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The use of flow analysis in foreign exchange: exploratory evidence

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Abstract

This paper provides questionnaire evidence on the role of flow analysis for professional traders and fund managers. This evidence suggests that besides fundamental information and technical analysis, the analysis of flows provides an independent third type of information for professionals. The view that flows can be used to learn about fundamentals is not consistent with the data. Instead, evidence indicates that flows more likely provide insight into semi-fundamental private information.

JEL classification: F31

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1. Introduction

"A source of informational advantage to the traders is their access to, and trained interpretation of, the information contained in the order flow" (Goodhart, 1988: p. 456). Although this has been common market wisdom for a long time, there have been no studies that systematically examine the use of flow analysis by foreign exchange professionals. This paper provides evidence that next to fundamental and technical analysis the analysis of flows is an independent third type of information. We thus add to the recent literature by presenting empirical evidence that the analysis of flows does affect the behavior of a significant group of professional FX market participants according to their own perspective.

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Thus, our contribution complements other work about the informational role of flows. For example, Lyons (1995, 1998) presents case study evidence on the importance of flows, Osler (1998) relies on flows to characterize exchange rate changes, Ito et al. (1998), Covrig and Melvin (2001) provide statistical evidence for information inherent in flows and Cai et al. (2001), Evans (2002) and Evans and Lyons (2002) improve exchange rate explanation by incorporating order flows.

According to (Lyons (2001): p. 4), "order flow is transaction volume that is *signed*" (i.e. indicating purchases or sales). From an ex ante logical point of view, flow analysis may share similarities with either technical analysis or fundamentalism. This leads to three different views about flow analysis which to some extent compete with each other, and which we list in the order of their affinity to the efficient market hypothesis (EMH):

Position 1. *Flow analysis is an expression of limited rational behavior.*

In this sense flow analysis is an analogue of technical analysis (see e.g. Shleifer and Summers, 1990). This view relies heavily on the assumption of informational efficiency of markets, according to which any attempt to acquire extra information is futile or even irrational, when costly resources are invested.

Position 2. *Flow analysis is a manifestation of rational learning about fundamentals.*

This view regards flow analysis as a certain form of fundamental analysis. Conceding time constraints and informational heterogeneity, flow analysis can be viewed as a rational way of trying to detect the results of other participants' fundamental analysis and thus parallels optimal learning from order flow such as in the seminal work of Kyle (1985).

Position 3. *Flow analysis provides interim information about short-run price movements but little information about fundamentals.*

This view is based on the assumption that the order flow can influence price paths of transactions prices in the short run. Flow analysis is understood as a separate kind of analysis if it aims at forecasting transactions prices from presently executed and planned order flows (see e.g. Ito et al., 1998; Covrig and Melvin, 2002). According to this view, flows also contain information about short-term trading objectives or liquidity considerations of other traders that may affect short-term price movements, but that will not affect medium-term asset prices. Such information is usefully termed semi-fundamental information.

Unfortunately, at present there is virtually no direct systematic information available about the importance and nature of flow analysis. Because of this lack of knowledge, it seems worthwhile to improve our understanding by conducting a questionnaire survey study among market participants. This study is organized