

Forex Content

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1. History of the Forex Market

The Foreign Exchange market, also referred to as the "Forex" or "FX" market is the largest financial market in the world, with a daily average turnover of well over US\$1 trillion -- 30 times larger than the combined volume of all U.S. equity markets.

"Foreign Exchange" is the simultaneous buying of one currency and selling of another. Currencies are traded in pairs, for example Euro/US Dollar (EUR/USD) or US Dollar/Japanese Yen (USD/JPY).

There are two reasons to buy and sell currencies. About 5% of daily turnover is from companies and governments that buy or sell products and services in a foreign country or must convert profits made in foreign currencies into their domestic currency. The other 95% is trading for profit, or speculation.

For speculators, the best trading opportunities are with the most commonly traded (and therefore most liquid) currencies, called "the Majors." Today, more than 85% of all daily transactions involve trading of the Majors, which include the US Dollar, Japanese Yen, Euro, British Pound, Swiss Franc, Canadian Dollar and Australian Dollar.

A true 24-hour market, Forex trading begins each day in Sydney, and moves around the globe as the business day begins in each financial center, first to Tokyo, London, and New York. Unlike any other financial market, investors can respond to currency fluctuations caused by economic, social and political events at the time they occur - day or night.

The FX market is considered an Over The Counter (OTC) or 'interbank' market, due to the fact that transactions are conducted between two counterparts over the telephone or via an electronic network. Trading is not centralized on an exchange, as with the stock and futures markets.

2. Understanding Forex Quotes

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Reading a foreign exchange quote may seem a bit confusing at first. However, it's really quite simple if you remember two things: 1) The first currency listed first is the base currency and 2) the value of the base currency is always 1.

The US dollar is the centerpiece of the Forex market and is normally considered the 'base' currency for quotes. In the "Majors", this includes USD/JPY, USD/CHF and USD/CAD. For these currencies and many others, quotes are expressed as a unit of \$1 USD per the second currency quoted in the pair. For example, a quote of USD/JPY 120.01 means that one U.S. dollar is equal to 120.01 Japanese yen.

When the U.S. dollar is the base unit and a currency quote goes up, it means the dollar has appreciated in value and the other currency has weakened. If the USD/JPY quote we previously mentioned increases to 123.01, the dollar is stronger because it will now buy more yen than before.

The three exceptions to this rule are the British pound (GBP), the Australian dollar (AUD) and the Euro (EUR). In these cases, you might see a quote such as GBP/USD 1.4366, meaning that one British pound equals 1.4366 U.S. dollars.

In these three currency pairs, where the U.S. dollar is not the base rate, a rising quote means a weakening dollar, as it now takes more U.S. dollars to equal one pound, euro or Australian dollar.

In other words, if a currency quote goes higher, that increases the value of the base currency. A lower quote means the base currency is weakening.

Currency pairs that do not involve the U.S. dollar are called cross currencies, but the premise is the same. For example, a quote of EUR/JPY 127.95 signifies that one Euro is equal to 127.95 Japanese yen.

When trading forex you will often see a two-sided quote, consisting of a 'bid' and 'offer'. The 'bid' is the price at which you can sell the base currency (at the same time buying the counter currency). The 'ask' is the price at which you can buy the base currency (at the same time selling the counter currency).

3. Forex vs. Equities

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If you are interested in trading currencies online, you will find that the Forex market offers several advantages over equities trading.

24-Hour Trading

Forex is a true 24-hour market, which offers a major advantage over equities trading. Whether it's 6pm or 6am, somewhere in the world there are always buyers and sellers actively trading foreign currencies. Traders can always respond to breaking news immediately, and P&L is not affected by after hours earnings reports or analyst conference calls.

After hours trading for U.S. equities brings with it several limitations. ECN's (Electronic Communication Networks), also called matching systems, exist to bring together buyers and sellers - when possible. However, there is no guarantee that every trade will be executed, nor at a fair market price. Quite frequently, traders must wait until the market opens the following day in order to receive a tighter spread.

Superior Liquidity

With a daily trading volume that is 50x larger than the New York Stock Exchange, there are always broker/dealers willing to buy or sell currencies in the FX markets. The liquidity of this market, especially that of the major currencies, helps ensure price stability. Traders can almost always open or close a position at a fair market price.

Because of the lower trade volume, investors in the stock market are more vulnerable to liquidity risk, which results in a wider dealing spread or larger price movements in response to any relatively large transaction.

100:1 Leverage

100:1 leverage is commonly available from online FX dealers, which substantially exceeds the common 2:1 margin offered by equity brokers. At 100:1, traders post \$1000 margin for a \$100,000 position, or 1%.

While certainly not for everyone, the substantial leverage available from online currency trading firms is a powerful, moneymaking tool. Rather than merely loading up on risk as many people incorrectly assume, leverage is essential in the Forex market. This is because the average daily percentage move of a major currency is less than 1%, whereas a stock can easily have a 10% price move on any given day.

The most effective way to manage the risk associated with margined trading is to diligently follow a disciplined trading style that consistently utilizes stop and limit orders. Devise and adhere to a system where your controls kick in when emotion might otherwise take over.

Lower Transaction Costs

It is much more cost-efficient to trade Forex in terms of both commissions and transaction fees. FOREX.com charges NO commissions or fees whatsoever, while still

offering traders access to all relevant market information and trading tools. In contrast, commissions for stock trades range from \$7.95-\$29.95 per trade with online discount brokers up to \$100 or more per trade with full service brokers.

Another important point to consider is the width of the bid/ask spread. Regardless of deal size, forex dealing spreads are normally 5 pips or less (a pip is .0005 US cents). In general, the width of the spread in a forex transaction is less than 1/10 that of a stock transaction, which could include a .125 (1/8) wide spread.

Profit Potential In Both Rising And Falling Markets

In every open FX position, an investor is long in one currency and short the other. A short position is one in which the trader sells a currency in anticipation that it will depreciate. This means that potential exists in a rising as well as a falling market.

The ability to sell currencies without any limitations is another distinct advantage over equity trading. In the US equity markets, it is much more difficult to establish a short position due to the Zero Uptick rule, which prevents investors from shorting a stock unless the immediately preceding trade was equal to or lower than the price of the short sale.

4. Forex vs. Futures

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The global foreign exchange market is the largest, most active market in the world. Trading in the forex markets takes place nearly round the clock with over \$1 trillion changing hands every day. It is the main event.

The benefits of forex over currency futures trading are considerable. The dissimilarities between the two instruments range from philosophical realities such as the history of each, their target audience, and their relevance in the modern forex markets, to more tangible issues such as transactions fees, margin requirements, access to liquidity, ease of use and the technical and educational support offered by providers of each service. These differences are outlined below:

- **More Volume = Better Liquidity.** Daily currency futures volume on the CME is just 1% of the volume seen every day in the forex markets. Incomparable liquidity is one of many advantages that forex markets hold over currency futures. Truth be told, this is old news. Any currency professional can tell you that cash has been king since the dawn of the modern currency markets in the early 1970's. The real news is that individual traders from every risk profile now have full access to the opportunities available in the forex markets.
- **Forex markets offer tighter bid to offer spreads than currency futures markets.** By inverting the futures price to compare it to cash, you can readily see that in the USD/CHF example above, inverting the futures dealing price of .5894 - .5897 results in a cash price of 1.6958 - 1.6966, 8 pips vs. the 5-pip spread available in the cash markets.
- **Forex markets offer higher leverage and lower margin rates than those found in currency futures trading.** When trading currency futures, traders have one margin rate for "day" trades and another for "overnight" positions. These margin rates can vary depending on transaction size. FOREX.com currency trading gives the customer one rate all the time, day and night.
- **Forex markets utilize easily understood and universally used terms and price quotes.** Currency futures quotes are inversions of the cash price. For example, if the cash price for USD/CHF is 1.7100/1.7105, the futures equivalent is .5894/ .5897; a methodology followed only in the confines of futures trading. Currency futures prices have the added complication of including a forward forex component that takes into account a time factor, interest rates and the interest differentials between various currencies. The forex markets require no such adjustments, mathematical manipulation or consideration for the interest rate component of futures contracts.
- **Forex trades executed through FOREX.com are commission free.** Currency futures have the added baggage of trading commissions, exchange fees and clearing fees. These fees can add up quickly and seriously eat into a trader's profits.

In contrast, currency futures are a small part of a much larger market; one that has undergone historical changes over the last decade.

- Currency futures contracts (called IMM contracts or international monetary market futures) were created at the Chicago Mercantile Exchange in 1972.
- These contracts were created for the market professionals, who at that time, accounted for 99% of the volume generated in the currency markets.
- While some intrepid individuals did speculate in currency futures, highly trained specialists dominated the pits.
- Rather than becoming a hub for global currency transactions, currency futures became more of a sideshow (relative to the cash markets) for hedgers and arbitrageurs on the prowl for small, momentary anomalies between cash and futures currency prices.
- In what appears to be a permanent rather than cyclical change, fewer and fewer of these arbitrage windows are opening these days. And, when they do, they are immediately slammed shut by a swarm of professional dealers.

These changes have significantly reduced the number of currency futures professionals, closed the window further on forex vs. futures arbitrage opportunities and so far, have paved the way to more orderly markets. And while a more level playing field is poison to the P&L of a currency futures trader, it's been the pathway out of the maze for individuals trading in the forex markets.

5. Calculating Profit and Loss

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For ease of use, most online trading platforms automatically calculate the P&L of a traders' open positions. However, it is useful to understand how this calculation is derived.

To illustrate a typical FX trade, consider the following example:

The current bid/ask price for EUR/USD is 1.2320/23, meaning you can buy 1 euro with 1.2323 US dollars or sell 1 euro for 1.2320 US dollars.

Suppose you decide that the Euro is undervalued against the US dollar. To execute this strategy, you would buy Euros (simultaneously selling dollars), and then wait for the exchange rate to rise.

So you make the trade: to buy 100,000 euros you pay 123,230 dollars ($100,000 \times 1.2323$). Remember, at 1% margin, your initial margin deposit would be \$1,232 for this trade.

As you expected, Euro strengthens to 1.2395/98. Now, to realize your profits, you sell 100,000 euros at the current rate of 1.2395, and receive \$123,950.

You bought 100k Euros at 1.2323, paying \$123,230. You sold 100k Euros at 1.2395, receiving \$123,950. That's a difference of 72 pips, or in dollar terms ($\$123,950 - \$123,230 = \$720$).

Total profit = US \$720

(TIP: When trading EUR/USD or any Euro cross e.g. EUR/JPY, each pip is worth \$10, per 100,000 trade).

6. Introduction to Technical Analysis

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Technical analysis is a method of forecasting price movements by looking at purely market-generated data. Price data from a particular market is most commonly the type of information analyzed by a technician, though most will also keep a close watch on volume and open interest in futures contracts. The bottom line when utilizing any type of analytical method, technical or otherwise, is to stick to the basics, which are methodologies with a proven track record over a long period. After finding a trading system that works for you, the more esoteric fields of study can then be incorporated into your trading toolbox.

Almost every trader uses some form of technical analysis. Even the most reverent follower of market fundamentals is likely to glance at price charts before executing a trade. At their most basic level, these charts help traders determine ideal entry and exit points for a trade. They provide a visual representation of the historical price action of whatever is being studied. As such, traders can look at a chart and know if they are buying at a fair price (based on the price history of a particular market), selling at a cyclical top or perhaps throwing their capital into a choppy, sideways market. These are just a few market conditions that charts identify for a trader. Depending on their level of sophistication, charts can also help much more advanced studies of the markets.

On the surface, it might appear that technicians ignore the fundamentals of the market while surrounding themselves with charts and data tables. However, a technical trader will tell you that all of the fundamentals are already represented in the price. They are not so much concerned that a natural disaster or an awful inflation number caused a recent spike in prices as much as how that price action fits into a pattern or trend. And much more to the point, how that pattern can be used to predict future prices.

Technical analysis assumes that:

- **All market fundamentals are depicted in the actual market data.** So the actual market fundamentals and various factors, such as the differing opinions, hopes, fears, and moods of market participants, need not be studied.
- **History repeats itself and therefore markets move in fairly predictable, or at least quantifiable, patterns.** These patterns, generated by price movement, are called signals. The goal in technical analysis is to uncover the signals given off in a current market by examining past market signals.
- **Prices move in trends.** Technicians typically do not believe that price fluctuations are random and unpredictable. Prices can move in one of three directions, up, down or sideways. Once a trend in any of these directions is established, it usually will continue for some period.

The building blocks of any technical analysis system include price charts, volume charts, and a host of other mathematical representations of market patterns and behaviors. Most often called studies, these mathematical manipulations of various types of market data are used to determine the strength and sustainability of a particular trend. So, rather than simply relying on price charts to forecast future market values, technicians will also use a variety of other technical tools before entering a trade.

As in all other aspects of trading, be very disciplined when using technical analysis. Too often, a trader will fail to sell or buy into a market even after it has reached a price that his or her technical studies identified as an entry or exit point. This is because it is hard to screen out the fundamental realities that led to the price movement in the first place.

As an example, let's assume you are long USD vs. euro and have established your stop/loss 30 pips away from your entry point. However, if some unforeseen factor is responsible for pushing the USD through your stop/loss level you might be inclined to hold this position just a bit longer in the hopes that it turns back into a winner. It is very hard to make the decision to cut your losses and even harder to resist the temptation to book profits too early on a winning trade. This is called leaving money on the table. A common mistake is to ride a loser too long in the hopes it comes back and to cut a winner way too early.

If you use technical analysis to establish entry and exit levels, be very disciplined in following through on your original trading plan.

Price charts Chart patterns There are a variety of charts that show price action. The most common are bar charts. Each bar will represent one period of time and that period can be anything from one minute to one month to several years. These charts will show distinct price patterns that develop over time.

Candlestick patterns Like bar charts patterns, candlestick patterns can be used to forecast the market. Because of their colored bodies, candlesticks provide greater visual detail in their chart patterns than bar charts.

Point & figure patterns Point and figure patterns are essentially the same patterns found in bar charts but Xs and Os are used to market changes in price direction. In addition, point and figure charts make no use of time scales to indicate the particular day associated with certain price action.

Technical Indicators Here are a few of the more common types of indicators used in technical analysis:

Trend indicators Trend is a term used to describe the persistence of price movement in one direction over time. Trends move in three directions: up, down and sideways. Trend indicators smooth variable price data to create a composite of market direction. (Example: Moving Averages, Trend lines)

Strength indicators Market strength describes the intensity of market opinion with reference to a price by examining the market positions taken by various market participants. Volume or open interest are the basic ingredients of this indicator. Their signals are coincident or leading the market. (Example: Volume)

Volatility indicators Volatility is a general term used to describe the magnitude, or size, of day-to-day price fluctuations independent of their direction. Generally, changes in volatility tend to lead changes in prices. (Example: Bollinger Bands)

Cycle indicators A cycle is a term to indicate repeating patterns of market movement, specific to recurrent events, such as seasons, elections, etc. Many markets have a tendency to move in cyclical patterns. Cycle indicators determine the timing of a particular market patterns. (Example: Elliott Wave)

Support/resistance indicators Support and resistance describes the price levels where markets repeatedly rise or fall and then reverse. This phenomenon is attributed to basic supply and demand. (Example: Trend Lines)

Momentum indicators Momentum is a general term used to describe the speed at which prices move over a given time period. Momentum indicators determine the strength or weakness of a trend as it progresses over time. Momentum is highest at the beginning of a trend and lowest at trend turning points. Any divergence of directions in price and momentum is a warning of weakness; if price extremes occur with weak momentum, it signals an end of movement in that direction. If momentum is trending strongly and prices are flat, it signals a potential change in price direction. (Example: Stochastic, MACD, RSI)

7. Understanding Margin

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Trading currencies on margin lets you increase your buying power. Here's a simplified example: If you have \$2,000 cash in a margin account that allows 100:1 leverage, you could purchase up to \$200,000 worth of currency-because you only have to post 1% of the purchase price as collateral. Another way of saying this is that you have \$200,000 in buying power.

Benefits of Margin With more buying power, you can increase your total return on investment with less cash outlay. To be sure, trading on margin magnifies your profits AND your losses.

Here's a hypothetical example that demonstrates the upside of trading on margin:

With a US\$5,000 balance in your margin account, you decide that the US Dollar (USD) is undervalued against the Swiss Franc (CHF).

To execute this strategy, you must buy Dollars (simultaneously selling Francs), and then wait for the exchange rate to rise.

The current bid/ask price for USD/CHF is 1.2322/1.2327 (meaning you can buy \$1 US for 1.2327 Swiss Francs or sell \$1 US for 1.2322 francs)

Your available leverage is 100:1 or 1%. You execute the trade, buying a one lot: buying 100,000 US dollars and selling 123,270 Swiss Francs.

At 100:1 leverage, your initial margin deposit for this trade is \$1,000. Your account balance is now \$4000.

As you expected, USD/CHF rises to 1.2415/20. You can now sell \$1 US for 1.2415 Francs or buy \$1 US for 1.2420 Francs. Since you're long dollars (and are short francs), you must now sell dollars and buy back the francs to realize any profit.

You close out the position, selling one lot (selling 100,000 US dollars and receiving 124,150 CHF) Since you originally sold (paid) 123,270 CHF, your profit is 880 CHF.

To calculate your P&L in terms of US dollars, simply divide 880 by the current USD/CHF rate of 1.2415. Your profit on this trade is \$708.82

SUMMARY

Initial Investment:
\$1000

Profit:
\$708.82

Return on investment:
70.8%

If you had executed this trade without using leverage, your return on investment would be less than 1%.

Managing a Margin Account

Trading on margin can be a profitable investment strategy, but it's important that you take the time to understand the risks.

- You should make sure you fully understand how your margin account works. Be sure to read the margin agreement between you and your clearing firm. Talk to your account representative if you have any questions.
- The positions in your account could be partially or totally liquidated should the available margin in your account fall below a predetermined threshold.
- You may not receive a margin call before your positions are liquidated.

You should monitor your margin balance on a regular basis and utilize stop-loss orders on every open position to limit downside risk.