Part 1

The Foreign Exchange Markets

Chapter 1

The FOREX Landscape

Introduction—What Is FOREX?

Foreign exchange is the simultaneous buying of one currency and selling of another. Currencies are traded through a broker or dealer and are executed in currency pairs; for example, the Euro Dollar and the U.S. Dollar (EUR/USD) or the British Pound and the Japanese Yen (GBP/JPY).

The FOReign EXchange Market (FOREX) is the largest financial market in the world, with a volume of more than $2 trillion daily. This is more than three times the total amount of the stocks and futures markets combined.

Unlike other financial markets, the FOREX spot market has neither a physical location nor a 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 time zone to another across the major financial centers. This fact—that there is no centralized exchange—is important to keep in mind as it permeates all aspects of the FOREX experience.

What Is a Spot Market?

A spot market is any market that deals in the current price of a financial instrument. Futures markets, such as the Chicago Board of Trade, offer commodity contracts whose delivery date may span several months into the future. Settlement of FOREX spot transactions usually occurs within two business

TABLE 1.1 Major FOREX Currencies

Symbol	*Country*	*Currency*
USD	United States	Dollar
EUR	Euro members	Euro
JPY	Japan	Yen
GBP	Great Britain	Pound
CHF	Switzerland	Franc
CAD	Canada	Dollar
AUD	Australia	Dollar

days. There are also *futures* and *forwards* in FOREX, but the overwhelming majority of traders use the spot market. I discuss the opportunities to trade FOREX futures on the International Monetary Market.

Which Currencies Are Traded?

Any currency backed by an existing nation can be traded at the larger brokers. The trading volume of the major currencies (along with their symbols) is given in descending order: the U.S. Dollar (USD), the Euro Dollar (EUR), the Japanese Yen (JPY), the British Pound Sterling (GBP), the Swiss Franc (CHF), the Canadian Dollar (CAD), and the Australian Dollar (AUD). See Table 1.1. All other currencies are referred to as *minors* and those from smaller countries, *exotics*.

FOREX currency symbols are always three letters, where the first two letters identify the name of the country and the third letter identifies the name of that country's currency. (The "CH" in the Swiss Franc acronym stands for Confederation Helvetica.)

A FOREX transaction is always between two currencies. This often confuses new traders coming from the stock or futures markets where every trade is denominated in dollars. The price of a pair is the ratio between their respective values. *Pairs, crosses, majors, minors,* and *exotics* are terms referencing specific combinations of currencies. I discuss these terms in Chapter 5, "The FOREX Lexicon." They are defined in the Glossary.

Who Trades on the Foreign Exchange?

There are two main groups that trade currencies. A minority percentage of daily volume is from companies and governments that buy or sell products and services in a foreign country and must subsequently convert profits made in foreign currencies into their own domestic currency in the course of doing business. This is primarily hedging activity. The majority now consists of investors trading for profit, or speculation. Speculators range from large banks trading 10,000,000 currency units or more and the home-based operator trading perhaps 10,000 units or less. Retail FOREX, as much as it has grown in the past 10 years, still represents a small percentage of the total daily volume but its numbers and significance are growing rapidly.

Today, importers and exporters, international portfolio managers, multinational corporations, high-frequency traders, speculators, day traders, long-term holders, and hedge funds all use the FOREX market to pay for goods and services, to transact in financial assets, or to reduce the risk of currency movements by hedging their exposure in other markets.

A producer of widgets in the United Kingdom is intrinsically *long* the British Pound (GBP). If they sign a long-term sales contract with a company in the United States, they may wish to buy some quantity of the USD and sell an equal quantity of the GBP to *hedge* their margins from a fall in the GBP.

The speculator trades to make a profit by purchasing one currency and simultaneously selling another. The hedger trades to protect his or her *margin* on an international transaction (for example) from adverse currency fluctuations. The hedger has an intrinsic interest in one side of the market or the other. The speculator does not. Speculation is not a bad word. Speculators add *liquidity* to a market, making it easier for everyone to transact business by setting efficient prices. They also absorb risks that exist in the marketplace. This latter differs from the gambler who creates risks in order to take them.

How Are Currency Prices Determined?

Currency prices are affected by a large matrix of constantly changing economic and political conditions, but probably the most important are interest rates, economic conditions, international trade, inflation or deflation, and political stability. Sometimes governments actually participate in the foreign exchange market to influence the value of their currencies. Governments do this by flooding the market with their domestic currency in an attempt to lower the price or, conversely, buying in order to raise the price. This process is known as central bank intervention. Any of these factors, as well as large market orders, can cause high volatility in currency prices. Reports of sudden changes in such factors as unemployment can drive currency prices sharply higher or lower for a short period of time. In fact, news traders specialize in attempting to capitalize on such surprises. Technical factors, such as a well-known chart pattern, may also influence currency prices for brief periods. However, the size and volume of the

FOREX market make it impossible for any one entity to drive the market for any length of time. Crowd psychology and expectations also figure in the equation determining the price of a currency relative to another currency. There are an enormous number of correlations between all these factors and they are almost certainly nonlinear in nature. That means they are constantly changing and rearranging themselves, sometimes in nonpredictive ways. Now you see it, now you don't. If you focus on one or a few of them, the others might change unnoticed. Quantum theory comes to mind.

Why Trade Foreign Currencies?

In today's marketplace, the dollar constantly fluctuates against the other currencies of the world. Several factors, such as the decline of global equity markets and declining world interest rates, have forced investors to pursue new opportunities. The global increase in trade and foreign investments has led to many national economies becoming interconnected with one another. This interconnection, and the resulting fluctuations in exchange rates, has created a huge international market: FOREX. For many investors, this has created exciting opportunities and new profit potentials. The FOREX market offers unmatched potential for profitable trading in any market condition or any stage of the business cycle. These factors equate to the following advantages:

- *No commissions.* No clearing fees, no exchange fees, no government fees, no brokerage fees if you trade with a market maker.
- *No middlemen.* Spot currency trading does away with the middlemen and allows clients to interact directly with the market maker responsible for the pricing on a particular currency pair, if you trade with an Electronic Communications Network (ECN).
- *No fixed lot size.* In the futures markets, lot or contract sizes are determined by the exchanges. A standard-sized contract for silver futures is 5,000 ounces. Even a "mini-contract" of silver, 1,000 ounces, represents a value of approximately $17,000. In spot FOREX, *you* determine the lot size appropriate for your grubstake. This allows traders to effectively participate with accounts of well under $1,000. It also provides a significant money management tool for astute traders.
- *Low transaction cost.* The retail transaction cost (the bid/ask spread) is typically less than 0.1 percent under normal market conditions. At larger dealers, the spread could be as low as 0.07 percent. Prices are quoted in *pips* for currencies. Today pip spreads can be zero at some periods for the most actively traded pairs, but typically range from two to five pips.

- *High liquidity.* With an average trading volume of more than $4 trillion per day, FOREX is the most liquid market in the world. It means that a trader can enter or exit the market at will in almost any market condition. I must note that at the time of the first edition of *Getting Started in Currency Trading* in 2005, the daily volume was slightly less than $2 trillion.
- *Almost instantaneous transactions.* This is an advantageous byproduct of high liquidity.
- *Low margin, high leverage.* These factors increase the potential for higher profits (and losses) and are discussed later. Traders have access to leverage of up to 400 percent although 50 percent to 100 percent is most common. 400:1 leverage means $1 controls $400 of currency.
- *A 24-hour market.* A trader can take advantage of all profitable market conditions at any time. There is no waiting for the opening bell. Markets are closed from Friday afternoon to Sunday afternoon. As the markets transition to the Asian Session, they usually go quiet from 5 P.M. to 7 P.M. Eastern Standard Time.
- *Not related to the stock market.* Trading in the FOREX market involves selling or buying one currency against another. Thus, there is no hard correlation between the foreign currency market and the stock market although both are measures of economic activity in some way and may be correlated in specific respects for a limited period of time. A *bull market* or a *bear market* for a currency is defined in terms of the outlook for its relative value against other currencies. If the outlook is positive, we have a bull market in which a trader profits by buying the currency against other currencies. Conversely, if the outlook is pessimistic, we have a bull market for other currencies and traders take profits by selling the currency against other currencies. In either case, there is always a good market trading opportunity for a trader. Although big price moves occur frequently, a crash is less likely to happen in currencies than stocks because a pair measures relative value. The U.S. Dollar (USD) can be in deep trouble, but so can the European Euro (EUR). The game is the ratio between the two. The top four traded currencies are: the U.S. Dollar (USD), the Euro Dollar (EUR), the Japanese Yen (JPY), and the British Pound (GBP). Fund managers are beginning to show interest in FOREX because of this non-correlation with other investments.
- *Interbank market.* The backbone of the FOREX market consists of a global network of dealers. They are mainly major commercial banks that communicate and trade with one another and with their clients through electronic networks and by telephone. There are no organized exchanges to serve as a central location to facilitate transactions the way

the New York Stock Exchange serves the equity markets. The FOREX market operates in a manner similar to that of the NASDAQ market in the United States; thus it is also referred to as an *over-the-counter* (OTC) market. The lack of a centralized exchange permeates all aspects of currency trading.

- *No one can corner the market.* 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. Even interventions by mighty central banks are becoming increasingly ineffectual and short-lived. Thus central banks are becoming less and less inclined to intervene to manipulate market prices. (You may remember the attempt to corner the silver futures market in the late 1970s. Such disruptive excess is not likely in the FOREX markets.)
- *No insider trading.* Because of the FOREX market's size and noncentralized nature, there is virtually no chance for ill effects caused by insider trading. Fraud possibilities, at least against the system as a whole, are significantly less than in any other financial instruments.
- *Limited regulation.* There is but limited governmental influence via regulation in the FOREX markets, primarily because there is no centralized location or exchange. Of course, this is a sword that can cut both ways, but the author believes—with a hearty caveat emptor—less regulation is, on balance, an advantage. Nevertheless, most countries do have some regulatory say and more seems on the way. Regardless, fraud is always fraud wherever it is found and subject to criminal penalties in all countries. Regulatory bodies such as the *Commodity Futures Trading Commission* (CFTC) and *National Futures Association* (NFA) are just now beginning to get a handle on some limited control of the retail FOREX business.
- *Online trading.* The capability of trading online was the impetus for retail FOREX. Today you can select from more than 100 online FOREX broker-dealers. Although none is perfect, the trader has a wide variety of options at his or her disposal.
- *Third-party products and services.* The immense popularity of retail FOREX has fostered a burgeoning industry of third-party products and services.

What Tools Do I Need to Trade Currencies?

A computer with reliable high-speed connection to the Internet, a small grubstake, and the information in this book are all that are needed to begin trading currencies. You do not even need the grubstake to practice on; a free demo account is offered by all retail FOREX brokers. In fact, I encourage you to open at least one demo account early in this book.

What Does It Cost to Trade Currencies?

An online currency trading account (a micro-account) may be opened for as little as $1! Mini-accounts start at $400. Do not laugh—micro- and mini-accounts are a good way to get your feet wet without taking a bath. Unlike futures, where the size of a contract is set by the exchanges, in FOREX you select how much of any particular currency you wish to buy or sell. Thus, a $3,000 grubstake is not unreasonable as long as the trader engages in appropriately sized trades. FOREX mini-accounts also do not suffer the illiquidity of many futures mini-contracts, as everyone essentially feeds from the same interbank currency "pool."

Market maker brokers take their expenses and profit by marking up the bid-ask spread. ECN brokers charge a flat lot fee to trade. As an example, if you buy and then later sell 100,000 EURUSD and the spread is two pips, you pay a total of four pips or approximately $40. ECN lot fees vary from $15 to $40 for a 100,000 lot. If you trade a larger lot size and/or frequently you will be able to negotiate these costs.

FOREX versus Stocks

Historically, the securities markets have been considered, at least by the majority of the public, as an investment vehicle. In the past 10 years, securities have taken on a more speculative nature. This was perhaps due to the downfall of the overall stock market as many security issues experienced extreme volatility because of the "irrational exuberance" displayed in the marketplace. The implied return associated with an investment was no longer true. Many traders engaged in the *day trader* rush of the late 1990s only to discover that from a leverage standpoint it took quite a bit of capital to day trade, and the return—while potentially higher than long-term investing—was not exponential, to say the least.

After the onset of the day trader rush, many traders moved into the futures stock index markets where they found they could better leverage their capital and not have their capital tied up when it could be earning interest or making money somewhere else. Like the futures markets, spot currency trading is an excellent vehicle for the pattern day trader that desires to leverage his or her current capital to trade. Spot currency trading provides more options and greater volatility while at the same time stronger trends than are currently available in stock futures indexes. Former securities day traders have an excellent home in the FOREX market.

There are approximately 4,000 stocks listed on the New York Stock Exchange. Another 2,800 are listed on the NASDAQ. Which one will you trade? Trading just the seven major USD currency pairs instead of 6,800 stocks simplifies matters significantly for the FOREX trader. Fewer decisions, fewer headaches. The trader can specialize in one, two, or three currency pairs and have a full plate offering all the opportunity he or she can seize.

FOREX versus Futures

The futures contract is precisely that—a legally binding agreement to deliver or accept delivery of a specified grade and quantity of a given commodity in a distant month. FOREX, however, is a spot (cash) market in which trades rarely exceed two days. Many FOREX brokers allow their investors to *rollover* open trades after two days. There are FOREX futures or forward contracts, but almost all activity is in the spot market facilitated by rollovers.

In addition to the advantages listed, FOREX trades are almost always executed at the time and price asked by the speculator. There are numerous horror stories about futures traders being locked into an open position even after placing the liquidation order. The high liquidity of the foreign exchange market (roughly three times the trading volume of all the futures markets combined) ensures the prompt execution of all orders (entry, exit, limit, etc.) at the desired price and time.

The caveat here is something called a requote or dealer intervention, which I discuss in a later chapter.

The Commodity Futures Trading Commission (CFTC) authorizes futures exchanges to place daily limits on contracts that significantly hamper the ability to enter and exit the market at a selected price and time. No such limits exist in the FOREX market.

Stock and futures traders are used to thinking in terms of the U.S. Dollar versus something else, such as the price of a stock or the price of wheat. This is like comparing apples to oranges. In currency trading, however, it is always a comparison of one currency to another currency—someone's apples to someone else's apples. This paradigm shift can take a little getting used to, but I will give you plenty of examples to help smooth the transition.

The author was a commodity futures trader and registered trading advisor for many years but has found currency trading much more to his liking for many of the reasons listed above.

I must reiterate: There is always some risk in speculation regardless of which financial instruments are traded and where they are traded, regulated or unregulated. Leverage is a door that swings both ways.

Both stock and futures traders must make a similar adjustment to currency trading: In stocks and futures the specific investment vehicle is denominated in dollars or local currency. In FOREX the underlying vehicle is a *pair*—the relative value of one currency to another.

Summary

FOREX means FOReign EXchange. The FOREX (FX) market is more than a $4 trillion-a-day financial market, dwarfing everything else, including stocks and futures. Because there is no centralized exchange or clearinghouse for currency trading the FOREX market is currently less regulated than other financial markets.

There are a wide variety of reasons to consider FOREX trading, including high leverage and low costs. Access to the FOREX markets via the Internet has resulted in a great deal of interest by small traders previously locked out of this enormous marketplace. Getting started requires only this book, a review of the FX landscape, a computer and Internet connection, and a small grubstake.