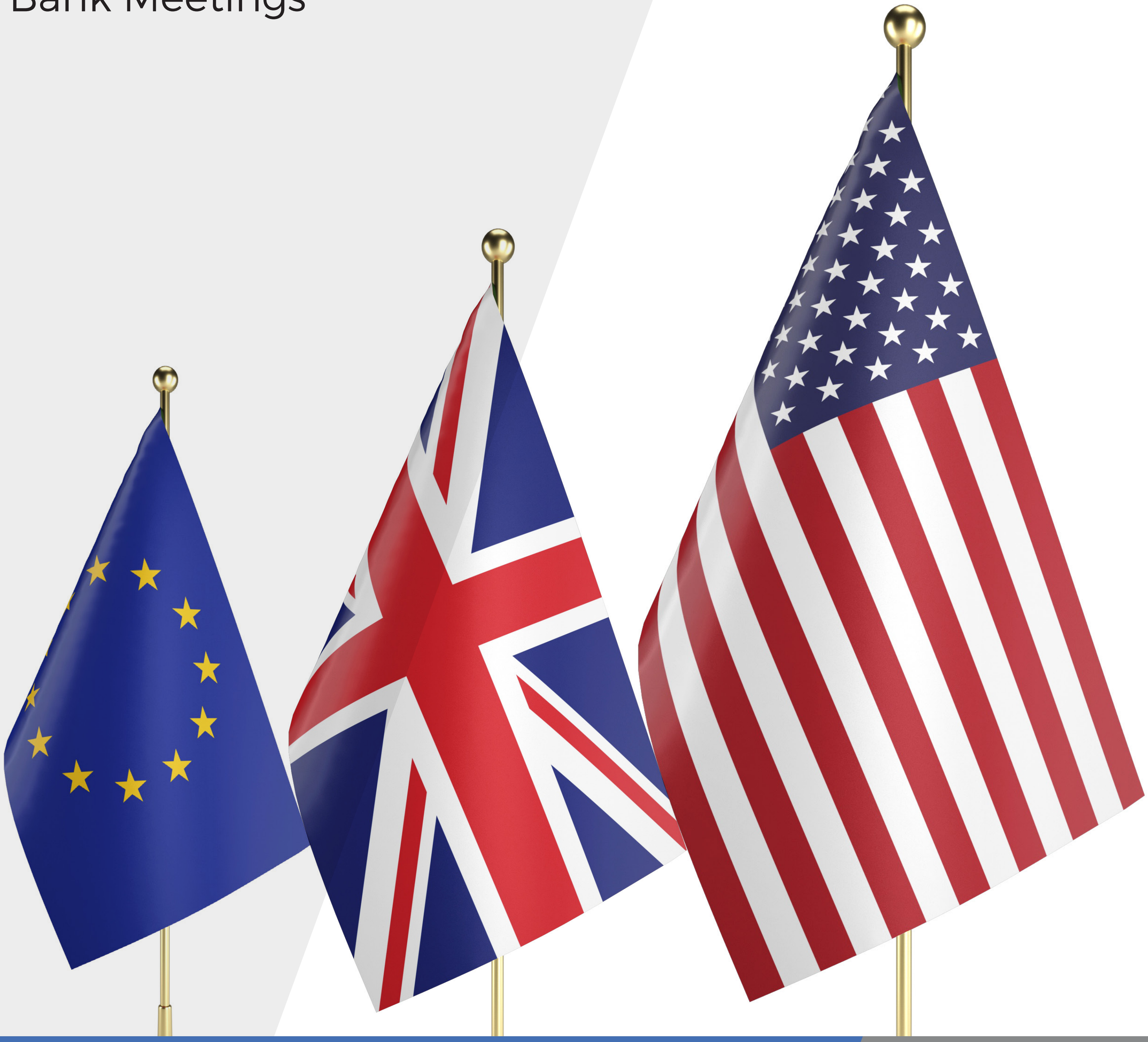
ADSS

Make Or Break

How to Trade Central Bank Meetings



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Introduction

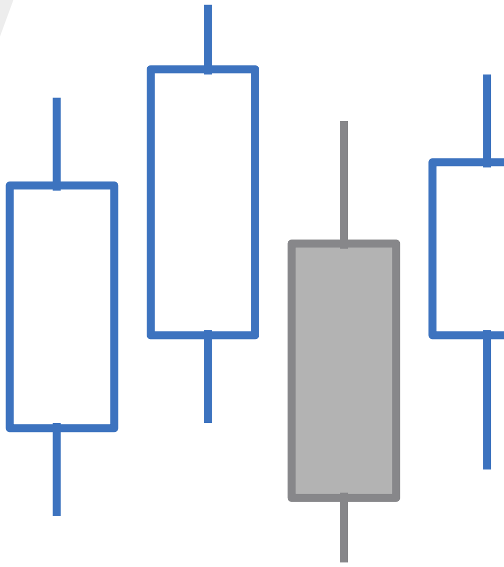
From the world's first Central Bank in Sweden, established in 1668, to the much more recently established European Central Bank in 1998, these regulatory authorities have shaped the global economy over the centuries. Central Banks are the most important market participants for any domestic economy.

Central Banks act as independent national authorities, determining monetary policy, regulating the banking industry and offering financial services to the common public. The main objectives of all Central Banks are:

- To stabilise the domestic currency value
- To keep unemployment levels low
- To control inflation.

In fulfilling these objectives, Central Banks directly impact the financial markets. For the forex market, the biggest factor that influences global foreign exchange rates is the interest rate changes made by the four major Central Banks of the world.

Importance of Interest Rates for Forex Traders



For day traders in the forex market, higher domestic interest rates mean higher interest accrued on currency investments, which, in turn, means a chance of higher profits. There is always a risk of currency rate fluctuation, which can, of course, significantly offset any interest-bearing rewards.

So, global investors tend to put money into economies that can offer better returns. With soaring interest rates, the domestic currency appreciates and global interest in it also widens. Usually, the Central Banks of a major country, such as the US or UK, hikes interest rates for a long duration, resulting in a broad trend against other currencies.

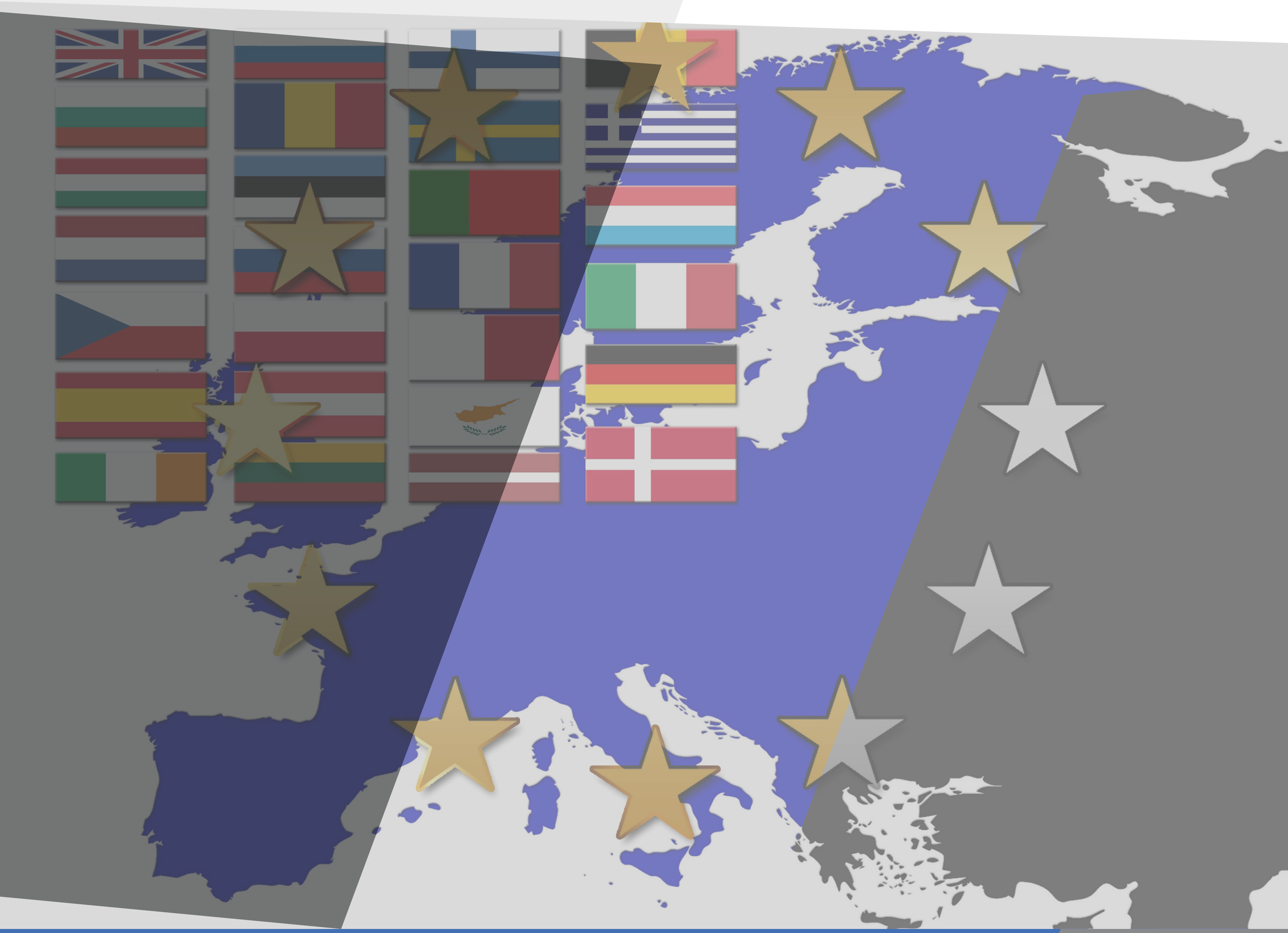
As a result, anything that affects global economies would significantly impact interest rate trades as well. For example, during the 2008 global recession, high-interest currency pairs sometimes moved over 1,000 pips a day, in the wake of global economic uncertainty. Such volatility isn't usually seen in day trading, but when it strikes, it leaves behind devastation and opportunity.

Central Banks	Interest Rate (May 2019)
Reserve Bank of India (RBI)	6.00%
Bank of England (BOE)	0.75%
European Central Bank (ECB)	0.00%
Federal Reserve (FED)	2.50%
Swiss National Bank (SNB)	-0.75%
Reserve Bank of Australia (RBA)	1.50%
Bank of Canada (BOC)	1.75%
Bank of Japan (BOJ)	-0.10%
Central Bank of the Russian Federation (CBR)	7.75%
People's Bank of China (PBOC)	4.35%
Central Bank of Brazil (BCB)	6.50%

Intraday trading strategies are often based on countries with higher interest rates combined but with a depreciating domestic currency. These disparities often signal a change in stance of the domestic Central Bank, usually that the rates might get lowered soon.

Interest rate is one of the major factors that govern the direction of currency price movements. However, as a forex trader, it is always a good idea to focus on the big picture. What does the economic data of the country say? Why is the Central Bank increasing or lowering the interest rate? What about the economic condition of the country against which the high-interest currency is being paired?

It is always a game of relationships, which is why forex traders should keep tabs on Central Bank meetings around the world.



How do Central Banks Decide on Interest Rates?

It is the job of the Board of Directors of each Central Bank to get together and carve out the monetary policy of the country, including the short-term interest rate at which banks can borrow from each other. Central Banks hold vast reserves of currency, as an asset, indicating the viability of a country to pay off foreign debt. The US Dollar, Euro, Pound Sterling and Japanese Yen are some of the most widely held currency reserves by sovereign nations.

During economic stagnation, Central Banks lower interest rates and make large scale asset purchases, so as to inject more money into the economy for banks and other institutions. This is to encourage increased lending or credit, in an attempt to drive economic growth.

When inflationary pressures are on the rise, following a long period of economic growth, Central Banks hike interest rates, so that individuals and businesses find it more difficult to get financing. This works to slow down inflationary growth and stabilise the economy.

So, forex traders can make predictions regarding interest rate decisions with the help of major indicators, such as:

- Consumer Price Index (CPI)
- Employment data
- Housing market data
- Consumer spending
- GDP growth

If these indicators show positive growth, the economy is performing well, so interest rates may be hiked or maintained. A significant drop in numbers is likely to lead to lower rates to encourage lending.

Tips

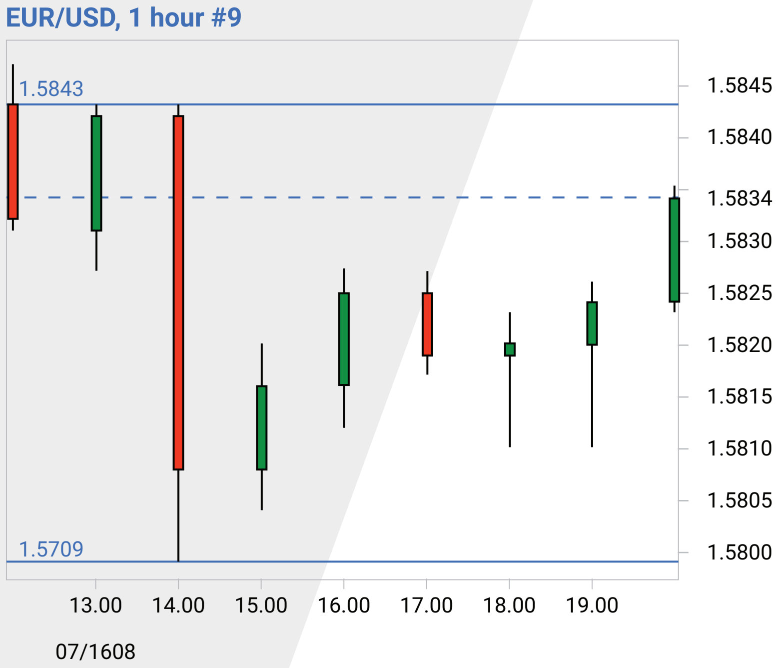
It is important to keep track of upcoming economic releases and announcements by Central Banks. Whatever trading strategies you follow, a good economic calendar can always help.

Central Bank Announcements

We often see market volatility around the speeches or announcements of the board of directors of any of the four major Central Banks. This is because they shed light on the inflation levels of their respective countries and the overall economic mood.

In July 2008, US Federal Reserve Chairman Ben Bernanke announced his semi-annual monetary policy before the House Committee, in which he surprisingly and strongly condemned fears of recession, while maintaining that the US Dollar was in a good place.

What followed was a short-term rally of the US Dollar, in anticipation of a future hike in interest rates. The EUR/USD declined 44 points over the course of an hour, a boon for US Dollar traders who were quick to identify the opportunity.



Tips

Act Quickly!
Forex prices can move at lightning speed when announcements hit the market. Traders rush to buy or sell ahead of the crowd and fast action could lead to better trading success.

Major Global Central Banks to Follow

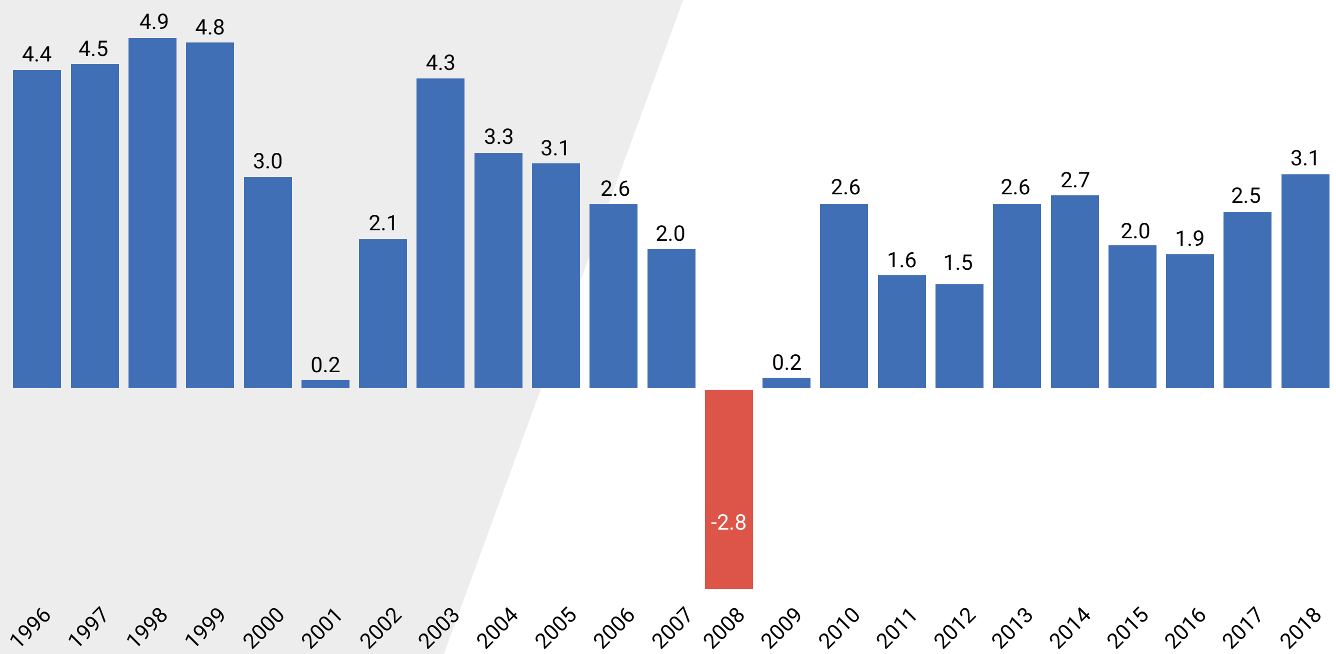
US Federal Reserve (The Fed) – An Increasingly Dovish Stance

The US Dollar is the world's reserve currency, being part of more than 87% of the forex transactions across the world. This makes the US Federal Reserve (Fed) the most influential Central Bank for the global economy. Its decisions regarding interest rates significantly impact other global currencies.

It is the Federal Open Market Committee (FOMC) that makes interest rate decisions. Naturally, FOMC meetings, which take place about eight times a year, are one of the most followed events by forex traders around the globe.

The US economy saw its fastest rate of expansion in 13 years in 2018, while unemployment rates fell to a 49-year low in May 2019. Inflation levels remained at, or above, the 2% target on all vital measures. The Fed funds target range in 2018 was set at 2.25%-2.50%.

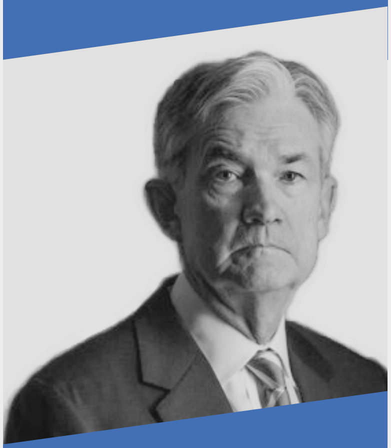
US Annual GDP Growth
Percent Change YoY



This growth trend continued into 2019. In the Fed meeting report released on May 1, 2019, the Central Bank announced that it would maintain the 2018 benchmark interest rate.

Investor Expectations: This was the third FOMC meeting held in 2019, and investors were not expecting any interest rate change, given the recent economic data, which showed low inflation, 3.2% increase in GDP in the first quarter and tightening financial conditions globally. This signalled a pause in interest rate hikes for some time.

Aftermath: Immediately after the press release, the US Dollar slid lower while the Dow Jones surged. However, these gains were quickly erased in response to follow-up commentary by the Fed Chairman, Jerome Powell, who hinted at low inflation levels being in a transitory phase, which could lead to a hike in interest rates in the future.



Jerome Powell
Chair of the Federal Reserve

> If we did see inflation running persistently below [the goal], that is something the committee would be concerned about, something we would take into account when setting policy.

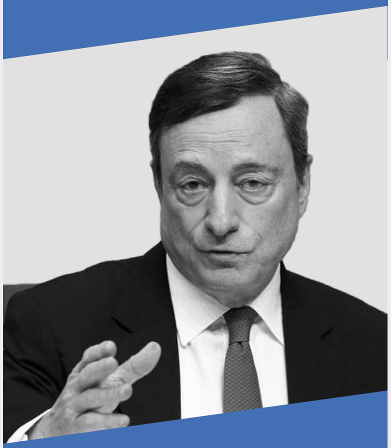
After his comments, treasury yields fell, the US Dollar strengthened and stocks sold off at a faster rate.

- EUR/USD went down some 60 pips, while GBP/USD went up by 50 pips.
- Dow Jones Industrial Average closed down 163 points
- NASDAQ Composite declined 0.6%

European Central Bank (ECB) – Inflation and Recession Fears

Established with the advent of the Eurosystem in 1998, the role of the ECB is to maintain price stability in all member states of the Eurozone. The body primarily responsible for interest rates is known as the Governing Council and is made up of 6 members of the ECB board, along with the Central Bank governors of all the individual nations in the Eurozone. ECB meetings take place every 6 weeks, although it makes policy decisions only in 10 of these meetings each year.

Investor Expectations: Monetary policy normalisation has been a focus of the ECB since late 2018. Mario Draghi, the President of the ECB at that time, confirmed in September 2018, that the Central Bank would cut bond-buying in half and halt the purchase of new assets over the course of the next few months. The bank asked the Italian government to re-submit its budget plans, as the proposed plan was against the block's fiscal laws. A likely budget deficit in Italy would push the Eurozone towards recession, against the backdrop of a protracted slowdown.



Mario Draghi
Pres.- Europäische Zentralbank

> It is pointless to bet against the Euro. It is pointless to go short on the Euro... It is pointless because the Euro will stay and it is irreversible.

Aftermath: The tone of the March 2019 meeting was more dovish than expected. Expectations that the ECB would delay interest rate hikes until the next year and the introduction of a new Targeted Longer-Term Refinancing Operation for banks led to huge pressure on the Euro, which fell against a surging US Dollar in the week leading up to the ECB meetings in March 2019. The Euro dipped 0.2% to $1.1318. Also, the Canadian Dollar (CAD) and Australian Dollar (AUD) declined to their lowest in five weeks at that time. Investors in these countries had expected easing in monetary policies too, on account of the ongoing global recession.

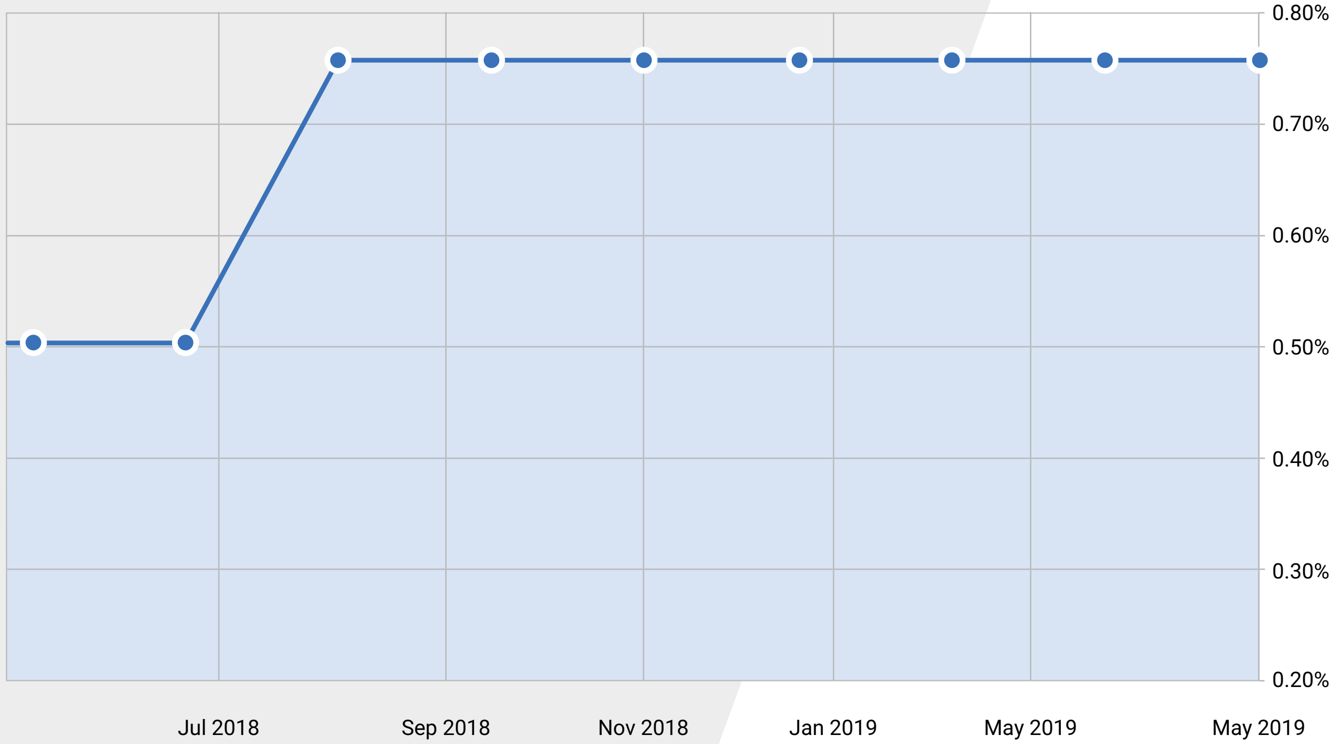
Euro/Dollar Heads Sideways

A dovish stance by a major Central Bank like the ECB generally leads to a a decline in the value of the currency. Volatility is crucial for short-term traders, since it offers greater opportunities to trade and win. The ECB's dovish stance led to the world's most traded currency pair, the EUR/USD, being stuck in the narrowest quarterly trading range since its inception. In fact, the Deutsche Bank's Currency Volatility Index dropped to 6.73, one of the lowest since January 2018.

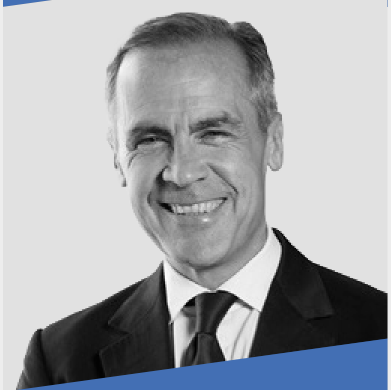
Bank of England (BOE) – Tackling the Brexit Crisis

The structure of modern Central Banks is based on the Bank of England (BOE). Set up in the 17th century to finance the country's war efforts against France, the BOE has been key to maintaining the financial stability of the country in the midst of the Brexit crisis. Interest rates are decided by the Monetary Policy Committee (MPC), which is comprised of 9 members. The Committee meets every 6 weeks and releases the minutes of its meeting on a Thursday. The MPC meeting is an important date on the UK economic data calendar for a trader. However, the press conference is not held if there is no change in interest rates.

Investor Expectations: Even after a six-month delay was granted for Brexit, investors and traders didn't expect any hike in interest rates in the May 2019 meeting, not until the UK left the EU with a proper deal. This expectation was unanimous, despite stronger than expected wage growth, retail sales, job creation and overall economic growth in early 2019. In a poll conducted by Reuters, 75 economists maintained that bank rates would not increase beyond the existing 0.75% till a Brexit solution was reached.



In fact, traders and investors remained unconvinced even after BOE Governor Mark Carney hinted at future interest rate hikes.



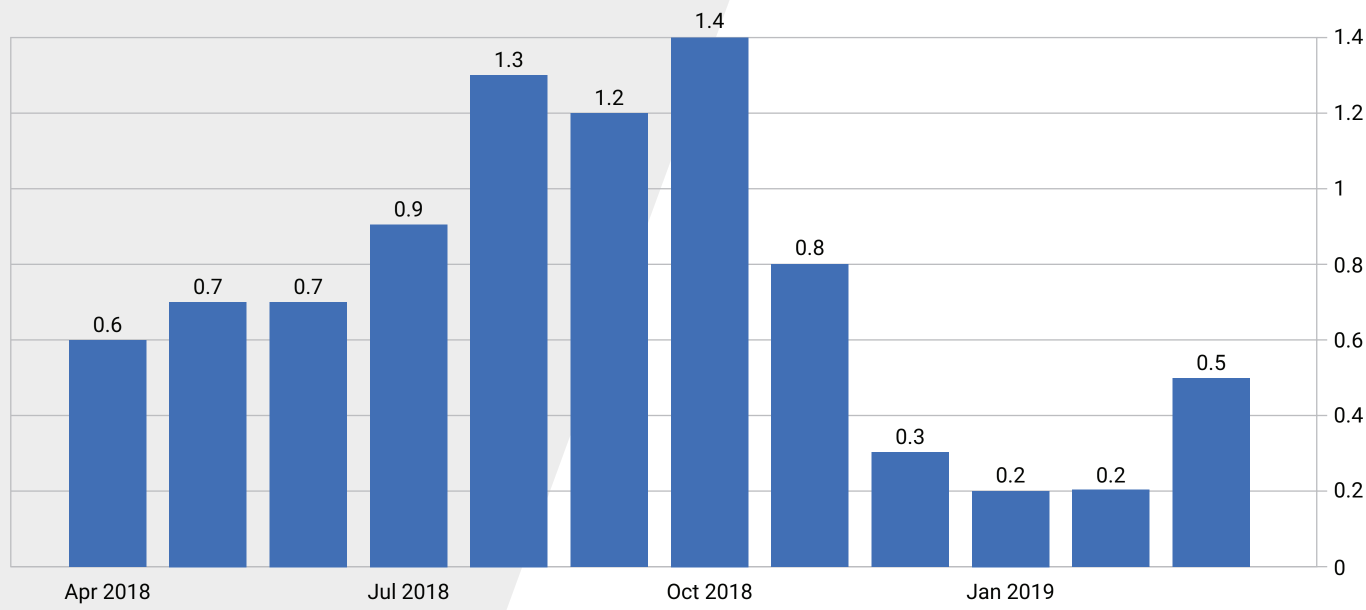
Mark Carney
Governor - The Bank of England

> If the economy performs as we expect, we think upward pressure on prices will build over the next few years and we will need to raise interest rates a bit more to keep inflation at target… Interest rates are likely to remain substantially lower than before the financial crisis.

Aftermath: Despite this hawkish tone by the BOE Governor, the GBP/USD rates declined after a two-week high. After the BOE decision, Pound Sterling initially rose, before declining to a day's low of $1.3019, down 0.2% on that day. However, the moves were much smaller than expected, perhaps due to hopes of a breakthrough in the Brexit talks.

Bank of Japan (BOJ) - A Stress on QE Easing

The Monetary Policy Committee of the BOJ comprises the Governor, two deputy governors and six other members. Since the economy is highly export driven, the country's Central Bank aims to keep the Japanese Yen at relatively weak levels. The bank has been known for its quantitative easing programmes, in which it buys government bonds to provide growth stimulus to the economy and to trigger inflation. However, the country has struggled with CPI data since the second decade of the 21st century.



Investor Expectations: A surge in volatility in Japanese Yen pairs was seen before the BOJ's interest rate decision in April 2019. However, investors did not expect much change from the March 2019 meeting, since the Central Bank had already forecasted a reduction in its bond purchase programme by ¥20 billion.

The USD/JPY formed tight trading ranges, as a result of a reduction in forex volatility around the world. Expectations for the pair were between 111.45 and 112.11, with a 68% statistical probability.

Aftermath: Interest rates were kept low in the meeting and key monetary stimulus settings also remained unchanged. The USD/JPY pair surged to 111.90.

What We Can Learn from All This

It can be clearly seen that investor sentiment, following Central Bank releases, can drive market volatility. The tone of the accompanying statement can especially cause bullish or bearish fluctuations in the market. The actual rate decision is relevant only within the context of market expectations. Hence, a rate increase might not always result in appreciation in currency value. Similarly, rate decreases do not necessarily translate into currency depreciation. Rather, a decision to keep policies on hold can cause larger market moves, based on expectation levels.

Also to be noted is the initial reaction vs. sustained market volatility. Positioning adjustment in response to data releases can result in an immediate spike in currency rates, which is often different from sustained fundamental effects on the entire market.

Thirdly, trader sentiment is often driven by reassurances (or lack thereof) from the governors and Chairpersons of the Central Banks. A clear contradiction in this case is the UK, which has one of the most stubborn trader sentiments in modern times. But, the United Kingdom is not alone in this. After the 2008 recession, investors around the world have much less confidence in the ability of Central Banks to control inflation rates.

Final Tips

It is clear that forex traders need access to an economic calendar and other forex news sources to stay in touch with upcoming ECB or Fed meeting dates. The impact of these news releases is felt across the global financial markets. Central Bank decisions are complex but could offer key trading opportunities, if understood properly.

Risk Warning:

CFDs are complex instruments and come with a high risk of losing money rapidly due to leverage. 73% of retail investor accounts lose money when trading CFDs with this partner. You should consider whether you understand how CFDs work and whether you can afford to take the high risk of losing your money.

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