TopstepFX's

# GUIDE TO THE FOREX MARKETS


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# TABLE OF **CONTENTS**

# 2017 IN REVIEW: **WHAT HAPPENED TO KING DOLLAR?**

Everyone thought 2017 was going to be the year of King Dollar. Following President Donald Trump's election on November 8, 2016, the U.S. Dollar (USD) rallied more than 4.5% against the Euro (EUR) — gaining from 1.1018 to close 2016 at 1.0521.

But that U.S. Dollar rally quickly fizzled. EUR/USD reached its low (1.0340) on January 3. Through the rest of the year, the Dollar lost 16%, closing at 1.2018 on December 29.

What happened? Not only did the Dollar abruptly turn in its tracks, but that turn came despite the fact that the Federal Reserve remained the only central bank taking a prolonged tightening stance throughout the year.

The Dollar's performance in 2017 is a head scratcher. According to long-time forex and currency futures trading legend Yra Harris: "No one has a definitive answer as to the fundamental reason why the U.S. Dollar fell." Harris said many have speculated on different reasons for the move, which include the Trump administration's preference for a weaker Dollar and the possibility that China might offer an alternative to paying for Crude Oil in Dollars.

"There are a lot of things in play that aren't making sense. Traditional correlations aren't playing out," Harris added, pointing to the spread between European and U.S. sovereign debt. A spread favoring U.S. investments would usually be supportive of the Dollar, but that's not happening. "While I'm not sure what the driving element is, there is something driving the U.S. Dollar lower at this point."

Wall Street has seemingly taken on one narrative: the Federal Reserve's tightening was already priced in and European growth surprised to the upside. Quartz[1] labeled the Eurozone's growth "the economic surprise of 2017," noting that its 2.2% GDP growth in 2017 was Europe's best year in a decade.

Contrast that with the narrative on January 1, 2017. Brexit was less than six months old, and there was concern populism could sweep elections in France and other European countries. Ultimately, the market's worst fears did not materialize.

But even if the European growth narrative explains the Euro's outperformance, why did the U.S. Dollar lose ground against every other major currency, from the Swiss Franc (CHF) and Japanese Yen (JPY) to the Australian (AUD) and New Zealand Dollars (NZD)?

And if the reason behind the move was so clear, why did macro hedge funds drastically underperform? According to the Barclay BTOP index, currency futures funds fell 9% in 2017.[2]

Those questions take us back to Harris' sage wisdom: "Something is going on, but I can't tell you what just yet."

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1 "The Economic Surprise of 2017 was Europe's Best Year in a Decade," Eshe Nelson, Quartz, December 25, 2017, https://qz.com/1163174/the-economic-surprise-of-2017-was-europes-best-year-in-a-decade/.

2 "2017: A Year Currency Investors Might Want to Put Behind Them," Katie Martin, Financial Times, December 27, 2017, https://www.ft.com/content/bdd83b0a-eb18-11e7-8713-513b1d7ca85a.

# MAJOR DRIVERS OF **MARKETS IN 2018**

After hitting a three-year low early in 2018, the U.S. Dollar seemingly found a base and started to rally. At the start of the year, we identified three themes that would drive prices, and it seems like they continue to play out. They are economic growth, global central bank policies and global geopolitical uncertainty.

## Economic Growth

Things are going[3] well in the global economy 10 years after the Great Recession. The Federal Reserve expects the U.S. economy will grow at 2.1% in 2018[1], down slightly from growth of 2.4% in 2017.

+ ECONOMIC GROWTH IS CRITICAL BECAUSE BOOSTING GROWTH ALSO PUSHES INFLATION HIGHER – AND HIGHER INFLATION MEANS THAT CENTRAL BANKS WILL RAISE INTEREST RATES, WHICH IS GENERALLY SUPPORTIVE OF A CURRENCY.

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3 "Economic Projections - Board of Governors. of the Federal Reserve System," Federal Reserve, September 20, 2017, https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20170920.pdf.

The International Monetary Fund (IMF) is a little more optimistic[4] on the world's largest economy. The IMF's October World Economic Outlook projected the U.S. economy would expand by 2.3% in 2018.[2] The recently passed tax cuts could add as much as 0.2% to that growth rate, bringing real GDP growth to 2.5%, the estimates suggest.

This growth will eclipse many other advanced economies, including Canada (2.1%), the European Union (2.1%), the United Kingdom (1.5%), and Japan (0.7%).

> "CENTRAL BANKS HAVE BROKEN THE MARKET. IT CAN STAY BROKEN FOR A WHILE, BUT TRADITIONAL RELATIONSHIPS AND FUNDAMENTALS WILL EVENTUALLY TAKE HOLD."
>
> Yra Harris, forex and currency futures trader

## Global Central Bank Policies

Central banks still have the largest impact on a currency by determining where interest rates will be. Speaking extremely generally, money will flow to those economies that offer high relative rates of return, bypassing low-

4 "World Economic Outlook, October 2017," International Monetary Fund, September 20, 2017, https://www.imf.org/en/Publications/WEO/Issues/2017/09/19/world-economic-outlook-october-2017.

yielding currencies.

In 2017, just three of the world's leading central banks raised interest rates: the Federal Reserve (three times), the Bank of Canada (twice), and the Bank of England (once). The Bank of Canada and Bank of England's last interest rate hikes in September and November, respectively, were accompanied by highs in their currencies relative to the U.S. Dollar. That's because the market took them as "dovish hikes," or hikes that would be followed by a prolonged period of equilibrium.

In fact, when the Bank of Canada met in October, it said the strength of the Canadian Dollar would slow the pace of inflation, providing it an opportunity to be more "cautious" with additional rate hikes.

Conversely, the European Central Bank (ECB) hasn't hiked interest rates a single time. And they're being very slow to remove accommodation from the market. But that hasn't caused any reluctance to buy Euros - yet.

Moving into 2018, it will be this discrepancy that drives markets. Be careful to monitor what markets have already "priced in" relative to what news is released. If it looks like any central bank is not tightening policy as fast as anticipated, the currency will likely suffer.

## Global Geopolitical Uncertainty

A recent theme in global markets, including foreign exchange, has been the lack of volatility, particularly during periods that would seemingly inspire volatility. Last year was the first in three without a currency flash crash. That's a good thing. But events that should have produced volatility - and therefore presented opportunities for traders - didn't materialize.

Whether that trend continues in 2018 is unclear. The German government is still in limbo. On January 7, Chancellor Angela Merkel's conservative Christian Democratic Union of Germany and the Social Democrats started talks in an attempt to bring back the "grand coalition" and maintain the

IN OCTOBER 2016, THE BRITISH POUND DROPPED 9% IN ABOUT 40 SECONDS.

IN JANUARY 2015, THE SWISS NATIONAL BANK (SNB) ENDED ITS PEG AGAINST THE EURO – CAUSING THE SWISS FRANC TO APPRECIATE MORE THAN 20% IN MINUTES.

status quo that has been in place for the past four years.

But it's not all good news, even if the talks play out. This is the longest period of fragmentation for modern, post-war Germany. And it comes at a time when political uncertainty and rising populism have gripped the world.

This is also the case for Italy, which will hold elections on March 4. The populist Five Star Movement and Lega Nord have ascended in the polls at the cost of the ruling Democratic Party.

Then there's Brexit. The fallout in 2017 was not as bad as expected, helping the British Pound gain 11% on the year. The low of the year was set by Prime

Minister Theresa May in a January 17 speech that stoked concerns of a "hard Brexit." Traders sold Sterling below 1.20 at the height of the panic.

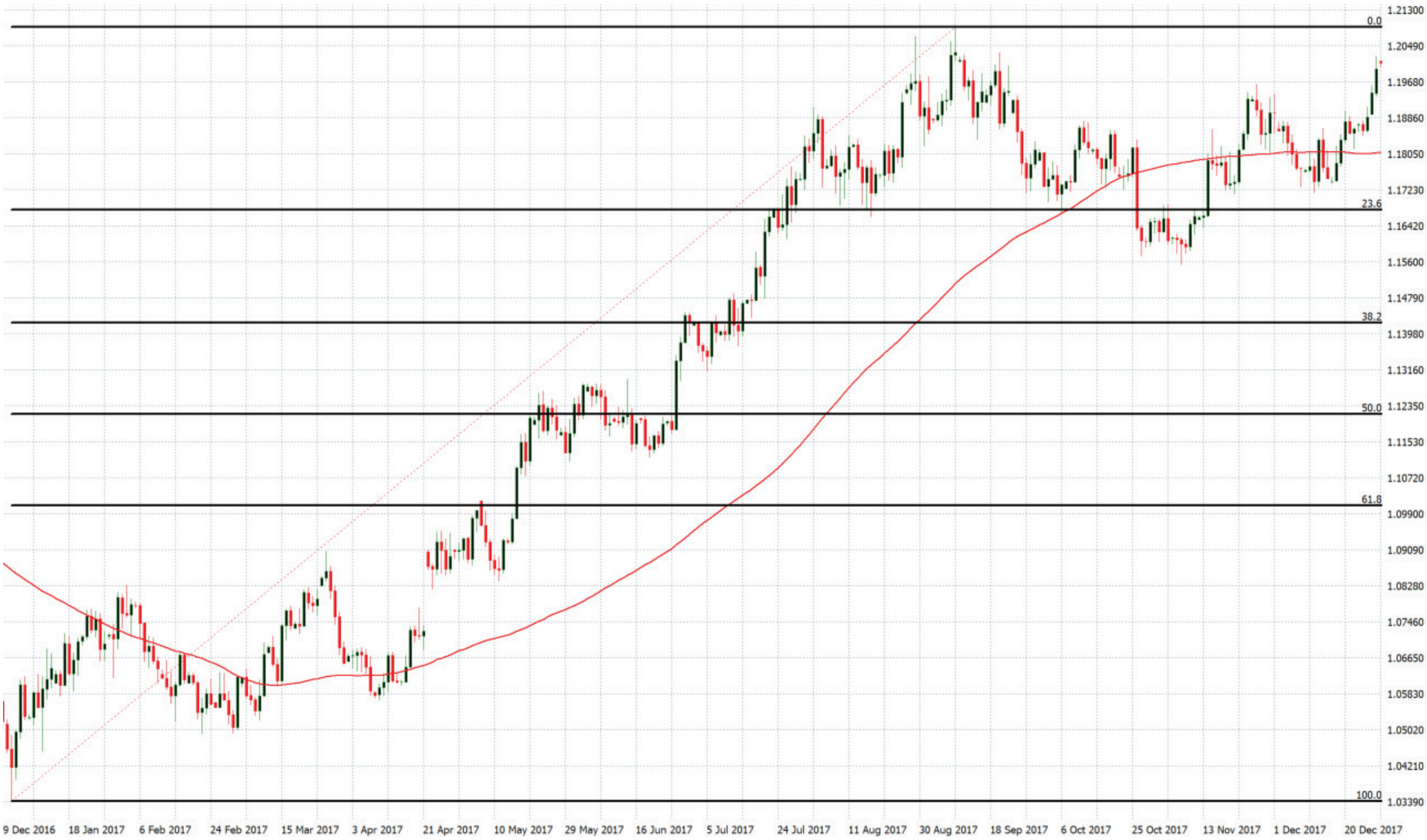
The Market's worst fears never materialized. In December, the U.K. and European Union reached an agreement in principle on the U.K.'s withdrawal. In March 2018, the EU is expected to agree upon guidelines, setting up Chief Negotiator Michel Barnier's self-imposed October 2018 deadline.

Just because the broad strokes have been agreed upon doesn't mean it will be smooth sailing from here forward. There are likely to be a lot of speed bumps as the EU and U.K. work out their divorce. However, as of writing, the worst fears that sent Sterling below 1.20 appear to be behind us now. Whether they re-emerge is to be seen.

# MAJOR PAIR **ANALYSIS**

## EUR/USD, GBP/USD, USD/JPY

# EUR/USD




A 2017 EUR/USD chart as seen on TopstepFX MetaTrader 4. It includes a 100-day moving average (red line) and a Fibonacci retracement drawn from the January 3 low to the September 8 high.

In 2017, EUR/USD was in a strong, seemingly unstoppable uptrend. What made the move so impressive was that it was somewhat unexpected. The U.S. Dollar came into the year on a strong note. But things can change quickly. They did in 2017.

As the prior chart shows, the first major breakout in EUR/USD came mid-April on the weekend of the

French presidential elections (April 23) when it became clear that Emmanuel Macron would defeat Marine Le Pen. The market feared Le Pen would ride in on a global wave of populism and might pull an upset – potentially leading the French to exit the EU. That did not happen, and the EUR/USD surged.

That spike was followed by a series of economic data points that showed strong European growth, ultimately leading to inflation concerns. In October, the ECB announced it would halve its monthly asset purchases from €60 billion to €30 billion. Though that initially caused EUR/USD weakness, the currency found support below the 1.16 handle.

Europe's strong data held up through year end, capped by German inflation figures on December 29. That data showed inflation at its highest level in more than five years, prompting the head of the ECB's bond purchase program, Benoit Coeure, to speculate that the ECB's stimulus program would not be extended past September 2018.

Mounting expectations for tighter monetary conditions gave further lift to the Euro, helping it make a late-year run above 1.20.

Now, in mid-2018, it's hard not to look back at that 2017 reversal of fortune and ponder whether 2018 will spur a similar move — only this time in the Dollar's favor. Since EUR/USD reached a high in mid-April, the pair fell $0.08. Whether that's because the interest rate differential between Europe and the U.S. is starting to take hold or because of rising populism that is casting doubt on the future of the EU remains to be seen.

Further, if it looks like the ECB won't withdrawal its stimulus as quickly as anticipated, the Euro's gains could reverse in their tracks. If it looks like the Federal Reserve will accelerate its interest rate hikes, that would be bullish for the U.S. Dollar.

## EUR/USD 2017 STATS

| 1.0340 | 1.2091 | 1.1800 | 1.1640 |
|---|---|---|---|
| Yearly low January 3 | Yearly high September 8 | 100-day moving average | 200-day moving average |

## TOP RISK FACTORS

1. Political uncertainty, including negotiations for a coalition government in Germany, upcoming elections in Italy, and ongoing Brexit negotiations
2. Congressional elections in the U.S. and continued uncertainty around U.S. President Donald Trump
3. European leaders' desire to weaken the Euro, particularly with respect to the Japanese Yen (EUR/JPY)

## CENTRAL BANK COMPARISON

**ECB** - Started tapering its bond buying program, slowly withdrawing stimulus

**FOMC** - Expected to hike interest rates three times in 2018, matching three hikes in 2017

## IMPORTANT DATES

**Starting January 7** (ongoing): German government negotiations

**January 25**
First ECB meeting under new bond buying program

**March**
European Union expected to agree to Brexit guidelines

**March 4**
Italian elections

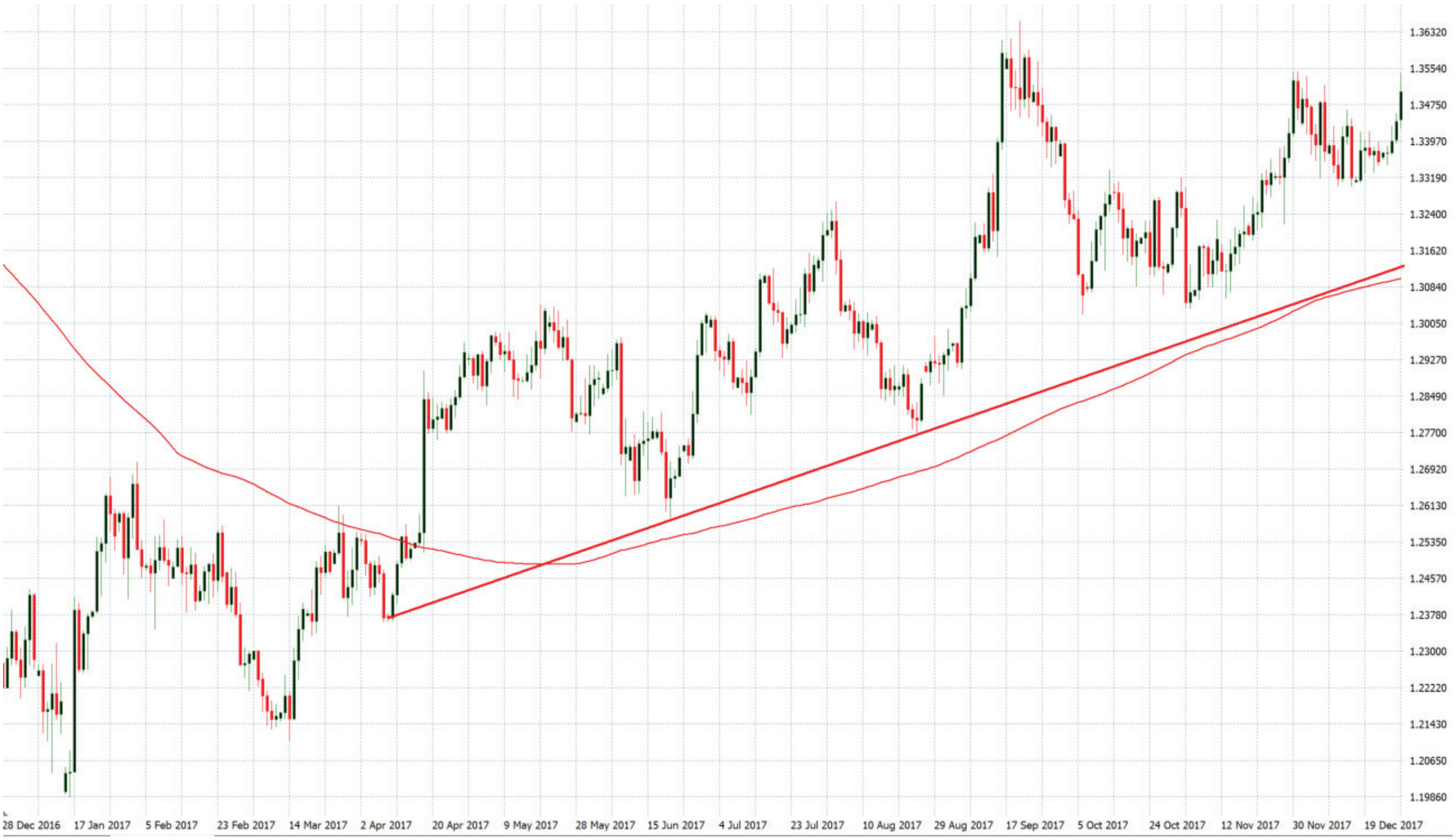
**March 21**
First FOMC meeting under new chair Jerome Powell; includes economic projections

**September**
Planned end of ECB bond buying program

**October**
EU Brexit negotiator Michel Barnier's self-imposed deadline on terms

**November 6**
U.S. Congressional elections

# GBP/USD




A 2017 GBP/USD chart as seen on TopstepFX MetaTrader 4. It includes a 200-day moving average (red line) and a upward sloping trend line connecting lows from April, June, and August.

The theme heading into 2017 was one of worry. Many in the market were worried there was going to be something to be worried about, expecting factors outside of typical “norms” would dominate the global economy. Brexit was one of the first “shocks.” Then President Donald Trump’s election in November 2016 magnified these concerns.

While equity markets took Brexit in stride, the Pound fell sharply. On June 23-24, 2016, Sterling fell from above 1.50 in the hours leading up to the vote results to settle at 1.35 at the end of the week – a 10% decline. By year end 2016, the Pound fell another 10% to close at 1.2343.

But that was the outlook on January 1, 2017. The view changed. The worry subsided. That's not to say that Brexit isn't a critical risk factor. In fact, it's still the risk factor. But the paranoia is gone, replaced by optimism that a mutually beneficial solution will be reached.

Whether those expectations become reality remains to be seen. Important deadlines come in March and October, but expect news to trickle out at any point during negotiations. Each headline can accompany a move. The more sensational or surprising the headline, the larger the move.

Even though this is good trading advice regardless of the currency pair, we recommend not holding Sterling positions over the weekend and always having stops when you are not closely watching the market.

## GBP/USD 2017 STATS

| | | | |
|---|---|---|---|
| **1.1987** | **1.3655** | **1.3286** | **1.3102** |
| Yearly low<br>January 16 | Yearly high<br>September 20 | 100-day<br>moving average | 200-day<br>moving average |

## TOP RISK FACTORS

1. Potential elections as Brexit divisions spur continued infighting in Prime Minister Theresa May's government
2. Ongoing Brexit negotiations and the final agreement, expected around October 2018
3. Congressional elections in the U.S. and continued uncertainty around U.S. President Donald Trump
4. Slower growth in the U.K., expected at 1.5%. Comparatively, growth in the U.S. is expected at more than 2.3%

## CENTRAL BANK COMPARISON

**BOE** - Expect "gradual" and "limited" interest rate increases over the next three years, with potentially two rate hikes this year

**FOMC** - Expect three interest rate hikes in 2018, matching three three hikes in 2017

## IMPORTANT DATES

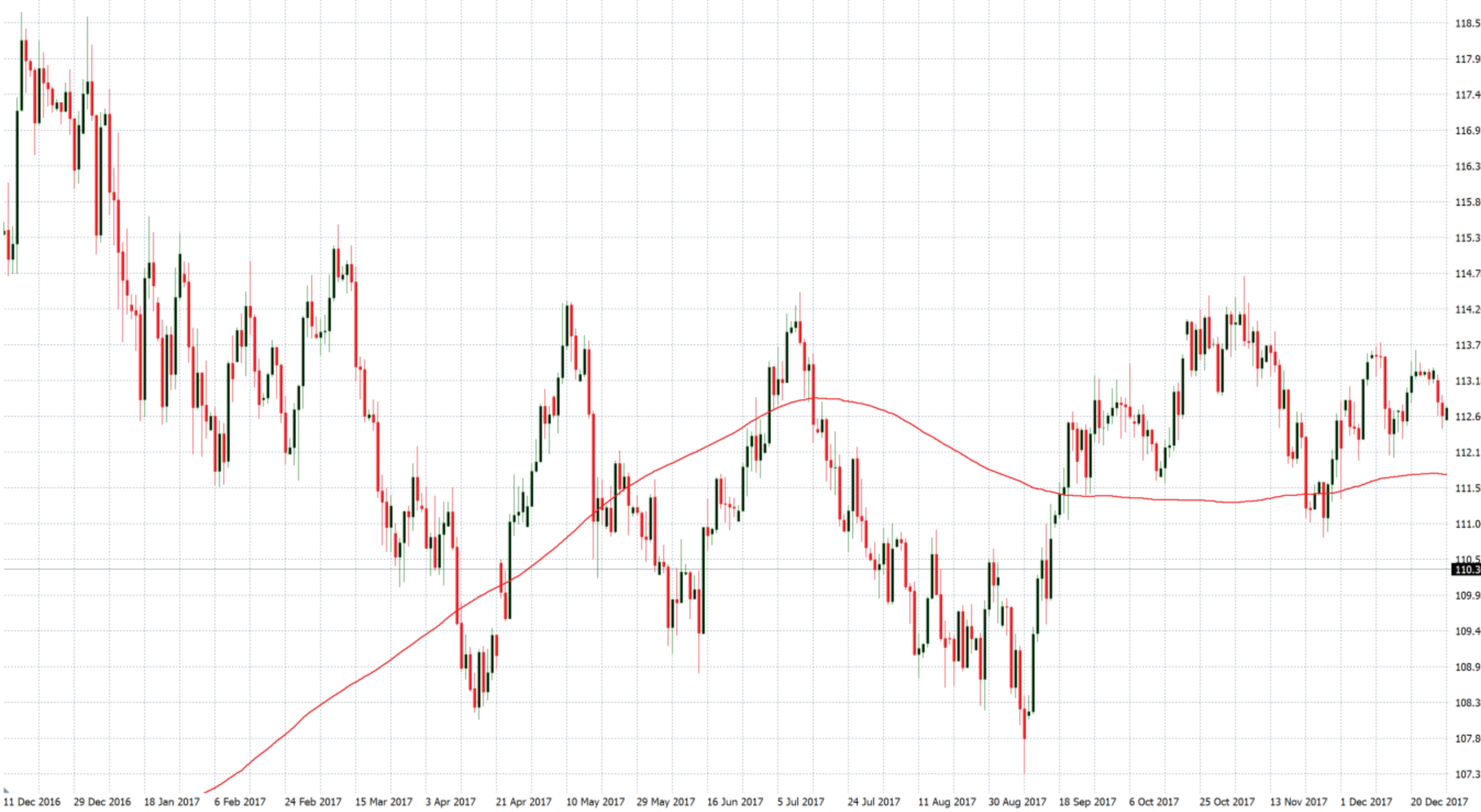
**March:** European Union expected to agree to Brexit guidelines

**March 21:** First FOMC meeting under new chair Jerome Powell; includes economic projections.

**October:** EU Brexit negotiator Michel Barnier's self-imposed deadline on terms

**November 6:** U.S. Congressional elections

# USD/JPY




A 2017 USD/JPY chart as seen on TopstepFX MetaTrader 4. It includes a 200-day moving average (red line).

Despite the U.S. Dollar's 2017 woes, the Japanese Yen struggled to perform better. In fact, for much of the year, USD/JPY bounced in a range between 114.50 and 108. That range narrowed during the final three months of 2017 when the pair traded between 111 and 114.

That suggests the price is just consolidating before the next directional move. Will it go up to 120 or down towards 100?

The answer appears to hinge on two considerations: the Bank of Japan's (BOJ) extreme monetary easing and the global community's willingness to support a weak Yen.

Despite a global growth resurgence, the Japanese economy is not roaring. While growth in 2017 was healthy and unemployment fell to a 20-year low, inflation is anemic, registering well below 1% on a recurring basis. And this is despite the massive stimulus, dubbed "Abenomics," the Japanese government implemented in 2012.

For all their effort, the Japanese government and central bank have not been able to break the back of deflation. Currency futures and forex trader Yra Harris said that at this point, "The Japanese are playing a very dangerous game," especially considering they don't have an exit strategy for the massive amount of stimulus they've injected into the economy.

As part of Abenomics, the BOJ has been the most accommodative central bank in the world. Assets owned by the BOJ account for more than 90% of Japan's GDP. For comparison, the Federal Reserve owns assets that amount to just 25% of U.S. GDP.

In addition to holding huge amounts of assets, the BOJ is also one of few central banks in the world that have taken interest rates to negative levels. These have been in place since January 2016.

But there is an emerging concern that low rates are having a profound negative effect on the Japanese banking sector and may actually decrease lending. While the BOJ may be able to hold steady again in 2018, the market will start clamoring for an exit strategy. And if the BOJ gives in, it is hard to imagine the Yen not appreciating.

## USD/JPY 2017 STATS

**107.32**
Yearly low
September 8

**118.60**
Yearly high
January 2

**112.44**
100-day
moving average

**111.79**
200-day
moving average

## TOP RISK FACTORS

1. Japanese inflation and the potential for the country to slip back into deflation despite extreme levels of accommodation

2. Congressional elections in the U.S. and continued uncertainty around U.S. President Donald Trump

3. Weakness in the Japanese Yen compared with major trading partners, like China, and competitors, like Germany

## CENTRAL BANK COMPARISON

**BOJ** - Extreme accommodation with no plans to exit; plagued by constant fears of deflation

**FOMC** - Expected to hike interest rates three times in 2018, matching three hikes in 2017

## IMPORTANT DATES

**January 23:** Bank of Japan's Q1 Outlook for Economic Activity and Prices

**March 21:** First FOMC meeting under new chair Jerome Powell; includes economic projections.

**April 27:** Bank of Japan's Q2 Outlook for Economic Activity and Prices

**July 31:** Bank of Japan's Q3 Outlook for Economic Activity and Prices

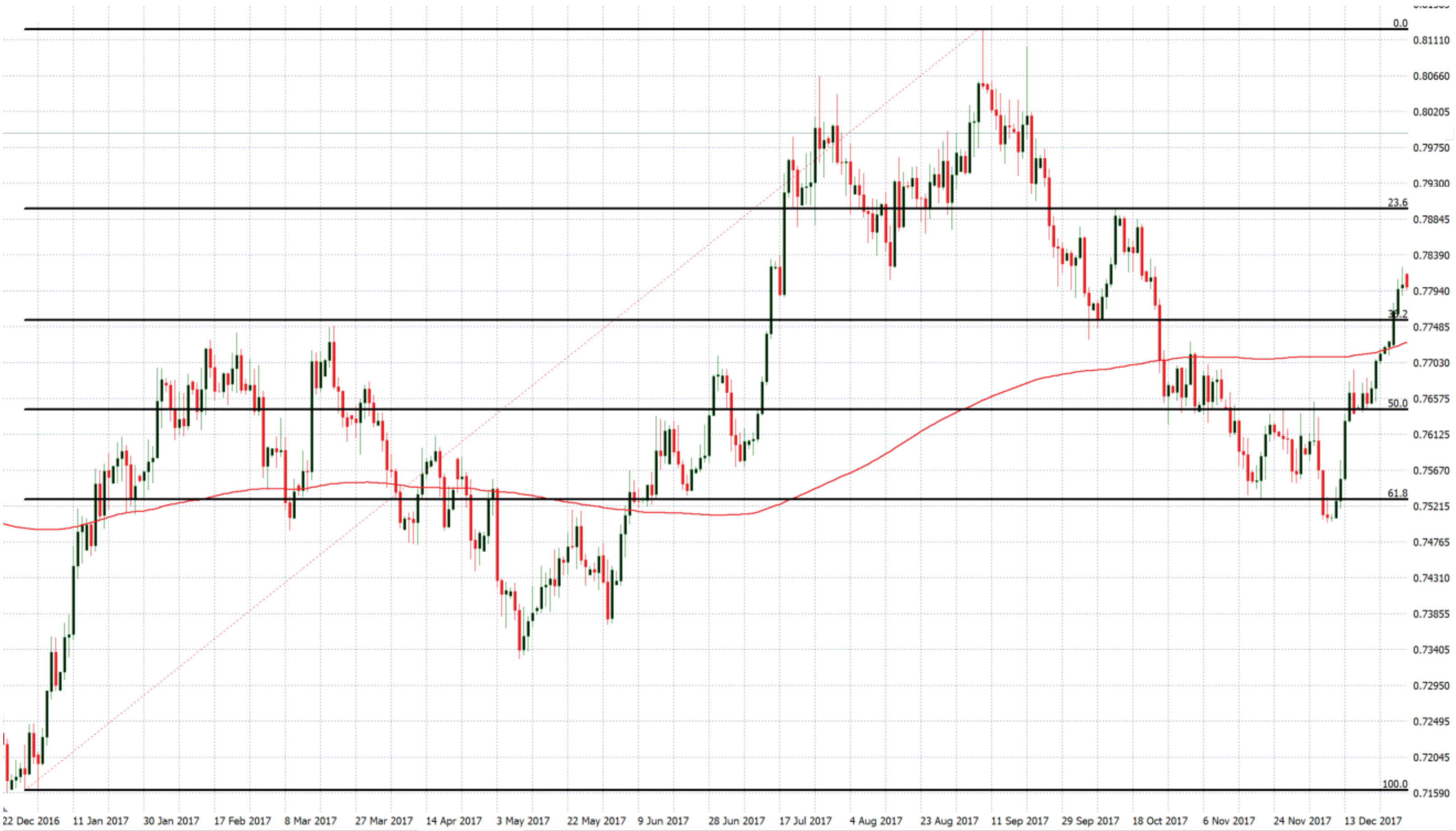
**October 31:** Bank of Japan's Q4 Outlook for Economic Activity and Prices

**November 6:** U.S. Congressional elections

# COMMODITY **CURRENCIES**

## AUD/USD, NZD/USD, USD/CAD

# AUD/USD




A 2017 AUD/USD chart as seen on TopstepFX MetaTrader 4. It includes a 200-day moving average (red line) and a Fibonacci retracement drawn from the January 2 low to the September 8 high.

Into the closing days of 2017, the Australian Dollar broke above its 200-day moving average — a bullish signal for future price. Strong November 2017 employment figures spurred that move higher as the Australian economy added 61,000 jobs (compared with estimates of 19,000). However in 2018, expectations that interest rate hikes were on the horizon have not come to fruition. That has AUD/USD stalling in the $0.74 to $0.76 range.

## AUD/USD 2017 STATS

| 0.7165 | 0.8125 | 0.7745 | 0.7729 |
|---|---|---|---|
| Yearly low<br>January 2 | Yearly high<br>September 8 | 100-day<br>moving average | 200-day<br>moving average |

## TOP RISK FACTORS

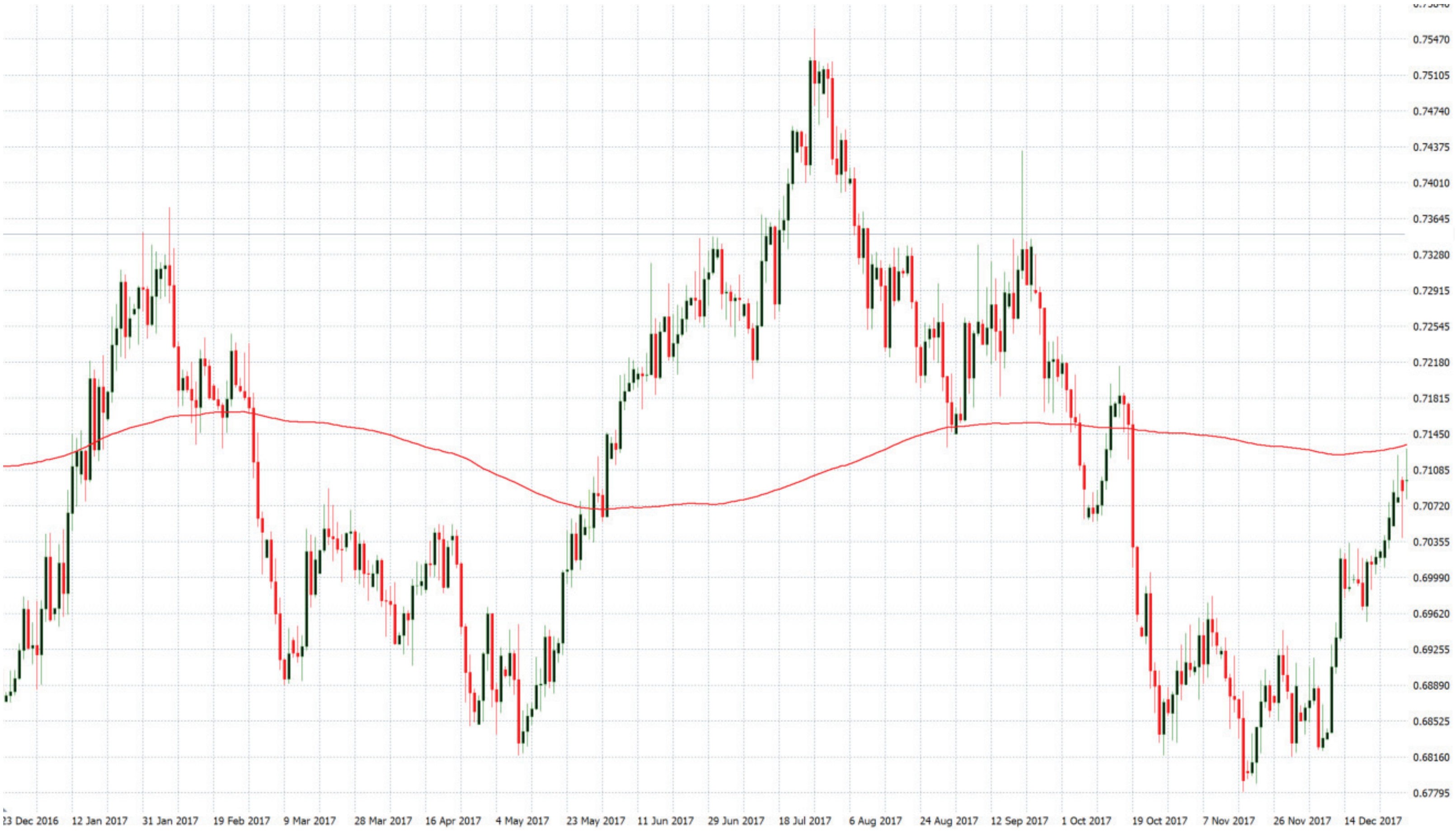
1. Commodity prices reversing
2. Risk aversion sparked by global uncertainty or an economic slowdown

## CENTRAL BANK COMPARISON

**Reserve Bank of Australia** - Neutral policy stance with no indications that it will move without strong surge in inflation and growth

**FOMC** - Expected to hike interest rates three times in 2018, matching three hikes in 2017

# NZD/USD




A 2017 NZD/USD chart as seen on TopstepFX MetaTrader 4. It includes a 200-day moving average (red line).

The New Zealand Dollar had an interesting 2017. Unlike the Australian and Canadian Dollars, which saw their highest point of 2017 against the U.S. Dollar in early September, the New Zealand Dollar hit its peak much earlier in July. It then proceeded to weaken, hitting its lowest level of the year in November. At that time, tepid inflation expectations and political uncertainty undermined the currency. As commodity prices rebounded to close the year, NZD/USD broke above its 100-day moving average, setting up further gains to start the new year.

## NZD/USD 2017 STATS

**0.6780**
Yearly low
November 17

**0.7558**
Yearly high
July 27

**0.7031**
100-day
moving average

**0.7131**
200-day
moving average

## TOP RISK FACTORS

1

Commodity prices reversing

2

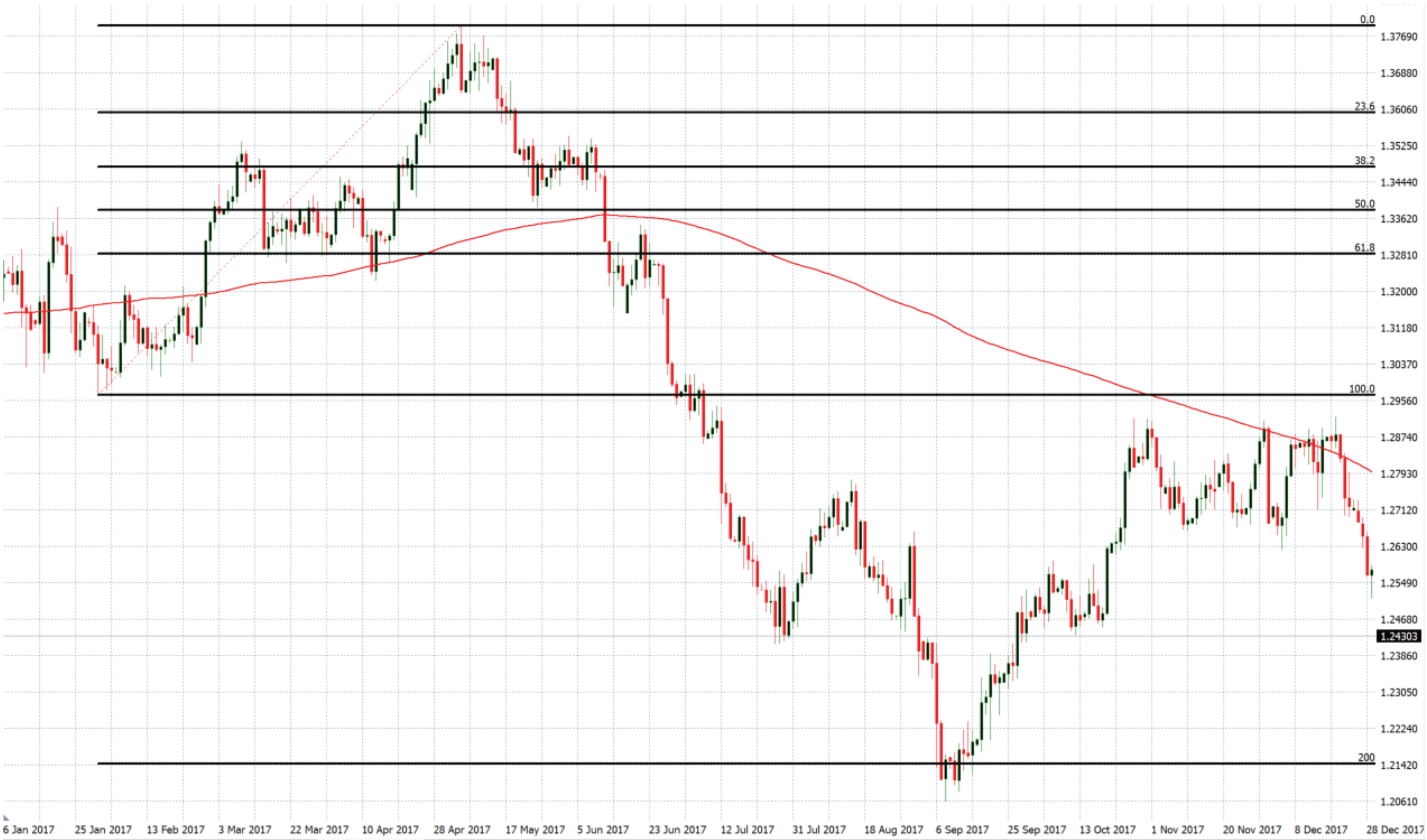
Risk aversion sparked by global uncertainty or an economic slowdown

## CENTRAL BANK COMPARISON

**Reserve Bank of New Zealand** - New dual mandate coming in 2018 to maximize employment, while controlling inflation

**FOMC** - Expected to hike interest rates three times in 2018, matching three hikes in 2017

# USD/CAD




A 2017 USD/CAD chart as seen on TopstepFX MetaTrader 4. It includes a 200-day moving average (red line) and a Fibonacci retracement drawn from the January 31 low to the May 5 high.

Despite the fact that Crude Oil prices rallied 17% in 2018, the Canadian Dollar is not performing well. That's because Canada's largest trading partner, the United States, is tightening restrictions on trade, without exempting its neighbor to the north. Not only does President Donald Trump want to renegotiate NAFTA (a stance known at the start of the year), but recently, he also imposed tariffs on steel and aluminum imports. Canada's waiver will end on May 31, and recent news suggests that the country will be subject to the tariffs. That's not good for the Canadian economy and doesn't bode well for NAFTA renegotiations.

All that news has forced the Bank of Canada's hawkish stance to the back burner. The USD/CAD rose more than 5% from its February lows. During that move, USD/CAD hit highs above $1.30 before falling back below the figure.

Now, as the United States and Canada fail to come to trade agreements, USD/CAD is in another bullish trend. It seems only a matter of time before 1.30 is overtaken for good, with the price potentially moving towards the 2017 high of 1.3793 by the end of the year.

## USD/CAD 2017 STATS

**1.2061**
Yearly low
September 8

**1.3793**
Yearly high
May 5

**1.2617**
100-day
moving average

**1.2798**
200-day
moving average

## TOP RISK FACTORS

1

NAFTA negotiations: the U.S. could potentially withdraw under President Donald Trump without meaningful changes

2

Movement in the price of oil

## CENTRAL BANK COMPARISON

**Bank of Canada** - Hiked twice in 2017, but lagging the U.S. Federal Reserve

**FOMC** - Expected to hike interest rates three times in 2018, matching three hikes in 2017