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| **Lesson 1: Intro to Fundamentals and the US Economy** |
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While technical analysis focuses solely on the analysis of historical price action, fundamental analysis focuses on everything else including things such as the overall state of the economy, interest rates, production, earnings, and management. When analyzing a stock, currency or commodity using fundamental analysis there are two basic approaches one can use which are known as bottom up analysis and top down analysis. Bottom up analysis very simply means looking at the details such, as earnings if we are talking about a stock, first and then working one's way up to the larger picture by looking at things such as the industry of the company who's stock you are trading and then finally the overall economic picture. Top down analysis on the other hand means looking at the big picture things such as the economy first and then working one's way down to the details such as earnings if we are talking about a stock.  
  
While there is some debate about which method is best my personal preference is for Top Down analysis and since by starting this way we can start with the things that apply to all markets and not just the stock market this is how we will start.  
  
The first thing that it is important to understand from a fundamental standpoint is what the economic situation is as it affects the financial instrument you are trading. As I am based in the US and the US is the World's largest economy this is what I am going to talk about, however most of the things I discuss here apply in a broad sense to any economy. When we begin to discuss the foreign exchange market in later lessons we will go into specific details of the other major and emerging market economies from around the world.  
  
According to Investopedia.com the definition of an Economy is "the large set of inter-related economic production and consumption activities which aid in determining how scarce resources are allocated. The economy encompasses everything relating to the production and consumption of goods and services in an area"  
  
People often refer to the US Economy as a capitalist or free market economy. A capitalist or free market economy in its most basic sense is one in which the production and distribution of goods and services is done primarily by private (non government) companies and the price for those goods is set by the free market. This is in contrast to a socialist or planned economy where production and distribution of goods and services as well as the pricing of those goods and services is handled by the government.  
  
While, as I state above, most people refer to the US Economy as a capitalist economy it is really more of a blended economy as the government does handle some things on behalf of the population such as the military, road building, and education.  
  
So why is this important for a trader to know? Very simply moves towards capitalism and free market ideas are normally seen by the market as pro business and growth while moves towards more socialist ideas are normally seen by the market as anti business and growth. With this in mind whenever there is a move towards capitalism by an economy all else being equal you will normally see markets rally on this news and whenever there is a move away from capitalism you will normally see markets sell off on this news.  
  
That’s our lesson for today. In tomorrow’s lesson we are going to take a deeper look into the different parts of the US Economy and what makes it tick so we hope to see you in that lesson.

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| **Lesson 2: Components of the US Economy, Part 1** |
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In our last lesson we gave an introduction to fundamental analysis with an introduction to the top down approach to analyzing fundamentals and the US Economy. In today’s lesson we are going to expand our discussion on the US economy by looking at the different pieces which make up the economy and how each piece is relevant to us as traders of the stock, futures, and/or forex markets.  
  
The first component of any economy is its natural resources. One of the key factors that allowed the United States to grow so quickly and become one of the world powers that it is today, is that it is a land that is rich in natural resources from oil which drives our industry, to lumber to build our houses, to our large coastlines, great lakes, and rivers which provide shipping access and move goods throughout the country.  
  
Understanding what natural resources are most important to a country and understanding what affects the prices of those resources is beneficial to not only commodities traders who trade the actual commodities such as oil and gold but also to traders of the stock and forex markets. We will go into these correlations in more detail in later lessons but a short example is that the US economy relies heavily on oil, so when the price of oil goes higher this is normally seen as a negative for the US Economy as it then costs more for companies to ship their goods, and for individuals to fill up their cars leaving them less money to spend. Similarly, as the US Imports much of its oil, when the price of oil goes up this means that more dollars are being sold and converted into the currencies of the countries which are exporting the oil to the US, therefore all else being equal weakening the US Dollar and strengthening the currency of the exporting country.  
  
The next component of any economy is its labor force, or the individuals who are working in that economy to produce goods and services from the countries natural resources. As the labor force in an economy gets paid for their labor, and then spends that money on the goods and services they and other components of the labor force have produced, they are an important driver of growth in any economy.  
  
The components which are watched in regards to labor are the size of the labor force in an economy, its rate of growth, its productivity level, and its skill level, and its mobility or ability to adapt to changing conditions. Another reason why the United States has the largest economy in the world is the size of its labor force is constantly growing allowing the economy to produce and sell more goods and services, it is a relatively mobile labor force which has allowed it to increase productivity faster than other nations through things such as early adoption of new technology, and it is an educated labor force.  
  
Why is this important from a trading standpoint? Here again we will go into more detail on this when we look at important economic numbers but a short example is if the labor force becomes more productive, this means that they are able to produce more goods in the same amount of time. This not only makes companies more profitable but it holds down prices for the consumer, giving them more money to spend on other goods and services, which drives growth, which means a higher stock market all else being equal. This increased growth can cause higher demand for commodities therefore causing the commodities markets to rally all else being equal, and can also have interest rate implications, something we will learn about in later lessons, which can affect the US Dollar.  
  
That’s our lesson for today. You should now have a good understanding of the first two components of the US economy its natural resources and labor force. I hope you are also beginning to see how the fundamentals are intertwined into all markets, so at least having a basic understanding of them is important regardless of whether you are basing your trading decisions on them or not. In tomorrow’s lesson we are going to look at the second two pieces of an economy: the Private Enterprise and the Government and the role that each of these play so we hope to see you in that lesson.

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| **Lesson 3: Components of the US Economy, Part 2** |
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In our last lesson we began a discussion on the different components that make up the US Economy and how these relate to trading with a look at the Natural Resources and Labor Force components. In today’s lesson we continue this discussion with a look at the Private Sector and Government components and how each of these relates to trading.  
  
While having lots of natural resources and a large well educated labor force to produce goods and services from those natural resources is a great thing, without a way to organize these first two components of the economy, not much would get done. This is where the small, medium, and large businesses which make up the private sector come in. In addition to organizing the labor force to produce goods and services, the private sector is also responsible for raising the capital necessary to bring all these things together which they do through private investors, loans from commercial banks, the bond market, and/or the equities market.  
  
While many people think that the US Economy is dominated by the large corporations, it may come as a surprise the large role that the small business play’s in the US Economy. According to the US Department of State:  
  
"Of the nearly 26 million firms in the United States, most are very small—97.5 percent ... have fewer than 20 employees," the U.S. Small Business Administration says. "Yet cumulatively, these firms account for half of our nonfarm real gross domestic product, and they have generated 60 to 80 percent of the net new jobs over the past decade."  
  
While we will go into more details about the private sector and how this all relates to trading in later lessons, it should be obvious at this point the large effect that the private sector has on all markets as they are the ones who: 1. Raise capital through bonds and stocks that we then trade, 2. produce the goods and services which drive demand for the commodities we trade and 3. Affect the foreign Exchange markets by playing a role in what goods and services are produced domestically, which we import from overseas, as well as cross boarder mergers and acquisitions.  
  
The fourth component that I am going to discuss here is the role that government plays in the US Economy. There are several important roles that the government plays in the economy which can drastically affect the markets one of the more prominent of which is that of Regulator. There are many parts of the US Economy that the government regulates with some of the more prominent areas being:  
  
Anti Trust Laws: These laws are in place to protect the consumer from businesses that grow so large that there are no other businesses that can compete with them, basically allowing those businesses to set unfair prices due to the lack of free market competition.  
  
Environmental Laws: These laws are in place to protect the environment by establishing maximum levels of pollution that businesses are allowed to produce and then checking to make sure that these levels are not breached through agencies such as the Environmental Protection Agency.  
  
Securities Regulators: The government is in charge of monitoring and regulating many parts of the financial system through agencies such as the Securities Exchange Commission and the Commodities Futures Trading Commission.  
  
The primary way in which the role that government plays in the regulation of the economy affects us as traders is through how increases in regulation and decreases in regulation are taken by the market. In general anything that makes it easier to do business which normally means less regulation is going to be seen as positive for the market and anything that makes it harder to do business which is normally associated with more regulation is going to be seen as negative for the economy.  
  
That’s our lesson for today. In tomorrow’s lesson we are going to continue our discussion on the role that government plays in the economy and how this relates to trading with a discussion on Fiscal Policy or how government spending and taxes affect the markets so I hope to see you in that lesson.

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| **Lesson 4: Fiscal Policy and The Business** |
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In our last lesson we looked at the private sector and government regulation components of the economy and how each of these relates to trading. In today’s lesson we are going to look at the second way that government plays a role in the economy which is through something known as Fiscal Policy.  
  
Fiscal policy can be defined for our purposes very simply as anything relating to government spending and taxation. Before looking at the fiscal policy role of government in trying to influence the economy, one must first have an understanding of the business cycle. For a number of reasons which are widely debated, the economy goes through repeated periods of growth and contraction over time which can be broken down into the following phases.  
  
1. **Contraction** where economic activity and growth slows and can turn negative  
2. **Trough** where the economy stops contracting and a new expansion begins  
3. **Expansion** or the speeding up of economic growth.  
4.**Peak** where the growth of the economy maxes out and begins to turn downward  
  
We could spend many months going over and debating why this is but for our purposes it is simply important to understand that, while the timing and length of each of these phases has varied widely, the above pattern repeats itself over and over again throughout history. This is important for us as traders to understand as different phases of the business cycle and changes in peoples forecasts of where the economy is in those cycles is arguably the greatest factor which effects the price level of every market.  
  
Prior to the great depression the US Government had a pretty hands off approach in regards to the business cycle. Since the great depression however the government has played a much more active role in the economy with its stated goals being to act to facilitate full employment and price stability. To help understand these goals and the balancing act that goes on between them as they often conflict, lets look at how each relates to the different phases of the business cycle.  
  
**1. During an expansion** we start to see more people employed as companies begin to sell more goods and services and need to hire more people to keep up with the demand. As economic growth picks up and more people are employed there are more people spending their paychecks which can cause prices to rise, something also known as inflation. Because of this effect on prices the government’s primary concern here will normally be trying to keep prices stable and inflation in check without hurting economic growth. The two things they can do in regards to Fiscal Policy to try and keep prices in check and inflation at bay are:  
  
**a. Raise Taxes:** By raising taxes money is taken away from the consumer who now has less money to spend helping to counteract the demand that is pushing prices up and causing inflation.  
  
**and/or**  
  
**b. Reduce Government Spending:** If the government does not spend as much on projects such as roads and things such as education then this takes some of the demand which is working to drive prices up and causing inflation out of the picture as well.  
  
This is important from a trading standpoint as while an increase in taxes or a reduction in government spending can help fight inflation it can also be seen as negative for the financial markets as demand is being taken out of the equation.  
  
**2.** **During a peak** we start to see employment and the amount of goods and services produced and sold by companies begin to level off. At this stage the government normally becomes more concerned with preventing a deep contraction which is known as a recession, or severe contraction which is known as a depression. The two tools which they have in their fiscal policy to work with here are:  
  
**a. Reduce Taxes:** By reducing taxes the government effectively puts money in the consumer's pocket allowing them to spend more money and drive economic growth. This is what we are seeing now with the economic stimulus package which was recently passed and is giving tax rebate checks out directly to the consumer.  
  
**and/or**  
  
**b. Raise Government Spending:** If the government spends more on projects such as roads and on things such as education then this increases demand in general which helps drive economic growth.  
  
**3. During a contraction**we start to see employment and the amount of goods and services produced and sold by companies start to fall. The fiscal policy tools that the government has at their disposal here are the two mentioned above. Although there are exceptions normally during this stage inflation is not a concern as demand is falling so the government can be more aggressive than they can during a peak.  
  
A second factor which can become a concern here is deflation, where a lack of demand actually causes prices to fall. This, according to Wikipedia can be a large problem which "sets off a deflationary spiral where businesses slow or stop investing, because the investment risk is perceived as higher than just letting the money appreciate due to deflation."  
  
Lastly and potentially even more potent of a problem which can occur during a contraction is stagflation which is a period of slow or negative growth which is accompanied by inflation. When this happens you can see how policy makers hands are somewhat tied because they are getting hit from both sides so to speak.  
  
**4. During a trough** we start to see the employment level and level of goods and services produced and sold by companies start to level off again. During this phase the expected action if any from the fiscal policy side would be to begin to reduce whatever policies had been put into place to help the economy grow as it moves into another expansionary cycle.  
  
While many believe that Fiscal policy has shown to be an effective tool in regulating the business cycle, as government spending and taxation must be approved by both Congress and the President, managing the economy through the use of fiscal policy is normally seen as a lot more tedious than the second tool that government has at their disposal which is known as Monetary Policy.  
  
This will be our topic of discussion in tomorrow’s lesson so we hope to see you then.

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| **Lesson 5: Why Interest Rates Move Markets, Part 1** |
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In our last lesson we learned about the business cycle, why it is important in trading, and how the government tries to influence the business cycle through something known as Fiscal Policy. In today’s lesson we are going to begin to learn about monetary policy with a look at one of its key components, interest rates.  
  
Interest rates at their core are the payment that a lender requires from a borrower in return for lending them money, normally stated as a percentage of the amount borrowed. If for example a lender makes a loan to a borrower of $100 for 1 year at an interest rate of 6%, then the interest payment and therefore cost of that loan for the borrower is $6.  
  
Interest is normally made up of the following components:  
  
**1. The Time Value of Money:** Under normal circumstances most people would prefer to have $1 given to them today rather than that same $1 given to them 1 year from now. The reasons here include the fact that if you have the dollar today then you can put it to work and potentially increase the value of that dollar over the next year or you can go ahead and buy something that you want now with your dollar rather than having to wait a year. As this is the case a lender is going to expect to be compensated for not being able to use the money he or she lends for a set period of time.  
  
  
**2. Inflation Expectations:** If prices are expected to be higher 1 year from now than they are today, then a lender of money is going to want to be compensated for that loss in value over the term of the loan.  
  
3.**How much Risk**there is that a loan will not be paid back. If a lender, for example, is lending money to someone he knows very well, has lent money to in the past and been paid back, and the loan amount is much smaller than his or her income, then that lender is going charge a lower interest rate than he will to someone that is not such a sure bet.  
  
As most of you already know people borrow money for a number of reasons some of the most common of which include:  
  
1. To buy a house (something known as a mortgage)  
2. To start or expand a business  
3. To buy consumer products (with credit cards)  
  
Because borrowed money makes up such a large percentage of spending in the US and many other countries, how easy and cheaply the general population can borrow money has a large effect on economic growth. As this is the case, in general when interest rates are expected to go higher (making it more costly for people to borrow and spend money) people will be expected to borrow and therefore spend less money, and economic growth will be expected to slow as a result. Because of this in general when interest rates are expected to rise the stock market will sell off in anticipation of slower overall economic growth.  
  
Conversely, when interest rates are expected to go lower (making it cheaper for people to borrow and spend money) they will be expected to borrow and spend more money and economic growth will be expected to rise. In anticipation of higher growth the stock market will normally rally all else being equal.  
  
To get an idea of just how much even small changes in interest rates can affect things consider this as an example:  
  
The payment on a $500,000 Mortgage at an annual interest rate of 6% is $2998 per month.  
  
If the interest rate is 8% instead of 6% however you now pay $3699 per month which is about $700 more per month, $8400 per year, and $252,000 in additional payments over the life of that same loan.  
  
So you should now have a good understanding of not only what interest rates are but also the important role that inflation plays in not only making goods more expensive but also in the cost of borrowing money.  
  
In our next lesson we are going to further our discussion on interest rates, monetary policy, and learn about one of if not the most powerful institutions in the financial markets, the Federal Reserve, so we hope to see you in that lesson.

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| **Lesson 6: Why Interest Rates Move Markets, Part 2** |
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In yesterday’s lesson we began our discussion on Monetary Policy with a look at one of its primary components, interest rates. In today’s lesson we are going to continue this discussion with another look at how interest rates affect the economy and therefore the markets, and by introducing the institution which implements Monetary Policy, the Federal Reserve.  
  
As we saw in our example yesterday, small movements in interest rates can have dramatic effects on the economy. Just as small changes in interest rates can dramatically increase the costs for individuals to own a home or borrow money to purchase other goods, they can also have a dramatic affect on the cost of doing business.  
  
It is for this reason that when interest rates rise, making borrowed money more costly, that people will also be less likely to start or expand a business. This not only has an effect on the business owner themselves but filters throughout the entire economy as less businesses being started and expanded means less jobs, which means less people getting paychecks, which means less people spending money and on and on down the line. The opposite is of course also true for when interest rates fall and business owners take advantage of access to cheaper borrowed money.  
  
In addition to interest rates affecting the stock market, interest rates also have direct and indirect affects on the bond, foreign exchange, and futures markets. Here are a couple of quick examples of this which we will expand on in later lessons:  
  
**The Bond Market:** When interest rates rise the value of existing bonds fall as investors can now purchase the same bond with a higher interest rate and vice versa.  
 **The Forex Market:** When Interest rates rise it becomes more attractive from a yield standpoint to own the dollar against other currencies or to invest in interest bearing dollar based assets. This creates a demand for dollars which will many times cause the dollar to strengthen. The reverse is also true when interest rates fall.  
 **The Commodities Market:** When economies grow at a greater rate as a result of lower interest rates this will mean a greater demand for commodities so their value will rise and vice versa.  
  
We are going to go into more specifics on each of these examples in the series of lessons which will be devoted to individual markets so if you do not understand this part don’t worry. I am simply giving these examples here to help further demonstrate the huge affect that interest rate levels have.  
  
Now that we understand the importance of interest rates to economic growth and therefore the markets and our own trading, the next thing to understand is how this relates to our discussion on the government’s role in the economy. As we have learned in previous lessons the government has two options when trying to influence the business cycle to keep prices stable and work towards full employment.  
  
The first which we have already discussed is Fiscal Policy, or exerting control over government spending and taxation to try and influence the business cycle.  
  
The second and perhaps most important to us as traders is Monetary Policy, which is exerting control over the money supply (which has a direct relationship with interest rates) also with the goal of influencing the economy and business cycle.  
  
The Federal Reserve or Fed as it is often called, is the institution responsible for administering monetary policy, and therefore can increase or decrease the money supply with the goal of trying to affect the level of interest rates in the United States. As the level of interest rates has such a large effect on everything in the economy from unemployment to inflation, this makes the Fed one of if not the most powerful institutions in the world.  
  
In tomorrow’s lesson we will learn more about the Fed and some of its key players so we can begin to have a better understanding of Monetary policy and how we as traders can profit from this knowledge, so we hope to see you in that lesson.

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| **Lesson 7: An Introduction to the Federal Reserve** |
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In our last lesson we finalized our discussion on the importance of interest rates and introduced the Federal Reserve. In today’s lesson we’re going to continue our discussion on the Federal Reserve by looking at the parts of the Fed which are relevant to us as traders so we can begin to understand how this one institution is able to create drastic moves in the markets.  
  
The Federal Reserve has many responsibilities which include regulating banking activity, playing a major role in operating the nation’s payments system, and maintaining the stability of the financial system. The role that is most important to us as traders and therefore the role in which we will concentrate on in our lessons, is its role in conducting the nation’s monetary policy.  
  
**\*\*\***As a side note here the Federal Reserve is also the Central Bank of the United States. I say this here because most countries have something which operates in much the same way as the Fed which is many times referred to in other countries as the Central Bank. While these institutions may be structured differently from the Fed, from a broad perspective many of the things you learn in our lessons on monetary policy will apply to any central bank.  
  
While the Fed’s objectives are set by law, its day to day activities are not subject to government approval. This is an important point to understand as it means that unlike Fiscal Policy, which must be approved by both Congress and the President, monetary policy can be enacted as the Fed pleases. This gives the Fed much more control over the economy at least in the short term, and is the reason why some people consider the chairman of the Federal Reserve to be more powerful than even the President.  
  
There are many interesting details about The Fed and its structure that I encourage everyone to explore, however the primary components which move markets, and are therefore the ones that we will focus on, are:  
  
**1. The Board of Governors:** Located in Washington DC the Board of Governors is at the top of The Fed’s food chain. It is made up of 7 members who are appointed by the president and confirmed by the Senate. To help keep The Fed from being influenced by political factors, 5 of the Fed Governors are appointed to staggered 14 Year terms. The Chairman and the Vice Chairman are appointed to 4 year terms and can be reappointed should the President wish to have them.  
  
**2. The Regional Federal Reserve Banks:** This is a network which includes the 12 regional Federal Reserve Banks, and 25 Branches. As most of you already know, different areas of the United States are comprised of different industries. As an example the New York area economy is influenced heavily by what is going on in financial services, while the San Francisco area economy is influenced heavily by what is happening in the technology sector. As this is the case, each of the regional banks are strategically located throughout the country so that the can stay abreast of current economic conditions in each area. **The 12 Regional Banks are Located In:**  
  
New York  
Boston  
Philadelphia  
Richmond  
Cleveland  
St. Louis  
Dallas  
Chicago  
Minneapolis  
Kansas City  
Atlanta  
San Francisco  
  
**3. The Federal Open Market Committee:** Normally referred to as the FOMC, this part of the system is made up of The Board of Governors and the 12 Presidents of the Regional Reserve Banks. The FOMC is the most important part of the Federal Reserve from a trading standpoint, as this is the entity that is responsible for Monetary Policy.  
  
Under Normal Circumstances the members of the FOMC meet 8 times a year to discuss economic conditions and to vote on what, if any, monetary policy actions should be taken. The voting members of the FOMC are:

* **The Board of Governors**
* **The President of the Federal Reserve Bank of New York**
* **4 Presidents from the other Regional banks**(who vote on a rotating basis)

As we’ve discussed in previous lessons, there is no greater mover of markets than changes in peoples anticipation of interest rates, and as the FOMC has the most control over interest rates, one could say that there is perhaps no greater mover of markets than the FOMC. It is for this reason that markets can go quiet for days in anticipation of an FOMC interest rate announcement or important speech by the Chairman or other voting member, and then explode with volatility shortly after.  
  
So, now that we have an understanding of its structure we can begin to discuss how the Fed goes about enacting monetary policy, what this means for the economy, and therefore how market’s are likely to move in different scenarios.  
  
This discussion will begin in our next lesson so we hope to see you then. As always if you have any questions or comments please leave them in the comments section below so we can all learn to trade together, and good luck with your trading.

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| **Lesson 8: How the Federal Reserve Moves Interest Rates** |
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Monetary Policy very simply is anything which relates to action by the Federal Reserve to influence the amount of money and credit available in the economy. To understand exactly what this means, one first must understand the concept of fiat monetary systems.  
  
**Fiat Monetary Systems:**The United States, like most major economies, has what is known as a fiat monetary system. A Fiat Monetary system very simply is any system which uses a monetary unit (in this case the US Dollar) which is not convertible to some commodity, in general a precious metal such as gold.  
  
Fiat money, is money that is backed by the credit of some entity, normally a government, and the value for which is derived from its relative scarcity and the faith placed in it by the population which uses it.  
  
This is important to us as traders because the fact that the Dollar is not convertible to a commodity such as gold gives the Federal Reserve the ability to increase or decrease the money supply as it sees fit, or in other words to enact Monetary Policy.  
  
With this in mind the 3 tools available to the Fed for enacting monetary policy are:

* **Open Market Operations**
* **The Discount Rate**
* **Reserve Requirements**

The most common tool that the Fed uses, and therefore the one that we will cover, is Open Market Operations. Once we have an understanding of this and how increases or decreases in the supply of money affect demand and prices, the other two less commonly used tools will be more easily understood.  
  
Through something which is known as the Open Market Committee, the Fed increases and decreases the supply of money by buying and selling US Government securities.  
  
When The Fed wishes to reduce interest rates they will increase the supply of money by buying government securities using money that was not available in circulation before they made their purchase. As with anything, when additional supply is added and everything else remains constant, price normally falls. In this case the price that we are referring to is the cost of borrowing money or interest rates.  
  
Conversely, when the fed wishes to increase interest rates they will instruct the open market committee to sell government securities thereby taking the money they earn on the proceeds of those sales out of circulation and reducing the money supply. When supply is taken away and everything else remains constant, price (or in this case interest rates which represent price) will normally rise.  
  
When the fed increases or decreases the supply of money they are doing so to try and directly influence something which is known as the Fed Funds Rate, or the interest rate in which charge to each other for overnight loans. With this in mind we now when we hear the fed has lowered or raised the Fed Funds rate by a quarter of a percentage point, for example, what has actually happened is they have increased or decreased the supply of money in the economy.  
  
As you can hopefully now begin to see if you’ve watched our lesson on fiscal policy, monetary policy is a strong tool which can affect the business cycle and therefore the markets in much the same way as fiscal policy. In tomorrow’s lesson we will look at exactly how this is done so we hope to see you in that lesson.

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| **Lesson 9: When the Federal Reserve Moves Interest Rates** |
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In our last lesson we looked at how The Fed enacts Monetary Policy by increasing and decreasing the money supply and what effect this has on interest rates. In today’s lesson we are going look at how The Fed will normally react at different points in the business cycle and what effect this is expected to have on the markets.  
  
As you hopefully remember from our previous lessons, the economy goes through periods of growth and contraction which tend to repeat over time. These movements are referred to as the business cycle, a chart of which you can see here:  
  
As we learned in our lesson on Fiscal Policy and the Business Cycle, the government tries to manage the business cycle with the goals of maximizing economic growth, employment, and price stability. As we learned in our last lesson the primary tool which the fed uses from a Monetary Policy standpoint to manage the Business Cycle is targeting the Fed Funds rate by increasing and decreasing the money supply.  
  
Let’s now take a look at the Business Cycle and the balancing act that the fed must play in trying to keep economic growth at its full potential, while at the same time sticking to its goal of price stability.  
  
**Expansions:** During an expansion employment is normally high and growing which means lots of people are getting paychecks to spend on goods and services and businesses are expanding to meet the growth in the economy. It is during this time that the balancing act The Fed must play between driving economic growth and keeping prices stable normally shifts towards the keeping prices stable side of the equation. In the early stages of an expansion the supply of goods and services can normally keep up with the demand, so prices remain in check. As the economy continues to heat up however situations can arise like we are seeing in the commodities markets as of this lesson, where demand is growing at a faster pace than supply, and therefore inflation begins to enter the picture.  
  
It is for this reason that during the expansionary phase of the economic cycle you will normally see The Fed become concerned with keeping prices in check without slowing growth too much. The way that they will due this is by reducing the money supply in order to slow economic growth so that inflation does not get out of hand. As we learned in our last lesson, reductions in the money supply means increases in the Fed funds rate, and as we have learned in previous lessons, increases in interest rates means slower economic growth, which means a sell offs in the stock market all else being equal.  
  
**Peaks**: During a peak employment is normally high but the growth in employment starts to slow and the growth in unemployment starts to rise. This means that growth in spending and therefore economic growth is leveling off and starting to turn downwards. As demand is moderating, this normally means that prices are also stable which allows The Fed to shift its attention back to keeping economic growth going and to avoiding a potential contraction.  
  
With this in mind, during a potential peak in the business cycle you will normally see The Fed increase the money supply to try and bolster demand, which means decreases in the Fed Funds rate. As we have learned in previous lessons decreases in interest rates means higher economic growth, which means stock market rallies all else being equal.  
  
**Contractions:** Although there are exceptions to this which we learned about in our lesson on fiscal policy, during a contraction price stability is not normally a concern and therefore the Fed’s full attention is placed on economic growth. This very simply means The Fed will become more aggressive in increasing the money supply, which means further reductions in the Fed funds rate, which means a pickup in economic growth and stock market rallies all else being equal.  
  
**Troughs:** During a Trough interest rate cuts have started to filter through the economy and are working to push it back towards an expansionary period. During this time the balance will normally begin to shift back towards price stability and the posture of The Fed will normally be one of either inaction or a bias towards tightening the money supply causing interest rates to rise. The reaction of the markets in this case will generally depend on how quickly the Fed moves to raise interest rates and how quickly the economy is expected to emerge from the trough.  
  
One last thing to note here is that there is a lag period between action by The Fed to increase or decrease the money supply and seeing the intended effects on the economy. As a general rule it takes 6 to 9 months to see changes in the money supply filter through and be reflected in the economy, so The Fed will often take Monetary Policy action in anticipation of future changes in the business cycle.  
  
That’s our lesson for today. In our next lesson we will look at how The Fed signals changes in Monetary Policy to the market before they are actually made, and how drastic market moves are expected to be under different circumstances. So we hope to see you in that lesson.

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| **Lesson 10: How the Fed Signals Policy Changes Beforehand** |
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In our last lesson we looked at how The Fed is expected to react at different points in the business cycle, and what the expected market movement will be as a result. In today’s lesson we are going to look at how the Fed goes about signaling to the market changes in their thinking on the direction of monetary policy, so we can begin to understand why markets react not only to Fed interest rate announcements but just as importantly to events which change the markets anticipation of how the Fed may react.  
  
While we have simplified the situation in order to better understand the basics of how The Fed uses monetary policy, as you can probably tell by now, forecasting economic conditions and using monetary policy to try and manage those conditions is a very difficult process. The members of the FOMC are constantly analyzing economic data from across the country to try and gauge where the economy is in the business cycle and what if any monetary policy action is needed.  
  
As we have touched on in previous lessons, the FOMC has 8 regularly scheduled meetings throughout the year where they meet to discuss current economic conditions and expectations of future conditions. It is at these meetings that decisions on what changes if any in monetary policy need to be made. Upon completion of these meetings a press released is issued an example of which you can see at the link below if you are watching this video on InformedTrades.com or in the description section if you are watching this video on Youtube.  
  
[FRB: Press Release--FOMC statement--January 30, 2008](http://www.federalreserve.gov/newsevents/press/monetary/20080130a.htm)  
  
As we’ve learned in previous lessons as well, what the FOMC decides to do with their target for Fed Funds Rate at this meeting has wide ramifications for the economy and therefore the markets. With this in mind the results of these meetings are closely followed by market participants. It is important to understand however that the market not only looks for whether or not the FOMC takes action on the Fed Funds Rate and by how much, but also for any clues in the Fed’s Statement as to what their bias may be for future rate decisions.  
  
This is a very key point to understand because the markets are always trying to anticipate what is going to happen and therefore they move up and down depending on what people think will happen to rates going forward. Anything that comes out from this meeting or any thing else that is in line with what the market expects should have little or no effect on the market. Conversely anything that comes out which changes the markets forecasts on what if any Fed action will be, can cause drastic moves in the markets as participants react to this new information and markets adjust accordingly.  
  
The large market volatility that can be caused when market participants are caught off guard by a change or lack thereof in the Fed Funds Rate is not a desirable outcome for anyone in the markets including the Federal Reserve. In order to try and prevent the large moves which occur when the market is caught off guard the Fed will always try to signal ahead of time what their stance is on interest rates, and more times than not by the time the FOMC decision is released, the market has already priced in whatever action if any is taken on the Fed Funds rate. The three main ways the Fed will signal its intentions to the market are:  
  
**1. The release of the policy decision after the FOMC Meeting**. Again here while the announcement of what if any change in the Fed Funds Rate target will be made is obviously an important component of the release, just as and many times even more important is the accompanying statement which normally includes the Fed’s “bias” going forward.  
  
By reviewing the statement from the most recent FOMC meeting at the link below this video if you are watching this on InformedTrades.com or in the description section if you are watching this on Youtube, you can see that the bias going forward is for the Fed to reduce interest rates. Although they say that “inflation needs to be monitored” they also say that they “expect it to moderate”. They also come right out and say that “downside risks to growth remain” and that they will “act as needed to address those risks”  
  
**2. The FOMC Meeting Minutes**. The notes or minutes from the latest FOMC Meeting are released 3 weeks after the meeting. These are a much more detailed account of what was discussed at the most recent FOMC meeting and market participants will pour over this release as well looking for clues as to future policy action.  
  
**3. Public Speeches:** Voting members of the FOMC will give speeches periodically where they will discuss recent economic events and sometimes signal potential changes in their bias. These speeches, especially ones made by the chairman of the fed who is its main voice, will also be closely monitored by market participants as well.  
  
  
Lastly, market participants will also closely monitor economic releases for any signals that the economy may be growing more or less than the market is currently expecting. There are a few economic releases that are the most important in this regard which will be the topic of our next lesson.