CHAPTER 1

The Business of Trading Money

WHAT IS FOREX?

Foreign currency is simply money valued against one currency or another, in most cases the U.S. dollar. Simply put, a forex trader is simultaneously buying one currency and selling off another. Money, after all, is what makes the world go 'round. There will always be demand and activity in this product. How to successfully trade this market or any market requires proper education of the vehicle in which you are trading and knowledge of the basic fundamentals and technical analysis tools. One also has to be fairly savvy in technology, as forex trading is virtually all done online through the Internet. Conquering the forex market and mastering success in trading absolutely requires identifying and learning how to avoid a multitude of pitfalls more than it does identifying trading opportunities. In fact, most professional traders will tell you that it is not any specific trading methodology or trading system that makes successful trades; rather it is the discipline and patience needed to master and to stick to their trading rules and to remain controlled in their overall trading methods. In order to win at trading, you must manage risks and understand that there will be lots of losing trades. Remember that success takes time, but mostly it requires consistency in how you seek, execute, and exit positions. If you want to conquer the forex market and wish to learn which technical tools will serve you best, then this is the right book for you.

My goal in this book is to present an easy yet comprehensible set of trading techniques and reliable trading tactics that you can apply in every-day trading circumstances. These techniques should help you identify frequently reoccurring trading opportunities. Yet to better enhance these techniques, I will cover why it is important to develop and maintain a systematic approach based on historical data that is back-tested either visually or by the aid of a computer or trading software program. The signals and methods can be applied for long and short positions. Forex has no restrictions on selling short, so these trading methods will improve and increase your trading opportunities because you can trade both long and short strategies. Imagine a trading product that allows you 24-hour access so you can apply techniques that will set your stop-loss levels, profit objectives, and various order types (such as contingency orders and trailing stops) to maximize your performance. This is what the forex market offers, including flexible leverage and commission-free trading.

WHY TRADE FOREX?

As I stated one moment ago, there will always be demand and supply for money. Democracy, capitalism, and the American dream have led people to seek fortunes. The problem is that many folks who rushed into a venture or an investment saw these dreams diminish as they got in either too late or too early or were just poorly informed. Looking back in recent history, manias such as the "tech wreck" and the stock market bubble financially ruined many people. And there were the innocent victims who invested in Enron, AT&T, and other such companies. I am not talking about speculators; I am referring to employees of those companies who had their retirement savings invested with their employers. Lately, we see weakness and a potential for a bubble to burst in the real estate market. Perhaps you are invested in a second home or know someone who made a killing buying and selling fixer-uppers. The term "flippers" was popular as FSBO (for sale by owner) signs were planted in the front lawn of houses across the United States as eager investors were enticed to flip the property and make a fast buck. If you were in the game early on, you did well. If you got in the game late and are holding onto excess inventory, then you are at risk.

In late June 2006, many investors were left holding the bag on excess inventory—they bought a housing unit (condo, town home, or home) to turn around and sell for a profit but, due to such market conditions as an excess supply of homes for sale, cannot sell the property. Most of their cash or past profits may be tied up in the investment. Even worse, they may be overextended in credit from their bank. These are the folks who will be exposed to major financial disaster. To make matters worse, the Federal Reserve (the Fed) raised interest rates once more, for a record-breaking 17 consecutive hikes. That brought the Fed Funds interest rate to 5.25 percent. The prime lending rate shot up to 8.25 percent. That put the fixed rate for a 30-year mortgage up to 6.62 percent (actual mortgage rates depend on your credit score, down payment, etc.). What this did in effect was to bring on higher borrowing costs, which slowed the housing market even more.

As of October 2006, both new and existing home sales have continued to slow. Higher mortgage rates had been expected to slow the housing market, and they finally started showing their effects. Just to show you, mortgage rates went up roughly 125 basis points since the same period starting from 2005. So when the reports came in from June 2006, new home sales edged down 3.0 percent to an annual rate of 1.131 million. New home sales were down 11.1 percent on a year-over-year basis. The graph in Figure 1.1 shows the rise in mortgage rates and the decline in new home sales.

It did not stop there either; existing home sales slowed with supplies rising. Existing home sales edged down 1.3 percent in June 2005. Existing home sales at that time were down 8.9 percent on a year-over-year basis. Supply became even more of an issue for existing homes than for new homes as inventory of unsold existing homes rose in June 2006 to 6.8 months from 6.4 in May 2006. That set a supply figure at a nine-year high. Figure 1.2 shows the same trend: As rates moved up, sales declined.

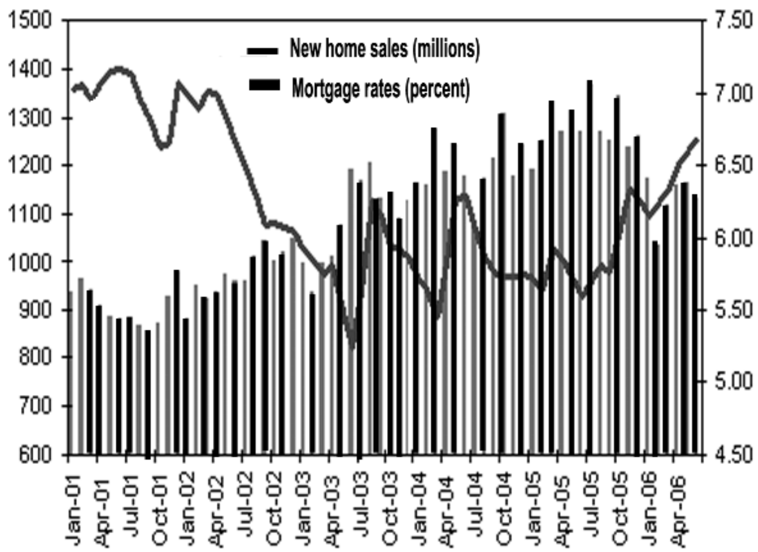

FIGURE 1.1 New Home Sales versus Nationwide Average Mortgage Rates

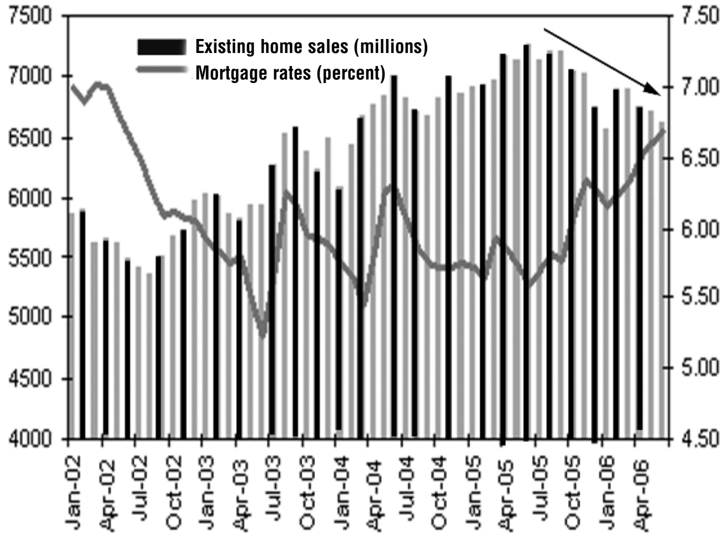

FIGURE 1.2 Existing Home Sales versus Mortgage Rates

This slowdown has many investors looking to maintain a means to generate an income, which is what is attracting so many people into trading the forex market. Some of the benefits of forex trading are that there is no traveling involved, you trade from the comfort of your home or office through the Internet, and you have virtually 24-hour access to the market. Yes, there are risks to trading; but as we have seen in the past, most investments come with risk. You just need to be properly informed and educated, and that is what I want you to achieve through reading and studying the material presented in this book.

FOREX OR FUTURES: WHICH IS RIGHT FOR YOU?

The Foreign Exchange (FX) is one of the fastest-growing investment arenas today. Large institutional investors and hedge funds are big players in the forex market; and in the past three years, the Foreign Exchange market had an estimated 50 percent increase in volume. Some had credited this increase to the large activity created by the online currency trading for the retail investor. The forex market is an over-the-counter market, which means that there is no main exchange or clearinghouse. This is contrary to the futures markets which offer futures trading in "open outcry" and electronic access; which is transparent pricing through a trading platform. This enables one to see the bids/asks and size, otherwise known as the "depth of market" (dome).

In this book, we will be looking at the different aspects of trading the currency markets, including the advantages and disadvantages of trading the forex market. In addition, you will learn how to use other resources to make better decisions on when to enter or exit your forex positions. Trading the forex offers leverage, leverage that the individual controls. Through the use of margin, an individual investor has the choice to increase or decrease leverage through various means. Most currency firms offer 100 times leverage on a regular size account; compare this leverage to the leverage offered to the average equity investor, and you can see why many traders are more attracted to trading the forex. As mentioned previously, leverage in the forex market can also be customized to the individual trader, which means that a trader can choose to lower or eliminate leverage while trading foreign currencies.

FOREX: THE ATM OF THE INVESTMENT WORLD

Foreign Exchange currency trading, otherwise known as the forex market, offers a completely different investment asset class that offers leverage and virtually unrestricted access 24 hours a day. Forex trades virtually around the clock from the Asian market open on Sunday night until the U.S. market close on Friday afternoon. One of the attractions from an individual trader's perspective is that there is this constant access to make a trade. In other words, in every transaction, a trader is long one currency and short the other. A position is expressed in terms of the first currency in the pair. For this reason, currencies are always traded in pairs; for example, if you have purchased euro and sold U.S. dollars, it would be stated as a euro/dollar pair. With a volume of over $1.5 trillion daily, the Foreign Exchange market is the largest and most liquid financial market in the world—more than three times the aggregate amount of the U.S. equity and Treasury markets combined. This means that a trader can enter or exit the market at will in almost any market condition with minimal execution risk. Due to the sheer size of liquidity, a continuous supply-and-demand driven product (we all use and need money), and the accessibility of trading make many professional traders consider the forex market like a bank's automatic teller machine (ATM).

The forex market is so vast and has so many participants that no single entity, not even a central bank, can control the market price for an extended period of time. Unlike other financial markets, the forex market has no physical location, no central exchange. It operates through an electronic network of banks, corporations, and individuals, trading one currency for another. The lack of a physical exchange enables the forex market to operate on a 24-hour basis, spanning from one zone to another across the major financial centers.

HARNESS THE POWER OF LEVERAGE

The forex market allows traders to control massive amounts of leverage with minimal margin requirements; some firms offer as much as 100-to-1 leverage. For example, traders can control a $100,000 position with $1,000, or 1 percent.

Obviously, leverage can be a powerful tool for currency traders. While it does contribute to the risk of a given position, leverage is necessary in the forex market because the average daily move of a major currency is about 1 percent, while a stock typically sees much more substantial moves in excess of 10 percent. When trading in the forex arena, the use of leverage is pretty much considered similar to an interest-free loan from your broker. It enables a trader to use as much as 200-to-1 leverage. This translates to having $500 in margin while controlling a $100,000 position in the market, or 0.5 percent of the position value. This is considerable leverage that can work in favor of as well as against an online forex trader. Once again, leverage can be seen as a free short-term credit allowance, just as it is in the futures markets, allowing traders to purchase an amount of currency exceeding that of their account balance. As a result, traders are exposed to an increased level of both risk and opportunity. Due to the nature of the leverage in the forex markets, positions are normally short-lived. For this reason, entry and exit points are crucial for success and must be based on various technical analysis tools. While fundamental analysis focuses on what should happen, technical analysis is based on what has or is happening at the current time.

Identifying the overall trend, whether it is short term or long term, is the most elementary element of trading with technical analysis. A weekly or monthly chart should be used to identify a longer-term trend, while a daily or intraday chart must be used for examining the shorter-term trend. After determining the direction of the market, it is important to identify the time horizon of potential trades and to apply those strategies to the appropriate trend. Therefore, the techniques covered in this book are highly effective in trading the FX markets. Technical analysis techniques will be your “bread and butter”; they will help you master and generate profits in the forex market.

Technical analysis is the study of historical prices in an attempt to predict future price movements. There are two basic components on which technical analysis is based: (1) prices and (2) volume. With the proper understanding of how these two components exploit the impact of supply and demand in the marketplace, combined with a stronger understanding of how indicators work, especially when combining candle charts and pivot analysis, you will soon discover a powerful trading method to incorporate in the forex market.

PLAY BOTH SIDES: LONG OR SHORT

If one wants to take advantage of a price decline, one of the advantages that the forex market has over equity markets is that there is no uptick rule as exists in the stock market; short selling in forex is similar to that in the futures market. By definition, when a trader goes *short*, he is selling a currency with the expectation that the price will drop, allowing for a profitable offset. If the market moves against the trader's position, he will be forced to buy back the contract at a higher price, resulting in a loss on the trade. There is no limit to how high a currency can go, giving short sellers an unlimited loss scenario. Theoretically, a short seller is exposed to more risk than a trader with a long position; however, through use of stop orders, traders can mitigate their risk, regardless if long or short. It is imperative that traders are well disciplined and that they execute previously planned trades, as opposed to spontaneous, spur-of-the-moment, emotionally driven trades. There are obvious benefits to short selling. This aspect of the forex market allows traders to profit from declining markets. The ease of selling contracts before buying them first is in contrast to typical stock trades. Market prices have a tendency to drop faster than they rise, giving short sellers an opportunity to capitalize on this phenomenon. Similarly, prices will often rally gradually with increasing volume.

As prices begin to reach a peak, trading volume will typically taper off—a signal to short sellers to initiate a trade. When a reversal does occur, there will typically be more momentum than for the corresponding up move. Volume will increase throughout the sell-off until the prices reach a point at which sellers begin to back off. The concept here is represented in detail in this book and is a powerful tool for swing and position traders. Even day traders will benefit from knowing volume analysis. It is important to know where to get the daily volume information and how to apply this information to foreign currency trading. I will share this with you shortly.

HEADLINE TRADES

The BBC commonly refers to the British Broadcasting Corporation; but in the forex market, it is trader's nomenclature or slang for the Big Boys Club:

banks, brokers, and corporations. And there is a fourth group: large hedge funds. Each one has made its mark in history using foreign currencies. Two milestone trades made headline news. These are the famous curency trades, both of which took advantage of taking short and long positions. Let's look at the hedge fund world when famed financier George Soros "broke" the Bank of England. He placed an estimated $10 billion bet that the British pound would lose value, and he won the bet! How about DaimlerChrysler, the parent company of Chrysler and Mercedes Benz; it reportedly made more money in the forex market that it did selling cars! Imagine explaining to your boss that you made more money hedging and trading foreign currencies than doing what you do best, building cars.

Another milestone event is as recent as early 2005. This involved Warren Buffett the founder of Berkshire Hathaway (the fourteenth-largest U.S. company, according to the July 4, 2006, issue of *Fortune* magazine). When the financial media was pounding out news stories that the dollar was in trouble, Warren made a statement that he was heavily short the U.S. dollar. Unfortunately, once he made that announcement, the dollar gained value and rallied for most of 2005. If you did not do your own research or homework and blindly followed his advice, things did not turn out so well for you.

In the remainder of 2005, the dollar moved higher against most major currency pairs. What turned the market around? Some of the events that drove the dollar higher were dictated by monetary policy as the Federal Reserve continued to raise interest rates. Then there were economic, geopolitical, and political developments on the domestic front that influenced the dollar's value. For starters, the Homeland Investment Act (HIA) was passed. The HIA is part of the 2004 American Jobs Creation Act and was intended to entice U.S.–based multiconglomerate corporations to bring money back into the United States. The window of opportunity for companies to take advantage of the HIA benefits prompted companies to increase the pace at which funds are repatriated to the United States. Since companies had only until the end of 2005, many analysts suspected that companies would rush to repatriate foreign profits by year's end and that there would then be a high dollar demand to convert foreign currencies. Geopolitical issues arose during the summer of 2005 when there were riots in France as a result of less support for the euro currency. That contributed to a very poor market sentiment and a lack of confidence in the euro. This was grounds for foreign investors to make a flight to financial safety, selling their currency to buy U.S. dollars. The tone was essentially dollar positive and euro negative, which is a result of a change in political views and shows how consumer sentiment can have a negative effect on a currency. I said earlier that technical analysis will be your "bread and butter" for profiting in the forex market; but you still need to be aware of fundamental developments, economic reports, and the times when these reports hit the newswires. As this section shows, fiscal policy changes can drive markets in new directions.

What may have contributed to the dollar rally in 2005 and hurt Mr. Buffett's position was the fact that other players may have been preying on his position. Berkshire Hathaway, Inc., is without a doubt a high-profile player. So when Warren Buffett announced he was going to cut back speculative positions against the U.S. dollar after losing profits due to surprising dollar strength, the buying to cover his shorts boosted the dollar. Keep in mind that Mr. Buffett had bet that the dollar would continue losing ground, as it did in 2004; he felt the massive U.S. current account deficit would be dollar negative. But instead, monetary policy dictated otherwise, as the Federal Reserve continued to raise interest rates. That was helping to drive demand as the interest rate differentials widened. In its third-quarter report in 2005, Berkshire Hathaway said it had cut its foreign-currency exposure from $21.5 billion to $16.5 billion. That was a significant amount of selling foreign currencies and buying U.S. dollars.

As you can see from the Dollar Index weekly chart in Figure 1.3, on a

FIGURE 1.3 U.S. Dollar Index Contract (monthly bars)
Used with permission of GenesisFT.com.

year-to-year basis, the dollar did make an outstanding run. However, that rally fizzled out in 2006. Also, keep in mind the dollar was at a high of 120.80 back in 2002; so depending on where Mr. Buffett was shorting the dollar, he could still be in a lucrative or profitable position. When I was wrapping things up for this book, the Dollar Index had managed to decline near the multidecade lows, and investor sentiment remained longer-term negative on the dollar. In addition, if you look at the longer-term price direction dating back since the inception of the Dollar Index contract, the Dollar Index is in a descending or declining channel.

The focus of this example is how shifts in monetary and fiscal policies can and do dictate price swings in the market, as happened in 2005 and 2006. Furthermore, foreign currency trading has become an acceptable asset class and valuable trading vehicle for the large multinational corporations. Just for your knowledge, the July 4, 2006, issue of *Fortune* magazine listed the top-10 largest U.S. corporations as ExxonMobil, Wal-Mart, General Motors, Chevron, Ford Motor, Conoco Philips, General Electric, Citigroup, American International Group, and International Business Machines. Funny that 30 percent of the top-10 businesses consisted of energy companies. I found this intriguing; Microsoft was ranked number 50 and Intel number 51. Who was number 100, you ask? John Deere. I think you can see the trends of investment flows and which sector is the leader as represented by the amount of a company's revenue growth. In 2006, the leader was British Petroleum!

Back in late 1999, money poured into technology stocks. In late 2003 and 2004, money poured into home builders. Then in 2005 and 2006, money poured into energy stocks, and not just for short-term trading but also for long-term investment opportunities in exploration and research and development for new oil fields and infrastructure repairs of pipelines and refineries. The most important terms to remember here are *money flow* and *sector leaders*. Following money flows, sector leadership among corporations can help you to determine where we are in a business cycle. We will talk about how these two concepts are important factors to monitor when trading foreign currencies. The relationships between how and where money is being made and which industry it is being made in directly impact foreign currency values and can help you in your trading decisions.

Money flows into one sector and out of another. If consumer demand is in technology, as was the case in the middle to late 1990s, then the U.S. dollar is strong. If demand changes to commodity-based products, such as crude oil, gold, and construction materials, the Aussie and Canadian dollars will appreciate. Australia and Canada are both producers of such commodity products as gold and lumber; and since Canada has vast reserves of tar sands, its currency benefits from higher crude oil prices.

THE PRIVATE BANKERS' CLUB HAS NOW TURNED PUBLIC

In the past, currency trading was exclusively accessible for individual speculators through the futures industry, whereas the spot marketplace in the banking arena was for the private bankers' club, the privileged few. This has all changed now, and the competition is fierce. The industry has expanded from what was an exclusive club of proprietary hedge fund traders, corporations, banks, and large institutions. Just to give you an idea of who the competition is that takes part in the forex arena, here is the list of the top five banks in the United States as of July 4, 2006, according to *Fortune* magazine. This is in order of capitalization: Bank of America, JP Morgan, Citigroup, Wachovia, and Wells Fargo. This does not include foreign banks or pension funds who participate in trading. Forex is no longer exclusive to the major trading firms, such as Goldman Sachs, Mitsubishi, Merrill Lynch, and Morgan Stanley. Now it is available to any and all individual traders who want to participate. You have 24-hour access in this market from your home or office right off your desktop or laptop computer.

Forex trading is considered the behemoth of the investment world, with more than $3.5 trillion in currency trading taking place per day, according to the Bank for International Settlements. There is more daily volume in the forex market than in all of the U.S. stock markets combined. There is no doubt that that is one reason why foreign currency has become so popular. Also, the market has liquidity; has favorable trading applications, such as the ability to go long or short a position; and has a tendency to trend well. Chart watchers love the currency market because it trades well based off technical analysis studies.

FOREX TRADES EASILY

The forex market offers traders free commissions, no exchange fees, online access, and plenty of liquidity. Unlike the futures products, the forex market uses *standardized contract values*, meaning that full-size positions are valued at 100,000. The one main element that has attracted investors was and is the commission-free trading. Plus, most forex firms require less capital to initiate a start-up account than a futures account. In fact, investors can open accounts on their debit and/or credit cards; and the practice still exists of online payments through PayPal.

Some firms offer smaller-size *flexi-accounts* that allow traders to start applying their skills at technical analysis with as little as $500. And there is also the *mini-account*, which allows individual investors to adjust their positions by not having too big a contract value per position, as they can add or scale into more or fewer positions to adjust the level of leverage according to their account size. This means that smaller-size investors are not excluded from trading because they can participate with mini-contracts. What is great about this feature is that a new trader or an experienced trader who is testing a system can trade the market with real money, rather than simply paper trading; the new traders can benefit from the actual experience of working with money and will be able to see how they handle the mental or emotional side of trading. People are emotionally driven. Fear, greed, and anxiety can wreak havoc on people's psyches. Therefore, practice trading with smaller leverage will not make you rich immediately; but it will help you hone your trading skills and help you develop confidence in your methods and execution skills.

Having real money on the line certainly helps people to learn about their emotional makeup. This is one great way to overcome the fear and greed syndrome that many traders seem to battle. Another excellent quality that forex mini-accounts have is that smaller-size traders can afford to trade multiple lots for scaling out of trades in order to let a portion of their contracts ride for a longer, more-profitable trade and still capture profits on a partial exit.

Another attraction is that most forex companies offer free real-time news, charts, and quotes with state-of-the-art order-entry platforms; some even have automated order-entry features, such as "one cancels the other" and "trailing stops." All of these tools and order entry platforms come at no additional charge to the trader. This market is a pay-as-you-go concept because there are no commissions—you simply pay a premium, or a higher spread, to buy and a higher spread to sell. Most forex dealers take the other side of your trade. You do not have direct access to the interbank market, as it is called. Because the forex market is decentralized, it is possible that five different companies are showing five different prices all at the same time within a few points (or PIPs, as they are called). Most forex traders are short term in nature, meaning they are quick-in-and-out players. Day trading in the forex market is beneficial for these traders due to the fact that there are no commissions, but the PIP spreads can and do add up.

IMPORTANT FEATURE

Flexi or mini forex accounts can be set up by an individual. The main benefit is that you can control the leverage and use smaller lot sizes, which enable you to trade multiple contracts that will allow you to scale into and out of a trade at various price points.

PAY THE SPREAD

Forex prices, or quotes, include a *bid* and an *ask*, similar to other financial products. The bid is the price at which a dealer is willing to buy and traders can sell a currency. The ask is the price at which a dealer is willing to sell and traders can buy a currency. In forex trading, unlike futures or equities, one has to pay a PIP (percentage in points) spread on entering and on exiting a trade. The *PIP spread* is the point difference between the bid and the asking price of the spot currency price. This can vary between two and six PIPs, depending on the volume and the popularity of the cross currency.

A typical example is the euro (EUR) versus the U.S. dollar (USD). We will see a bid price on the EUR/USD of 1.2630 and an asking price of 1.2633, which means you are paying a three-PIP spread. The spread essentially works like this. You place a buy on the EUR/USD at 1.2633, but you won't see breakeven on the trade until the price moves to 1.2633 bid. If you are trading a mini-account, you will see a $3.00 deduction for your trade profit on entry. Once the price moves to 1.2633 bid, then your account comes out of the red and into the black. In an exotic cross such as the euro versus against the Japanese yen or the New Zealand dollar versus the Japanese yen, you might pay a higher bid-ask spread of 6 to 12 PIPs. You need to check with your forex dealer for the listing of PIP spreads per preset crosses and pairs trades.

WHAT ABOUT INTEREST?

If you want to hold a position for several days, a rollover process is necessary. In the spot forex market, all trades must be settled within two business days at the close of business at 5 P.M. (Eastern Standard Time, EST). The only fee involved here is the interest payment on the position of currency held. At times, depending on the position, you can receive an interest payment as well. This is where the term tomorrow/next (Tom/Next) applies. It refers to the simultaneous buying and selling of a currency for delivery the following day. As with futures, the forex market is now regulated to an extent and comes under the scrutiny of the self-imposed regulators, such as the National Futures Association after the Commodity Futures Trading Commission (CFTC) Modernization Act passed in 2002; but since there is no centralized marketplace, many forex dealers can and do make their own rules and policies. Because forex dealers are in the business to make money and to provide a service for traders, some firms will charge interest on your account but not make an interest payment to your account unless you meet certain financial requirements. Again, because these dealers are in the business to make money, I have heard stories that some will even increase the interest charge by more than double the going rate; and if they do give a credit offer, the rate will be below what the market is really at.

Since most traders in forex are short term in nature, by settling up or closing out their positions by 5 P.M. (EST), they are not generally concerned with the interest rate charge aspect. Also, unless they have serious positions on (over $1,000,000 value), the interest charge will be minimal anyway and not something that should distract from the job at hand, which is trading. My advice is this: Do your homework when looking for the right dealer to trade through and ask questions regarding interest charge policies when holding positions for several days.

IS THERE GOING TO BE A NEW KID IN TOWN?

Yes, there is going to be a new kid; and by the time this book is published, the name and place will be FXMarketSpace. This entity represents a collaborative effort between two foreign currency industry leaders: Reuters and the Chicago Mercantile Exchange (CME).

This venture is expected to launch in 2007. What it will do is facilitate spot trading transactions on six major currencies against the U.S. dollar: the euro, the Japanese yen, the British pound, the Australian dollar, the Swiss franc, and the Canadian dollar. Four cross-currency pairs will also be supported. FXMarketSpace intends to add more products in forwards and options at a later date. Since the forex market has changed dramatically over the past few years, many players, such as hedge funds and commodity trading advisors who manage money, have entered the market with a new set of needs, one of which is order anonymity.

This concept will be the first over-the-counter FX trading platform to offer central counterparty clearing and full trade anonymity. FXMarketSpace will also be accessible through multiple portals, giving its users unprecedented breadth of access to its trading platform. These characteristics are expected to increase participation and to enhance liquidity in the forex market. FXMarketSpace combines the central counterparty model and clearing function of the Chicago Mercantile Exchange with the global distribution network and direct processing capability of Reuters. It is supported by one of the best matching and clearing technology programs and offers industry-leading matching-engine capabilities provided by the CME.

Who Is Reuters?

Reuters is the leading provider of news, financial information, and technology solutions to institutions, businesses, and media worldwide. Founded in 1850, Reuters has always been committed to delivering information using the best available technology. In 1992, Reuters pioneered electronic trading services and established its presence with the launch of Reuters Dealing (originally D-2001, now Dealing Direct), an electronic peer-to-peer trading platform. Since then, the Reuters platform, in its formative and subsequent versions, has provided a catalyst for forex trade-volume growth by significantly reducing both execution speed and transaction costs.

FXMarketSpace

This venture will offer participants unprecedented choice of access to its platform through a variety of means including CME's i-Link API, Reuters Dealing 3000 and Reuters 3000 X-tra desktops, Reuters standard transactions, API Select Independent Software Vendors (ISVs), and portals of participating clearing member firms. FXMarketSpace is targeted to meet the explosive growth in demand for currency transactions by banks and other financial institutions, including traditional asset managers, proprietary trading firms, leveraged funds, currency managers, hedge funds, and commodity trading advisers (CTAs). It is designed to provide increased price transparency, to introduce trading anonymity, and to heighten forex market accessibility. These three features will attract more players, which in turn will increase market liquidity and market efficiency for the next generation of forex traders. All market participants will be able to trade against the same set of firm, executable prices. The central counterparty clearing model provides for full anonymity and eliminates the need for bilateral credit lines to support trading activities. The company's matching host provides increased transparency through both a five-level depth of book display with bid/offer quantities and detailed "time and sales" information. Firms may utilize the existing CME telecommunications hubs to facilitate their connections to FXMarketSpace, providing improved speed of access while reducing costs. Hubs are currently located in London, Amsterdam, Dublin, Paris, Milan, Gibraltar, and Singapore. Customers may utilize either their existing Reuters infrastructure or secure Internet connections to access the market.

FXMarketSpace will reduce counterparty risk by being the buyer to every seller and the seller to every buyer by employing CME clearinghouse functionalities. If you bought this book to learn about the trading opportunities in the forex arena or even if you are a seasoned trading pro, look to learn some of my techniques. Keep your eyes and interest open on this new venture for currency trading; it promises to revolutionize the way we trade. It is like combining the best of futures and the spot forex market. Perhaps as it develops the centralized marketplace, we will have access to spot forex volume and will not need to worry about capturing that data from the futures market.

WHY TRADE THE SPOT FOREX MARKET?

From all the financial instruments traded, forex is believed for a number of reasons by many professional traders and analysts to be one of the best-suited markets to trade using technical analysis methods. First, it is well-suited because of its sheer size in trading volume; according to the Bank for International Settlements, average daily turnover in traditional Foreign Exchange markets amounted to $1.9 trillion in the cash exchange market and another $1.2 trillion per day in the over-the-counter (OTC) Foreign Exchange and interest-rate derivatives market as of April 2005. Second, the rate of growth and market participants in forex trading has increased some 2000 percent over the past three decades, rising from barely $1 billion per day in 1974 to an estimated $2 trillion per day by 2005. Third, since the market does not have an official closing time, there is never a backlog or “pool” of client orders parked overnight that may cause a severe reaction to news stories hitting the market at the U.S. bank opening. This generally reduces the chance for price gaps. Currencies tend to experience longer-lasting, trending market conditions than do other markets.

These trends can last for months, or even years, as most central banks do not switch interest rate policies every other day. This makes them ideal markets for trend trading and even breakout systems traders. This might explain why chart pattern analysis works so well in forex trading. With such widespread groups playing the game around the world, crowd behavior plays a large part in currency moves; and it is this crowd behavior that is the foundation for the myriad of technical analysis tools and techniques. Due in part to its size, forex is less volatile than other markets. Lower volatility equals lower risk. For example, the Standard & Poor’s (S&P) 500 Index trading range is between 4 percent and 5 percent daily, whereas the daily volatility range in the euro is around 1 percent. Trading veterans know that markets are interdependent, with some markets more heavily influenced by certain markets than others. We covered some of these relationships looking at futures and certain stocks and how interest rates move equity markets and currencies. We will learn in coming sections how to detect hidden yet repeating patterns that occur between these related markets. Forex is the ideal market for the experienced trader who has paid his or her "trading tuition" in other markets. Forex is by far the largest market in dollar volume. At times it can be less volatile; experiences longer, more accentuated price trends; and does not have trading commissions as we discussed. However, there are no free lunches. Traders must use all the trading tools at their disposal; the better these fundamental and technical tools, the greater their chance for trading success.

While intermarket and other relationships are often complex and difficult to apply effectively, with a little high-tech help, traders and investors can enjoy the benefits of using them without having to scrap their existing trading methods.

FOREX VERSUS FUTURES MARKET

The futures market through the International Monetary Market (IMM) of the Chicago Mercantile Exchange has many benefits as well. Founded in 1898, CME is the leader in the FX futures arena, accounting for 96 percent of all currency futures contracts traded on a worldwide basis. The Chicago Mercantile Exchange pioneered this segment by offering the world's first financial futures contracts on seven foreign currencies in May 1972. Since that time, it has continued to expand its reach in FX by introducing new products, expanding its customer base and leveraging the market leading technology found in CME Globex®, its proprietary electronic trading platform. The exchange handles over a billion contracts valued at more than $638 trillion on an annual basis. It is a public company; and as of August 18, 2006, the stock (CME) was trading at 461.35. Amazing, considering that when this stock was first released in its initial public offering (IPO) in December 2002, it was trading at under 40 per share! The history of the exchange and the innovator of the IMM, Leo Melamed, who brought foreign currency trading to life, is legendary. It has allowed investors, large and small, to trade foreign currencies exclusively for nearly 25 years before the explosive growth of spot forex was available. As with any product, there are strengths and weaknesses. I wish to share with you the facts so you can determine which investment vehicle suits your taste and trading style.

First, you should know the symbols for the individual futures currencies as quoted against the U.S. dollar. There are just minor differences between spot forex and futures symbols, as shown in Table 1.1.

Note that futures trade in quarterly cycles; and to differentiate between the various contract months, futures have universal symbols for each of the different contract months. December is "Z," March is "H," June is "M," and September is "U." Here is what you would use with a charting or quote ven-

TABLE 1.1 Symbols for Futures and Forex Quoted against the U.S. Dollar

Currency	Futures Symbol	Forex Symbol—Nickname
Euro currency	EC	EUR/USD—Euro
British pound	BP	GBP/USD—Cable
Japanese yen	JY	USD/JPY—Yen
Australian dollar	AD	AUD/USD—Aussie
Canadian dollar	CD	USD/CAS—Loonie
Swiss franc	SF	USD/CHF—Swissy

dor to get a futures contract quote on a June 2007 euro currency—ECM7. On some quote and charting services, the current year or the next contract month going forward would be assumed and understood. The quotes symbols for the different expiration months and various contract sizes of the futures markets are confusing, but you can quickly learn these variables.

At times, the futures arguably have tighter "spreads" between the bid and the asking prices; plus there is no interest charge or rollover fee every other day. In addition, the futures markets offer options for longer-term traders. There are transactions costs that apply per round turn; but if the brokerage commission exchange, regulatory, and transaction charges are less than the PIP spread in forex, an active speculator would be given a better cost advantage using the futures markets instead of the forex spot market. For example, let's compare a trade in forex on a contract value similar in size to one on the futures exchange. Use the example of a euro futures contract on the CME with a contract size of USD125,000 worth of euros, where each tick or PIP would be 12.50 in value. If the commissions and related fees are $10, which is the average charge by most brokerage firms, that is your transaction cost per round turn. That is $5 to buy and $5 to sell out of the position. Keep in mind that the contract value is 25 percent higher than a full-size forex position, too. If a day trader in forex trading in a 100,000 full-lot-size contract pays two PIPs on every transaction of a position, this trader would be charged $20 per round turn transaction. The futures arena also has other interesting features and products; one is the U.S. Dollar Index® contract traded on the New York Board of Trade. It is computed using a trade-weighted geometric average of six currencies. It trades virtually around the clock; the trading hours are from 7:00 P.M. to 10:00 P.M., then from 3:00 A.M. to 8:05 A.M., and then from 8:05 A.M. to 3:00 P.M. Unlike the forex, there are daily limits on the price movement, with 200 ticks above and below the prior day's settlement, except during the last 30 minutes of any trading session, when no limit applies. Should the price reach the limit and remain within 100 ticks of the limit for 15 minutes, new limits will be established 200 ticks above and below the previous price limit. The chart in Figure 1.4 shows a breakdown of the six currencies and their respective

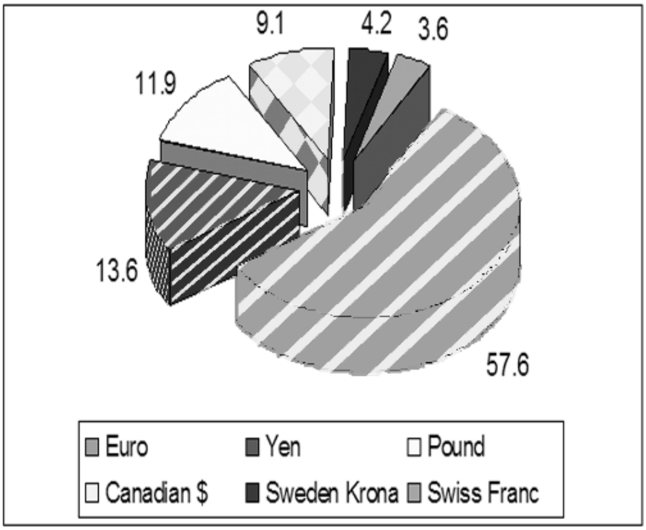

FIGURE 1.4 Currencies and Their Respective Average Weights

weights on the average. The top four include the euro, which is the heaviest weight with 57.6 percent; then the Japanese yen with 13.6 percent; then the British pound with 11.9 percent; and the Canadian dollar with 9.1 percent. The Swedish krona is only 4.2 percent and the Swiss franc 3.6 percent.

FOREX ANALYSIS IS SIMPLER

From an analytical point of view, tracking the forex market is a much simplified trading vehicle when compared to the futures products. One reason is due to the uniform contract sizes. In the forex market, the standard lot size is $100,000. The tick, or PIP, value varies in the futures products based on the contract, and the contract size varies on the different currencies. For example, the euro is $125,000, and the tick value is $12.50 per point; the Canadian dollar is $100,000, and the tick value is $10 dollars per point. The British pound futures have a contract value of $62,500, which makes each tick worth $6.25. The yen is worth $125,000, so every point is valued at $12.50; but it is quoted inversely to the cash market. For instance, the futures is quoted at 0.8610, and at the same time the spot forex would be bid at 116.50 and offered at 116.54. Forex traders do not have to deal with what is known as rollover. Every quarter in the futures markets, there is an expiration of the contracts. The rollover period takes place in the second week of every June, September, December, and March. It is at that time that you need to convert or roll out of the old contract month and then into the new month or next expiration contract going forward. Commodity markets can cause confusion and can create errors during a rollover period. Often times, when I was a frequent guest on CNBC, Joe Kernan hated the crude oil market because it rolled every month. Generally there was a $2 premium from one month to the next; so in early November 2006, crude fell to just $55.00. But when the front contract month expired and the next rolled over, prices were quoted $2 a barrel higher. The same scenario exists for currencies; however, the rollover is every three months.

The first notice day and last trading day combined with the options expirations can hinder trading and cause confusion; there are situations where traders place orders for the wrong contract months during this "switching period." This rollover period gets confusing even for an old pro like me; but if you know what to expect, then you can prepare for the event. We have not covered this topic yet (which will be covered in depth in the next few chapters), but the greatest technical tool for forex trading is *pivot point analysis*. It is based on a mathematical formula to predict future support and resistance target levels. If you are calculating pivot points for the futures markets, you already know that you need to constantly switch your analysis from the expiring contract to the new contract month. This can cause "gaps" in your analysis. Take, for example, the rollover that occurred in March 2006. On March 7, the March futures contract was still trading and was quoted at 0.8485. The June futures contract had become the lead month and was quoted at 0.8597. That would mean that there was a gap of over 100 PIPs due to what is called the *basis*—the difference between the cash market today and the futures contract for delivery in June. The basis includes what is known as the *carrying costs*.

As a trader, I would need to adjust my numbers and analysis for this gap or start backtracking prior sessions to accommodate for the price differences. It is done every quarter; and, believe me, it is a royal pain. So not only do you have to be careful placing the right contract, but you need to know the various margin requirements, the right expiration dates, the contract values, and the value of each tick (point). I am not going to give you the "let's turn lemons to lemonade" line here; futures rollover is a pain in the neck.

To summarize, the benefits of trading the spot forex market outweigh trading the futures markets from many perspectives. If you acknowledge that paying the PIP or spread for your trades is not cutting into your profits, especially since you do get free charts, news, and order execution privileges, then trading in the spot forex market is better than the futures markets. Granted, most forex dealers trade platforms and charting capabilities are not high-powered systems but they do allow a beginner to execute trades without additional software expenses. The analytical tools such as volume analysis and open interest studies combined with the CFTC *Commitment of Traders* (COT) report data can and should be integrated for spot forex trading. If you can learn to merge the benefits of both worlds, then perhaps one of the best short-term trading vehicles is the spot currency market known as forex.

GEM OF A BENEFIT IN FUTURES

One of the best features of the futures markets is that they have listed options; and because these are futures products, they also have the access of the transparency on how many options on the futures contracts are available to buy and how many options on the futures contracts are offered to sell. This book, *Forex Conquered*, is designed to give you specific trading plans on all aspects of foreign currency trading opportunities. I feel that there are many, many choices; and yet so few people are aware of them. Options are just one futures trading vehicle, and many forex traders have had only limited exposure to options. Therefore, I want to introduce you to what they are and how you can benefit from them in your trading career. To start with, there are two types of options: a call and a put. And there are two kinds of positions for each call and put: a buyer and a seller, or an option writer.

A buyer or long option holder of a call has the right but not the obligation to be long a futures position at a specific price level, for a specific period of time and for a specific price called the *premium*. A buyer or long option holder of a put has the right but not the obligation to be short a futures position for a specific price that is paid by the buyer at a specific price level and for a specific period of time. For option buyers, the premium is a nonrefundable payment, unlike a margin requirement for a futures contract where it is a good-faith deposit. Premium values are subject to constant changes as dictated by market conditions and other variables, such as time decay and the distance between the underlying value of the market and the strike price of the option. One more factor that determines an options value is the *volatility rate*, which is based on price fluctuations in the activity on the underlying futures market. The wider and faster the price movements are, the higher the volatility level is; and a higher volatility rate will help increase the options value.

There are other variables that are used to calculate an options value, such as interest rates and demand for the options itself. For instance, if you bought a call option and if the underlying futures market is moving up toward your strike price, then the option's premium value may increase, because option writers or sellers will want more money and buyers will have to pay more for the premium of the option. This is an example of an increase in demand for the option as a direct result of the market's expectation of the movement in the price direction.

One of the first things to know about buying options in futures is that you do not need to hold them until expiration. Option buyers may sell their position at any time during market hours when the contracts are trading on the exchange. Options may be exercised at any time before the expiration date during regular market hours by notifying the broker. Usually one exercises in-the-money options; this is called the *American style* of option exercising. It is called the *European style* of option exercising when the option can only be exercised on the day the option expires.

A seller or option writer of a call or put grants the option buyer the rights conveyed from that option. The seller receives a price that is paid by the buyer, that is, the premium. Sellers have no rights to that specific option except that they receive the premium for the transaction and are obligated to deliver the futures position as assigned according to the terms of the option.

A seller can cover his or her position by buying back the option or by spreading off the risk in other options or in the underlying futures market if market conditions permit. A buyer of an option has the right to either offset the long option or exercise his option at any time during the life of the option. When a trader exercises his option, it gives the buyer the specific position (long for calls and short for puts) in the underlying futures contract at the specific price level as determined by the strike price. Options are generally exercised when they are *in the money* (ITM)—the strike price is below the futures price for a call option and above the futures price for a put option.

HOT TIP

The Chicago Mercantile Exchange, as of July 31, 2006, started trading European-style options on the British pound, the Canadian dollar, and the Swiss franc; futures contracts; and euro and Japanese yen contracts. These options, if in the money, are automatically exercised at expiration. European-style options are used by most options traders in the OTC FX markets. Because there is no risk of early exercise, they are often priced lower than American-style options. European-style options on CME FX futures are traded electronically, virtually around the clock, from Sunday afternoon to Friday afternoon on the CME trading platform and Monday morning through Friday afternoon on the trading floor.

There are three major factors that determine an option's value, otherwise known as the premium.

1. *Time value*—the difference between the time you enter the option position and the life the option holds until expiration. An option that has more time value is worth more than an option that is soon to expire, all things being equal. The term *wasting asset* is applied to an option because the closer the time comes to the option's expiration, the less the option is worth.
2. *Intrinsic value*—the distance between the strike price of the option and the difference to the underlying derivative contract. If an option's strike price is closer to the underlying futures contract, it will be more expensive than an option that is further away. The term used is a call option, which gives the buyer the right, not the obligation, to be long the market. A call option will cost more if the strike price is closer to the actual futures price. The reverse is true for put options. A put option will be more expensive if it is closer to the derivitive market price. These two examples are considered to be out of the money (OTM), because neither is worth exericising. (An in-the-money option is referred to when the strike price is below the futures for a call option and above the futures for a put option.)
3. *Volatility*—the measure of historical price changes. Volatility accounts for the pace of price change. In periods of violent price moves, options will command high premium values. Volatility is calculated by the magnitude of a market's past price move and current market condition.

Let's review some examples and at the same time help review what we have covered as forex and futures relate to each other. Keep in mind that the value of a futures contract is $125,000 worth of euros, the initial margin requirement as of August 29, 2006, is $2,835, and the maintenance margin is $2,100. These are subject to change without notice and are set by the individual exchanges.

Option Strategy Exercise

On August 29, 2006, at 12:00 P.M. (EST), the forex spot euro currency was at 127.67. At that precise moment, the December futures contract was at 128.49. Reference the *basis*, which is the price difference between where the spot market is valued and where the futures price is traded. That difference is 0.82 points. The 130.00 strike price for the December euro currency call option, which expires on December 8, 2006, has a shelf life of 101 days until it expires. The premium was quoted at 1.67 points. Each point is worth $12.50, so the value or cost of that option would be $2,087.50. At expiration, the December futures contract price would converge to represent what the spot forex market price would be.

The basis would narrow as futures becomes the cash market. For you to just break even, as this was an out-of-the-money call option at expiration, the spot and futures markets would need to be at 131.67. That is the point value of the premium added to the strike price of the option (130.00 + 1.67 = 131.67). That's the bad news. The good news is that if the market price moved within the first 30 days after you purchase the out-of-the-money call option, then the value would theoretically increase by 0.17 percent, which was determined by the "delta," one of what is called the "Greeks." It is a calculation that helps options traders to determine prices for option premiums.

By the same token, an out-of-the-money put option with a strike price of 125.00 was valued at 85 points or $1,062.50 (85 × 12.5 = $1,062.50). The 125.00 put option was out of the money by 349 points (125.00 – 128.49 = 3.49).

Applying the Strategy

First, if you are outright bullish on the euro and thought the dollar would decline to new all-time lows, the best strategy for unlimited rewards and limited risk would simply be to buy a long-term call option, which in the example using the 130 December strike would be less money and defined risk to the premium you paid, $2,087.50. Second, if you thought the dollar would rally and the euro would decline with the same risk/reward parameters, then using the OTM 125 put option would be a good consideration because your maximum risk would be the premium you paid, $1,062.50.

There are many combinations of option plays with various names, such as "strangles and straddles." Using options allows you a whole new world of opportunities other than long/short outlooks in a specific time frame. Table 1.2 shows the spread between the strikes and the actual cash or spot market; they are roughly equal to each other, with the call at a 233-point-spread difference to the spot and the put at a 267-point-spread difference to the spot. Only the futures markets has the big point spread difference; and remember, as we get closer to expiration, the futures becomes the cash market, and the basis narrows with time. Therefore, another strategy called a *strangle* would be, if you thought the price of the euro was going to stay in a range between 125 and 130, to sell (or write) both the call and the put options. This way you would receive the premium of both the call and the put. You would have changed your risk parameters because writing options have limited profit potential with unlimited risks and your margin requirements would increase as well.

TABLE 1.2 Pricing Options

130 Call Option	125 Put Option
167 points, or $2,087.50	85 points, or $1,062.50
233-point spread to spot	267-point spread to spot
151-point spread to futures	349-point spread to futures

However, by writing the call and the put options, you would collect a combined 252 points (167 for the call and 85 points for the put), or $3,150.00 (252 × $12.50 = $3,150.00). The margin required would be twice the amount of one position since there are two contracts minus the premium collected, or $2,520.00. Once again, the margins can change; and if the underlying market makes an adverse move sharply above 130.0 or well below 125.00, you have unlimited risk exposure. But let's check one aspect out: If the market does move above 130.00 at expiration, you have a break-even price of 132.52. If the market declines, your break-even level would be 122.48.

If you had no clue which way the market would move but felt there was going to be a massive breakout one way or another, particularly in the time horizon of the three-month shelf life of the December option, then employing what is called a *straddle* would limit your risks while allowing you to participate. A straddle occurs when you buy the 130 call and the 125 put. In this case, you would need to pay out $3,150.00, which is the amount of the two premiums. Keep in mind that your breakeven at expiration would be 132.52 on the upside and 122.48 on the downside. So at expiration, anything above or below those levels would start to accrue profits.

In the Money

Using the same variables as in the preceding example, a 125.00 call option would be considered in the money since the futures market was at 128.49. This call option has an intrinsic value that is the difference between the strike price and the underlying market of 349 points (125.00 – 128.49 = 3.49). That leaves a balance of 94 points given for the time premium value. Notice that the 130 call option was entirely out of the money and has more time premium value built into the option. Sometimes it pays to buy in-the-money options versus out-of-the-money options.

Collar, Not Choke, the Market

For a dollar bear or a euro bull, here is one of my favorite option strategies. It is a hedge strategy using both options and the underlying market, which under the right circumstances can work very effectively as far as risk-to-

TABLE 1.3 Option Price Comparisons

130 Call Option	125 Put Option
Collect 167 points	Pay 85 points
82-point credit	185-point risk/315-point reward

reward ratios and money management tactics are concerned. The opposite position can be implemented as well if you are bullish the U.S. dollar and bearish the euro. Let's examine a bullish collar strategy for longer-term traders. This strategy allows you to participate in a limited move with limited risk and still lets you sleep at night. If you trade the spot forex market, you will need two accounts: a forex account and a futures account. Forex traders who take a long position in the spot euro currency market with a full $100,000 lot size position will need to add $25,000 worth of mini lots to be equal in capitalization size with one futures contract. First, you want to enter the options side by selling the 130 call option and then buying the 125 put option. Once your order is filled, then enter the long position. You will collect premium from the short call option, which you will use to finance the put option. You are collecting more premiums from the call side and will have a credit, as Table 1.3 shows.

Also keep in mind that this is not an equally weighted position due to the basis difference between the spot and the futures markets; but as time passes, remember that the futures will line up with the spot market. If you are long the spot euro at 127.67, keep in mind that the futures market was at 128.49. But as you know, on any given day, generally both the cash and the futures will move in tandem, with a gradual decay in the futures market's basis. The key here is that you have protection to the downside calculated at expiration of 185 points; your maximum reward is 315 points. This is close to a one-to-two risk/reward ratio.

In order to make the collar strategy worth executing, you generally want to collect a premium or get a credit on the strategy or, at the very least, not pay out-of-pocket money on the options side. Since these are options on a futures contract, you will be charged a commission; therefore, you will need to check rates and margin requirements with different futures brokers. Futures brokers cannot lower the margin that the exchange sets, but they can increase the amount. So you need to do your homework. As far as options are concerned, they do have great benefits from the aspect of simple speculating on a directional price move to the use and application as an insurance vehicle, which is what we refer to as a hedge. As a foreign currency trader, certainly expanding your knowledge of these features and benefits can enhance your trading opportunities on various time frames, especially longer-term horizons. Using options to hedge positions into long holiday weekends, before government reports (such as the monthly unemployment number), or before Federal Open Market Committee (FOMC) meetings can help protect your account during violent adverse price moves, especially when they are short-lived. It is one aspect of trading with which all traders and investors should become more familiar.

TRADING CURRENCY STOCKS?

Foreign currency trading is not just for gamblers or hungover commodity traders. It really has become a respected asset classification and is extremely popular with professionally managed trading entities and hedge funds. Foreign currency is so hot that major players are taking it to the extreme. How so? Well, there is now what is called exchange traded funds (ETFs) on foreign currencies. The first to be introduced was the Euro Currency Trust (FXE). On the first day of trading, the Euro Currency Trust had over 600,000 shares trading hands.

Advantages and Disadvantages

As with any product, there are advantages and disadvantages to ETFs. One is that this vehicle has an annual expense of 0.4 percent of assets. If that amount is not enough (the interest rate is below the 0.4 percent expense ratio), then the sponsor can withdraw deposited euros as needed, which could diminish the amount of euros each ETF share represents. The currency ETFs are linked to the spot price versus the U.S. dollar. The obvious strategy to make money in these vehicles is to see the value move in the desired trade direction (you can buy and sell short) and to cover the interest charge less the trust expenses.

The benefactor or the depository for the ETF is JP Morgan Chase Bank. This product is structured as a grantor trust, and Bank of New York is the trustee. Here is how JP Morgan will make money: It will maintain two euro-denominated accounts in London, a primary account that will earn interest and a secondary account that will not earn interest. JP Morgan will not be paid a fee for its services to the ETF. It will instead generate an income or accept the risk of loss based on its ability to earn a spread on the interest it pays to the trust by using the trust's euro position to make loans in other banking situations. To be sure, JP Morgan has an advantage of floating money, so I would not worry that it will put itself in a position of extreme risk. As it has control over granting lending rates, I do not think that anyone will expect that the trust will pay the best available interest rate back to the

ETF so it will lock in a profit. The bank is in the business of making money. The best feature for individual investors for using an ETF is that it allows one to accumulate exposure without excessive leverage in the euro currency for a long-term position play. It can also be used as another means to hedge forex transactions. Each share of the ETF will represent 100 euros plus accrued interest. Under the guidelines of an ETF, it is acceptable to trade the short side without the uptick rule. Also, ETFs are listed on exchanges and trade throughout the day like individual securities. Since it is a tradable vehicle, unlike the forex market, it does charge a commission, which needs to be paid to a brokerage firm, to buy or to sell ETF shares.

Downside Risk

One of the downside risks to U.S. shareholders is that these ETFs are not insured by the Federal Deposit Insurance Corporation (FDIC), according to documents filed with the Securities and Exchange Commission (SEC). Also, interest on the primary account accrues daily, with rates based on the most recent Euro Overnight Index Average (EONIA), minus 0.27 percent that is paid monthly. The rate can change over time, according to the prospectus from Rydex; so there is no fixed rate or cost. This is a minor consideration; but for a large hedge fund, this could make a difference to an individual investor looking to take advantage of a long-term investment play. I hardly think this will cause a major change in the value of the investment.

For the record, the ETF's net asset value (NAV) is based on the Federal Reserve Bank of New York noon buying rate and expressed in U.S. dollars. And as you can imagine, the true influence on the value of this product is the same group of variables that affect the spot currency markets. Therefore, I believe that combining traditional technical analysis with the futures data, such as the *Commitments of Traders Report*, Volume and Open Interest studies, can greatly enhance the performance of longer-term investors over time. In June 2006, Rydex released six additional curency ETFs. So if you want to hedge or speculate that the U.S. dollar is strengthening or weakening against major foreign currencies and like the idea and concept of ETFs, now there is a pretty good inventory of product to choose from. The new currency ETFs trade on the New York Stock Exchange (NYSE) uner the symbols shown in Table 1.4.

To summarize, each unit represents 100 shares. You can sell short without the uptick rule that exists in stocks. ETFs allow a longer-term trader with limited risk capital to participate in an opportunity against the U.S. dollar versus major currency markets. Trading hours are during the U.S. equity markets' session—9:30 A.M. (EST) until 4:00 P.M. (EST). If you want to

TABLE 1.4 ETF Symbols on the NYSE

Currency	Symbol
Euro currency	FXE
British pound	FXB
Japanese yen	FXC
Australian dollar	FXM
Canadian dollar	FXA
Swiss franc	FXF
Swedish krona	FXS

read more on the subject of currency ETFs, especially about the risks, charges, and expenses on these products visit www.rydexfunds.com.

DIVERSIFICATION THROUGH TRADING PERIODS

So far, we have introduced you to various products to take advantage of foreign currency markets through the spot forex and futures and now through exchange traded funds via the stock market. Many traders and investors need to incorporate *diversification* into their arsenal of investments. Many believe the best means to diversify is through investments that have little to no correlation with each other with reserve cash balance, such as stocks, bonds, real estate, commodities, forex, and cash parked in a certificate of deposit (CD) or government Treasury bill (T-bill).

If you have a passion for currency trading, then in order to utilize diversification to the extreme, consider your overall allocation of your investment strategies within this sector. Depending on your time constraints, you may only be able to participate to a limited extent in day trades during the European session or early morning U.S. hours as economic numbers are released. As such, you should also have devotion toward holding positions as they go into a strong trend mode and should carry a position for more than a few days. This is known as a *swing trade*. Then, if you want to really capture a longer-term market trend, finding the right vehicle and strategy will allow you to hold a longer-term position. Let's define what I consider the three important time periods and classifications of a trade.

1. *Day trade*—1 minute up to 24 hours.
2. *Swing trade*—2 days to 10 days.
3. *Position trade*—10 days to 1 year or longer.

Day traders can use the forex or futures markets for small price swings. Swing traders can also use the forex and futures markets but can also implement an option strategy, such as a long call or a long put. This is a good consideration if you want to take advantage of establishing a position ahead of a major economic report, such as the Monthly Jobs number or a central bank meeting where you expect an interest rate adjustment to create a price shock in the market. For longer-term position trading where you would want to take advantage of a fundamental policy change or a technical trading program, you have several doors open to you besides just trading spot forex. You can implement an options strategy as an outright trade or use options as a hedge to reduce your risk exposure, which in turn can reduce your margin requirements. Also, you can invest in an ETF and gradually add positions without excessive risk exposure; and because ETFs have no time decay element, such as options on futures, you can really hold onto a position for a very long time. In a perfect world, I would say that a trader's time factor would limit him or her to a percentage breakdown to allocate resources to trading forex as I indicate in Figure 1.5—25 percent to day trading, 40 percent to swing trading (since a majority of significant market moves happen over a period of 3 to 10 days and then enter in a consolidation period), and 35 percent to position trading (to account for slow periods, time off, and vacations).

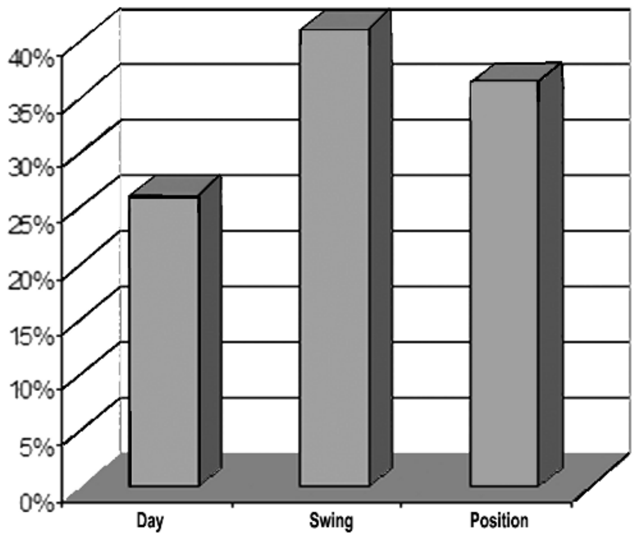

FIGURE 1.5 Allocation of Resources

Which Currency Tracks What and Why?

As Figure 1.4 showed, the most popular or heavily weighted currency against the dollar is the euro. There are several considerations and nuances that each individual currency tracks, as each not only is affected by the U.S. dollar but also is manipulated by its own country's economic and political influences. From a historic perspective, let's examine the top-five major currencies and what influences their values:

1. *The Euro.* The euro was first introduced to world financial markets as a currency in 1999 and was finally launched with physical coins and banknotes in 2002. The European Union is composed of these member countries: Austria, Belgium, Greece, Germany, France, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain. The largest members are considered socialist countries; and as a result, these countries tend to run the largest governmental budget deficits. The European Central Bank (ECB) dictates monetary policy and puts more emphasis on inflation concerns than it does on economic contraction. We have seen in the past where the ECB would rather maintain steady interest rates in periods of slower economic growth than lower rates and risk igniting inflationary pressure. As a result, the ECB is less likely to frequently adjust rates.
2. *The Japanese Yen.* The Japanese economy depends on sales of export. For the most part, Japan is a net importer of raw material goods, especially crude oil. Japan's economic machine hinges on foreign demand for their manufactured goods. Their main customers are the U.S. consumer and Europe. One of the biggest concerns that faced the Bank of Japan (BOJ) in the 1990s was deflationary pressures. This compelled the BOJ to keep what was known as a zero-interest policy to help reignite its economy. In turn, it also artificially kept the value of the yen low as many savvy investment funds made billions of dollars in what is known as a carry trade—one entity would borrow cheap money at nearly zero interest, export those funds to another country, and park them in a higher-interest-bearing account. This transaction prompted selling of yen to buy the currency in which those funds were to be invested or parked. U.S. Treasury notes and bonds as well as German bunds were the target of these transactions. As a result, the yen would trade lower against the U.S. dollar and the euro. Therefore, trading the yen/euro cross pair is a viable market to trade. One more consideration when focusing on factors that can influence the yen's value is that China is one of Japan's competitors. Since China also artificially floats its currency, the yuan, against the U.S. dollar, China's monetary policy also weakens or can put downward pressure on the yen's value.

3. *The British Pound.* The Bank of England (BOE) is in charge of dictating monetary policy in the Unted Kingdom. One of the main influences on Britain's economy is oil production in the North Sea. Money may make the world go round, but energy keeps it running. With that said, you will see in history that as oil prices rise, the British pound also tends to follow suit. However, oil supplies are dwindling in the North Sea, and Britain is using more and more natural gas. As of August 2006, Britain was Europe's biggest consumer of natural gas, and it is continuously increasing imports of the fuel to make up for declines in crude oil production. As a result, natural gas prices in Britain have risen an average of 60 percent from 2005 through 2006. It is now reliant on natural gas and susceptible to economic risk exposure if there are outrageous price spikes in the cost of that product. As of 2004, Britain became a net importer of natural gas. If natural gas prices spiral out of control, this factor can influence consumer spending or can create a surge in inflationary pressure; and that would justify action by the Bank of England to change monetary policy. This scenario could influence the value of the British pound. The pound is also sensitive to economic developments of its European neighbors. Therefore, trading the cross of the euro against the pound is a very liquid trading relationship.
4. *The Canadian Dollar.* The Canadian dollar is often referred to as the "loonie." The French equivalent of loonie is *huard*, which is French for *loon*, the bird that appears on the face of the Canadian one dollar coin. The Bank of Canada (BOC) sets monetary policy as it is the central bank for that country. Back in November 2000, the BOC adopted the system of eight meetings each year, in which it announces whether it will change its interest rate policy, just as in the United States. Canada is rich in natural resources, especially crude oil. The primary source of Canada's growing crude oil supplies are vast oil sands reserves. Oil sands production, which exceeded the 1 million barrels per day (b/d) plateau late in 2003, is forecast to more than double by 2015 to almost 2.6 million barrels per day. With 175 billion barrels of reserves, it is the second-largest petroleum deposit in the world. Since the United States is Canada's biggest client, as oil prices rise, the value of the Canadian dollar will be supported in value.
5. *The Swiss Franc.* The Swissy, as it is called, is considered the safe-haven currency, as it is backed by gold. The Swiss National Bank makes monetary policy decisions based on events that impact the value of gold as they influence the value of the currency. Factors that influence the Swiss franc are inflation, excessive economic growth or periods of economic contraction, and periods of political instability. The

Swiss franc tracks the value of the euro; but during periods of European upheaval, as occurred in 2004 when there existed dissention among members of the European Union, the Swiss franc will outperform the euro.

Fundamental News Drives the Markets

Traders who are new to forex can take comfort in knowing that analyzing and forecasting exchange rate movements does not rely solely on macroeconomic factors, the "big picture" issues. These are concepts for which information is readily available but that are not so intuitively grasped by the masses. Currency traders who are looking to capture big moves in exchange-rate movement definitely should focus on the fundamentals and the understanding of what drives interest rate differentials between various countries. The currency pairs are traded especially when attempting to assess the value of currencies.

Traders need to be aware of several key elements and events that can cause currency values to move. For one, the adjusting of interest rates by central banks is a major factor that moves markets. These decisions are based on many concerns, such as international trade flows, investment flows, the health of individual country's economies, and inflation worries. The opposite concern, as has been the case for Japan for over a decade, is deflation. These are the same factors that can and do influence moves on the stock and bond markets.

Our civilization has evolved into a very complex international capitalistic environment. Some governments intercede to help benefit their economies through government support programs, as had been the case in China. China had artificially supported its currency, the yuan, to move in relationship with the U.S. dollar. Then we have multinational conglomerate corporations, whose money flow needs can and do influence short-term price swings in currencies. Throughout these developments, it has become increasingly difficult to target one single effect on the value of a currency in the short term, especially one weighted against the U.S. dollar. Take for example what happens in an economic business cycle. Money flow moves where there are better opportunities either from the perspective of attractiveness on rate of return or from a safety issue in uncertain times. Huge investment funds can move money to higher-yielding interest-earning instruments, namely bonds, or to foreign stocks. When major hedge funds see better opportunities from one country to another, they have the resources to move quickly with limited restrictions. These shifts in trading strategies also cause short-term moves in currency values.

Historically, when we see signs of economic changes taking place, money flows in the equity markets move from one sector to another as the economic business cycle goes into an expansion mode, then into a contraction, and then back into an expansion mode. Foreign investors may wish to take part in these changes as well, therefore increasing capital flows to the United States, which will have a short-term supportive boost for the dollar. As of the middle of October 2006, what we were possibly entering would have been considered an early-stage economic contraction. There were many factors at play that would lead to that conclusion. For starters, the Federal reserve had raised interest rates by 0.25 percent 17 consecutive times over a two-year period, bringing the federal funds rate to 5.25 percent. It concluded its interest-rate-hiking campaign based on concerns that it might choke off liquidity, bringing more risks to economic growth than the risks of inflation. That was a pretty good tip-off that the economic expansion phase just might moderate. As a result of increased interest rates, even the housing market turned south, as we discussed previously (see Figures 1.1 and 1.2). We had been in a longer-than-normal economic expansion period, starting from early 2003 through mid-2006. With this said, it was at the time considered a “long in the tooth” recovery (lasting more than 40 months), especially after the economic contraction period that followed 9/11/01.

Treasury Yield Relationship to Currencies

With the Federal Reserve interest-rate hikes and escalating energy prices taxing the American consumer, it is no wonder we were expecting a contraction. Some argued with the longer-term yields on Treasury bonds inverting in relationship to shorter-term maturities. This gave even more reasons to suspect a more-than-moderate slowdown might occur. Based on historical standards, when interest rates on the long end of the yield curve are below those of shorter-term maturities, we have entered into recessionary periods. The word *recession* was being tossed about by many leading analysts as a result of this reoccurring. As of August 21, 2006, the yield on the 10-year note was at 4.84, and the yield on the 2-year note was at 4.87. Figure 1.6 plots the yield on the various Treasury maturity issues. As you can see, the yield on the 10-year note dips below that of the 2-year note and creates the inversion.

An investor or a foreign central bank can park money into a short-term instrument and receive close to a 5 percent return without risk. That is one feature that will attract foreign capital flows and help support the dollar. This effect will occur until better opportunities evolve elsewhere. As a forex trader, you want to monitor yields on a global scale or events or reports that may impact these rates.

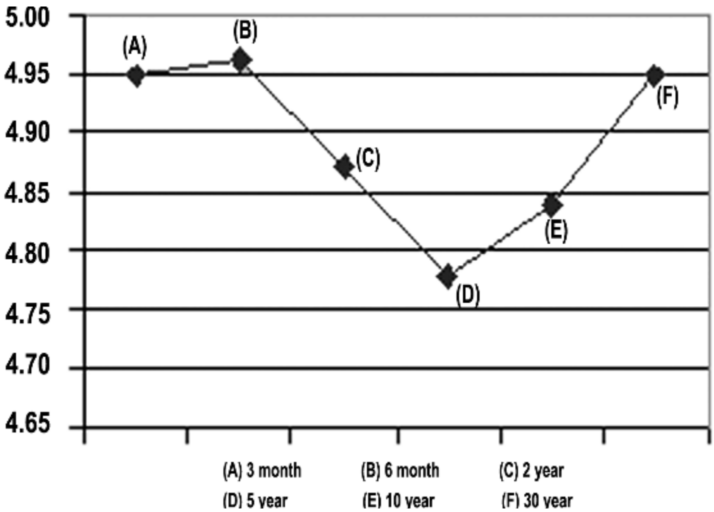

FIGURE 1.6 Yield on Treasury Notes, as of August 21, 2006

ECONOMIC CONDITIONS CLUES TO WATCH FOR

- Inverted yield curve gives warning of an economic slowdown.
- Flat yield curve signals economic recovery.
- Steep yield curve signals economic expansion.

Lessons Learned from Energy Prices

We can benefit with the knowledge from where energy prices are, especially crude oil. As prices rise, oil-producing countries increase their wealth. However, oil-consuming nations are at a disadvantage, and the increased cost of fuel can contribute to a recession, as occurred in the United States in the 1970s. If you think about it, higher fossil fuel prices actually act like a taxing effect on consumers. However, after a prolonged price appreciation, to reflect the higher energy costs, producers eventually need to raise prices in their finished goods and services to maintain a decent profit margin and not absorb the burden of higher energy costs. Who pays the price? You and I, the consumer, and that is inflationary. Crude oil prices hit an all-time high close at $78.40 per barrel on July 14, 2006 (see Figure 1.7), due to global demand and fighting in the Middle East. Tensions flared between Israel and Lebanon. Fears arose when many suspected Iran and Syria

FIGURE 1.7 Crude Oil Prices
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were backing Hezbollah with supplies, fears that Israel would take action to stop the weapon shipments. The markets were on edge as that region was deteriorating by the minute. If that was not enough, Iran was threatening to continue with its nuclear program, despite UN resolutions to have them stop enriching uranium. Iran's Supreme Leader Ayatollah Ali Khamenei was quoted as saying, "Iran would press ahead with its pursuit of nuclear energy," thus indicating it would not follow requests or directions from the United Nations. President Bush was quoted as saying we are in "challenging times" in a speech made on August 21, 2006. This was in reference to the global war on terrorism. This strongly impacted crude oil prices, as did the geographical location of Iran and the Straits of Hormuz, where oil cargo vessels sail to the Western world.

Imagine how sensitive the area was with reports that Iran was "testing" surface-to-sea missiles. There are two points I want to bring to your attention: (1) We want to look at the impact higher energy prices have on the dollar versus the currency of oil-producing countries, such as Canada and Britain. (2) We can determine from history that with higher energy prices, the United States is susceptible to recessionary pressures, which put further pressure on the dollar.

As a trader, I want access to as much relevant information as possible to give me clues to the overall market conditions so that I can make a more-educated trading decision. If I know that higher crude prices will weigh on economic development, I need to ask myself how can I profit from that situation. Based on a widely accepted business-cycle flow chart, we see business sectors that perform better under certain market conditions. As we enter a late-stage economic expansion (as I believe we entered in mid-2006), energy markets make a move, as do basic materials, as building is going like gangbusters. Then as higher interest rates slow consumer spending and credit costs a little more, we see money moving into safer issues, such as consumer staples and utilities. This occurs as consumer confidence declines in the economy, and people rein in spending. Technology is weakest during an economic contraction period as capital spending dries up. Figure 1.8 defines the various stages of the business cycle. At the top of the pyramid, when we are in the middle to late expansion period, we see energy as one of the top money sectors. As the economy slows, demand for fuel declines; people are more cognizant of their spending habits and start conserving.

Now to confirm that we were, in fact, in a period of contraction, we would look to see if these similarities were reflected in the various stock index performances. If we were entering a period of economic contraction,

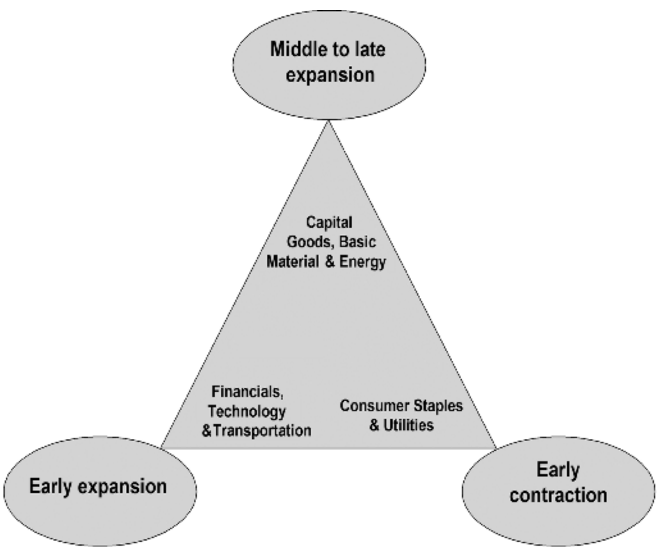

FIGURE 1.8 Stages of the Business Cycle

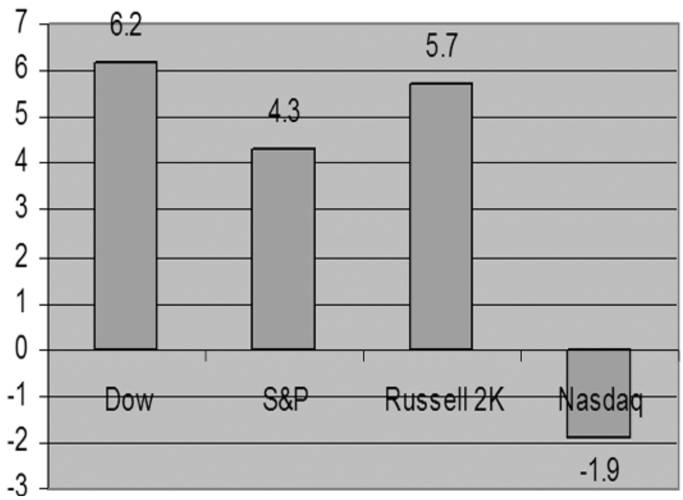

FIGURE 1.9 Year-to-Date Gain, 12-31-2005 to 8-18-2006

the Dow Jones Industrial Average, which represents 30 of the top blue-chip stocks, many of which offer dividends, might outperform the other indexes. We would certainly expect the Dow to outperform the Nasdaq. Let's examine Figure 1.9. This graph shows the year-to-date gain from December 31, 2005, through August 18, 2006. The Dow outperformed all the major stock indexes during that seven-and-a-half-month period. Notice the negative return on the Nasdaq? The key word here is *negative*. That implies that businesses, investors, and consumers are not positive on the economic outlook here in the United States. That does not bode well for the U.S. dollar. What we would look for as a clue that the dollar has bottomed would be for a period of economic expansion led by the technology sector. Until we see signs that the economy reenters a new business cycle, the U.S. dollar might just as well remain under pressure.

As we look ahead to the 2008 presidential election, this period may redefine an economic expansion. So watch for signs as technology leads the way. This may attract foreign investment flows, and the dollar may bottom at that time. Longer-term and short-term position traders can profit by watching for resurgence in the U.S. economy and confidence in the dollar. Eventually, it will reign supreme again. If the U.S. economy continues to grow, and if inflationary pressures build, then the Fed will probably continue to raise rates. This action will help support the dollar's value.

GEOPOLITICAL EVENTS

Like all markets, the currency market is affected by what is going on in the world. Key political events around the world can have a big impact on a country's economy and on the value of its respective currency. Turmoil, caused by labor strikes and terrorist attacks, as we have witnessed in this new millennium, can cause short-term price shocks in the currency markets. Terrorist attacks seem to have played more havoc on the energy markets than on the currency markets in 2006, but we need to be aware of any lasting economic impact these heinous acts have before we react by forming an opinion and placing a trade. We have heard the term *flight to safety*, indicating that traders are moving money from one country to another, thereby causing shifts in currency values. These events need to be monitored by forex traders as well.

Monetary and Fiscal Policy

When central banks act, it is called *monetary policy*. Other factors controlled by government decisions are referred to as *fiscal policy* changes, which are controlled by political concerns. Such changes can be linked to a change in specific laws, the changing of the guard, so to speak, such as how a new leader can and certainly does influence currency values. If a new leader is voted into office and does not have the confidence to run a country effectively, then we can see money leaving a country, which causes a decline in value of that currency. Therefore, these two points are major concerns for which forex traders should watch.

1. Economic conditions, including outlook on interest rates and inflation.
2. Fiscal policy changes and political leadership.

These factors have a long-term impact, which makes forex attractive to trade due to the long-term trending conditions established by central bank decisions based on these factors. Forex also offers investors some diversification, necessary as protection against adverse movements in the equity and bond markets.

Let's go over what you and I will see on a day-to-day basis through reports and news events and apply what is otherwise known as *fundamental analysis*—the study of tangible information in order to anticipate supply and demand flows. Several events can directly affect the outcome of supply. For example, changes in interest rates from country A would make its currency less valuable compared to the currency of country B where one would receive a higher rate of return on money invested. This would certainly reduce the demand for country A's currency. That is a prime example of a supply/demand–driven event.

How about trying to decide or to anticipate if there is a change in the strength or the weakness of an economy? This is where we really need to pay close attention to specific reports. For starters, a report showing a country's employment rate might reveal what the potential for future household disposable income is. It would give analysts and economists an idea of how much spending could occur due to the number of people working. Another aspect of fundamental analysis may be the ability to follow and understand the political scene on both an international and a domestic level.

If the European Central Bank meets and announces that it will raise interest rates in a surprise move, this will have an immediate impact on the value of the euro and, inversely, the U.S. dollar. If values of these currencies shift abruptly and severely, then products that are imported and exported would be priced differently. Ultimately, this could cause a ripple effect on the prices of goods and services. It is important to understand and to interpret what the potential outcome might be in the markets you are trading when these special reports are released. For a fundamental trader not to know what day or time a report is released could be hazardous to his financial health. At the very least, even if you are a veteran trader or a beginner, it cannot hurt to be aware of the main fundamental factors that might affect the markets you are trading. You should be aware of what could happen before most reports are released. That is why news services put out what time current events and special reports are coming out. Publications like *Barron's Weekly*, *Investor's Business Daily*, or the *Wall Street Journal* will most likely show you what you will need to know to stay in tune with the markets. Most forex dealers also provide special calendars that include the date and times that most major economic and agricultural reports are released. A calendar of events is also available free of charge at www.fxtriggers.com. Trading is not an easy venture, and there is one bit of advice that I wish you would follow: Be aware of the day's current events if you are in the markets. Knowing about a major report before it is released is sometimes better only because you have a chance to eliminate a surprising adverse market move. You could always make an adjustment to your position before a report is released.

Another reason you want to follow the developments on the economy is because it usually dictates how various equity markets and financial products will perform. The stock market likes to see healthy economic growth because that equates to better or substantially larger corporate profits. The bond market prefers a slower sustainable growth rate that will not lead to inflationary pressures. By watching and tracking economic data, analysts and investors will be better able to stay in tune with the markets and their investments. Moreover, foreign capital flows may increase if U.S.

instruments are higher-yielding than those abroad. We want to track the value of these instruments because that can give us a clue that there will be a shift in currency values.

Understanding what fundamental events dictate the markets at a given time may give you better insight to trade a currency based on the price direction of these financial products. The terms *yield maturity*, *rates*, and *prices* are all relevant in forex trading.

Playing the Carry-Trade Game

Each foreign currency has a central bank that issues an overnight lending rate. This is a prime gauge of a currency's value. In recent history, low interest rates have resulted in the devaluation of a currency. Many analysts assume this is a function of the *carry-trade strategy*, employed by many hedge funds. This is a trade where one buys and holds currencies in a high-yielding interest rate market, such as the United States, and sells or borrows money from a foreign country where the currency is in a low-yielding interest rate market, such as exists in Japan. There is a significant risk exposure to this investment, which requires large capital, or a highly leveraged position from an exchange-rate fluctuation.

Understanding Treasuries: Yield and Price

When I discussed the inverted yield curve and pointed out the discrepancy between the 10- and 2-year notes as shown in Figure 1.6, I wanted to further explain how these instruments work and the relationship to forex. Let's first define what a Treasury bond is and how it works and is priced out. U.S. Treasury bonds (T-bonds) are by all definitions a loan. Taxpayers are the lenders. The U.S. government is the borrower. The government needs money to operate and to fund the federal deficit, so it borrows money from the public by issuing bonds.

When a bond is issued, its price is known as its "face value." Once you buy it, the government promises to pay you back on a particular day that is known as the "maturity date." They issue that instrument at a predetermined rate of interest called the "coupon." For instance, you might buy a bond with a $1,000 face value, a 6 percent coupon, and a 10-year maturity. You would collect interest payments totaling $60 in each of those 10 years. When the decade was up, you'd get back your $1,000. If you buy a U.S. Treasury bond and hold it until maturity, you will know exactly how much you're going to get back. That's why bonds are also known as "fixed-income" investments; they guarantee you a continuous income and are backed by the U.S. government. There are also the concepts of *yield* and *price*. That is what confuses most investors. It is very simple: When yield goes up, price goes down; and vice versa.

Treasury Bonds, Bills, and Notes

The U.S. government issues several different kinds of bonds through the Bureau of the Public Debt, an agency of the U.S. Department of the Treasury. Treasury debt securities are classified according to their maturities:

- Treasury *bills* have maturities of 1 year or less.
- Treasury *notes* have maturities of 2 to 10 years.
- Treasury *bonds* have maturities greater than 10 years.

Since there are more equity traders in the investment world than there are forex traders, this investment area may attract more participants. If the equity markets are forecast to generate normal to even subnormal returns based on a historical standard for 2006 and beyond, then the appetite for making money may attract the individual investor to trade in the Treasury and forex markets.

WHICH REPORTS ARE MORE IMPORTANT THAN THE OTHER?

I want you to know that whether you are a beginner or an advanced trader, it is important to know what to look for and how certain reports may affect the price behavior of the markets. Figure 1.10 shows what I see as the major focuses of economic reports here in the United Statees and what is in my opinion the order of importance. My selection holds true in all business cycles. The number-one focus should always be to read and to listen to what the voting members of central banks are looking at and on what they are basing their decisions to adjust interest rates. That makes sense, right? So the releases of their FOMC meeting announcements are important, as well as the minutes of their last meeting. The minutes are released within two weeks of the last FOMC meeting. In Figure 1.10, I have two small branches from the FOMC meetings: One is the Beige book; heighten your awareness of this, as it is released two weeks prior to a Fed meeting. The other is the Federal Reserve districts business surveys; these reports will show the underlying strength or weakness of everything from business credit conditions to the health of the consumer debt to income ratios.

You and I want to watch the reports and speaking engagements of the voting members of the FOMC. Generally, they will give clues as to what their intentions are and what their concerns are. One series of reports is the Fed's Beige book, and the other reports are the individual Fed district business surveys, such as the Philadelphia Fed survey. Then we trickle down

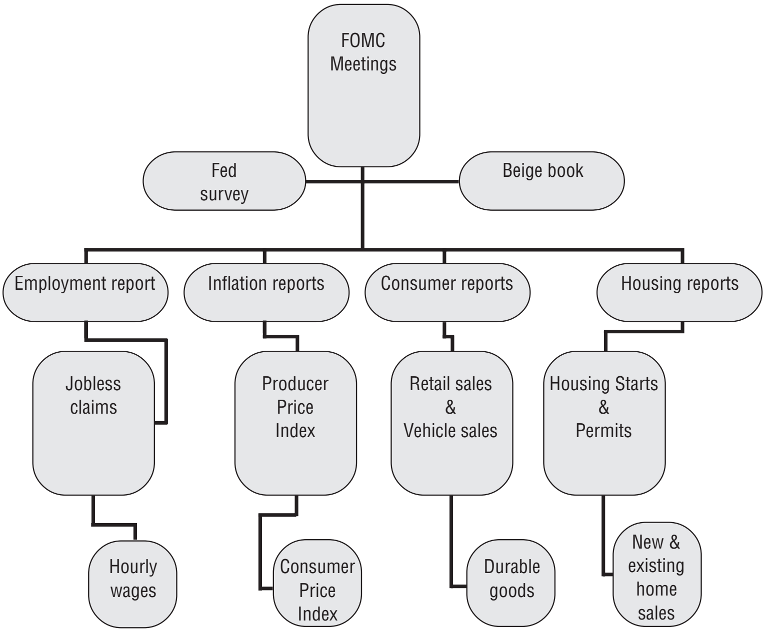

FIGURE 1.10 Economic Report Reference Chart

the flow chart reading from left to right and see the employment situation; in good times, we should see a low employment level with moderating wage costs. In hard times, we should see high unemployment rates. When times are good, as in the period through 2005 when the nation's unemployment level was under 5 percent, we need to be aware of ugly inflationary pressures; so forex traders need to focus on these inflation reports, such as the Producer Price Index and the Consumer Price Index. After that, taking a look at the financial health of the consumers is key to determining the continued strength or weakness of the economy. After all, if they have no more spending cash or are maxed out on their credit cards, we can anticipate a downturn in the retail sector, right? If the consumer stops shopping for clothes, electronic products, home design products, cars, or appliances, which we consider durable goods, then that won't be good for the economy and the Fed would be expected to stop raising interest rates or to possibly *lower* rates.

Here is a great example of why we want to pay attention to Fed speakers. When newly appointed Chairman Ben Bernanke took over, he had a private conversation with Maria Bartiromo, anchor of CNBC, one weekend. When she revealed his thoughts in an exclusive interview on national

TV, the markets responded in such a way that Bernanke will be more selective in what he says and who he talks to at private functions! Once again, we need to follow the people who make the decisions, and we need to listen to and to read what drives their decision-making process for adjusting interest rates.

FOMC Meetings

The Federal Open Market Committee consists of the seven governors of the Federal Reserve Board and five Federal Reserve Bank presidents. The FOMC meets eight times a year in order to determine the near-term direction of monetary policy. Changes are now announced immediately after FOMC meetings. There are a few accompanying statements the Fed may make after it announces any adjustments in interest rates. One statement is if the economy is at risk for economic weakness, or the other is if the economy is at risk for inflationary pressures. And there is always a chance for a neutral stance.

Beige Book

The Beige book is a combination of economic conditions from each of the 12 Federal Reserve regional districts. Truthfully, the report is aptly named the Beige book due to the color of its cover. This report is released usually two weeks before the monetary policy meetings of the FOMC. This report on economic conditions is used at FOMC meetings, where the Fed sets interest rate policy. These meetings occur roughly every six weeks. If the Beige book portrays an overheating economy or inflationary pressures, the Fed may be more inclined to raise interest rates in order to moderate the economic pace. Conversely, if the Beige book portrays economic difficulties or recessionary conditions, the Fed may see the need to lower interest rates in order to stimulate activity.

EMPLOYMENT REPORTS

The unemployment rate is a strong indicator of a country's economic strength. When unemployment is high, the economy may be weak and its currency may fall in value. The opposite is true as well. Many economists look for answers to the question "What is a country's full employment capacity level?" That knowledge will give clues to the peak in productivity and economic output. That also helps determine a country's capital flows and is, therefore, good information for currency traders to follow for longer-term trend identification. The unemployment rate measures the number of unemployed as a percentage of the nation's workforce. Nonfarm payroll employment tallies the number of paid employees working part time and or full time in the nation's business and government sectors.

There are several components that are also included in the employment report. One is the average hourly work week; that figure reflects the number of hours worked in the nonfarm sector. Another component is the average hourly earnings; it shows the hourly rate that employees are receiving. There are two versions of this report. One is a weekly report that is released every Thursday morning; and the other, the more influential report, is the monthly figure that is usually released on the first Friday of every month. The fear when we are at or near "full employment is that employers might have to pay overtime wages to their existing workforce and use higher wages to bring in new workers from the competitor. This action can raise labor costs because of a shortage of workers. This leads to wage inflation, which is bad news for the stock and the bond markets. Federal Reserve officials are always on the lookout for inflationary pressures. In August 2006, the monthly employment report showed a less-than-expected increase in new jobs. This gave a hint to traders that the Federal Reserve might halt its interest-rate-hiking campaign. That so-called campaign took the Fed funds rate from 1.0 percent to 5.25 percent with a record-setting 17 consecutive interest-rate adjustments. When the market thought the Fed was done due to the potentially weakening jobs market, the dollar fell sharply and foreign currencies exploded in value in short order. The British pound chart in Figure 1.11 shows a 15-minute time period, one of my favorite time periods to watch for trade signals. The bullish indicators, as represented by the triangles that are pointing up, generated buy signals before the report was released (the construction and theories behind this particular trading system will be discussed throughout this book) and would have given an extremely profitable trade. The explosive behavior of the market's reaction was due to the sentiment that the Fed would change its interest-rate policy from a tightening mode to a neutral watch-and-review mode.

One other method I utilize is trading like or similar markets, which is often referred to as trading *tandem* market relationships. In a situation that reveals a major change in interest-rate policy, such as a surprise in the employment growth or a contraction in the United States, we should see the dollar move against the entire spectrum of currencies. Call it a second-dimension confirmation technique.

Figure 1.12 shows the euro currency. Utilizing the same time period as in Figure 1.11, a 15-minute chart, we have similar buy signals generated before the report. It was the internal technical condition of the market on not one but two "like" or tandem markets that signaled that a change might take place in the value of these currencies.

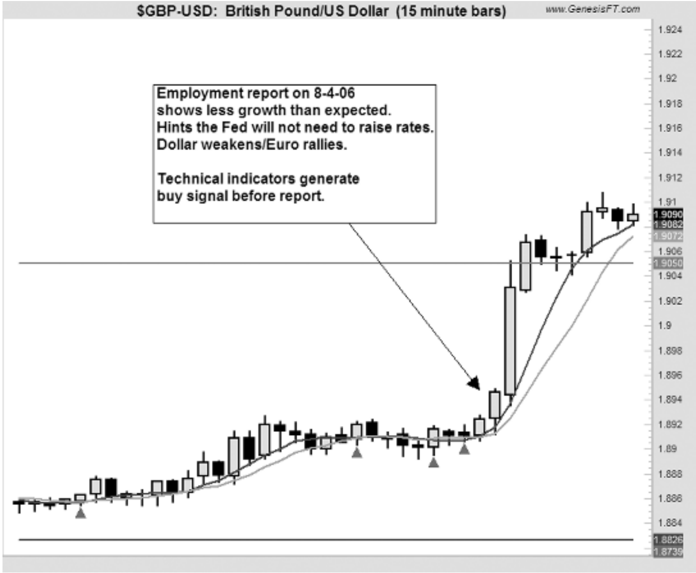

FIGURE 1.11 British Pound Explodes on Employment Report
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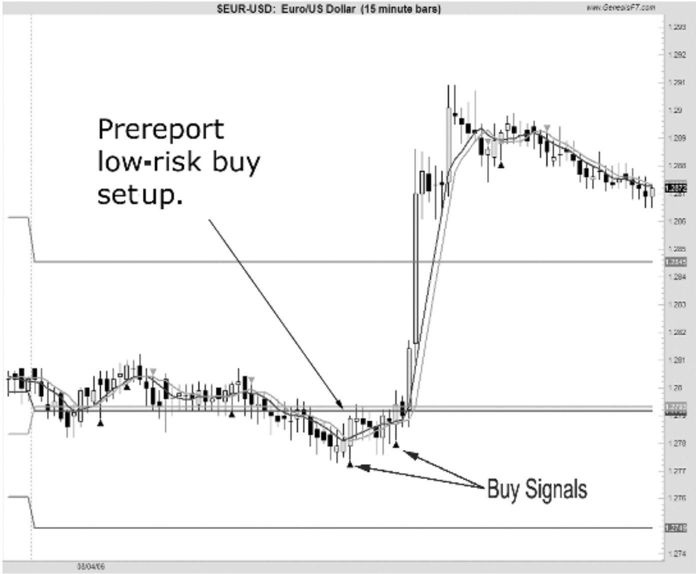

FIGURE 1.12 Euro/U.S. Dollar (15-minute buy signals)
Used with permission of GenesisFT.com.

As the charts show, a major change in fact did take place; the euro rocketed to the upside, generating over a 170-PIP profit per position in less than one hour. If you examine the two charts closely, you can see that while they both generated buy signals, both were at or near their pivot point support levels; but the trend in the British pound before the report was in an upward direction and the trend in the euro was in a declining mode.

What is interesting about this observation is that some traders were bound to be selling prior to the report, possibly because they were unaware that a significant report was due out or that it was an important enough event to warrant attention or because they were not looking at the same specific technical techniques that we will be covering in this book.

TRADING BEFORE REPORTS

Here are the major reports that have created dramatic and violent price swings in currencies. I want you to have a good understanding of what they mean so you can relate possible shocks to the markets when and if they are dramatically changed from what is expected before the reports' release.

- *Employment Cost Index* (ECI). This is a measure of total employee compensation costs, including wages, salaries, and benefits. The ECI is the broadest measure of labor costs. The employment cost index helps analysts determine the trend of the direction of employers' cost of having employees. This can give economists a clue whether inflation is perking up from a cost-of-doing-business standpoint. If a company needs to pay more to hire qualified workers, then the cost of doing business increases. This reduces profit margins. Companies usually raise their prices to consumers if their costs increase, and that is where the inflation theme plays out.
- *Producer Price Index* (PPI). This is a measure of the average prices paid by producers for a fixed basket of capital and consumer goods. The PPI measures price changes in the manufacturing sector. Inflation is a general increase in the prices of goods and services.
- *Consumer Price Index* (CPI). This is a measure of the average price level of goods and services purchased by consumers. Monthly changes in the CPI represent the rate of inflation. The consumer price index is the most widely followed indicator of inflation in the United States. Just knowing what inflation is and how it influences the markets can put an investor ahead of the game. Inflation is a general increase in the price of goods and services. The relationship between inflation and interest rates is the key to understanding how data like the CPI influence the markets. Higher energy prices, manufacturing cost increases, med-

ical costs, and imbalances in global supply and demand of raw materials and food products all weigh on this report. Take the price of gasoline we pay at the pumps. If gas prices escalate to the point where it costs $30 to fill up a car, or $60, or even $100, as was the case in 2006, consumers will have less spending money for other items. Even weather can be a factor on short-term changes on food. What would be the cost of tomatoes at the grocery store after a damaging freeze in California or in Georgia—$3 or $4 per pound? It has occurred. Think of the restaurants that serve salads and lose revenue, let alone the farmer whose crop is destroyed. This all plays a part in the CPI number. The core rate is the inflation number that excludes the volatile food and energy components.

- *Gross Domestic Product* (GDP). This is the broadest measure of aggregate economic activity and accounts for almost every sector of the economy. Analysts use this figure to track the economy's performance because it usually indicates how strong or how weak the economy is, and that helps predict the potential profit margin for companies. It also helps analysts gauge whether the economy is accelerating or slowing down. The stock market likes to see healthy economic growth because that translates to higher corporate profits.
- *Industrial Production and Capacity Utilization Rate.* This is a measure of the physical output of the nation's factories, mines, and utilities. The capacity utilization rate reflects the usage of available resources and provides an estimate of how much factory capacity is in use. If the utilization rate gets too high (above 85 percent), it can lead to inflationary pressures. Industrial production shows how much factories, mines, and utilities are producing. Since the manufacturing sector is estimated to account for one-quarter of the economy, this report can sometimes have a big impact on the stock and financial markets' movement.
- *Index of Leading Indicators.* This report is a composite index of 10 economic indicators that typically lead overall economic activity. The Index of Leading Indicators helps to predict the health of the economy, such as recessions and economic expansions.
- *International Trade.* This measures the difference between imports and exports of both goods and services. Changes in the level of imports and exports are an important tool that is used to gauge economic trends both here and overseas. This report can have a profound effect on the value of the dollar. That in turn can help or hurt multinational corporations whose profits overseas can diminish when they convert their funds back to the United States, especially if the U.S. dollar is overvalued. Another valuable aspect of this report is that imports can

help indicate demand for foreign goods here in the United States and exports may show the demand for U.S. goods in overseas countries.

- *Institute of Supply Management* (ISM) *Index* (formerly the National Association of Purchasing Managers [NAPM] Survey). This survey is a composite diffusion index of national manufacturing conditions. Readings above 50 percent indicate an expanding factory sector. The ISM Index helps economists and analysts get a detailed look at the manufacturing sector of the economy. Since manufacturing is a major source of strength for the economy and can reflect the nation's employment condition, this report is very important to watch.
- *Factory Orders.* This reports the dollar level of new orders for manufacturing durable and nondurable goods. The data from this report shows the potential that factories will be increasing or decreasing activity based on the amount of orders they receive. This report provides insight to the demand not only for hard goods, such as refrigerators and cars, but also for nondurable items, such as cigarettes and apparel.
- *Productivity and Costs.* Productivity measures the growth of labor efficiency in producing the economy's goods and services. Unit labor costs reflect the labor costs of producing each unit of output. Both are followed as indicators of future inflationary trends. Productivity growth is critical because it allows for higher wages and faster economic growth without inflationary consequences.
- *Consumer Confidence.* This is a survey or a poll of consumers' opinions regarding both their present conditions and their expectations regarding their economic conditions. Five thousand consumers across the country are surveyed each month. The theory here is that the level of consumer confidence is directly related to the strength of consumer spending. Consumer spending accounts for two-thirds of the economy. If consumers are confident that times are good, spending is likely to remain stable or even to increase. If consumer confidence is weak, then more times than not consumers save and do not spend money. This shift in spending habits can help or hurt the developments in the economy from durable goods sales to home or car purchases. If consumers are not confident, then they are less likely to purchase those big-ticket items.
- *Personal Income and Spending.* Personal income is the estimated dollar amount of income received by Americans. Personal spending is the estimated dollar amount that consumers use for purchases of durable and nondurable goods and services. This economic number is important because if consumers are spending more than they make, eventually the spending will stop, thus causing a downturn in the economy. Another aspect to consider is consumers who save, maybe in-

vesting in the markets, and that can increase the value of stock prices. In addition, it can also add liquidity to the banking system if the money goes to savings or money market accounts.

- *Durable Goods Orders.* These reflect new orders placed with domestic manufacturers for immediate and future delivery of factory-made products. Orders for durable goods show how busy factories will be in the months to come as manufacturers work to fill those orders. The data provides insight into demand for things like washers, dryers, and cars and also takes the temperature of the strength of the economy going forward.
- *Retail Sales.* These measure the total sales at stores that sell durable and nondurable goods. This can reveal the spending habits of consumers, and the trend of those spending "sprees" can more often than not influence analysts' expectations for future developments to the economy.
- *Construction Spending.* This report shows analysts the amount of new construction activity on residential and nonresidential building jobs. Prices of such commodities as lumber are sensitive to housing industry trends. In addition, business owners usually will put money into the construction of a new facility or factory if they feel confident that business is good enough to validate an expansion.
- *Housing Starts.* This is a measure of the number of residential units on which construction is about to start. The backbone of the U.S. economy is construction. Think about this: When you purchase a new home, you probably also purchase durable items, like refrigerators, washers and dryers, furniture, and lawn care products. This is known as a ripple effect throughout the economy. Think of all the jobs produced from construction to factory and transportation and even to communication and technology that goes into the building and financing and furnishing of a new home. The economic commerce is substantial, especially when there are a hundred thousand or more homes built in a month around the country. At the very least, the data from housing starts can help project the price direction for the sector of stocks in homebuilders, mortgage banks, and appliance companies. It used to be that lumber and copper futures prices were dramatically affected by the Housing Starts figure. However, since the development of prefabricated and new construction materials, especially fiber optics and plastics (PVC is used for plumbing rather than copper), lumber and copper are now less sensitive to the building industries' trends.
- *Mortgage Bankers Association Purchase Applications Index.* This is a weekly index of purchase applications at mortgage lenders. This is a good leading indicator for single-family-home sales and housing construction. It provides a gauge of not only the demand for housing but

also economic momentum. Each time the construction of a new home begins, it translates into more construction jobs and income, which will be pumped back into the economy.

- *New Home Sales.* This is the number of newly constructed homes with a committed sale during a month. The level of new home sales indicates housing market trends. This provides a gauge of not only the demand for housing but also economic momentum. People have to be feeling pretty comfortable and confident in their financial position to buy a house. Furthermore, this narrow piece of data has a powerful multiplier effect throughout the economy and, therefore, across the markets and your investments. By tracking economic data such as new home sales, investors can gain specific investment ideas as well as broad guidance for managing a portfolio. Each time the construction of a new home begins, it translates to more construction jobs and income, which will be pumped back into the economy. Once the home is sold, it generates revenues for the home builder and the realtor. It brings a myriad of consumption opportunities for the buyer. Furniture and large and small appliances are just some of the items new home buyers might purchase. The economic ripple effect can be substantial, especially when a hundred thousand new households around the country are doing this every month. Since the economic backdrop is the most pervasive influence on financial markets, new home sales have a direct bearing on stocks, bonds, interest rates, and the economy in general. In a more specific sense, trends in the new home sales data carry valuable clues for the stocks of home builders, mortgage lenders, and home furnishings companies.
- *Existing Home Sales.* This is the number of previously constructed homes with a closed sale during the month. Sales of existing homes (also known as home resales) are a larger share of the market than new homes and indicate housing market trends. This provides a gauge of not only the demand for housing but also economic momentum. People have to be feeling pretty comfortable and confident of their own financial situation to buy a house. Analysts follow economic data such as home resales because this generates a tremendous economic ripple effect. Even for existing homes, buyers may purchase new refrigerators, washers, dryers, and furniture.
- *Consumer Credit.* This report measures consumer credit that is outstanding. Since one of U.S. consumers' pasttimes is to "charge" goods and services to their credit cards, the overall changes in consumer credit can indicate the condition of individual consumer finances. On one hand, economic activity is stimulated when consumers borrow within their means to buy cars and other major purchases. On the other hand, if consumers pile up too much debt relative to their income lev-

els, they may have to stop spending on new goods and services just to pay off old debts. That could put a big dent in future economic growth. The demand for credit can also have a direct effect on interest rates. If the demand to borrow money exceeds the supply of willing lenders, interest rates rise. If credit demand falls and many willing lenders are fighting for customers, they may offer lower interest rates to attract business.

- *Business Inventories.* Alan Greenspan watched this report; you should become familiar with it as well. This report shows the dollar amount of inventories held by manufacturers, wholesalers, and retailers. The level of inventories in relation to sales is an important indicator for the future direction of factory production.
- *Consumer Confidence.* There are several such surveys that gauge consumer attitudes; one is the Conference Board, and another is the University of Michigan. These reports reveal both the present situation and expectations regarding economic conditions. The level of consumer confidence is generally assumed to be directly related to the strength or weakness for consumer spending. Generally speaking, the more confident consumers are about their own personal finances, the more likely they are to spend. Think of how you act and feel as a "consumer." If you have money in the bank and feel confident that your job is secure, buying an extra gadget or splurging on a night out usually won't be trouble, right? But if times are tough, then the purse strings get pulled in, correct?

HOT TIP

Get a calendar of events; check it every day to find out which reports will be released and at what time. Also be aware if there are scheduled speakers, such as heads of central banks, the president, or voting members of the FOMC. Make sure you converted these report release times for the time zone in which you live and trade. That way you will be prepared and not hit with an unexpected news-driven, price-shock event.

WHEN IS THE BEST TIME TO TRADE?

Forex traders use fundamental analysis as described earlier to identify trading opportunities by analyzing economic information for a longer-term perspective. Short-term traders should also understand which reports can cause a shift in currency markets and know when they are released.

Knowing the best times to trade the markets will help you nail down when a potential trade may materialize. The pie chart in Figure 1.4 showed that the largest percentage value traded against the U.S. dollar was the euro; therefore, that suggests that one of the highest-volume time periods would be when the European session opens. The central place of foreign currency dealings is in London, where the second-most-active trading volume occurs (the U.S. session being the first). Therefore, London is where there are likely to be large-range swings in the market granting day traders an opportunity to profit. That session begins at 3 A.M. (EST) and goes until 11:30 A.M. (EST). So a euro to U.S. dollar (EU/USD) or euro to British pound (EU/BP) or British pound to U.S. dollar (BP/USD) pair would be an appropriate selection to trade during the European session. The U.S. session opens at 8 A.M. (EST), which overlaps the European session; these two sessions combined generate the bulk of trading activity. Most major U.S. economic reports are released at 8:30 A.M. (EST); and, as expected, the currency markets generally react off those reports. This offers traders the opportunity to trade off violent price spikes when economic news is released, especially when the news is a surprise.

Once the U.S. markets close at 5 P.M. (EST), the currency markets are available to trade; but it is not until the Asian session opens at 7 P.M. (EST) that markets will experience potential price swings as volume levels rise. During the Asian session, traders would want to focus on the Australian dollar and the Japanese yen and the trade opportunities offered by the USD/JY or the USD/AUS or the cross pair trading the JY/AUS dollar. Notice that the Asian markets overlap the European session as well, so the Japanese yen versus the euro cross (JY/EU) is a popular pair to trade. Table 1.5 shows the time zones on which you want to focus when trading spot forex markets.

Forex Traders Can Benefit from Futures Data

Forex traders can integrate futures data to help in trading decisions, such as taking a trading signal based on chart patterns in the futures and trans-

TABLE 1.5 Trading Times for Forex

Trade Session	Eastern Time	Greenwich Mean Time
Asian open	7:00 P.M.	23:00
Asian close	4:00 A.M.	08:00
London open	3:00 P.M.	07:00
London close	11:00 A.M.	15:30
U.S. open	8:00 A.M.	12:00
U.S. close	5:00 P.M.	21:00

lating it into a trading trigger signal in a forex market. Spot FX and futures trade in tandem, and any price difference is called the "basis"; both FX and futures generally trade, pricewise, equally on a day-to-day basis (within a few PIPs). As we discussed previously, forex markets are decentralized, so there is not a collective database to measure two distinct studies, such as volume and open interest. These are important tools, so let's review the basics. If you are just using your FX dealer's trading platform for charts and quotes, you will not be able to get the volume and open interest information. However, you need only end-of-day data, and you can search the Internet for end-of-day charting data for futures markets. If you do subscribe to a charting software company, then it can add end-of-day charts for nothing or a very nominal monthly charge.

Volume

At this point, it is important to define what the *volume figures* are that you can receive and analyze in the forex market. The volume for forex pairs represents the number of transactions or ticks and not true trade-size activity. Forex does not have actual trade-size information because there is not a central marketplace to tabulate and send the information out to traders. The true definition of *volume* is the number of trades for all the total contract months of a given future's contract, both long and short, combined. For example, the futures foreign currency markets trade on quarterly expirations—the March, June, September, and December contract months. The volume will represent the total for all the trades in each contract month. Most technical analysts believe that volume is an indicator of the strength of a market trend. It is also a relative measure of the dominant behavior of the market. Here is a further explanation; volume is the measurement of the market's acceptance or rejection of price at a specific level and time. There are several theories and so-called rules when using volume analysis on price charts; the first one is that if a market is increasing in price and the volume is increasing, then the market is said to be in a bullish mode and can indicate a continued move in the direction of the trend.

The exact opposite is true for a declining market. However, if a substantial daily market price increase or decrease occurs after a long steady uptrend or downtrend, especially on unusually high daily volume, it is considered to be a "blow off top or bottom" and can signal a market turning point or trend reversal. Here are some guidelines to use when using volume analysis.

- Increasing volume in a rising price environment signals excessive buying pressure and could lead to substantial advances.

- Increasing volume in a falling price environment might signal a continual fall in prices or a prolonged bearish trend.
- Decreasing volume in a rising price environment may indicate a plateau and can be used to predict a reversal. Especially when prices make a higher high such as occurs with divergence patterns, a decline in volume with a rise in prices is extremely bearish.
- Decreasing volume in a weaker price environment shows that fresh sellers are reluctant to enter the market and could be a sign of a trend reversal.
- Excessive volume in a high price environment indicates that traders are selling into strength and often creates a price ceiling.
- Excessively low volume in a low price environment indicates that traders are buying on weakness and often creates a floor of support.

I want you to study the chart in Figure 1.13; it shows the trends that occurred in the Japanese yen futures contract. If you recall, earlier in the book, I gave an example of the confusing aspect of the quotation of yen futures contracts versus spot forex contracts. Figure 1.13 shows what I was referring to. The futures contracts are quoted yen to dollar, FX is quoted dollar to yen. Let's go over how to interpret the data, and then I will explain

FIGURE 1.13 Japanese Yen Trends (daily bars)
Used with permission of GenesisFT.com.

how you will apply that information to the forex market. Looking at the chart from left to right, the first trend (point A) condition is down. The corresponding volume levels are also trending lower. This indicates that, with the decreasing volume in the weakening price environment, new sellers are reluctant to enter the market and that a reversal is imminent. As the market bottoms in late April (point B), the sharp price increase is followed with a rise in volume, indicating prices can sustain an advance. Finally, when the high of the move has formed (point C), it is made with a large bearish engulfing candle pattern. The trend reverses as sellers enter the market and longs liquidate their positions. Notice that this new downtrend is on increasing or rising volume, which alerts you that a substantial move is in the works.

Two Flaws in Volume

As with life or any aspect of trading, nothing is perfect. Collecting and analyzing volume is no exception, especially in the futures markets. The first flaw is that the data is delayed by one day. You can get real-time tick volume, which shows how many times a price level was traded, but not real-time contract size volume; the exchanges do not post this information until the following day. There is a huge difference in the two concepts. The second flaw is that as a futures contract month gets closer to expiration, it converges with spot prices and becomes the cash market. At that point, it no longer is a “futures” contract. For example, a September futures contract expires around the middle of the month by late August traders moving their positions out of the September and rolling over into the next contract month, which would be a December contract. As this occurs, the volume levels start to artificially decline in one month as the further-out contract month starts to increase. This can be confusing and generate false signals.

HOT TIP

Stay ahead of the crowd! I have a solution and can help you possibly beat the system! Remember the section on the currency ETFs? They trade in real time; they track almost identically to the spot currency markets (perhaps even better compared to forex dealers); and because they are listed on the New York Stock Exchange, they report real-time transaction volume! The drawback here is that they only trade during the U.S. equity market session—9:30 A.M. (EST) to 4:00 P.M. (EST).

Let’s examine this principle of using volume analysis from the euro ETF (FXE) versus the futures market, which is shown in Figure 1.14. The

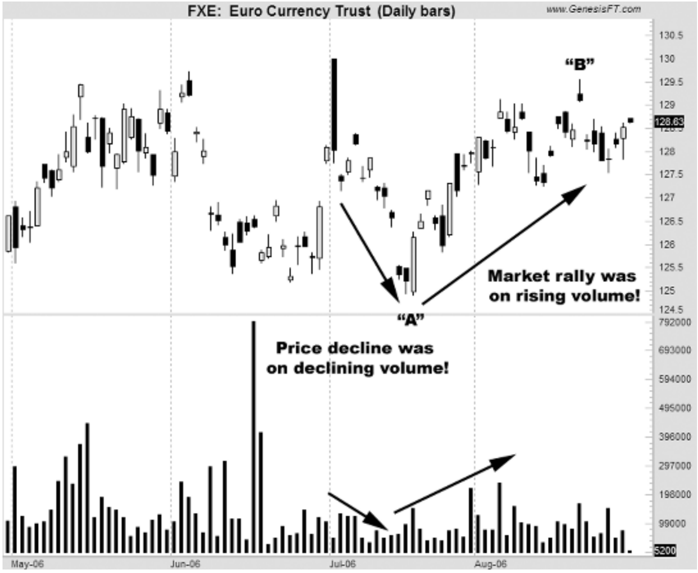

FIGURE 1.14 Euro Currency Trust (daily bars)
Used with permission of GenesisFT.com.

first thing that should pop out at you is the fact that the ranges of each bar (or, in this chart, the candles) are comparatively smaller than the ones in Figure 1.15, which is a spot forex euro currency. This is because the euro ETF only trades during the U.S. equity market session. However, if you compare the price points as shown at point A and point B on both charts, you will see that the lows and the highs are almost exactly the same. The volume analysis is easily tracked, and you do not have to account for the rollover effect that exists in the futures markets. This is a continuous market. You can easily see where the market declines in price on declining volume; and as a reversal forms into an uptrend, it is accompanied with an increase in volume. This again is a very healthy sign that the trend may maintain more upward momentum. The increase in volume helps amplify the magnitude of an increase in the value of the euro.

Armed with this information, you can make better decisions for staying on the long side of the market if you are a day trader. As a swing trader, you may wish to exploit the potential for a serious price advance. If you are a position trader, you can develop a solid trading plan with various choices in strategies or trading vehicles.

Figure 1.15 shows that at point A, we broke below a previous swing low. Some traders may have looked at that as a sign of continuing weakness in prices. However, with the aid of volume analysis, the price decline was

FIGURE 1.15 Euro/U.S. Dollar (daily bars)
Used with permission of GenesisFT.com.

on sharply declining volume. That was indicating that sellers were running out of steam and that a price reversal was imminent. The very low marked by point A shows a very strong reversal engulfing/piercing candle pattern. That was a confirming clue that the price decline had ended. If you have knowledge on the technical analysis theory and combine the use of several indicators, such as price and volume studies, you will increase your probability of success.

Open Interest

Open interest reveals the total amount of open positions that are outstanding and are not offset or delivered on. Remember that in futures trading, this is a zero-sum game: For every long, there is a short; or for every buyer, there is a seller. The open interest figure represents the longs or the shorts, but not the total of both. So when examining open interest, the general guidelines are that when prices rise and open interest increases, this reveals that more new longs have entered the market and more new money is flowing into the market. This reflects why the price increases. Of course, the exact opposite is true in a declining market. Chartists combine both the price movement and the data from volume and open interest to evaluate the condition of the market. If there is a price increase on strong volume and open interest increases, then this is a signal that there could be a continued trend advance. The opposite is true for a bear market when prices decline. Also, if prices increase, volume stays relatively flat or little changed, and open interest declines; this then reflects a weakening market condition. This is considered to be a bearish situation because if open interest is declining and prices are rising, then this shows that shorts are covering by buying back their positions rather than new longs entering the market. That would give a trader a clue that there is a potential trend reversal coming. Here is a guide as to how to identify an opportunity when there is a major top or bottom in the spot forex markets using this information: When observing a continued *long-term* trend in a spot forex currency in order to spot a *climaxing market condition* or reversal of the trend, whether it is in an uptrend or a downtrend, clues to watch for:

- Prices start to fluctuate with wider-than-normal daily price swings or ranges, or are in an extremely volatile condition.
- Prices move against the trend accompanies unusually strong volume and a decline in open interest.

The market is getting ready to turn or reverse the trend.

In Figure 1.16, the graph is a futures euro contract with the volume and open interest study. The bar graph represents the volume with the open interest overlaid by plotting a line measurement.

Notice after the peak in prices, the volume started to dry up (decline).

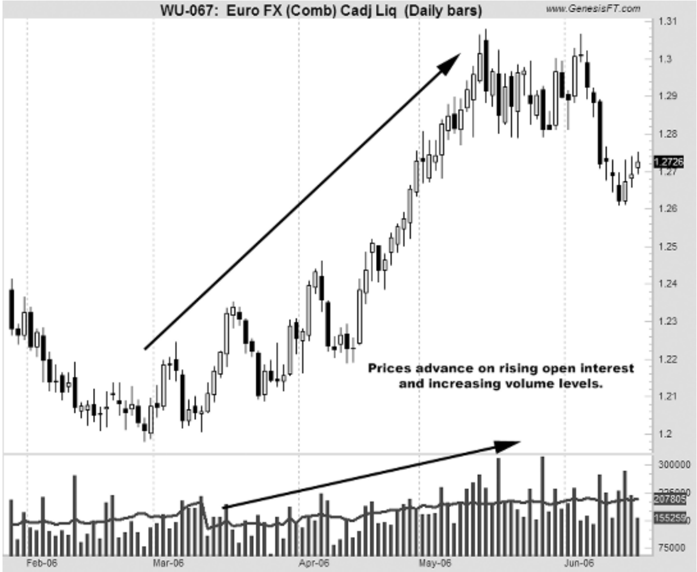

FIGURE 1.16 Euro (daily bars)
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Open interest started to decline confirming a top was in place. This was a warning that a trend reversal was forming rather than a small correction. Therefore, spot forex traders would more clearly recognize that selling rallies and/or looking to take sell signals at resistance would be a more fruitful and profitable course of action, due to the bearish volume and open interest signals that the futures markets provided.

INSIDER TRADING INFORMATION: *COMMITMENTS OF TRADERS* REPORT

There is one more piece of information that spot forex currency traders can "borrow" from the futures industry; it is the Weekly Commodity Futures Trading Commission's *Commitments of Traders* report. The primary purpose for this report is to monitor trading activity and to have a tight surveillance program in order to identify situations that might pose a threat of a market or price manipulation and, therefore, allow traders to take appropriate action.

The CFTC market surveillance staff closely monitors trading activity in the futures markets in order to detect and prevent instances of potential price manipulation. Some consider this "insider trading" information because every week we get to take a look at which investor group is taking which side of a trade. There are many studies and books written on the subject. (Larry Williams was a pioneer on the subject. Also, it was covered in my first book *A Complete Guide to Technical Trading Tactics* (Wiley, 2004), on pages 162–165.) As a veteran trader for over 26 years, I have used this information to capture many significant moves in the markets. In the sample shown in the table in Figure 1.17, there are several categories. The first is the Non-commercial, which lists all large professional traders or entities, such as hedge funds, commodity trading advisers, commodity pool operators, and locals on and off the exchange floors. It includes any trading entity that hits a reportable position limit; for instance, in the CME, in 2006, the limit for currencies was 400 contracts.

The next category of importance is the Commercials, which includes banks and institutions or multinational conglomerate corporations looking to hedge a cash position. The long and short open interest shown as Nonreportable positions is derived by subtracting total long and short reportable positions from the total open interest. Accordingly, for Nonreportable Positions, the number of traders involved and the Commercial/Non-commercial classification of each trader are unknown. This balance of positions is assumed to be the small speculators. If you look at the first column under Non-commercials, you see the breakdown of how many long po-

CFTC Commitments of Traders Report - CME (Futures Only)

BRITISH POUND STERLING - CHICAGO MERCANTILE EXCHANGE Code-096742
FUTURES ONLY POSITIONS AS OF 04/11/06

	NON-COMMERCIAL			COMMERCIAL		TOTAL		NONREPORTABLE POSITIONS	
	LONG	SHORT	SPREADS	LONG	SHORT	LONG	SHORT	LONG	SHORT
(CONTRACTS OF 62,500 POUNDS STERLING) OPEN INTEREST: 79,127									
COMMITMENTS	16,971	22,595	0	42,536	37,687	59,507	60,282	19,620	18,845
CHANGES FROM 04/04/06 (CHANGE IN OPEN INTEREST: -244)	2,956	-2,104	0	-6,352	5,470	-3,396	3,366	3,152	-3,610
PERCENT OF OPEN INTEREST FOR EACH CATEGORY OF TRADERS	21.4	28.6	0.0	53.8	47.6	75.2	76.2	24.8	23.8
NUMBER OF TRADERS IN EACH CATEGORY (TOTAL TRADERS: 64)	17	19	0	16	17	33	36		

FIGURE 1.17 CFTC *Commitments of Traders* Report—CME (futures only)

sitions versus short positions are held. The next line shows the changes from the prior week; this is important information because you will be able to see if these guys unloaded some of their positions or added to them from one week to the next. The line under that tells you what percentage of long and shorts is held, and the last line shows how many traders control longs or shorts. The information is gathered as of the close of business every Tuesday by each of the clearing brokerage firms and is turned over to exchange officials, who then report the information over to the regulatory body know as the CFTC. This information is released on Friday afternoons at 3:30 P.M. (EST). Before acting on a decision based on this information, it is critical to know if there was a major price swing from Tuesday's close to the time the information was released because positions may have changed hands.

CAN YOU MAKE MONEY FROM THIS INFORMATION?

There is always a chance to make money; the key is to be able to afford not to be too heavily leveraged if the market moves further than anticipated. This report is like an insider information report. It acts like a true consensus of who literally "owns" the market. A forex trader can use this data to determine if market participants are too heavily positioned on one side of the market in a long-term trend run. It is generally the small speculator who is left holding the bag. I mean, let's face it, money moves the market;

and the banks and large professional traders are a bit savvier when it comes to their business. After all, one would think a bank has a good idea of the direction interest rates are going to go in once a central bank meeting occurs, right?

Suppose the small speculators are showing a nice short position of, say, at least two longs for every one short. If the Non-commercials are net long and the Commercials are net long, chances are that the small speculators will be wrong. I am looking for imbalances in markets that have been in a trending market condition for quite some time, and therefore I can develop a game plan and start looking for timing clues to enter trades accordingly. Keep in mind that the Commercials can and sometimes are not right; they are not in the market to time market turns. They are hedging their risk exposure in a cash position. Therefore, the Non-commercials, or professional speculators, in the short term are considered the smart money. Here are some general guidelines to follow:

- If Non-commercials are net long, Commercials are net long, and the Nonreportable Positions category is net short by at least a two-to-one margin, look at buying opportunities. In other words, go with the pros.
- If Non-commercials are net short, Commercials are net short, and the Nonreportable Positions are net long by at least a two-to-one margin, look at selling opportunities.
- If Non-commercials are net long, Commercials are net short, and Nonreportable Positions are neutral, meaning not heavily net long or short, look at buying opportunities. Stick with the smart money, the bank and institutions category.

Let's put the theories to the test combining volume with the *Commitments of Traders* data by studying the chart in Figure 1.18. This is the British pound futures contract; the chart pattern resembles a rounding bottom or an inverted head-and-shoulders formation (both of which we will cover in the following chapters). The CFTC report was released on the close of business on April 14, 2006. With the information at hand, we can determine that the Commercials (banks and institutions) were net long the market, the large speculative Non-commercials were net short, and the Nonreportable small speculators were net long. Granted, these are not heavily weighed numbers—we don't see a tremendous imbalance like a two-to-one ratio of net shorts versus net long in the small speculator category—but we do see a two-thirds grouping of net longs led by the Commercials and the Nonreportable small speculators. The Non-commercials are the only ones net short and needing to buy back their shorts. If we integrate our newfound knowledge of using volume studies, we can determine that prices are rising with an increase in volume. This signals a

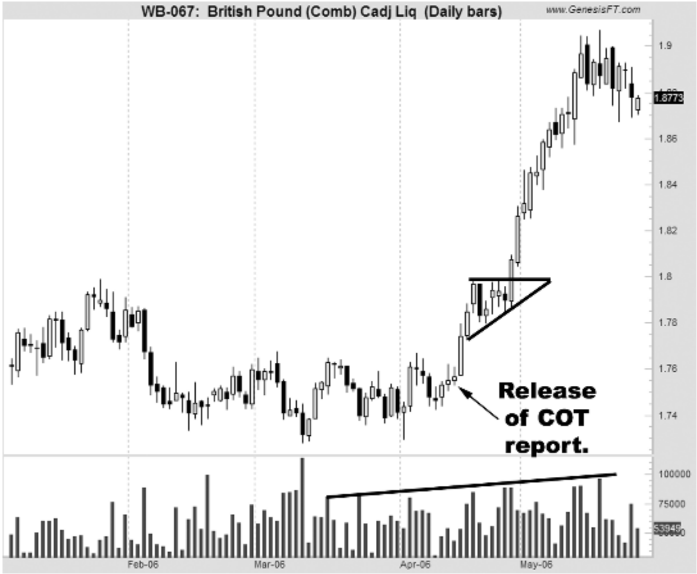

FIGURE 1.18 British pound (daily bars)
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healthy market condition for the bulls. It signals that buyers are entering the market, not just a small short covering rally. In early May, we see a small consolidation pattern called an ascending triangle form; and as prices break out to the upside, the volume levels are increasing as well, indicating continued strength and a strong bullish trend.

Now let's look at the spot forex market as shown in Figure 1.19. Examining the low in April, a candle shows a hammer pattern that formed in both the spot forex and the futures markets. Then, taking the information from the CFTC *COT* report released on that Friday, we know Commercials were net long. In addition, we see the increase in volume, as shown in the futures chart in Figure 1.16. This helped clearly identify that higher prices were accompanied with rising volume. This is a very healthy sign that a major price move could be underway. Here is an example of where digesting the information on volume with *COT* data could help you make the decision to diversify your trading approach with a long-term position. From what we have covered in this chapter, you could go long an outright spot forext British pound or could enter in a mini-lot position. You could use a futures option strategy or could invest in the British pound ETF (FXB). Several techniques that we will go over in this book are trend-line breakouts from wedge patterns and the Defcon III trading signals that alert to long entry as indicated with the little triangles shown in Figure 1.19. The

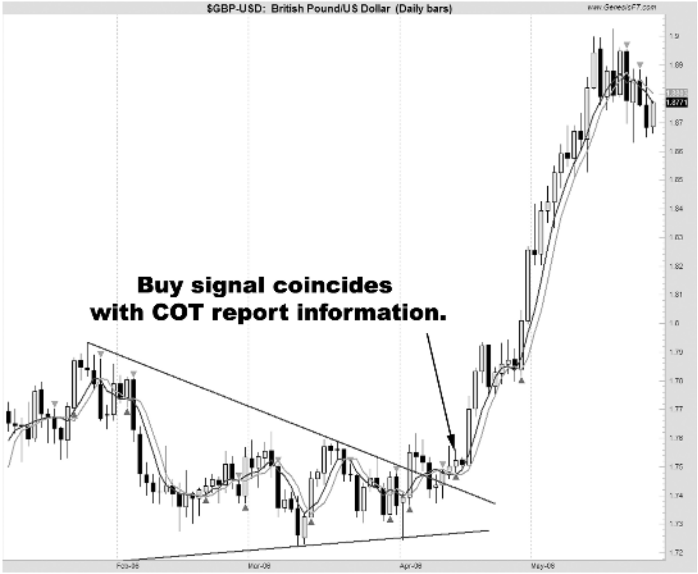

FIGURE 1.19 British pounds/U.S. Dollar (daily bars)
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factual data revealed in the CFTC *COT* report is tremendously important information; and, best of all, it is easy to access and free.

IMPORTANT WEB SITE INFORMATION

To access the CFTC *COT* reports, go to this link:
http://www.nationalfutures.com/CFTC_Reports.htm