

Currency personalities

Unique fundamental circumstances and the transition from one trading center to the next can create distinct currency “personality traits” traders can use to their advantage.

BY BRIAN DOLAN

The vast majority of trading volume in the global currency market pits the U.S. dollar against other major currencies. Which currency pair should you trade? The easy answer is to view all currency pairs as essentially equivalent.

However, that simple solution overlooks the fact that different currency pairs have distinct attributes and behaviors that can be characterized as “personality traits,” and these traits have important implications for trade timing, entry and exit levels, and other aspects of trading.

Traders are likely to experience better results if they are aware of the idiosyncrasies exhibited by different currency pairs as well as understand the forces behind such traits.

Liquidity by currency pair

There are a number of factors that influence the trading personalities of major currency pairs, and they all stem from real-life — and in most cases, quantifiable — determinants. The primary element that defines a currency pair’s trading personality is its liquidity.

Although the global forex market is

the largest and most liquid of all financial markets, that liquidity is not evenly distributed across all currency pairs. Also, liquidity can vary significantly throughout the trading day depending on which financial centers are currently active.

The most recent Bank for International Settlements (BIS) triennial survey of the global foreign exchange market, conducted in April 2004, indicates the relative proportion of volume among major currencies has remained mostly steady since the surveys first began in 1989.

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TABLE 1 — THE FX MAJORS

The most actively traded currency pairs involve the U.S. dollar. These six currency pairs, commonly know as “the majors,” account for 72 percent of average daily forex volume. Non-U.S. dollar pairs account for only about six percent of volume.

Currency pair	Symbol	Percent of daily volume
Euro/U.S. dollar	EUR/USD	28%
U.S. dollar/Japanese yen	USD/JPY	17%
British pound/U.S. dollar	GBP/USD	14%
Australian dollar/U.S. dollar	AUD/USD	5%
U.S. dollar/Swiss franc	USD/CHF	4%
U.S. dollar/Canadian dollar	USD/CAD	4%

Source: Bank for International Settlements (BIS) triennial survey (www.bis.org)

FIGURE 1 — LESS LIQUIDITY HELPS USD/CHF LEAD THE WAY

USD/CHF (top) frequently leads the way for the more liquid EUR/USD (bottom), in this case making a test of support from recent lows while EUR/USD lags slightly. The break by USD/CHF signals that EUR/USD will break similar resistance and move higher.



Source: eSignal



The numbers show the U.S. dollar was on one side of 89 percent of all transactions, the Euro 37 percent, the Japanese yen 20 percent, the British pound 17 percent, the Swiss franc 6 percent, and the Australian and Canadian dollars around 5 percent each. (One-sided percentages will total 200 percent since another currency is always on the other side.) As such, these seven currencies account for about 90 percent of all global volume in currency trading.

Another BIS breakdown of trading volume by currency pair shows the Euro/U.S. dollar (EUR/USD) pair remains the most actively traded pair, accounting for 28 percent of daily forex volume. This is followed by the U.S. dollar/Japanese yen (USD/JPY) at 17 percent, British pound/U.S. dollar (GBP/USD) at 14 percent, Australian dollar/U.S. dollar (AUD/USD) at 5 percent, and U.S. dollar/Swiss franc (USD/CHF) and U.S. dollar/Canadian dollar (USD/CAD) at about 4 percent each. These six currency pairs, commonly known as "the majors," account for 72 percent of average daily volume; non-U.S. dollar pairs account for only about six percent of volume.

Liquidity by market center

Although global volume statistics provide a reference point for market liquidity, analyzing trading volume by financial center provides a more specific picture of activity throughout the global trading day, and holds important tactical implications for gauging market movements. The BIS survey breaks down daily trading volume by country.

Asia-Pacific centers (Australia, Japan, Hong Kong, and Singapore) account for about 21 percent of daily trading volume, while Europe is responsible for nearly 53 percent of daily volume (the UK alone does almost one-third of daily global turnover). North America (U.S. 19.2 percent, Canada 2.2 percent) comprises roughly 22 percent of daily turnover. Approximately 96 percent of forex volume occurs between these three trans-global trading sessions.

Overall liquidity fluctuates as the trading day moves on. At no time is this more evident than in the early hours at the opening of the week's trading, when only a few trading centers (namely Wellington, New Zealand, and Sydney, Australia) are active, and liquidity is at its low point.

This liquidity nadir can often lead to exaggerated moves in currencies, particularly if significant news events transpire over the weekend, as normal market depth is unavailable to moderate impulsive flows. Among the most common over-the-weekend events likely to trigger volatile opening moves (or gaps from the prior close) are unexpected statements from G7 meetings (see "'G' meetings: Do they move the market?" *Currency Trader*, July 2005) and election results, as was recently the case following the French rejection of the EU constitution.

However, the early hours of the week's trading tend to be stop-loss hunting expeditions. Such forays tend to occur fol-

lowing sharp moves into the close of the previous week's trading. In such circumstances, traders caught on the wrong side of a one-way Friday afternoon move (but who are able to hold on through the close) frequently leave stop-loss orders just beyond the extremes of the move. When trading resumes early Monday, market makers Down Under are confronted with a cluster of stop-loss orders just beyond the opening levels, assuming the new open is near the prior close.

The result is frequently an opening flurry of action that sees nearby stop-loss levels triggered, only to see prices subsequently reverse once the stops are placed. When placing orders over a weekend, traders should be prepared for such early, order-driven moves, and this may affect the levels at which orders are placed. Sharp, stop-loss driven, opening moves are also opportunities for traders to leave limit orders at or beyond likely stop-loss levels, potentially gaining better entry levels than might otherwise seem possible.

The weekly opening in the Asia-Pacific session is only one of several periods where session liquidity comes into play. Other flurries of activity regularly occur as major trading centers wind down their trading activity on any given day, taking their liquidity with them. Among these are the London/European close, which occurs around midday for North American traders, and the close of the Chicago Mercantile Exchange's (CME) currency futures session at 3 p.m. ET, which also coincides with a notable decrease in spot forex trading among major interbank participants.

With a better picture of market liquidity by currency pair and financial center, let's now examine some of the characteristics of the four major currency pairs, with an eye to how they might affect trading decisions.

EUR/USD

The EUR/USD's premier status reflects the fact that the U.S. and Eurozone are the world's two largest economic zones. The Euro is one of the three legs of the world's major currency blocs (EUR, USD, JPY), and thus reflects major shifts in global asset allocations. Also, the Euro is the second-most significant reserve currency after the U.S. dollar, accounting for nearly 60 percent of the composite U.S. dollar index.

In this sense, the Euro frequently acts as a foil to the U.S. dollar and is the primary currency in which overall dollar sentiment is expressed. Of course, EUR/USD will respond to Europe-specific developments, such as interest-rate changes and economic data, but more frequently it will be the dollar side of the equation that drives the currency pair. As a result, traders need to be aware of the dominant themes driving the market and understand whether it is a U.S.- or European-based story behind a move.

The EUR/USD's liquidity is unmatched by any other major currency pair, reflected in its tighter spreads and tendency to trade tick by tick. Moreover, EUR/USD receives

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FIGURE 2 — RESPECT NOT THE SAME

Not all currency pairs respect technical levels to the same degree: GBP/USD (top) exhibits frequent false breaks of technical levels in contrast to USD/JPY (bottom), which tends to respect such levels more closely.



Source: eSignal



additional liquidity through the “crosses” (non-dollar cross-rates such as EUR/CHF and EUR/GBP), as less-liquid dollar pairs (e.g., USD/CHF and GBP/USD) are turned into more-liquid cross positions (Figure 1). For example, if a hedge fund sells a large amount (e.g., more than \$50 million) of USD/CHF to an interbank market maker, the market maker is unlikely to be able to unload the trade on the market without driving the price significantly against himself and locking in a quick loss. Instead, the market maker will immediately buy the equivalent dollar amount of EUR/USD, creating a long EUR/CHF position (long EUR/USD + long USD/CHF = long EUR/ short CHF). Given the deeper liquidity of EUR/CHF vs. USD/CHF, the market maker now has a chance to exit the overall position with less slippage and possibly even at a profit. This cross-flow can distort price action in a countertrend fashion as a cross position is then exited. This makes EUR/USD ideal for very short-term traders, because they are able to open or close positions with minimal slippage.

The depth of interest and liquidity in EUR/USD can lead to prolonged tests of support and resistance as limit orders at these levels are absorbed by the market. This can create the impression a directional move is stalling, sometimes inducing a brief reversal, when it is simply a matter of time before the market is able to work its way through orders. Apart from major data releases, EUR/USD tends to exhibit its greatest volatility during the previously mentioned periods of session illiquidity.

USD/JPY

The Japanese yen (JPY) is the third leg of the major currency/trade bloc triangle and USD/JPY is the second most actively traded currency pair. In its role as the primary regional currency (it is also the second-largest national economy after the U.S.), the yen is frequently used as a proxy for other Asian currencies that are not freely traded or are too illiquid to trade efficiently.

For example, speculation over the revaluation of the Chinese renminbi (RMB), or yuan, as well as the actual event, has manifested itself in periods of frenzied yen-buying because the yuan is not freely traded in the spot market. There is also a belief that a revaluation of the yuan will result in other Asian currencies strengthening in tandem.

Historically, USD/JPY has been one of the most politically-sensitive currencies because of the perpetual trade surplus Japan runs against the U.S. and other major economies. This made the yen a strategic bargaining lever as U.S. officials sought to open Japanese markets to foreign products, and also made it vulnerable to official U.S. or G7 pronouncements. More recently, though, China has displaced Japan as the most worrisome trading partner for the U.S., while Japan continues to emerge from a decade-long recession.

The Ministry of Finance (MOF) is the most powerful governmental department in Japan — it exercises more influence over the economic scene than the Bank of Japan (BOJ), the central bank. As recently as early 2004, the MOF via the BOJ had been waging an aggressive campaign of currency market intervention to halt a rise in the yen they believed was fueled by excessive speculation and threatened an economic recovery. In the process, the MOF/BOJ spent tens of billions of dollars propping up the greenback and limiting yen gains. The yen occupies a central place in the Japanese financial market psyche, and daily comments from MOF officials are a mainstay of USD/JPY trading.

The trading characteristics of USD/JPY are perhaps best understood by noting two key facts: Japan has the highest domestic savings and investment rate in the world, resulting in massive financial portfolios invested in financial instruments throughout the world; and Japanese cultural tendencies favor intra-Japanese cooperation and communication.

The practical effect of these two features is large concentrations of market interest at common levels, typically resulting in clusters of stop-loss and limit orders at key technical points. This herd-like behavior often results in large, volatile moves followed by extended periods of range-bound consolidation, as the pack responds *en masse* to breaks of key levels and then settles down. The pervasiveness of Japanese institutional interest in USD/JPY means the pair tends to respect technical levels far more than other currency pairs, with a lower likelihood of false breaks (Figure 2). This suggests traders need to respond more quickly to the breakout of key levels rather than waiting for pullbacks or a bounces to enter. There tends to be a “clustering” of market orders around technical levels, which favors placing stop-loss orders just beyond key technical levels (e.g., 5 to 15 pips).

The rationale here is significant limit orders will typically be in front of such levels, and the unfolding of a larger market move will be needed to get through those limit orders first. Traders focusing on USD/JPY should pay special attention to candlestick and “Ichimoku” technical analysis (a form of candlestick charting where trend, support, and resistance levels are plotted on a chart, allowing the “equilibrium” price to be seen at a glance), as they are widely followed in Asia and will frequently signal reversals or major breakouts.

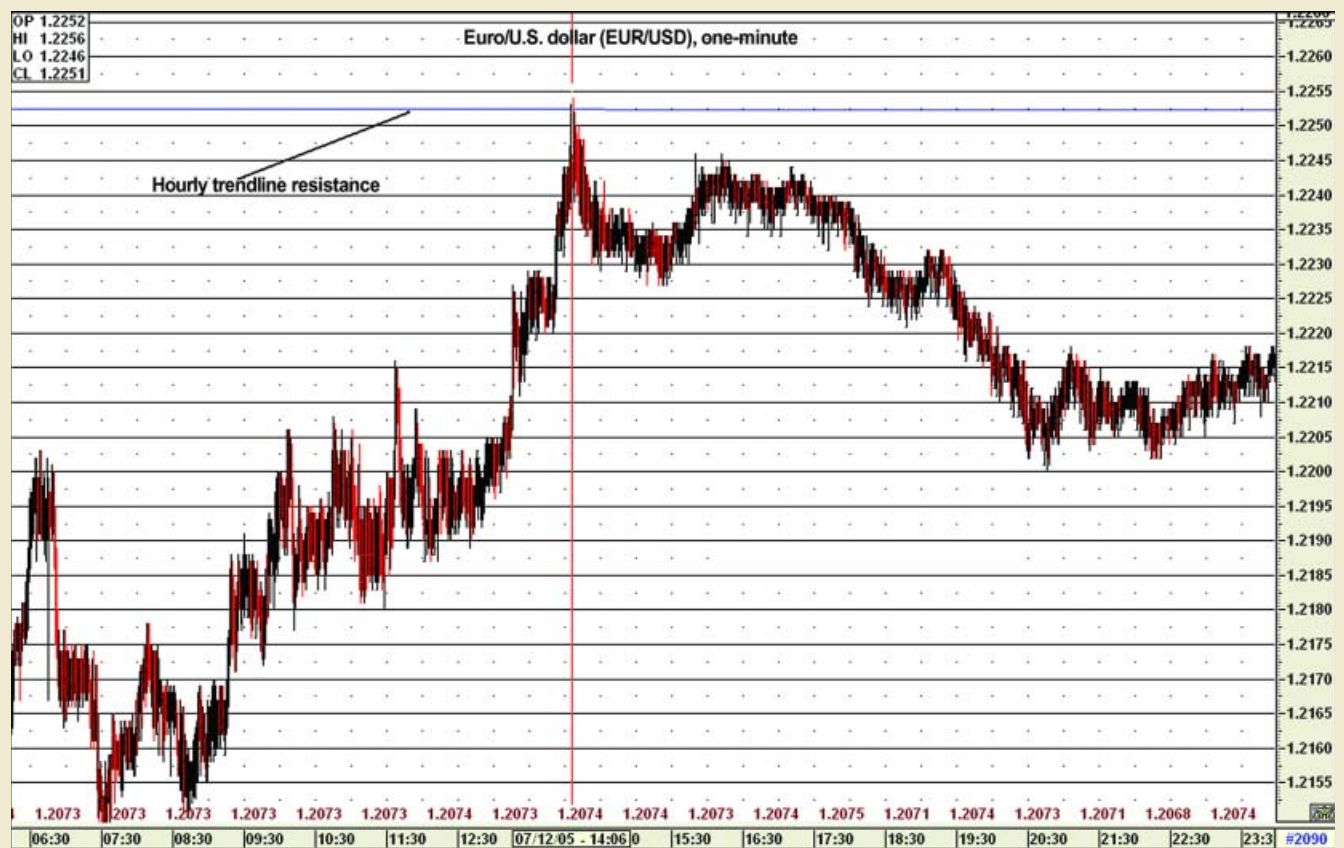
Also, traders need to be aware of the major yen currency pairs, as technical breaks in these can frequently spill into USD/JPY and push it out of the driver’s seat.

Finally, liquidity in USD/JPY tends to be thinnest on the last trading day of each month and at the end of financial semesters (March and September) as Japanese institutions scale back their presence in the market at these times. The result can be highly erratic and unpredictable market movements.

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FIGURE 3 — EUR/USD FOLLOWS USD/CHF

USD/CHF (top) bounces, signaling a low and suggesting that EUR/USD's rally (bottom) will soon stall at the equivalent resistance level.



Source: eSignal



GBP/USD (“Sterling” or “Cable”)

Trading the pound is not for the faint of heart. The British currency is traditionally among the most volatile and erratic currencies because of its lower liquidity available and larger point value. Prior to the introduction of the Euro in 1999, only the “Commonwealth” currencies (GBP, AUD, and NZD) had values denominated in U.S. dollars. Historically, this meant that movements in the pound were among the most risky and expensive, which restrained market interest and liquidity.

For example, option volatilities in the pound tend to run about 10 to 20 percent higher than comparable EUR/USD or USD/JPY volatilities. This is most evident in the pound’s wider spot spreads, as well as its tendency to move in multiple-point jumps — unlike the EUR/USD, which tends to move pip by pip. This suggests traders are better off paying offers or hitting bids to enter the market than waiting for the market to “back and fill.”

Because of the lower liquidity and higher volatility, the pound tends to act as a leader in major U.S. dollar moves, frequently reaching or breaching coincidental technical levels before EUR/USD does. As a result, even traders who are not actively trading the pound still need to monitor its behavior and technical levels for clues about what the EUR/USD rate might do.

For instance, if negative U.S. news sends the dollar lower and the pound and Euro higher, the pound is likely to test identical resistance levels (say, recent daily highs) before the Euro, because the depth of the Euro market will slow its advance.

If the pound breaches those recent highs and follows through, it is a strong signal the Euro will also breach its recent highs and experience follow-through buying. By the same token, if the pound stalls at those recent highs, it is also a likely signal the Euro will fail in its up move.

In a highly directional market, the pound will tend to display extreme one-way behavior, rarely pulling back more than a few pips, while EUR/USD will offer greater corrective opportunities to enter. This suggests traders who are caught on the wrong side of a move need to react more aggressively and not hold out hope for a pullback, while those who are with the move can stay in longer with a trailing stop.

When it comes to technical levels in relatively calm markets, the pound frequently exhibits false breaks, as stop-loss orders placed near technical levels make for tempting targets for market players. It is not uncommon for the pound to trade 15 to 20 points through a technical level, and then reverse after associated stop-buying has run its course. This suggests traders need to anticipate potential false breaks and adjust their position size and order level accordingly.

Following the London close, liquidity in the pound falls

precipitously, creating the risk for unexpected, position-related moves in North American afternoon trading.

USD/CHF (“Swissy”)

The Swiss franc holds a place among the majors because of Switzerland’s unique stature in the global financial marketplace. It is estimated that about one-third of the world’s private assets are domiciled in Switzerland. Given its historical neutrality and legendary privacy laws, Switzerland’s currency is frequently viewed as a safe-haven alternative to the U.S. dollar in times of geo-political uncertainty.

This was especially true during the Cold War, but it has become less of a factor since then (the last conspicuous appearance occurring in the run-up to the Iraq war). The Swiss National Bank (SNB) is one of the more active central banks when it comes to influencing its currency, but this mostly applies to the franc’s level relative to the Euro (EUR/CHF), since the vast majority of Swiss trade is with the Eurozone. Traders should closely follow SNB comments, especially when EUR/CHF is near the extremes of 1.50-1.60, which has been the SNB’s preferred range since early 2003.

The Swiss franc shares many of the same characteristics as the British pound in terms of volatility and liquidity, and also tends to act as a leader in major dollar moves. However, while pound moves often stem from UK-specific news, the Swissy tends to more closely mimic EUR/USD, but with greater volatility. This makes the Swissy ideal to watch as a leading indicator for the larger EUR/USD (Figure 3).

Like the pound, the Swissy will tend to move very fast and exhibit little if any pullback in dollar-driven moves, again favoring traders who are quick on the trigger. False breaks of technical levels are also a common feature of USD/CHF in relatively calm markets; traders should adjust order levels and position sizes in a similar fashion to the pound. EUR/CHF exerts a strong pull on the Swissy and traders need to pay attention to major cross levels as well. Liquidity in USD/CHF is never very good, but it evaporates quickly following the European close, leading to frequent stop-loss driven moves in the North American afternoon.

Bottom line

Major currency pairs frequently exhibit distinct trading behaviors based on market liquidity, time zones and historical market evolution. While no behavioral pattern is 100 percent reliable all the time, certain traits of currency pairs can be identified and relied on to enhance trading results. Traders are more likely to experience better results if they appreciate the different traits of various currency pairs and incorporate them into their tactical trading strategies. 📌

For information on the author see p. 6.

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