

Certainly, many traders have heard about fundamental analysis at least once in the past, when searching about the stock market. Why is that? Simply because Fundamental analysis is very popular among market participants, and it is considered as one of the most used approaches when dealing with financial markets.

Moreover, Fundamental analysis is not dedicated to the stock market only but can be employed in other markets such as currencies, commodities, and bonds. However, the use of such analysis is completely different depending on the market we will trade on, therefore, we will try to give a definition of Fundamental analysis for the most liquid markets which are Currencies and stocks.

Definition of Fundamental Analysis for Stocks

Fundamental analysis of the stock market can be defined as the evaluation of the intrinsic value of a specific asset. Through this type of analysis, investors are looking at a wide range of external factors to assess the price of stocks. There are two ways to perform such analysis. The first method is called a Top-Down while the second one is Bottom-Up.

The top-down approach focuses on the macroeconomic variables that might affect the future price of stocks. The decision-making process is based on the overall economic conditions at a first stage, followed by a sector analysis before to focus on individual companies within that sector.

Investors starts their analysis from a wider angle and start to narrow their research until they manage to classify specific stocks within sectors that offers the highest potential for growth.

Conversely, A bottom-up analysis is performed on a micro level where investors are looking at individual companies that have strong fundamentals (like financial statements, sales, earnings reports, profits after taxes) before to analyze the performance of the sector and finally looking at the health of the entire economy.

Definition of Fundamental Analysis for Forex

Fundamental analysis of the forex market is a study that deals with the environmental factors that may affect currency prices. Traders are analyzing, the state of the economy alongside with political and social forces. To summarize, countries that have a good economic outlook may see their currencies moving higher, in the opposite, countries with a bad economic outlook are likely to have a weaker currency.

Fundamental Analysis Pros and Cons

While fundamental analysis remains an objective approach as mentioned earlier, it is a complex and time-consuming process.

Dealing with several calculations and a lot of financial figures can lead to errors.

In the other side, fundamental analysis is practically useless for short-term trading and do not provide timing solutions to take advantage of liquid and volatile markets. Also, it does not offer money management tools (invalidation and exit levels when the trade goes wrong or market reverses quickly in the opposite direction).

It is also important to note that financial markets are irrational due to investors psychology and emotions.

Many times, we do see excessive peaks in both fear and greed which creates unsustainable sharp moves. Per example in the stock market, a company with strong fundamentals does not necessarily sees its stock moving higher, which keeps such analysis exposed to unexpected negative news that can negate all previous fundamental calculations.

Technical Analysis Pros and Cons

Technical analysis can be defined as the study of market activity, price, and volume. It uses charts, statistical tools, and pattern analysis, to forecast future price direction.

It is a powerful tool to improve market timing and provide clear entries and potential price targets especially in the short-term. However, the reliability of some chart patterns is not proven statistically as past results do not guarantee future performance. Another drawback of technical analysis is that it cannot be fully programmed for a systematic trading system. It is difficult to code chart patterns which makes strategies back testing very subjective.

In addition, technical analysis tends to be more effective in the short-term rather than the long-term.

Therefore, traders should use both technical and fundamental analysis in combination to seek further confirmation.