SUNIL MANGWANI

Important Things to Know about your Currencies

Sunil Mangwani provides valuable insights into the relationships that exist between various major currency pairs and other major commodity markets. Intermarket analysis is a fairly new field of market study that is coming of age.

The Forex market is the largest financial market in the world, trading nearly $4 trillion each day.

This figure is ascertained by the Bank of International Settlements (BIS), which surveys major Forex market participants every three years. It creates a volume estimate based on the information it gathers. The most recent Bank of International Settlement survey was completed in April 2007 and yielded the estimated volume figure of Forex and related markets at over $4 trillion. On an interesting note, this figure represents an increase in volume of about 70% from the 2004 survey.

Since the Foreign Exchange currency market is a highly dynamic market with price oscillations within a single minute, it allows traders to enter and exit the market many times a day.

With the different kinds of currency pairs available for trading, it becomes difficult for a trader to follow all of them. Usually, it is advisable for a trader to focus on one or two currency pairs and understand their characteristics. This is because each and every pair has specific characteristics with a certain correlation to other currency pairs and to other markets as well.

We will be looking at some strong correlations between currency pairs as well as the correlations some currencies have with other markets. These facts can help a trader confirm price movements, thus gaining an extra edge in the markets.

The Correlation between Currency Pairs

There are definite relationships that exist between the major currencies like the euro (EUR), British pound (GBP), Australian dollar (AUD) and New Zealand dollar (NZD) that are paired similarly with the U.S. dollar (USD) – EUR/USD, GBP/USD, AUD/USD and NZD/USD.

It is rather obvious that if the U.S. dollar is weakening, these currencies will rally. The following chart shows this correlation and one can see the similarity in the market action between the currencies.

The first currency listed in a pair is affected by the fundamental factors of its respective country's economy, which can serve to cause a breakdown in the relationship. Ideally, we should be looking for correlations that are strong, to enable us to use the information to our advantage.

The strongest relationships between currencies can be found between the EUR/USD and USD/CHF, which have an inverse relationship.

The price movements of these two currency pairs are mirror images. If EUR/USD is rallying, then USD/CHF will have downward price movement and vice-versa.

The following chart shows the comparative price movement of both of these currency pairs, and this inverse relationship can be seen very clearly.

So how does one take advantage of this inverse relationship?

The most obvious detail is that one must not trade both of the currencies at the same time.

If one is long the EUR/USD, logically one should not be long the USD/CHF at the same time, since the USD/CHF would be experiencing an opposite move.

And…neither is it advisable to take opposing trades in these two pairs, because if the trade goes wrong, losses would be incurred in both currencies. Ideally, one should trade either of the two pairs.

The best way to take advantage of this inverse relationship is to crosscheck trades by looking for confirmation factors on the other currency pair. If a trader is planning to take a long position in the EUR/USD, as a check he should look for a similar short setup on the USD/CHF.

If such an opposite setup is present in the USD/CHF, it only adds further credence to his long EUR/USD trade.

The U.S. Dollar Index

The U.S. Dollar Index measures the performance of the U.S. Dollar against a basket of world currencies.

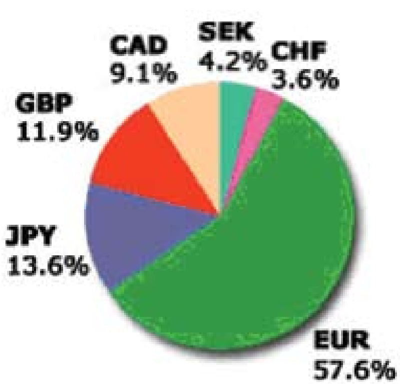
This basket consists of the following currencies and their percentage weighting.

Euro	57.6%
Japanese yen	13.6%
Great Britain pound	11.9%
Canadian dollar	9.1%
Swedish krona	4.2%
Swiss franc	3.6%

The euro comprises the largest segment of the basket because it replaced the West German mark, the French franc, the Italian lira, the Dutch guilder and the Belgian franc, all of which were formerly represented in the index prior to the introduction of the euro.

Chart 1 – Comparative currency chart

Here is a pie chart showing the breakdown of the components of the U.S. Dollar Index.



Since the euro makes up a major portion of this basket, it is rather obvious that it should have a strong correlation with the U.S. Dollar Index.

As the following chart shows, the EUR/USD has a very strong inverse relation with the U.S. Dollar Index.

This inverse relationship is very similar to that of the USD/CHF, one can use this fact for a stronger confirmation of a trade in either market.

In addition to the correlations between the currency pairs, one must also be aware of the deep correlations that the currencies have with other markets. One can use these factors to confirm the expected price movements of the currency being traded, since a second confirmation is always better and safer.

Intermarket Correlations – Gold

Gold has a very strong influence on the Forex markets. Gold is inversely related to the U.S. Dollar Index, and one can see this naturally strong relationship even on intraday movement.

If gold rallies, the U.S. Dollar Index weakens and vice versa, as shown on the following chart.

Applying the previously discussed relationship of EUR/USD to the relationship between gold and the U.S. Dollar Index, it stands to reason that the movement of the EUR/USD currency pair and gold market move hand-in-hand.

But the currency pairs with the strongest correlation to gold are the AUD/USD and the NZD/USD. These 2 currency pairs are known as 'commodity currencies' and the movement of gold affects them to a very large extent.

The following chart shows this strong relation between gold and AUD/USD.

Crude Oil

Another commodity that affects the Forex currency markets is crude oil. Similar to gold, crude oil has an inverse relationship with the U.S. Dollar Index, but has a strong correlation with the Canadian dollar (USD/CAD).

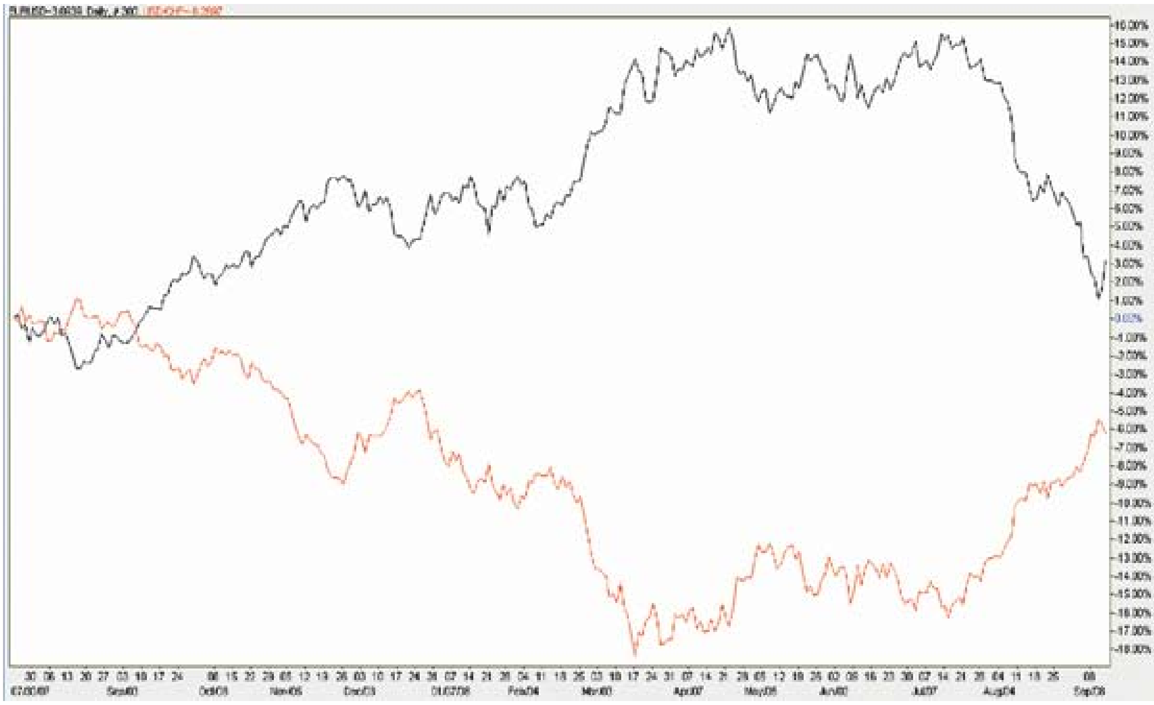


Chart 2 – EUR/USD and USD/CHF charts

The Canadian dollar is also known as a 'commodity currency,' but it has a stronger relationship with crude oil than with gold. The Canadian dollar moves in tandem with crude oil, and as a result has a strong inverse relation with the USD/CAD.

The following chart shows this inverse relation. It does not stand out well on the chart because the price frequency of crude oil has been much larger than that of the USD/CAD.

U.S. Equity Indices

The Dow Jones Index and the S&P 500 Index have a strong correlation with the yen pairs, specifically the USD/JPY, GBP/JPY and the EUR/JPY.

This relationship is very strong on longer and shorter time-frames.

The following chart shows the exact price movement between the Dow Jones Index and the GBP/JPY on the weekly timeframe.

And we can see a similar correlation on an intraday 1-minute chart.

Interest Rates

From the longer-term perspective that position traders look at, a major factor that influences the trends of currencies is interest rates.

It is a fact that money seeks out the highest rate of return. Stable countries that keep the macro-economic factors such as taxes and inflation controlled tend to enjoy higher interest rates and growth. Global currencies always seek out these higher rates of return. The benchmark for interest rates has traditionally been government bonds, which have a very strong relationship with a nation's currency.

When the bond yields are rising, that country's currency will rise in value against other currencies.

Now in this complex world of finance, yields rise when bond prices fall, and yields fall when bond prices rise. Hence, a country's currency will have a very strong inverse relationship with its government bond prices.

Other Fundamental Factors

In the Forex market, there is a clear connection between technical and fundamental analysis, and specifically for economic factors such as growth of GDP.

The OECD is the "Organization for Economic Cooperation and Development," which is an "international organization helping governments tackle the economic, social and governance challenges of a global economy." The OECD releases quarterly predictions for national GDP growth. The following table shows the data released by the OECD, with the predictions for growth in the third and fourth quarters of 2008

Chart 3 – EUR/USD and the U.S. Dollar Index

Chart 4 – Gold and the U.S. Dollar Index

GDP growth in the G7 countries

	2008Q3	2008Q4
Japan	2.4	1.4
United States	0.9	0.7
Canada	0.8	2
G7	0.8	0.7
Euro	0.4	0.8
France	0.2	0.6
Germany	0	0.1
Italy	0	0.6
United Kingdom	**-0.3**	**-0.4**

Source: OECD (annualised quarter on quarter growth)

OECD projections for Q3 and Q4 growth in the G7 countries – Source: OECD

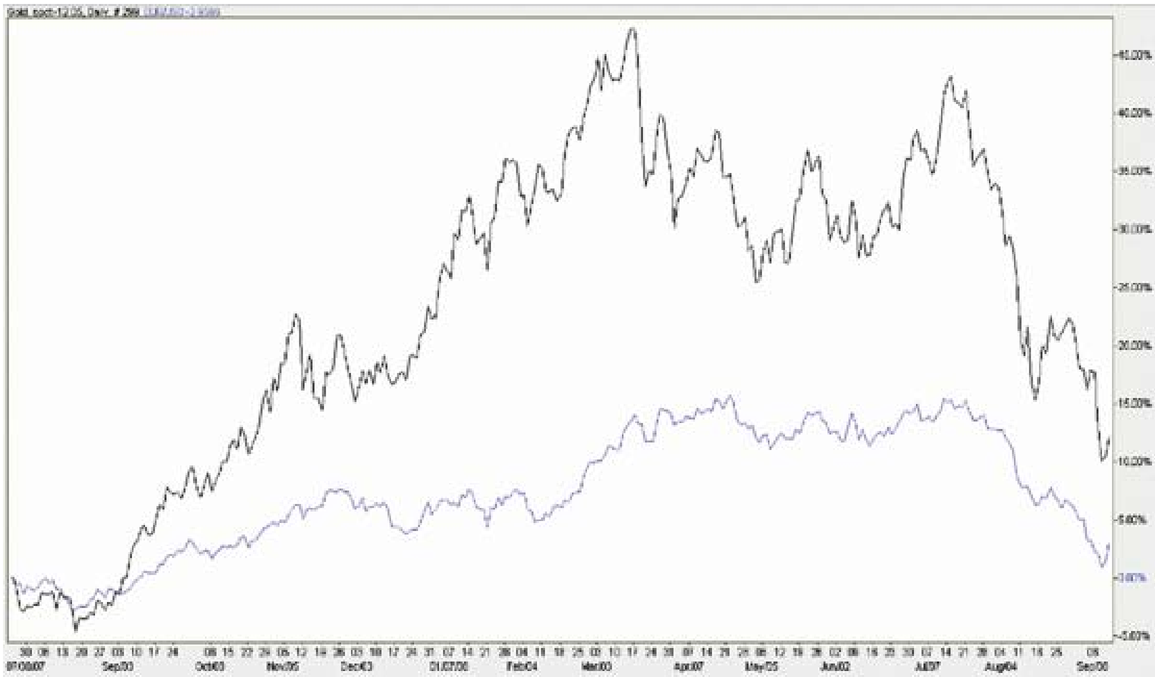


Chart 5 – EUR/USD and gold

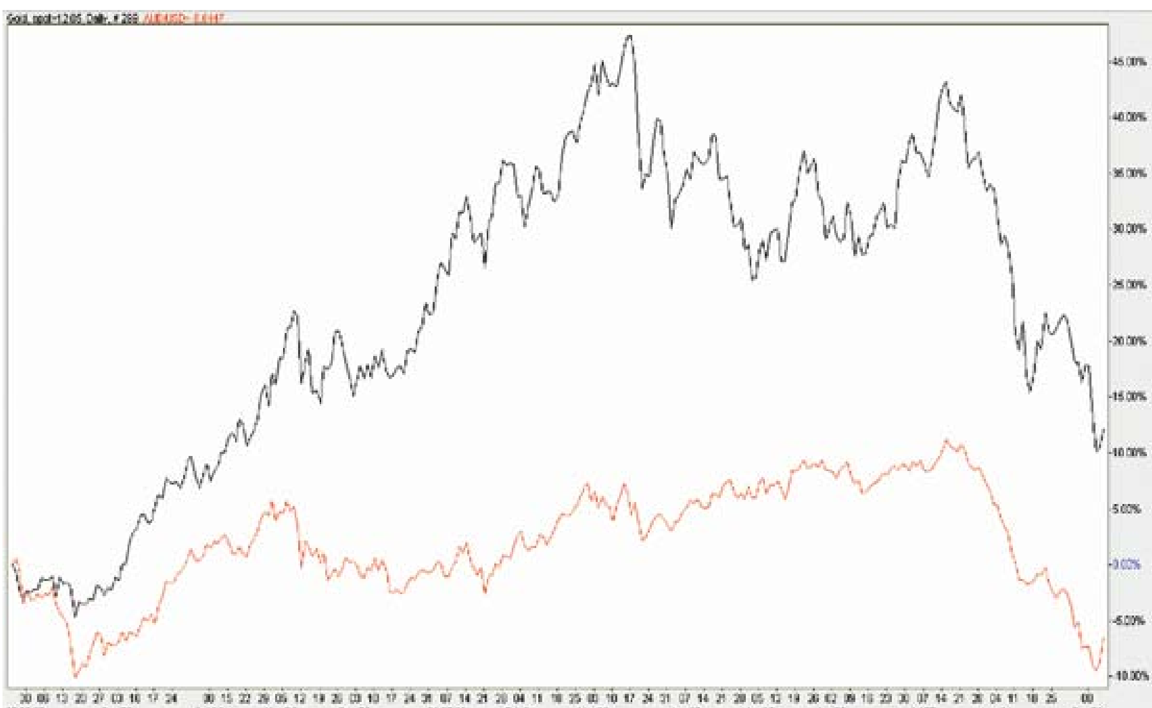


Chart 6 – Gold and AUD/USD

The OECD predicts Japan will have the strongest economic growth of any G7 country, while the United Kingdom has been downgraded to have the weakest growth. And this prediction was released about the same time there was a strong breakdown in the GBP/JPY charts. So, at this stage, one could say that the Japanese yen is technically and fundamentally stronger than the British pound.

As they say, the world is a village and there is a definite correlation between most of the global financial instruments and a strong interlinking of the worldwide markets. One cannot possibly keep track of all the factors influencing the various currencies, but knowing the important factors will give you a definite edge.

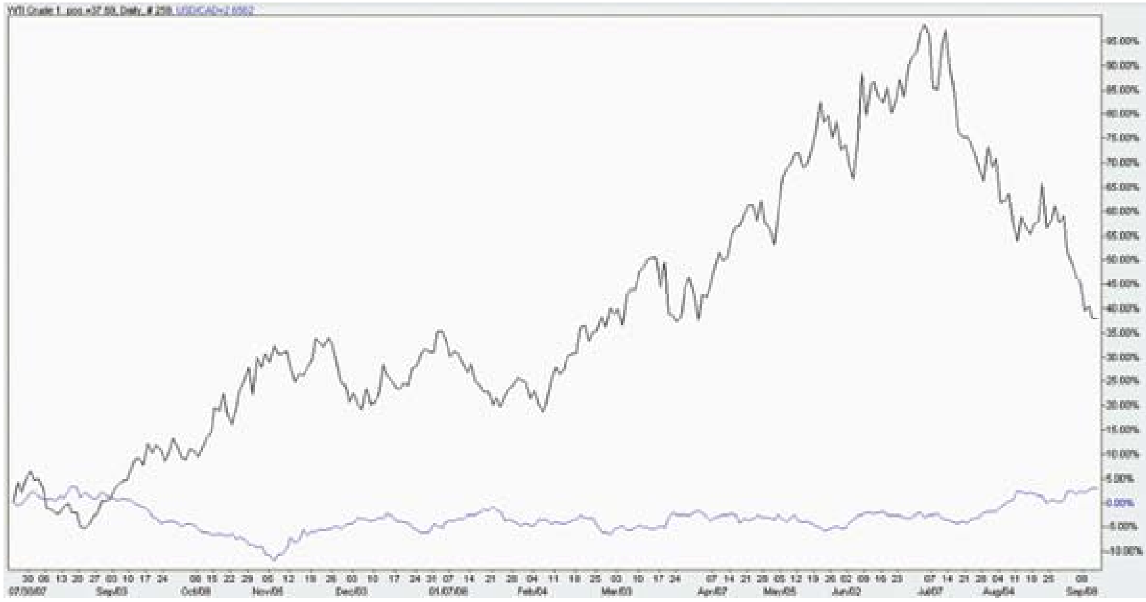


Chart 7 – Crude oil and USD/CAD

Chart 8 – Weekly Dow Jones Stock Index and GBP/JPY

Hence, it is advisable to concentrate on one or two currency pairs, which will make it easier to look at all these correlations.

Here are some important statistics on the currency pairs. This information should provide an additional edge to the trader. Each currency has an expected daily range, which is the price distance a market should move within a 24-hour time cycle. These ranges are calculated on the difference between the daily high price and low price from historic data.

The data for the percentage share that is traded on the different currencies is also available. The following table shows the breakdown of daily volume figures of the major currency pairs.

Average Daily Range

EUR/USD	111 pips	AUD/USD	85 pips
GBP/USD	156 pips	NZD/USD	81 pips
USD/CHF	127 pips	GBP/JPY	172 pips
USD/JPY	102 pips	GBP/CHF	161 pips

Chart 9 – One Minute Dow Jones Stock Index and GBP/JPY

If a trader decides to trade the EUR/USD currency pair, knowing that it has a large trading volume at 27% and an expected daily range of 111 pips. Then, he can start looking for different correlations to isolate a stronger confirmation of a trade.

Pair	Share
EUR/USD	27%
USD/JPY	13%
GBP/USD	12%
AUD/USD	6%
USD/CHF	5%
USD/CAD	4%
EUR/JPY	2%
EUR/GBP	2%
EUR/CHF	2%
Other	27%
Total	**100%**

(Source: BIS Triennial Survey 2007)

Sunil Mangwani is a Physics graduate with a Diploma in Financial Management.

He has been trading the Forex market for the last 6 years and devises simple trading strategies based on his vast knowledge and in-depth study in the field of technical analysis.

He has worked as content provider and article writer with different websites such as www.surefire-trading.com; www.trading-strategies.info and www.guppytraders.com.

He has also developed video modules on specialized topics, and has contributed technical articles to different magazines like "Traders," "The Trading-Journal" and also to the educational sections of websites like Trade2Win etc.

He has been the "Director of Education" at FxInstructor, where he conducts 'Live trading room' webinars, where the price action is analyzed in real time and trades taken in real-time based on the techniques taught.

In his years of trading and experience of teaching technical analysis, he has realized that applying technical analysis is not enough to be a successful trader. One can be successful in this exciting, fulfilling and demanding business, if and only if, one has a definite plan on how to approach the market.

If a trader has an iron clad "Trading Plan" with the 3M's Method, Money, and Mind, it automatically puts that trader into the top 15% bracket of the winners. Now, he conducts special coaching for developing specific trade plans at www.fibforex123.com

His vast repertoire of services on this website also includes Live Trading room training, special webinars on educational topics & advanced trading strategies.

He can be contacted at shellcon@eth.net and sunil@fibforex123.com