Fundamentals for Traders Tutorial

Everyone would probably agree that the "fundamentals" – or at least traders' perception of them – are ultimately the driving force underlying market prices. Much of today's market analysis is based on prices, but it is the fundamentals that produce the prices. The challenge for traders is how to best learn about and study fundamentals in markets. Unfortunately, despite their significance, there is no quick and easy way to study market fundamentals, and you can't find resources that focus only on fundamentals that impact all markets.

The most obvious fundamental factors are supply and demand for a particular market, especially the physical commodities. But lots of macro fundamental factors effect supply/demand and impact commodity and financial futures prices: weather, world politics, consumer tastes and consumer attitudes, disruptions in distribution channels, inflation, interest rates, currency values, natural disasters and much more.

The number of fundamentals is enormous, adding to the difficulty of trying to interpret what they mean even when you do have the most recent reliable data. Every market is affected by fundamentals in related markets, putting an emphasis on intermarket analysis, but every market also has its own set of fundamentals.

For most traders, perhaps the most useful advice on fundamentals is to know when the key known events – reports, news releases, elections, etc. – are going to occur. You can't predict the surprises – tsunamis, assassinations, etc. – but for those events that are scheduled on a calendar, you should be aware of the time when they could cause a price ripple, even though you rely on technical analysis for your trading decisions. It would be a bonus to know something about the history behind the event and have an idea about what traders are anticipating on an upcoming announcement.

This tutorial provides an overview of fundamentals, but a trader involved in a specific market should find other sources to study the fundamentals for that market in more detail.

Moving Targets

One of the first important points to keep in mind about fundamentals is that they are changing constantly. What you read in the *Wall Street Journal* or a magazine or a newsletter regarding market fundamentals can be outdated tomorrow or by next week.

Also remember that many of the numbers released in government or other reports and regarded as fundamentals are based on estimates. Even the most thorough government effort to get precise figures usually comes down to official estimates and educated guesses. Whether they are factually correct or not, they are the numbers that economists and traders have to deal with, and you will have to accept them for what they are even if you skeptical about their accuracy.

Not only do the numbers change constantly with each new report or update but market conditions also are always changing. A given number that may be bullish in one set of circumstances may draw a much different reaction in other circumstances. That is because the market may have gotten used to what was considered a bullish figure originally and now accepts the number as a "normal" figure or because the demand situation has changed for the same amount of supply.

Equally as important as the actual estimates are traders' perception of them based on their expectations. Traders may expect to see a certain fundamental number in a report and set prices accordingly. For example, if traders expect a crop report to show a bullish number, they may bid up prices ahead of the report. Then by the time the report is released with that number, the bullishness may have been exhausted, and a report that might have been considered bullish gets a bearish price response instead. That's the "buy the rumor, sell the fact" reaction discussed in the tutorial on basic trading concepts.

There are a couple of other points that should be made about fundamentals in general:

- Demand is not the same as consumption. What is consumed is one thing; what is the demand for the available supply is quite another.
- You may be exactly right about a fundamental but your timing may be off. For example, maybe you have the final corn production figure pegged exactly in August but the market isn't in tune with that number. You may just be too early.

- Any number of events can cause fundamental surprises overnight. Weather, natural disasters, political disruptions or many other events may change the whole complexion of a market, and you always need to take into account the possibility of such sudden shifts in the outlook.

Because of the nature of fundamentals and the difficulty in getting accurate information and then interpreting it correctly, many traders have turned to technical analysis addresses, the study of price action that incorporates all of the fundamental factors affecting prices. Price is the composite reflection of every news event and/or other fundamental known to all traders.

'Cash' Markets and 'Basis' Levels

All futures markets are based upon some type of underlying cash or physical market (also called the "prompt" or "spot" market). A futures market must be tied to some type of actual market to keep the futures market price fairly valued and actively traded.

For example, for corn, there is a futures market traded in Chicago and hundreds of "cash" corn markets that set the price that farmers actually receive for the crop they harvest and deliver to their local elevators. Crude oil has a futures market traded in New York and London and a physical crude oil market that prices what is refined into various industrial products such as gasoline. The situation is similar for other raw commodities futures. All have some type of an underlying cash market, even those futures contracts that are settled in cash.

U.S. Treasury bond futures have a cash market, which is the actual debt sold at auction by the U.S. Treasury Department through bonds, notes and bills. Stock index futures also have a cash market, based on the actual prices for individual stocks in the index.

'Basis' as a Gauge of Supply/Demand

"Basis" is the difference between the futures price and the cash price – between the price of corn futures in Chicago and the cash corn price at the local elevator, for example. Basis varies, depending on proximity to shipping points, availability of transportation and other factors, not to mention supply and demand considerations and whether users actually want to take delivery of the available supply. Basis can be positive or negative. For example, if supply for a commodity is tight in a given area and demand is strong for the physical commodity, the cash price may be higher than the futures price. Generally, transportation expenses account for the largest portion of cash basis or the difference between cash and futures prices.

Changes in cash basis are not as volatile as changes in cash market or futures prices. Changes in basis tend to follow seasonal patterns. At harvest, grain supplies are generally more plentiful, resulting in a higher demand for transportation services and an increased cost to move grain (wider basis). Post-harvest improvement in basis often occurs because of increased availability of transportation services at a better price and improvements in local supply and demand conditions.

Country grain elevators base the price they will pay farmers for their grain on the price of grain futures at the Chicago Board of Trade. For example, a grain elevator in central Nebraska will likely have a wider basis than will a grain elevator located on the Mississippi River in Dubuque, Iowa, because shipping costs to get grain from the elevator in central Nebraska to the Gulf of Mexico are more than the shipping costs for the elevator located in Dubuque shipping to the Gulf of Mexico.

You might hear a cash soybean price quote from a grain elevator in Nebraska of "28 cents under the May futures contract" whereas the cash soybean quote from a Dubuque elevator might be "8 cents under May futures." At the Gulf of Mexico, cash soybeans could be quoted at "30 cents over the May contract." As the cash grain gets closer to its final shipping or other usage destination, basis "narrows."

Futures traders tuned to fundamentals watch changes in cash basis levels closely because that is one of the best reflections of actual supply and demand. Commercials go to great lengths to keep history and study various cash basis levels for the markets in which they are involved.

Economic Reports

Governments gather and tabulate mountains of statistics and release dozens of economic reports every day. Sometimes the task is not so much getting fundamental information but sorting out that which is relevant to prices.

Economic statistics are made public on a regularly scheduled basis and help market observers monitor the pulse of the economy. Because they are so closely followed by almost everyone in the financial markets and frequently draw a market reaction, the first thing you should know about these fundamental snippets of information is exactly when they will be released. Most brokerage firms produce economic calendars, or you can get the date information on the internet. Knowing when a key report such as U.S. employment is due to be released may help to explain some market moves.

You may not be a fundamental analyst, but you should have some sense of what the economic data is revealing about the economy. You should know which indicators measure the growth of the economy (Gross Domestic Product) and which measure the inflation rate (Producer Price Index and Consumer Price Index). You don't have to be an economist, but after a while, you should become familiar with shifts in the major economic indicators. Some are much more important to traders than others, and that importance may change over time as the markets key on different reports at different times.

Remember the admonition earlier in this tutorial: The actual numbers often are not as important as traders' expectations and whether the data falls within the boundaries of what the market is anticipating. A couple of other caveats should be mentioned about economic reports if you use them in your fundamental analysis:

- What is mentioned in the media headlines often may not be what is really important in the data. Don't just jump on the headline figures to make a trading decision.
- Statistics are frequently revised. A current number that appears to be a big surprise may just have resulted from a previous figure that was revised, giving a misleading impression about the size of any change in the new data. Look beyond the current report to see what was done to previous reports and see how the latest figure compares historically.

Economic indicators published for other countries may not mean the same thing as a U.S. indicator does. If you are going to trade currencies, for example, you should know what is covered in economic reports from another country and how that might differ from the same type of statistic in the United States or in Germany.

Major U.S. Economic Indicators

Among the hundreds of economic reports released by the U.S. government or its agencies, some have more importance than others, as far as the trader is concerned. Following is a sampling of some reports that tend to have the most effect on financial markets, keeping in mind that this list could change as other reports gain more attention:

Gross Domestic Product (GDP) – The sum of all goods and services produced either by domestic or foreign companies. GDP indicates the pace at which a country's economy is growing (or shrinking) and is considered the broadest indicator of economic output and growth.

Industrial Production – Chain-weighted indicator measuring the change in production of the nation's factories, mines and utilities. Usually associated with capacity utilization, a measure of industrial capacity and how many available resources among factories, utilities and mines are being used. The manufacturing sector accounts for one-quarter of the U.S. economy. The capacity utilization rate provides an estimate of how much factory capacity is in use.

Purchasing Managers Index (PMI) – The Institute of Supply Management, formerly called the National Association of Purchasing Managers (NAPM), releases a monthly composite index of national manufacturing conditions, constructed from data on new orders, production, supplier delivery times, backlogs, inventories, prices, employment, export orders and import orders. It is divided into manufacturing and non-manufacturing sub-indices.

Producer Price Index (PPI) – A measure of price changes in the manufacturing sector. PPI measures average changes in selling prices received by domestic producers in the manufacturing, mining, agriculture and electric utility industries for their output. PPI figures most often used for economic analysis are those for finished goods, intermediate goods and crude goods.

Consumer Price Index (CPI) – A measure of the average price level paid by urban consumers (80% of population) for a fixed basket of goods and services. CPI reports price changes in more than 200 categories. It also includes various user fees and taxes directly associated with the prices of specific goods and services.

Durable Goods Orders – Measures new orders placed with domestic manufacturers for immediate and future delivery of factory hard goods. A durable good is defined as a good that lasts an extended period of time (more than three years) during which its services are extended.

Non-farm payrolls – A feature report released on Friday of the first week of each month that indicates the number of new jobs generated by the economy during the previous month and the percentage of workers seeking employment that remain unemployed.

Employment Cost Index (ECI) – Payroll employment is a measure of the number of jobs in more than 500 industries in all states and 255 metropolitan areas. The employment estimates are based on a survey of larger businesses and counts the number of paid employees working part-time or full-time in the nation's business and government establishments.

Retail Sales – A measure of the total receipts of retail stores from samples representing all sizes and kinds of business in retail trade throughout the nation. It is the timeliest indicator of broad consumer spending patterns and is adjusted for normal seasonal variation, holidays and trading-day differences. Retail sales include durable and nondurable merchandise sold and services and excise taxes incidental to the sale of merchandise. Excluded are sales taxes collected directly from the customer.

Housing Starts – Measures the number of residential units on which construction is begun each month. A start in construction is defined as the beginning of excavation of the foundation for the building and is comprised primarily of residential housing. Housing is very interest rate sensitive and is one of the first sectors to react to changes in interest rates. Significant reaction of start/permits to changing interest rates signals interest rates are nearing a trough or peak. To analyze, focus on the percentage change in levels from the previous month. The report is released around the middle of the following month. Existing home sales and new home sales are other significant reports that reflect how the housing market is doing, one of the most important aspects of the economy.

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