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CHAPTER 4.1

Intermarket Relationships

Commodity Market and the Forex Market

The rise of global demand for commodities has tied the commodity market and the Forex market closer together. Virtually every economy around the world has to import some of the commodities it consumes. To buy these commodities, importers must exchange their currency for the currency of the economy from which they are importing the goods. This transaction drives the demand for the exporter's currency higher, which increases the value of that currency. This transaction also drives the supply of the importer's currency lower, which decreases the value of that currency.

Three of the major currencies—the Canadian dollar (CAD), the Australian dollar (AUD) and the New Zealand dollar (NZD)—are closely related to commodity values because they are major commodity exporters. As the price of commodities rises, the value of these currencies typically rises. As the price of commodities falls, the value of these currencies typically falls.

Each of these commodity currencies, as they are known among forex traders, is affected differently by various commodities. For example, the Australian dollar is highly correlated with gold. As the price of gold goes higher, the value of the Australian dollar also goes higher. As the price of gold goes lower, the value of the Australian dollar also goes lower. While this correlation isn't perfect, it is significant.

Paying attention to what is happening in the commodity market during the next few years can lead you to greater profits in your forex trading. Demand from global growth should continue to push commodity prices higher for years to come. Be prepared to take advantage not only of the currencies that will strengthen as commodity prices increase but also of the currencies that will weaken.

Bond Market and the Forex Market

Next to the Forex market, the global bond market is the second largest financial market in the world. Governments, institutions and individual investors all participate actively in the global bond market, and each one of these market participants is looking for the same thing: a profitable return on investment.

Government bonds make up the largest percentage of the global bond market. These bonds are typically viewed as risk-free investments because they are backed by the full good will and faith of strong national governments. However, not all government bonds were created equal. Some governments pay a higher interest rate for their bonds than do others. International investors take these interest rates into account when they are deciding where to invest their money. Typically, bonds with higher interest rates are more attractive to investors—as long as the economies covering the bonds are relatively stable.

Investors who wish to buy government bonds must buy these bonds with the currency of the represented government. If international investors wish to buy U.S. government bonds, they must first exchange their currencies for U.S. dollars (USD). This increased demand for U.S. dollars (USD) drives the value of the USD higher. At the same time, the increased supply of international currencies on the market drives the value of these currencies lower.

Knowing which governments offer higher interest rates on their government bonds and which bonds are gaining popularity among international investors will help you know which currencies to buy and which currency to sell. Fortunately for you, the international bond market rarely changes directions instantaneously. Rather, it cycles in longer-term, somewhat predictable trends that you can exploit.

Stock Markets and the Forex Market

Individual investors around the world seem to watch stock markets more closely than any other market. Stocks are exciting, they have been around for a while and most individual investors can relate to the companies in which they are buying stock. When times are good in the stock market, money flows in. When times are bad and the stock market, money flows out.

Globalization has made it easier for investors from one country to invest in the stock markets of other countries. If investors see that stocks in the United Kingdom are performing well, they will rush to buy those stocks. If they see that stocks in Japan are starting to outperform stocks in Europe, they will take their money out of Europe and put it into Japan.

To invest in stocks in the United Kingdom, foreign investors must first convert their currencies into British pounds (GBP). This increased demand for British pounds (GBP) drives the value of the GBP higher. At the same time, the increased supply of international currencies on the market drives the value of these currencies lower.

Forex investors closely watch how the stock markets in major countries are performing. If the stock market in one country starts outperforming the stock market in another country, forex investors know that other investors will most likely be moving their money from the country with the weaker stock market to the country with the stronger stock market. This will drive the value of the currency for the country with the stronger stock market higher and the value of the currency for the country with the weaker stock market lower. By buying the currency from the country with the stronger stock market into selling a currency from the country with the weaker stock market, you can potentially make a handsome profit.

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