Chapter 1

Currency Trading 101

In This Chapter

- Looking at currency trading as a business
- Getting a sense of what moves currencies
- Developing trading strategies to exploit opportunities
- Implementing the trading plan

The forex market has exploded onto the scene and is the hot new financial market. It's been around for years, but advances in electronic trading have now made it available to individual traders on a scale unimaginable just a few years ago.

We've spent our professional careers in the forex market and we can't think of a better traders' market. In our opinion, nothing quite compares to the speed and exhilaration of the forex market or the intellectual and psychological challenges of trading in it. We've always looked at our work as essentially doing the same thing every day, but no two days are ever the same. Not many people can say that about their day jobs and we wouldn't trade it for the world, no pun intended.

What Is Currency Trading?

At its heart, currency trading is about speculating on the value of one currency versus another. The key words in that last sentence are *speculating* and *currency.* We think that looking at currency trading from those two angles — or two dimensions, if you allow us to get a little philosophical — is essential.

On the one hand, it's speculation, pure and simple, just like buying an individual stock, or any other financial security, in the hope that it will make a profitable return. On the other hand, the securities you're speculating with are the currencies of various countries. Viewed separately, that means that currency trading is both about the dynamics of market speculation, or trading, and the factors that affect the value of currencies. Put them together and you've got the largest, most dynamic and exciting financial market in the world.

Throughout this book, we approach currency trading from those two perspectives, looking at them separately and blending them together to give you the information you need to trade in the forex market.

Speculating as an enterprise

Speculating is all about taking on financial risk in the hope of making a profit. But it's not gambling and it's not investing. Gambling is about playing with money even when you know the odds are stacked against you. Investing is about minimizing risk and maximizing return, usually over a long time period. Speculating, or active trading, is about taking calculated financial risks to attempt to realize a profitable return, usually over a very short time horizon.

To be a successful trader in any market requires

- Dedication (in terms of both time and energy)
- Resources (technological and financial)
- Discipline (emotional and financial)
- Decisiveness
- Perseverance
- Knowledge

REMEMBER

But even if you have all those traits, there's no substitute for developing a comprehensive trading plan (see Chapters 11, 12, and 13). You wouldn't open up a business enterprise without first developing a business plan (at least we hope not!). So you shouldn't expect any success in trading if you don't develop a realistic trading plan and stick to it. Think of trading as if it were your own business, and approach it as you would a business enterprise, because that's what it is.

TIP

Above all, try not to take your trading results too personally. Financial markets are prone to seemingly irrational movements on a regular basis, and the market doesn't know or care who you are and what your trade idea is.

Currencies as the trading vehicle

If you've heard anything at all about the forex market, it's probably that it's the largest financial market in the world, at least in terms of daily trading volumes. To be sure, the forex market is unique in many respects. The volumes are, indeed, huge, which means that liquidity is ever present. It also operates around the clock six days a week, giving traders access to the market any time they need it. (In Chapter 2, we give you a sense of the scale of the forex market and how it operates on a daily basis. In Chapter 3, we look at who the major forex players are.)

Few trading restrictions exist — no daily trading limits up or down, no restrictions on position sizes, and no requirements on selling a currency pair short. (We cover all the mechanics and conventions of currency trading in Chapter 4.)

Selling a currency pair short means you're expecting the price to decline. Because of the way currencies are quoted and because currency rates move up and down all the time, going short is as common as being long.

Most of the action takes place in the major currency pairs, which pit the U.S. dollar (USD) against the currencies of the *Eurozone* (the European countries that have adopted the euro as their currency), Japan, Great Britain, and Switzerland. There's also plenty of trading opportunities in the minor pairs, which see the U.S. dollar traded against the Canadian, Australian, and New Zealand dollars. On top of that, there's cross-currency trading, which directly pits two non-USD currencies against each other, such as the Swiss franc against the Japanese yen. Altogether, there are anywhere from 15 to 20 different currency pairs, depending on which forex brokerage you deal with. (See Chapters 5 and 6 for a look at the fundamental and market factors that affect the most widely traded currency pairs.)

Most individual traders trade currencies via the Internet through a brokerage firm. Online currency trading is typically done on a margin basis, which allows individual traders to trade in larger amounts by leveraging the amount of margin on deposit.

The *leverage,* or margin trading ratios, can be very high, sometimes as much as 200:1 or greater, meaning a margin deposit of $1,000 could control a position size of $200,000. But trading on margin carries its own rules and requirements and is the backdrop against which all your trading will take place. Leverage is a two-edged sword, amplifying gains and losses equally, which makes risk management the key to any successful trading strategy (see Chapter 13).

Before you ever start trading, in any market, make sure you're only risking money that you can afford to lose, what's commonly called *risk capital.* Risk management is the key to any successful trading plan. Without a risk-aware strategy, margin trading can be an extremely short-lived endeavor. With a proper risk plan in place, you stand a much better chance of surviving losing trades and making winning ones. (We incorporate risk management throughout this book, but especially in Chapters 11, 13, and 19.)

What Affects Currency Rates?

In a word — information. Information is what drives every financial market, but the forex market has its own unique roster of information inputs. Many different cross-currents are at play in the currency market at any given moment. After all, the forex market is setting the value of one currency relative to another, so at the minimum, you're looking at the themes affecting two major international economies. Add in half a dozen or more other national economies, and you've got a serious amount of information flowing through the market.

Fundamentals drive the currency market

Fundamentals are the broad grouping of news and information that reflects the macroeconomic and political fortunes of the countries whose currencies are traded. (We look at those inputs in depth in Chapters 7 and 9.) Most of the time, when you hear someone talking about the fundamentals of a currency, he's referring to the economic fundamentals. Economic fundamentals are based on:

- Economic data reports
- Interest rate levels
- Monetary policy
- International trade flows
- International investment flows

There are also political and geopolitical fundamentals (see Chapter 7). An essential element of any currency's value is the faith or confidence that the market places in the value of the currency. If political events, such as an election or scandal, are seen to be undermining the confidence in a nation's leadership, the value of its currency may be negatively affected.

Gathering and interpreting all this information is just part of a currency trader's daily routine, which is one reason why we put dedication at the top of our list of successful trader attributes (see "Speculating as an enterprise," earlier in this chapter).

Unless it's the technicals that are driving the currency market

The term *technicals* refers to *technical analysis,* a form of market analysis most commonly involving chart analysis, trend-line analysis, and mathematical studies of price behavior, such as momentum or moving averages, to mention just a couple (see Chapter 10).

We don't know of too many currency traders who don't follow some form of technical analysis in their trading. Even the stereotypical seat-of-the-pants, trade-your-gut traders are likely to at least be aware of technical price levels identified by others. If you've been an active trader in other financial markets, chances are, you've engaged in some technical analysis or at least heard of it.

If you're not aware of technical analysis, but you want to trade actively, we strongly recommend that you familiarize yourself with some of its basics (see Chapter 10). Don't be scared off by the name. Technical analysis is just a tool, like an electric saw — you don't need to know the circuitry of the saw to know how to use it. But you do need to know how to use it properly to avoid injury. (Chapter 20 offers several great reading suggestions to expand your technical trading knowledge.)

Technical analysis is especially important in the forex market because of the amount of fundamental information hitting the market at any given time. Currency traders regularly apply various forms of technical analysis to define and refine their trading strategies, with many people trading based on technical indicators alone. (See Chapters 14, 15, and 16 for how traders really use technicals.)

Or it may be something else

We're not trying to be funny here. Honest. What we are trying to do is get across the idea of the many cross-currents that are at play in the forex market at any given time. Earlier in this chapter, we note that currency trading is just one form of market speculation, and that speculative trading involves an inherent market dynamic (see "What Is Currency Trading?," earlier in this chapter).

Call it what you like — trader's instinct, market psychology, sentiment, position adjustment, or more buyers than sellers. The reality is that the forex market is made up of tens of thousands of different traders, each with a different view of the market and each expressing his view by buying or selling different currencies at various times and price levels.

That means that in addition to understanding the currency-specific fundamentals, and familiarizing yourself with technical analysis, you also need to have an appreciation of the market dynamic (see Chapter 8). And that's where trading with a plan comes in (see the following section).

Developing a Trading Plan

If your e-mail inbox is anything like ours, you probably get inundated with random penny-stock tips or the next great Chinese stock initial public offering (IPO). (If you're not, please send us your spam filter.)

Those are about the only times you're going to get a message telling you how to trade. The rest of the time you're going to be on your own. But isn't that what speculative trading is all about, anyway?

Don't get us wrong, we're not trying to scare you off. We're just trying to make it clear that you're the only one who knows your risk appetite and your own trading style. And very likely, you may not have even settled on a trading style yet.

Finding your trading style

Before you can develop a trading plan, settling on a trading style is essential. (See Chapter 11 for more on trading styles.) Different trading styles generally call for variations on trading plans, though there are plenty of overarching trading rules that apply to all styles.

What do we mean by a *trading style?* Basically it boils down to how you approach currency trading in terms of

- **Trade timeframe:** How long will you hold a position? Are you looking at short-term trade opportunities (day trading), trying to capture more-significant shifts in currency prices over days or weeks, or something in between?
- **Currency pair selection:** Are you interested in trading in all the different currency pairs, or are you inclined to specialize in only one or two?
- **Trade rationale:** Are you fundamentally or technically inclined? Are you considering creating a systematic trading model? Are you a trend follower or a breakout trader?
- **Risk appetite:** How much are you prepared to risk and what are your return expectations?

TIP

We don't expect you to have answers to any or all of those questions, and that's exactly the point. As you read this book, we hope you'll be thinking about what trading style you'd like to pursue. Feel free to experiment with different styles and strategies — that's what *practice accounts*, or demo accounts, are for. (See Chapter 2 for the best way to utilize practice accounts.)

At the end of the day, though, zeroing in on a trading style that you feel comfortable with and that you can pursue on a consistent basis helps. Your own individual circumstances (including work, family, finances, temperament, and discipline) will be the key variables, and you're the only one who knows what they are.

Planning the trade

Whatever trading style you ultimately choose to follow, you won't get very far if you don't establish a concrete trading plan and stick to it (see Chapter 11).

Trading plans are what keep small bad trades from becoming big bad trades and what can turn small winners into bigger winners. More than anything, though, they're your road map, helping you to navigate the market after the adrenaline and emotions start pumping, no matter what the market throws your way.

We're not telling you that currency trading is any easier than any other financial market speculation. But we can tell you that trading with a plan will greatly improve your chances of being successful in the forex market over time. Most important, we want to caution you that trading without a plan is a surefire recipe for disaster. You may survive a few close calls, but a day of reckoning comes for any trader without a plan — it's just what happens in markets.

The starting point of any trading plan is to identify a trading opportunity (see Chapter 12). No one is going to give you a call or shoot you an e-mail telling you what and when to trade. You have to devote the effort and gray cells to spotting viable trading opportunities yourself.

Throughout this book, we offer our own observations on how the forex market behaves in many different respects. We think there are plenty of kernels for spotting trade opportunities in those observations. (In Chapter 12, in particular, we show you a number of concrete ways to look at the market with a view to spotting trade opportunities.) Above all, be patient and wait for the market to show its hand, which it always does, one way or the other.

Executing the Trading Plan from Start to Finish

The start of any trade comes when you step into the market and open up a position. How you enter your position, how you execute the first step of your trading plan, can be as important as the trade opportunity itself. (More on getting into a position in Chapter 14.) After all, if you never enter the position, the trade opportunity will never be exploited. And probably nothing is more frustrating as a trader than having pinpointed a trade opportunity, having it go the way you expected, but having nothing to show for it because you never put the trade on.

The effort and resources you invest in researching, monitoring, and analyzing the market come to a concrete result when you open a trade. You're now exposed to price fluctuations and your trading account will register a profit or loss as a result. But that's just the beginning of it.

Just because you have a trading plan doesn't mean the market is necessarily going to play ball. You need to be actively engaged in managing your position to make the most of it if it's a winner and to minimize the damage if the market is not going in your favor (see Chapter 15).

REMEMBER

Active trade management is also critical to keeping more of what you make in the market. In our experience, making money in the forex market is not necessarily the hard part. More often than not, keeping what you've made is the *really* hard part.

You need to stay on your toes, and keep thinking about and monitoring the market while your trade is still active. The market will always be moving, sometimes faster than at other times, and new information will still be coming into the market. In Chapter 15, we look at several different ways you can monitor the market while your trade is open, as well as how and when you should adjust your trade strategy depending on events and time.

Exiting each trade is the culmination of the entire process and you're either going to be pleased with a profit or disappointed with a loss. Every trade ends in either a profit or a loss (unless you get out at the entry price); it's just the way the market works. While your trade is still active, however, you're still in control and you can choose to exit the trade at any time. In Chapter 16, we look at important tactical considerations to keep in mind when it's time to close out the trade.

Even after you've exited the position, your work is not done. If you're serious about currency trading as an enterprise, you need to review your prior trade for what it tells you about your overall trading style and trade execution. Most important, reviewing your trading results is how you stay focused and avoid lapses in discipline that could hurt you on your next trade.

Only then is it time to move on to the next trading opportunity.