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Interest Rates Drive Forex Trading

By Boris Schlossberg

Whenever I hold a seminar in some hotel room across the world bombarding the crowd with slide upon slide of economic data, inevitably one exasperated member of the audience stands up at the end of my presentation and proclaims, “OK, these are all very nice pictures and graphs and you sound like a smart boy, but what’s the one thing I need to know to trade the currency market?”

Of course, there is no good answer to that question.

The currency market is so vast that on any given day myriad factors can affect price. The latest economic data, the fast-changing political developments, and the broad movements of equity and credit markets can all influence currency movements, creating trends that are often reversed from one session to the next.

That is why forex traders are news junkies who are equally familiar with the latest intrigue in the Japanese Diet and nuances of the New Zealand dairy contracts.

BIG AND SMALL PICTURE

In fact, what makes currency trading so much fun is that it requires the skills of a generalist.

Instead of burrowing through a stack of 10-K reports, as many stock market investors often do and becoming lost in the accounting minutiae, currency traders focus on the great macro and micro economic trends of the day, giving them a global perspective that can be financially rewarding and intellectually stimulating.

RATES RULE

Nevertheless, if I were forced to distill my forex analysis to one variable, there is no doubt what it would be: interest rates. When you understand the direction of interest rates, you will be able to predict the direction of a currency. There are, of course, some exceptions that I will address later.

But as a general rule of thumb, interest rates are unquestionably the most dominant driver of trade in the currency market.

THE SPREAD

The reason interest rates matter is because currencies are actually ultrashort-term bonds.

Every major currency in the world has an interest rate attached to it that is based on the benchmark rate of the country's central bank.

For example, as of mid-July, the rates in Australia are set at 4.5 percent while U.S. rates are only 0.25 percent, or 25 basis points. Therefore, the difference in the Australian dollar/U.S. dollar (AUD/USD) pair is approximately 400 basis points, or 4 percent.

EARNING CASH

Every day you are long that currency pair your forex dealer will credit your account approximately one-365th of that difference in rates. Four percent may seem like a relatively small return, but the forex market provides the trader with the opportunity to leverage his or her account up to 100-to-1.

So in the most extreme example possible, if a trader held a long AUD/USD position at the start of the year and the pair simply maintained the same rate, he or she would be able to realize a 400 percent profit on the position despite the fact that there were no capital gains on the trade.

BE SMART WITH LEVERAGE

Of course 100-to-1 leverage is an absurd example. At such high leverage, the margin of safety is extremely thin and the trader will most likely be margin called out of the position before realizing any gains.

However, much more modest leverage ratios of 5-to-1 or even 10-to-1 are frequently employed by long-term institutional and retail currency traders alike to benefit from interest rate differentials in currencies. This strategy is known as the carry trade.

At the height of its popularity (before the credit crunch of 2008 forced most of the industrialized economies to lower their benchmark rates to near zero levels), the carry trade attracted as much as $1 trillion dollars of investment capital, demonstrating the importance of interest rates to the currency market.

THE RATE RATIONALE

A widening of interest rate differentials is not a monolithic dynamic that always guarantees an increase in the currency pair. Context is everything.

The reason for the jump in the rates matters even more than the rise itself. If the country's short-term rates are increasing as a result of a strong economic performance, then the increase in rates should translate to positive performance for the currency.

Witness the action in the Australian dollar this year as the Reserve Bank of Australia became the first G-20 central bank to commence a concerted monetary tightening program (see Figure 1).

Australia's economy experienced the shallowest recession and the strongest rebound in the industrialized world. Demand for the country's iron ore and coal from energy-hungry China spurred strong growth and brought unemployment down to an enviable 5.1 percent rate.

FIGURE 1
The S&P 500 SPDR (SPY) Daily Prices

Source: Stockcharts.com

The Australian economic boom led to the highest short-term rates among advanced nations and helped boost the currency price along the way.

FLIP SIDE

On the other hand, if an increase in rates is a result of high inflation or the loss of confidence by credit markets, then the impact on the currency will most likely be negative.

Last spring, many of the southern European economies of the eurozone experienced a crisis of confidence as investors balked at financing the fast-growing fiscal deficits in the region. Greek bonds, for example, traded as much as 1,000 basis points above German bunds, but investors still refused to buy them.

The sovereign debt crisis sent the euro reeling to multiyear lows as the currency fell below the $1.20 level for the first time in three years.

The decline in the euro illustrates the importance of understanding the motivation behind the movement in interest rates (see Figure 2).

Despite the fact that throughout this period European short-term rates were higher than those of the U.S. (1 percent versus 0.25 percent), investors approached the currency with all the enthusiasm of radioactive waste.

Although short euro/U.S. dollar positions actually cost traders a small amount of carry every day, they were more than happy to enter those positions because the credit risk far outweighed the benefit of the small interest rate gain.

CALCULATING RISK

When evaluating the investment case for interest rates, it is helpful to think about the parable of two neighbors.

Suppose you have two next door neighbors. On one side is a man who you have known for 20 years. He is a hardworking guy who has always held a steady job and has always kept his word in the past. He asks you for a $1,000 loan and promises to pay you back 10 percent interest in three months.

Your other neighbor is a layabout who has not held a steady job in years and seems to live on a mysterious source of income. She also asks you for $1,000 loan and promises to pay you 30 percent in a month.

FIGURE 2
Euro/U.S. Dollar, Daily

Source: Dealbook 360

To whom would you loan your money? For most folks, the first neighbor is a much better risk even though he is willing to pay a lower rate of interest.

CASE-BY-CASE

Currencies, like neighbors, need to be evaluated on an individual basis. Although increasing interest rates are generally the primary fundamental driver of movement in the market, they alone do not guarantee an uptrend. Still, if a trader wants to focus on only one fundamental variable that truly matters, interest rates would be it.

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