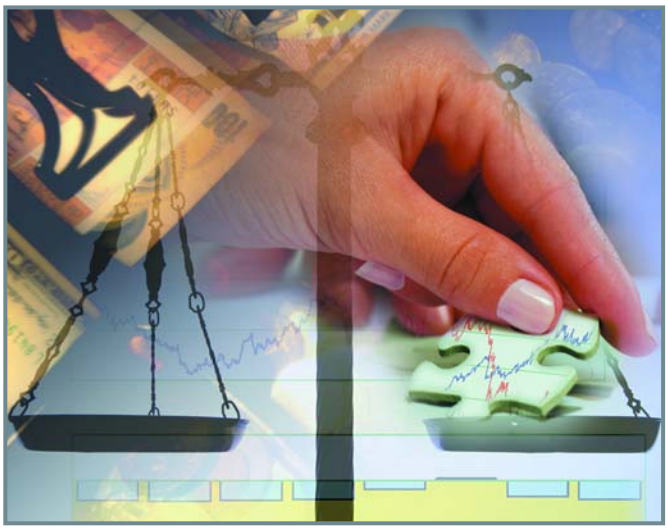

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Ball of confusion

As 2004 draws to a close, the forex market seems to be setting up some kind of a cliffhanger, with the U.S. dollar in the starring role. Will it or won't it veer over the edge? Half the trading world seems to be banking on a big dollar rebound in 2005 (despite Fed Chairman Alan Greenspan's comments that clobbered the bulk on Nov. 19), while the other half is looking for the currency to really fall out of bed after stabilizing (somewhat) recently.

Also open to debate is whether the G7 will attempt to engineer a "soft landing" for the greenback or let the market cut its legs out from under it.

The overall economic and intermarket picture is about as confusing as it could be. While the dollar is weak, commodities are up, stocks are up and treasury yields are down. The normal relationships seem dead or on serious vacation.

In "The Great Global Imbalance Hoax" (see p. 16), Barbara Rockefeller looks at the dollar's drop in terms of the real implications of the U.S.'s current account deficit and the fear that foreign investors, especially central banks, will withhold demand for U.S. securities, especially treasuries, until the dollar stops dropping. Rockefeller argues there's more to this story than meets the eye, and the deficit is mostly a red herring.

Open to debate is whether the G7 will attempt to engineer a "soft landing" for the greenback or let the market cut its legs out from under it.

With so many currency pairs wandering in consolidation, how this problem works itself out will have serious repurcussions for all forex traders and investors.

If you want to get away from the dollar (at least hypothetically) for a little while, "The short-term British pound/Japanese yen carry trade " (p. 22) looks at an interesting pattern in the pound-yen rate that should interest short-term traders looking to take advantage of one of the unique characteristics of the forex market — the transition from one trading center to the next throughout the 24-hour market day. Also, "Hot rates" (p. 13) includes a big-picture look at the Aussie dollar/yen pair.

But all roads in forex still have a tendency to lead to the dollar, and the question hanging over the market now is: Will the dollar come alive in '05?

Mark Etzkorn, Editor-in-chief

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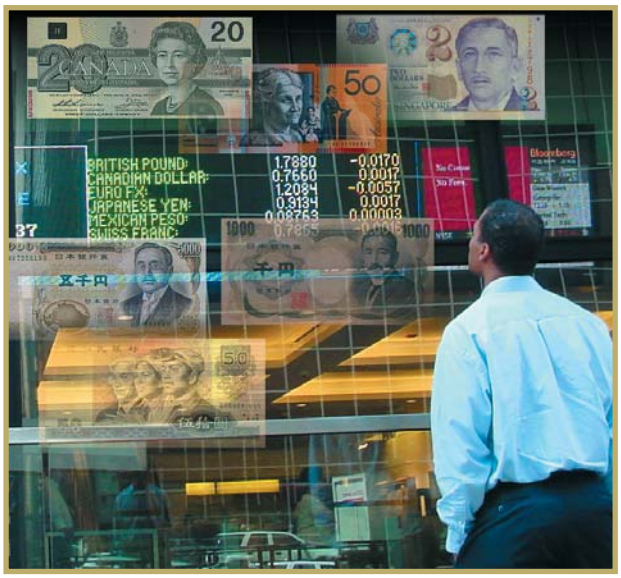
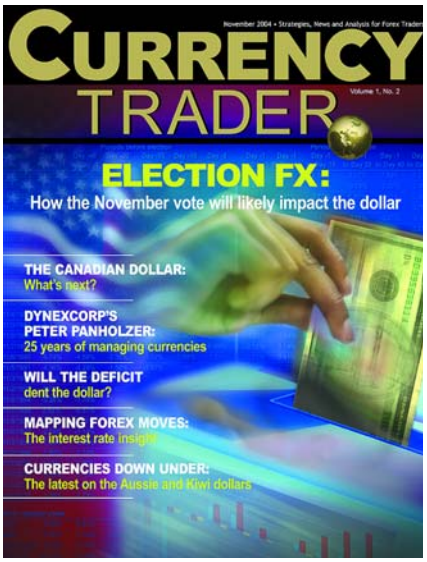
▼ **Dave Floyd** is a professional FX and stock trader who has been trading on behalf of his own account since 1994. He currently offers an FX Advisory Service and FX Managed Accounts through his firm, Aspen Trading Group (www.aspentrading.com).





No paper trail?

Great job with this magazine! But one question: Are you ever going to have a printed version?

— Dan Imperato

We have no plans for a print edition. Currency Trader *is designed for a global audience, which is best served by online distribution.*

However, the magazine is designed and formatted to print out in perfect page form. Readers who want hard copies of certain articles only need to hit their print buttons.

We are aware the Zinio Reader software currently only allows for printing two pages at a time, but Zinio has indicated they are looking at that issue and things could change in the future.

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Awww, Canada

I must say that *Currency Trader* stands for quality. It is a very informative and educational magazine and has no real competition in the subject area. The net community was in need of something like this. Keep up the good work!

— Ivan Ballevona
Toronto

Dollar daze

I enjoyed the story on the dollar's behavior after elections ("Elections and the U.S. dollar," *Currency Trader*, November 2004) but I think it, and Maria Fiorini Ramirez' dollar outlook ("The dollar and the deficit"), highlight one of the basic challenges of trading: The best idea in the world sometimes doesn't mean anything. Both articles make good cases for a stronger dollar (in the near-term and further out), but as yet, the dollar has remained weak.

It won't be that way forever, but it just goes to show you how hard it is to know when a trend will stop being your friend, and the limitations of rationale analysis.

— Jerry Blancard

Reuters and the Chicago Mercantile Exchange: A match made in heaven?

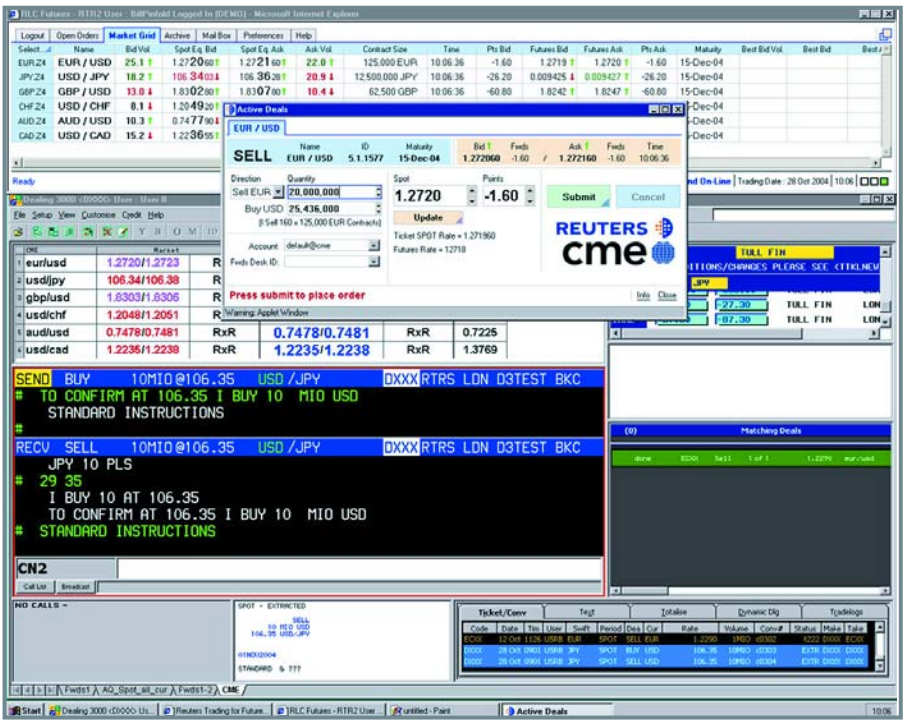
What's behind the CME-Reuters partnership and will individual forex traders be able to take advantage of it?

The Chicago Mercantile Exchange and Reuters LLC are planning to open up currency futures trading to a wider customer base. And the partnership is more than just the CME displaying its market data on Reuters terminals, as some in the industry previously thought.

The two organizations have agreed to electronically connect their foreign exchange networks: the eFX futures contracts traded on CME's Globex electronic trading system and Reuters' Dealing 3000 system, which trades spot forex. The agreement is scheduled to go live for beta testing in December.

The partnership should have a significant impact on CME currency volume, adding depth and liquidity, according to Richard Sears, managing director for foreign exchange in the products and services division of the CME.

"We've displayed [our data] in spot-equivalent terms," he says. "We now quote it the way the cash [forex] markets do. It takes futures contracts and strips the interest-rate bit out so [traders] can compare futures prices to spot prices."



Positive reaction in FX market

The partnership basically breaks down barriers between futures and spot forex market participants. Specifically, Reuters will take a market data feed from CME and convert the currency futures prices into the spot forex rates the interbank market is accustomed to using.

Reaction in the FX markets has been positive.

"It's a good idea because more and more traders are now watching FX futures *and* the spot FX prices for indications and potential price action," says Dave Floyd, trader and owner of Aspen Trading. "It reminds me of the way we used to watch the S&P futures so closely for clues on what stocks might be about to make a move."

Despite concerns by some critics that FX is too big a market for an exchange model, "it simply isn't," Sears says.

"The bigger it gets the better. If there were only a handful of players, they would all know each other. Anonymity will add to the appeal of the system," he says.

With 17,500 stations around the world, Reuters brings the mainstream interbank FX market to the partnership, while the CME contributes a different group: The CME's customer base is 50 percent hedge funds and commodity trading advisors (CTAs).

Credit risks

If the partnership works, the implication is many of the parties involved will have to relax their credit-risk con-

straints. Banks that usually only trade with other banks would not potentially be trading directly with hedge funds and CTAs.

But the CME/Reuters stance is that while Reuters will provide easier access to the wider range of trading opportunities, the CME will offer credit intermediation.

The agreement offers a method of removing credit as an obstacle to the search for new liquidity and brings a regulated product to a market with an appetite for regulation. The CME operates a capital-efficient market because it functions as a central counterparty (CCP) that assumes responsibility for trade clearing.

While some banks might not want to operate in that environment, the cost of capital usage, which will increase in the future, means any efficiency will be seized on. The market model of futures exchanges, with their central counterparties, is appealing to market participants, Sears says. The idea is, if this deal develops as it could, there's a chance the spot FX world will adopt an exchange model and the CME and Reuters will be the two major beneficiaries.

"This is a whole new opportunity for [us] to get bank customers," Sears says.

Reuters and the CME have worked together before in the development of the Globex platform.

Additionally, rumors emerged in mid-November the CME is interesting in acquiring Instinet, Reuters' stock-trading business, to broaden its trading reach beyond futures.

"Acquisitions and consolidation are an important part of CME's growth strategy, but we do not comment on any specific aspect of that strategy," says David Prosperi, spokesperson for the CME.

• • • PIPS

CHINESE COMPANIES GET HELP

▼ A trio of financial groups — ABN Amro, Credit Suisse First Boston and ING — are going to offer derivatives that will help Chinese companies minimize fluctuations in currencies. The firms are able to offer the products thanks to a loosening of financial rules by the Chinese Government. The derivatives will allow Chinese businesses to hedge against swings in the price of foreign currencies. Other firms are interested in offering the derivatives but are awaiting approval from China.

FOREX ON THE TIFFE

FX TIFFE

▼ Published reports indicate the Tokyo International Financial Futures Exchange (TIFFE) will start a forex margin trading market early in 2005. Both individuals and institutions will be able to trade on the exchange, which will begin by trading the U.S. dollar, euro, pound and Australian dollar. Traders on the exchange will have 10 times leverage (i.e., a $10,000 deposit will allow them to trade $100,000 worth of securities).

CME volume update

The Chicago Mercantile Exchange electronic trading volume in November achieved a new trading record of 3.7 million contracts. This was the second time the exchange traded more than three million contracts in a single day electronically, the last time being 3.5 million contracts traded on Aug. 6.

CME electronic foreign exchange (eFX) also set a record on Friday, Oct. 27 with 270,648 contracts traded, compared to the previous overall eFX record of 236,000 set on Oct. 28. The strong volume in CME eFX was driven by a record in EuroFX futures on CME Globex of 143,331. The exchange also set a new record in CME Eurodollar futures traded on CME Globex with 2.1 million contracts.

Dollar policy

U.S. Treasury Secretary John Snow gave no signal of a shift in the U.S. dollar policy on Nov. 17 after it slumped to yet another low against the euro.

He maintained steadfast language in recent weeks when asked about the dollar, apparently ruling out any U.S. support for intervention to stem the slide in the currency.

Snow has denied the argument that Washington favors a weaker currency to help exports and the economy.

In addition, G20 policymakers made no mention of the dollar's slide in a statement issued at the end of their meeting in Berlin, reinforcing the view that major nations have accepted the need for a weaker dollar to correct the U.S.'s trade gap.

The G20's call for more Asian currency flexibility was seen putting more downward pressure on the dollar, according to news reports.

Financial markets had been speculating the G20, which includes the Group of Seven (G7) rich nations and big developing countries such as China, might create the kind of international accord the G7 struck in 1986 to manage major currencies.

The end of BOE rate hikes

Is the tightening cycle in the U.K. complete?

BY CURRENCY TRADER STAFF

After a series of aggressive rate hikes over the past year, the Bank of England (BOE) held its repo rate steady at 4.75 percent at its Nov. 4 meeting. Many analysts believe this may mark the end of the tightening cycle in Britain — at least for now. The next meeting is set for Dec. 9.

"The BOE inflation report was a bit less concerned about inflation going forward," notes Bob Lynch, currency strategist at BNP Paribas in New York. "We do think the tightening cycle is complete."

Housing prices have stopped rising and by some measures have even registered declines in recent months.

Although housing-price inflation still registered a hefty 13.8 percent year-over-year increase in September, actual housing prices declined -0.1 percent during September, according to the UK Office of the Deputy Prime Minister (ODPM). However, the key point for the BOE is "the rate of increase has decelerated substantially," Lynch says. "We had been seeing price increases at a 20-percent per year rate."

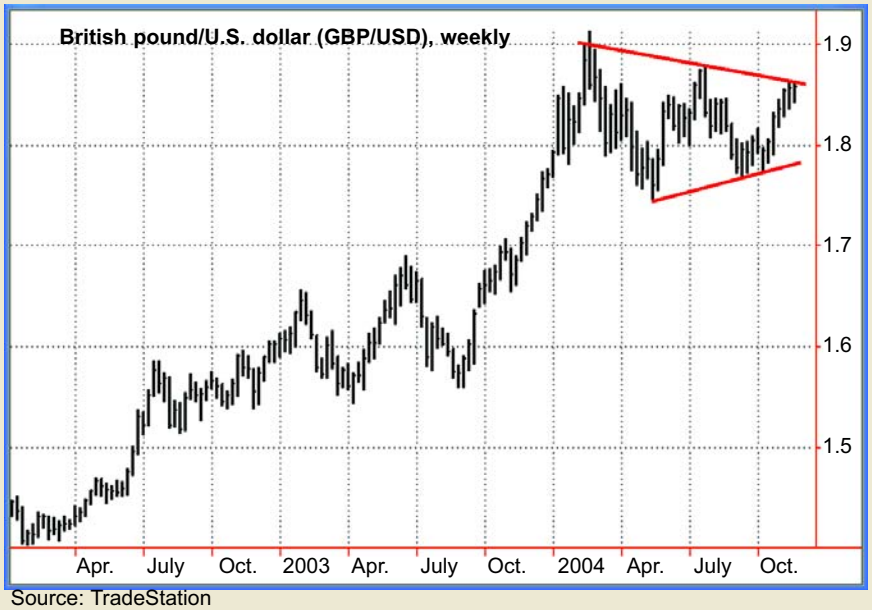
In terms of overall growth in Britain, Kathleen Stephansen, director of global economic research at Credit Suisse First Boston, says the economy isn't doing too badly. While a soft patch was seen in the third quarter with a 2.2-percent growth rate, Stephansen forecasts overall GDP growth at 2.8 percent in the UK in 2005. BNP Paribas' official forecasts for 2005 GDP growth are slightly lower at 2.5 percent.

"They've had a very strong economy over the past few months," says Tom Rogers, senior currency analyst at Thomson Financial. "They are growing stronger than the rest of Europe."

In other economic news, the UK trade deficit narrowed sharply in September to 4.5 billion pounds from 5.2 billion pounds. Analysts point to an 11-percent jump in exports to non-European Union countries as the key factor behind the shrinking gap. Broad-based improvement occurred, with impressive gains to Asia, including a 15-percent increase to China and 27-percent increase to Japan.

FIGURE 1 — TESTING RESISTANCE

In November the pound-dollar rate (GBP/USD) had reached the upper trendline of a triangle consolidation on the weekly chart.



Source: TradeStation

Analysts point to signs the housing market is cooling off in Britain as one factor that could keep the BOE on the sidelines in the months ahead.

Pound picture

What has this meant for the British pound? The sterling soared to a 12-year high at $1.91 in February 2004, driven in part by aggressive BOE rate hikes and the positive interest rate differentials those hikes created for the currency.

However, since February, the pound-dollar rate has formed a triangular consolidation pattern on the weekly chart with the most recent swing-high resistance around $1.87 and swing-low support around $1.77 (Figure 1). As of mid-November, the pound had edged toward the upper end of that range and is poised to test resistance at the $1.87 area.

Macro factors

Renewed weakness in the U.S. dollar, which saw the euro push to all-time highs in the $1.30 area, have helped

support sterling in recent weeks, analysts say.

Another factor that supported the pound from mid-October to early November was reserve shifting from dollar assets into the pound by the Bank of India. However, Rogers notes as of mid-November they stopped buying sterling.

The key question for forex traders is: what will the end of BOE rate hikes mean for the pound, which has been stuck in a narrowing consolidation?

From an interest-rate differential standpoint, Credit Suisse First Boston's Stephansen notes "the ECB [European Central Bank] hasn't begun hiking yet. Since the BOE is at the end of its tightening cycle, this policy divergence could bring a correction to the sterling."

ECB left rates steady at its early November meeting at 2.00 percent. ECB President Jean Claude Trichet highlighted improvements in economic strength in the euro zone area, but warned about the negative impact from higher oil prices. The ECB's only mandate is to ensure price stability. The inflationary impact from stronger energy prices could move the central bank to raise rates there.

U.S. dollar action

However, given the market's general acceptance that the tightening cycle is likely over in Britain, action in the sterling may, at least in the short-term, be driven by the direction of the U.S. dollar.

"As opposed to developments in the UK, the key hinge point for the pound is the dollar," Lynch says.

Thomson Financial's Rogers expects the pound to test the $1.88/1.90 area before the year is over.

"I don't think the dollar sell-off is over yet," he explains.

While Rogers is upbeat on the outlook for the pound, he does note that recent gains in the sterling have not kept pace with euro and Swiss franc strength.

"Because rates are likely on hold, it is definitely holding the pound back from making stellar gains," he explains.

The technicals

Looking at the charts, Rogers highlights key levels for forex traders to watch on the downside. He points to the bottom coming in at $1.8393.

"We bounced off the bottom three times in the past two weeks," he says. "If we go below that level a lot of people will start to think the uptrend is over."

Andrew Chaveriat, technical analyst at BNP Paribas, also says the key level on the upside is $1.8770, the July high. Gains through that key resistance point would target a retest of the $1.91 area, he says.

"I would be bullish at this point and buy these dips," he says.

He also highlights the $1.83 area as key to watch on the downside.

"A close under there would signal a deeper retracement," Chaveriat concludes.

Hot rates

Japanese, Australian, and Canadian currencies offer some of the most compelling forex trades right now.

BY CURRENCY TRADER STAFF

Wondering what the most active and interesting forex rates to trade right now are? *Currency Trader* asked three analysts for their top cross rates heading into the New Year and they chose AUD/JPY, AUD/USD, and USD/CAD.

According to Brian Dolan, director of research at Gain Capital, action in the AUD/JPY could prove interesting over the next several months. While AUD/JPY had, as of mid-November, pushed to its highest level (around 81.75) since March 2004, Dolan highlights a number of fundamental and technical factors that could make that trend switch gears. Generally, Dolan favors selling the Australian dollar vs. the yen.

While fundamental factors are positive for both of these currencies, Dolan believes the yen is more likely to appreciate amid "potential for revaluation of the Asian currencies," which would allow the yen to strengthen, he says. While many Asian countries, notably China, have been able to artificially keep their currency levels relatively weak despite robust growth, "the next major shift will likely see these currencies appreciate," Dolan says. Any strengthening of the Chinese currency would probably spill over to the yen.

A second factor likely to support a retreat in the AUD/JPY rate over the next several months is a decline in "uridashi" issuance, Dolan speculates. Uridashi refers to non-yen fixed-

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FIGURE 1 — AUD/JPY: POISED TO DROP?

In addition to fundamental factors, a potential head-and-shoulders top in the AUD/JPY rate implies the possibility of a correction down to the 74.00/75.00 level.

Source: Gain Capital

income instruments sold to Japanese investors. Uridashi denominated in Australian dollars have been a popular choice among Japanese investors, simply because of higher Aussie interest rates. However, "uridashi issuance peaked in 2003 and is expected to decline further this year," Dolan notes.

As the Japanese economy continues to show signs of improvement, Japanese investors may choose to keep their investment dollars at home. If the decline in uridashi issuance continues, the demand for Aussie dollars will decrease.

Finally, Dolan highlights a potential head-and-shoulders top formation on the monthly AUD/JPY chart as a negative factor (see Figure 1). Dolan says as long as the 82.50 resistance area (established by a trendline connecting the tops of the two shoulders) holds, he looks for an eventual retreat back to approximately 74.00/75.00 (the level of the pattern's "neckline") over the next six months.

Another look down under

Sean Callow, currency strategist at Ideaglobal, offers another top cross rate pick. He points to the AUD/USD as a hot cross to watch. A daily chart reveals the Australian dollar has been screaming higher vs. the U.S. dollar in recent weeks (see Figure 2). The cross rate soared from a low at 68.53 in early September to the 78.45 area in mid-November.

First, Australia is boasting an interest rate of 5.25 percent, or the second highest in the industrialized world right now.

"That is a good solid yield for anyone to be sitting on right now," Callow says.

Also, the country is enjoying solid fundamentals, including a strong domestic economy lately, with unemployment in October hitting its lowest level (5.3 percent) since 1978. Gross domestic product growth is expected to remain robust in the 3.5 percent area.

"The strong domestic economy underpins the relatively high interest rates, with no fears of a rate cut," Callow says.

Another factor supporting additional gains in the AUD/USD is the rising

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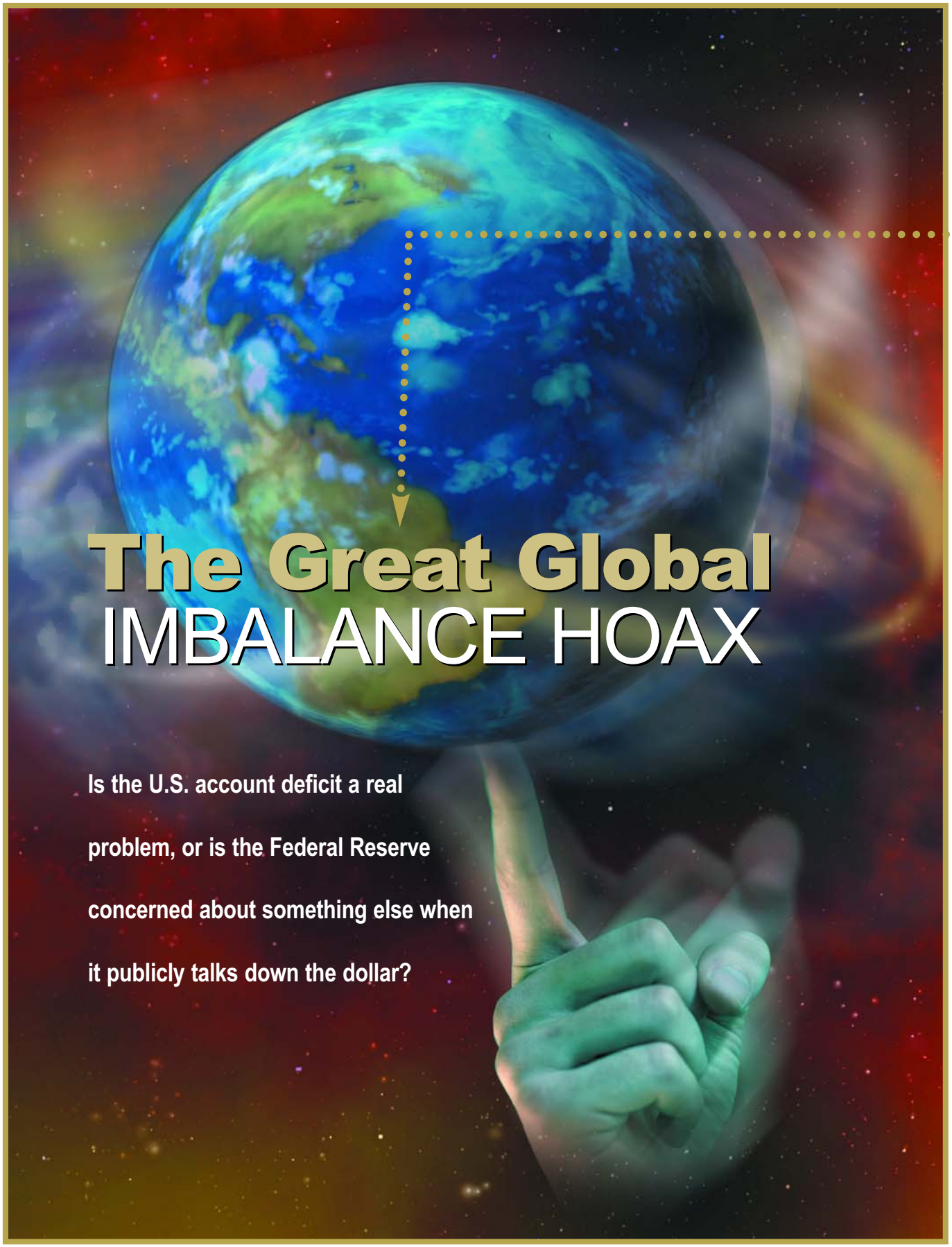

The Great Global IMBALANCE HOAX

Is the U.S. account deficit a real problem, or is the Federal Reserve concerned about something else when it publicly talks down the dollar?

BY BARBARA ROCKEFELLER

From November 2003 to February 2004, and again going into year-end 2004, the dollar fell more than 10 percent against the Euro. In each case, the underlying cause of the dollar's drop was universally reported to be the "structural global imbalance," whereby the U.S. runs a huge current account deficit that is offset by foreigners, including central banks, who buy U.S. financial assets.

It's not so much the U.S. current account deficit itself that propels the dollar downward, but the fear that foreign investors, especially central banks, will withhold demand for U.S. securities, especially Treasuries, until the dollar finishes dropping or the real return is compellingly greater than the return on equivalent assets.

We've been here before. In fall 1985, the countries that later came to be known as G7 (U.S., Great Britain, Germany, France, Canada, Japan, and Italy) met secretly at the Plaza Hotel in New York and decided to drive down the price of the dollar to correct a trade imbalance of about $120 billion annually. The dollar fell 21 percent against the Deutchemark the following year, and another 18 percent the year after that. In 2000, the trade imbalance again became a big topic in the foreign exchange market. That time, the dollar rose against the euro.

What's different this time is the Federal Reserve is doing most of the talking. The fear of inadequate foreign funding of the current account deficit has been voiced by a whole slew of Fed officials, both regional Federal Reserve Board presidents such as Janet Yellen (San Francisco) and Robert McTeer (Dallas) as well as Fed Governor Ben Bernanke.

Ahead of the G20 meeting in Berlin, Fed Chairman Alan Greenspan laid down the rules for thinking about the global imbalance (www.federalreserve.gov/BoardDocs/speeches/2004):

"The question now confronting us is how large a current account deficit in the United States can be financed before resistance to acquiring new claims against U.S. residents leads to adjustment. Given the size of the U.S. current account deficit, a diminished appetite for adding to dollar balances must occur at some point."

Once you get past the ornate language, you realize this is practically an invitation to sell dollars. It's also a near-verbatim repeat of what Greenspan said in 2000, except then he was speaking in a considerably more relaxed, almost offhand way. This time, Greenspan was speaking at a major European conference and knew his words would flash around the world in seconds.

Treasury Secretary John Snow contributes to open acceptance of the dollar falling when he says, on principle, U.S. policy is for a stronger dollar, but if the market wants to take the dollar down, the U.S. believes in free markets.

Fed chairman Alan Greenspan's comments at the G20 meeting in Berlin were practically an invitation to sell dollars.

Consensus opinion

By now, everybody is talking about the dollar's inevitable further decline, with even an august figure such as former Fed chairman Paul Volcker speaking of a 75 percent probability of a currency "crisis" sometime in the next five years. Publications ranging from *The Economist*, *Business Week* and *Wall*

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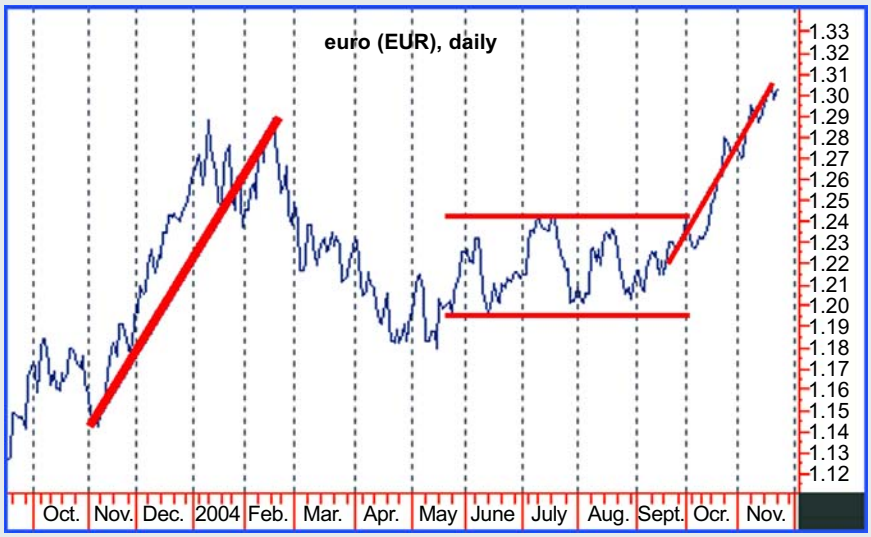
FIGURE 1 — TWO CURRENT ACCOUNT PANICS: EURO/DOLLAR, 2003-2004

In late 2003 and currently, the dollar has plunged vs. the euro.



Source: eSignal

Street Journal to mass-market magazines and network TV news all solemnly declare the dollar is going to hell in a handbasket.

Traders flinch at such a consensus, because when everybody agrees and has already positioned himself short dollars, there's nobody left to sell and push the price down.

But academics and some analysts flinch, too, because the global imbalance is not necessarily a bad thing. Besides, devaluing the dollar won't fix anything — the trade deficit will not improve by much. A 10-percent drop in the dollar induces less than a 10-percent (if any) improvement in the trade balance.

Growth in the U.S. generates more imports than growth in other countries. Even if all the major countries had the same growth rate, the U.S. would still import more than other countries would import, including from the U.S. Because correcting the current account imbalance is mostly a case of correcting the trade imbalance, the only way for the U.S. to export more than it imports would be to go into slower growth or even recession. But the rest of the world relies on the U.S. for export-led growth, so if the U.S. imports less, other countries would go into relatively deeper recessions and import even less from the U.S. This is a real Catch-22.

So why do we have the Federal Reserve and the U.S. Treasury out on the conference circuit goading the foreign exchange market into a frenzy over the current account deficit? After all, the current account deficit has been growing steadily since 2000 — the dollar has gone up, down and sideways during the same period. (In fact, it has done all three in the past year.) These moves are not correlated with changes in the deficit, as illustrated by Figure 1.

The global imbalance obviously does not have a direct one-to-one relationship with the dollar. From an economic standpoint, in the typical trade-deficit situation, importers create an oversupply of the currency. In this case, the oversupply of dollars should make it less valuable. However, when demand for dollars is high for investment purposes, the power of the trade deficit to depress the dollar's price becomes weak, and everybody knows it.

This is why, from a trader's viewpoint, the monthly trade figures don't contain useful information. These days, it's the capital flow report that counts. In September, global investors were willing to increase their net holdings of dollar-denominated assets by 5.8 percent in a month when the dollar was falling by 1.3 percent. Crisis? What crisis?

We have no hard evidence anybody is unhappy about owning dollar-denominated assets. In fact, the most recent Treasury capital flow report (Nov. 16) reports that net portfolio investment rose to $63.4 billion in September (from an upwardly-revised $59.9 billion in August). Net portfolio flows into the U.S. are averaging $72.2 billion per month so far this year, compared to $58.2 billion in 2003 and $47.9 billion in 2002. And the cumulative annual inflows are stunning — $649.5 billion in the first nine months of 2004: a 26 percent increase over 2003's $514.5 billion. Considering the actual rate of return on short-dated money is zero or negative, this is quite a feat. China, for example, is sitting on $60 billion in dollar cash.

The capital inflows are more than enough to cover the current account deficit, which is running at an annual rate of about $665 billion. To speak of a funding crisis is to cry wolf, and Greenspan admits it:

"Current account imbalances, per se, need not be a problem, but cumulative deficits...raise more complex issues. Market forces should over time restore, without crises, a sustainable U.S. balance of payments. At least this is the experience of developed countries, which since 1980, have managed and eliminated large current account deficits, some in double digits, without major disruptions."

"Sustainable" deficits is a reference to a study in 2000 by the Fed showing the outer limit of a current account deficit is about 5 percent, and after that, currency depreciation kicks in as an balancing mechanism (www.federalreserve.gov/pubs/ifdp/2000/692/default.htm). Deficits become unsustainable when they reach or surpass 5 percent of a nation's GDP.

The U.S. is beyond that point today. The Q2 current account deficit stands

at 5.7 percent of GDP, compared to the previous high of 4.5 percent in 2000 and 3.5 percent in 1986. The U.S. deficit is also about 1 percent of global GDP and more importantly, takes back, in the form of capital flows, about two-thirds of the cumulative current account surpluses of all the world's surplus countries, according to Larry Summers, former Treasury Secretary and now President of Harvard University. The size is unique. No country has ever run such massive deficits before.

This time it's different

Can we really say the U.S. is exempt from the same fate that befell other countries with unsustainable deficits?

Well, yes, and this is the sense in which the Fed and the Treasury are begging the market, "Please don't throw me in the briar patch, Br'er Fox." None of the academic studies involves a country that has the world's largest and freest economy, that is the sole military superpower, and that possesses the world's largest financial markets boasting the highest liquidity, transparency and variety of instruments.

We honestly don't know what constitutes "sustainability" regarding the U.S., and we don't want to find out. We don't know whether the dollar should fall because of the current account deficit, but the attitude in Washington seems to be, "Let's talk it down ahead of time, just in case." Without some amelioration of the deficit today, by next year it could be 6.5 percent of GDP, 7.8 percent in 2008, or 13 percent by 2010, according to other studies cited by Summers. We know we can escape through the briar patch of devaluation, but we have no idea what we would do if the current account deficit was 13 percent of GDP and *then* the world's investors decided to bail out of dollar assets. Other countries have survived such high deficits, but other countries don't have the U.S.'s place in the world.

We have to ask whether the government talking the dollar down is just a precautionary measure. After all, you can argue the deficit is an integral part of the international monetary system today. Foreigners borrow in the dollar as well as hold it as a store of wealth. In many instances, they use their store-of-wealth dollars as collateral for dollar debt. Recently the National Bureau of Economic Research sponsored a paper arguing the availability of these dollars "liberates" capital formation in poor countries from inefficient domestic financial markets. The economists say the empirical evidence (using China as a test case) bears out the idea. This helps to explain why emerging market countries show an outflow of some $450 billion in the latest year to rich countries, which seems like an aberration, unless some of the capital is being recycled back to them in the form of collateralized debt.

> In the peculiar way of markets, an official public acceptance of the dollar falling can have the perverse effect of lifting the dollar, at least for a while.

Debt: The story behind the story

If the U.S. financial authorities are not as scared as they want us to think, what are they really up to? Talking the dollar down is, strangely, one way of talking it up. In the peculiar way of markets, an official public acceptance of the dollar falling can have the perverse effect of lifting the dollar, at least for a while. To some extent, this is a function of relief that everything is out in the open, but it's also a mark of respect and confidence in a government that hasn't always earned praise from economists and financial experts on other matters, such as fiscal rectitude and trade protectionism.

But I suspect it's not about the dollar at all. It's not about the current account, either, except as a reflection of something else going on — the low U.S. savings rate, which is joined at the hip to the deficit. In short, it's about nothing less than the sustainability of the U.S. economy.

It's the other big fact of American financial life: The U.S. is not only a debtor nation, it is also a nation of debtors. The saving rate in the U.S. is only 1 to 2 percent of income, and has been falling for over 20 years. In fact, it has fallen the most since 2000. All value judgments aside, when a country imports capital but then spends it on consumption goods rather than capital investment, it is failing to prepare for the future. From the point of view of the Fed chairman and Treasury secretary as stewards of the economy, it's not the sustainability of the current account deficit we should be questioning, but rather the sustainability of U.S. growth. Abundant, cheap foreign money has led us onto the path of profligacy, economically speaking.

The high capital inflows have led the U.S. into the bad habit of spending too much and saving too little. How do you induce people to save? In a free market economy, you give them inducements, like higher returns that are more desirable than a better car or another pair of shoes. Higher returns can be delivered via tax breaks, too, but tax breaks are not the Fed's to give. Higher returns are.

But alas, all that foreign money is literally standing in the way. In September, San Francisco Fed President Yellen got this particular current

continued on p. 20

account panic rolling by saying the Fed wants to normalize interest rates by nudging them higher, but the relatively high dollar is an obstacle. The Fed wants to normalize interest rates to a historically neutral level, thought to be about 3 to 3.5 percent (from the current 2 percent). But the Fed can manage rates only at the very short end of the yield curve. The relatively high dollar draws in foreign capital that allows rates at the longer end of the yield curve to be artificially low.

The last thing the Fed wants is a crisis where it has to raise interest rates to prevent a run on the currency, which is what happened in the UK in 1991. The Bank of England raised rates 3 percent in the space of a few days in an effort to control the pound falling out of the European Rate Mechanism (the occasion of Mr. Soros' fabled billion-dollar profit). It may not be too fanciful to imagine that the Fed has been deliberately driving the dollar down to avoid exactly this outcome — not because it gives a fig about the dollar *per se*, but because it wants to set rates in its own time and according to its own ideas.

Consider the Fed's mandate. Yes, it has to maintain financial market stability, but it's far more interested in growth and employment than in the terms of trade, except as the terms of trade influence domestic production.

Here is the hidden agenda. The Fed wants to normalize rates, not for the sake of normalization, but to prevent a run on the dollar and to restore the incentive to save. After all, if the U.S. consumed less and saved more, the trade deficit would be substantially lower and no one would feel the urge to stage a run on the dollar in the first place. The U.S. would not need capital flow from foreign countries to fund the current account deficit — it would have sufficient domestic savings to buy all the government and corporate debt instruments on offer. This is not to say the Fed places a moral judgment on saving as a social virtue, but rather as the one truly sustainable mechanism to ensure further growth and employment.

The market talks about the sustainability of the current account deficit. Financial economists talk about the sustainability of the inward capital flows. But the Fed and the Treasury view both the current account and the capital account as a by-product of real economic activity, and what they talk about is the sustainability of U.S. growth. If it takes a weaker dollar, so be it. The dollar is not the central thing. In this context, it's only a unit of account. This is the sense in which all the hullabaloo about the sustainability of the current account is a hoax. It is sustainable today, but as the U.S. economy becomes less independently capable of prosperity, the longer it relies on foreign savings.

Now we have come full circle. The current account deficit is not really creating a dollar crisis — the Fed and the Treasury are talking it down. They must know the lower dollar will not cause much improvement in the current account, even if other efforts behind the scenes are successful in pressuring China to revalue the renmimbi. It's silly to be selling the dollar against the euro and other European currencies when Europe accounts for only about 9 percent of trade. China alone accounts for 30 percent of the deficit, and a growing proportion of it. Asia, including Japan, accounts for over half of the deficit.

But negotiations to get Asian countries, especially China, to repeg or to float their currencies are matters of state, not of economic and financial management. China's revaluation, which will probably occur within the next year, will provide some minor relief in the current account, but not a permanent fix. After all, China has billions of people willing to work for pennies in order to get a bicycle, a sewing machine and indoor plumbing. The wildly uneven cost of labor can never be equilibrated by mere currency price adjustments. China will always be able to compete with U.S. companies and export to the U.S. more than it imports.

Because of the unique and unprecedented position of the U.S. in the world economy and financial system, devaluing the dollar is not going to take the current account deficit to zero or transform it into a surplus. Asian revaluation will go a long way toward reducing the horrendous size of the deficit, but even after China, South Korea and the others revalue, we will still have a trade deficit for decades to come. The terms of trade are against the U.S. — Americans simply have too high a standard of living relative to the rest of the world. Moreover, as Greenspan said in Berlin, raising the savings rate in the U.S. will go toward fixing the true current account problem, the dependence on foreigners, but it can't do the whole job. So, even in the best of all possible worlds, we are stuck with a "structural" deficit. The next job for the market is to decide upon a deficit-to-GDP ratio it can live with. What's the number? Something south of 5% of GDP.

The true solution to the U.S. current account deficit is to let it wax and wane with cyclical developments, but not to depend on offsetting foreign capital inflows. Foreign capital inflows should be the icing on the cake, not the cake. The cake should be domestic savings adequate to fund capital investment. The only way to lift up the savings rate is to raise the rate of return. Who is in charge of rates of return? The Fed — but also the folks in Washington who pass tax bills. Privatization of Social Security, anyone?

The U.S. is not only a debtor nation; it is also a nation of debtors.

For information on the author see p. 8.

cost of exports. Australia is a major exporter of coal, wheat, natural gas, gold and steel. The Reserve Bank of Australia estimated its commodity price has risen 16 percent year-over-year, as of October.

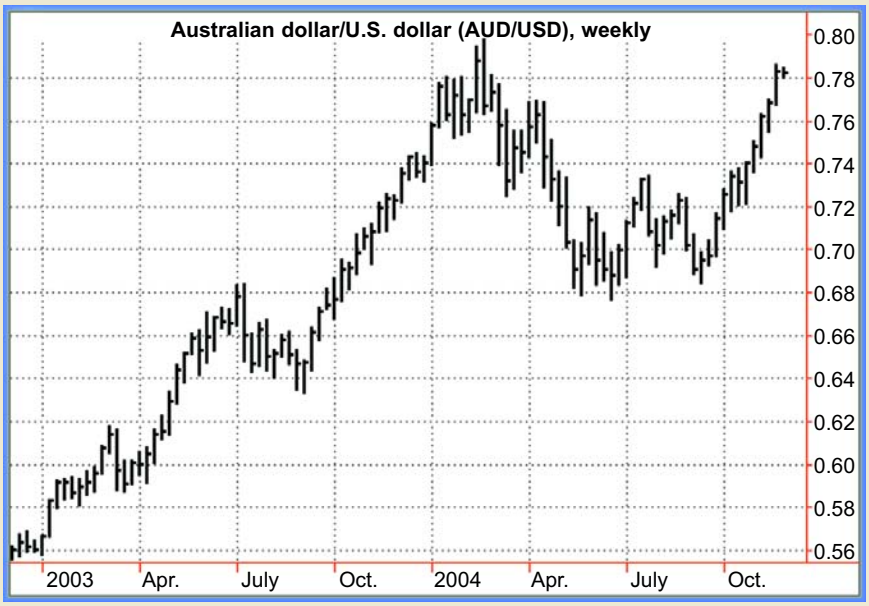
"That directly helps Australia's export revenue," Callow explains.

Callow also notes that speculators looking for a place to put on bearish trades on the U.S. dollar have an advantage of buying the Aussie dollar because, "you get a decent yield pick-up and are not likely to face a central bank on the other side. The Reserve Bank of Australia does intervene at times, but generally it is small scale. They will not be trying to take on the market."

Near term, Callow sees the AUD/USD testing the 80.00 mark, possibly before year-end. If that level cracks, Callow expected additional upside momentum toward the 82.00 or 83.00 area by first quarter 2005.

FIGURE 2 — AUD/USD: MORE ROOM TO MOVE?

The Aussie dollar has skyrocketed vs. the U.S. dollar since September. The next technical resistance zone is around 80.00 — the level of the February 2004 top.



Source: TradeStation

Weak buck trade

Guy Gengle, vice president of dealing at Global Forex Trading (GFT), points to the U.S. dollar/Canadian dollar (USD/CAD) as a hot trade to watch. Over the longer-term, Gengle says "I don't think you can negate the weaker (U.S.) dollar."

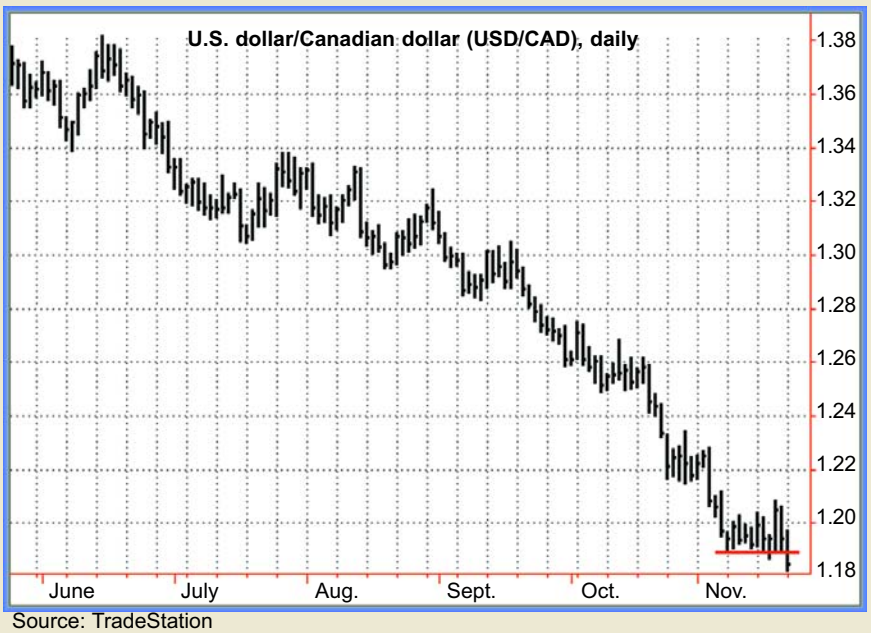
A look at a daily USD/CAD chart reveals a steady and strong downtrend in the USD, and the CAD at its highest level vs. the buck in more than a decade.

As of mid-November, the USD/CAD had pushed to a new low at the 1.18 area (Figure 3). Gengle sees potential for a short-term corrective bounce in the dollar, vs. Canada, which could offer short-term traders plenty of opportunity, he said. A corrective rebound could see USD/CAD bounce up toward the $1.22/1.23 zone, Gengle speculates.

Looking beyond any market correction, however, the longer-term downtrend in the U.S. dollar vs. the Canadian dollar was likely to resume, Gengle says. On the downside, he highlighted the $1.18 area as a "big level." Declines through that floor could open the door to further depreciation, perhaps even as low as $1.12/1.13.

FIGURE 3 — USD/CAD: SET TO CHALLENGE THE ROUND NUMBER

The USD/CAD rate has continued to set new lows after breaking below a series of short consolidations. With no previous chart level to reference, the "whole number" of 1.18 is the next likely support level to watch.



Source: TradeStation

To read about a trade in the USD/CAD rate, see this month's Forex Diary (p. 48).

The short-term British pound/Japanese yen carry trade

BY CURRENCY TRADER STAFF

It pays to have a currency pair's rollover charges on your side.

Find out how the daily rollover has affected GBP/JPY — a popular carry trade — in recent years.

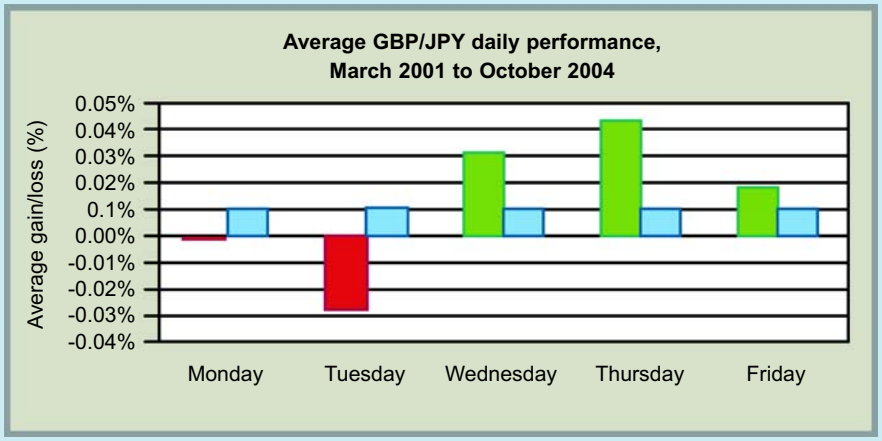
Rollover fees are often overlooked, yet they can seriously affect a forex trade's profit or loss, depending on the currency pair, your forex dealer's rules and each trade's length. These charges are based on the interest-rate difference between the currency you buy and the one you sell (or vice versa) when you trade a currency pair and hold it past the daily rollover time — typically 5 p.m. ET.

For example, if you go long GBP/USD and hold it "overnight," or past 5 p.m., your forex broker may give you a small credit because you bought British pounds and sold U.S. dollars at the same time, and short-term interest rates are currently higher in Great Britain than the U.S. Similarly, if you short this currency pair, your broker may charge a small fee as the trade "rolls over" into the next day. (For more information about rollovers, see "Rollover fees: Understanding the fine print.")

While rollovers don't apply to intraday traders, this feature is the crux of the carry trade, or buying a currency with a higher interest rate and simultaneously selling one with a lower rate and earning the difference between both rates (see "Getting a lift from the carry trade," *Currency Trader*, Oct. 2004). Like dividends, any rollover fees you earn (or owe) are separate from the currency pair's gains or losses, but they can help enhance a trade's profit or mitigate its loss if the daily rollover is in your favor.

FIGURE 1 — AVERAGE DAILY GBP/JPY MOVES, MARCH 2001 TO OCT. 2004

Over the past three years, the GBP/JPY currency pair has slumped at the start of the week and began a slight rally on Wednesday. This pattern suggests that traders boost the GBP/JPY as they attempt to gain from Wednesday's two-day rollover.



Source: Fxtrek

Rollover opportunity?

Many traders view the carry trade as a longer-term (i.e., days, weeks or months) approach since the interest you earn is based on the trade's length. In theory, however, it's possible to buy a currency pair such as the British pound/Japanese Yen (GBP/JPY), whose base currency's interest rate (4.75 percent) is much higher than the quote currency's rate (0 percent), just before the day's rollover, earn the rollover credit and exit the trade following this event.

Because GBP/JPY's rollover credit is

three times as large on Wednesdays to account for the weekend (see sidebar), this study focuses on the currency pair's behavior in the days and hours surrounding this weekly occurrence.

We analyzed daily GBP/JPY performance since March 2001 to find out how Wednesday's triple rollover costs influenced this pair's behavior. We then studied hourly GBP/JPY price data surrounding each day's 5 p.m. rollover time since January 2003 to find out how this event affected intraday price moves.

Overall, GBP/JPY slumped on Monday and Tuesday, but rose Wednesday through Friday. On an intraday basis, GBP/JPY climbed as the 5 p.m. rollover approached and sold off in the early evening — a pattern that was magnified on Wednesday. Both tendencies suggest traders bid up prices in anticipation of the daily rollover, especially Wednesday's three-day interest-rate payoff.

The short-term GBP/JPY carry trade

On March 19, 2001, the Japanese government lowered its overnight interest-rate target to 0 percent and has held it at that level for 44 months, which means that traders can borrow the yen and pay no short-term interest. In contrast, Great Britain's short-term interest rate was 5.75 percent in early March 2001, and has been at least 3.50 percent over the same period. Therefore, the British pound/Japanese yen has provided a daily rollover payment for buyers since March 2001.

Figure 1 shows the average daily GBP/JPY performance on each day of the week from March 20, 2001 to October 29, 2004 (935 trading days), and compares each price move to its benchmark move, or typical daily behavior during the same period. Because the forex market trades 24

continued on p. 24

Rollover fees: Understanding the fine print

Getting a straightforward answer about daily rollover fees from your forex broker isn't easy. Although rollover fees are based on the short-term interest-rate differences of the two currencies you exchange for one another in the forex spot (cash) market, each FX dealer has its own rules, which can make the process confusing.

The spot market has a two-day settlement period, which means that if you buy one GBP/JPY standard lot (£100,000) on Tuesday, the transaction will settle on Thursday. If you hold this trade past 5 p.m. on Tuesday, your broker will roll the settlement forward to Friday and may add between $1 and $20 to your account as they calculate interest you earned.

As of Nov. 16, Great Britain's short-term interest rate was 4.6 percent higher than Japan's (4.75 percent and 0.15 percent, respectively, according to Forexnews.com). Therefore, the daily rollover credit on this trade is roughly $12.60, or ($100,000 * 4.6 percent)/365. (The actual rollover amount depends on your balance and the difference between GBP's borrowing rate and JPY's lending rate.)

Wednesday's rollover is three times as large because it accounts for interest earned over the weekend. For example, if you enter and exit a trade on Wednesday prior to rollover, both trades settle on Friday. However, if you hold the trade "overnight" and close it after the rollover, your trade won't settle until Monday, and you earn (or pay) three days of interest instead of one. Trades that should settle on holidays also earn (or owe) an additional day's interest.

However, forex dealers are not obligated to pay interest. Some brokers, such as Forex Capital Markets (FXCM), only credit your account if you trade with at least 2 percent margin. Oanda calculates interest earned on currency pairs each second, instead of once a day. Other brokers charge a daily rollover fee even if you're long a higher-interest-rate currency.

Most FX dealers' rollover time is 5 p.m. ET, but other brokers such as GFT Forex and MG Financial Group roll positions forward at 3 p.m. ET.

TABLE 1 — AVERAGE DAILY GBP/JPY STATS — MARCH 2001 TO OCT. 2004

Wednesdays and Thursdays have been GBP/JPY's most bullish days since the Japanese government lowered short-term interest rates to zero on March 19, 2001.

	Monday	Tuesday	Wednesday	Thursday	Friday
Instances	186	187	189	187	186
Avg:	0.00%	-0.03%	0.03%	0.04%	0.02%
Med:	-0.04%	-0.02%	0.07%	0.09%	-0.01%
Benchmark:	0.01%	0.01%	0.01%	0.01%	0.01%
Max:	1.92%	2.05%	2.00%	2.08%	2.11%
Min:	-1.51%	-1.94%	-2.74%	-2.26%	-1.79%
Pct. >0:	46.24%	48.66%	56.61%	57.75%	49.46%

Source: Fxtrek

Average and median

The mean (or average) of a set of values is the sum of the values divided by the number of values in the set. If a set consists of 10 numbers, add them and divide by 10 to get the mean.

A statistical weakness of the mean is that it can be distorted by exceptionally large or small values. For example, the mean of 1, 2, 3, 4, 5, 6, 7, 200 is 28.5 (228/8). Take away 200, and the mean of the remaining seven numbers is 4, which is much more representative of the numbers in this set than 28.5.

The median can help gauge how representative a mean really is. The median of a data set is its middle value (when the set has an odd number of elements) or the mean of the middle two elements (when the set has an even number of elements). The median is less susceptible than the mean to distortion from extreme, non-representative values. The median of 1, 2, 3, 4, 5, 6, 7, 200 is 4.5 ((4+5)/2), which is much more in line with the majority of numbers in the set.

hours a day, our Comstock data (via FXtrek) measured each day from 5 p.m. ET to 5 p.m. the next day.

The daily price moves in Figure 1 are quite small, but they illustrate interesting patterns. GBP/JPY tended to trade sideways on Monday, lagging its 0.01-percent benchmark. On Tuesday, the currency pair dropped an average -0.03 percent, but Wednesday's 0.03-percent gain began a modest three-day rally, which beat its benchmark each day and totaled 0.09 percent. The figure shows the pound/yen posted the largest average daily gain (0.04 percent) on Thursday, and inched 0.02 percent higher on Friday.

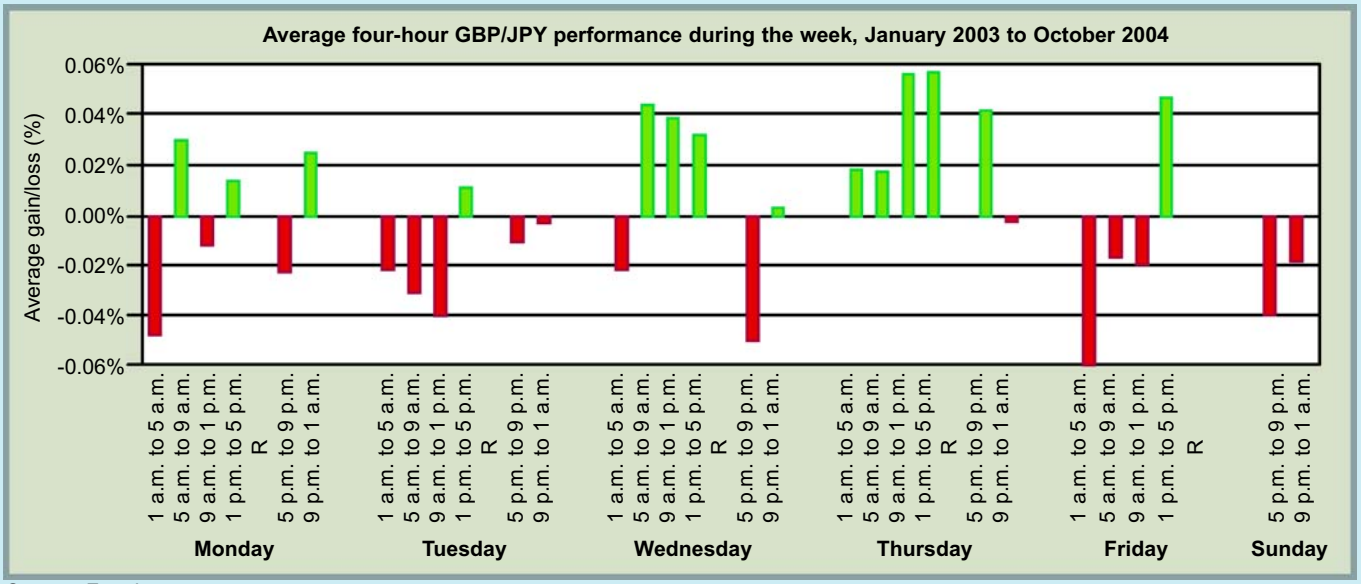
Table 1 (see p. 23) shows each day's average performance and compares it to its median, benchmark, maximum and minimum values. The table also lists each day's percentage of positive moves. A comparison of the table's average and median values suggests GBP/JPY's lackluster performance during the first two days of the week is accurate, but its climb on Wednesday and Thursday might be slightly higher than Figure 1 shows.

For example, the pound/yen's average is flat on Monday, but its median is -0.04 percent, which suggests a few extreme positive moves skewed the average higher than it should be. Similarly, Wednesday's and Thursday's medians are higher than their average values, which suggest the opposite condition.

GBP/JPY's largest average and median gains (0.04 and 0.09 percent, respectively) as well as its highest probability of gains (57.75 percent) occurred on Thursday.

FIGURE 2 — AVERAGE FOUR-HOUR GBP/JPY PRICE MOVES, JANUARY 2003 TO OCTOBER 2004

The daily 5 p.m. (ET) rollover time only seems to influence GBP/JPY on Wednesdays and Thursdays. Wednesday's rollover costs are doubled to account for holding the currency pair over the weekend, and the figure shows that GBP/JPY rose on Wednesday afternoon prior to the 5 p.m. rollover and briefly dropped after the event.



Source: Fxtrek

When the clock strikes five

Figure 1 and Table 1 show GBP/JPY rose toward the middle of the week, but they don't indicate whether Wednesday's unique rollover affects the pair's price moves surrounding this event. To find out if this weekly occurrence has influenced GBP/JPY prices, we studied hourly price data from Jan. 1, 2003 to Oct. 31, 2004, or 475 trading days, and divided each day into six 4-hour periods, with the 5 p.m. rollover as the focal point: 1 a.m. to 5 a.m., 5 a.m. to 9 a.m., 9 a.m. to 1 p.m., 1 p.m. to 5 p.m., 5 p.m. to 9 p.m. and 9 p.m. to 1 a.m. the next day.

Figure 2 shows the average gains or losses for each four-hour period during the entire week (30 total periods), which start and end at 1 a.m. ET on Monday morning. (The forex market is closed from Friday at 5 p.m. to Sunday at 2 p.m. Our data resumed on Sunday at 5 p.m., except between July 18 and Oct. 31, 2004, when it began on Sundays at 4 p.m.)

A distinct pattern appears in the two four-hour periods surrounding each day's 5 p.m. rollover, which is labeled "R" in Figure 2. GBP/JPY gained ground from 1 to 5 p.m. and fell from 5 to 9 p.m. each day except Thursday. Although GBP/JPY continued to rise immediately following Thursday's rollover, the currency pair's rally in the eight hours leading up to rollover was three times as large than its post-rollover, eight-hour gain from 5 p.m. to 1 a.m. (0.12 percent and 0.04 percent, respectively).

On Tuesday and Friday, GBP/JPY fell throughout the day except in the four-hour period from 1 p.m. to 5 p.m. Figure 2 also shows that the currency pair's tendency to rise prior to this event and sell off afterwards has been strongest on Wednesday. The pound/yen increased 0.11 percent in

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TABLE 2 — AVERAGE FOUR-HOUR STATS, JANUARY 2003 TO OCTOBER 2004

While the most dramatic drop occurred from the four-hour period before the 5 p.m.(ET) rollover to four hours after the event on Wednesday (0.03-percent average gain to -0.05-percent average loss), the currency pair lost ground between these two periods on each day of the week

	1 a.m. to 5 a.m.	5 a.m. to 9 a.m.	9 a.m. to 1 p.m.	1 p.m. to 5 p.m.	R	5 p.m. to 9 p.m.	9 p.m. to 1 a.m.
Monday	95	95	95	95		95	94
Avg:	-0.05%	0.03%	-0.01%	0.01%		-0.02%	0.03%
Med:	-0.03%	0.01%	-0.01%	0.01%		-0.01%	0.04%
Max:	0.59%	1.28%	0.55%	0.88%		0.79%	0.76%
Min:	-0.74%	-0.79%	-1.17%	-0.42%		-0.90%	-0.62%
Pct >0:	45.26%	51.58%	48.42%	51.58%		46.32%	58.51%
Tuesday	94	94	94	94		94	94
Avg:	-0.02%	-0.03%	-0.04%	0.01%		-0.01%	0.00%
Med:	-0.01%	-0.03%	-0.03%	0.00%		-0.01%	0.00%
Max:	0.83%	1.01%	0.73%	0.81%		0.33%	0.38%
Min:	-1.04%	-0.78%	-0.85%	-0.51%		-0.58%	-0.69%
Pct. > 0:	47.87%	47.87%	44.68%	51.06%		48.94%	45.74%
Wednesday	95	95	95	95		94	94
Avg:	-0.02%	0.04%	0.04%	0.03%		-0.05%	0.00%
Med:	-0.01%	0.03%	0.04%	0.04%		-0.04%	0.00%
Max:	0.58%	0.93%	0.90%	0.52%		0.45%	0.78%
Min:	-0.94%	-1.06%	-0.74%	-0.41%		-0.61%	-0.43%
Pct. >0:	46.32%	52.63%	54.74%	53.68%		32.98%	51.06%
Thursday	95	95	95	95		95	95
Avg:	0.02%	0.02%	0.06%	0.06%		0.04%	0.00%
Med:	0.04%	-0.01%	0.07%	0.07%		0.02%	-0.03%
Max:	0.67%	1.07%	0.97%	0.37%		0.68%	0.82%
Min:	-0.81%	-0.80%	-0.64%	-0.31%		-0.26%	-0.40%
Pct. >0:	52.63%	49.47%	60.00%	65.26%		52.63%	37.89%
Friday*	96	96	96	96		96	95
Avg:	-0.06%	-0.02%	-0.02%	0.05%		-0.04%	-0.02%
Med:	-0.06%	-0.02%	-0.05%	0.06%		-0.04%	-0.02%
Max:	0.54%	0.90%	0.98%	0.81%		0.86%	0.45%
Min:	-1.14%	-0.88%	-0.71%	-0.51%		-0.76%	-0.57%
Pct. > 0:	42.71%	45.83%	41.67%	60.42%		45.83%	42.11%
Overall	475	475	475	475		474	472
Avg:	-0.03%	0.01%	0.01%	0.03%		-0.02%	0.00%
Med:	-0.02%	-0.01%	0.00%	0.03%		-0.02%	-0.01%
Max:	0.83%	1.28%	0.98%	0.88%		0.86%	0.82%
Min:	-1.14%	-1.06%	-1.17%	-0.51%		-0.90%	-0.69%
Pct. >0:	46.95%	49.47%	49.89%	56.42%		45.36%	47.03%

** The forex market closes at 5 p.m. on Friday so the evening hours (5 p.m. to 9 p.m.) shown here are actually Sunday's price moves (see Figure 2).*

Source: Fxtrek

the 12 hours preceding rollover — the figure's second highest 12-hour gain — and then dropped -0.05 percent in the subsequent four hours.

Despite this brief loss, Figure 2 shows GBP/JPY's most bullish period occurred from Wednesday at 5 a.m. to Thursday at 9 p.m.

Table 2 (see p. 25) compares various statistics for all 30 four-hour periods shown in Figure 2 (average, median, maximum and minimum values and percentage of positive moves). The table's final six rows summarize the pound/yen's intraday performance.

The table shows that each period's average and median values are roughly in line with each other, which indicates GBP/JPY's gains and losses in Figure 2 are fairly reliable. As expected, all but one of the periods' average gains in Table 1 also have a greater chance of gaining ground than losing it (i.e., the percentage of positive moves is greater than 50 percent). Similarly, each of the table's average losses has a winning percentage of less than 50 percent.

Table 2's larger gains and losses also correspond to greater chances of moving in the desired direction. For example, Thursday's 0.06-percent increases in the two four-hour segments from 9 a.m. to 5 p.m. have two of the table's three highest probabilities of gains (60 and 65.26 percent, respectively).

Wednesday's shift from a 0.03-percent average gain from 1 p.m. and 5 p.m. to a -0.05-percent loss following the rollover is the second-largest dropoff between time segments. However, the currency pair's probability of gains sank from 53.68 to 32.98 percent in that same period — the table's largest probability decline.

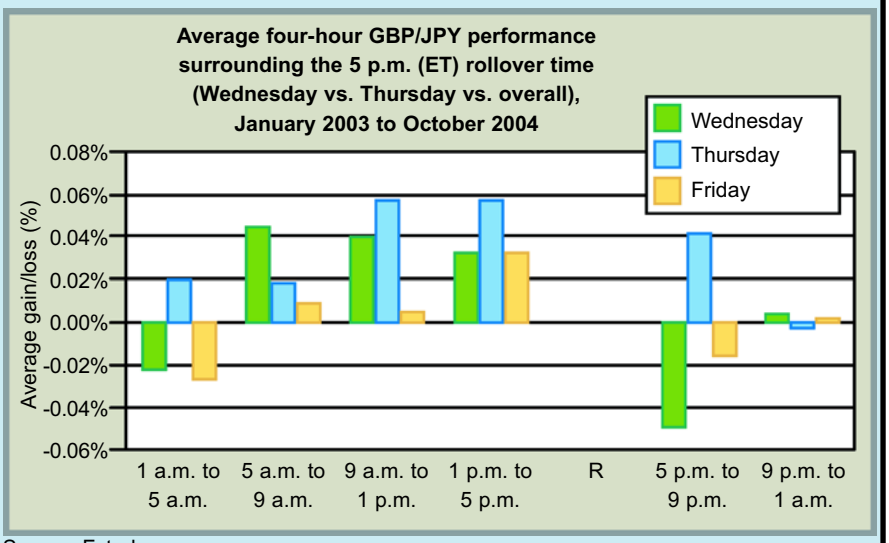
Table 2's summary statistics confirm GBP/JPY tended to climb briefly prior to rollover and sink after the event. Overall, the currency pair rose 0.03 percent, on average, from 1 p.m. to the 5 p.m. rollover and then fell 0.02 percent in the following four hours. Although this change is small, the prior period's biggest individual loss widened from -0.51 to -0.90 percent, and its chance of gains dropped from 56.42 to 45.36 percent following the rollover — two further signs the decline is accurate.

Figure 3 highlights GBP/JPY's average four-hour gains and losses on Wednesday and Thursday and compares them to the currency pair's overall performance. Though the pound/yen's Wednesday performance adheres to the established pattern, its bullish behavior on Thursday stands out.

GBP/JPY posted average gains in five of Figure 3's six periods on Thursday, which was the only day the currency pair gained ground following each rollover (see Figure 2 and Table 2).

FIGURE 3 — FOUR-HOUR PRICE MOVES REVISITED

This figure compares Wednesday's and Thursday's four-hour GBP/JPY performance with the overall pattern since January 2003. The currency pair tended to rise in the 12 hours preceding its 5 p.m. (ET) rollover and sell off in the early evening. However, GBP/JPY was most bullish on Thursdays as it gained ground from 5 a.m. to 1 a.m. the next day.



Source: Fxtrek

One hour at a time

To analyze the pound/yen's behavior around the 5 p.m. rollover in more detail, we measured the currency pair's hourly gains and losses from 1 p.m. to 9 p.m. and focused on the two hours immediately surrounding the daily rollover. Figure 4 is similar to Figure 3, but shows GBP/JPY's average performance over a shorter timeframe.

In general, the pound/yen rallied during three of the four hours prior to rollover and sold off between 5 p.m. and 6 p.m. The currency pair then traded sideways in the final three hours. It's no surprise GBP/JPY gained ground on Thursday during seven of the eight hours shown in Figure 4, but it's interesting the one lackluster hour occurred right after the rollover. Wednesday's gains and losses are less consistent, but it's clear that GBP/JPY fell further than usual following that triple rollover.

Table 3 is identical to Table 2, except it tracks the pound/yen's performance in hourly segments. The currency pair's average price moves are even smaller here than in Table 2, but GBP/JPY still tended to increase slightly as 5 p.m. approached and sink following it.

This study's average price moves seem almost too small to trade, but

TABLE 3 — HOURLY STATS

Although the average hourly GBP/JPY changes are quite small, there is a distinct shift in the two hours surrounding the daily 5 p.m. rollover. The percentage of positive price moves sinks from above 50 percent to below that level on each day (except Thursday).

		1 to 2 p.m.	2 to 3 p.m.	3 to 4 p.m.	4 to 5 p.m.	R	5 to 6 p.m.	6 to 7 p.m.	7 to 8 p.m.	8 to 9 p.m.
Monday	Avg:	0.01%	-0.02%	0.00%	0.02%		-0.01%	-0.01%	0.01%	-0.01%
	Med:	0.02%	-0.01%	0.00%	0.01%		-0.01%	0.00%	0.01%	-0.01%
	Max:	0.73%	0.25%	0.20%	0.27%		0.31%	0.32%	0.60%	0.45%
	Min:	-0.58%	-0.35%	-0.20%	-0.19%		-0.41%	-0.26%	-0.62%	-0.56%
	Pct. > 0:	55.79%	43.16%	49.47%	56.84%		45.26%	49.47%	51.58%	47.37%
Tuesday	Avg:	0.01%	-0.02%	0.00%	0.02%		-0.01%	0.00%	0.00%	0.01%
	Med:	0.02%	-0.03%	0.01%	0.02%		0.00%	0.01%	-0.01%	0.02%
	Max:	0.39%	0.34%	0.20%	0.36%		0.33%	0.18%	0.31%	0.41%
	Min:	-0.34%	-0.37%	-0.34%	-0.15%		-0.26%	-0.20%	-0.30%	-0.39%
	Pct. > 0:	56.38%	38.30%	52.13%	59.57%		46.81%	54.26%	45.74%	55.32%
Wednesday	Avg:	0.01%	-0.02%	0.03%	0.01%		-0.02%	-0.02%	0.00%	-0.01%
	Med:	0.01%	-0.02%	0.02%	0.01%		-0.01%	-0.01%	-0.01%	-0.01%
	Max:	0.36%	0.33%	0.28%	0.24%		0.13%	0.47%	0.36%	0.32%
	Min	-0.48%	-0.37%	-0.23%	-0.20%		-0.26%	-0.35%	-0.53%	-0.81%
	Pct. > 0:	55.79%	43.16%	69.47%	56.84%		42.11%	40.00%	46.32%	48.42%
Thursday	Avg:	0.01%	0.01%	0.02%	0.01%		-0.02%	0.01%	0.01%	0.03%
	Med:	0.02%	0.01%	0.01%	0.02%		0.01%	0.01%	0.01%	0.03%
	Max:	0.37%	0.24%	0.31%	0.20%		0.22%	0.20%	0.53%	0.38%
	Min	-0.19%	-0.21%	-0.20%	-0.16%		-0.26%	-0.24%	-0.30%	-0.28%
	Pct. > 0:	56.25%	54.17%	54.17%	58.33%		52.08%	54.17%	56.25%	59.38%
Friday*	Avg:	0.00%	0.01%	0.01%	0.02%		-0.06%	0.01%	0.01%	0.00%
	Med:	-0.01%	0.01%	0.00%	0.02%		-0.04%	0.02%	0.02%	-0.01%
	Max:	0.39%	0.31%	0.29%	0.35%		0.56%	0.43%	0.51%	0.45%
	Min	-0.35%	-0.45%	-0.20%	-0.28%		-0.83%	-0.57%	-0.41%	-0.35%
	Pct. > 0:	47.37%	54.74%	44.21%	57.89%		32.63%	58.95%	56.84%	46.32%
Overall	Avg:	0.01%	-0.01%	0.01%	0.02%		-0.02%	0.00%	0.00%	0.00%
	Med:	0.01%	0.00%	0.01%	0.02%		-0.01%	0.01%	0.01%	0.01%
	Max:	0.73%	0.34%	0.31%	0.36%		0.56%	0.47%	0.60%	0.45%
	Min	-0.58%	-0.45%	-0.34%	-0.28%		-0.83%	-0.57%	-0.62%	-0.81%
	Pct. > 0:	54.32%	46.74%	53.89%	57.89%		43.79%	51.37%	51.37%	51.37%

** The forex market closes at 5 p.m. on Friday so the evening hours (5 p.m. to 9 p.m.) shown here are actually Sunday's price moves (see Figure 2).*

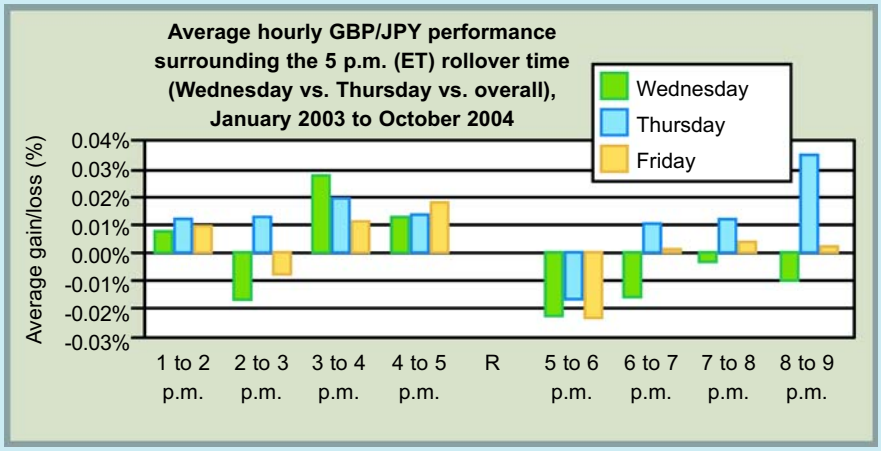
Source: Fxtrek

Table 2 shows these tendencies are more compelling when multiple measures of performance such as average, median and percentage of positive moves all point in the same direction.

Figures 2 and 3 suggest going long GBP/JPY at 1 a.m. on Thursday, hold the trade past the 5 p.m. rollover and exit at 9 p.m. Figure 4 shows you may have to weather a small drop following the rollover, and you won't earn as much interest if you entered the trade on Wednesday. However, you'll probably profit more from higher GBP/JPY prices than from additional rollover fees.

FIGURE 4 — HOURLY GBP/JPY PERFORMANCE

On an hourly basis, the currency pair rose two hours before the 5 p.m. (ET) rollover and fell immediately following it.



Source: Fxtrek

The macro factor

Most active traders favor technical trading approaches, but the effectiveness of price-based approaches depends on understanding the macroeconomic and fundamental factors driving the currency market.

BY DAVE FLOYD

While most individual traders doubt the usefulness of fundamental or macroeconomic analysis, many of the largest players in the FX market rely heavily on it.

Although the conclusions you draw from macro or technical analysis might ultimately be similar, having a tangible rationale for entering the market, as opposed to simply obeying a line on a chart, can do a great deal to bolster confidence in your trading and deepen your understanding of how foreign exchange works.

We'll review some of the key macro factors in the FX markets and see how they can provide insight into potential market moves. Then we'll look at some recent trades illustrating how to combine macro research with technical patterns.

Although there are any number of fundamental factors at work in the FX market at a given time, we will address the following three: interest rate differentials, commodity prices and the level of risk aversion among traders at a given time. They are easy to understand and illustrate in the market.

Interest rates: Attracting capital

An interest rate differential is the spread between the prevailing interest rates in two countries. All else being equal, capital flows to countries offering higher interest rates, which benefits those currencies.

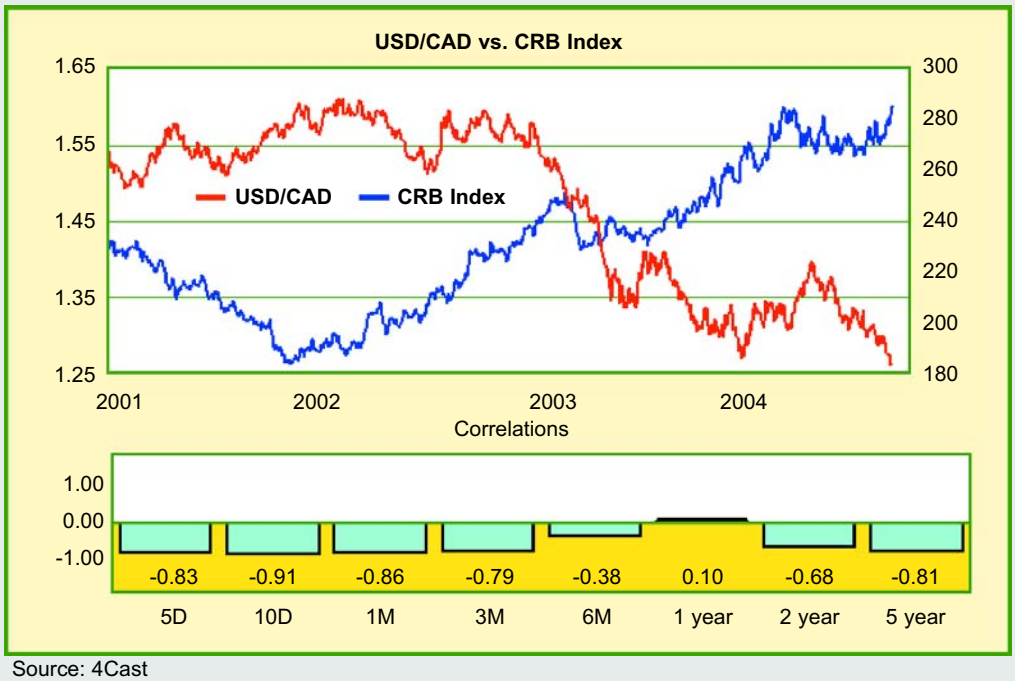
In a time with historically low interest rate yields worldwide, traders will often accept greater risk to seek out those markets offering the highest yield. In the U.S., the Federal Funds rate is at 2 percent after the Federal Reserve raised the rate .25 points at its Nov. 9 meeting, while New Zealand has an equivalent rate of 6.25 percent (the next meeting is this month, with

no hike expected), making the New Zealand dollar (NZD) a more attractive currency to hold than the U.S. dollar (USD) in terms of yield.

However, the NZD's yield does not represent a risk-free rate. If the NZD depreciated vs. the USD during the time of your investment in New Zealand, the rate differential advantage could be wiped out. Hence, gaining an extra 4.25 percent (the difference between the two rates) per annum while also enjoying the potential capital appreciation on the long NZD position itself has been a logical move for many traders.

FIGURE 1 — CANADIAN DOLLAR AND COMMODITIES

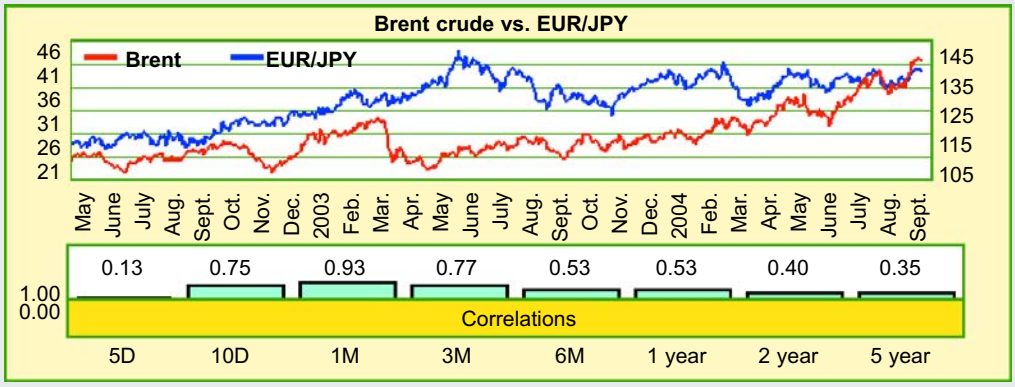
The USD/CAD rate tends to move inversely to commodity prices, shown here by the Reuters/Commodity Research Bureau (CRB) index. The correlation figures show the negative relationship between the two. Note the five-year correlation (far right) is -0.81, indicating the two price series have had a strong tendency to move in opposite directions.



Source: 4Cast

FIGURE 2 — OIL AND YEN

The fact the euro/Japanese yen rate tends to be positively correlated to crude oil (meaning the yen drops in value as crude appreciates) underscores the yen's vulnerability to rising oil prices.



Source: 4Cast

Commodity prices

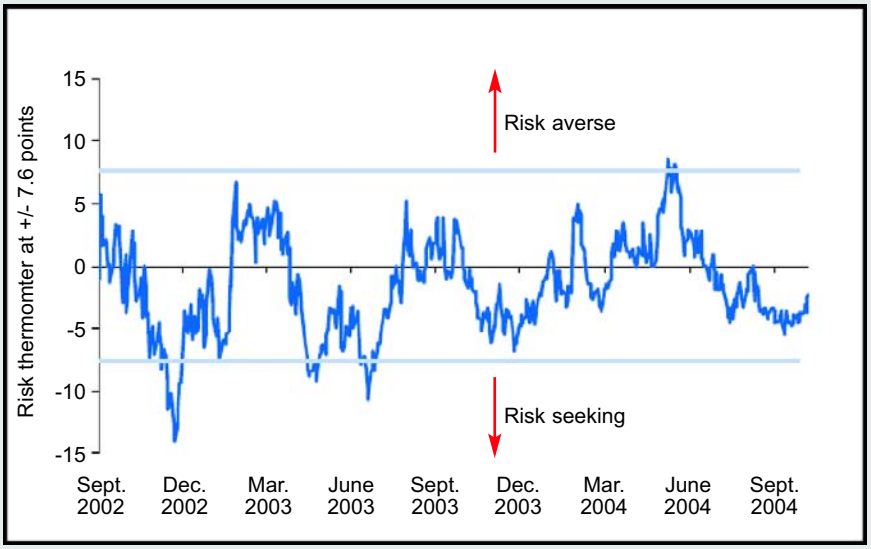
Commodities are the driving force of growing economies. China has emerged as a major player in worldwide manufacturing and has become a large consumer of commodities such as oil and grains. Surprisingly, however, China does not produce much in the way of agriculture, so commodity-based economies that stand to export heavily to China, such as Australia, New Zealand and Canada, will benefit.

Figure 1 shows how the U.S. dollar/Canadian dollar (USD/CAD) rate is inversely related to commodity prices, meaning the CAD gets stronger relative to the USD as commodity prices rise. Below the price chart is a list of several statistical correlations between the two series over different time periods (five days, 10 days, one month, etc.). Negative cor-

continued on p. 30

FIGURE 3 — RISK AVERSION THERMOMETER

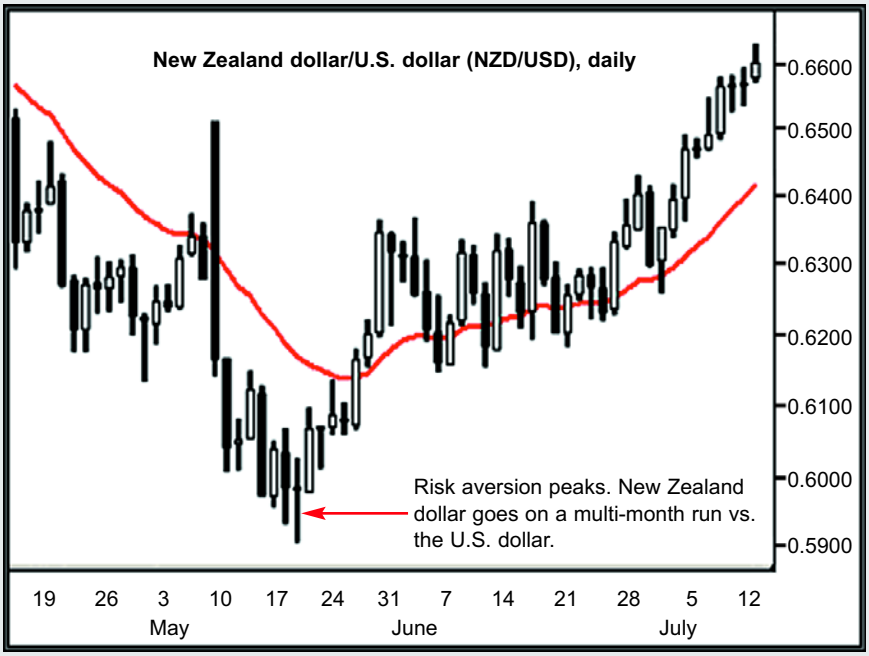
This gauge of investor risk tolerance developed by RBC Capital Markets increases when traders are more averse to risk and decreases when they are more willing to accept risk.



Source: RBC Capital Markets

FIGURE 4 — NZD BENEFITS FROM RISK-SEEKING

In late May 2004 — a high point in the Risk Aversion Thermometer in Figure 3 — the New Zealand dollar (NZD) took off to the upside.



Source: eSignal

relation figures reflect data series that move in opposite directions, with -1.00 representing a perfectly inverse relationship (one goes up while the other goes down proportionally). Positive correlation figures reflect the opposite, with +1.00 representing two series moving in tandem.

Another notable historical relationship is the impact of rising oil prices on Japan, represented by the Nikkei stock index and the Japanese yen (JPY). Higher oil prices have a negative impact on global economic growth as a whole, and Japan specifically because it is highly dependent on imported oil.

With oil prices rising significantly over the past year, the impact on both Japan and the global economy has been noticeable. And when global economic growth is poised to slow, in this case because of higher oil prices, Japan typically suffers.

Given a large percentage of Japan's capital inflows are the result of equity purchases, the link between higher oil prices and a weaker yen and Nikkei is clear. If global economic growth is waning, Japan will be negatively impacted because they are a large exporter. Hence, equity inflows into Japan will decrease when growth slows or is expected to slow — and rising oil prices have been an impediment to global growth. Figure 2 (p. 29) shows Brent crude oil and the euro/Japanese yen (EUR/JPY) rate, along with various correlation figures.

The risk environment

The final macro component we will discuss is the prevailing attitude of traders and investors toward assuming risk. There are many methods for estimating this factor, and a wise approach is to consult several inputs and create a composite barometer or index.

When public risk-tolerance is high in the stock realm, you will likely see

solid interest in IPOs, highly speculative stocks, etc. The same dynamic exists in currencies. For example, the NZD, CAD and Australian dollar (AUD) are considered "risk-seeking" currencies. Given they are "reflation plays" — a trade that is banking on economic growth developing — and sensitive to commodity prices, they are usually more sensitive to changes in the global economy.

Such currencies will typically have an inverse relationship to investor risk tolerance. Figure 3, which shows the Risk Aversion Thermometer, a trader risk gauge created by RBC Capital Markets, illustrates the rise and fall of risk tolerance. Figure 4 shows the NZD/USD rate embarking on a multi-month uptrend around the same time the Risk Aversion Thermometer in Figure 3 peaked. Figure 5 shows the same pattern in the USD/CAD, where the downtrend actually reflects Canadian dollar gains vs. the U.S. dollar.

The relationships described here are by no means static. However, seeking out simple associations such as these can identify favorable trade conditions, as well as avoid trades that might look good from a technical perspective, but have potential weaknesses on the macro level.

Macros at work in the market

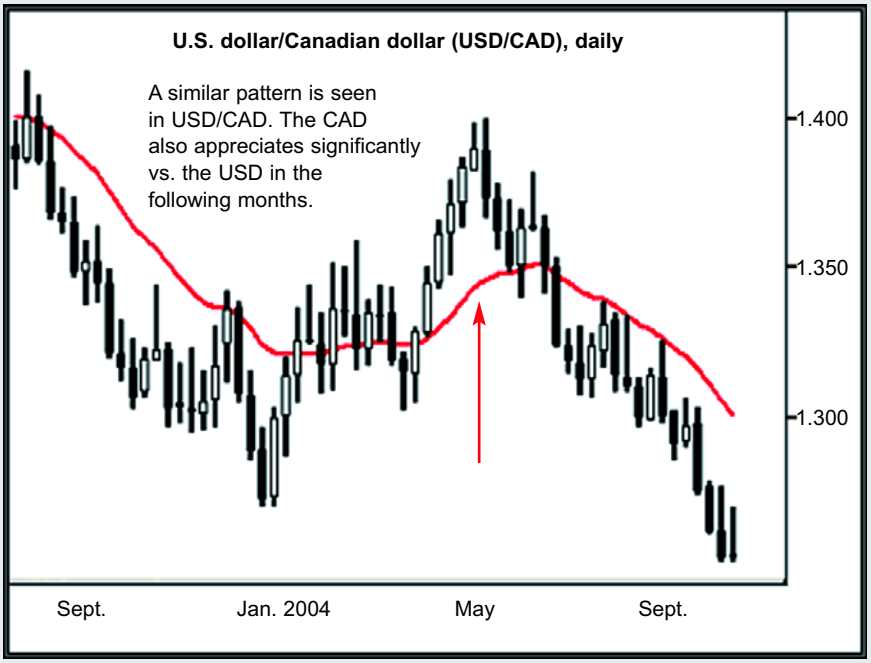
For the past few years both New Zealand and Australia have benefited handsomely from rising commodity prices and exports to China.

In late August 2004 the Reserve Bank of New Zealand (RBNZ) raised rates yet again — the fifth .25-point hike in 2004 — because the prospect of an overheating economy was seen as a greater potential problem than a rapid rise in interest rates. Despite the fact China's growth was moderating, the RBNZ believed dampening specula-

continued on p. 32

FIGURE 5 — CAD TURNING POINT

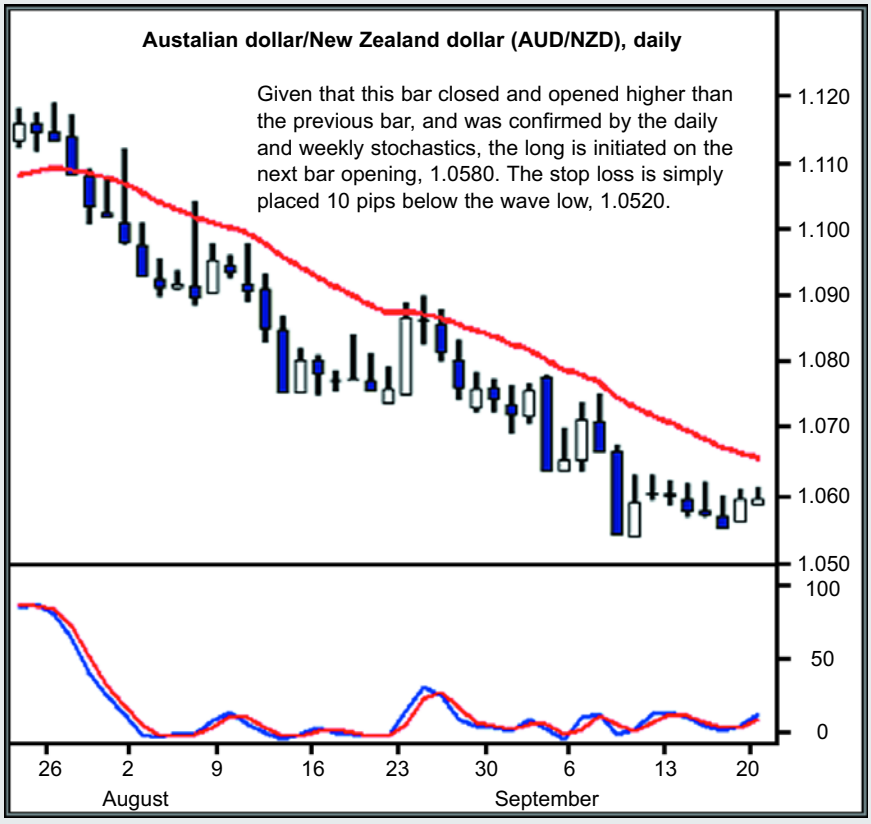
As was the case with the New Zealand dollar (NZD), May 2004 turned out to be an inflection point for the Canadian dollar vs. the U.S. dollar.



Source: eSignal

FIGURE 6 — DIVERGING INTEREST RATES

Diverging interest-rate policies in New Zealand (continued rate hikes) and Australia (end of a rate-hike cycle) cause the AUD/NZD rate to tumble in August 2004. Several bullish candles and a flat-to-higher stochastic oscillator accompanied an initial bottom and rebound in September.



Source: eSignal

tion in the housing sector was its first priority.

Meanwhile, Australia had paused a monetary tightening cycle while awaiting more data on housing, retail sales and inflation. The result was the sharp decrease in the AUD/NZD shown in Figure 6 (p. 31). While this chart certainly does not look like a "buy" from a technical perspective, there were broader reasons to believe the currency pair could be putting in a bottom.

Macroeconomic theory supports the idea the aggressive rate hikes by the RBNZ would soon filter through New Zealand's economy, impacting growth. With a typical interest rate "lag factor" of eight to 12 months, fall 2004 was shaping up to be a potential adjustment period for the AUD/NZD rate. Although some key economic data still had not yet been released in early October, the market was beginning to bet the pace of economic growth was starting to wane — a viewpoint that was ultimately reflected in the charts.

After many weeks of relentless price declines, the daily and weekly charts (Figures 6 and 7, respectively) confirmed a bottom could be in place as defined by the stochastic oscillator. On the second-to-last candle in Figure 6 (p. 31), the AUD/NZD rate made a higher low and closed above the open while the stochastic indicator made a higher low. A similar pattern appeared in Figure 7 (Another factor that led to the conclusion the AUD/NZD was due to turn up was the fact that the daily chart was completing the fifth wave of an *Elliott Wave* pattern.) A long trade was initiated on the next day's open at 1.0580, with a stop at 1.0520, which was 10 pips below the most recent low.

FIGURE 7 — WEEKLY PERSPECTIVE

The weekly AUD/NZD chart included a signal similar to the one on the daily chart — a higher stochastic and a bar opening higher than the previous bar.

Source: eSignal

As expected, either the rapid rise in interest rates in New Zealand or some conclusion to the tightening process would be the catalyst needed to propel AUD/NZD higher (see Figure 8). The catalyst materialized on Oct. 27 when the RBNZ indicated its monetary tightening phase was nearing completion. The new landscape now clearly favored Australia, as it indicated rate hikes may not be done. The currency pair quickly traded back through its 50-day exponential moving average (EMA) before touching the 200-day EMA at 1.1030. On Nov. 9, the New Zealand Finance Minister indicated he was "uncomfortable with the current value of the NZD" and the currency was likely nearing a top and would face headwinds going forward. The result was a nice push back above the 200-day EMA. (As of Nov. 10, the trade was still open, with a revised stop loss of 1.0790.)

The Euro/British pound (EUR/GBP) rate provides another example of the insights macro factors contribute to a trade. This scenario, which also resulted in a long position, is somewhat similar to the AUD/NZD example. In this case, we were looking for a contraction in the rate differential between the European Union and Britain.

Britain had been aggressively raising rates through 2004 in an effort, as Bank of England (BOE) president Eddie George stated, "to stem the tide in the rapid increase in housing prices." The BOE was determined to nip this problem in the bud rather than let a full-

scale economic bubble develop and burst, thereby throwing cold water on consumer spending, which could send the economy into a recession.

It was at this time the European Central Bank (ECB) had halted rate cuts, as the economy was beginning to enjoy the benefits of relaxed monetary policy. The inevitable conclusion was rates would rise on the European continent but not in Britain. The prevailing carry trade environment (a carry trade consists of buying the currency with the higher interest rate vs. the currency with the lower interest rate in order to capture yield) was drawing to a close and a possible interest rate "catch-up" in Europe vs. UK was in store. See "The short term British pound/Japanese yen carry trade" on p. 22 for more information.

The charts, of course, were already bearing this out, but again, a tangible macro story allows one to really stay with a trade knowing what logically should unfold.

Figure 9 shows the EUR/GBP rate. In this case, there was a straightforward pullback within an uptrend. Pullbacks within clearly established trends offer a clear edge vs. trying to pick bottoms; trends tend to continue after periods of consolidation at support levels.

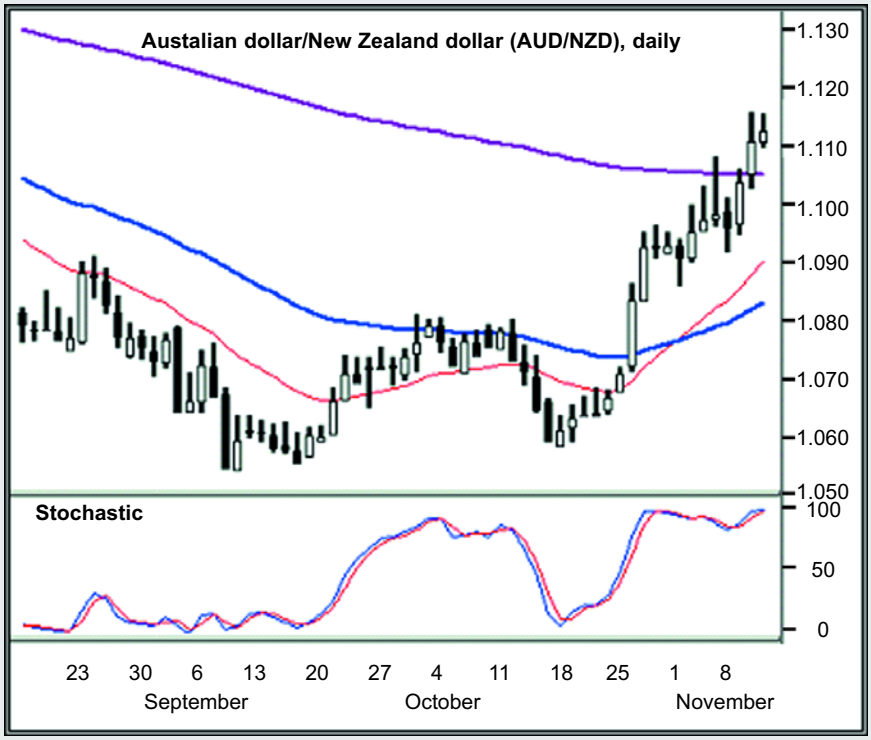
The EUR/GBP moved higher in the subsequent weeks. Continued comments from the Bank of England signaled rate hikes were all but done, while the ECB left the door open for further hikes.

The dollar's continued weakness also played a role in pushing this trade higher. With Asian central banks intervening to protect their currencies from appreciating vs. the dollar, the euro bore the brunt of the dollar weakness because the ECB rarely conducts direct open market intervention in the euro.

For information on the author see p. 8.

FIGURE 8 — ROLE REVERSAL

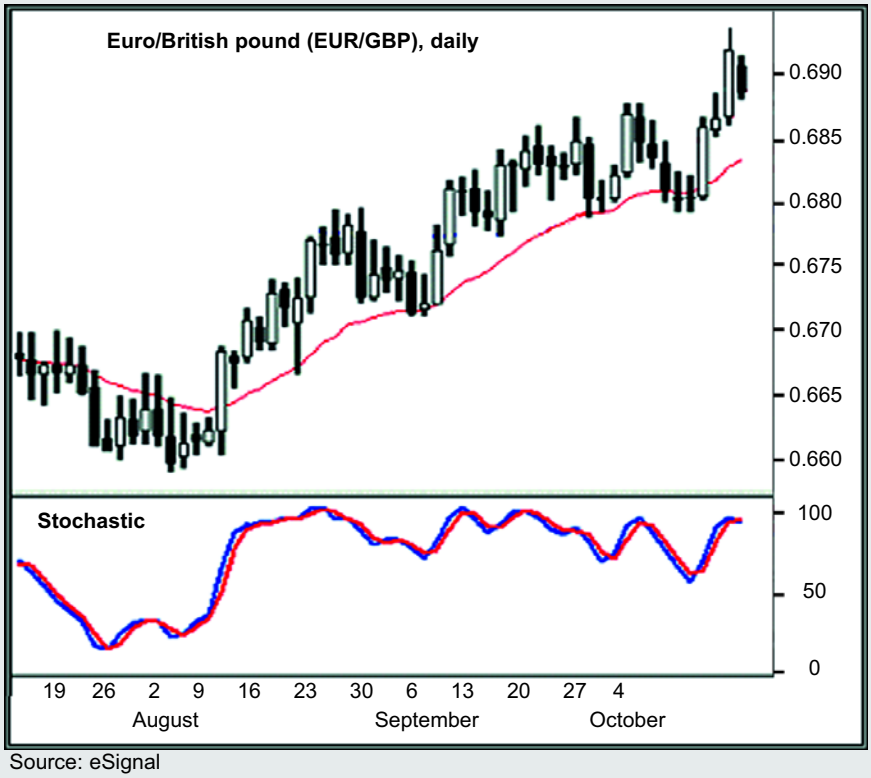
The AUD/NZD rate took off to the upside in late October when New Zealand announced it was halting rate hikes and Australia left the door open for further hikes.



Source: eSignal

FIGURE 9 — CONTRACTING RATE DIFFERENTIAL

Interest rate shifts between the euro and British pound resulted in a rally in the EUR/GBP rate. The pullback in the latter part of August offered technical traders an opportunity to enter the existing trend.



Source: eSignal

Bulletin boards

Market-related bulletin boards and chat rooms aren't hard to find. Those catering specifically to forex and currency trading are not as plentiful, however.

Additionally, message boards are only helpful if they're active and full of participants. A board doesn't help if a legitimate post is greeted by more silence than somebody trying to use pesos in London, or a Swiss franc in Toronto.

Unfortunately, when it comes to the Internet, you have to go through a lot of coal to find a diamond. While discussion sites focusing exclusively on the FX world can be found with a simple Web search, discovering the ones that actually have some substance requires a little more research.

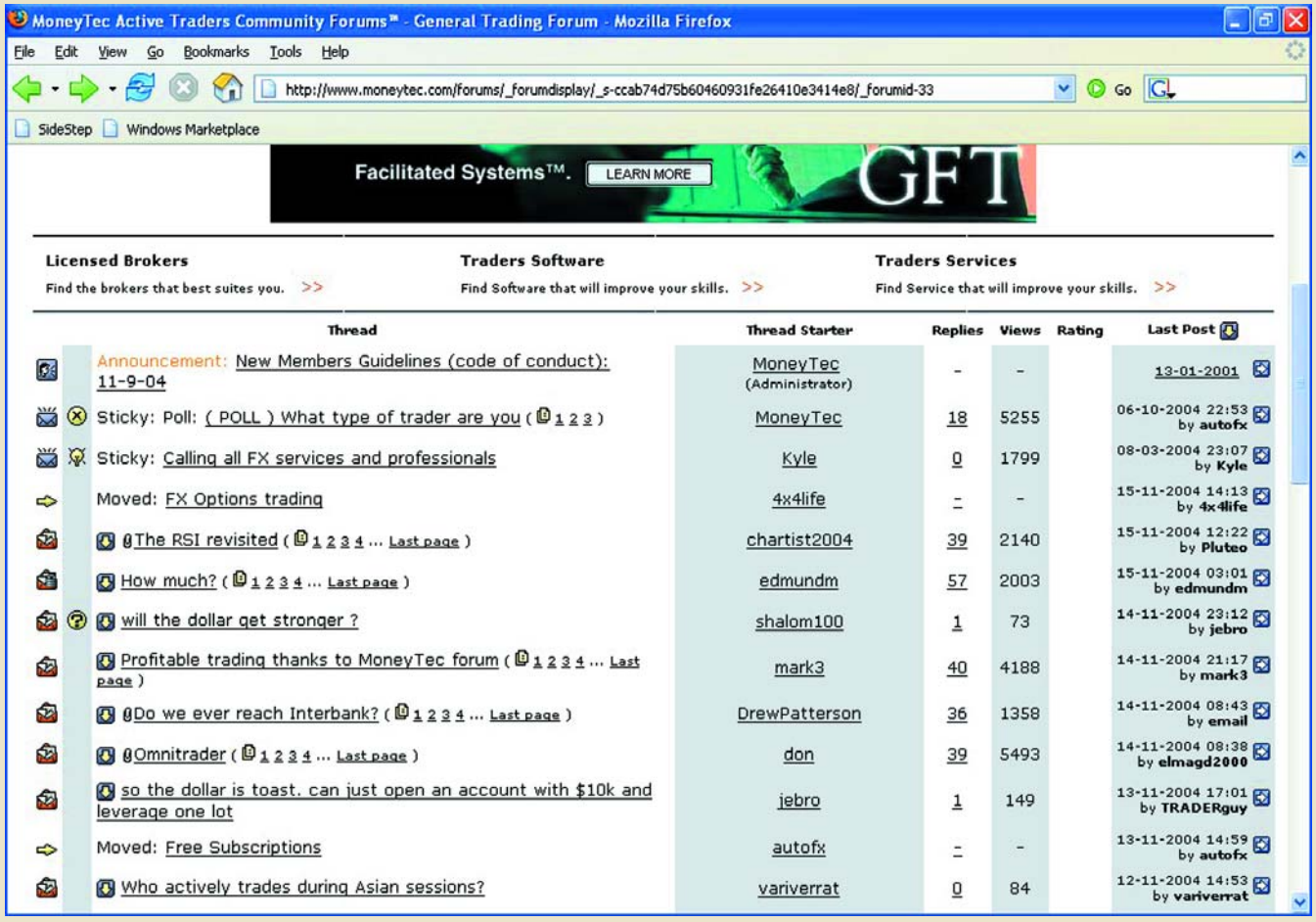
One of the best boards are the forums at MoneyTec (www.moneytec.com/forums/index.php). There are more than two dozen forums, divided into several categories (e.g., Main Discussion, Trading for a Living, Trading Styles and Strategies, Tools of the Trade, etc.), and many have thousands of views and hundreds of replies.

That's a good sign, because it indicates questions will get answered, or at least generate a discussion. There's nothing more frustrating to a person with a legitimate comment or question than to post it and get no responses, forcing the poster to try again at another site.

Additionally, the site is easy to navigate. Threads are listed singularly, one after the other, and reading the replies can also be done in an easy, organized fashion. MoneyTec is also good because it is completely devoid of advertisements on the main forums page, although some forums are sponsored. (Some of the posts are from firms and individuals trying to sell a product, but this is the case at any message board.)

MoneyTec.com

MoneyTec features numerous highly trafficked message boards.



Judging from the posts we looked at, it seemed users at MoneyTec had developed a sense of community — it was obvious in many cases certain posters had become familiar with each other, as posts mentioned other members by name and some asked specific questions of specific posters.

Plus, there were very few posts that strayed from the main topic of the thread. This is often the death of message boards — interspersed with legitimate conversation are posts that add nothing to the discussion, and only serve to discredit or otherwise blur the poster or the message. This can cause new posters to avoid a site, preventing the site from growing and eventually minimizing or negating its effectiveness.

Oanda.com, (www.oanda.com) also features a good message board (www2.oanda.comcgi-bin/msgboard/ultimatebb.cgi). It has eight forums and the threads inside are lively and active. Forex News (www.forexnews.com/forum/ forum.asp) has a decent forum as well — active, but poorly organized.

Another good site is the Forex Forum section of Forex Factory (www.forexfactory.com/forex-forum).

Forex Forum only has three main forums — General Forex Discussion, Town Square and Forex Related News. But the General Forex Discussion forum is lively, with almost 400 threads as of mid-November. What's better, many of the threads have multiple replies, and when we checked, the entire first page (18 different topics) had been replied to within the past week.

ForexForum.net (www.forexforum.net) has a fair amount of forums, but only minimal participation. Although people are reading the posts (as evidenced by the number of views), very few are taking the time to respond.

Elite Trader (www.elitetrader.com), a site originally designed for stock traders, has since branched out into other instruments, including forex, and the site — which claims more than 30,000 members — is consistently crowded.

While forex forums — FX Trading and FX Brokers — comprise only two of the dozens of forums at Elite, both feature heavy traffic and plenty of responses. One thread in the FX Trading forum was started on Aug. 16, 2004, and was still going strong as of late November — it has more than 2,000 responses and 48,000 views. Those are the kind of eyeballs you're looking for if you have a serious topic worthy of discussion.

Although Elite Trader isn't specifically designed for forex trading, it's probably the best option for forex traders looking for a place to share ideas and questions.

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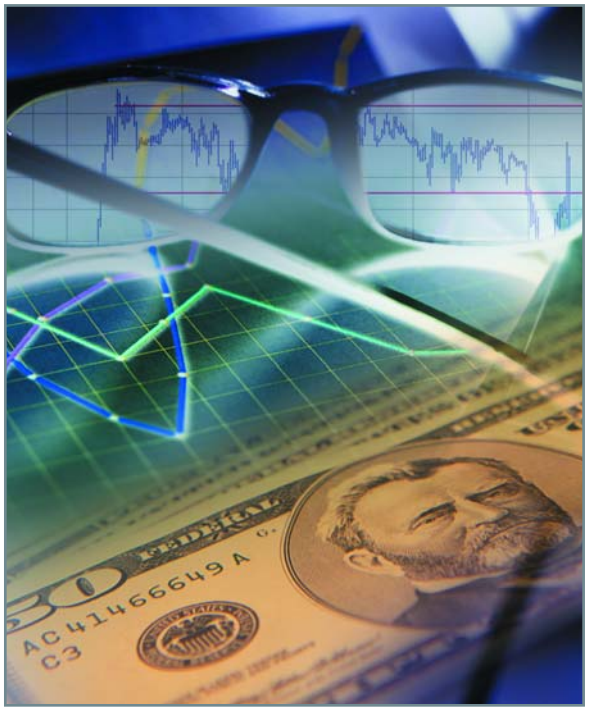
Economic reports in the forex market

A look at the top economic indicators and when they are most likely to shape market sentiment.

BY CARLISE PETERSON



Macro analysis in the FX market is complicated for many traders because foreign exchange participants don't necessarily digest economic data the same way as their stock counterparts, and there's also data from multiple countries to contend with. It takes a vigilant trader to stay on top of it all.

Not all the reports have immediate importance, but some are crucial, and it is essential to know which constitute news and affect market sentiment and which are irrelevant at a given time.

"How economic reports affect the FX markets depends on whether you're trading in a declining, or weakening environment," says Brian Dolan, vice president of research at Gain Capital. "Fundamentals have a lot of weight in a weakening environment."

Naturally, reports that reflect the U.S. job market are more important during a weak economic environment. When the environment strengthens and the economy is improving, inflationary reports become more of a focus.

Jobs, jobs and jobs

Dolan lists the top report in the current environment as — not surprisingly — the non-farm payroll numbers (released as part of the monthly employment report, and almost always the most closely-watched U.S. economic indicator), followed by retail sales, personal income expenditures and durable goods.

"My thinking is the employment report is more significant now in terms of assessing the economy," he says. "[Employment] is the prevailing model of growth; it's supposed to be strong in what we thought was a growing economy. You won't have a sustainable economy without jobs."

The U.S. Labor Department's monthly payroll numbers — which reflect the actual payroll statistics of non-farm jobs — is important to the U.S. dollar because a vigorous jobs report could drive interest rates higher, which can make the dollar more attractive to foreign investors. A weak report softens demand for U.S. currency because it puts downward pressure on rates, potentially making the dollar less appealing to foreign investors.

"The employment report plays a critical role in the actions of the dollar," says Alex Beuzelin, foreign exchange market analyst at Ruesch International. "The markets view it as a good barometer of economic activity and it plays a role as to why the Fed raises and lowers rates."

Consumption and spending

According to Dolan, the second group of key indicators is "hard data" such as retail sales and durable goods, both of which are related to private consumption.

"[Private consumption] is what ultimately will determine the direction of the dollar," he says. "You're not going to buy a big-ticket item such as a refrigerator when times are tough. It's a real-time indicator."

Lots of U.S. retail activity (read *shopping*) firms up interest rates, which is bullish for the dollar. However, an overly robust retail sales report can cause trouble for the dollar because many of the goods U.S. consumers buy are imported. A jump in imports increases demand for non-dollar currencies to pay for all of the imports, which can hurt the dollar.

Durable goods orders are important because they provide a look at what products will be produced in the months ahead. The actual goods are products with a life expectancy of at least three years. A jump in orders suggests employees and factories will be busy, while a decline suggests assembly lines will slow and plants may close, which is bad for the economy.

Another indicator that falls into the

"real-time" private consumption category is the personal income and spending report, released by the Bureau of Economic Analysis. It records the income Americans receive and how much they spend and save. A vigorous increase in income and spending is good for the dollar as high consumer demand encourages growth and places upward pressure on interest rates, but too much spending can trigger inflationary worries.

"Reports that pertain to consumer spending are important to the currency markets right now," says Beuzelin. "[This data] is very important — if it is true the U.S. economy is moving out of its soft patch. The Fed is optimistic [about the economy] and the FX market is skeptical of that optimism, so participants pay more attention to consumer reports."

Inflationary measures

The third most important set of economic statistics, according to Gain's Dolan, is inflation data, including that reflected in the Institute for Supply Management (ISM) report, inventory data, and consumer prices.

The ISM report provides one of the first glimpses inside the economy every month. It surveys purchasing managers in the manufacturing and non-manufacturing (i.e., service) industries, the latter in a separate report later in the month. Although the report sounds rather dry, it is closely monitored because the activity of manufacturing purchasing agents reflects the pickup in demand for manufactured products, which in turn is a barometer for manufacturing activity in general.

Some lagging indicators may indicate the economy is supposedly expanding or contracting when it really is not. For example, a gross domestic product (GDP) report can affect a

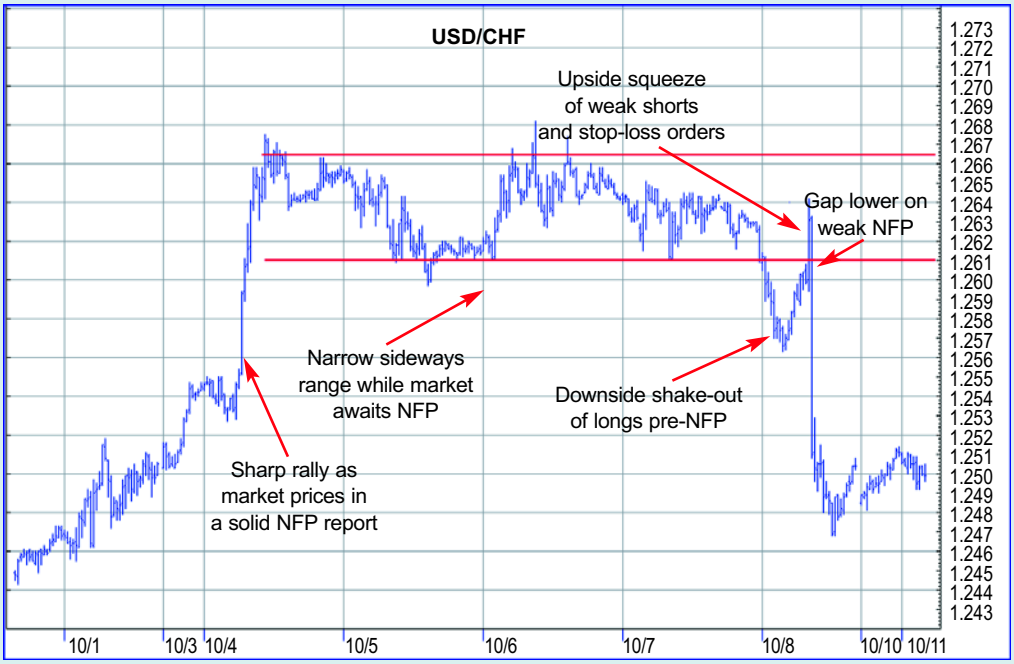
continued on p. 38

Trading the payroll number

On Monday, Oct. 4, before the September employment number came out, the European market began to price in a better-than-expected jobs report by buying up the dollar, as shown in Figure 1 of the USD/CHF rate. After a sharp rally from 1.2530 to 1.2670, the market settled into a narrow sideways range between approximately 1.2610 to 1.2670 through Thursday. In the final eight hours before the employment number release, the market made several feints, first down out of the range (chasing out weak longs who had bought anticipating a strong non-farm payroll number) and then up (squeezing out weak shorts who had sold the break of the range). At the moment of the NFP release (8:30 a.m. Friday, Oct. 8), the market had returned to the midpoint of the range around 1.2630/40.

FIGURE 1 — MOVING THE MARKET

At the beginning of the week culminating in the release of the September employment numbers, traders bought up the USD/CHF in anticipation of a strong report. The weak report on Oct. 8 almost instantaneously wiped out those gains.



Source: Brian Dolan, director of research, Gain Capital

The non-farm payrolls (NFP) number came in at +96,000, well below consensus expectations and much weaker than optimistic longs had expected. (August's NFP job gain was also revised lower.) The negative reaction was instantaneous as the market gapped 100 points lower to 1.2530 as trapped longs tried to exit. The initial reaction to the NFP data erased Monday's entire rally, which was based on the market pricing in a strong NFP report.

few months of consumer confidence reports, Dolan says, as the nation spends and consumes according to what the GDP reveals.

The GDP's effect on the FX market is determined by how strong or weak the report is. A strong report tends to spur corporate profits and firm up interest rates, making the dollar more attractive to foreign investors.

As the economy grows stronger, eventually the focus shifts to inflationary indicators such as the Consumer Price Index (CPI), Dolan says. The CPI reflects price inflation in retail goods and services by measuring the average change in retail prices over time in a basket of 200 assorted goods and services. It does not have as much of an effect as some other reports on the FX markets, but can still have an impact because of its relevance to interest rates. If rates surge on growing inflation concerns, it can hurt the U.S. dollar. High

Economic reports

The meaning of a particular number can be debated endlessly, depending on the market context it occurs in. No number can ever be considered a concrete indicator of inflation or the state of the economy. For example, today's inflationary employment report may be offset by next week's benign CPI. True trends in economic statistics only emerge over time.

However, that does not prevent the markets from reacting in knee-jerk fashion to report releases. Traders will respond particularly dramatically when a number "surprises" the market, coming in notably higher or lower than expected. While these reactions are often short-lived, they still pose problems (or opportunities, depending on your perspective) for traders. It is only in retrospect that most people can label a particularly dramatic number a sea change or an anomaly.

Here's a quick summary of some of the major U.S. economic report releases.

Employment

• **What it is:** Two surveys measuring 1) the number of people on payrolls and 2) the unemployment rate. Also measures average hourly earnings and the length of the average work week.

• **Who puts it out:** Bureau of Labor Statistics (www.stats.bls.gov).

• **When it's released:** 8:30 a.m. ET on the first Friday of the month after actual month (i.e., November's employment statistics are released in early December).

• **What it means:** The payroll report — probably the most widely watched report in the financial markets — measures the current state of the economy by way of the employment situation. It is more of a lagging indicator.

Strong employment is generally considered the bedrock of a solid economy. The more people who work and the more money they make, the more money they can spend, which will increase the demand for goods and services. However, if supply can't keep up with demand, inflation can develop, as explained in the next section.

Consumer Price Index (CPI)

• **What it is:** The difference in price from one month to the next for a fixed basket of consumer products, used as a common measure of inflation. The "Core CPI" does not include food and energy prices.

• **Who puts it out:** Bureau of Labor Statistics (http://stats.bls.gov).

• **When it's released:** 8:30 a.m. ET around the 15th of the month for the previous month's data (i.e., the March CPI is released around April 15).

• **What it means:** A rising CPI indicates increasing inflation, while a high CPI indicates already high inflation. According to standard economic theory, inflation increases when supply no longer can keep up with demand, which usually occurs at or near the peak of the business cycle and when the unemployment rate is low.

High inflation, or expectations of high inflation, usually leads to higher interest rates, as lenders of money want to be compensated for the diminishing purchasing power of their dollars. Higher interest rates, in turn, mean higher costs of doing business for all parties in the economy (both investors and companies).

Gross Domestic Product (GDP)

• **What it is:** A quarterly measure of the production and consumption of goods and services, broken down into several sub-categories.

• **Who puts it out:** Bureau of Economic Analysis (www.bea.doc.gov).

• **When it's released:** 8:30 a.m. ET, approximately one month after the end of each quarter.

• **What it means:** GDP is used to define business peaks and troughs, and together with employment data, it gives an important indication of productivity growth and economic strength.

Usually a growth rate between 2.0 and 2.5 percent is considered positive when combined with an unemployment rate of 5 to 6 percent. A higher growth rate and/or a lower unemployment rate might indicate inflationary pressure. A lower growth rate might indicate the economy is stalling. A relatively large increase of inventories might indicate a future decrease in the growth rate, as production (supply) at least temporarily has outgrown demand.

Thus, both numbers too low or too high can be interpret-

U.S. inflation erodes the value of dollar-based investments held by foreigners.

A related measure is the Producer Price Index (PPI), which measures the change in prices paid by businesses for raw and semi-finished goods (as opposed to what consumers pay for finished products). A fast-rising PPI can hurt the dollar because the Fed can respond so aggressively as to jeopardize U.S. economic growth altogether.

However, a gradual rise in inflation accompanied by well-timed tightening of interest rates can lead to a steady or rising dollar.

"Inflationary indicators are not as much of a concern right now," says Dolan.

Imports and exports

In his book *The Secrets of Economic Indicators*, Bernard Baumohl, director of The Economic Outlook Group and for-

continued on p. 40

ed negatively, depending on the current position in the business cycle. The fear of inflation, for example, generally gets more pronounced the longer a high-growth period lasts.

Retail Sales

• **What it is:** The most timely, albeit volatile, report of consumer spending patterns, excluding any type of services.

• **Who puts it out:** U.S. Census Bureau (www.census.gov).

• **When it's released:** 8:30 a.m. ET around the 13th of the month after the actual month.

• **What it means:** As is the case with the CPI, rising retail sales numbers might indicate demand is about to outstrip supply, which might lead to higher inflation. However, because the data doesn't include services, but does include gas, cars and food, it is very volatile and subject to large seasonal changes and subsequent revisions.

Durable Goods

• **What it is:** The current demand (new orders) and supply (shipments) balances in the economy.

• **Who puts it out:** U.S. Census Bureau (www.census.gov).

• **When it's released:** 8:30 a.m. EST around the 26th of the month after the actual month.

• **What it means:** The durable goods number is another volatile indicator. It measures the demand for, and supply of, domestic products with an expected life length of at least one year, including both "intermediate" goods (for instance, building materials) and finished goods (cars, computer equipment, etc.). The report monitors the rate of growth within several large industry sectors, such as auto and electronics.

If demand is higher than supply it might indicate a new period of economic growth is around the corner. However, if demand stays above supply while unemployment is low, it also might indicate higher inflation ahead, as the industry will meet the demand with higher prices rather than increased production. This is most likely to occur at the end of a bull market and at the peak of the business cycle.

Institute for Supply Management (ISM) index

• **What it is:** A monthly survey of 300 purchasing managers, representing 20 different industries.

• **Who puts it out:** Institute for Supply Management (www.ism.ws).

• **When it's released:** 10 a.m. ET on the first business day of the month after the actual month.

• **What it means:** The index is designed to fluctuate around 50, with readings above 50 indicating a growing economy. Too-high numbers or extended periods of growth might indicate the economy is about to overheat. Using ISM index, a business cycle trough could be defined as a reading at or above 44 a few months in a row.

The markets are very sensitive to unexpected discrepancies in this number, especially if that also coincides with a turning point in the index.

Industrial Production (IP) and Capacity Utilization

• **What it is:** A monthly measure of the domestic industrial output, weighted according to each input category's relative importance.

• **Who puts it out:** Federal Reserve Board (www.federalreserve.gov)

• **When it's released:** 9:15 a.m. ET around the 15th of the month after the actual month.

• **What it means:** It's an indication of different trends within various industries. In addition, it estimates the "capacity utilization" (the level of potential production capacity at which a business, such as a factory, is operating) within the economy, which, must be interpreted carefully because of the difficulty of estimating the maximum capacity in the first place.

One aspect of these reports that has become evident is their imprecise nature. Aside from highly publicized criticisms of how indicators such as the CPI have been calculated in the past, traders should understand these reports are merely barometers that are subject to seasonal fluctuations, anomalous readings and yes, human error. Many of them are regularly revised, so the number that shook the market a month ago may turn out to imply something different when it is updated and revised.

Each month Currency Trader *includes a Currency Calendar listing upcoming report releases. The* Active Trader *Calendar, which includes specific stock, futures and options information, can be found at www.activetradermag.com/calendar.htm.*

mer Time magazine economics reporter, lists the economic data with the most impact on the dollar as the employment report, international trade, GDP, the current account deficit and industrial production/capacity utilization. The ISM report and consumer prices are further down Baumohl's list, although still in the top 10.

International trade summarizes import and export activity between the U.S. and other countries. In general, the foreign exchange market views any kind of increase in trade surplus as favorable to the dollar, according to Baumohl's book.

"Trade data is extremely important to the FX markets right now, especially if the GDP is above 5 percent," Beuzelin says.

The current account balance data summarizes the net change in four areas: merchandise trade, services, income flows (the net income received from investing in foreign assets) and unilateral transfers (transfers of foreign aid, government grants and pension payments).

Participants in the FX markets generally pay more attention to this data than other types of traders. A deterioration in the U.S. current account balance — essentially a broad accounting of America's trade and investment relationship with the rest of the world — will, over time, wear away the value of the dollar. If the trade balance or the difference in the value of a country's imports and exports rises and moves toward surplus, it can hurt the dollar, according to Baumohl.

This data has more impact when the economy is weakening and is currently being closely monitored.

"U.S. growth has moderated enough that it makes [it more likely] account deficits will have an impact on the dollar," Beuzelin says.

Never cut and dried

Although economic numbers can offer great insight into the economy and the behavior of the FX market, it's risky to put too much emphasis on an individual reading because many economic numbers fluctuate dramatically from month to month. Also, almost all of these numbers are released after the fact.

For example, although the employment report is generally regarded as the most important economic report in all markets, it is a lagging indicator and there are often tremendous changes in the payroll figures from month to month. The difference between October, when 337,000 jobs were created (nearly double what Wall Street expected), and September, when only 96,000 jobs were created, is a recent example. Accordingly, analysts and traders often average certain economic figures over several periods to smooth the readings.

International numbers

Not only is there a slew of U.S. data to remember, there are also crucial reports released in other countries that affect currency prices. Traders need to investigate which economic data is most critical in a certain country during a given period.

For example, in addition to housing prices and retail sales, manufacturing, industrial production and trade balance data are important in the U.K. and Japan because they tend to be more manufacturing and export-oriented countries, according to Dolan. He also says understanding things such as employee compensation, which often differs from practices in the U.S., makes interpreting non-U.S. data more meaningful.

"In Japan, private consumption data is very important, like it is here," he says. "But there, overtime earnings and seasonal bonus data are also extremely important. Bonuses comprise a significant amount of Japanese income, and if they are declining, you can bet private spending will fall."

In Japan, numbers depend on where the main economic liabilities are, according to Beuzelin. Exports are very important there as well.

Lately, U.K. economic data has been weakening slightly: housing prices have moderated over the last few months, and some key reports, such as the September industrial production data, have come in weaker than expected.

The U.K. central bank's rate-setting body, the Monetary Policy Committee, has been hiking rates in an attempt to curb the inflationary pressures stemming primarily from rampant consumer demand, particularly in the housing market, according to Beuzelin.

"If we see housing prices continuing to cool, that will weigh on the pound but be good for the dollar," he says.

Although some believe certain economic reports in general are untrustworthy, there are economic reports and data relationships that prove consistently reliable, Dolan says. For example, in Japan, machine orders are closely watched. If machine orders sink but tool orders rise, there will probably be more machine orders next month.

"You have to really know the data, know what to look for and what matters and why," he says. "Investors have been pulling out of Japan — or the media has been saying that money is leaving Japan — because the economy isn't growing. But [the machine orders and tool orders] data proves otherwise."

All types of FX traders — not just fundamentally-oriented players — must inevitably keep abreast of economic conditions at home and abroad if they want to avoid being broadsided by the market.

"Investors should really be betting on consumer confidence," Dolan says.

If consumer spending is not picking up consistently in Japan, it will undermine the yen and the dollar, Beuzelin says. It addresses the issue of whether, in the long run, Japan can sustain its growth and whether wages are growing too.

"Over time, the underlying economic performance of a country determines how well a currency will perform," Beuzelin says.

"You cannot understate the important of economic indicators as a driver of FX market activity."

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FOREX (vs. U.S. DOLLAR)

Rank	Country	Currency	Current price vs. U.S. dollar	1-month gain/loss	3-month gain/loss	6-month gain/loss	52-week high	52-week low	Previous rank
1		South African rand	0.1729	6.07%	14.23%	11.22%	0.1729	0.135	3
2		Australian dollar	0.7922	5.91%	11.20%	9.44%	0.8005	0.6773	1
3		Swiss franc	0.8781	5.65%	11.19%	8.51%	0.8821	0.7559	4
4		Swedish krona	0.1492	5.56%	11.73%	9.65%	0.1493	0.1283	6
5		Brazilian real	0.3665	4.58%	7.56%	12.55%	0.3663	0.3103	16
6		euro	1.3307	4.52%	9.72%	7.79%	1.3329	1.1758	7
7		Taiwanese dollar	0.03109	4.18%	5.50%	4.02%	0.03132	0.02801	12
8		Thai baht	0.02542	4.05%	5.43%	3.03%	0.02592	0.0239	15
9		Canadian dollar	0.8493	3.96%	10.37%	13.29%	0.8532	0.7138	5
10		British pound	1.8944	3.47%	5.51%	2.95%	1.9141	1.7086	10
11		New Zealand dollar	0.7179	3.45%	8.86%	11.53%	0.7207	0.591	2
12		Japanese yen	0.009724	3.37%	6.23%	7.22%	0.00979	0.0087	8
13		Singapore dollar	0.6115	1.72%	4.42%	3.79%	0.6115	0.5775	9
14		Russian rouble	0.03532	1.56%	3.11%	2.38%	0.0354	0.0336	11
15		Indian rupee	0.02227	1.53%	2.74%	0.90%	0.02303	0.02145	14
16		Hong Kong dollar	0.1287	0.08%	0.39%	0.31%	0.129	0.1281	13

As of Nov. 26, 2004

INTEREST RATES

Rank	Country	Rate	Nov. 26	1-month	3-month	6-month	Previous
1	Germany	BUND	118.42	1.07%	3.06%	5.49%	1
2	Japan	Government Bond	138.75	0.09%	2.13%	0.94%	2
3	Australia	3-year bonds	94.75	0.09%	0.35%	N/A	5
4	UK	Short sterling	95.15	0.05%	0.33%	0.45%	3
5	U.S.	10-year T-note	112.015	-1.11%	-0.21%	2.47%	4

NON-U.S. DOLLAR FOREX CROSS RATES

Rank	Rate	Symbol	Current	1-month gain/loss	3-month gain/loss	6-month gain/loss	52-week high	52-week low	Previous
1	Aussie $	Yen	81.482	2.59%	5.31%	2.38%	85.559	74.28	2
2	Aussie $	Pound	0.4183	2.53%	6.02%	6.69%	0.4273	0.372	1
3	Franc	Yen	90.3319	2.34%	5.28%	1.38%	90.8151	80.5368	5
4	Franc	Pound	0.4636	2.26%	6.02%	5.74%	0.4647	0.4179	3
5	Aussie $	Canada $	0.9331	1.99%	0.91%	-4.44%	1.0534	0.8863	8
6	Franc	Canada $	1.0343	1.72%	0.91%	-5.51%	1.1054	0.9952	13
7	Aussie $	Euro	0.5955	1.46%	1.65%	1.78%	0.6358	0.5643	7
8	Franc	Euro	0.6603	1.26%	1.70%	0.83%	0.665	0.6297	11
9	Euro	Yen	136.84	1.15%	3.71%	0.60%	139.03	125.81	15
10	Real	Yen	37.5987	0.98%	1.15%	5.47%	39.3067	34.3301	16
11	Real	Pound	0.193	0.88%	1.92%	9.64%	0.1991	0.1714	14
12	Canada $	Yen	87.3705	0.59%	4.41%	6.54%	89.7805	78.0564	6
13	Canada $	Pound	0.4484	0.49%	5.13%	10.66%	0.454	0.397	4
14	Real	Canada $	0.4305	0.35%	-3.41%	-1.14%	0.4684	0.4212	19
15	Aussie $	Franc	0.9026	0.28%	0.02%	1.03%	0.9894	0.8547	9
16	Pound	Yen	194.93	0.12%	-0.71%	-4.53%	208.03	185.52	10
17	Real	Euro	0.2747	-0.22%	-2.66%	4.88%	0.2909	0.2575	18
18	Canada $	Euro	0.6384	-0.60%	0.72%	5.95%	0.6635	0.5916	12
19	Pound	Euro	1.4253	-0.99%	-4.57%	-5.13%	1.5279	1.4096	17
20	Real	Aussie $	0.4615	-1.71%	-4.42%	3.12%	0.5039	0.4276	20

GLOBAL STOCK INDICES

Rank	Country	Index	Current	1-month gain/loss	3-month gain/loss	6-month gain/loss	52-week high	52-week low	Previous
1	Brazil	Bovespa	24,998	8.60%	9.66%	23.72%	25,072	17,601	8
2	Hong Kong	Hang Seng	13,895.03	7.50%	7.99%	15.85%	14,091.89	10,917.65	12
3	Germany	Xetra Dax	4,154.27	7.03%	7.75%	6.90%	4,202.45	3,618.58	10
4	India	BSE 30	6,035.03	6.36%	14.91%	15.79%	6,249.6	4,227.5	3
5	Mexico	IPC	12,076.08	6.08%	15.55%	16.67%	12,078.88	8,288.43	2
6	US	S&P 500	1,182.65	6.05%	6.56%	5.73%	1,188.46	788.9	11
7	Egypt	CMA	1,181.58	6.02%	17.49%	24.01%	1,181.58	783.06	6
8	Australia	All ordinaries	3,922.9	5.22%	9.81%	12.76%	3,928.2	3,173.3	4
9	Italy	MIBTel	22,458	4.85%	9.23%	9.59%	22,665	19,655	5
10	France	CAC 40	3,782.2	4.30%	4.03%	3.23%	3,856.01	3,396.59	9
11	Switzerland	Swiss Market	5,548.5	3.94%	2.09%	-2.22%	5,941.7	5,264.5	15
12	Singapore	Straits Times	2,028.43	3.50%	5.39%	12.41%	2,050.78	1,205.31	13
13	UK	FTSE 100	4,741.5	3.33%	6.07%	6.39%	4,823.8	4,283	7
14	Canada	S&P/TSX composite	9,057.97	2.65%	8.02%	8.16%	9,059.29	7,822.34	1
15	Japan	Nikkei 225	10,833.75	1.49%	-2.73%	-2.94%	12,195.66	7,606.69	14

ACCOUNT BALANCE

Rank	Country	2004	Ratio*	2003	2005+
1	Hong Kong	16.404	10	16.697	16.598
2	Taiwan	21.3	6.9	29.202	19.378
3	Germany	118.525	4.4	52.933	129.726
4	Japan	159.402	3.4	136.238	148.931
5	Denmark	4.289	1.8	6.327	4.543
6	Canada	28.195	2.9	17	25.243
7	France	-12.761	-0.6	5.474	-13.246
8	Italy	-18.074	-1.1	-21.942	-13.315
9	United Kingdom	-43.338	-2	-33.39	-43.098
10	Spain	-33.066	-3.4	-23.549	-36.462
11	United States	-631.268	-5.4	-530.669	-641.678
12	New Zealand	-4.102	-4.4	-3.267	-4.151
13	Australia	-32.036	-5.3	-30.212	-30.248

Totals in billions of U.S. dollars

**Ratio: Account balance in percent of GDP; +Estimate*

Source: International Monetary Fund, World Economic Outlook Database, October 2004

Simple Moving Average

New traders: Learn the logic and uses of the simple moving average.

BY CURRENCY TRADER STAFF

The simple moving average (SMA) is probably the best-known technical indicator. It is used to smooth price action and highlight trends.

Calculation

The SMA is the average price of an instrument over a specific time period:

n-day moving average = Sum($Price_t$, $Price_{t-1}$ ... $Price_{t-N}$)/n
where,
$Price_t$ = today's price
$Price_{t-n}$ = price n days ago

For example, a 20-day moving average is the average price of the most recent 20 days. The closing price is usually used in the calculation, although the high, low, opening or average price of a price bar can be substituted. To calculate, add the closing prices of the last 20 days and divide by 20.

As a market moves forward in time, the newest price is added to the average and the oldest is dropped from it. Table 1 shows a series of daily closing prices and the five-day SMA values that result from progressively averaging the five most recent days' prices.

Moving averages can be calculated for any time frame — daily, intraday, weekly, monthly, etc. For a five-minute bar chart, for example, a 10-bar moving average would be the average price of the 10 most recent five-minute bars. We will continue the discussion in terms of daily bars for simplicity.

TABLE 1 — CALCULATING THE SMA

Calculating a five-day simple moving average: With each new day, the most recent closing price is added to the moving average calculation and the oldest price is dropped from it.

Date	Close	5-day SMA	
Day 1	13.00		
Day 2	12.25		
Day 3	12.13		
Day 4	12.19		
Day 5	11.88	12.29	Average of day 1 to day 5
Day 6	12.00	12.09	Average of day 2 to day 6
Day 7	11.94	12.03	Average of day 3 to day 7
Day 8	11.31	11.86	Average of day 4 to day 8

Applications

Moving averages smooth price action and are primarily used to highlight and define trends. Longer moving averages (e.g. 50, 100, 200 days) reflect long-term trends; shorter moving averages (e.g. five days, 10 days, 20 days) reflect short-term trends.

A basic moving average-based definition of a trend is that a market is in an uptrend when it is trading above its moving average and in a downtrend when it is trading below its moving average. The magnitude of the "trend," however, depends on the length of the moving average. For example, a stock may be trading above its five-day moving average, and thus be in a very short-term uptrend, but at the same time be trading below its 50-day moving average, and be in an intermediate- to longer-term downtrend.

Figure 1 shows three moving averages on a daily chart of the USD/CAD currency pair: a five-day (red), a 20-day (blue) and a 60-day (green). Each average reflects — to varying degrees — the strong downtrend that commenced in June 2004. Notice that the longer the moving average, the smoother the line — the more the shorter-term market fluctuations ("noise") are filtered out.

The basic moving average trend signal is the ***crossover***, which occurs when price moves from below the moving average to above it (signaling rising prices and an uptrend) or moves from above the moving average to below it (signaling falling prices and a downtrend). In Figure 1, notice at the far left of the chart, the price bars were above the 20- and 60-day SMAs; price first crossed below the 20-day average, then the 60-day average, signaling the market was turning lower. (Also notice the change in direction of the 60-day SMA from up to down in early July; some traders also define trends in terms of the direction of a moving average.)

Similarly, trend changes can be signaled by a ***moving average crossover***, which occurs when a shorter-term moving average (say, 20 days) crosses above or below a longer-term moving average (say, 60 days). When the shorter average crosses above the longer average, an uptrend is implied; a downtrend is suggested when the shorter average crosses below the longer average. In Figure 1, the five-day average crossed below the 20-day average almost at the same time (in late June) the 20-day average crossed below the 60-day average, reflecting the price shift from uptrend to downtrend.

Key points

Because they track the average price of a market over time, moving averages lag price action in direct proportion to the number of days (referred to as the period length or lookback period) used to calculate them. The longer the moving average, the greater the lag. This means that trend changes signaled by longer-term moving averages will occur long after the actual change in price direction has taken place. Essentially, moving averages signal trends after the fact.

Figure 2 highlights this. The longer the moving average, the longer it takes to signal (by virtue of price crossing below the moving average) the downtrend that began in February 2004 in the EUR/USD currency pair. Price did not remain consistently below the 100-day moving average (green) until nearly a month after it crossed definitively below the 20-day moving average (red).

There are many penetrations above and below the 20-day moving average in Figure 2 (as well as the five- and 20-day average in Figure 1). Although moving averages filter out market noise and highlight price direction in trending markets, they are subject to frequent ***whipsaws*** (when price crosses repeatedly above and below the average) in non-trending markets, or in any kind of market when the moving average is too short — and thus too sensitive — to price fluctuations.

Figure 3 (p. 46) shows how price repeatedly jumps above and below a 30-bar SMA (on a 10-minute bar chart) when USD/CAD is in the initial sideways (trading range) period but stays consistently above the moving average during the subsequent strong up move. A basic moving-average trend-change signal — a crossover above or below the moving average — would technically occur with each one of the penetrations during the sideways period, underscoring one of the primary limitations of using moving averages.

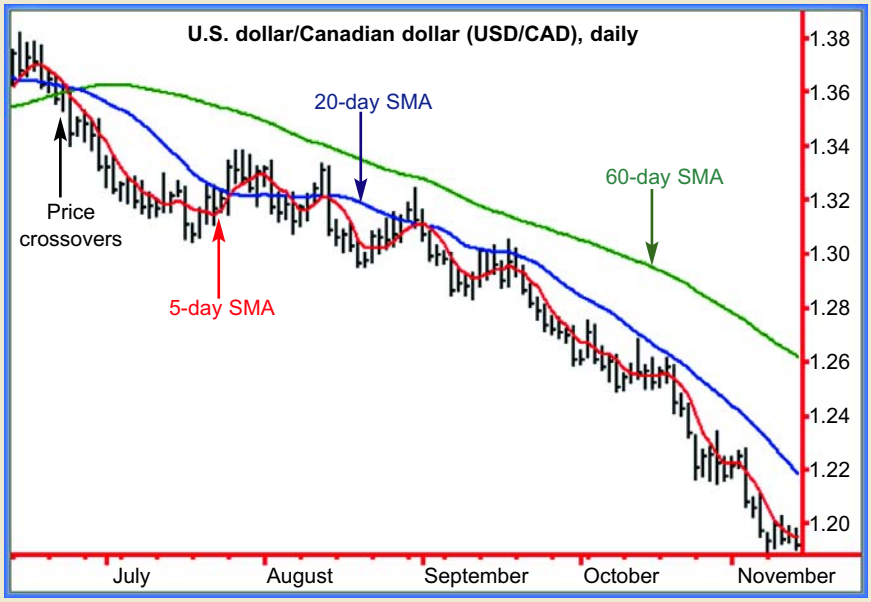
One method to avoid overly frequent moving-average penetrations is to increase the length of the moving average. However, this decreases the timeliness of trade signals.

This also highlights another aspect of using moving average — or any other technical indicator, for that matter. It is impossible to know, except in retrospect, what length moving average will perform "best" — that is, provide reasonably timely indication of trend changes without excessive whipsaw action. There are no magic numbers — despite repeated popular references to 50-day and 200-day moving averages, for example. A lookback period that tracks the market well

continued on p. 46

FIGURE 1 — SIMPLE MOVING AVERAGES

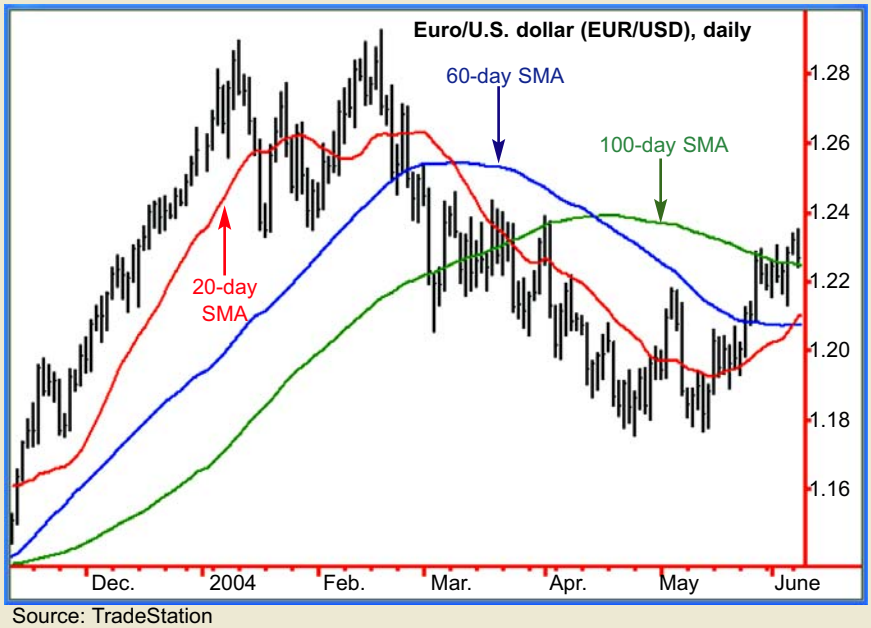
Five-day, 20-day and 60-day SMAs smooth price action and highlight trend to varying degrees.



Source: TradeStation

FIGURE 2 — MOVING AVERAGE CROSSOVERS

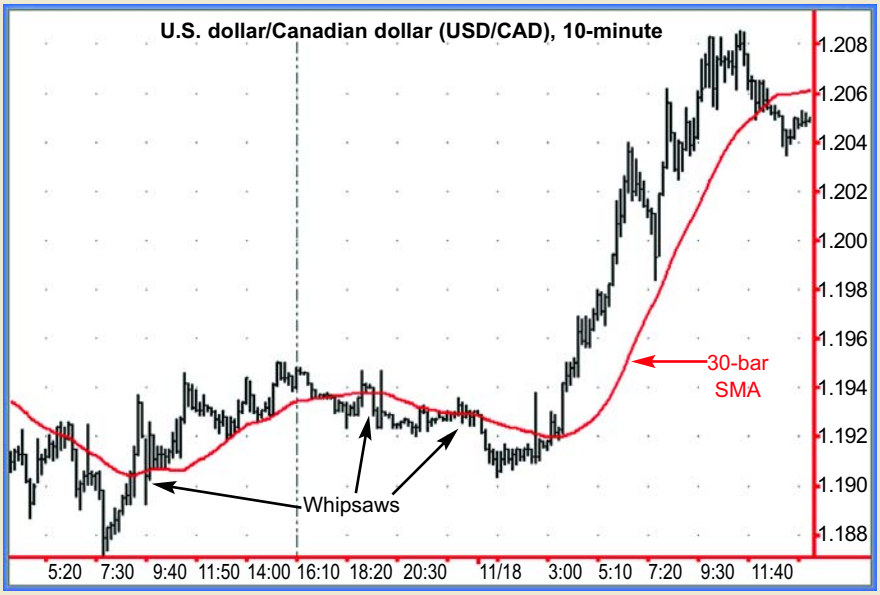
The longer the moving average, the more it lags changes in price direction. Price crossed below the 100-day SMA well after it moved below the 20-day and 60-day SMAs.



Source: TradeStation

FIGURE 3 — THE WHIPSAW PROBLEM

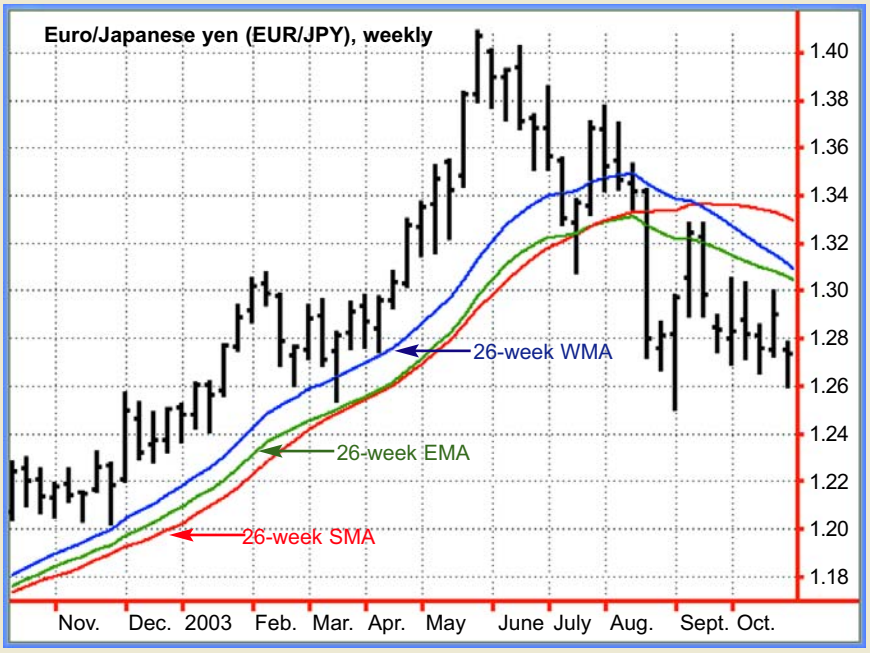
Price repeatedly crosses above and below the moving average when the market moves sideways, which would result in many "false signals" for traders using a basic price-moving average crossover approach.



Source: TradeStation

FIGURE 4 — SIMPLE, WEIGHTED AND EXPONENTIAL MOVING AVERAGES

WMAs and EMAs emphasize more recent price action, while SMAs treat each price equally. The WMA and EMA here respond faster than the SMA to the end of the uptrend.



Source: TradeStation

one month might perform horribly the next.

Despite their popularity, some traders believe moving averages alone are not useful trading tools (as opposed to being analytical tools) because they are backward-looking by nature and too simple to offer any edge (i.e., specifically because so many people use them). However, SMAs can be used with other tools and techniques. For example, they can function as trade filters: If price is above a moving average of a certain length, only buy signals from a short-term pattern strategy can be acted upon.

Variations

There are other types of moving averages besides the simple moving average. Most of these variations alter the basic moving average calculation to emphasize more recent price action. The two most popular are the weighted moving average (WMA) and the exponential moving average (EMA).

A five-day simple moving average is simply the sum of the five most recent closes divided by five; each day's price is given equal emphasis in the calculation. By comparison, a five-day weighted moving average would multiply each day's price by a certain factor, with the most recent price receiving the heaviest weighting. The sum of these weighted closes would then be divided by the sum of the weighting factors to derive the WMA.

The EMA is a special kind of weighted moving average that uses all the prices available (rather than a set number of bars, e.g. 20 or 50), using what is called a smoothing constant (ranging from 0 to 1) to weight prices.

A full discussion of weighted and exponential moving averages is outside the scope of this introductory article. Visit www.activetradermag.com for more information on these tools and consult the other resources listed below.

Figure 4 compares 26-bar simple (red), weighted (blue) and exponential (green) moving averages on a weekly chart. The distinguishing characteristic of weighted and exponential moving averages is that they will emphasize the most recent price activity, which is sometimes helpful and sometimes misleading. In this case, price was above all three averages during the uptrend (the WMA, which hugged price most closely) was penetrated once; the WMA and EMA began to turn slightly lower in August while the SMA continued to move higher — even though price had peaked in late May.

The January 2005 edition of *Currency Trader* will cover

weighted and exponential moving averages in greater detail.

Bottom line

The simple moving average is a basic indicator used to smoothing price action and defining trends, but it is not a sophisticated trading tool. It is impossible to know the "best" moving average length to use to define the dominant trend because market conditions constantly change.

In non-trending or highly volatile markets, moving averages can result in repeated "whipsaws" and false signals. Trading strategies built on moving averages generally require extra filters or rules to compensate for these limitations.

Additional research

Trading Systems and Methods (3rd Edition), Perry Kaufman 1998, John Wiley & Sons, New York.

Schwager on Futures: Technical Analysis, Jack Schwager, 1996, John Wiley & Sons, New York.

Technical Analysis of the Financial Markets, John Murphy 1999, New York Institute of Finance, New York.

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INDICATORS IN THIS ISSUE

Stochastic basics

The stochastic indicator is an oscillator, which is a technical tool designed to highlight shorter-term momentum and "overbought" and "oversold" levels (points at which a price move has, theoretically at least temporarily exhausted itself and is ripe for a correction or reversal).

Calculation

The stochastic oscillator consists of two lines: %K and a moving average of %K called %D. The basic stochastic calculation compares the most recent close to the price range (high of the range – low of the range) over a particular period.

For example, a 10-day stochastic calculation (%K) would be the difference between today's close and the lowest low of the last 10 days divided by the difference between the highest high and the lowest low of the last 10 days; the result is multiplied by 100. The formula is:

$\%K = 100*\{(C_t-L_n)/(H_n-L_n)\}$

C_t is today's closing price

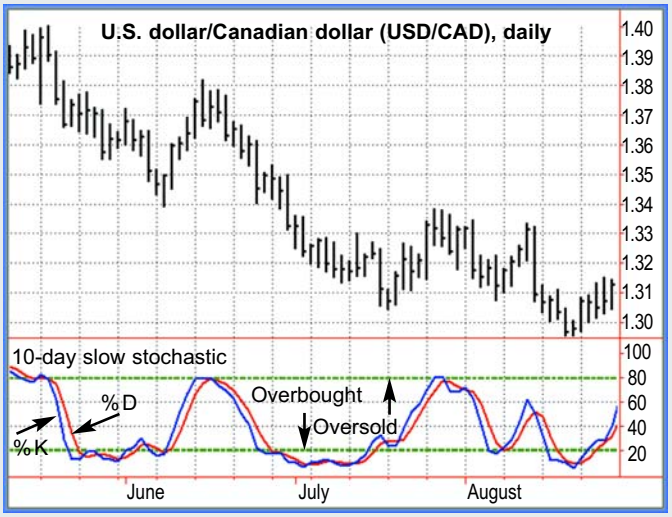
H_n is the highest price of the most recent *n* days (the default value is five days)

L_n is the lowest price of the most recent *n* days

The second line, %D, is a three-period simple moving average of %K. The resulting indicator fluctuates between 0 and 100.

FIGURE 1 — 10-BAR STOCHASTIC OSCILLATOR

The stochastic oscillator consists of two lines: %K and a three-period moving average of %K called %D. The indicator follows the general swings of the USD/CAD, although the overall downtrend skews the indicator slightly to the downside: Notice the stochastic's lows are further below the "oversold" line (20) than the indicator's highs are above the "overbought" line (80).



Source: TradeStation

Fast vs. slow

The formula above is sometimes referred to as "fast" stochastics. Because it is very volatile, an additionally smoothed version of the indicator — where the original %D line becomes a new %K line and a three-period average of this line becomes the new %D line — is more commonly used (and referred to as "slow" stochastics, or simply "stochastics"). Figure 1 shows a 10-day stochastic: The lookback period is 10 days and a three-day moving average is used to smooth both the %K and %D lines.

Any of the parameters — either the number of periods used in the basic calculation or the length of the moving averages used to smooth the %K and %D lines — can be adjusted to make the indicator more or less sensitive to price action.

Horizontal lines are used to mark overbought and oversold stochastic readings. These levels are discretionary; readings of 80 and 20 or 70 and 30 are common, but different market conditions and indicator lengths will dictate different levels.

Related reading: "Indicator Insight: Stochastics," *Active Trader*, August 2000, page 82.

You can purchase and download past Active Trader *articles at www.activetradermag.com/purchase_articles.htm* .

Playing a fake-out breakout.

LAST MONTH'S TRADE

Date: Friday, Oct. 29, 2004.

Entry: Sell the USD/CAD at 1.2182.

Last month's trade completed shortly after press time. The U.S. dollar/Canadian dollar currency pair (USD/CAD) followed through to the downside when the next trading session began (later on the same day we marked the trade to market). The market eventually fell to and through our exit point and we took our profit accordingly.

LAST MONTH'S TRADE SUMMARY

Date	Rate	Entry	Initial stop	Initial target	IRR	Exit	Date	P/L	LOP	LOL	Trade length
10/29/04	USD/CAD	1.2182	1.2308	1.2055	1.01	1.2055	11/4/04	+.0127 (1.04%)	.0152	-.0099	4 days

NEW TRADE

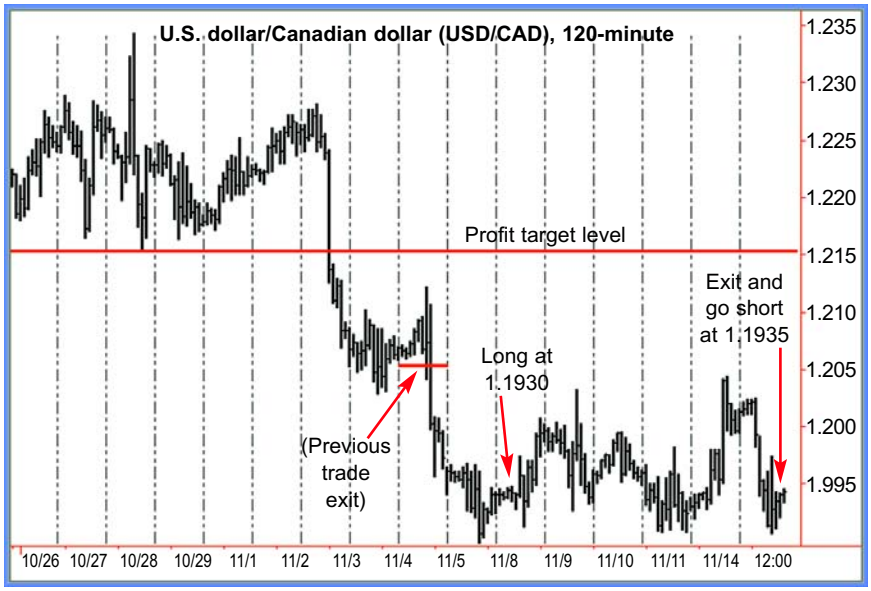
Date: Monday, Nov. 8, 2004.

Entry: Buy the USD/CAD at 1.1930.

Reason(s) for trade/setup: This trade is based on analysis discussed in the November 2004 issue of *Currency Trader* describing the potential for a longer-term reversal in the USD/CAD rate.

Initial stop: 1.1866, which is 33 pips below the day's low. This trade constitutes bottom picking, so we'll want to exit if the currency pair does not quickly move in our direction.

Initial target: 1.2155, which is the low of the consolidation the market broke below. We will take partial profits at this level, raise the stop and look for a move above the high of the consolidation. Even if an up move turns out to be merely a temporary correction, a move to the most recent resistance (former support) level would be logical.



Source: TradeStation

RESULT

Exit: 1.1935.

Reason for exit: Discretionary exit based on the currency pair's formation of a trading range and repeated failure to follow-through on upside moves. This led us to reverse positions in anticipation of a downside breakout.

Profit/loss: + 5 pips.

Trade executed according to plan? No.

Lesson(s): The market basically languished after we entered the market. We exited and reversed position because the market's behavior negated the original trade premise. With the dollar's weakness still intact and the currency pair's inability to move in the (initially) expected direction — despite two fairly strong intraday moves in that direction — the USD/CAD seems poised to try to move back down; the current consolidation is looking more like a pause on the daily chart. If a market doesn't do what it's "supposed" to do, it's often a sign it's going to do the opposite.

We basically scratched the long position, so we lose nothing by reversing the trade.

TRADE SUMMARY

Date	Rate	Entry	Initial stop	Initial target	IRR	Exit	Date	P/L	LOP	LOL	Trade length
11/8/04	USD/CAD	1.1930	1.1866	1.2155	1.01	1.1935	11/15/04	+.0005	.0114	-.0022	6 days

Legend: IRR — initial reward/risk ratio (initial target amount/initial stop amount); LOP — largest open profit (maximum available profit during lifetime of trade); LOL — largest open loss (maximum potential loss during life of trade).

Monday	Tuesday	Wednesday	Thursday	Friday	Saturday
		1 **U.S.:** ISM report on business **Australia:** Index of commodity prices **Japan:** Account balances	**2** **ECB:** Governing Council meeting **Japan:** Monetary base **Germany:** Retail turnover; Employment	**3** **U.S.:** Employment report	**4**
6 **Germany:** Orders received and manufacturing turnover	**7** **Australia:** Official reserve assets	**8** **Great Britain:** Monetary Policy Committee meeting	**9** **U.S.:** Wholesale inventories **Great Britain:** Monetary Policy Committee meeting **Japan:** Balance of payments **Germany:** Production index; Foreign trade	**10** **U.S.:** PPI **Japan:** Corporate goods price index	**11**
13 **U.S.:** Retail sales **Great Britain:** PPI	**14** **U.S.:** Trade balance; FOMC meeting **Italy:** Balance of payments **Canada:** Manufacturing survey; Trade balance **Japan:** Monetary survey	**15** **U.S.:** CPI	**16** **ECB:** Governing Council and General Council meeting	**17** **U.S.:** CPI **Canada:** CPI **Germany:** Bankruptcies	**18**
20 **U.S.:** Leading indicators **Canada:** Wholesale trade **Great Britain:** Capital issues **Germany:** PPI	**21** **Canada:** Retail trade; Leading indicators	**22** **U.S.:** GDP **Canada:** Employment	**23** **U.S.:** Durable goods **Canada:** GDP **Great Britain:** Productivity; GDP: Balance of Payments	**24**	**25**
27 **Japan:** Corporate service price index	**28**	**29**	**30**	**31** **Australia:** International reserves and foreign currency liquidity **Italy:** International reserves and foreign currency liquidity	

Legend

CPI: Consumer Price Index
ECI: Employment Cost Index
FOMC: Federal Open Market Committee
GDP: Gross Domestic Product
PPI: Producer Price Index
ECD: European Central Bank

The information on this page is subject to change.
Currency Trader is not responsible for the accuracy of calendar dates beyond press time.