Fundamental vs. Technical Analysis

Fundamental analysis

Fundamental analysis is the application of macro economics to interpret the "big picture" of an economy and as well as microeconomics to ascertain market conditions of a country. In the Forex, fundamental analysis of foreign exchange rates involves analyzing data and making judgments one country's currency versus another to determine possible future value.

Typical questions a fundamental trader would ask are:

"What are interest rates?"

"What is the state of government affairs?"

"Is the country or region at war or peace?"

"Does the country have a large account deficit?"

"Is there political uncertainty?"

Besides key economic indicators such as Interest Rate announcements, Employment reports, and GDP, some of the key fundamentals affecting a currency pair are:

Asset Markets – A country's equity markets, such as the stock market. The flow of funds into other financial assets of a country can increase the demand for that country's currency. The net flow of funds into investment products influences the demand for a currency and causes it to be bought and sold.

Balance of Trade – A country's balance between its: Exports vs. Imports, Foreign Spending vs. Foreign Aid, and Domestic vs. Foreign Investments. A currency will move as a result of a nation's global trading position. Those countries that run a trade deficit generally have a decline in their currency. Those with a surplus, generally have appreciating currencies.

Political Environment– Overall national confidence, stability and certainty in a nation's government.

Major news event – War, terrorism, catastrophic event, weather.

Expectations vs. Sentiment – Expectations are formed ahead of the release of economic data. Sentiment is the prevailing market attitude as a result of the overall economic assessment, general market conditions, or other factors.

Intervention – A tactic by a nation's Central bank to counter undesirable exchange rate movements to ensure domestic economic growth and stability.

Technical analysis

Technical analysis is the application of evaluating market activity by analyzing historical price performance as an indication of future performance. Technical traders use specific methods to identify potential market activity by means of trend recognition, pattern identification, and price ranges. Questions a technical trader asks are:

"Where is price now in comparison to where it was yesterday?"

"What is the major support and resistance levels?"

"Is price movement trending up or down?"

"Is price movement in a narrow trading range?"

"Where are the key price breakout levels?"

Some of the key components of technical analysis are:

Price – First and foremost, price is king of technical analysis. Knowing price variables such as Open, High, Low, Close is valuable information. Yet, understanding price action as the currency pair moves is equally as important. For instance, multiple new highs or new lows in a short term period could signal a break of a range.

Support – Often referred to as the support level, it is the price a currency pair trades but does not trade below over a period of time. Support is the price point at which the majority of the market believes that prices will trade higher thus causing an increase in demand as Long positions start to outnumber Short positions.

Resistance – Often referred to as the resistance level, it is the price a currency pair trades but does not trade higher over a period of time. Resistance is the price point at which the majority of the market believes that prices will trade lower thus causing decrease in demand as Short positions begin to outnumber Long positions.

Trend – In general, it is the current market direction based upon consistent change or movement in price. For instance, an upward trend is shown by successive higher prices while a downward trend is represented by consecutive lower prices over a period of time. A price break of a trend is sometimes considered a signal for the market to be in a reversal.

Channel – Also referred as a price range, it is often shown on a chart as price fluctuating between support and resistance levels over a period of time. The most common channel is sideways. But, a channel can be upward or downward.

Moving Average – one of the most popular tools in technical analysis is a calculation of the average price of the currency pair over a period of time. It is used to observe changes in price for potential trends and recognizable trade patterns. Typically, the shorter the time period the more volatile or choppy the moving average becomes. Whereas, the longer the time period, the smoother the moving average is.

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