CHAPTER 2.2

Economic Value Boosts Currency Values

ECONOMIC STRENGTH BOOSTS CURRENCY VALUES

Strong economies generally have strong currencies. The two seem to go hand in hand. When an economy is performing well, it means that corporations are making profits, most of the workforce is employed and, in most cases, interest rates are going up. Each one of these characteristics of a strong economy benefits you as a Forex trader.

You will remember from the first fundamental analysis section that rising interest rates are the most predictive indicator for rising currency values and central banks around the world determine interest rates in their respective economies. These central banks typically raise interest rates when inflation—as measured by the consumer price index (CPI) and the producers' price index (PPI)—starts growing too quickly.

Economic growth spurs inflation on. Here's how it works. The stronger the economy is, the higher the demand for workers becomes. As demand for workers goes up, wages for those workers also goes up. The more money workers take home in their paychecks, the more money they have to spend at retail stores, on cars and on houses. As demand for goods and services increases, the price for those goods and services also increases—in other words, inflation.

Naturally, if central banks watch inflation indicators (like the CPI and PPI) in their decision-making process, you would assume they would also be interested in watching economic strength indicators to see how strong an economy is—and they most certainly are.

Central banks watch the following fundamental economic indicators to gauge the strength of an economy, and so should you:

Contents	
	Gross domestic product (GDP)
	Payroll Employment
	Durable goods orders
	Retail sales

GROSS DOMESTIC PRODUCT (GDP)

The Gross Domestic Product (GDP) is the broadest measure of aggregate economic activity available. Reported quarterly, GDP growth is widely followed as the primary indicator of economic strength.

GDP represents the total value of a country's production during the period and consists of the purchases of domestically produced goods and services by individuals, businesses, foreigners and the government.

As GDP reports are often subject to substantial quarter-to-quarter volatility and revisions, it is preferable to follow the indicator on a year-to-year basis. It can be valuable to follow the trend rate of growth in each of the major categories of GDP to determine the strengths and weaknesses in the economy.

A high GDP figure is often associated with the expectations of higher interest rates, which is frequently positive, at least in the short term, for the currency involved, unless expectations of increased inflation pressure is concurrently undermining confidence in the currency.

PAYROLL EMPLOYMENT

Payroll employment is a measure of the number of people being paid as employees by non-farm business establishments and units of government. Monthly changes in payroll employment reflect the net number of new jobs created or lost during the month and changes are widely followed as an important indicator of economic activity.

Payroll employment is one of the primary monthly indicators of aggregate economic activity because it encompasses every major sector of the economy. It is also useful to examine trends in job creation in several industry categories because the aggregate data can mask significant deviations in underlying industry trends.

Large increases in payroll employment are seen as signs of strong economic activity that could eventually lead to higher interest rates that are supportive of the currency at least in the short term. If, however, inflationary pressures are seen as building, this may undermine the longer term confidence in the currency.

DURABLE GOODS ORDERS

Durable Goods Orders are a measure of the new orders placed with domestic manufacturers for immediate and future delivery of factory hard goods. Monthly percent changes reflect the rate of change of such orders.

Levels of, and changes in, durable goods order are widely followed as an indicator of factory sector momentum.

Durable Goods Orders are a major indicator of manufacturing sector trends because most industrial production is done to order. Often, the indicator is followed but excludes Defense and Transportation orders because these are generally much more volatile than the rest of the orders and can obscure the more important underlying trend.

Durable Goods Orders are measured in nominal terms and therefore include the effects of inflation. Therefore the Durable Goods Orders should be compared to the trend growth rate in PPI to arrive at the real, inflation-adjusted Durable Goods Orders.

Rising Durable Goods Orders are normally associated with stronger economic activity and can therefore lead to higher short-term interest rates that are often supportive to a currency at least in the short term.

RETAIL SALES

Retail Sales are a measure of the total receipts of retail stores. Monthly percentage changes reflect the rate of change of such sales and are widely followed as an indicator of consumer spending.

Retails Sales are a major indicator of consumer spending because they account for nearly one-half of total consumer spending and approximately one-third of aggregate economic activity.

Often, Retail Sales are followed less auto sales because these are generally much more volatile than the rest of the Retail Sales and can therefore obscure the more important underlying trend.

Retail Sales are measured in nominal terms and therefore include the effects of inflation. Rising Retail Sales are often associated with a strong economy and therefore an expectation of higher short-term interest rates that are often supportive to a currency at least in the short term.

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