A Trader's Guide To Global Markets

Tracking the world. What markets to trade?

Over the last few decades, traders have been able to get exposure to more markets around the world.

Trading across global markets has become more accessible than ever. But with that access comes a wider range of choices. From equities and indices to commodities and forex, there are many asset classes available for trading, each with its own dynamics.

This guide is designed as a starting point for traders looking to understand how global markets work. It outlines key information about the major asset classes and highlights a few important considerations to keep in mind when deciding where to begin.

Currencies, often referred to as forex (short for foreign exchange), make up the world's largest and most actively traded market.

Currencies

Currencies are followed by treasuries, equities and commodities. While foreign exchange trading has long been dominated by large global banks and institutions, it has become increasingly popular and accessible to individual traders.

Currencies are traded differently from other markets, such as equities or commodities. When you trade shares, for example, you're buying a single asset. If the share price goes up, you make a profit. If it goes down, you take a loss. Currency trading, however, is done in pairs, with one currency being traded against another. Returns in currency markets are relative, with profit and loss being measured by how one currency performs relative to another. For example, on a given day, the US Dollar (USD) could appreciate relative to the Euro (EUR), Swiss Franc (CHF) and British Pound (GBP), but decline relative to the Japanese Yen (JPY), Canadian Dollar (CAD) and Australian Dollar (AUD).

As the world's reserve currency, trading in the US Dollar related pairs is the foundation of currency trading around the world. The most active pairs known as the majors include EURUSD, GBPUSD, USDCHF and USDJPY. Currency pairs that don't involve USD are known as cross pairs. Popular cross pairs include GBPEUR, EURJPY, and AUDCAD.

Pricing in currencies is based on the first currency in the pair, also known as the base currency. In the case of EURUSD, this means how many USD it would take to buy one EUR. When EURUSD goes up it means that the EUR is gaining in value. When EURUSD goes down, it means EUR is losing value, or USD is gaining value.

Trading in resource-focussed currencies such as AUDUSD and USDCAD is also popular, as the valuation of these currencies - plus those of other resource-producing nations such as the New Zealand Dollar (ZND), Norwegian Krone (NOK) and South African Rand (ZAR) - tends to be influenced by commodity prices, which represent a significant part of the goods traded by these countries. Note that CAD and NOK tend to be more sensitive to energy prices, AUD and NZD to metal and grain prices and ZAR to precious metal prices.

USD and JPY tend to be seen as more defensive currencies. Because of their low interest rates, investors tend to borrow money at lower rates in these countries and try to earn higher returns elsewhere, in what is widely known as the carry trade. In times when investors are interested in taking on risk the carry trade increases and capital flows out of USD and JPY into other currencies. When fear increases and traders become more risk averse, they tend to sell off their riskier assets and pay back their USD and JPY based loans.

Trading is available in many different types of commodities and basic resource products.

Commodities

There are two main types of participants in commodities markets; hedgers and speculators.

Hedgers are those who want to lock in a price for a product that they intend to deliver or use at a future point in time. For example, afarmer about to plant wheat may want to lock in a price for when they deliver it in September, while a baker needing wheat for June may want to lock in their price before that for planning and budgeting purposes.

This category tends to be dominated by industry participants.

Commodity prices are mainly impacted by changes in the supply and demand of a particular good being traded. Speculators are those interested in attempting to profit from changes in prices as supply and demand conditions change. They have no intention of delivering or taking delivery of physical goods. Most traders fall into this category.

Commodities tend to fall into a number of groups that share similar chracteristics:

a. Precious Metals (gold, silver)

While the general public may consider precious metals as jewellery, gold and silver in particular have also been used as currencies for centuries. Precious metals tend to be viewed as a store of value and tend to attract interest during times when investors are concerned that the value of paper money (particularly the US Dollar) may fall.

b. Energy (crude oil, natural gas, gasoline, heating oil)

Energy prices and usage demand tends to be linked to global economic growth as people generally use more energy during prosperous times and cut back during lean times. For example, businesses may operate more shifts or consumers may travel more in times of economic growth. Weather can have an influence on pricing of energy commodities that are used in home heating such as natural gas and heating oil.

A significant part of the global energy supply, particularly crude oil, tends to be produced in or travel through politically unstable regions. Because of this, political risks can impact the price of oil, particularly during times when supplies may be limited.

Although crude oil is a global market, prices tend to be more sensitive to economic conditions in the United States and China, the world's largest energy consumers.

c. Base Metals (Copper)

Metals with industrial applications also tend to be sensitive to global economic activity with demand generally increasing as economies grow. Supply can be increased by the development of new mines, while supply can be limited by strikes or other operational difficulties.

d. Grains (wheat, corn, soybeans)

As more economies have evolved from subsistence farming to emerging industrial societies in recent decades, the demand for agricultural commodities has been steadily increasing.

Grain prices tend to be impacted more by developments on the supply side of the market.

Developments that can have a negative impact on supply - such as droughts and floods can lead to shortages and push prices up. On the other hand, when prices rise farmers tend to plant more crops so the impact can be mitigated over longer periods of time.

e. Other commodities

There are a number of other commodities that can be traded, including coffee, sugar, cocoa and many others. Differences in each market tend to be related to weather conditions in producing areas and changing demand conditions worldwide.

Indices

Another type of instrument that is commonly traded are indices which allow traders to get exposure to a particular sector or market.

Most indices that are tradable are based on a basket of the largest and most actively traded companies on a particular exchange or in a particular country.

Some of the best known indices include:

Europe

- UK100
- Germany 40
- French 40

North America

- US30
- US SPX500
- US NDAQ 100
- US Small Cap 2000
- Canada 60

Asia Pacific

- Hong Kong 50
- Japan 225
- Australia 200

There can be some differences between indices depending on which sectors make up the largest weightings in the basket. For example, the SPX500 tends to be more heavily weighted in consumer products, financial services, technology and health care. Canadian and Australian indices tend to carry a higher weighting in Materials and Energy producers. While the UK100 has a large weighting in banking, pharmaceuticals and oil.

Treasuries

Government bonds, also known as treasuries, are another highly active trading market. They allow traders to take positions based on broader economic trends in different countries, such as changes in interest rates, inflation, or central bank policy.

Banks and institutions tend to purchase bonds with the intention of holding them to maturity and view the interest rate on the bond as the primary return on their investment. Over time, bond prices tend to fluctuate along with economic conditions, creating opportunities for traders.

The compensation through interest rates that investors demand in order to purchase a bond tends to be driven by two major factors, inflation and repayment risk. In order to earn income over time, investors need their bonds to return at least the rate of inflation in the issuing country. In addition, investors tend to demand a premium to cover the risk that the bond issuer may default on either the principal or interest payments since you can't throw debtors into jail any more in most countries.

Based on this, investors tend to demand higher interest rates from countries running high rates of inflation. As has been seen during the European sovereign debt crisis, issues such as high government deficits or high national debt levels can increase the risk of insolvency and lead investors to demand higher interest rates to compensate them for their risks.

Because the interest rate on most bonds is fixed after issuance, bond prices change over time to reflect changing interest rates. Suppose a 10-year bond is issued at 5.0% interest and a year later, new 9-year bonds are being issued at 4.0%. Because the 5.0% bond carries a higher interest rate, all else being equal, investors would be willing to pay more for that bond. On the other hand, if investors could get 6.0% on new 9-year bonds, they would not be willing to pay as much for the 5.0% bond.

Bonds tend to be issued at a price of 100.0, known as par, and are expected to be redeemed for the same price at maturity. If interest rates on new bonds increase, the price of existing bonds tends to drop so that they trade below 100.0, or at a discount. The potential for capital appreciation offsets the lower interest rate. Similarly, if the interest rate on new bonds falls, the price of existing bonds tends to rise to trade at a premium to par with the capital loss over time, offsetting the higher interest rate.

The key for bond traders to understand is this inverse relationship between interest rates and bond prices.

The time to maturity is also an important factor. Central banks tend to use short-term rates to speed up or slow down economic growth. Because of this, the difference between short-term and long-term rates can fluctuate quite a bit. Most of the time, long-term rates are higher to reflect the risk of changing developments over time, but sometimes short-term rates can rise above long-term rates, particularly when central banks are trying to slow economic growth or control inflation.

Most people first become familiar with the world of investing through individual shares and stock markets.

Shares

Companies around the world issue shares to the public for many reasons, primarily to raise capital for expanding their business. Additional benefits for corporations of being publicly traded include generating a higher profile with potential customers and the public at large, the sharing of risk among more investors, reducing the company's capital costs, succession planning for founders and more. The sale of shares from a company's treasury to shareholders is known as the primary market.

Once a company completes its initial public offering, its shares then usually trade on a traditional stock exchange such as the NYSE (New York), FSE (Frankfurt) or LSE (London) or list on an over the counter exchange such as NASDAQ (New York) where trades are executed directly between brokerages. Both of these are known as secondary markets.

Generally speaking, a share price will rise when expectations around a particular company are positive such as improved earnings in future from increased sales or new contracts, a higher dividend, a takeover bid or other development. On the other hand, expectations of negative developments such as a slowdown in the business, regulatory changes, losing contracts or political changes can lead traders wanting to sell which may put downward pressure on the price.

One regular development that tends to influence trading is a company's earnings report. The timing of these reports tends to be publicised well in advance with analysts who follow the company weighing in with their expectations. Many companies also publish their own expectations, known as guidance. How a company's results and future guidance fare relative to expectations can have a major impact on short- and medium-term trading trends.

Here are four major categories that stocks may fall into:

a. Interest Sensitive – Financial Services, Utilities, Telecommunications

These companies tend to have higher debt loads and because of this interest payments represent a significant part of their expense base. These companies tend to outperform in times of falling interest rates and tend to underperform when rates are rising quickly.

b. Defensives – Consumer Staples and Health Care

Companies in these areas tend to have fairly stable and predictable revenue and earnings streams. They tend to produce or sell goods that people use day to day regardless of economic conditions such as personal care products, groceries and pharmaceuticals. They tend to outperform the market during recessions and tend to underperform in stronger economic times.

c. Economically Sensitive – Consumer Discretionary and Industrials

These areas tend to do very well in times of prosperity and poorly during recessions as they represent goods and services that can be sacrificed or substituted during tough times. Some examples within these groups include: auto makers, clothing stores, business services, and airlines.

d. Capital Spending Sensitive – Energy, Materials, Technology

Growth for companies in these groups tends to come from large-scale projects that take time to implement. As a result, they often move more slowly in response to the economic cycle. Companies typically wait for confirmation that conditions have improved before committing to major projects. After a market peak, they tend to complete projects already under way before reducing budgets. Note that for technology, this mainly applies to companies who sell hardware, software and services to business customers. There are an increasing number of technology companies that sell primarily to consumers and would potentially fall into the economically sensitive group.

Which Markets to Trade?

Deciding which markets to trade involves a range of considerations, including but not limited to market conditions, volatility, and individual trading objectives. Here are some factors summarized by the traders:

a. Trading What Is Familiar

Most traders start out trading shares of companies that they are familiar with, or which are located in the same country before branching out internationally or trading different asset classes.

b. Trading Similar Asset Classes

Once traders have gained some comfort trading in one area, traders may want to expand into related areas. For example, expanding trading from shares to indices or from resource shares to related commodities.

c. Small Picture Versus Big Picture

Traders more interested in taking advantage of broad national or global trends may find currencies, treasuries or indices more appealing. On the other hand, those interested in doing some digging and finding unnoticed opportunities may find trading in shares more interesting.

d. Time Zones

The markets which are active during the time of day that traders plan to trade may also influence the decision. If you traders to trade during the business day, markets in local region may offer the best opportunities. If traders plan to trade in the morning or evening, there may be more opportunities in other regions.

e. Relationships Between Markets

Although the details of trading in different markets or asset classes may vary, the underlying drivers of movement tend to be the same across markets, such as interest rates, inflation expectations, GDP growth, risk factors and more.

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CMC Markets Asia Pacific
Pty Ltd ABN 11 100 058 213 AFSL No. 238054
cmcmarkets.com/en-au

CMC Markets NZ Limited Company
Registration Number 1705324
cmcmarkets.com/en-nz

CMC Markets
Asia Pacific Pty Ltd

Level 20, Tower 3, International
Towers, 300 Barangaroo
Avenue NSW 2000, Sydney
Australia

cmcmarkets.com/en-au

CMC Markets
NZ Limited

Level 39,23 Albert Street,
Auckland Central
1010, Auckland
New Zealand

cmcmarkets.com/en-nz