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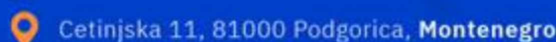
Introduction to Fundamental Analysis



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Fundamental Analysis on Forex

For predicting market trends, two forms of analysis are used: fundamental and technical (the chart study of past behaviour of currencies prices). The fundamental one focuses on theoretical models of exchange rate determination combined with major economic factors and their potential to influence foreign exchange rates.

1. Theories related with exchange rate

determination Purchasing Power Parity:

This parity specifies that the price of a good in one country should be the same as the price of a similar good in another country, traded at the current rate. The purchasing power parity principle is divided into two types: absolute and relative forms. In the absolute version, the exchange rate precisely equals the weighted average of all commodities manufactured in a country divided by the ratio of the two countries' general price levels. This version, however, only works where two countries that manufacture or use the same products can be found. Furthermore, the absolute version presupposes that shipping costs and trade barriers are marginal. In fact, transportation costs vary significantly across the globe. Trade walls are still there, sometimes visible and sometimes unseen, and they have an effect on prices and delivery of products. Finally, the relevance of brand names is ignored in this edition. Cars are selected, for example, not only on the basis of the best price for the same model of vehicle, but also on the basis of the brand ("You are what you drive").

The discrepancy between the percentage change in the domestic price level and the percentage change in the international price level must equal the percentage change in the exchange rate from a given base period in the PPP relative version.

The relative version of the PPP has its own set of issues: defining the base date is complicated or subjective, trade barriers are a true and thorny topic, and different price index weighting and the presence of different items in the indexes make comparison difficult, and over time, countries' internal price ratios which change, allowing the PPP to change.

Finally, the spot exchange rate is unaffected by relative domestic and international markets. Financial market dynamics, not commodity market conditions, affect the exchange rate in the short term.

Theory of Elasticities:

According to the theory of elasticities, the exchange rate is essentially the foreign exchange price that keeps the balance of payments in equilibrium. In other words, the elasticity of demand to market changes determines how responsive the

exchange rate is to a shift in the trade balance. For example, if country A's imports are high, the trade balance would be low. As a result, the exchange rate increases, causing country A's exports to increase, resulting in an increase in domestic income and a reduction in foreign income. Whereas a rise in domestic income (in country A) leads to an increase in domestic consumption of both domestic and foreign products and, as a result, more demand for foreign currencies, a decline in foreign income (in country B) leads to a decrease in domestic consumption of both domestic and foreign goods and, as a result, less demand for the country's own currency.

Modern monetary theories on short-term exchange rate volatility:

The effect of short-term stock markets and the long-term influence of commodity markets on foreign exchange are both taken into account in modern monetary theories on short-term exchange rate volatility. The supply and demand for financial commodities, as well as foreign capacity, are said to be the sources of the difference between the exchange rate and purchasing power parity.

One of the modern monetary theory claims that a one-time domestic money supply rise causes exchange rate fluctuations because it raises hopes of higher potential monetary inflation.

The financial markets are used in the buying power parity theorem. If the amount of domestic income and domestic interest rates decide the demand for currency in all countries where currencies are traded, so a higher income raises demand for transaction balances while a higher interest rate increases the opportunity cost of keeping money, lowering the demand for money.

The exchange rate changes instantly to preserve constant interest rate equilibrium in a second strategy, but only in the long term to maintain PPP. Commodity markets adapt more slowly than stock markets, resulting in volatility. The complex monetary method is the name given to this edition.

Synthesis of traditional and modern monetary views:

Any of the stricter criteria were modified into a combination of the existing and current monetary philosophies in order to best suit the former theories to the reality of the market.

A monetary shock triggers a short-term capital outflow, resulting in a payments deficit that necessitates an exchange rate adjustment to restore balance of payments equilibrium. Exchange rate instability is triggered by speculative factors, energy market disruptions, and the presence of short-term capital mobility. The degree of change in the exchange rate is determined by the market elasticity of customers.

Since stock markets adapt quicker than commodity markets, the exchange rate is determined by capital market adjustments in the short term and commodities changes in the long term.

2. Economic for the fundamental analysis

Traders use information from objective analyses of specialists published in journals, as well as charts and tables on several graphical metrics, for quantitative research on the Forex market, much as they do on every other commodities market. Except for the Gross Domestic Product and the Job Cost Index, which are published quarterly, all fundamental metrics are usually released monthly.

Any economic indicator is published in pairs. The first number represents the most recent time frame. The updated statistic for the month previous to the most recent date is the second number. For example, economic data for the month of June, the most recent date, is published in July. In addition, the same economic indicator statistic for the month of May has been revised in the release.

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Economic statistics are published at various intervals. Economic data were usually published between 8:30 and 10:00 a.m. ET in the United States. It's crucial to keep in mind that the most important foreign exchange data is published at 8:30 a.m. ET. The United States currency futures markets open at 8:20 AMET to prepare for last-minute changes.

Economic Indicators

The Gross National Product (GNP)- The Gross National Product (GNP) is a metric that calculates the economy's overall output. At the macro level, this metric is made up of the amount of consumer expenditure, investment spending, government spending, and net trade. The gross national product (GNP) is the total value of all products and services generated by US citizens, whether in the US or abroad.

The Gross Domestic Product (GDP)- The Gross Domestic Product (GDP) is the total value of all goods and services generated in the US, whether by domestic or foreign firms. In the case of the US economy, the variations between the two are purely

nominal. Outside of the United States, GDP estimates are more common. The United States frequently publishes GDP estimates to make it possible to measure the results of various economies.

Consumption Spending- Personal income and discretionary income provide for consumption. Consumers' decisions to spend or invest are social in nature. Consumer trust is also a key predictor of customers' willingness to turn from investing to spending when they have disposable income.

Investment Spending-Fixed investment and inventories make up investment, or total private domestic consumption.

Government Spending-Related to special expenditures, government spending has a large effect in terms of both sheer scale and impact on other economic metrics. Until 1990, for example, military spending in the United States accounted for a substantial portion of total jobs in the country. In the short term, the defence cuts made at the time raised unemployment rates.

Net Trade-Another significant portion of the GNP is net trade. Since 1980, globalization and economic and political trends have had a major effect on the United States' ability to succeed internationally. The trade deficit in the United States has hindered the aggregate growth of the economy in recent decades. GNP can be measured in two ways: inventory flow and expense flow.

Industrial sector indicators

The combined productivity of a country's factories, infrastructure, and mines is measured by the **Industrial Production** indicator. It is a significant economic metric that represents the strength of the economy and, through extrapolation, the strength of a given currency from a fundamental standpoint. As a result, traders in foreign exchange use this economic proxy as a possible trading signal.

Capacity utilization indicator consists of total industrial output divided by total production capability. Under standard market conditions, the term refers to the maximum amount of production a plant will produce. Capacity consumption is not a significant economic metric for the foreign exchange industry in general. However, its economic ramifications can be useful for fundamental research in certain cases. 81.5 percent is a "normal" figure for a stable economy. If the statistic is greater than 85%, the data indicates that factory demand is overheating and the economy is approaching full capacity. Inflation is preceded by high-capacity consumption rates, and the foreign exchange market expects the central bank to increase interest rates to prevent or combat inflation.

The number of durable and nondurable products orders is referred to as **Factory Orders**. Food, clothes, light industry materials, and products intended to maintain

durable goods are examples of nondurable goods. Orders for durable goods are discussed separately. For foreign exchange traders, the factory orders predictor is of little importance.

Items with a life expectancy of more than three years are included in **Durable Goods Orders**. Automobiles, appliances, chairs, jewellery, and toys are examples of durable goods. Main metals, equipment, electrical machinery, and transportation are the four major groups.

The measure provides a breakdown of orders between defence and non-defence to remove the instability associated with broad military orders. This information is important for foreign exchange markets because it reflects consumer confidence.

Since durable goods are more expensive than nondurables, a high value in this metric indicates a consumer's willingness to buy. As a result, a positive number is usually optimistic for the local currency.

Items manufactured and stored for potential sale make up a **Business Inventory**. The collection of this data is easy, and the market is not shocked by it. Furthermore, financial accounting and computerization aid in the unparalleled monitoring of company inventories. As a result, this indicator's significance for foreign exchange traders is minimal.

Inflation indicators

Producer price index (PPI) - It includes data from nearly every area of the economy, including manufacturing, mines, and agriculture. Around 3400 commodities are included in the survey used to measure the index. The following weights were used to calculate the index for some of the most significant groups: food (24%), gasoline (7%), automobiles (7%), and clothes (6%). Unlike the CPI, the PPI does not include imported goods, services, or taxes.

Consumer price index (CPI) - The overall shift in retail prices for a fixed market basket of products and services is expressed in this measure. The CPI is calculated using a sample of prices for food, housing, clothes, gasoline, transportation, and medical services that people buy on a daily basis. The following weights are assigned to the most significant categories for the computation of the index: housing (38%), food (19%), gasoline (8%), and automobiles (7%). The two indices, PPI and CPI, are helpful in assisting traders in assessing inflationary behaviour, considering the fact that the Federal Reserve claims the indexes exaggerate the strength of inflation.

Gross national product implicit deflator - It's calculated by dividing the current dollar GNP figure by the constant dollar GNP figure.

Gross domestic product implicit deflator - It’s calculated by dividing the current dollar GDP figure by the constant dollar GDP figure.

The tacit deflators for GNP and GDP, as well as the corresponding GNP and GDP estimates, are published quarterly. The implied deflators are often considered to be the most accurate indicator of inflation.

Merchandise Trade Balance

It is a vital economic predictor. It’s worth has the potential to cause long-term shifts in monetary and foreign policies. The net difference between an economy's exports and imports makes up the trade balance. The data includes six categories:

- food,
- raw materials and industrial supplies,
- consumer goods,
- autos,
- Capital goods,
- Other merchandise.

Employment Indicators

The unemployment rate is a key economic metric that has ramifications in a variety of regions. The rate of work, of course, is a good indicator of a country's economic health. The unemployment rate is a lagging predictor of the economy. It's a valuable aspect to keep in mind, particularly during economic downturns. Although most people are concerned about the labor market's health and recovery, work is the last economic metric to improve. When an economic downturn results in employment losses, it takes time for managers to gain psychological trust in the economy's recovery before new vacancies are created. When new jobs are introduced in small businesses, the change in the work prospects can be masked at the person level, and therefore not completely mirrored in the results. The jobs reports have a big impact on the financial markets, particularly the foreign exchange markets. In the case of foreign exchange, data is particularly influential during times of economic transformation, such as recovery and contraction. The value of the metrics in serious economic conditions stems from the picture they paint of the economy's wellbeing and the maturity of a market cycle. A declining unemployment rate implies a maturing period, while a rising unemployment rate indicates the reverse.

Consumer spending indicators - For foreign exchange traders, retail sales are a significant consumer-spending measure since it indicates the intensity of consumer demand as well as the consumer sentiment factor in the measurement of other economic indicators including GNP and GDP.

The nonfarm payroll rate, rather than the monthly unemployment rate, which is published as a percentage, is the most widely used job statistic. The ratio of the difference between the overall labor force and the working labor force divided by the total labor force is used to determine the average. However, the data is more dynamic and produces more detail. The unemployment rate, factory payrolls, nonfarm payrolls, average wages, and average workweek are all regular metrics that traders watch in Forex. Manufacturing and nonfarm payrolls are the most important job statistics, followed by the unemployment rate.

Employment Cost Index (ECI) - The Employment Cost Index is a comprehensive analysis of worker compensation, including jobs, pensions, and fringe benefits, that measures wages and inflation.

Consumer Spending Indicators based on retail selling volume data are relevant for the Forex market because they display the level of consumer demand and sentiments, which is used to calculate other indicators such as Gross National and Gross Domestic Products.

Retail Sails - For foreign exchange traders, retail sales are an important consumer-spending measure because they display the extent of consumer demand as well as consumer trust. Retail sales are an especially significant economic predictor in the United States. In contrast to other nations, such as Japan, the United States' economy is focused on the market. More merchandise would be manufactured or purchased whether the customer has enough disposable revenue, or credit for that matter. Retail revenue data causes an economic "trickle-up" impact to the manufacturing industry.

For this economic measure, the seasonal factor is important. December, because of the holiday season, and September, which is back-to-school month, are the retail sales months that foreign exchange traders are most interested in. As a result of the change in after-Christmas sales to pre-December sales days, November is becoming an increasingly significant month. In the United States, another fascinating occurrence happened. Despite the early 1990s economic downturn, the number of retail revenue was unusually strong. The profit margin, on the other hand, was much slimmer. The explanation for this is that consumers are gravitating toward discount stores.

Traders closely monitor retail prices to determine the economy's general strength and, as a result, the currency's strength. This metric is published once a month.

Consumer Sentiment - It's a household survey designed to determine whether an individual's tendency to spend money to raise or sustain their expenses in relation to the fulfilment of the household's actual needs and, by extension, the labor market situation.

Auto Sales - Despite the auto industry's value in terms of both production and revenue, the amount of auto sales is not a commonly tracked economic metric by foreign exchange traders. The American automakers suffered a long stretch of steady market share decline before starting to recover in the early 1990s. However, automotive production has been more internationalized, with American cars being manufactured outside the US and Japanese and German cars being assembled in the US. Auto sales numbers are difficult to use in foreign exchange forecasting due to their ambiguous existence.

Leading Indicators

The leading indicators consist of the following economic indicators:

- Average workweek of production workers in manufacturing
- Average weekly claims for state unemployment
- New orders for consumer goods and materials (adjusted for inflation)
- Vendor performance (companies receiving slower deliveries from suppliers)
- Contracts and orders for plant and equipment (adjusted for inflation)
- New building permits issued
- Change in manufacturers' unfilled orders, durable goods
- Change in sensitive materials prices

Personal Income - Individuals, nonprofit organizations, and private trust funds all earn profits. Wages and pensions, rental income, dividends, interest earnings, and transition payments (Social Security, federal unemployment insurance, and veterans' benefits) are all included in this indicator. Wages and pensions are a reflection of the underlying economic situation. This metric is important for the distribution industry. Market sales of durable and nondurable products are restricted without sufficient personal income and a purchasing proclivity. Personal income is insignificant for FX traders.

3. Forex Dependence on Financial and Socio-political Factors

The importance of **Financial Factors** in fundamental research cannot be overstated. Changes in a government's monetary or fiscal policy will eventually trigger structural changes, which will be expressed in exchange rates. Only economic factors can cause financial factors. Financial factors can take precedence over economic factors as governments concentrate on various aspects of the economy or have additional foreign responsibilities. In the early 1990s, the European Monetary System (EMS) proved to be a painful example of this. The inherent artificiality of this strategy was discovered by the reality of the industry.

Interest Rates were used irrespective of the current economic climate, which culminated in a very costly approach. Since foreign exchange, by extension, entails parallel trades of two currencies, the market must therefore concentrate on two

different interest rates. This is the interest rate divergence, which is a fundamental business trend. Traders respond to increases in the interest rate difference, not just the interest rates themselves. For example, if all five G-5 countries agreed to cut their interest rates by 0.5 percent at the same time, the impact on foreign exchange would be neutral so interest rate differentials would be zero. Of instance, the discount rates are usually cut arbitrarily, causing improvements in the interest gap as well as the exchange rate. Interest rates are used like any other consideration by traders, who trade based on assumptions and reality. For eg, if there is a report that the discount rate will be lowered, the relevant currency will be sold ahead of time. It's likely that the currency will be purchased back after the cut, or the other way around. A sharp currency shift is likely to be triggered by an abrupt change in interest rates.

The time lag between the rumor and the reality, the motives for the interest rate change, and the perceived value of the change are all factors that impact the trading decision. A delayed discount rate adjustment is usually priced in by the consumer. It is market-neutral and it is a foregone conclusion. The markets are likely to go against the central banks, sticking to the true fundamentals rather than the political ones, if the discount rate is adjusted for political rather than economic purposes, as is usual in the European Monetary System. This occurred in September 1992 and the summer of 1993, when European central banks spent unheard-of sums of money struggling to shore up their currencies while having high interest rates. As a result of the market's perception that certain interest rates were artificially strong, the respective currencies were vigorously sold. Finally, traders struggle with the supposed meaning of an interest rate differential adjustment.

A **Political Crisis** is often hazardous to the Forex market because it can result in a sudden drop in trade volumes. Prices dry up easily in sensitive circumstances, and gaps between bid and offer can range between 5 to 100 pips. Unlike predictable political events (elections to parliament, signing of interstate treaties, etc.) that occur at a specific time and enable the economy to react, political crises occur unexpectedly. Currency traders have an uncanny ability to adapt to crises. To prevent large losses, traders should respond as quickly as possible. They don't have much time to make decisions; in reality, they always just have seconds. Returning to the market following a recession will be difficult.