CHAPTER 1

Making Money in Up and Down Markets

Learn the rules or the game is over before it started.

People like to buy. That seems to simply be a fact of human behavior. One of the things that most traders and investors look for are markets that are heading up and will continue going higher. I can no more tell the future than anyone on Wall Street, and my guess is that your crystal ball is at the repair shop as well. So what can we do? Given the widespread preference for buying, the best thing to do is find a market where you can find a bull market no matter what. That's the forex market.

This is where the U.S. dollar comes in. The six most popular pairs in the forex market are either U.S. dollar–correlated majors or U.S. dollar–based

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commodity currencies also known as "comm dolls." You didn't think I was going to let you sound like a newbie now, did you?

Let's briefly discuss the difference. U.S. dollar–correlated majors are the euro/U.S. dollar, the U.S. dollar/Japanese yen, the British pound/U.S. dollar, and the U.S. dollar/Swiss franc. The four pairs trade against the U.S. dollar. The reason these are "correlated" is that the movements of these pairs have a strong relationship to the U.S. dollar, which we can track with the U.S. dollar Index. We'll talk in the next section about the relationships in detail, but for now keep in mind that the forex is a game of comparison. Is the U.S. dollar gaining or losing ground to another nation's currency?

If it seems as though I am spending an inordinate amount of time driving this point home it is because I think far too many traders forget that trading forex is a very tangible thing. It personally affects our everyday lives and the everyday finances of corporations and banks. Our world and collective economies are not isolated, and the global economy is now more intertwined than ever. Anyone who for a moment bought into the theory that somehow the U.S. economy was dislocated from Europe, Asia, and the BRIC countries (Brazil, Russia, India, China) should now know different after witnessing a cataclysmic global slowdown. My point here is that forex, the relationship between different currencies, is at the heart of the worldwide financial system and the more you understand this relationship the better overall trader you will become. Now who said forex trading couldn't make you a better person?

FILL IN THE BLANKS

In case you're new to forex, here's the one line synopsis of what the foreign exchange market is: How many __ will I get for __?

How many *yen* will I get per U.S. *dollar*?
How many U.S. *dollars* will I get per *euro*?

So basically depending upon the strength or weakness of the U.S. dollar you may be able to get more or less of another currency in exchange. I think of it as the airport analogy. Let's say we all jump on a flight to Paris and upon landing we look to exchange our pocketful of U.S. dollars for euros. The forex rate will dictate what we get.

Traders and investors track, analyze, and use this price movement to determine whether they feel this rate will go higher or lower.

That brings us to commodity currencies or "comm dolls." Maybe you have heard a little about what these pairs are and how they behave. My take is a little different, so let's start with the basics. Generally speaking, commodity currencies are just what their name would suggest: a currency pair that has a strong correlation back to a particular commodity. Simple, right? Well, not so fast.

The Australian dollar/U.S. dollar, New Zealand dollar/U.S. dollar, and U.S. dollar/Canadian dollar are the three pairs you will most commonly call "comm dolls." Let's use the U.S. dollar/Canadian dollar or "canada" as an example. The "canada" has a relationship to the energies complex, meaning crude oil, heating oil, natural gas. It moves, however, with a strong correlation to crude oil. Why? Well, consider that the country of Canada is one of the world's leading exporters of crude oil (from www.eia.doe.gov/pub/oil_gas/petroleum/data_publications/company_level_imports/current/import.html).

You better bet the supply and demand of crude affects the Canadian economy. But is that the end of the story for commodity currencies? No, not even close. You see this pair has a correlation to the U.S. dollar as well. Remember it's the U.S. dollar/Canadian dollar pair. We not only have to consider the impact of crude oil on the Canadian dollar itself but also how the U.S. dollar is moving against the Canadian dollar.

I am going to go into great depth later on about these relationships and my Forex Market Pulse. For now, though, think about this: Does crude oil affect the Canadian economy alone? I think we have seen what high crude oil prices have done to the U.S. economy as well. So bottom line? All pairs that have a relationship back to the U.S. dollar will have a certain amount of impact from crude oil. And that means that all U.S. dollar pairs can be considered comm dolls to a certain extent. Now that's not something you will hear from most traders, but I'm here to tell you that's the way it is.

So, there's always a bull market somewhere in the forex. When you consider all the different countries, commodities, and the relationship they have with one another, it's easy to begin to understand that while some currencies are being beaten down, others are rallying in comparison or are considered safe haven currencies. This is why you will always find that some pairs are heading lower while others are ripe for buying.

A BULL IS ON THE LOOSE!

One of the more appealing aspects of the forex market, beyond the 24-hour always open trading, is the fact that there's always a bull market somewhere amongst the pairs. The idea of buying a stock or futures contract or a forex pair is much more familiar to most people, especially since most of us are already familiar with investing. Investing and trading do have two

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completely different mindsets. For investors, the whole idea is ownership: to own more shares of a company or mutual fund or even ETF (electronically traded funds). Most people incorrectly believe that trading is buying low and selling high . . . wrong! That is actually investing. Now, of course, investors do hope that their holding will increase in value, but that is secondary to ownership.

Traders don't own anything; in fact, they don't want to because the goal in trading is to profit from price movement. Instead of owning, traders control shares, contracts, lots, or pairs with leverage. Now what does all this have to do with playing U.S. dollar strength or weakness? Traders understand that in order to profit from price movement they must buy and short. That's right, "short." After all, trading means making money in up and down markets. If you were only to play one side of the market you would consistently miss opportunities to benefit from when the U.S. dollar moves a pair lower.

Consider this move. The U.S. dollar gains strength on the euro. The resulting move on the chart would be weakness, a sell-off and even a downtrend in the EUR/USD (euro/U.S. dollar). In order to profit from this relationship a trader would have to short or sell the EUR/USD. Here's another example, one that has hit closer to home for most people. Crude oil has been on a rollercoaster as of late, reaching new highs and selling off to significant lows. In fact, over the course of less than six months, crude oil has moved over $100. Crude oil has a strong correlation to the commodity currency of the U.S. dollar/Canadian dollar (USD/CAD). The USD/CAD is affected by U.S. dollar movement but as with all forex analysis, you must consider the other side of the pair, in this case the Canadian dollar. The Canadian dollar or "loonie" is affected by crude oil prices because Canada is a huge exporter of oil. When oil strengthens, this helps the loonie strengthen. If oil weakens, it can take the loonie down with it. So as the crude oil market sells off, the loonie has been weakening against the U.S. dollar, which results in a downtrend on the chart of the USD/CAD. The only way to benefit from that movement in the forex would be to short the USD/CAD and profit from the weakness.

SHORTING

The real value in trading has always been the fact that traders can profit in both up and down markets. This has always been one of those ideas that people have a hard time wrapping their brains around. Even though I spent a good deal of time telling you that you can always find a bull market in forex, that's not where I want you to stop looking for opportunities. I'll let you in on a little secret. Gravity applies to the markets too. Prices always fall quicker than they rise. It's a function of fear and panic. And, yes, you can profit from it. But before you think of me as some heartless trader preying upon fear, remember that trading and investing must have participants willing to sell. I'm not sure where this concept blipped off the radar, but it's one that the general public doesn't seem to get: For every buy there is a sell. The reason prices move higher or lower is based upon where the transaction takes place. However, there still must be a buyer and seller willing to do a deal in order for a trade to take place.

Let's discuss it in terms that most people can visualize, the housing market. When a house goes up for sale you have a seller, that's the current homeowner. This homeowner is hoping that there is demand—and lots of it! More demand for the house, and the price at which they can sell (think of it as where the trade will be done at) will be higher. Less demand, and the price at which they will likely sell will be lower. The stock, futures, and forex markets work the same way. When there are plenty of homes for sale and not as many buyers, that's a buyer's market. If you were to plot that on a chart, the trend for home prices would be down. Now take that same scenario and apply it to a stock. Let's use IBM. If IBM came out with a bad earnings report, or if a new product line flopped, or a problem was found in server design—any one of the myriad of issues that can hurt a company and a stock—the value of IBM would likely go lower over concern for what these issues mean to IBM sales and profits. What if you could profit from prices heading lower? We all know we can profit from prices moving higher as good news is discounting into a stock and both traders and investors buy in expectation of more success, profits, and sales from IBM. But what if events go the other way?

I'm going to warn you that you may need to reread this until you get the mechanics of what I am going to explain implanted in your mind. It may take some time to click, but once it does, it's going to open a whole new world to you and your trading opportunities. I remember the first time I was introduced to the concept of shorting. It was foreign and took me a week to understand. Conceptually it made sense, but it wasn't until I understood order flow that it made total sense. I began to see why it was such an important concept and a viable position to take in a downtrending market. Funny enough, I actually thought for a short while that it was illegal until my broker walked me through what I am about to explain to you. Remember that while you read this, until people are willing to sell and short the market as we know it, it would not exist. I'm not trying to be dramatic, it's just plain fact.

I could just say that when you are shorting a market (stocks, futures, or forex) you're selling it at a higher price and buying it back at what you hope to be a lower price for a profit. But selling something you don't own doesn't necessarily make sense, does it? And for those of you who are already familiar with shorting, I am probably preaching to the choir, but come along for the ride here regardless. You may find out a few things about order flow you didn't know before.

I am going to use a stock example again, because time and teaching literally thousands of traders has taught me that using this as a frame of reference seems to be one that most people feel comfortable with, and the mechanics apply to any market. Let's take our old friend IBM again. Big Blue is heading lower, and as a trader you understand that one of your options would be to take a short position in IBM with hopes that it will head lower still from your selling price. How, who, and why?

The how of shorting is basically a process by which your brokerage will allow you to borrow shares of IBM. So that's where you get the stock to sell: You are getting it, borrowing it, from your broker! Next is taking these borrowed shares of IBM and selling them into the market. Who will buy it from you? The markets are divided into two groups, buyers and sellers, also known as the bid and ask, respectively. Buyers bid on a stock they want to buy and like all buyers they would like to pay as little as possible. The ask, or sellers, are on the other side. They own what the buyers want, and of course they would like to sell it for as high a price as they can get. How much they will get for it depends upon whether it's a buyer's or seller's market, just like real estate.

Imagine two lines of traders, one of buyers and one of sellers. These two groups are lined up by placing the bidder or buyer who is willing to pay the most for IBM at the front of the "buyer's line" and the seller who is willing to sell for the least amount at the front of the "seller's line." The difference between the highest bid and the lowest ask is the spread. Starting to make sense?

At the front of each line are the two participants that are closest to being able to get a deal done. So who gets their price? Well, that's determined by the overall direction of the market. The seller will have the advantage if prices are heading higher (more demand) while the buyer will have the advantage if prices are heading lower (more supply). In the trading world this balance can go back and forth from moment to moment. Since we are talking about shorting, we'll assume that the overall market psychology is bearish. This means that the overall direction of the market is heading lower and that the buyers are able to have their way, which means that the trades are generally being done at lower prices.

So since you are shorting and you have your borrowed shares of IBM, you are on the ask or "seller's line." You have a price that you would like to sell these shares for, and your hope is that you can find a buyer and that prices will head lower after you sell your shares.

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So how do you profit from such a position, and why would anyone buy it from you? The first part is easy. Since you borrowed the shares from your broker, all the broker expects is that you return the shares to them. It's much like borrowing a book from the library. The library made you get a card so you are "approved" to borrow a book, and they expect you to return it. The broker in this case is typically going to let you have those shares borrowed out for pretty much as long as you need them. When you sold IBM, you collected a certain price per share from the buyer knowing that at some point you are going to need to buy some IBM sooner or later to return what you borrowed. Let me say that again, because here is often where the wheels fall off the wagon for a lot of folks.

You sold your borrowed shares of IBM into the market, and the buyer of those shares gave you, for sake of keeping this simple, $100 per share. Now you have this $100 per share, and that's half the equation here of this short position. Now based on your analysis you think that prices should head lower, and by golly, they do! $98 . . . $93 . . . $88 . . . $87 . . . $84 . . . until they level off at your target of $80. So you sold at $100 and prices sold off to $80—a $20 difference. Remember, your broker wants their shares back at some point, and you've decided today's the day and $80 is the price. So you execute another order. Your first order was a SELL. Your second order is a BUY. This will allow you to realize the $20 profit and return the shares of IBM back to your broker, thus closing out your short position. You sold these shares at 100 and are buying them back at 80, so the difference is yours.

I had also mentioned the "Why?" Why would someone buy these shares from you? Well, that's what is so wonderful about the markets. There are always going to be contrary opinions. Without them there would be no market. When I think I see a buying opportunity, there is someone out there who thinks that I am out of my mind and that there is a selling opportunity. Without both sides of the equation, buyers and sellers, there would be no market; there would be no investing, no trading, nothing! So next time you hear about someone shorting the market, remember, there had to be a buyer for that trade to be done and without both types of market participants there would be no liquidity. We'll talk later about liquidity and how the forex is the most liquid market on the planet and why that's so important to us as traders. For now though, I hope your mind is starting to see the opportunity in playing both sides of the market.

And by the way, my shorting example of IBM has nothing to do with anything happening in the market. I have been an investor in IBM for many years. It is the first stock I ever owned. My father, a proud IBMer, worked for them until the day he passed away.