TRADING STRATEGY SERIES

03. Fundamental Trading:

5 Trading Tips that will Ignite your Trading

Overview

This is the third of a series of mini e-books from FP Markets designed to provide you with trading strategies and a guide to some of the technical and charting tools used by the best traders to maximise their returns and minimise trading errors. For any strategy you implement, the aim is to make sure the potential reward is greater than the total risk, and that wins on good trades more than cover the smaller losses on losing trades. To be a successful trader you will require discipline, planning and careful reflection to refine your skills.

Trade Planning – Pre-Trading Preparation

You can't ignore fundamentals.

As traders gain experience, they realise the markets are interlocking. Movements in the equity markets can be symptoms of changes taking place in the currency markets, for example, which may feed into, or be a reaction to, changing commodity prices.

That makes attention to some basic fundamentals essential for every trader. A big fundamental change in macro economic conditions can move markets in shares, currencies and commodities in tandem. The oil price is not isolated from the value of the US dollar, which in turn is partly affected by the global economic outlook, and that means growth – or lack of it – in Asia and Europe.

Your trade preparation must include soaking up knowledge about how the unemployment figures released in the US on a particular weekend, for example, might affect the value of your long trade in a small-cap Australian mining company.

The effect won't always be direct. The US unemployment figure, if it is unfavourable (higher), may lead traders to reduce trades in risky assets. Assets considered risky are those that benefit from any increase in economic demand but tend to fall in price when demand becomes more sluggish.

Small-cap Australian miners, exposed to global demand through commodity prices, are among the more risky assets that traders know to avoid buying, or look to go short in, when there are prospects of slowing world demand. A long trade in such stocks is at risk if the US unemployment figures convince investors that risky assets should be sold to protect against losses.

The figure shows the adjust unemployment rate versus the Russel 2000 index which is a proxy for small capitalisation stocks. There is a clear relationship between Unemployment and Investment in risky assets such as small cap stocks.

The markets tend to look at the longer term when pricing shares, commodities and currencies. In other words, it attempts to factor in all the influences it knows may have an effect in the foreseeable future, rather than looking at just the immediate effects. The swings of confidence in a positive solution to the European debt crisis in 2012 were reflected in the value of the euro against other currencies, because the outcome will have a long-term effect on the European economy.

01 The macro view

Currency values, and to a lesser extent commodity prices, can be used to give a big-picture snapshot of market reaction to macro economic factors, allowing traders to assess sentiment at the macro level without the need to research fundamental factors in minute detail. The Australian dollar, for example, is able to indicate the global perception of Australia's economic prospects in its daily movements.

When the Reserve Bank of Australia reduced the official cash rate from 4.50 per cent to 4.25 per cent in December 2011, the value of the Australian dollar at first remained steady at above parity (around $US1.02) and in fact even strengthened, because there was hope of a European solution. As it became clear that the debt crisis was still unresolved, the drop in local interest rates then took effect, along with a turn in sentiment, leading to a week-long decline in the Australian dollar's value to below $US0.98.

From a foreign investor's point of view, the Australian dollar is a useful asset to buy when commodity prices – particularly metal prices -- are rising, global demand is strengthening, Chinese and Asian growth is strong and the Australian economy is benefiting from these forces. It is preferred over many currencies because its yield on cash deposits is higher than that available in, say euros, yen or US dollars.

As a trader, you will have noticed that the fundamental drivers of our currency are almost exactly the same as those that help determine the prices of our big resources stocks, such as BHP and Rio, which make up a large proportion of the S&P/ASX 200 index. Little wonder that our share market tends to rise and fall with rises and falls in the value of the Australian dollar. The correlation is not perfect for a number of reasons – among them the fact that the Australian economy as a whole is more than just mining and energy companies. Banks and financials, as well as industrial and retail stocks, rely more heavily on the domestic economy and are less influenced by global demand than mining and export stocks.

Even if you are trading Australian shares or share index CFDs, rather than commodities or currencies, it's good practice to begin your trading day by getting the big picture from currency and commodity movements. Here are some of the websites you may wish to visit for this purpose:

Bloomberg General financial, currency and commodity news
http://www.bloomberg.com/

CNBC General financial, currency and commodity news
http://www.cnbc.com/

Kitco Information and prices for precious metals
http://www.kitco.com/

Daily FX Currency news and prices
http://www.dailyfx.com/

Forex Factory Trader forums on foreign exchange
http://www.forexfactory.com/

Traders willing to learn what effects different fundamental factors have on the markets can base much of their trading purely on feeds of news and data rather than on analysis of technical factors shown by price and volume data.

But if you do this, you will still need some basic chart analysis in order to place your stop losses appropriately. Charts are to some extent self-fulfilling, in that those who use them exclusively tend to base their trades on such technical factors as trend lines, moving averages, support and resistance and reversal patterns. Studying such technical factors will give you some idea what other traders are likely to do if your trade, based on fundamentals, moves in your favour, and this provides a clue to sensible exit points.

02 Trading macro headlines

Macro headlines are those that reflect global trends or that may have an effect on global trends in the future. For most of the first half of 2012 the biggest macro trend was the burgeoning European debt crisis that showed up first in Greece and affected all those countries who have adopted the euro as their currency, including France, Germany and Italy.

Other dominant themes in the global economy in 2011 were the hesitant US economic recovery and the nation's need to reduce government debt and the prospects for continuing economic growth in China and elsewhere in Asia.

But trading the trends has not all been plain sailing. Despite the Eurozone's problems, the euro itself held up remarkably strongly for much of the year, much of the reason being the mid-year funding deadlock in the US that took America to the brink of default before a last-minute agreement was made.

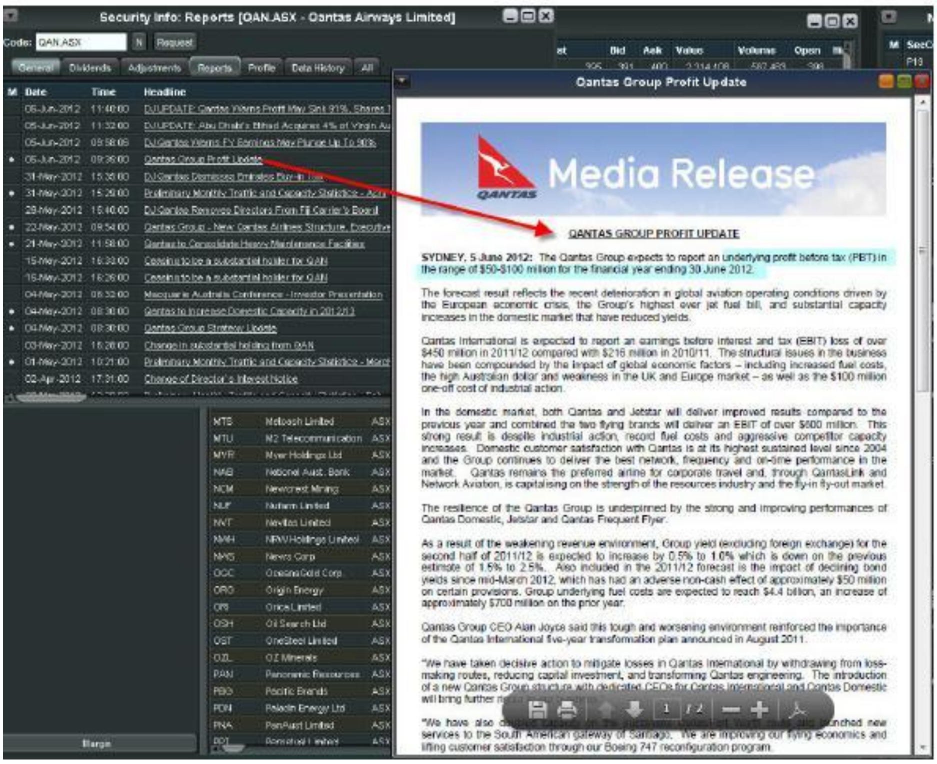
Making trading profits from the headlines has been a matter of trading over a short time frame, using sound money and risk management, and following market sentiment as it changed, often dramatically, from nervousness and risk avoidance to optimism and readiness to take on risk. It also means being aware of how the markets are likely to react to a headline, which may not be hard financial numbers but merely announcements of central bank action to ease monetary policy.

The best way of getting to know what this might mean for the markets is to follow the economic and financial news and expert commentary from sites like those given above to become familiar with the probable market reactions to financial news.

03 Trading company announcements

At the other end of the scale from macroeconomic influences that may affect markets in commodities, currencies and equities are the company-specific data that allow you to track the fortunes of those shares you are familiar with and trade regularly.

Although a stock will also be affected by macro forces such as exchange rates, traders who track individual companies are more interested in industry specific or company specific news.
As a rule of thumb, any event or indicator of results that will affect the cash flow of the business over the ensuing three months is likely to see a reaction in terms of the share price.



The obvious events to be aware of are the company's regular reports of earnings and announcements of dividends (if applicable). For exploration companies, the latest drill and assay reports are provided to the Australian Securities Exchange (ASX) and the ASX website will alert you to any new reports.

From a trading point of view, market expectations about forthcoming results are important. Analysts who research the company will form a view of its likely progress, and the shares are likely to improve in price if results are better than expected, and to fall if expectations are not met.

04 Important ratios

Return on assets (ROA). Take a company's net income and divide it by the value of its net assets to give its return on assets, or its ability to earn money from its business. Comparing this with earlier figures lets you gauge whether ROA is rising or falling. A falling ROA is a sign that a company's growth may be faltering. This number also enables a comparison with the returns on other assets, including other shares.

The price-earnings ratio, also called the p/e ratio, tells you how many years' earnings the current share price represents. A stock trading at $5.00 and earning 25c a is trading at 20 times earnings, which is much higher than the **Australian average for listed companies of about 12-14 times earnings. Quality companies trading significantly below 12 times projected earnings for the coming year deserve further attention.** The p/e ratio allows you compare similar companies to determine which represent the best value.

Net tangible asset backing per share, or NTA, which is found by taking the net value of assets less liabilities and dividing it by the number of shares on issue to give the theoretical value of the company. Companies tend to trade above their net asset value, the premium representing their future prospects as going concerns. Quality companies rarely trade at or below their net asset value.

Markets in 2011 have been over-reacting to fundamental news, announcements and data. The smallest difference from expectations in numbers such as inflation, interest rates and unemployment can have an immediate effect on the markets as traders react with a knee-jerk.

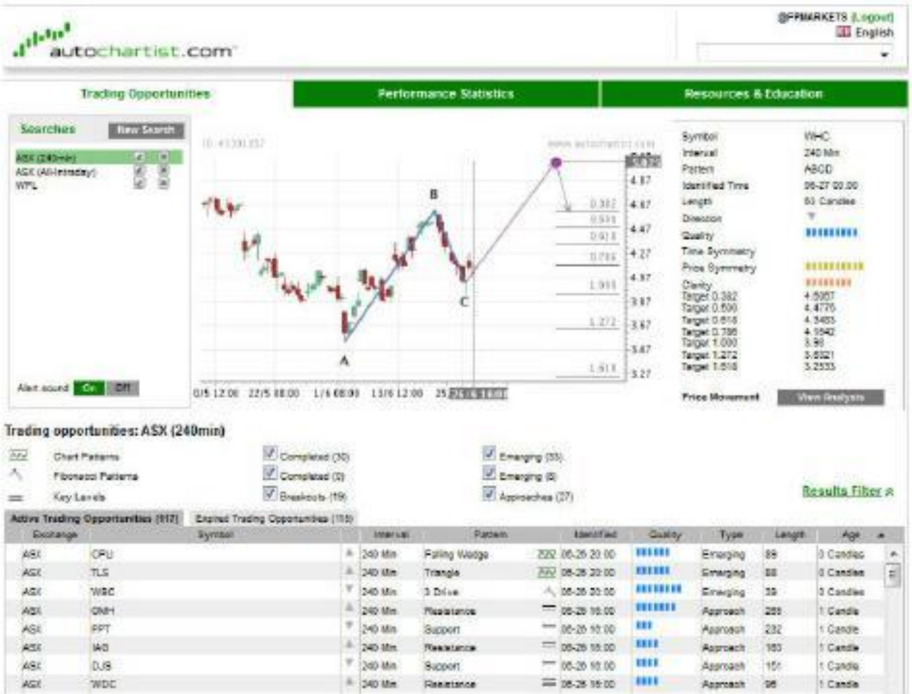
While fundamental analysis is essential for long-term traders and investors, short-term traders can't ignore fundamentals because the market, especially recently, has become so reactive to fundamental factors.

05 Trading Tools – Scanning Tools

Scanning software is a tool that can be used to increase the number of potential trades you make by monitoring a wide range of trading instruments to identify those whose trading patterns indicate a likely reversal of direction, a break-out from a consolidation pattern, or a likely continuation of an existing trend.

The biggest benefit is the time saved in searching for patterns manually on individual stocks. By scanning thousands of stocks, commodities, currencies and other instruments such as indices, and identifying chart pattern as they form, scanning software lets you analyse a greater number of potential trades than you could manually.

Autochartist, **a free scanning software package available through FP Markets**, provides you with a report on any company or instrument on your list that becomes a prospective trade as indicated by the software's pattern recognition algorithms. The report tells which pattern is forming, the implications (bullish or bearish), gives any supporting indicators, and reveals support and resistance levels to help you set stop-losses.



The software will even provide automatically generated trading suggestions, with entry levels, stop-loss levels and take-profit levels outlined for your convenience. The suggestions need not be followed slavishly; you can adjust entry points and stop-loss levels based on your experience of how a particular stock behaves.

Because the software keeps analysing price and volume in your chosen instruments throughout the day, alerting you to any new potential trades as they arise, the time you spend in analysis can be greatly reduced and more opportunities can be found. Users can use customised search criteria to filter out patterns that do not conform to their personal trading style or time frame.

Traders who prefer operating on a short time frame, trading and exiting within the space of a day (day traders) may also find it useful to investigate the Spark financial information software suite developed by Sydney-based Iguana2.

Among other things, Spark provides updating of intra-day charts in real time so that you can monitor indicators and your chosen chart signals easily, storing custom chart settings that suit your trading style.

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A feature of Spark that makes it attractive to many traders is its ability to show market volume and depth in real time.

Summary

In summary this series will deliver trading strategies and frame these with helpful information that will help you improve as a trader.

This eBook first looks at pre-trading preparation and how to best make use of the wealth of financial information available from various sources. It then focuses on fundamental trading – using the data for specific trades. Finally, it discusses the use of scanning software as a means of saving time when analysing a large variety of stocks and instruments.

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