|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| |  |  |  | | --- | --- | --- | | |  | | --- | | **Lesson 1: How Trade Flows Move the Forex Market** | |  | | |  | |
|  |

In today's lesson we are going to start a new module on what moves the forex market with a look at something which is known as trade flows.  
  
As most of you are aware, when the market for something is allowed to operate in an unrestricted manner, price is set by the intersection of supply and demand. This means that if there is more demand than supply for something then price should rise. Conversely if there is more supply than demand for something, then price should fall. When supply and demand are equal then price should stay the same.  
  
Currencies are no exception to this basic economic concept. At its core the value for a free floating currency is determined by the demand for a particular currency in relation to its supply. While this is a simple concept, determining what the supply/demand situation for a particular currency is, and trying to forecast changes in that equation, is a little bit more difficult of a proposition, and is what currency traders who focus on fundamentals try to ascertain.  
  
With this in mind ,whenever anything happens such as an increase or decrease in the amount of goods and services imported or exported by a country, an economic news release, speech by a fed official, or geopolitical event, a currency trader will always ask the question: "How does this affect the supply demand situation, and therefore the value of the currency that I am trading?"  
  
In order to keep this straight in our heads its best to think of things that can affect the supply/demand equation as fitting into one of two categories. The first, which we are going to discuss in this lesson, is what is known as trade flows. Trade flows are anything that involve money moving in and out of a country as a result of global commerce. This basically means money flowing out of countries as a result of goods and services being imported from other countries, and money flowing into countries as a result countries exporting goods and services to other countries.  
  
When a country imports goods this adds currency of the importing country to the market and creates demand for the currency of the exporting country. The reason for this is that the goods are normally bought in the currency of the country where they are produced, so the entity importing the goods must exchange their currency for the currency of the entity that is exporting the goods.  
  
As an example lets say that a US Corporation is importing 1 Million US Dollars worth of steel from a Canadian steel producer. In order to purchase this steel, the US Corporation must pay the Canadian corporation in Canadian dollars. As the US Corporation most likely does not have cash sitting around in Canadian Dollars, they will go out into the market and sell US Dollars and buy Canadian dollars.  
  
As you can see here, the buying and selling of currencies which takes place as part of this transaction, creates an increase in demand for Canadian Dollars while simultaneously adding supply to the market for US Dollars. While a transaction of this size would not have much if any affect on the market, if this type of transaction was multiplied many times over, you could see how the two currencies of the countries involved in the transactions would be affected.  
  
In general countries which rely heavily on imports will see a weakening affect on their currency as a result of this, all else being equal, and countries who have economies which are more export oriented will see a strengthening affect as a result, all else being equal.  
  
That's our lesson for today. In our next lesson we are going to learn about the second category of market moving flows which is known as capital flows so we hope to see you in that lesson.

|  |
| --- |
| **Lesson 2: How Capital Flows Move the Forex Market** |
|  |

In our last lesson we began the fourth module of our free forex trading course with a look at the basics of how the trade flows between countries can affect the value of those countries currencies. In today’s lesson we are going to look at the second category of things that move the forex market, capital flows.  
  
Capital flows encompass all of the money moving between countries as a result of investment flows into and out of countries around the world. Here instead of money flowing between countries to buy each others goods and services, we are talking about money flowing into and out of the stock and bond markets of countries around the world, as well as things such as real estate and cross boarder mergers and acquisitions.  
  
Just as the importing or exporting of goods shifts the supply demand balance for a particular country, so do the flows of money coming into and out of the country as a result of capital flows. As the barriers to investing in foreign countries have come down as a result of the internet and other factors, it is much easier for fund managers and other investors to take advantage of opportunities not only in their domestic markets, but anywhere in the world. As this is the case, when a market in a particular country is showing above average returns, foreign investors will often flood the market with capital, buying up the assets of that country looking to earn above average returns as well. When this happens it not only affects the markets of that country, but also the value of its currency, as foreign capital must be converted into local currency in order to participate in the markets there.  
  
While most people are more familiar with the equities markets, an important thing to note here is that the bond markets in most countries are much larger than the equities markets, and therefore can have a greater affect on the currency. When the interest rates being paid for the bonds in a particular country are high, this tends to attract capital to that country from foreign investors seeking to take advantage of that higher yield, creating a demand for the local currency here as well.  
  
Lastly, cross boarder mergers and acquisitions are also part of the capital flows category and when they happen on large levels can move the market as well. As an example, if Deutsche bank (a large German bank) were to buy Washington Mutual here in the United States, this would create a large demand for dollars and increase the supply of Euros on the market as Deutsche Bank sold Euros for dollars in order to complete the transaction.  
  
As you can probably imagine there are a myriad of factors that can affect both trade and capital flows for a particular country, and therefore its currency. As currency traders it is our responsibility to know what to expect in terms of a reaction in the FX market when different things happen, so always think of things in terms of how something effects the supply demand relationship. Once you understand this it is next important to understand whether that effect fits into the trade flow or capital flow category since, as we will learn in later lessons, some countries are affected more by trade flows than capital flows and vice versa.  
  
That's our lesson for today. In our next lesson we will look at something which is known as the current account which is the tool used to measure a country's trade flows so we hope to see you in that lesson.

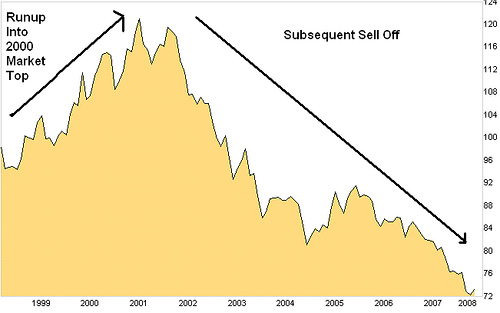
|  |
| --- |
| **Lesson 3: The Current Account and Measuring Trade Flows** |
|  |

In our last lesson we looked at the second category of what moves the forex market with a look at capital flows. In today’s lesson we are going to continue our free forex trading course with a look at how trader flows are measured, through something which is known as the current account.  
  
While the concept that we are going to be covering here is fairly involved, I am covering this not because I feel we need to know all the details, but because having a general understanding of how the flows of money in and out of a country are measured, is important to help understand how the value of currency is affected by those flows. Now that we have an understanding of both trade and capital flows we are going to learn how each is measured starting with the current account.  
  
The basic formula for calculating the current account for a country, is exports - imports of goods and services (also referred to as the balance of trade) Net Factor Income from Abroad (basically interest and dividends) net transfer payments (like aid given to foreign countries).  
  
In general for the countries whose currencies we are focused on, the balance of trade portion of the formula is the main component we are concerned with and very little if anything will ever be heard about the other two components.  
  
When thinking about a countries imports and exports (balance of trade), you will often hear a country described as having either a current account surplus or a current account deficit. A current account surplus basically means that a country is exporting more than they are importing which, as we learned in our lesson on trade flows, should strengthen the value of the currency all else being equal. A current account deficit basically means that a country is importing more than it is exporting which should weaken the value of its currency all else being equal.  
  
If you remember from our lesson on trade flows I gave the example there of a US company needing to import 1 Million Dollars worth of steel from a Canadian steel producer. Just to give a simple example lets say for a second that this was the only transaction that both the United States and Canada did with foreign countries. If this were the case then the United states would have a current account deficit of 1 Million Dollars and Canada would have a current account surplus of 1 Million dollars.  
  
Now obviously there are millions of transactions just like this one which go on between countries all over the world. The current account measures these transactions so we as traders can have an idea of whether the value of a countries currency should be increasing or decreasing based on the trade flows of that country, all else being equal.  
  
As of this lesson China has the largest current account surplus at $363 Billion and the United States had the largest current account deficit at $747 Billion. It is because of this that many argue China's currency is too weak and the US Dollar is too strong, two imbalances which have started to right themselves over the last year.  
  
Here is a graph of the current accounts of some of the major countries whose currencies we are focused on, so you can have an idea of whether those countries are more import or export oriented. As we will learn this is something which is going to be important when analyzing economic data relating to those currencies.  
  
**Japan: A Surplus of $201 Billion  
Germany: A Surplus of $185 Billion  
Switzerland: A Surplus of $67 Billion  
Canada: A Surplus of $28 Billion  
New Zealand: A deficit of $10 Billion  
France: A deficit of $35 Billion  
Australia: A Deficit of $50 Billion  
Italy: A Deficit of $58 Billion  
United Kingdom: A Deficit of $111 Billion**  
  
That's our lesson for today. In our next lesson we will look at how the capital flows side of the equation is measured so we hope to see you in that lesson.

|  |
| --- |
| **Lesson 4: The Capital Account and Measuring Trade Flows** |
|  |

In our last lesson we continued our free forex trading course with a look at how trade flows are measured through something known as the current account. In today's lesson we are going to switch back to the capital flows side of the equation with a look at how these are measured through what is known as the capital account.  
  
The basic formula for calculating the capital account is: Increase in Foreign Ownership of Domestic Assets (things such as real estate, cross boarder M&A, and Investments by Foreign Companies in local operations) - Increase in Domestic Ownership of Foreign Assets Portfolio Investment (things such as stocks and bonds) Other Investment (things such as loans and bank accounts).  
  
As with the current account it is for our purposes not important to understand all the intricate details of the capital account, but simply that where the current account measures money flowing in and out of a country as a result of trade flows, the capital account measures money flowing in and out of the country as a result of capital flows.  
  
As we discussed in our lesson on capital flows, when a market in a country is outperforming the markets in other areas of the world, money will flow into the country from foreigners seeking to participate in those out sized returns. These capital flows are reflected in the country's capital account. This is the case whether we are talking about a country's stock market, bond market, real estate market etc.  
  
As a quick example lets say that a mutual fund located in the United States invests $1 Million Dollars in the Canadian Stock Market, and a Canadian real estate firm buys the equivalent amount of real estate in the United states. Just for simplicities sake, if these were the only transactions that took place between these two countries and any other country, the Capital Account for both the United States and Canada would show a balance of zero, as the two transactions would have exactly offset themselves.  
  
As with the current account when a country sees strong inflows or outflows of capital, this has a direct affect on its currency. When there are significant inflows this creates demand for the currency, pushing the value of the currency up, all else being equal. Conversely, when there are significant outflows, this creates a market supply of the currency, pushing its value down all else being equal.  
  
As you may be able to tell by now, it is the interaction of both the current account and the capital account that fundamental traders focus on, as it is the imbalances here that theoretically cause the value of a currency to rise and fall over the long term. This will be the topic of our next lesson so we hope to see you then.

**Lesson 5: The Balance of Payments**  
In our last lesson we learned about the capital account and how this measures flows relating to foreign investment into and out of a country. In today's lesson we are going to combine what we have learned about the current and capital accounts by looking at something which is known as the balance of payments.  
  
As we discussed briefly in our last lesson it is the interaction of flows of money relating to international trade and investment that ultimately determines the value of a currency over the long term. When demand strengthens for the exports of a particular country and/or investments by foreigners into that country increase, then, all else being equal a currency should strengthen. Conversely, when demand weakens for the exports of a particular country and/or investment by foreigners in that country falls, then, all else being equal a currency should weaken.  
  
It is the interaction of the current account and the capital account that measures this, and when combined these make up a country's balance of payments. The balance of payments is very simply the total transactions by a country with all other countries in the world, or in other words the combination of both trade flows and capital flows into one report. By following a country's balance of payments and its related indicators, an FX trader can gain great insight into the potential future direction of a country's currency.  
  
To help understand this better lets look at the example of the US Dollar. As we've discussed in previous lessons, the United States has run a very large current account deficit for quite some time, meaning that the country has imported many more goods and services than it has exported. As this chart of the US Dollar Index shows however, for a number of years the US Dollar continued to strengthen, despite this large current account deficit.



As you can see here going up into 2000 although the US ran a persistent current account deficit, the currency overall continued to strengthen before starting to sell off from late 2000 forward. Now I am making some pretty significant generalizations here for simplicities sake, but there are two major reasons that fundamental traders will point to as reasons for this:  
  
1. Although this is starting to change somewhat, there has for many years been a strong demand for US Dollars because the US Dollar is the currency of choice for many major central banks to hold as their reserve currency, with Japan and China being the countries you will hear most about in this regard. This creates a demand for dollars on the capital flows side of the equation that helped to offset the persistent current account deficit going into 2000.  
  
2. As most of you will remember the NASDAQ top which happened in March of 2000 was preceded by a major bull market in the United States, one in which foreign investors were active participants. As we learned about in our lesson on capital flows this also created a large demand for dollars, further helping to offset the large current account deficit.  
  
After the sell off of the NASDAQ however, foreign investors fled the US Stock market along with a lot of other traders and investors. As there was no longer as much foreign capital flowing in to offset the large current account deficit, the US Dollar began to weaken. As the dollar began to weaken this created a chain reaction with the central banks who began to diversify into the EURO and other currencies, further exacerbating the dollar's sell off.  
  
This created a situation where the current account deficit in the United States remained large (creating a market surplus of US Dollars from an international trade standpoint) and the inflows of capital into the US stock and bond markets began to fall, lowering the demand for dollars which was offsetting the current account deficit.  
  
While it is not important to understand all the intricate details at this point, what you do need to understand is that in order to have a feel for the long term fundamentals of a currency, it is important to have a general understanding of what is happening from both a trade flows and a capital flows standpoint, and how these two things interact with one another. As we will learn in coming lessons all fundamentals with currencies can be related back to these two basic concepts, so for your homework assignment for this lesson I encourage you to consider the following question:  
  
As the value of the US Dollar falls what effect if any should this have on the large current account deficit in the United States and why?  
  
If you would like to post your answer in the comments section of this lesson on InformedTrades.com for discussion this is something that I always encourage.  
  
That's our lesson for today. In our next lesson we will look at some additional examples of how trade flows and capital flows are moving the market right now in today's market so we can have a better understanding of both and can generate some potential trading ideas as well.

|  |
| --- |
| **Lesson 6: How Interest Rates Move the Forex Market Part 1** |
|  |

In our last lesson we continued our discussion on what moves the forex market with a look at something which is known as the balance of payments. Now that we have an understanding of how trade flows and capital flows interact with one another to establish the longer term direction of a currency, we are going to continue our free forex course with a look at some specific examples from the current market environment, starting with an explanation of how interest rates move the forex market.  
  
Like current and future earnings prospects are the most important factors to consider when trying to forecast the long term direction of a stock, current and future interest rate prospects are the most important factors to consider when trying to forecast the long term direction of a currency. Because of this fact, currencies are highly sensitive to any economic news that can affect the country's interest rates, an important factor for traders of all time frames to understand.  
  
As we learned in module 8 of our free basics of trading course located in the free course section of InformedTrades.com, when the central bank of a country raises interest rates this not only affects the short term rate that they target, but the interest rates for all types of debt instruments. If the central bank of a country raises interest rates then debt instruments of all types are going to become more attractive to investors, all else being equal. This not only means that foreign investors are more likely to invest in the debt of that country, but also that domestic investors are less likely to look outside the country for higher yield, creating more demand for the debt of that country and driving the value of the currency up, all else being equal.  
  
Conversely, when a central bank lowers interest rates, then interest rates on all types of debt instruments for that country are going to be less attractive to investors, all else being equal. This not only means that both foreign and domestic investors are less likely to invest in the debt of that country, but that they are also more likely to pull money out to seek higher returns in other countries, creating less demand for, and a greater market supply of that currency, and driving its value down, all else being equal.  
  
Once this is understood, it is next important to understand that foreign investors are exposed to not only the potential profit or loss from interest rate changes on the debt instrument they are investing in, but also to profits and losses which result from fluctuations in the value of that country's currency. This is an important concept to understand, as it generally will work to increase the profits for investors when interest rates increase, as the increase in the value of the currency is realized when they sell the investment and convert back into their home country's currency. This gives the foreign investor that much extra return on their investment, and that much extra incentive to invest when interest rates rise, driving the value of the currency up further all else being equal.  
  
Conversely when interest rates decrease, there will be less demand for the debt instruments of a country not only because of the lower yield to investors, but also because of the decrease in the value of the currency that normally comes with a decrease in interest rates. The additional whammy of a loss to the foreign investor from the currency conversion that results as part of the investment, further incitivizes them to put their money elsewhere, decreasing the value of the currency further, all else being equal.  
  
That's our lesson for today, in our next lesson we will help drive this point home with an example of this exact situation at work in today's market environment, so we hope to see you in that lesson.

|  |
| --- |
| **Lesson 7: How Interest Rates Move the Forex Market Part 2** |
|  |

In our last lesson we continued our free forex trading course with a look at interest rates and how the capital flows associated with movements in the interest rates of a country affect the value of its currency. Now that we have a basic understanding of how interest rates move the forex market, lets help drive this point home with a specific example from today's market environment.  
  
For our example we are going to say that I am a savvy investor located in the United States who is seeking a good place to park some savings where I can earn a decent return on my money. For this particular slice of my portfolio I am looking for an interest paying instrument that will pay me a steady stream of cash on my money.  
  
As many of you already know a government or corporate bond will do just this paying me whatever the interest rate is as set by the country's central bank that I am investing in, plus an additional interest rate depending on the length of the bond that I am investing in (for example a 1 year bond is generally going to pay me a lower rate of interest than a 10 year bond) and for the extra risk that I take on for different type of bonds (for example a government bond is normally going to pay me less than a corporate bond because there is less chance that the government is going to default on the loan).  
  
So, knowing this, I decide that I would like to invest in a bond that pays me a good rate of interest, and I am not looking to get too speculative about this investment, so I prefer a government bond over a corporate bond. For our example we are going to say for simplicity's sake, that the bonds of the countries that we have available to invest in pay an interest rate equal to the interest rate in the country as set by the central bank.  
  
Now with this in mind the next thing that I do is list out all the different interest rates for the major countries of the world and I come up with:  
  
**United States: 2.00%  
Euro Zone: 4.00%  
Japan: .50%  
United Kingdom: 5.00%  
Australia: 7.25%  
Canada: 3.00%  
New Zealand: 8.25%  
Switzerland: 2.75%**  
  
After reviewing my options its seems pretty clear that if I am just going on interest rates, then New Zealand is the place to put my money as this will earn me an extra 6.25% in interest each year over investing that same money in the United States. Now I am not going to drag the lesson out by including all the history of the interest rates in New Zealand here, but I will tell you they have been in a high interest rate environment relative to the United States for quite some time. With this in mind if I would have have followed this logic in the past then it would have played out very well for me not only from an interest rate standpoint but also, as this chart shows, from a currency appreciation standpoint. Because I would have been investing in New Zealand bonds I would have been holding New Zealand dollars and also benefiting from the large run up in the New Zealand Dollar:



Now obviously hindsight is 20/20 and I have simplified things here for our understanding, but this is not too far off from how international investors including large market moving hedge funds and other players think. It is also a great example of the forces we have spoken about in our lessons on capital flows and in our last lesson on interest rates at play in today's market.  
  
That's our lesson for today. In our next lesson we are going to continue our discussion on how interest rates move the forex market with a look at something which is known as the carry trade, which is also one of the more popular trading strategies in the forex market, so we hope to see you in that lesson.

|  |
| --- |
| **Lesson 8: How to Trade the Carry Trade Strategy Part 1** |
|  |

In our last lesson we continued our free forex trading course with a look at a specific example of how interest rates move the market. In today's lesson we are going to look at one of the more popular strategies employed by currency traders looking to take advantage of interest rate differentials, the carry trade.  
  
As we learned about in our lessons on how rollover works in module two of this course, when holding a position past 5pm NY time traders earn interest when they are long the currency with the higher interest rate. Conversely, when traders are long the currency with the lower interest rate they pay interest when holding a position past 5pm NY time.  
  
Like the US investor in the example from our last lesson who took his US Dollars and invested them in New Zealand Bonds to earn a higher return, currency traders can also take advantage of countries which offer higher interest rates. Luckily for us however taking advantage of interest rate differences between countries is generally much easier for currency traders who can do so with a simple click of the mouse.  
  
To help demonstrate this lets look at the interest rates as set by the central banks for the main currencies which we are interested in. As you can see here and as we went over in our last lesson, rates as set by the Federal Reserve in the United States are currently at 2%, and rates as set by the Bank of New Zealand are currently at 8.25%.  
  
Now lets bring up a screen shot of the simple dealing rates window of the FXCM platform and locate the New Zealand Dollar/US Dollar Currency pair. If we buy this currency pair, then we are long the New Zealand Dollar which is the higher yielding currency, and short the US Dollar which is the lower yielding currency. With this in mind we earn $10 per contract held past 5pm NY time as shown in the Roll B column of the simple dealing rates window. Conversely, if we sell this currency pair then we are short the higher yielding New Zealand Dollar and Long the lower yielding US Dollar, so we pay $15 dollars per contract held past 5pm NY Time, as shown in the roll s column of the window.  
  
As you can see here, we can take advantage of the higher interest rates in New Zealand by buying New Zealand Dollars and Selling US Dollars with the click of the mouse, and without having to go through the trouble of figuring out how to buy New Zealand bonds as we would have had to in our last lesson.  
  
Because of the simplicity of this strategy and the fact that in addition to the interest that one earns by being long the currency with the higher interest rate there is the opportunity for capital appreciation should the higher yielding currency move in one's favor, this is a hugely popular strategy. This is important to us as traders not only because it is a strategy that we may want to consider trading at some point, but also because a huge amount of capital flows in and out of currencies based on this strategy, making it a major market mover in both the long and short term time frames.  
  
Lastly, it is important to us as traders to understand that when a trader is long the carry, meaning that he or she is long the currency pair with the higher interest rate, then that trader is normally trading with the wind at their back as they are getting paid every day they hold their position, regardless of what happens to the exchange rate. Conversely when a trader is short the carry, meaning that they are long the currency pair with the lower interest rate, then they are generally trading with the wind in their face as they are paying money every day, regardless of what happens with the exchange rate.  
  
Thats our lesson for today, in our next lesson we will continue our discussion of the carry trade with a look at the role that leverage plays in the strategy, as well as some other factors that need to be considered so we hope to see you in that lesson.

|  |
| --- |
| **Lesson 9: How to Trade the Carry Trade Strategy Part 2** |
|  |

In our last lesson we began our discussion of the carry trade and how forex traders implement this strategy to take advantage of interest rate differences between different countries. In today's lesson we are going to continue our discussion on the carry trade, with a look at the role that leverage plays, as well as some of the things traders look out for when trading this strategy.  
  
As we saw in yesterday's lesson, if a trader buys the NZD/USD currency pair, then as of this lesson, they will earn $15 per contract held past 5pm NY time on Monday, Tuesday, Thursday, and Friday. As we learned in our lesson on rollover in module two of this course, they will earn 3 days worth of rolls or $45 on Wednesday to take into account Saturday and Sunday when the market is closed. This brings the total interest paid for the 7 days in the week to 7 \* 15 = $105. As there are 52 weeks in a year if a trader held this position for an entire year and the rollover rate did not change, they would earn (105 \* 52) = $5460 in interest from the rollover portion of the trade.  
  
At the current market rate for NZD/USD as of this lesson of .7687 this is an annual return from just the rollover portion of the trade of $5460/$76,870 = 7.1%. This of course makes the large assumptions for simplicity's sake that the exchange rate and rollover rate will remain the same as they are today for the 1 year period that the trader is in the trade.  
  
Now you may be thinking to yourself at this point, "well Dave I was kind of excited about this whole carry trade thing and was seeing how it was so popular until I see a 7.1% return plus all the caveats. To be honest with you this does not get me too excited and I don't really see why this is all that popular."  
  
As some of you may have already realized however, if we were to utilize some of the leverage that is available to us in the forex market as we learned about in module two of this course, then we might be able to take that 7.1% return and juice it up into something a little more interesting. So with this in mind, lets say I leveraged this position 2 to 1, which most traders I think would agree is still pretty conservative.  
  
This would double the return from the rollover portion of the trade to 14.2%, a return that if generated consistently would out perform the long term average return of the US Stock market. Taking this a bit further, if I increased the leverage to a more aggressive 3 to 1, that would put my return from rollover at 21.3%, and if I upped the leverage to an even more aggressive 4 to 1 that would put me at 28.4%, a return that if I consistently generated year after year, would put me among the top traders in the world.  
  
When people first see this many times their initial reaction is one of excitement, which makes them want to jump right into a trade. As with most things however, if making money was this easy then everyone would be a millionaire, so while this is an enticing return, and while there has been a lot of money made by people employing carry trade strategies, there are other things to consider:  
  
**1. Exchange Rate Fluctuations** which can cause additional profits or wipe out all profits and cause losses on the trade.  
  
**2. Changes in Interest Rates** which can increase the positive rollover, decrease it, or cause a trader to end up paying for holding the position instead of earning.  
  
**3. The Use of Leverage** amplifies any gains made on the strategy but also amplifies any loss should the trade begin to work against the trader.  
  
It is how traders deal with these unknowns that separates traders who consistently make money with carry trade strategies from those who do not, a topic which we will discuss in our next lesson.

|  |
| --- |
| **Lesson 9A: How to Trade the Carry Trade Strategy Part 3** |
|  |

In our last lesson we looked a little deeper into one of the more popular strategies traders use in the forex market, the carry trade. In today's lesson we are going to continue our discussion on the carry trade with a look at some of the factors outside of current interest rate differences that must be considered to have a full understanding of all the factors included in a carry trade strategy.  
  
As we have learned in our first two lessons on the carry trade, it is the size of the difference between interest rates in the countries whose currencies we are trading that ultimately determines how much we either pay or receive for holding a position past 5pm New York Time. With this in mind it is only logical that if the difference in interest rates between two countries changes, then so will the rollover amount that is either paid or collected when trading those country's currencies.  
  
As a quick example lets take another look at the NZD/USD. As of this lesson if we were to buy the NZD/USD currency pair then we would earn $10 for each contract we held past 5pm NY time. As we have learned in our first two lessons the reason why we would earn $10 is because we are long the NZD where currently interest rates are at 8.25% and short the USD where interest rates are currently 2% as of this lesson. So with this in mind we are long the positive interest rate differential of 8.25%-2% which equals 6.25%.  
  
Now lets say in our example that interest rates in the United States went up by 1% to 3%, while interest rates in New Zealand stayed the same. If this were to happen then our positive interest rate differential of 6.25% would drop to 5.25%. Very simply here, as the positive interest rate differential has decreased the amount of money that we earn for holding the position has decreased as well.  
  
Conversely, if rates were to rise in New Zealand and stay the same in the United States then the interest rate differential would grow in our favor, and the amount we earn for holding a position past 5pm should grow as well. So you can see here that one of the first things that must be considered when thinking about a carry trade is what the current interest rates are, and what they are expected to be for the life of the trade.  
  
A second thing which must be considered when thinking about a carry trade is the exchange rate fluctuation that may occur while a trader is in the position. Traders may consider a number of things here, the most popular of which are one of or a combination of:  
  
**1. Capital Flows:** Most importantly here is interest rate expectations which as we discussed in our lesson on how interest rates move the forex market, when interest rates rise in a country, interest bearing assets generally become more attractive to investors, which will many times drive the value of a currency up all else being equal, and vice versa when interest rates fall.  
  
Notice here that I say interest rate "expectations". As we have talked about extensively in module 8 of our free basics of trading course, markets anticipate fundamentals so in general once an interest rate increase or cut is announced, it has already been priced into the market.  
  
**2. Trade Flows:**Most importantly here is affects on the current account.  
  
We will be discussing how traders go about forcasting changes in capital and trade flows in the coming lessons. The third thing which traders focus on and which we have already covered in our basics of trading course is:  
  
**3. Technical Analysis:** As carry trades are generally longer term trades many traders will look at the overall trend in the market and use technical analysis to try and determine when they think the trend is going to be in their favor if they open a carry trade.  
  
The importance of developing a plan to trade the exchange rate fluctuation portion of the carry trade in addition to the simple holding of a position overnight to earn interest cannot be overstated. To help drive this point home lets have another look at the chart for the NZD/USD.



As you will notice from this chart, in a little over 3 months the NZD/USD has fallen over 500 pips. As we learned in module 2 of this course the value of a 1 pip move in the NZD/USD currency pair is $10 meaning that in US Dollar terms this is a $5000 loss had a trader entered a long position at the top of the market to try and take advantage of the positive carry. If you remember from our last lesson at the current rate of $10 per lot held past 5pm NY Time a trader would earn $3640 for holding a position for 1 year, which in this case would unfortunately not be enough to offset the $5000 loss that was taken in 3 months.  
  
As a homework assignment for tonight I would like everyone to think about the following question:  
  
What are some possible reasons that the currency pair has sold off so much, and could they have been predicted?  
  
If you would like to post your thoughts in the comments section of this lesson on InformedTrades.com we would love to see them and I will personally reply to all comments.  
  
That's our lesson for today and that wraps up our lessons on the basics of the carry trade. In tomorrow's lesson we are going to start a new series on the fundamentals of the forex market where we will delve into how traders go about forecasting interest rates for things like the carry trade so we hope to see you in that lesson.