

Introduction to Foreign Exchange Trading



After reading this chapter, you will be able to:

- Understand the basic facts and history of the global foreign exchange market.
- Appreciate the characteristics that set forex apart from other financial markets.
- Assess who the real market players are, and how they may affect currency prices.
- Decide whether foreign exchange trading is right for you.
- Know what to expect from this book.

Trading Money to Make Money

Foreign exchange trading is essentially about trading money. There are several reasons why people and institutions would want to trade money. The two primary reasons are currency conversion and speculation. Currency conversion is simply the changing of money from one currency to another for the primary purpose of purchasing goods, services, or assets from a foreign country. For an American company to buy British goods, for example, would necessitate the conversion of U.S. dollars to British pounds.

This book will focus exclusively on foreign exchange trading for speculative purposes, or trading money with the explicit goal of making money. This speculation process is very similar to trading in stocks or futures. The goal, whether on a long-term or short-term basis, is to earn profits from price changes. Just as a stock like Microsoft will move up and down in price, currencies will also move up and down in price. The real trick is to be on the right side of the move, and to reap profits in return for assuming the risk of taking the trade.

Of course, there are many important ways in which trading foreign exchange is completely different from trading stocks or futures, but the primary objective is the same. If a trader buys shares in Microsoft, for instance, the hope is that the value of the shares will go up and the trader will earn profits. In the same vein, if a trader buys the Japanese yen, the hope is that the value of the yen increases so that the trader will earn a profit on owning that currency.

Learning how to make money by trading money is not an easy task. There are many factors that combine to make any given foreign exchange trader a successful one. This combination usually includes

plenty of often painful trading experience, good risk management skills, solid technical and fundamental analytical abilities, and a sound psychological make-up. All of these will be discussed in detail further along in the book.

To begin with, though, an introduction to the world of foreign exchange trading is in order. This will cover all of the basics, and will begin with a very brief history lesson.

Striking Gold

Although money in one form or another has been around pretty much since the beginning of time, modern speculative foreign exchange trading (also known as “FX,” “forex,” or “currency trading”) is considered to have begun on a major scale relatively recently. In modern times, the world’s currencies truly began to float freely and be traded extensively in the early 1970s, after the collapse of the Bretton Woods Agreements.

These agreements, established during the tail-end of World War II in July 1944, came about as a result of meetings between representatives of all the Allied nations in Bretton Woods, New Hampshire, U.S.A.

Among other accomplishments resulting from Bretton Woods, each of these nations agreed to adopt a monetary policy that would effectively fix the exchange rate of its currency in relation to the U.S. dollar, which in turn would be fixed to gold at a rate of USD \$35.00 per ounce of gold. These changes were akin to reinstating characteristics of the Gold Standard, but this time via the U.S. dollar.

Clearly, with the Bretton Woods Agreements in place, foreign exchange trading on any significant scale was virtually impossible and nonproductive due to the nonfloating nature of currency values. While the valiant purposes of Bretton Woods were to control conflict, maintain monetary stability, and discourage currency speculation, the agreements underwent increasing pressure as the U.S. suspended the dollar's convertibility into gold in 1971. The Bretton Woods Agreements finally collapsed in the same year.

By 1973, with the complete collapse of Bretton Woods and other similar agreements that strived to impose order on the global currency system, the world's currencies truly began to float much more freely. This meant that the market forces of supply and demand would take precedence over international political consensus, and that mass speculation by banks and institutions would soon become rampant. Although most individual traders could not take part in the new market, this time period marked the birth of modern-day forex trading as we know it today.

Buying and Selling at Retail

Fast forward to around 1996, as computers and the Internet began making online financial trading both practical and in demand. With stock trading starting to go online, foreign exchange brokers/market-makers began emerging to create and satisfy a new demand for retail forex trading. Prior to this time, access to speculative forex trading was reserved almost exclusively for banks and large institutions. With the advent of online platform trading, however, access for the average individual trader/investor opened up in a major way.

This new frontier of retail currency trading was in the arena of “spot forex,” which was clearly differentiated from futures and forwards. Spot foreign exchange trading is distinguished by its almost immediate delivery of the currency, rather than future delivery. Of course, in speculative currency trading, the actual physical currency never gets delivered—delivery is simply “rolled over” continuously to the next delivery date *ad infinitum* (or until the trading position is closed). The foreign exchange broker performs this important function in order to facilitate speculative trading, as opposed to having customers actually convert money to/from a foreign currency. In spot forex, the customary delivery settlement timeframe for most currency trades is the date of trade execution plus two days (T+2).

Big and Liquid, Like the Ocean

There are many characteristics that set the modern-day foreign exchange market apart from other financial markets like equities (stocks) and futures. Many of these characteristics help to make foreign exchange an appealing market for traders and investors coming from other financial markets.

When most people first hear about the foreign exchange market, they are usually introduced first to the sheer size of the global forex system. Along with this size comes a magnitude of liquidity almost unimaginable in any other financial market. Liquidity is defined simply as the degree to which an asset, like a currency, can be bought or sold in the market without having a significant effect on the asset’s price. The liquidity of currencies, especially the “major” ones like the U.S. dollar and the euro, is unrivaled by any other financial instrument, including stocks, bonds, and futures contracts.

Among other implications of this high level of liquidity, because of the staggeringly high volume of transactions and the countless number of traders (both institutional and retail) involved in this market, it is extremely difficult for any individual market participant to manipulate foreign exchange prices artificially in any significant manner.

This blanket statement, however, notably excludes the world's central banks (e.g., the U.S. Federal Reserve (the Fed), the European Central Bank (ECB), the Bank of Japan (BOJ)), which can and do attempt to manipulate the markets. This type of manipulation activity, however, has become an accepted part of the forex trading game, and generally does not offer an unfair advantage to any speculative market participant. Furthermore, central bank attempts to manipulate currencies for the purposes of furthering national economic policy are usually much easier to accept than, for example, the profit-minded manipulation of individual stocks by often unscrupulous traders.

Apart from potential central bank manipulation, just how big is the foreign exchange market that it can claim its place as the most liquid market the world has known? According to the most recent statistics issued by the Bank for International Settlements (BIS), which serves as an international organization and “bank for central banks,” the average daily turnover in the primary foreign exchange markets is estimated to be around \$3.2 trillion (as of April 2007). This figure represents an unprecedented three-year growth rate of 69%, and far eclipses the volume traded in any other financial market in the world.

Of this \$3.2 trillion, about \$1 trillion is in “spot” foreign exchange trades, which, as mentioned earlier, are forex trades that are distinguished by immediate delivery of the currency. Spot foreign

exchange is the type of trading that most individual traders in the retail forex market are primarily concerned with. While some individual traders get involved with currency futures and other derivative financial instruments, the growth of the spot foreign exchange arena has largely eclipsed these smaller markets.

Open 24/5

Besides the sheer size and liquidity of the foreign exchange markets, which can certainly be a great advantage to the average speculative trader, another distinguishing characteristic of forex is its global, decentralized nature. Essentially, it is an over-the-counter (OTC) market, where the different currency trading locations around the globe electronically form a unified, interconnected market entity. Among other advantages stemming from this fact, all currencies can be traded electronically 24 hours a day as the major global markets open, overlap, and close, one after another.

From the perspective of New York time (U.S. Eastern Time), the markets open up as follows.

The very beginning of the week falls on Sunday afternoon in New York, when the New Zealand banks open at 2:00 PM New York time. At 5:00 PM (still New York time) the financial markets in Sydney, Australia, open. Tokyo then opens at 7:00 PM, followed by Hong Kong and Singapore concurrently at 9:00 PM. At this point, all five of these currency-trading financial markets are open: New Zealand, Australia; Japan; Hong Kong; and Singapore.

In the wee hours of Monday, Frankfurt, Germany, opens up the primary euro market at 2:00 AM, New York time. By this time,

New Zealand and Australia are already closed, and the East Asian markets of Tokyo, Hong Kong, and Singapore are on their last legs. The European time zone continues shortly thereafter with the opening of the pivotal London session. Customarily the market with the most liquidity (as most foreign exchange trading has traditionally occurred within the London market), London session opens an hour after Frankfurt, at 3:00 AM NY time.

Finally, at 8:00 AM on Monday morning, the New York financial markets are the last of the major global markets to open. Since New York is also a strong foreign exchange trading market, much like London and Frankfurt, the overlap between these three markets—around 8:00 to 11:00 AM NY time—represents among the most active, liquid, and volatile trading hours available in forex. At the same time, however, the period surrounding the London opening currently takes the crown for the most active foreign exchange market.

A couple of hours before the close of the New York market, the New Zealand market opens up again at 2:00 PM to begin the whole globe-hopping process all over again. After Monday, this seamless process continues on every weekday until Friday, when the close of the last foreign exchange market in New York signals the end of the trading week at around 4:00 to 5:00 PM New York time. Therefore, from around 2:00 PM on Sunday to 5:00 PM on Friday, forex trading takes place 24 hours a day, five days a week.

One important note to keep in mind about trading currencies at all hours of the day and night is that even though a particular market happens to be closed, it does not mean that the currency specific to that market is not being traded. For example, when London opens in the middle of the night in New York while the U.S. markets are

closed, some of the most active trading of the U.S. dollar occurs. Beginning traders are often under the mistaken impression that a country's currency is only traded when that country's markets happen to be open. This is untrue only because the foreign exchange markets are traded by people and institutions around the world via a global, decentralized network. Therefore, U.S. dollar trading, for example, is not dependent on the business hours of any centralized, physical exchange located in the United States.

The fact that foreign exchange can be traded 24 hours a day means that traders have the advantage of choosing when it is most convenient to trade, considering their own personal schedules. For this reason, many traders hold full-time jobs while trading forex during off-hours. This provides a tremendous amount of flexibility that is not offered in other major trading markets. Of course, those traders that choose to take advantage of the most active markets must necessarily watch the currencies during the most active times, like during London or New York market openings. But the fact that all currencies can be traded 24 hours a day means that there is almost always price movement available upon which to trade.

Playing in the Majors

Just because there is price movement in a given currency does not necessarily mean that the currency is liquid and heavily traded. On the contrary; although the number of currencies in regular use around the world comes close to the number of countries in existence, only a very small handful of these currencies make up the vast majority of forex trading volume. This is yet another unique characteristic of

the foreign exchange market in comparison to other financial markets, and it can certainly be considered an advantage for traders.

According to the BIS, the most-traded currency, by far, is the U.S. dollar, with consistently greater than 85% of the average daily turnover in foreign exchange trading. The distant second place currency is the Eurozone's euro, with around a 37% share. Rounding out the top currencies are the Japanese yen with approximately 16%, and the British pound with 15% (because there are two currencies in each traded pair, the percentages of all the currencies combined, including the top-traded currencies cited above, will equal 200% instead of 100%). The structure of currency pairs as they are traded in the foreign exchange market will be discussed in Chapter 2, which covers basic trading mechanics.

Because of the fact that only a few currencies form most of the activity in the foreign exchange market, which means that these currencies are the most liquid and active, it is usually recommended for beginning traders to concentrate initially just on the major currencies. This avoids confusion and promotes focus in trading.

When matched together into predetermined currency pairings (as will be described further in Chapter 2), these currencies make up the four "majors." These majors are all U.S. dollar-based and include, first and foremost, the EUR/USD (euro against U.S. dollar). This key currency pair is considered not only the most actively traded currency pair available, but also the most actively traded financial instrument in the world.

Following behind EUR/USD are USD/JPY (U.S. dollar against Japanese yen), and GBP/USD (British pound against U.S. dollar).

Finally, USD/CHF (U.S. dollar against Swiss franc) has even less liquidity because of the progressively diminishing market activity of the Swiss franc over the years, but it is still considered one of the majors. AUD/USD (Australian dollar against U.S. dollar) and USD/CAD (U.S. dollar against Canadian dollar) are next in line in terms of trading activity, but are not generally considered among the majors.



IN THE REAL WORLD

Currency Terminology

As in other businesses and industries, foreign exchange trading has evolved its own vernacular over time. To outsiders, some of the terminology used by professional forex traders may seem a bit peculiar. But it has become virtually a language unto itself for those that deal with currencies on a daily basis. Here are some of the most common examples of currency terminology:

Currency or Currency Pair

GBP (British Pound)

CAD (Canadian Dollar)

USD (U.S. Dollar)

AUD (Australian Dollar)

NZD (New Zealand Dollar)

EUR/USD (Euro/U.S. Dollar)

GBP/USD (British Pound/U.S. Dollar)

USD/JPY (U.S. Dollar/Japanese Yen)

USD/CHF (U.S. Dollar/Swiss Franc)

USD/CAD (U.S. Dollar/Canadian Dollar)

Common Terminology

Sterling

Loonie

Greenback

Aussie

Kiwi

Euro

Cable

Dollar-Yen

Dollar-Swiss or Swissy

Dollar-Canada

Unlike stock trading, where there are countless possible securities to choose from, foreign exchange trading is much simpler and more straightforward in terms of selecting trades. Sticking to the majors—as many foreign exchange participants are wisely apt to do—allows traders to focus their efforts in an efficient manner rather than disperse their attention among a multitude of different securities. In a time marked by progressively increasing information overload, a limited set of trading options can certainly be seen as a significant benefit.

Leveraged to the Hilt

Another feature of foreign exchange trading that differentiates it from other financial markets is the astronomical levels of leverage that are commonplace in the forex world. The specifics of utilizing this leverage will be discussed in Chapter 2. For now, though, it should be known that many foreign exchange brokers will offer up to 400:1 leverage on the average retail trading account. This means that \$1 in a trader's forex account can control up to \$400 in a currency trade. The implications of this are mind-boggling. No other major financial market offers even close to this kind of leverage.

As will be discussed further in Chapter 2, however, this can be both a very positive feature as well as a very negative one. By definition, leverage is a type of financial magnification. While it is true that high leverage magnifies profits, it will also magnify losses equally. Oftentimes, it is this high level of leverage that summarily wipes out otherwise healthy trading accounts. Used with a great deal of caution, however, high leverage of the magnitude found in forex trading can offer tremendous possibilities to the upside as well as to the downside.

The Players

Knowing and understanding who the primary players are within the foreign exchange market goes a long way in helping individual traders approach the market in an informed manner. In terms of market impact, the most influential group of participants in the forex market would have to be the major banks. From the perspective of speculative trading, these banks have a great deal of funds to throw around, and the traders at many of these banks are responsible for moving astronomical amounts of money. Of course, banks also do a lot of nonspeculative currency exchanges for clients, but the speculative activity is really what moves the currency markets in the most dramatic manner. When there are big, sudden moves in currency prices, more often than not the banks, as a collective entity, are behind a good portion of the move.

Next in the hierarchy of speculative currency traders would have to be the hedge funds and other investment firms. In recent years, these entities, which often control a great deal of discretionary client equity, have progressively increased their speculative activities in foreign exchange. Because of the sheer enormity of the funds at their disposal, some of these firms come close to rivaling the major banks in their power to influence the currency markets.

Other participants in the foreign exchange market are not generally considered speculative players, and therefore may not be as influential in their trading activities as the participants described above. These include the central banks, which, as discussed earlier, are not considered speculative in their market activities. Rather, central banks get in the game primarily to further their economic policy agendas.

Because of their vast importance in helping ultimately to determine currency value, however, central banks certainly have the potential to impact currency prices with their attempts at currency manipulation.

Companies wishing to convert their funds to a foreign currency in order to purchase foreign goods or services are another example of nonspeculative market players. When their currency exchange activities are factored in collectively, these companies may help partially determine the course of international trade flow. Though this collective activity can certainly have some lasting impact on the currency markets, it is perhaps not influential enough to be of great significance to speculative foreign exchange traders.

The last group of market participants in foreign exchange is, by far, the smallest and least significant with regard to influence on the market as a whole. This group consists most notably of people like you, the individual retail trader. Whether you have \$100 or \$100,000 or even more to trade through your retail forex broker, none of your trading activity will likely ever move the currency markets in any appreciable way. That is not to say that you are at all unimportant. Rather, it just means that your trades, along with those of every other individual forex trader combined, will probably never influence the direction of the vast foreign exchange market. This, again, goes back to the sheer size and liquidity of the market, as well as the fact that its activity is so overwhelmingly dominated by well-heeled financial institutions whose funds dwarf those of individual retail traders.

But while retail traders, via their brokers, will unlikely ever influence the course of the foreign exchange market, they can certainly learn how to trade it effectively and hopefully to extract

profit from it. That is precisely the goal for the rest of this book. From basic forex trading mechanics to common analytical methods to specific trading strategies and risk management techniques, this book is intended to steer individual traders effectively through the maze that is foreign exchange trading.

What Moves the Forex Markets?

In order to steer through this maze successfully, foreign exchange traders should become familiar with the forces that drive this market. Although there are many traders who insist that market drivers, or causes of price fluctuations, are unimportant because everything is already reflected in price action on the charts, it would be a grave mistake to ignore the fundamental roots of market movement. As will be discussed further in Chapter 4 on fundamental analysis, knowing what moves the forex market is integral to becoming an informed, and therefore well-equipped, foreign exchange trader.

The primary movers of currency exchange rates are all tied to the basic forces of economics, as will be described in detail within Chapter 4. For now, though, a simplification of the cause of currency exchange rate movement can be said to relate directly to the process of international capital flow. This is simply the movement of money from one currency to another. International capital flows, in turn, are caused by basic economic supply and demand factors.

As will be expounded on in Chapter 4, supply and demand are determined by a number of different factors. Most notably, these factors include a country's interest rates, inflation situation, GDP growth, employment, trade balance, and other barometers of economic

health. If demand for a currency increases (and/or supply decreases) as a result of one or a combination of these factors, that currency's exchange rate will generally increase in relation to other currencies. Conversely, if demand for a currency decreases (and/or supply increases) as a result of one or a combination of the factors above, that currency's exchange rate will generally decrease in relation to other currencies. It is a simple concept, but one that is not so simple to utilize in attempting to forecast market directions.

Aside from the fundamental market drivers just described, technical factors are often overlooked or underestimated in their ability to help move the forex markets. Although this will all be discussed in great detail in Chapter 3, a brief explanation here will help illustrate the point.

Traders in many banks, hedge funds, and other potential market-moving institutions will often use certain techniques of technical analysis to help them make trading decisions. These traders all have access to the same price charts. Furthermore, these charts all show the same patterns, key price levels, and technical phenomena, with perhaps just some minor differences due to variations in the traders' individual interpretations.

This means that these influential players are generally all seeing the same types of technical events on the charts, which will often prompt many of them to buy at a similar price level, as well as sell at a similar price level. When a great deal of institutional money is on the same side of the market at the same approximate price level, prices can and will be influenced in one direction or another. In fact, this phenomenon of collective trading activity by influential market players is considered one of the primary causes of support and resistance

levels being respected so precisely in many instances. One of the most significant concepts in foreign exchange trading, support/resistance will be explored in much more detail in Chapter 3, which covers technical analysis.

What to Expect from This Book

The core of this book begins with in-depth descriptions of basic foreign exchange trading mechanics in Chapter 2. This includes all of the terminology and explanations necessary to get started in foreign exchange trading. From the structure of a currency pair to the intricacies of margin and leverage as they pertain to forex trading, Chapter 2 will get true beginners up and running quickly. The chapter is also directed at experienced traders coming from other financial markets, serving as a thorough discourse on the unique intricacies of trading currencies.

Following the chapter on basic trading mechanics is Chapter 3, which is a comprehensive discussion of technical analysis as it is applied to foreign exchange trading. The tools of technical analysis are perhaps the most tangible and accessible trading tools available to the individual foreign exchange trader. Software programs used specifically for charting prices in the foreign exchange market abound, and they provide the most popular way for most currency traders to make trading decisions. From free-hand trendlines to mathematically derived chart indicators to complex pattern formations, the primary tools of technical analysis, as they are used to trade forex market movement, will be the sole focus of Chapter 3.

Next is Chapter 4, which is devoted exclusively to fundamental analysis as it applies to foreign exchange trading. This important

discipline can best be described as the study of factors that drive currency exchange rate movement. From interest rates to inflation to economic growth and much more, the fundamental concepts described in Chapter 4 provide an essential foundation of knowledge for forex traders who wish to understand what really makes the foreign exchange markets tick.

Moving on to Chapter 5, this is where the knowledge gained in previous chapters can be put to practical use. Chapter 5 is all about foreign exchange trading methods and strategies, or the ways in which top currency traders tackle the markets on a daily basis. Included in this chapter are sections on strategic trading based on trends, breakouts, chart patterns, news, interest carry, divergences, multiple timeframes, and much more. The methods and strategies contained in this chapter provide traders with practical ideas that can be used almost immediately to trade forex.

Finally, Chapter 6 closes the book with some extremely important elements of trading. This chapter is found at the end of the book because it introduces perhaps the most advanced concepts in the book, and not because its contents are any less important than other subjects. On the contrary, concepts like risk and money management, trading discipline, and the optimal trader's psychology, are often considered by experienced traders to be among the most important components of a successful trading career. Since many beginning traders instead believe that finding the best trade entry point is the most crucial aspect of good trading, it is especially imperative that these novice traders pay particularly close attention to Chapter 6.

As a whole, this book should serve as a solid introduction and guide to the fascinating world of foreign exchange trading. Much

more can be said about the minute intricacies of how this market works. But in order to learn how it really works, the very best teacher beyond this book on the essentials is a lot of hands-on experience. Nothing beats getting your hands dirty by getting in there and actually practicing. Fortunately, this is extremely easy in today's retail currency trading environment. Virtually every reputable forex broker offers free practice account demos of their trading platforms, complete with real-time prices, charting software, and newsfeed services. With these convenient resources at every prospective forex trader's fingertips, there is absolutely no excuse not to get out there and start trading currencies with play money in a practice account.

Chapter Summary

In this introduction to *Essentials of Foreign Exchange Trading*, a brief history and description of the development of the foreign exchange market was touched upon. After the collapse of the Bretton Woods Agreements, which essentially fixed exchange rates, speculative currency trading was able to develop in an extremely rapid manner.

Fast forward to the past decade or so, and this development became even more rapid with the help of the Internet and technology enhancements. Modern-day spot forex trading via retail electronic platforms has opened up new opportunities for legions of individual traders.

Characteristics inherent in the foreign exchange market that differentiate it from other financial markets include the fact that it is the most heavily traded market in the world, by far. This ensures that its liquidity is second to none. Another differentiating characteristic

is that forex is open 24 hours a day (except weekends), as the market travels seamlessly around the globe with the changing time zones. Other notable distinguishing features include the fact that there are only a handful of tradable currencies to worry about, as opposed to countless stocks and options, as well as the fact that forex offers extremely high leverage levels (currently up to 400:1).

The key speculative players in the foreign exchange market include the major commercial and investment banks, as well as the larger hedge funds. The lowest rung on the totem pole of influential participants consists of individual retail traders. Although there may be a great deal of enthusiasm in this group, individual traders are generally unable to move the forex markets in any appreciable way.

The primary drivers of foreign exchange price movement include key fundamental factors like interest rates, GDP, employment, and inflation, which all help affect the basic economic supply and demand situation for each currency. Besides the fundamentals, technical factors can also contribute significantly to exchange rate movement.

Finally, the rest of the chapters in this book were introduced. In its entirety, this book serves as an essential guide to foreign exchange trading, as the title suggests. But nothing could ever take the place of hands-on, practical experience. Forex traders are fortunate to have their pick of free demo practice accounts provided by forex brokers. These accounts generally differ from real accounts only by the kind of money traded (play money versus real money). Therefore, it is incumbent upon the serious student of forex to practice diligently with these demo accounts, as no better method exists of gaining invaluable experience and self-directed education at no cost.