

CHAPTER 1

Trading Vehicles, Stock, ETFs, Futures, and Forex

Welcome to *Trading Triggers*. If you are an active trader or a first-time investor looking for a trading method that suits your personality, then you have the right book. Trading for a living is an amazing and yet risky business. There is more to trading than buying and selling. There are often-missed but important issues that many books do not mention, such as not only how to make money in the market but also how to keep it and create a positive cash flow. The purpose of this book is to take you to a new level of trading knowledge by giving detailed explanations of technical tools that will help you develop your own trading system so you can cultivate and extract money from the market, especially those traders who want high alpha (big returns) with reasonable standard deviation (volatility). I will explain some of the most obvious yet simple concepts of how to interpret technical analysis and improve your chart-reading skills so you can make money in the markets.

There are two theories on how markets perform: efficient market theory and random walk theory.

1. *Efficient market theory* lends to the belief that markets are always priced correctly because the current price reflects all factual information. If the markets are efficient, then no fundamental information will give an investor an edge in the market.
2. *Random walk theory* lends to the belief that price movements do not follow any pattern or trend and that past price behavior cannot be used

to predict future price movements. In other words, the markets are completely unpredictable.

I fall in the category of believing that history can and does repeat itself. People can and do make money based on technical analysis, and I am here to help prove it.

IMPORTANCE OF A RULE-BASED APPROACH

You may have heard of Jesse Livermore, who was immortalized by Edwin Lefèvre's book *Reminiscences of a Stock Operator* (G. H. Doran, 1923; Wiley, 2006). Jesse was considered one of the greatest speculators of his day. Many of his principles and ideas are still used. His three key concepts of trading are (1) timing, (2) risk management, and (3) emotional control.

This quote from Richard Smitten's *Trade Like Jesse Livermore* (Wiley, 2005, p. 70) sticks with me because it is as true now as it ever was (keep in mind that Jesse committed suicide in 1940, so this was stated nearly 70 years ago): "All through time, people have basically acted the same way in the stock and commodity markets as a result of greed, fear, ignorance, and hope: that is why the formations and patterns recur on a constant basis. The patterns the traders and technicians observe are simply the reflections of human emotional behavior."

Most traders who are consistently profitable have learned to develop a rule-based approach that doesn't change. They have within their arsenal of trading tools, definitive, recognizable, and frequently reoccurring patterns that can be used to trade by a set of established trading rules. They can clearly define, without guessing or using a vague approach, support and resistance levels and what to do once prices reach those levels. Moreover, they have the ability to clearly define their entry, stop-loss, or risk parameters and their profit objectives in a consistent, repetitious fashion each time they place a trade. This is what I do when trading my own account and what I have taught my son and even my own father. My dad used to think trading commodities was like gambling until I showed him a method. This is the same method that will be disclosed in these pages.

It is important for you to realize that it is the emotional balance that helps keep you on the profitable side of the ledger. You must never anticipate what the market might do, but rather wait for confirmation on your triggers.

Most traders who are profitable are flexible as to the anticipated outcome that may occur on each trade. Successful traders have the mindset to develop the perspective that their trading business is to manage their

money rather than to predict the future. Successful traders can emotionally handle losing trades or the negative trades that result from an error or trading equipment malfunction. Remember that the business of trading for a living requires that you establish some kind of structure in a marketplace with countless variables. Why not consider trading by a set of rules? Most traders do not trade by a system; the term “black box” just means that a trader has input a set of trading parameters and automatically executes a trade based on a specific set of criteria—strict rules to automatically trade by.

START TRADING AS A BUSINESS

If you are currently trading for a living or if you are expanding your knowledge to learn how to trade for a living, remember that this is a business. You need to treat it like a business. Therefore, some considerations need to be made, for example, forming a corporation in order to deduct such expenses as your computer equipment, quote feed, DSL (digital subscriber line), office rent, travel to investment conferences, and continued education seminars. What matters most to every trader and investor is creating a positive cash flow. You wouldn't want to finally start learning to make money consistently in the market and find out that you cannot take any expense deductions. You should seek advice from a tax specialist so that you can take advantage of all regular and necessary expenses as business deductions and save thousands of dollars each year.

Let's add up the examples I mentioned: Suppose your quote feed is \$200 per month and your DSL is \$40 per month. Renting a small one-room office could run \$500 to \$700 per month. Then there are equipment expenses, such as your desktop computers, a laptop for travel, monitors and printers and ink cartridges and general office supplies to purchase and upgrade from time to time, say \$2,000. Attending an investment conference could mean \$700 roundtrip airfare, plus \$250 per night for hotel and meals. If you have business entertaining expenses and went to at least two conferences per year, you could be talking as little as \$5,000 to as much as \$25,000 in actual business expenses that can be deducted if you are running trading as a business.

If you are a first-time smaller investor and decide that trading for a living is something you have the financial resources, time, and emotional makeup to do, what business plan do you have in place to protect the money you make in the market? Where will you put your profits as a short-term trader? Some traders have had many problems with this issue; it is similar to the old expression of “Robbing Peter to pay Paul.” After all, who

wants to make money in a buy-and-hold long-term position strategy only to give it back day trading, and vice versa.

I am going to show you a trading method based on combining candle charts, to help identify shifts in momentum, and pivot point analysis. I will teach you very succinct rules, which is what I have taught to professional traders on the floor of the exchanges and introduced to thousands of private investors, including other leading trading educators who now effectively teach my trading methods. I will walk you through deciding what investment vehicles are available, when and how to decide which investment vehicle would better suit a trader under various market conditions, and how to develop a trading strategy based on the specific trading triggers.

EDUCATION IS THE KEY TO SUCCESS

Traders need and, moreover, have an *obligation* and responsibility to understand as much as possible about how the markets that they trade work and what makes them function. It is vital to your success that you continue to learn not only about the market but also about your trading hardware or computer equipment. For example, if you trade off a laptop, you should know how to disable the tapping feature on the touch pad. After all, who wants to accidentally place the wrong order on line? That has happened to traders because the touch pad is ultrasensitive. Simply moving your finger or having your shirt sleeve touch the pad can act as an action click. Traders should know how to set up and troubleshoot office or home Internet connections or at least have a brokerage account that offers assistance in taking over-the-phone orders.

Traders need to learn and comprehend all the features and benefits that charting software packages offer and should know all about the order entry platforms and, more specifically, the brokerage firm rules and procedures for trading. Traders should make sure the brokerage firm has the title of the account set up so if ever there is a situation where you wish to wire money into an account, it matches the name on the bank to your trading account. You don't want an important wire to be rejected. In a situation where you want to either put on more positions or add a second account to trade a great opportunity, how sad it would be for back-office personnel to reject the wire, resulting in a lost opportunity.

A great trader is always looking to learn. One of the best processes to learn is asking a series of questions; evaluating the dynamics of a situation or event; and seeking out how to take advantage of that event within the financial resources, risk factors, and time constraints in place.

The traits that most professional and consistently profitable traders

possess are that they follow a trading plan on extensively tested research and limit losses while letting winning positions ride. Winning traders exhibit the qualities of patience and discipline. The techniques that will be taught in this book will help you master those two qualities.

Other traits that winners possess are that they diversify into various trading positions, while committing only 10 to 40 percent of accounts equity in the markets. Successful traders commit their full attention to the market trends and prices, and they act on trading signals immediately.

They also seem to possess the ability to accept winners and embrace losers, and they don't let either of these outcomes generally influence their next trade decision. They stay in the now and react to what the market is currently doing. Winning traders take breaks from trading. Through continued education and the process of asking questions, they gain an edge and stay on top of their competition through diversification or other more advanced trading strategies.

TRADERS NEED TO ASK MORE QUESTIONS

The process of asking questions is what is needed in order to gain more knowledge. The trouble is, most traders do not have enough experience to know what the right questions are. If you apply simple common sense, then you will be on a great start to learn how to identify investing or trading opportunities and find the right strategy to take advantage of those opportunities.

Some questions traders need to ask themselves include, just for starters: How much time do I have to dedicate to the markets? If I enter a day trade, do I have the time to watch this position, or do I have an appointment or meeting scheduled for that day? What are the possible outcomes of what I am about to do, based on what I have control over?

Focus on what it is you want to achieve, write it out, and concentrate on that goal. Think of the consequences or possible outcomes of your actions so you will have a more balanced emotional reaction if the outcome is not as positive as you expected. Ask questions such as:

- Do market conditions warrant increasing or decreasing my position size?
- Are there reports coming out that may impact the market or my position?
- Are my entry and exit targets justified?
- If the market is so bearish, why won't it go down?
- If the market is so bullish, why won't it rally?

Trading without asking questions or without probing leads to trading blindly or without a plan. It opens the door for destructive emotional interference. Another quote from Jesse Livermore helps confirm this: “There is nothing new on Wall Street or in stock speculation. What has happened in the past will happen again and again and again. This is because human nature does not change, and it is human emotion that always gets in the way of human intelligence. Of this I am sure.” (Smitten, *Trade Like Jesse Livermore*, p. 167)

That statement was made over 65 years ago and is without a doubt still applicable to this day. Do not let your emotions get in the way of your trading decisions. If you ask the right question before placing a trade, you stand to gain an edge on winning the emotional battle of trading. It is generally those who are afraid of losing through fear itself who stand to lose because that emotion will interfere with rational, well-thought-out trading plans.

Asking yourself the right questions will help you to choose a more appropriate investment vehicle or trading strategy. For example, ask yourself before entering a trade: What are the time expectations for a result to occur? Do I have availability of time to see the trade through? Would short-term day trading or swing trading be possible if I have a regular day time job? In what time zone do I start work? This is relevant because a person living on the West Coast could trade an early morning market such as the Chicago Board of Trade (CBOT) bond contract opening session; however, a person with an early morning job may want to consider foreign currency or forex (Foreign Exchange) trading on the European session starting at night.

In order to know what time demands you need, you should also ask yourself if you have the tolerance for trading a leveraged product and if you have the tolerance for the risks: Should I use a time period stop—if the market does not move or react within a specified time period, should I exit the position? Should I use a conditional stop, such as a “stop-close only” order? Does my order platform take such orders, or do I need to manually watch and then implement such an order? (In intraday trading, the answer is yes, you need to manually watch the close of the time period you are trading in.) Can I afford to place a stop, say, 10 or 20 percent of my overall account value?

You need to be clear and honest with yourself when answering these evaluation questions. Remind yourself by asking: Why am I trading? What are my expectations? (I have met too many people that look at trading as an easy and quick way to make money or to replace their current career.) Based on your trading account size or your risk capital, ask: What returns will I need in order to generate sufficient income? Is my starting equity size or bank roll inclusive of my living expenses? Are my expectations on that return realistic on a constant basis?

These questions are important because they will help you to determine

which type of investment vehicle and which type of diversified trading strategies you can incorporate into your trading repertoire.

RISK PER TRADE

A most important yet simple thought process that a trader can start with is learning how to determine how much equity to put into any one trade or position. How much to risk per trade is a concept that many novice traders fail to realize until it is way too late. They end up learning the exact wiring instructions on a regular basis to their brokerage account; the real hard cases end up remembering those instructions by heart. Once you learn and have the confidence to trade a system or follow a trading plan with a set of conditions and specific rules, you still need to have an effective method for risk controls. I would start by considering how much risk per trade I should use by looking at my overall account size, then at the market's volatility and liquidity conditions, and then at a certain percentage of the overall account on a percentage basis. Let me show you what I mean; and when we go over various stop types and methods later in the book, you will be able to better comprehend my meaning. If a person wanting to start a day trading account begins with \$10,000 and uses a 10 percent risk factor per trade based on the overall beginning equity size, if the first five trades go bad, then he or she has lost 50 percent of the overall account. Therefore, it is imperative that traders learn different techniques to protect their trading equity. Investors also need to know the number of positions with which they should start in connection to the account size and the point at which they add on to their contract lot or position size. In Chapter 11, I will go over a method to help you determine answers to those questions. Then you will have a better understanding of a proper ratio and the point at which you should start to increase your trading size.

NUMBER ONE TRADING FOCUS—RISK MANAGEMENT

As most trading books will explain, risk management is the key to survival and what trading is really all about. While it may sound like a cliché, the hard truth is that consistently profitable trading, in my opinion, significantly depends on proper risk taking and risk management combined. Winning traders follow a tried-and-tested plan based on rules or on a defined set of criteria. Winning traders recognize the importance of risk management and of money management. As I stated in my first book, the common denomi-

nator among losing traders was that most guess and hope and usually say, when asked about placing a stop-loss or taking a profit, "I'll think about it."

Always remember that when trading with a set of rules, you will never be 100 percent right. But if you do *not* follow a set of rules, you increase the odds of being 100 percent wrong in your trading. If you manage your trading risks and execute promptly on the trade signal, then you increase the odds that you will be successful. When trading, your mind can play tricks on you. You start to anticipate a buy signal only to act on a false signal. You need to learn when and how an actual signal is generated and what and when you should trigger the action to initiate a trade. When you are trading market signals by a predefined set of rules and a set of criteria, then the mind cannot play tricks on you. When a signal says buy, then buy; when a signal says sell, then sell. It's that simple. Generally speaking, from my experience, if a trader says, "I am tired of this," and decides not to take the signal, that ignored signal is the one that becomes a big winner. If you have traded before, you may relate to that syndrome. For day traders in stock or stock index futures, this usually happens in the last hour of the trading session!

DIVERSIFICATION IS THE KEY TO SUCCESS

This observation was written by Peter L. Bernstein in his book *Against the Gods, The Remarkable Story of Risk* (Wiley, 1996):

All of the tools we use today in risk management and in the analysis of decisions, from the strict rationality of game theory to the challenges of chaos theory, stem from the mathematical developments that took place between 1654 and 1760 with two exceptions: In 1875 Francis Galton, an amateur mathematician, discovered regression to the mean; and in 1952, Nobel Laureate Harry Markowitz, then a young graduate student at the University of Chicago, demonstrated mathematically why putting all your eggs in one basket is an unacceptably risky strategy and why **diversification** is the nearest an investor or business manager can ever come to a free lunch. That revelation touched off the intellectual movement that revolutionized Wall Street, corporate finance, and business decisions around the world; its effects are still being felt today. (pp. 5–6)

With that notion came the concept of exploiting diversification by means of spreading investment and risk capital in various markets, such as stocks, bonds, real estate, precious metals, and commodities. There are

various methods to trade those investment vehicles through the use of real estate investment trust (REIT) mutual funds, exchange traded funds (ETFs), and other derivatives products, like single stock futures, stock index futures, and options. There are simple and complex strategies even more so with the use of options and inter- and intramarket spreading or pair trading opportunities. We will cover some sophisticated strategies in this book as well as basic investment strategies to help you create your own retirement fund.

HABITUAL WINNERS FOLLOW TRADING PLANS

Traders need to consider new techniques that will allow for increased profitability and ways to reduce risks. This book will demonstrate how you can identify *conditional* changes in the markets and how you can utilize my techniques in certain setups and triggers based on an approach to using candle charts and pivot point analysis that may be different from what you have encountered before.

You will learn which leading price indicators are the best to use, plus professional chart-reading techniques and how to apply this knowledge to make trading decisions based on facts rather than on opinions. You would be surprised at how many times I am asked what my “feeling” is on the market. I can feel upset, I can feel warm, I can feel cold; but I just can’t feel the market. I can see the price action and can act on a shift in the momentum, and I can determine that the market is currently in an uptrend or a downtrend or in a consolidation phase. I certainly can’t feel the market.

I want to walk you through some top chart patterns or setups and triggers so that you can develop a trading plan based on a testable trading system. This will be a method with a complete set of rules that do not arbitrarily change. You will be able to use these concepts in many different markets and in different time frames. This book will go into more specific rules and explanations of setups and triggers than my first book did. Not only was that first project, *The Complete Guide to Technical Trading Tactics: How to Profit Using Pivot Points, Candlesticks, & Other Indicators*, a great introductory book that touched on several trading concepts, but it was the first work that introduced traders to the concept of integrating candlestick charting with pivot point analysis. Some of the principles in that first project will be used here, but this book will cover in greater detail how to apply and use those methods so you can learn to make money with the triggers. I would suggest that you get that book if you have not already done so, as there are many great tips and suggestions described in those pages.

In this book, I want to teach you what to search for when chart reading. I am not going to go into detail on every specific candlestick chart pattern because I generally only use them to help identify where the market closes in relationship to the open or the past price points, such as the high or low points, rather than rely on them to signal a trade based on traditional chart formations.

I believe that, like many things in life, the more you repeat positive actions, the more you will experience and receive positive reactions. In trading, that translates to simply following rules, waiting for signals to transpire, and then acting on those signals, rather than anticipating that signals will form. When signals trigger a buy, then go long; when a signal triggers a sell, then exit the long or go short. As I stated earlier, following a set of rules will not guarantee that you will be 100 percent right in your trading results; but by not following a set of rules, your chances increase that you may be closer to 100 percent wrong in your trading results. One must learn to cut losses and let winning trades ride. It sounds like a cliché to trading veterans; but the fact is that it is so simple, yet it is so hard to do. By accepting this process of learning some simple principles and then following a few sets of rules, which I will go into in this book, you become a better trader; and that may translate into becoming a *more profitable* trader.

One trait I have noticed that most novice traders possess is that they try to overanalyze and overcomplicate matters. In order to help simplify your thinking, remember this: There are only four common denominators that each of us has equal access to—the *open*, the *high*, the *low*, and the *close* of any given market, in any given time frame. There are two other values to measure: *volume* and, for futures traders, *open interest*. However, even these two elements cannot be finalized or completely calculated until the close of each trading session. Therefore, it is important that you realize that the *close* is the single most important aspect when using and applying all forms of technical analysis studies.

So no matter what market or trading vehicle you are trading—whether it is a stock, a futures or commodity market, a stock index, the forex currency markets, or even an exchange traded fund, you need to watch the *close* of the time period in which you are trading to capture a clue in order to initiate a trade, manage the trade, and learn the right exit spot. Always remember that the *close* is the most important element and what matters most to focus on when trading. It is the relationship of the *close* to past price action and to the *high*, the *low*, and the *open* that will help measure or weigh a value of a given market at any given time. Therefore, you can get a more accurate gauge of what to do. In trading terms, the choices you have are to buy, to sell, to spread off, or to do nothing and hold onto your cash. Sometimes not knowing what to do translates into not entering a position. Remember that being in cash or standing on the sidelines is a trade, too.

Once you grasp the understanding that it is the close that shows you what the current market value is, then you should have a clue as what your next trading decision should be. If you learn to act on the close for your trading decisions and on triggers, that information will help stack the odds in your favor that you are going with the current flow or in the right market direction. That includes any time period for which you are trading. That means if you are a day trader using a 5-minute period, you cannot act on an intratime period signal. You need to wait for the five-minute period to conclude before acting on a trigger. The same goes for a 5-minute, a 60-minute, a daily, a weekly, or even a monthly time period.

The clues for which we as traders are looking are what we need to initiate a trading decision and are what I define as a trading *trigger*, which will be explained later in the book. Once you understand how markets work, understand simple charting techniques, and have a fundamental working knowledge of indicators and what dictates increases or decreases in values of a given product at a given time (such as supply and demand factors) and how that is represented on a chart, then you will have gained a better edge in the market and will have stacked the odds of success in your favor.

There is one flaw in any system, and it is generally from the execution side rather than from the construction side of the system. To be specific, most traders who lose while trading a system fail to trade by the signals generated by that system. Either they fail to act once the signal is generated, or they anticipate that a signal will be generated thus acting on a false signal.

It is imperative that once you read this book you learn that you must wait for the actual signal to trigger, and that occurs in most cases by the close of the time period in which you are trading. Even when a system generates a losing trade, it will signal a trigger to get out. You must act on confirmed signals rather than on anticipation of those signals or, more important, on your personal hunches.

Once you have a working knowledge of the markets and the confidence in what the possible outcome of those triggers might be, working with a few setups and signals will allow you to find a trading opportunity; and then you will be able to apply the appropriate strategy. You can diversify trading styles, such as integrating a day trade into a position trade, utilizing an option strategy, or applying the information on various trading vehicles.

I talked about this concept of “finding opportunity, then applying a strategy” in my first book: I called it playing the Monte Hall game, *Let's Make a Deal*. Look behind door number one, and review the risk rewards; then look at the strategy behind door number two, and review the risk and rewards there; and then finally open door number three, and see if that strategy appeals to your analysis of risk and rewards. Remember, you can determine, if an opportunity is longer term in nature, to use an option strat-

egy (such as an outright long call or put); a ratio back spread; or, if the best opportunity exists taking a position in a stock, a stock index future or possibly an ETF or a holding company depositary receipt (HOLDR).

INVESTMENT VEHICLES

There are all types of trading and investment vehicles. Some are slightly more complex than others, and some offer increased leverage, such as futures and even forex currency markets. Some have short life spans due to expirations, such as an option or a futures contract. A trader or an investor needs to examine his or her personality profiles, tolerance for risk, personal time availability to devote to trading, and the time objective or turnover for achieving specific profit objectives. Once those are determined, then he or she needs to choose the right trading vehicle or a mixture of asset classes in order to apply a trading strategy.

Therefore, it is important to have several different types of trading accounts for taking advantage of various investment products and levels of risk, such as long-term retirement versus short-term speculative trading opportunities. A stock account will allow you to trade stocks, stock options, mutual funds, and ETFs.

A futures account will allow you to take advantage of the many opportunities of various commodity markets and options, in addition to day and swing trading the highly liquid stock index futures markets such as the Dow, Standard & Poor's (S&P), Russell 2000, and Nasdaq 100 contracts. Some futures brokerage firms even have access for spot foreign currency trading on their trading platforms. I have been in the futures and trading business since 1978. I trade my own money, I have been a broker, managed a brokerage firm, owned a trading firm, but, most of all, I enjoy trading my own money. In fact, the principles I am sharing in this book are the same techniques that I have taught my family. Remember that my father used to think commodity trading or day trading was like gambling. But at age 71, he started gaining an interest in what I was doing, especially as he saw the fruits of my labors. More important, he witnessed the trading successes my son was also achieving and started to see that the pattern of what I was doing was teachable. In 2002, I had my son start a retirement stock account with what I call a core position of select stocks. One such stock was General Electric, which he purchased at 24.60; another stock I had him purchase was Rambus at 5.62. In both cases, he made out extremely well. In fact, if you know stocks, you may recognize that those prices were darn close to the exact lows in 2003. Let me tell you it was not by chance or luck that I had picked those prices; it was by using the methods I am going to describe in this book.

Incidentally, here is how my son got hooked on day trading: In early 2005, he was watching me on one of my appearances on CNBC. My son is self-employed; he owns cellular phone stores and sells satellite dish systems. He keeps the television on in his stores to show customers the satellite systems. After watching my appearance on CNBC, he left the television on; later that day, he started listening to *Mad Money*—the Jim Cramer show. Anyway, my son started trading his own stock account.

He called me one day to ask my opinion on a particular stock. That's when I found out what he was up to. Now, my son is pretty smart; but there were several things he was not familiar with, for instance, what a stop-loss order was. As you might imagine, I was insanely furious with him for not knowing important yet basic concepts of trading. After I got through yelling at him, his mom (my wife) got hold of him; after that conversation, one of my trading courses was shipped out FedEx, and he quickly studied. He got back on the right track, gained an interest, and learned how to trade by my set of rules and by looking for such trading patterns as a high close doji (HCD) buy signal and a low close doji (LCD) sell signal. Both of these specific setups and triggers are covered in this book. The next course of action was to get him set up with the right markets to day trade and to open the right brokerage account to meet his needs for both his short- and long-term objectives. Now this is what I taught my son, and he has been consistently improving in his trading ever since. That is what my Dad saw, and he found merit in my methods. Therefore, I hope this solidifies your belief that traders can and do make money trading in the markets. Just find the right methods with which you are comfortable, stick to the trading rules (such as waiting for the triggers, rather than anticipating and acting prematurely), find an investment strategy (such as day, swing, or position trading), and then get confident that you are applying the right strategy with the right product (whether it is stocks, futures, options, foreign currencies, or forex markets). You have the potential to become a successful trader once you have these conditions mastered. The next process is finding the right software product and brokerage firm.

I have been in the industry for over a quarter of a century, so I know what to look for in both trading firm and software that suit my needs. I have the experience to know that not all trading companies are equal. The plain truth about it is that some companies are just better than others. Remember the debacle of REFCO? These guys were a behemoth in the futures and spot foreign currency trading business. They had a ton of talented people, some who are ex-employees of mine and some who I consider friends. I never did trade through them. Mainly, I was happy elsewhere. But as the years passed, REFCO just became too big. I like personalized service, and I don't need a company to provide me with daily research. You need to find out what appeals to you and how to make a brokerage firm work for you.

It's not the other way around. Keep in mind that a brokerage firm should be considered an employee—it works for you! I have a rating sheet for my subscribers of my advisory service of the pros and cons of several brokerage firms. If and when you are looking for a brokerage firm and want to see a ratings consensus, just visit www.nationalfutures.com, where I can give you a heads up on the pros and cons of several trading firms and the ones that I have accounts with. You can use it to find out which one fits your trading needs. As I say, some are better than others. Trading expenses such as commissions are important, but dealing with a cheap deep-discount commission brokerage firm that has no backup support does not suit my needs. A solid company that has competitively priced commissions, a loyal support staff, and pleasant customer service is what I look for. I like one that actually answers the phones and takes care of an issue immediately; that is the ideal company to do business with, and there are many of them. That is the information I share on my web site.

FX—FOREX

You may be familiar with or have heard the term *foreign exchange market*, which is known as the spot forex or FX market or foreign currency market. It is an over-the-counter foreign currency market. You can trade foreign currencies against the dollar, which is known as the *cross*, such as the euro currency versus the U.S. dollar; or you can trade *pairs*, which is two separate foreign currencies traded against each other, such as the euro versus the Japanese yen. It is a 24-hour marketplace in which most companies do not charge commissions; rather, a spread on each side of the bid-and-ask of a trade is taken. Traders like this feature because they feel it is a “pay as you go” cost of doing business.

This book will go into explaining several investment vehicles, such as stocks, futures, options, and forex. I want you to realize that the technical trading patterns, setups, and triggers I will teach and explain in this book are applicable to all of these trading vehicles.

STOCK TRADING OPPORTUNITIES

Stocks offer opportunities to long-term investors based on a company's performance. There are many advantages and disadvantages when trading stocks. Some feel that stocks should be a buy-and-hold investment vehicle, and I agree to some extent. I believe the world and business move in cycles, as does any industry or business sector. Investors need to monitor which

sector or industry is hot or running cold, as the dot-com bubble demonstrated. Since we can learn from history and a picture speaks a thousand words, let's go over a few chart examples if you want to know more about the disadvantages of investing in stocks. If you were invested in these companies, had a bad experience, and do not want to be reminded, just flip through these next few pages. If you are new to the investment world and want to know how fast fortunes and retirement accounts were lost, just ask investors who bought Enron, WorldCom, United Airlines, Kmart, and FAO Schwartz just before these companies filed for bankruptcy. And that is just a few of the companies that took major dives. There are those investors that are hanging onto hopes of their stocks coming back to life, companies like Lucent, as shown in Figure 1.1. Lucent Technologies, Inc., engages in the design and delivery of systems, services, and software to communications service providers, governments, and enterprises worldwide. It will take a lot more patience to see this stock come back to life. This stock was going to be the next IBM of the telecommunications world, which goes to prove that you can't believe everything you hear.

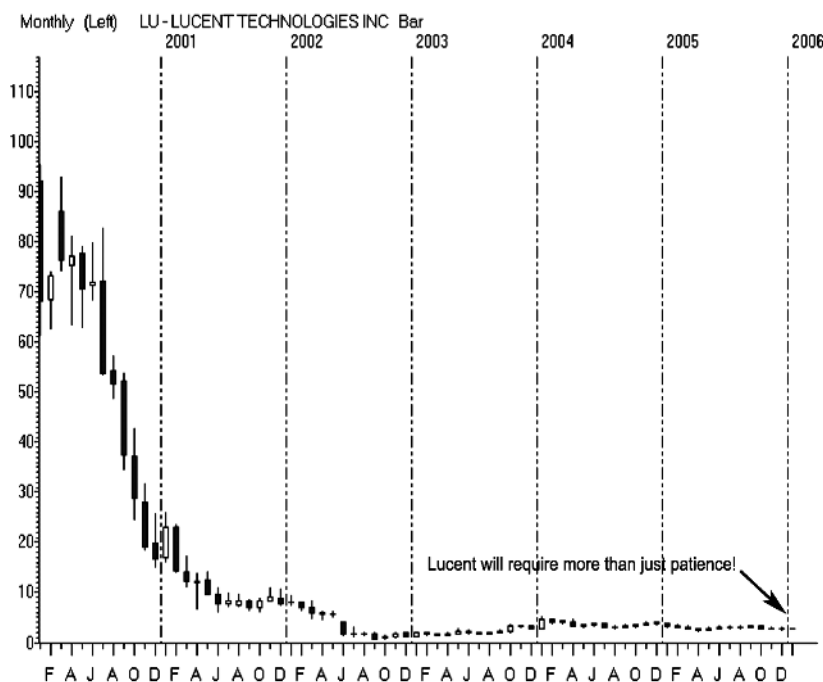


FIGURE 1.1

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Then there was the new age revolution of fiber optics. Remembers JDS Uniphase? This company provides communications test and measurement solutions and optical products for telecommunications service providers, cable operators, and network equipment manufacturers. The company operates in three segments: Optical Communications, Commercial and Consumer, and Communications Test and Measurement. As Figure 1.2 shows, this stock has just never come back to life.

Then there are some companies that had investors gleaming with joy—that there was never a chance those stocks would drop, but drop they did. However, not all stories have bad endings. Take a look at Rambus, Inc., a company that provides chip interface products and services. Its memory interface products include XDR memory interface, RDRAM memory interface, and DDR controller interface technologies, which provide an interface between memory chips and logic chips. Figure 1.3 shows that there is life and hope for some stocks, this one included.

One more darling from the Internet craze was Red Hat, Inc., which provided a competitive operating system to Microsoft. Red Hat has related

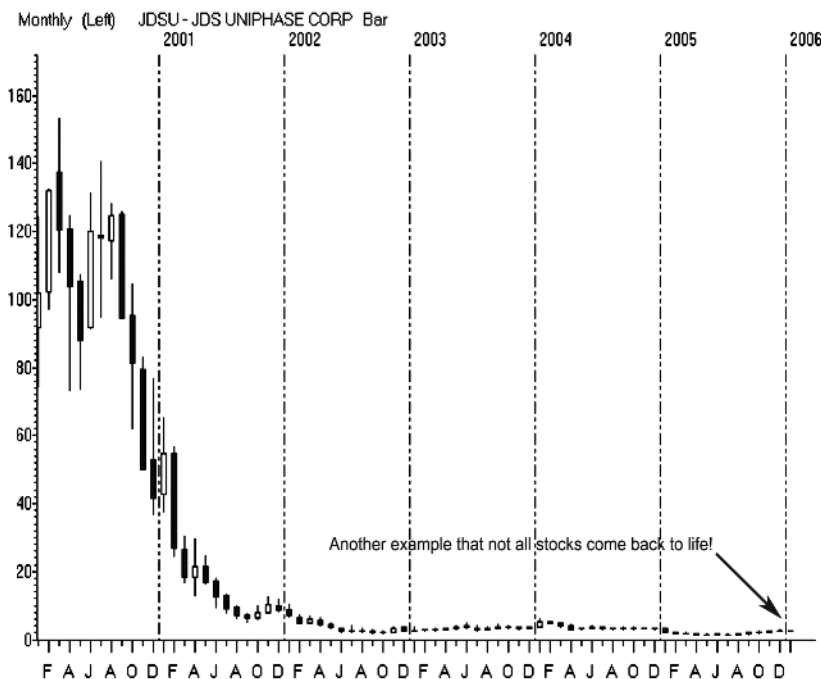
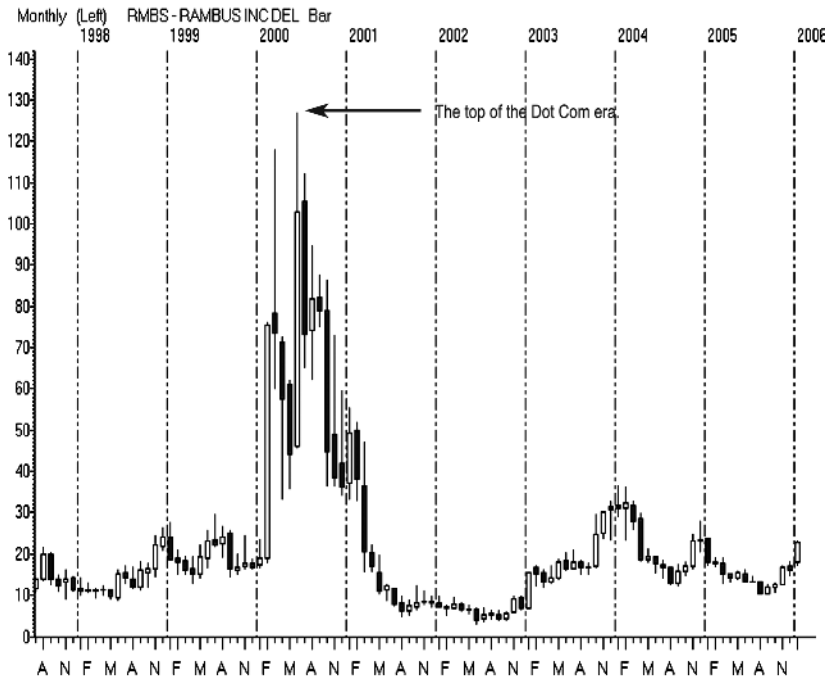


FIGURE 1.2

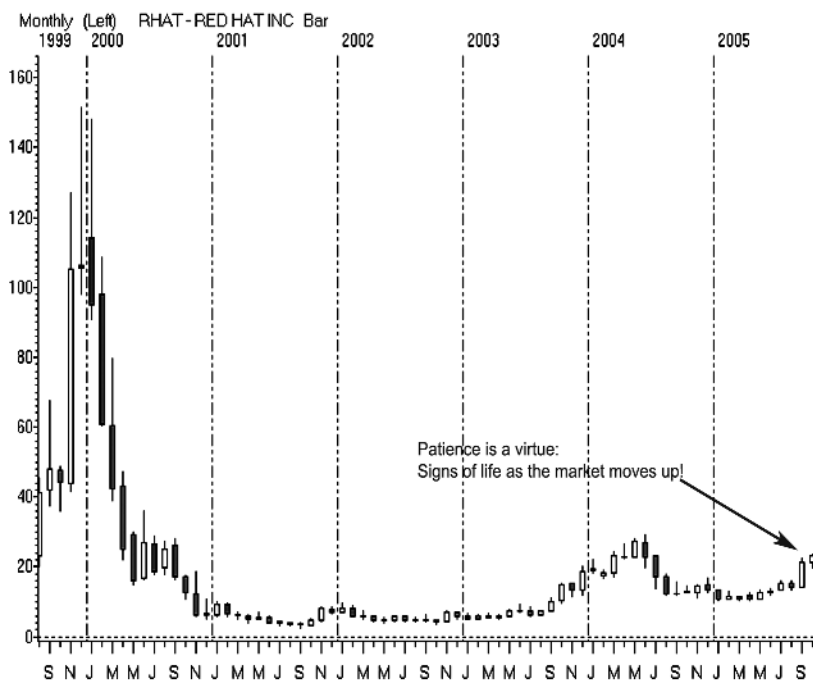
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**FIGURE 1.3**

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software and services based on open source technology for various enterprises. Its products include Red Hat Enterprise and Linux Red Hat Application Solutions, which include software for managing web content and software development. The Linux systems and storage availability was a sure thing for investors, one of those “can’t lose” propositions. As Figure 1.4 shows, that is not how Wall Street saw it in the long run or how it rewarded the stock price. However, there is hope; and as you can see, the stock is springing to life. The examples here illustrate how investors need to watch over their own investments. The markets generally overreact both on rallies and on declines. Sectors and business cycles change; competition can force companies to lower prices, thus resulting in lower profit margins. Business models, consumer spending habits, and the leadership or management of a firm can change. That can have a direct impact on and can change the morale and the business structure of a company. And that is what can affect a company’s bottom line.

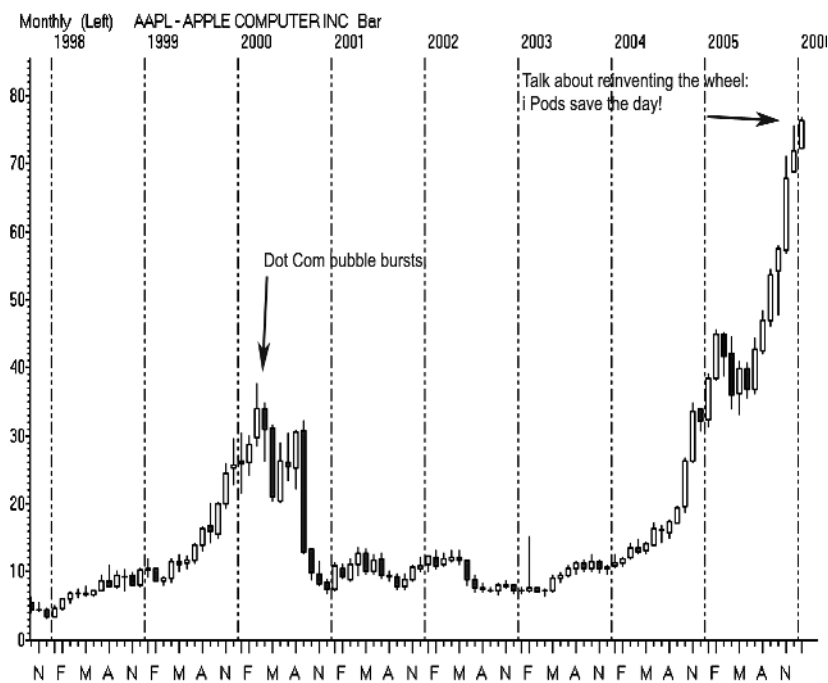
The dot-com implosion and stock market crash did not wipe out all companies; and, of course, some companies fared better than others. A great example of bringing a company back to life is, without a doubt, Apple Computer, Inc.! This company manufactures, designs, and markets per-

**FIGURE 1.4**

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sonal computers and related software, services, peripherals, and networking solutions worldwide. The company's products and services include the Macintosh line of desktop and notebook computers. It was the introduction of the iPod portable digital music player, accessories, and services that helped propel this company into a killer performer and one of the best comeback stocks from the dot-com and stock market peak in 2001. Steve Jobs is the cofounder and CEO of Apple; and as I stated a moment ago, it is leadership and motivation that can help inspire a company to great fortunes, as Figure 1.5 shows.

When you look at a strong performer of a stock in a specific sector, traders and investors are obviously looking for appropriate risk/reward opportunities to trade that stock. There are many choices and various strategies to employ. This is the selection process of what we do in "finding opportunities and selecting the right strategy." Once again I call it the "let's make a deal" game. What we are doing is simply looking for the best strategy that maximizes our level of expected returns while minimizing our risks. We are looking for the optimal trading strategy. Traders can examine and weigh what is the most appropriate risk/reward perspective:

**FIGURE 1.5**

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- *Door Number One:* Could be an outright stock purchase with a selective stop-loss.
- *Door Number Two:* Could be utilizing the options market. That can be an exciting and worthwhile exploration of a simple purchase of a call option to utilize leverage or the use of a more complex strategy, such as a bull call spread, or a hedging program, such as a collar strategy. The latter uses the premiums collected from the sale of an out-of-the-money call option to purchase a close-to-the-money put option, which in turn protects the price erosion of an underlying stock position.
- *Door Number Three:* Could be taking a trading opportunity by implementing a spread strategy, which would involve buying one stock and selling short another. This is a sophisticated strategy and one that beginners should study extensively prior to implementing. However, if you enjoy following and understanding who and what the competitor is in a specific sector or industry group, this could be your cup of tea. Selecting the right stocks requires extensive research and a good working knowledge of the fundamentals of that sector or industry. After all, you

are looking for one company to outperform the competitor, so you need to know as much as possible about that business.

Trading decisions and correct stock selection involve more than looking at a chart and a few technical indicators. I believe it helps to look a little deeper in expected earnings forecasts and price-to-earnings (P/E) ratios to see if the stock is expensive or cheap relative to current prices. Calculating P/E ratios is an easy concept; for example, if a stock is trading at \$40 per share and has an earnings of \$4 per share, the P/E ratio would be the price of the stock divided by the earnings—\$40/\$4, or 10 times earnings.

SPREAD TRADING TIPS

If you decide to take advantage of a spread trade, you should realize that it is a risky business. You could be on the wrong side of both markets. Since spreading involves selling short one stock and simultaneously buying another stock, if the price goes in the opposite direction of both trades, you can lose on both sides of the trade. Selling short is a hard concept for many traders, both novice and experienced, to grasp. Believe it or not, there are some folks who are not aware that you can sell first without owning the security. Short selling means you are betting that the price of a given product will decline; therefore, you would be selling first without owning the underlying product with the hopes of buying back later at a lower price. Selling short is considered highly speculative for stock traders; the process involves “borrowing” the stock from the brokerage firm, if the firm has that security in inventory. Shorting stock is very similar and should not scare investors. It is a very simple concept; in fact, it is just the opposite for longs. You want to buy low and then sell out later at a higher price. With shorting, you are selling first and buying back later, hopefully at a lower price to generate a profit.

There are certain restrictions; for one, you need to set up a margin account with your brokerage firm. Another restriction carries potential execution risks: Due to Securities and Exchange Commission (SEC) regulations, there is what is known as the “uptick” rule. The uptick rule was established in the 1930s to prevent a bear market raid on a stock. In order to execute a trade, the stock needs to trade at a price higher than the preceding transaction price in the same security. For example, if you wanted to enter a spread by selling Dell Inc. and buying Apple, you would have been anticipating or looking for Apple to outperform Dell’s price gains. Or if both stock prices decline, you would want Dell to decline more than Apple. But in order to effectively execute that strategy, you would want to

enter the sell side of the spread first because there are no restrictions on entering the long side, just on the short side of the transaction. Let's say you enter the long side first without confirmation that you were filled on the short side; if the market on the position you hold—the long side—goes down and if both markets moved in tandem, you would need an uptick on the short side in order to be in the spread. Imagine if you went long first and the stock dropped. Then when you are finally able to execute the short side, the market has plunged. That would translate into an actual loss. So if you do not get filled first on the short side, the worst that can happen is that you lose a trading opportunity. This is a great example of why traders have the obligation of knowing all there is about the market they trade in. As you can see in Figure 1.6, Dell has moved in the same direction as Apple, but Apple has outperformed as a price leader. The spread opportunity between these two computer manufacturers, long Apple and short Dell, would have generated a tidy profit.

Another example of a spread opportunity within competitors of the same industry or sector would be Best Buy versus Circuit City, as shown in



FIGURE 1.6

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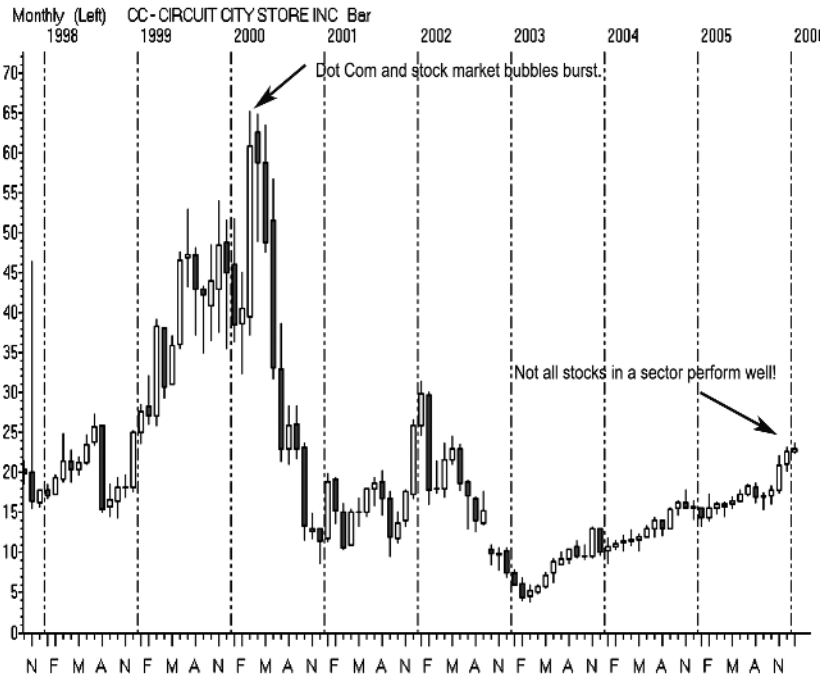
Figure 1.7. As consumers flocked to retail malls before the holidays to purchase gifts such as Apple's iPods, if you want long Best Buy as the sector leader and short Circuit City, Best Buy stock outperformed Circuit City stock. As you can see from the chart, after the stock market bubble burst in 2000, Best Buy managed to maintain a positive trend higher. It is the leadership of the company and the consumer loyalty that really have helped to support this company's growth and profitability. One reason is Best Buy continued to sell appliances versus one of their rival competitors and as a result they saw sales rise 7.7 percent from 2004 through 2005. They also had aggressive gains in web sales, and online revenue jumped 40 percent as more customers shopped and redeemed gift cards online for the same time period.

Best Buy's main competitor, Circuit City, decided or needed to cut back and close stores and then discontinued selling appliances to stay afloat. It depended on increasing DVD and CD sales and on electronic products. As the housing boom materialized soon after that decision, Circuit City gave up market share to Best Buy; and no doubt companies such as Home Depot and Sears picked up increased revenues in appliance sales. Therefore, it



FIGURE 1.7

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**FIGURE 1.8**

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was hard for Circuit City to reenter selling that product line. As you can see in Figure 1.8, Circuit City's stock just had not been a great performer in that sector. The company was founded in 1949, so it has a long history and may survive the competition. However, if consumers start to spend less on home electronic products in 2006 and 2007, this company may have trouble getting its stock price back up to the 2000 high near 65 per share. Circuit City will need consumers to continue to buy and upgrade new televisions, camcorders, and digital cameras to boost revenues. I personally have no intentions of buying another camcorder; I barely use the one I have. As for game software, game hardware, and personal computer software, those are competitive products; so I believe Circuit City will have to do more to survive the next few years of what is being forecast as a consumer electronic sales recession. Therefore, one would need to look closer at these two companies and decide which one has more to gain or which one has more to lose; once a decision is made, this would be a good pairs market for a spreading strategy.

Investors have many trading opportunities with stocks, as you can see

from the preceding few pages. There are many ways to analyze a company, from taking a simple look at the P/E ratio to using technical analysis studies. Investors can see which company is the leader in a specific sector and invest with that leader. As you can see in the cases of Apple versus Dell and Best Buy versus Circuit City, holding a diversified portfolio of stocks may help investors see profits or a positive cash flow. Realistically, you can't own shares in every stock. Longer-term investing—you know, the buy-and-hold mentality, sometimes referred to as the Warren Buffett method—helps toward generating big gains in solid companies. But remember that World-Com and even Lucent Technologies were solid companies at one point. So the message here is that investors need not only to be selective in which markets they buy and hold but also to monitor their positions. There is the idea that you can buy stock in a company to which you relate or from which you purchase products . . . companies like Starbucks, as shown in Figure 1.9. This company has solid growth, great coffee; it carries with each 20-ounce cup, named a Vente, a solid jolt of caffeine. That is what keeps me going back, day after day, dropping two dollars per cup for the Starbucks “experience.” Starbucks has made stellar gains and is a great moneymaking



FIGURE 1.9

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stock. It has solid industry leadership, textbook marketing concepts, and, more important, customer loyalty. These are all the qualities to look for when selecting a long-term purchase.

BECOME THE NEXT WARREN BUFFETT

I believe that stocks should be traded as an investment, but there are many ways to capture a profit. I must say for all investors and for every trader, you can start your own mutual fund. It requires discipline not only to open a stock account but also to fund it and add to it every month. If you are a new investor, just reading this book to see if trading for a living is for you, it is imperative that you start somewhere and start with a select stock account first. The discipline is that you should add money in the account every month, like you are paying a bill. If you are under 30, consider it your retirement. You are paying your bills in the future now. That is some of the best advice anyone gave me, and I think it is worthy of passing on to you. Once you gain more experience, you can separate long-term investing from short-term speculative trading, which is one form of diversification. After all, you may see a long period of flat performance in one of your core holdings. Short-term day trading, if you have the time and resources, can be a rewarding experience. Imagine owning Wal-Mart and for literally seven years experiencing a loss to a flat performance. Figure 1.10 illustrates the market's sideways move in one of the world's biggest retail stores.

If you are considering supplementing your investment techniques, one of the many drawbacks of trading stocks for a short-term day trader with a small trading account is that you are limited to how many trades you can make, especially if your account is less than \$25,000 and you are not signed up for a margin account. In that case, you are limited to five round-trip buy-and-sell trades per week due to SEC rules. So short-term trading would not be a good consideration for stocks. That is where trading stock index futures and forex markets takes over, as I will explain in the following pages.

There is one high-risk, high-reward method of trading stocks that I have not covered yet: getting in on an initial public offering (IPO) stock. Those investors lucky enough to get in on an IPO like Google (goog), the Chicago Mercantile Exchange (CME), or even the Chicago Board of Trade (CBOT—stock, BOT) were able to double, triple, quadruple, or even better, their initial investment dollars.

The Chicago Board of Trade has been around for over 155 years, and I imagine it will likely continue to be around for another 155 years, with little competition in products traded on its exchange and with the increase in popularity on the electronics metals products, such as gold and silver, plus

**FIGURE 1.11**

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this stock price move like a rocket. Many see the Chicago Board of Trade mimicking the Chicago Mercantile Exchange success story. As Figure 1.12 shows, in just three short years, CME stock went from under 40 to close to 400 by late November 2005.

The biggest surprise of the three had to be the gains by Google, as Figure 1.13 shows. After the dot-com implosion in 2001, not many were willing to experiment with any Internet stock. That mentality may be the one reason why this stock had such a move, from a contrarian point of view, that is.

LONG-TERM INVESTING OR SHORT-TERM TRADING

We have briefly covered ways to trade stocks and certain methods to trade leaders of stocks in certain sectors. Investing carries less stress, fewer day-to-day decisions, and less risk than trading does; and with that come fewer rewards. Just as we all have different personalities, there are that many opinions on how to *trade* the markets.

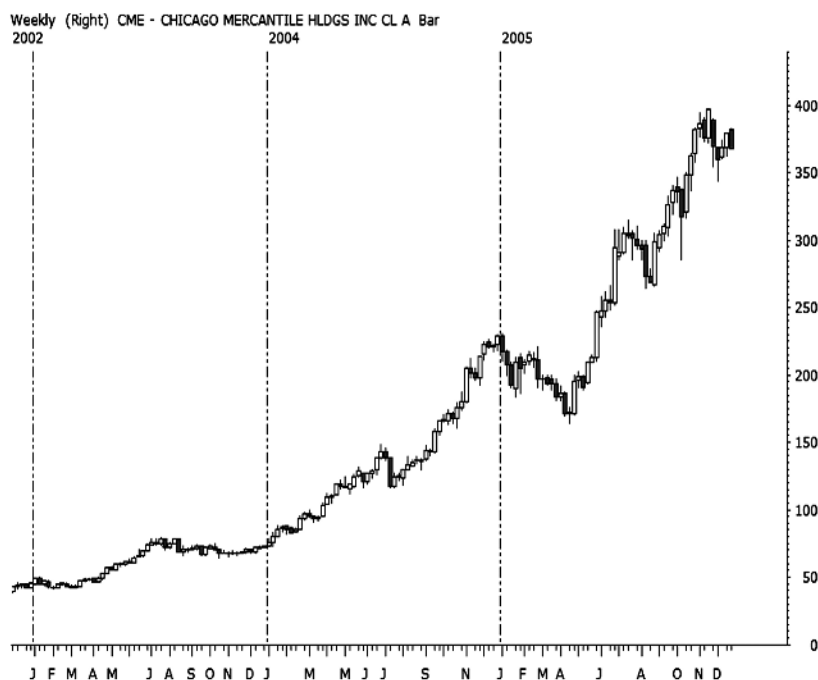


FIGURE 1.12

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Some of the keys to successful trading are:

- *Diversification.* This not only applies to markets, such as a wide assortment of stocks in a portfolio, but also to trading different strategies and various investment instruments.
- *Risk Management.* Profitable trading also comes from skills acquired from practicing discipline, patience, and risk management techniques that preserve your capital.
- *Behavior or Emotions.* Successful trading means removing the most destructive element, negative emotional feelings that plague investors when trading: fear, greed, and anxiety. Finding the right mixture of investment products and trading styles can teach you to feel secure when trading.

The methods we cover in this book can be applied to the topic of selecting stock and spread trading, as we just covered, and to long-term-position trading, as in the style of trading for which Warren Buffett is famous.

**FIGURE 1.13**

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EXCHANGE TRADED FUNDS

Exchange traded funds (ETFs) are listed on different exchanges and are traded on the open market. Choosing this kind of product allows an investor to select the right sector of performance, rather than pinpointing an individual stock. The benefits of trading ETFs compared to a mutual fund are enormous: They allow diversification; they incur more effective transaction costs; there is pricing transparency; and they are tax efficient. After all, it is almost impossible for an individual trader with limited trading resources to effectively track and trade every stock in all sectors of the market. ETFs are index-based investment vehicles and are traded as a share of a single security based on an entire portfolio of stocks. The advantage here is that the trader can mix the benefits of applying technical analysis and fundamental analysis to a combination of stock and index trading.

In the most recent development, ETFs have started to include products related to commodities such as crude oil, gold, and silver; but also they have expanded into the forex arena by launching a euro currency product.

Personalized Mini-Mutual Fund

Instead of agonizing over which stock will outperform in a certain sector, you can use ETFs as an investment vehicle that has certain stocks in a basket as one unit, listed as a sector fund. This allows individual investors to invest in a group of stocks in a sector, rather than relying on a mutual fund to do it for them. Moreover, many mutual funds charge management fees and at times do not fully invest all an investor's cash in the market. Because ETFs trade like a stock, the price of which fluctuates daily, an ETF does not have its net asset value (NAV) calculated every day like a mutual fund. By owning an ETF, you get the diversification of an index fund plus the ability to sell short, buy on margin, and purchase as little as one share.

Another advantage of an ETF is that the expense ratios for most ETFs are lower than that of the average mutual fund. When buying and selling ETFs, you have to pay the same commission to your broker that you'd pay on any regular order. ETFs allow you to sell without the uptick rule, so you can short right away, even after the market is in a strong downtrend. You do not have to wait until the close of the day settlement price as happens in a mutual fund. Another benefit is the tax consequences because of shielding from capital gains due to the fact that ETFs do not change holding like a mutual fund does. So purchasing shares of ETFs is a viable alternative to investing in mutual funds for individual investors. Keep in mind that many of the ETFs available today have access to trading options around the ETF. Therefore, you can develop simple or more complex hedge or spreading strategies tied around an ETF. There are some negatives, such as the three-day settlement restriction and a bid/ask spread just like any other market; but the benefits certainly outweigh the negatives, especially for longer-term swing and position traders.

The Birth of ETFs

The original ETF was offered to the investing public back in 1993 by the American Stock Exchange (go to www.amex.com for more listings) and was known as the SPDRs, which stands for Standard & Poor's Depositary Receipts and corresponds with the price movements of the Standard & Poor's 500.

The more actively traded and by far more popular ETF came with the QQQs, which directly correspond with the Nasdaq 100. Then there are the Diamonds, which move in correlation to the Dow Jones Industrial Average. ETFs have since expanded, and there is now a new breed of investment vehicles to capture opportunities in sectors known as HOLDRs. These trading vehicles are based on certain stocks in a certain sector, known as a basket of diversified stocks in a specific sector.

Just as the examples comparing the U.S. Real Estate Trust (IYR) shown in Figure 1.14 to Toll Brothers, ETFs can offer investors a relationship to overall sector performance that is better than outright exposure in just one stock if you are wrong in your investment decision. As we go forward in the book, I will show you a technical analysis method such as pivot points using a longer-term time frame and how it can help you determine entry and exit targets, such as targeting almost the exact high in Toll Brothers, as well as other stocks.

As you can see in the comparison of the two charts in Figure 1.15, Toll Brothers took a nasty hit while the Real Estate Investment Trust ETF rebounded from the correction.

Looking at a related or similar stock, such as Caterpillar in Figure 1.16, you would assume that if the construction or housing and real estate markets could experience a setback due to the 14 interest rate hikes orchestrated by the Federal Reserve, then a company that manufactures construction and heavy equipment might suffer a significant correction as

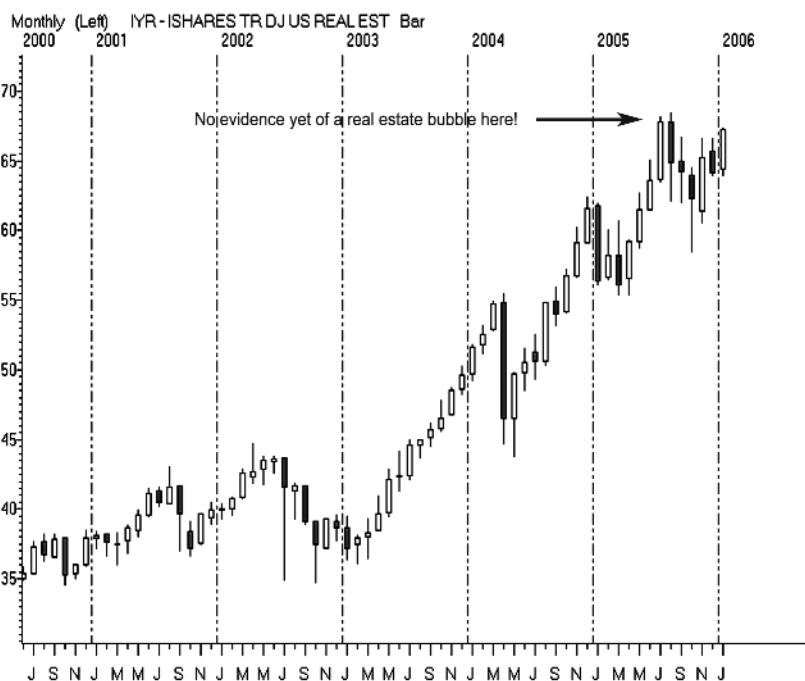
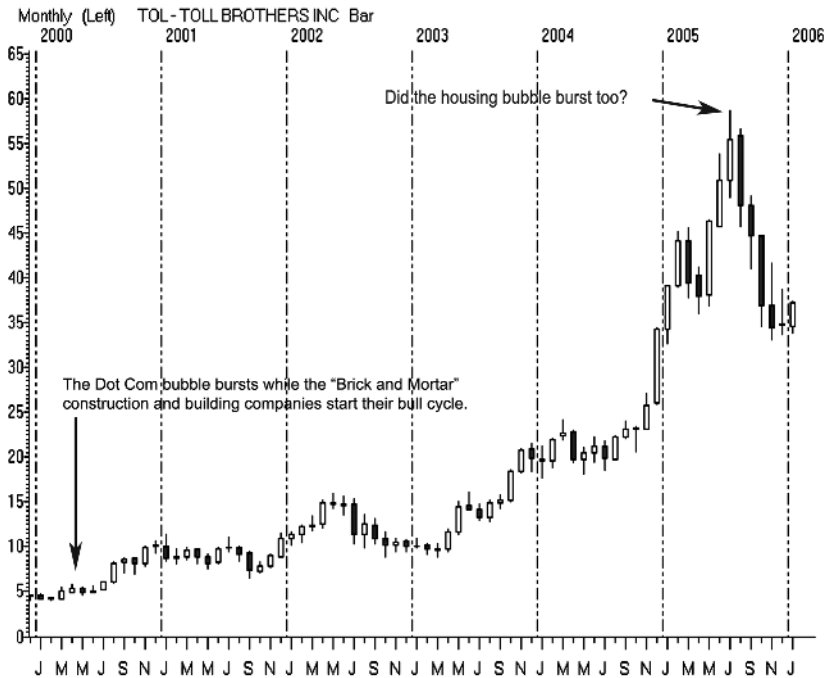


FIGURE 1.14

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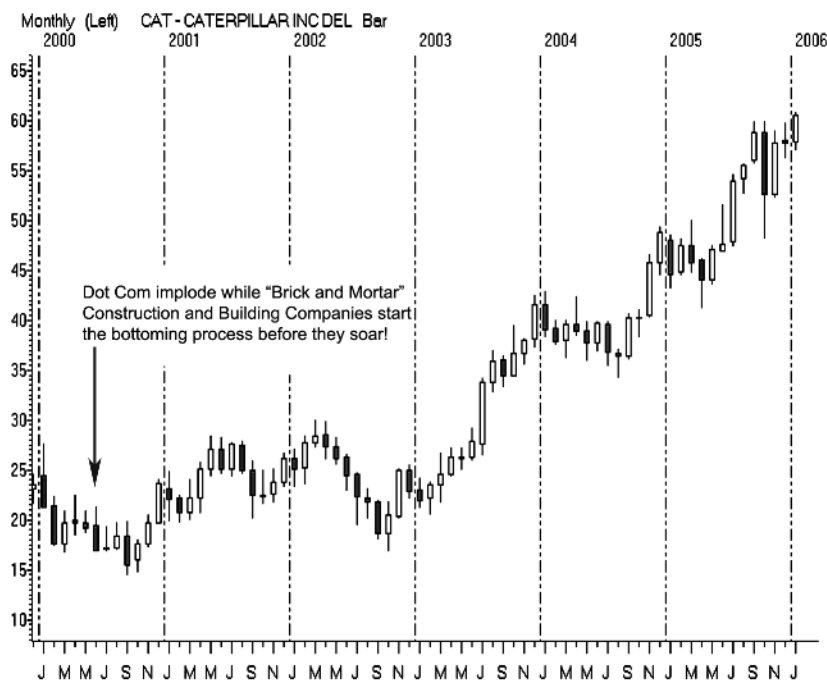
**FIGURE 1.15**

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well. However, that was not the case, as the chart illustrates. In fact, it is quite the opposite. So by utilizing an ETF and investing in an overall sector, an investor has a better chance of gaining a better rate of return. By using the technical analysis methods that will be covered in this book, an investor can apply those signals to ETF markets. Keep in mind that options will eventually be available for most ETFs as well. That will offer investors quite an edge as far as hedging or protecting against adverse market moves, too.

Hot Sectors, Hot Stocks

In order to take advantage of a hot sector of the market, such as energy, biotechnology, technology, Internet, brokers, semiconductors, telecom, and cyclical, to name a few, how would an investor identify the best stocks in that sector and then narrow it down to one or two stocks and be right? That is generally the tough part of investing. Trading an ETF or a HOLDR can help remove that difficulty and may help a longer-term investor achieve that goal. Moreover, it can also allow an individual to literally trade like a hedge fund through means of diversified sectors and allow for implement-

**FIGURE 1.16**

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ing simple to sophisticated trading strategies integrating options as stated earlier. With market liquidity and market transparency, traders using ETFs can buy or sell at current market values rather than at assigned market values based on the close, as is the case when investing in mutual funds. In fact, some mutual funds may not be fully vested in stocks at a given time. This means your cash may not be working at 100 percent capacity.

Currency ETFs

This book will also reveal more about the forex markets or foreign currency trading. And on that subject, there was a new ETF that may appeal to those who want to participate in currency investing but have neither the time capacity nor the desire for excessive leverage exposure. Rydex Investments launched the first-ever currency-based exchange-traded product back in December 2005.

The Euro Currency Trust (FXE) is an ETF that tracks the price of the euro, with each share representing about 100 euros plus accrued interest. Shares of the trust, called “Euro Currency shares,” trade on the New York

Stock Exchange (NYSE). The ETF has a 0.4 percent annual fee. Investors generally pay commissions to buy and sell ETFs, which trade daily on exchanges as stocks do. Initially, the trust registered 17 million Euro Currency shares, for a total offering price of about \$2 billion. Shares of the ETF can be sold short and are eligible for margin, as most ETFs are. Notice the correlation of price movement in the ETF shown in Figure 1.17 with the euro FX currency futures contract shown in Figure 1.18.

Granted there is more liquidity in the price of the euro futures contract; but keep in mind the that the euro ETF was in its third week of trading after its initial launch date. I suspect that by the time this book is published, the volume and liquidity will improve dramatically.

Commodity ETFs

Not all ETFs track the price movement of the underlying derivative market exactly. Take for example the OIH chart shown in Figure 1.19. As you com-

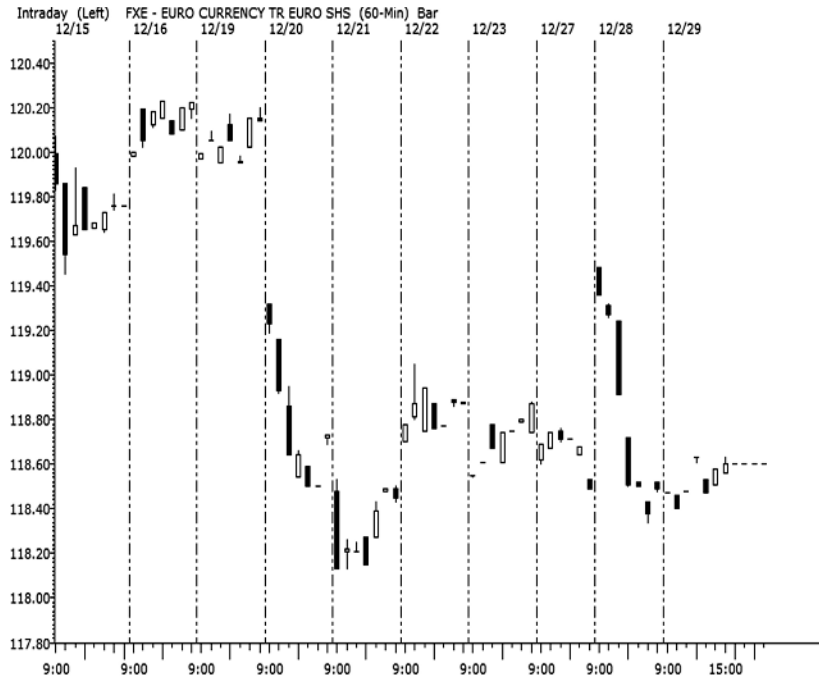


FIGURE 1.17
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FIGURE 1.18

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FIGURE 1.19

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pare moves in the underlying commodity of crude oil, as shown in Figure 1.20, you will see that at times the correlation is not 100 percent exact. In fact, at times the ETF has actually been a leading price indicator of the underlying commodity price move! Now there is an ETF that is more closely correlated to crude oil, such as the United States Oil Fund (USO).

The example in Figure 1.21 is streetTRACKS Gold ETF, traded on the NYSE. It was launched in late 2004; and as of December 2005, when I started writing this book, it was trading roughly 2.1 million shares a day. It has attracted \$5.65 billion from investors. Each share of the ETF represents one-tenth of an ounce of gold, which allows mutual funds or private investors to invest in gold without actually owning the metal. It mirrors or tracks the price movement of gold almost exactly, as you can see from Figure 1.21 when compared to the gold futures chart in Figure 1.22.

The objective of the trust is for the value of its shares to reflect at any given time the price of gold owned by the trust at that time, minus the trust's expenses and liabilities. The trust is not actively managed. It receives gold deposited with it in exchange for the creation of baskets of iShares. The trust sells gold as necessary to cover the trust's liabilities, and



FIGURE 1.20

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Daily (Right) GLD - STREETTRACKS GOLD TR GOLD SHS Bar
2005



FIGURE 1.21

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Daily (Right) /YGG6-Feb 06 Gold mini CBOT Bar



FIGURE 1.22

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it delivers gold in exchange for baskets of iShares surrendered to it for redemption. The trust is not an investment company registered under the Investment Company Act of 1940 nor a commodity pool for purposes of the Commodity Exchange Act. This is traded on the American Stock Exchange (AMEX).

Figure 1.22 shows the CBOT gold minicontract; and as you can see as you compare the two charts, the price movement in the gold ETF shown in Figure 1.21 mirrors almost exactly the price movement in the gold futures contract.

For silver bulls, bears, or spread traders, the newest ETF addition was the AMEX iShares Silver Trust (SLV). It is a fund based on the daily price of one ounce of silver as set by the London Bullion Market Association. Those spread traders buying gold or selling silver now can use ETFs. The key in showing you the various markets as compared to the ETFs is that you realize that once you identify the opportunity, you then can make a good decision on which opportunity best presents itself. While futures offer the leverage, you may want to invest longer term; and an ETF would be right up your alley without having to pick a gold or silver mining stock. If you are bullish on precious metals but don't want to buy the physical metal and if you have the luxury to trade options, then an ETF would be the right choice.

It does not go without saying that an outright stock selection can provide a great return and can at times outperform the sector and even the underlying market. Look at the price move for Newmont Mining in Figure 1.23. This stock took off and never looked back, even when the price of gold and the gold ETF made a price correction. There are times when that can happen. Even if you were to purchase long call options, the most profitable rate of return comes from the leverage of an outright long call option position in a straight up move, such as Newmont experienced. The question is how many times can that trade and, more important, the timing of such an event be replicated.

Another advantage of an ETF is the availability and structured use of iShares. If you are trying to match the most liquid investment vehicle with a specific sector or group of like stocks, this may be the right investment choice. iShares are considered to be like an open-ended mutual fund that reinvests dividends. This investment class is always fully invested in the market; so when the market moves up and you are long, you would fully benefit. These index funds also trade just like stocks. Each fund share represents a proportion of ownership in each stock that makes up the index. As we have briefly discussed, to make the right choice in an investment and choose the right stock, you can utilize fundamental analysis, such as earnings per share and market capitalization, to determine what the potential futures earnings might be. This data can help you determine if the stock is

Daily (Right) NEM-NEWMONT MINING CORP Bar

**FIGURE 1.23**

RealTick graphics used with permission of Townsend Analytics, LTD.

ripe as a buying opportunity or if the price is too high or overvalued and should be avoided. Considerations that can never be determined are the hidden demand for a company's product and the way the company is run, to see if the profit margins are high or if operating costs and deep discounts to retailers cut into the company's bottom line. Therefore, it could be prudent to possibly play the sector through an ETF, which effectively would eliminate the issue of selecting the wrong stock or the underperformer of that specific sector.

The Hot Stock

Take, for example, one of the most amazing come-from-behind stories in 2005 and early 2006. Advance Micro Devices (AMD) triumphed, surpassing Intel's price level. It would have taken patience and discipline to stick with this winner; but outperform it did, and what a hot stock it was, as the chart shows in Figure 1.24!

For a specific ETF or iShare that would list AMD and Intel, you would look at the iShares Goldman Sachs Semiconductor (IGW) listing. The top 10

**FIGURE 1.24**

RealTick graphics used with permission of Townsend Analytics, LTD.

holdings as of 12/31/2005 were Texas Instruments, *Intel*, Motorola, Applied Materials, STMicroelectronics NV, Marvell, Technology Analog Devices, Broadcom, *Advanced Micro Devices*, and Maxim Integrated Products.

Intel was a darling among institutional traders and mutual funds, but it had not performed well, let alone offered enough volatility to day trade or even swing trade a position. There was just not enough movement in this stock, as Figure 1.25 shows.

So how was an investor to make money, and how would one possibly choose to invest in AMD instead of Intel? Actually, once a few simple concepts of identifying market price momentum through candle charts are covered in the next few chapters, you will see how and why to stick around when a market goes into a trending phase. Also, once you learn these techniques, it will be pretty easy to help select the right stock. Another simple investment decision would be to buy the iShares Goldman Sachs Semiconductor ETF! As you can see from Figure 1.26, the semiconductor ETF moved up. It would have been a far better trade simply being outright long AMD from under 15 in March 2005, but the torture of watching Intel go nowhere would have been a reason to buy the semiconductor ETF and

participate in a profit. The key in using these vehicles is for those who like a specific sector and do not have unlimited resources to buy a wide spectrum of stocks. It is also appealing to those who want longer-term trades and who hold a regular day job and cannot day trade for a living, at least not yet.

Once again, the difficulty of choosing the right stock in a competitive industry in a specific sector can be overcome; and it may be more profitable by considering trading an ETF. The previous comparisons of Best Buy and Circuit City, Dell and Apple, and AMD and Intel all are excellent examples of how an investor may have a difficult time anticipating which stock outperforms another in a specific sector. Therefore, for a longer-term stock trader, ETF investment vehicles could be a solution, helping to boost the bottom line, and can be added to his or her investment portfolio.

ETFs and some HOLDERS have the greater advantage of trading put and call options within a prescribed period of time. An investor can even buy calls such as on the pharmaceutical HOLDERS. Here is a tactic that I have used before with some success, especially if there are buy signals on several individual stocks within a sector. Go ahead and purchase, with a reasonable time until expiration, an in-the-money or close-to-the-money call option on the HOLDER itself. The pharmaceutical HOLDERS can be traded based on signals from Abbott, Merck, and Pfizer.

So you can utilize ETFs and their respected relatives and apply several strategies; also you can use intermarket relationships to determine buy or sell signals and devise a trading strategy dependent on those signals. Once you have a good feel for a stock that correlates or links best with an ETF, then you can use a spread or "pairs" trading strategy or even a hedge strategy using options. Deciding what is best for your risk capital making, using an ETF, you no longer need to make a precise pick for a stock in a specific sector.

In conclusion, trading opportunities exist in these investment vehicles for all investors; and best of all, they respond quite well using technical analysis to project support and resistance levels as derived from pivot point analysis and the momentum techniques that certain candle patterns indicate, which are the specific techniques disclosed in this book. This knowledge should give you, the individual investor, quite an edge in the market!

FUTURES MARKETS: LEVERAGE SYSTEM

We will go over several techniques for helping you identify trading opportunities in the futures markets. So far we have gone over using exchange traded funds versus stocks; pairs trading in related stocks; and using commodities for identifying opportunities in ETFs, such as the oil service

HOLDRs (OIH) or the U.S. Oil Fund (USO) versus crude oil futures. The Euro Currency Trust (FXE) is a more direct move for stock traders playing the euro currency futures versus the U.S. dollar. Then there is the street-TRACKS Gold ETF (GLD) compared to the CBOT electronic gold futures contract, or now a trader can use the iShares Silver Trust to trade against the physical silver market.

Stock traders can now apply and take advantage of so many commodity markets; but as I mentioned, the futures market is a great investment vehicle to many savvy and financially well-funded traders. Even smaller-sized traders can benefit from trading the futures market through the *responsible* use of the margin system, otherwise referred to as a “good faith deposit.” What is a *futures contract*? It is a legally binding agreement to buy and sell a commodity or financial instrument sometime in the future at a price agreed upon at the time a transaction was made. Contracts are standardized according to delivery points of interest, quality, quantity, and time of accepting or making a delivery. It is estimated that less than 3 percent of all transactions actually result in a delivery. In the case of stock index trading, there is a cash settlement over the value of the contract.

Stock Index Futures

For day or swing traders following the stock market, the futures market offers an advantage over stocks from tax liability perspective. Always check with your accountant; but, generally speaking, profits generated in a futures account are taxed at a rate significantly lower than that for a stock account.

One confusing aspect and perhaps a drawback for many traders switching from equities or even forex to trading futures is that there are so many products with various contract sizes. There is no consistency or constant in tick value fluctuations or dollar value in the price changes. For example, the CBOT mini-Dow contract is \$5 times the overall Index. When the Dow was at 10,500, the overall value was 52,500. The margin was set at \$2,600, or just under 5 percent. E-mini-S&Ps are 12.50 per tick (four ticks per point). If the point value is \$50, the overall value of the contract if the S&P is at 1,200.00 is \$60,000. In the currency markets, the euro is 12.50 per tick; the Canadian dollar is 10 per tick; the British pound is 6.25 per point but trades in a minimum two-tick fluctuation. (In my first book [*A Complete Guide to Trading Tactics*, Wiley, 2004], I listed all the commodities and the contract sizes on pages 8 and 9; please refer to that for a comparison. Or you can ask your futures broker to provide the listing of contract specifications.)

The exchanges where the individual futures products are traded set the margin requirements. Generally speaking, an initial margin requirement

on a futures product runs anywhere from 2 percent up to 10 percent of a contract's overall value. So now a trader needs to know which exchange the product is traded on, how much risk capital is needed to invest per contract, and how much each point value is. Let's look at the New York Mercantile Exchange's crude oil contract: The contract size is 1,000 gallons; every tick or point fluctuation equals \$10. A \$1 move per contract is a \$1,000 price move. When prices were at \$65 per barrel, the contract value was \$65,000. The margin requirement was, at one point, nearly \$9,000 per contract, almost 14 percent of the overall market value. The extremely high margin requirement reflected the extreme level of volatility and the inherent risk associated with that increased volatility.

The futures markets also have a value for stock traders to make decisions on asset allocations to their stock portfolios. In the agriculture sector, for example, you can study the price direction of soybeans, use traditional technical analysis tactics to determine the strength of a trend, and see if corresponding stocks linked to that market are worth switching or allocating funds toward. In Figure 1.27, we see soybeans making a seasonal harvest bottom at the end of November.

Another advantage futures have is that you can trade signals to diversify in other investments. Anticipating that the market may establish a seasonal bottom, you may want to explore stocks directly linked to the agriculture industry, instead of being exposed to potential risks due to what might appear to be an overleveraged investment vehicle, such as a futures contract. After all, every penny in soybean futures was \$50 at the time that I was preparing this book, and the minimum margin requirement was \$1,148. That means that on a small 20 cent move, you could lose nearly 95 percent of the initial investment per contract.

There are other considerations you could use, such as an options strategy, to effectively reduce risk exposure, such as going long a futures contract and buying a put option for protection; but in this strategy, you need to time the right option expiration. An alternative strategy would be going long a related market, such as stock in Monsanto shown in Figure 1.28.

Notice that this stock exploded in early November. The best part here is that there were seasonal factors to support a buy signal; and the technical picture shows what I call a "high close doji trigger," which we will disclose in this book. In fact, this is a great example to demonstrate why using a like or related market analysis approach can help you achieve better results in your trading. Cycle and seasonal studies can really help you in selecting stocks. The futures markets can certainly aid in that analytical process. Not only do commodities move in cycles, but the economy and businesses do as well.

There is one man who sticks out above the rest as the premier expert in the field of intermarket relationships—John J. Murphy. He has written

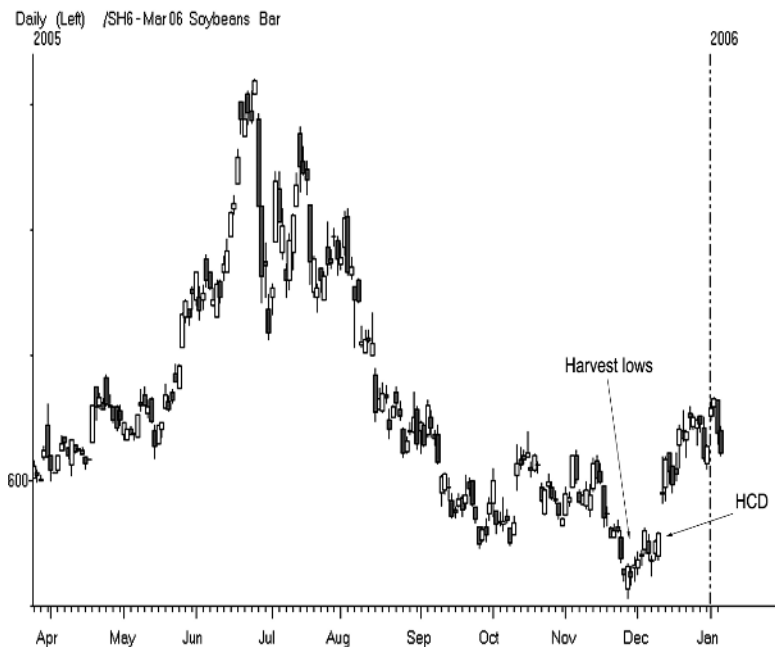


FIGURE 1.27

RealTick graphics used with permission of Townsend Analytics, LTD.



FIGURE 1.28

RealTick graphics used with permission of Townsend Analytics, LTD.

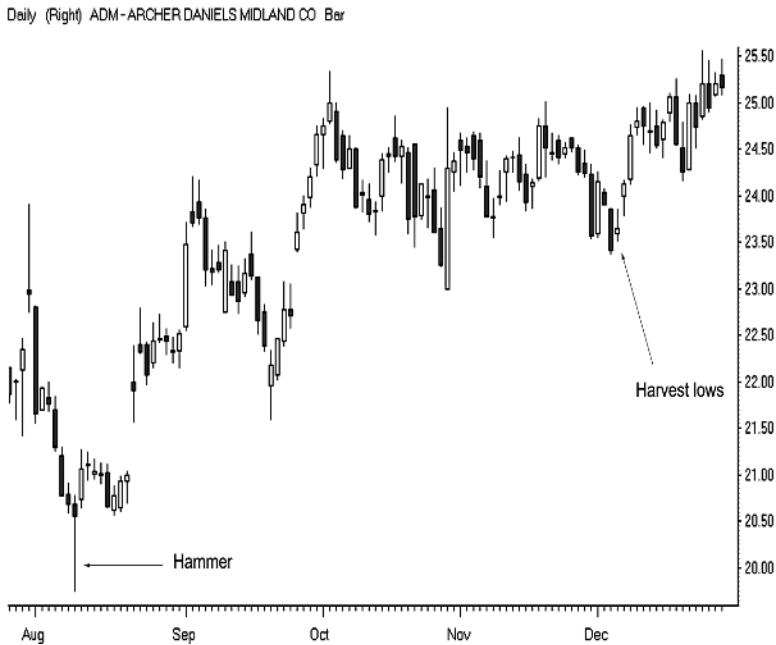


FIGURE 1.29

RealTick graphics used with permission of Townsend Analytics, LTD.

many books on the subject; the latest, titled *Intermarket Analysis: Profiting from Global Market Relationships*, will really help you in your educational journey.

Let's look at two more agriculture related stocks: One in Figure 1.29 is Archer Daniels Midland, which as you can see did rise but not significantly; however, it did rise in tandem with the soybean market. The other stock is Bunge Limited, shown in Figure 1.30, which mirrored the chart pattern in Figure 1.29 and moved higher at almost exactly the same time that the bottom in the soybean futures was formed.

Tandem Trading Techniques

Intermarket relationships have existed for years. It is very easy to track and look for trade setups in futures from a historical perspective, but timing a trade can be difficult due to the magnitude of the leverage as previously discussed. Don't get me wrong; futures are a very viable investment vehicle. I have made a very lucrative living trading commodities for the past 26 years. I just want you to learn that you can use futures to help make diver-

**FIGURE 1.30**

RealTick graphics used with permission of Townsend Analytics, LTD.

sified investment decisions on a broader scale. The key to making money in the markets is managing risk . . . end of story. Knowing the right strategy and having exposure to other markets and strategies can help you achieve your financial goals. Using similar or like markets or those that trade in tandem, especially markets that have strong relationships, traders can develop trading techniques or strategies by using signals based on one market and applying them to another, such as commodities and stocks or an ETF. Keep in mind that not all relationships work all the time. Look at past market relationships, such as the dollar and gold: Generally when the dollar goes up, gold goes down; but that certainly was not the case in 2005. How about when the Fed raises interest rates? Generally, long-term bond yields rise as well; but that did not occur in 2005 either. In fact, commodities and bond yields usually trend together; and that did not occur in 2005. Federal Reserve chairman Alan Greenspan called the decline in long-term yields a “conundrum.”

As we saw commodity prices rise, we saw the Federal Reserve raise rates at a “moderate” pace, acting at 16 consecutive meetings to adjust the Fed funds rate by 0.25 percent each time. This was in response to the per-

ception that inflation was rearing its ugly head. (As of the printing of this book, the Fed was still in rate-hiking mode!) Due to higher energy costs and as reflected in the Producer and Consumer Price Indexes, we had seen a pickup in inflation; and historically, many commodity prices rise besides gold and silver, such as sugar, coffee, and cotton.

The Reuters/Jefferies CRB (Commodity Research Bureau) Index, originally developed in 1957, is one of the most often cited indicators of overall commodity prices, offering investors a broad and reliable benchmark for the performance of the commodity sector. It is traded on the New York Board of Trade and started trading back in 1986. The “RJ/CRB” Index was revised in 2005 to reflect 19 commodity futures prices: aluminum, cocoa, coffee, copper, corn, cotton, crude oil, gold, heating oil, live cattle, lean hogs, natural gas, nickel, orange juice, silver, soybeans, sugar, unleaded gasoline, and wheat.

If you examine the chart of the RJ/CRB Index shown in Figure 1.31, the stratospheric rise is obvious and would indicate that inflation was or will be



FIGURE 1.31

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trickling down to consumers. Again, price increases in commodities historically signal a rise in inflationary pressures.

Investors and traders can use stocks or ETFs to capitalize on commodity plays; but at times, it pays to diversify and have a commodity account. Not all stocks offer participation in all commodity moves, so it is wise to explore using commodity markets as an investment.

A Case in Point

A fundamental event, besides an increase in demand, that helped create a shortage of supplies in energy and other commodities in 2005 was the weather. Hurricanes Katrina, Rita, and Wilma gave a lift to sugar and orange juice futures while harming certified coffee facilities in New Orleans and, to a lesser extent, Miami. These weather-related events were pure commodity market plays. Let me walk you through one of these 2005 events: The day before Hurricane Wilma passed through Florida, my wife and I had watched the Weather Channel intensely and decided to stick around because all the news reported that the hurricane would be downgraded to a tropical depression by the time it crossed over Naples and exited on the other side of Florida, in Palm Beach. The day before, we had played golf; and it was a splendid day: 83 degrees or so, a light breeze, and not a cloud in the sky. We were planning to leave for Chicago the following Sunday, and we could have easily changed our tickets and left early. Well, at 6 A.M. on October 24, we woke up and discovered that Wilma had gained strength and merged with another storm, named Alpha; and Wilma had turned into a low-grade Category 3 hurricane! All I could think of at the moment my wife turned the TV on was, "I better make some coffee because we are going to lose power." By the time the coffee had finished brewing, click, all the lights went out.

However, we were prepared: The cars had gas, the shutters were up, and we had a generator; so life was not so bad for that week. The morning of the hurricane, CNBC had called to see if I was in Florida and asked me what I thought would happen to the orange juice crop. I did a live interview via my cell phone, reporting on the weather conditions and what might happen to the orange crop. I stated that "we could see at least a 10 percent price gain from the 1.11 level to possibly as high as 1.25, as the storm would pass through sections of Indian River County." It was also that storm that devastated the soon-to-be-harvested sugar cane crop. As it turns out, that was a solid prediction and exactly what played out in the markets. If you had a commodity account, you may have taken up that opportunity in orange juice. In fact, orange juice eventually moved as high as 164 by May 11, 2006.

FUNDAMENTAL EVENTS INFLUENCE PRICE DIRECTION

There is an old saying, “Think like a fundamentalist, but trade like a technician”—a great line that applies when trading commodities or any market for that matter. Here is how that line applies to the hurricane situation. The orange juice crop was slightly damaged; there was a reduction in supplies in the southern growing region in Florida. Prior to the hurricane, prices moved higher in anticipation of a loss of inventory; what was unknown was how much higher. The market traded higher after what appeared to be a significant damaging hurricane.

Fundamentally, the market was vulnerable for any further price shocks. Then, as we approached the traditional seasonal frost scare period in mid-January through February, the market would be more vulnerable to increased volatility. In fact, that was what occurred in 2006, as Figure 1.32

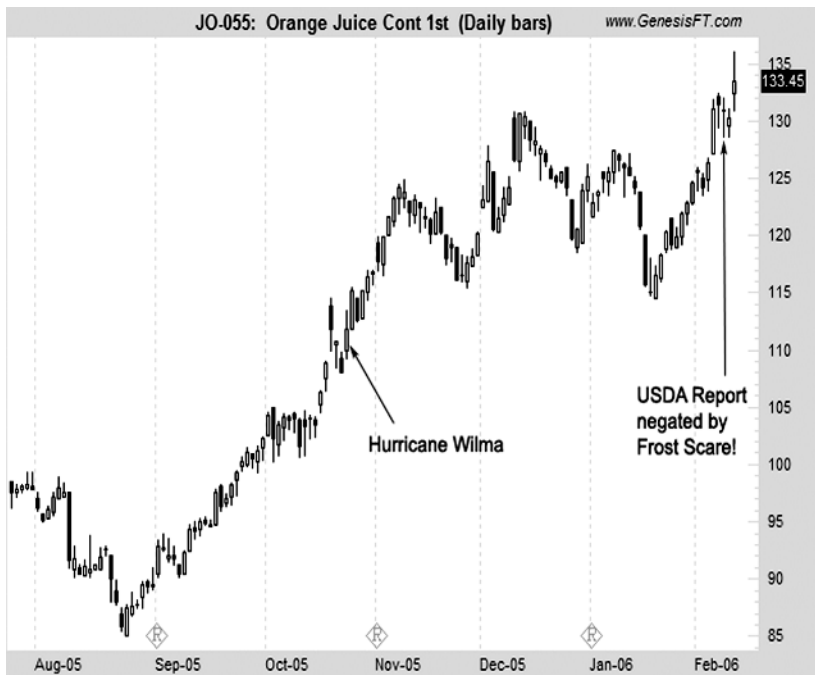


FIGURE 1.32

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shows. The fundamental supply/demand report outlook, as shown in the U.S. Department of Agriculture's (USDA's) monthly crop report, did not reveal a major supply/demand imbalance to warrant higher prices. But a frost scare would! The anticipation that crops would suffer from frost damage propped prices sharply higher. The point is that you need to be aware of what fundamental factors influence a market. Markets do not always move when they should on facts presented, but there are circumstances that can and do make markets move! A hurricane in South Florida before harvest time is one such situation.

NOT ALL NEWS AFFECTS MARKETS EQUALLY

Hurricane-related damage in 2005 played a major role in the reduction of supplies to the sugar market more so than it did in orange juice. Also, the fundamental backdrop of the sugar market was more significant than the orange juice market because it has a dual role: Sugar is a food product, and it is used as a biofuel to make methanol. It set record price gains in 2005, especially as energy prices surged. Raw sugar prices more than doubled in 2005, climbing and making new 24-year highs. Brazil, the world's largest producer, uses most of its crop to make fuel because of the high cost of gasoline. With that information, we would expect that after Hurricanes Katrina and Rita impacting the Louisiana crops and then Hurricane Wilma making a direct hit on Florida's crop, prices would take off like a rocket! But don't forget that sugar is produced all over the world and that there are sugar beets and sugar cane. It is almost impossible to measure inventories from all growing regions of the world, and the market knew that after Hurricane Wilma hit. The fundamental event that impacted the orange juice market had a different effect there than it did on the sugar market.

As you examine Figure 1.33, notice that prices actually decline after Hurricane Wilma. It took almost one month for the market to realize that there was a significant loss in Florida's crop, and speculative money pored into the market to take advantage of higher prices. A Trend Traders technical price break signals to get long this market, and substantial profits were made. It may appear that the fundamental and technical outlooks were not in sync; and by late January/early February of 2006, traders started to sense that the market was getting slightly ahead of itself, or overbought. Traders who were long started to liquidate some positions in preparation for the USDA's monthly crop report. If you look closely at Figure 1.33, the very high of the market was formed by a candle pattern named a shooting star. (Chapter 7 focuses on how to spot reversals like this one.) The market did

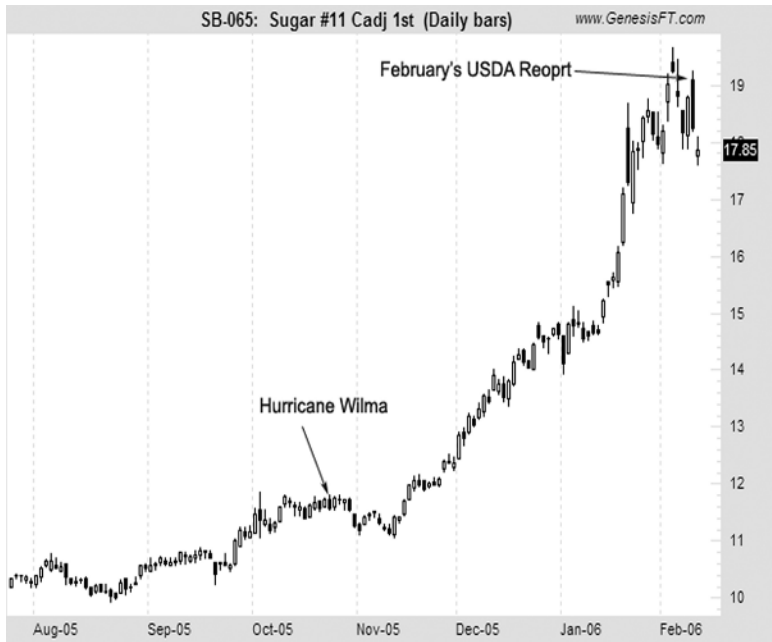


FIGURE 1.33

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not behave according to what the fundamentals dictated. Prices rallied in a delayed effect and then continued higher on speculative buying interest.

What I want to illustrate next is how markets do *not* act according to the following:

- What fundamentals dictate.
- Common sense.
- Rational emotional intelligence.

The high was made in the sugar market on February 3 at 19.65, one week earlier than the USDA crop report. Table 1.1 shows the actual government report, the boldface type indicating that total sugar supplies increased from 11,870 to 12,026! But best of all, total usage declined from 10,523 to 10,365! Ending stocks show there are more surplus inventories. Since that report, prices have declined significantly.

Therefore, remember: *Fundamentals do not always jibe with what the charts show. Think like a fundamentalist but trade technically.*

TABLE 1.1

U.S. Sugar Supply and Demand Report 2-9-2006 (1,000 short tons, raw value)

Item	2004/2005 Previous	2004/2005 Feb 9	205/2006 Previous	2005/2006 Feb 9
Beginning stocks	1,897	1,897	1,347	1,347
Production 2/	7,877	7,877	7,593	7,593
Beet sugar	4,611	4,611	4,435	4,458
Cane sugar	3,266	3,266	3,158	3,131
Florida	1,693	1,693	1,455	1,428
Hawaii	258	258	260	260
Louisiana	1,157	1,157	1,263	1,263
Texas	158	158	180	180
Imports	2,096	2,096	2,770	3,090
Total Supply	11,870	11,870	11,710	12,026
Exports	259	259	175	175
Domestic	10,215	10,215	10,215	10,190
Food	10,046	10,046	10,050	10,050
Other	169	169	165	140
Miscellaneous	49	49	0	0
Total Use	10,523	10,523	10,390	10,365
Ending Stocks	1,347	1,347	1,320	1,661
Stocks/Use ratio	12.8	12.8	12.7	16.0

FOLLOW THE MONEY FLOW

Fundamental events are not the only factors that drive prices. We see evidence of increased participation from speculators as reflected by the increase in volume and open interest levels. Most commodity markets, besides orange juice and sugar, showed massive money inflows by hedge funds, pension funds, and individual investors in 2005 as commodities prices rose. The Reuters/Jeffries CRB Index, as shown back in Figure 1.31, is a great illustration of that fact. This trend may continue in 2006 and possibly beyond into 2008. The hurricanes in 2005 affected not only the agricultural markets described here but also the energy markets, as previously mentioned. In 2005, natural gas prices skyrocketed, and unleaded gasoline prices exploded. Many stock analysts may not have been trading commodities directly, but they certainly were watching their price movements and using that data to track their portfolios.

My point is that we have entered a time period in which our civilization

and culture are entwined in a very complex financial relationship in which commodity markets play a serious role. Think about this: Ten years ago, we did not trade freely or openly as we do now with China; in fact, China now has its own exchange, the Zhengzhou Commodity Exchange. Then there are India and other parts of Asia; as their commerce and economic growth develop, so will the need for trading.

More and more investors are participating in the markets around the globe, even in Latin America. Markets have become more confusing to trade, and therefore we need to look for opportunities and to keep our defense up to be more risk averse. Using spread trading in the futures markets can help you achieve those goals; the opportunities are endless. Keep in mind the important principles of trading that depend on these elements:

- Prices reflect forces influenced by supply and demand factors.
- Prices represent the collective action of buyers and sellers who are dictating what the current price of a given product is perceived to be at a given time.

Stocks Influenced by Commodities

Now that commodities are moving and have attracted the attention of sophisticated hedge fund and commodity trading advisors, money has been flowing back to this investment industry. Investors use fundamental information such as weather conditions and apply technical analysis techniques to time entries and exits. Corporations, banks, and institutions are using the markets to hedge against losses incurred in the cash markets, for example, the airline industry, where some companies were buying energy futures contracts to lock in prices prior to the big price surge. Smart move! Higher prices in commodities such as crude oil certainly have an influence on the airline stocks. Therefore, tracking commodity prices is important for stock traders.

We will go over specific trading strategies as well as some back-testing results that will substantiate a pretty good method for trading the futures markets. This introduction was designed to show you that there is more to commodity trading than meets the eye and to show you not only how you can utilize price moves in the futures to profit from a futures contract but also how you can apply that knowledge in other areas of investing. In fact, stock traders can greatly benefit from information unique to the commodity markets. One such bit of information is released by the Commodity Futures Trading Commission (CFTC) and is known as the *Commitment of Traders (COT) Report*. It is referred to as legal “insider trading” information, which is covered in the next few pages; so read on!

FOREX, THE CURRENCY CASH MACHINE

Foreign exchange currency trading, otherwise known as the *forex* market, offers an investment asset class that is completely different from stocks of futures and offers leverage and virtually unrestricted access 24 hours a day. Forex trades virtually around the clock, from when the Asian market opens on Sunday night until the U.S. markets 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.

Forex is the simultaneous buying of one currency and selling of another. In other words, currencies are always traded in pairs; 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 example, if you have purchased euro and sold U.S. dollars, it would be stated as a euro/dollar pair.

The foreign exchange market (forex, or FX) is the largest and most liquid financial market in the world, with a volume of over \$1.5 trillion daily—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. 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.

Margin and 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.

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 fundamental 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 forex markets.

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: prices and volume. By having the proper understanding of how these two components exploit the impact of supply and demand in the marketplace, 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.

Long or Short

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, if one wants to take advantage of a price decline. 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. The result is 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 the use of stop-loss orders, traders can mitigate their risk regardless of long or short positions. It is imperative that traders are well-disciplined and execute previously planned trades, as opposed to spontaneous trading based on a "feeling that the price will decline."

Benefits for Selling Short

There are obvious benefits to short selling. This aspect of the forex market allows traders to profit from declining markets. The ease of selling con-

tracts before buying them first is in contrast to typical stock trading. 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 trend toward a peak, trading volume will typically taper off. This is a signal that many short sellers look for to initiate a trade. When a reversal does occur, there will typically be more momentum than there was with the corresponding up move. Volume will increase throughout the sell-off until the prices reach a point at which sellers begin to back off.

Famous Short Plays

There have been quite a few milestone memories from famous currency trades, with both short positions and long. For example, famed financier George Soros “broke” the Bank of England by winning an estimated \$10 billion bet that the British pound would lose value! How about Daimler Chrysler, the parent company of Chrysler and Mercedes Benz—reportedly it made more money in the forex markets than it did selling cars! On the negative side, in early 2005, Warren Buffett announced the U.S. dollar was in trouble and stated he was heavily short the U.S. currency. That did not turn out well for him, as the dollar rallied for the most part during all of 2005. What turned the market around? There were many issues—mainly political, geopolitical, and economic developments—that influenced the dollar’s value. For starters, many U.S.-based multi-conglomerate corporations were prompted to bring money back into the United States due to the Homeland Investment Act (HIA). The HIA is part of 2004 American Jobs Creation Act and was intended to encourage U.S.-based companies to bring money back home.

The window of opportunity afforded by the HIA 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 be a high dollar demand to convert foreign currencies. Don’t forget, during the middle of 2005, there were riots in France. That contributed to poor market sentiment toward the euro zone, thus giving ground for a flight to safety, and helped foreign investors switch to buying U.S. dollars. The tone was essentially dollar-positive and euro-negative, which is indicative of politics having a negative effect on the euro. Meanwhile, the broader market was also most likely influenced by the high-profile move by Berkshire Hathaway, Inc.’s, Warren Buffett to cut back speculative positions against the U.S. dollar after losing big on it due to surprising dollar strength.

Mr. Buffett had bet that the dollar would continue losing ground, as it

did in 2004, as 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 to \$16.5 billion, down from \$21.5 billion in June 2005.

As you can see from the dollar Index weekly chart in Figure 1.34, on a year-to-year basis, the dollar did make an outstanding run. However, keep in mind that the dollar was at a high of 120.80 back in 2002; so depending on where Buffett was shorting the dollar, he could still be in a lucrative position. The focus of this story is how shifts in monetary and fiscal policies can and do dictate price swings in the market, as happened in 2005.

Forex trading is considered the juggernaut in 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. Other reasons why forex attracts so many individual investors



FIGURE 1.34

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are that the market has liquidity and favorable trading applications, such as the ability to go long or short a position, and that it trends and trades well, based off technical analysis studies.

In the past, currency trading was accessible for speculators through the futures industry when the central marketplace in the banking arena was for 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 traders and banks to a location where any and all individual traders who want to participate have access in this 24-hour market from their home or office computers or laptops.

The forex markets offer traders free commissions, no exchange fees, on-line access, and plenty of liquidity. Unlike the futures products, the markets are standardized contract values, meaning a full-size position is 100,000 value across the board. The one main element that attracted investors is the commission-free trading. Plus, most forex firms require less capital to initiate a start-up account than a futures account does. In fact, investors can open accounts on their debit and/or credit cards, and the practice of accepting payments online through PayPal exists.

Some firms offer smaller-size flexi accounts, allowing traders to start applying their skills at technical analysis with as little as \$500 and trading ultraminiaccounts with leverage. This feature of what is known as miniaccounts allows individual investors to adjust their positions by not having too big a contract value per position; they can add or scale into greater or lesser positions to adjust the level of leverage according to their account size. Smaller-size investors are not excluded from trading; they can participate with minicontracts. What is great about this feature is that a new trader or an experienced trader who is testing a new system can trade the market with real money, rather than simply paper trading, and benefit from the actual experience of working out execution issues and, more important, of seeing how they handle the mental or emotional side of trading. Having real money on the line certainly helps teach 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 miniaccounts have is that traders with low-equity accounts can afford to trade multiple positions without being exposed to excessive risks like full-sized positions for scaling out of positions in order to let a portion of the position ride a profitable position, while capturing profits on a partial exit. We will go over more on that style of trading later.

What Benefits Do Forex Firms Offer?

Besides offering leverage accounts, other benefits that most forex companies offer are free real-time news, charts, and quotes with state-of-the-art

order-entry platforms; and 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.

These features may sound too good to be true. With all the benefits that the forex market offers, most newcomers want to know what the catch is. There are some slight cost factors that relate to execution; you pay a premium or a higher spread to buy and a higher spread to sell. Also, most forex companies take the other side of your trade; you do not have direct access to the interbank market, as it is called. Since 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 (PIPs—percentage in points). Since most forex traders are short-term in nature, meaning they are quick in-and-out players, day trading in the forex markets is beneficial for these traders due to the fact that there are no commissions; but the PIP spreads can and do add up. There lies the catch.

Buy and Sell 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 a trader can sell a currency; and the *ask* is the price at which a dealer is willing to sell and a trader can buy a currency. In forex trading, unlike futures or equities, you have to pay a percentage in price (PIP) spread on entering 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 four PIPs on a euro versus U.S. dollar spread. The spread varies on other currency pairs and is usually wider on more exotic cross markets, such as the Canadian dollar versus the Swiss franc.

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. (EST). The only fee involved here is the interest payment on the position of currency held. At times, depending on the position, a trader 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, forex markets are now regulated to an extent and come under the scrutiny of the self-imposed regulators, such as the National Futures Association after the CFTC Modernization Act passed in 2002; but since there is no centralized marketplace, many forex dealers can and do make their own markets, as discussed earlier.

Why Trade Spot Forex Markets?

Of all financial instruments traded, forex is believed by many professional traders and analysts to be one of the best-suited markets to trade based off technical analysis methods, for a number of reasons. First is 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 the number of market participants in forex trading have grown some 2,000 percent over the past three decades, rising from barely \$1 billion per day in 1974 to an estimated \$2 trillion 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 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 S&P 500 Index trading range is between 4 percent and 5 percent daily, while 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 changes in interest rates can move equity markets as well as the currencies markets. We will learn in coming chapters how to detect hidden yet repeating patterns that occur between these related markets and how forex traders can profit from these patterns.

Which Is Bigger—Stocks or Forex?

Forex is by far the largest market in dollar volume, is less volatile, experiences longer and more accentuated price trends, and does not have trading commissions. Forex is the ideal market for the experienced trader who has

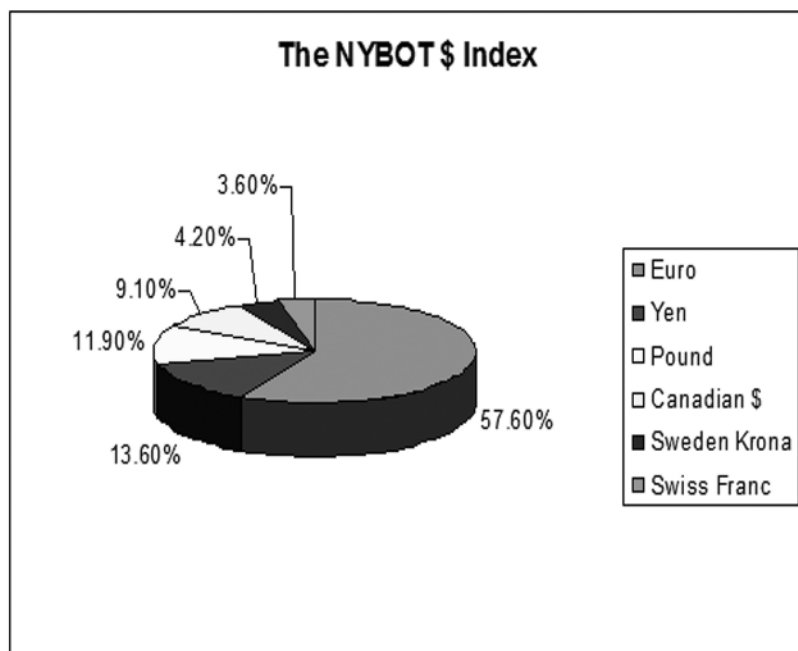
paid his or her “trading tuition” in other markets. However, there are no free lunches. Traders must use all the trading tools at their disposal. The better these fundamental and technical tools, the greater is their chance for trading success. While intermarket and other relationships are often complex 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

The futures market through the International Monetary Market (IMM) of the Chicago Mercantile Exchange has many benefits as well. Some believe there are tighter spreads between the bid and the asking price, 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 by using the futures markets instead of the forex spot markets.

Let's compare a trade in forex to a trade with a similar-size contract value on the futures exchange, using the example of a euro futures contract on the CME, where it has a contract size of USD 125,000 worth of euros, where each PIP would be 12.50 in value. If the commissions and related fees are on a par with most discount brokerage firms, \$20 is your transaction cost per round turn, that is, \$10 to buy and \$10 to sell out 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 does a \$100,000 full-lot-size contract and pays three PIPS on every transaction for both the entry and the exit of each position, this trader would be charged \$30 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, as was shown in Figure 1.34. That index is computed using a trade-weighted geometric average of six currencies. It virtually trades around the clock—the trading hours are from 7 P.M. to 10 P.M., then from 3 A.M. to 8:05 A.M., and then from 8:05 A.M. to 3 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, then new limits will be established 200 ticks above and below the previous price limit. Figure 1.35 shows a breakdown of the various currencies and their respective weights on the average. The top four include the euro, which is the heaviest weight at 57.6 percent,

**FIGURE 1.35**

followed by the Japanese yen at 13.6 percent, then the British pound at 11.90 percent, and the Canadian dollar at 9.10 percent.

FOREX TRADERS BENEFIT FROM FUTURES MARKETS INFO

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 translating it into a trading trigger signal in a forex market. Because spot FX and futures trade in tandem, the price difference is called the *basis*. Generally, day-to-day, they are geometrically equal (within a few PIPs). Since, as we discussed, forex markets are decentralized, 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 what the basics are and how a forex trader can use this futures information.

Volume is the number of trades for 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. A further explanation is that 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: First, if a market is increasing in price and the volume is increasing, the market is said to be in a *bullish* mode and can indicate further price increases. Second, the exact opposite is true for a declining market. If price is declining and volume increases, it is said to be in a *bearish* mode and indicates further price decreases. However, if a substantial daily market price increase or decrease occurs after a long steady uptrend or downtrend, especially on unusually high daily volume, the move is considered to be a “blow-off-top or bottom exhaustion” and can signal a market turning point or a 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 while prices are falling* may signal a bear move.
- *Decreasing volume while prices are climbing* may indicate a plateau and can be used to predict a reversal.
- *Decreasing volume with a weaker price environment* shows that fresh sellers are reluctant to enter the market and could be a sign of a future downtrend.
- *Excessive volume while prices are high* indicates that traders are selling into strength and often creates a price ceiling.
- *Excessively low volume while prices are low* indicates that traders are buying on weakness and often creates a floor.

Open interest reveals the total amount of open positions that are outstanding in existence and not offset or delivered upon. Remember that in futures trading, this is a zero-sum game so that for every long there is a short or for every buyer there is a seller. The open interest figure represents the longs or shorts but not the total of both. So when examining open interest, the theory or 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 on 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. Of course, 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, then the market condition is weakening. 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 use this information to identify an opportunity when there is a major top or bottom in the spot forex markets: When observing a continued *long-term* trend in a spot forex currency, if it trades as a futures contract (whether it is in an uptrend or a downtrend), when prices start to fluctuate with wider than normal daily price swings, or ranges, or are in an extremely volatile condition, if it is combined with unusually strong volume and a decline in open interest, this is referred to as a *climaxing market condition*. The market is getting ready to turn or reverse the trend.

In Figure 1.36, the graph is a split chart of the futures euro currency on top with the volume and open interest study in the middle. The spot forex euro currency is on the bottom. Notice that after the peak in prices, the vol-

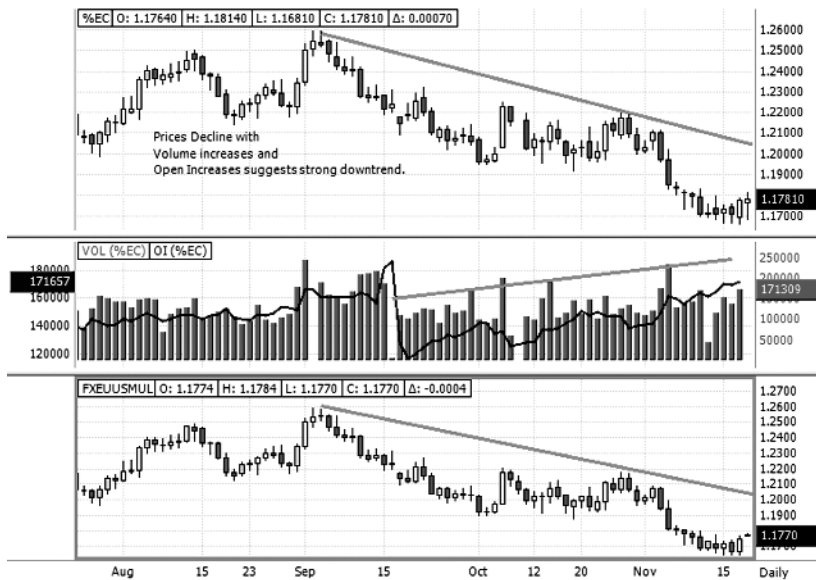


FIGURE 1.36

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ume was increasing, as was the open interest. This was a warning that a trend reversal was forming, rather than a small correction. Therefore, spot forex traders would have a better decision-making process, that selling rallies and looking to take sell signals at resistance would be a more fruitful and profitable course of action.

INSIDER TRADING INFORMATION

There is one more source of information that stock and spot forex currency traders can borrow from the futures industry. It is the Weekly Commodity Futures Trading Commission’s Commitment of Traders (COT) report. 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. In fact, it was covered in my first book on pages 162–165.)

As a futures trader for over 26 years, I have used this information to capture many significant moves in the markets. Figure 1.37 shows that

EURO FX - CHICAGO MERCANTILE EXCHANGE								Code-099741	
FUTURES ONLY POSITIONS AS OF 09/20/05									
----- ----- ----- -----								NONREPORTABLE	
NON-COMMERCIAL			COMMERCIAL		TOTAL			POSITIONS	
----- ----- -----			----- -----		----- -----			----- -----	
LONG	SHORT	SPREADS	LONG	SHORT	LONG	SHORT	LONG	SHORT	
----- ----- -----									
(CONTRACTS OF 125,000 EUROS)						OPEN INTEREST:		118,666	
COMMITMENTS									
29,052	30,480	832	52,941	47,456	82,825	78,768	35,841	39,898	
CHANGES FROM 09/13/05 (CHANGE IN OPEN INTEREST:						-44,077)			
-269	8,744	-762	-35,756	-54,177	-36,787	-46,195	-7,290	2,118	
PERCENT OF OPEN INTEREST FOR EACH CATEGORY OF TRADERS									
24.5	25.7	0.7	44.6	40.0	69.8	66.4	30.2	33.6	
NUMBER OF TRADERS IN EACH CATEGORY (TOTAL TRADERS:						95)			
32	29	11	25	20	62	55			

FIGURE 1.37

there are several categories. The first is the “non-commercial”—all large professional traders or entities, such as a hedge fund, a commodity trading advisor, commodity pool operators, and locals on and off the exchange floors. Any trading entity that hits a reportable position limit (for instance, in the CME currencies, at the end of 2005, the limit was 400 contracts) is reported by the clearing firm to the exchange, which then turns the information over to the CFTC.

The next category is the “commercials”—banks and institutions or multinational conglomerate corporations looking to hedge a cash position. The long and short open interest shown as “nonreportable positions” are 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 is unknown. This balance of positions is assumed to be the small speculators. If you look at the first column under non-commercials, you will see the breakdown of long positions versus short positions. The next line down 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 the percent of longs and shorts that are held. The last line shows how many traders there are that 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 to the regulatory body known as the CFTC. This information is released on Friday afternoons at 3:30 P.M. (ET).

It is critical before acting on a decision based on this information to see if there was a major price swing from Tuesday’s close to the time the information was released on Friday, because positions may have changed hands. For example, in Figure 1.37, if the British pound was at 1.7400 at 5 P.M. on Tuesday and the price at Friday’s close was 1.7000, it will indicate a 400-point move. If the COT showed small speculators net long, I will assume that the speculators were no longer long, as not many small speculators can handle a 400-point loss.

Can traders benefit and make money from this information? The answer is that there is always a chance to make money. The key is to be able to afford to be not too heavily leveraged if the market moves further than anticipated. The COT 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 in a long-term trend run if market participants are too heavily positioned on one side of the market. It is generally the small speculator who is lefty holding the bag. 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 what direction interest rates are going to go 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 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 for using the COT Report:

- 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 category is net long by at least a two-to-one margin, look at buying opportunities.
- If non-commercials are net long, commercials are net short, and the nonreportable positions category is neutral, meaning not heavily net long or short, look at buying opportunities and stick with the smart money speculating non-commercials.

WHAT EVENTS MOVE THE CURRENCY MARKETS?

Traders need to be aware of several key elements and events that can cause currency values to move. For one, intervention plays a role in the currencies. When the Bank of Japan felt that its export business would suffer at the hand of an overvalued yen, it would intervene and sell yen to buy U.S. dollars. Countries like Canada and Australia, which produce raw commodities, saw a rise in their currency valuations as global demand increased for their goods and as their economies improved as well.

Foreign currency markets are mainly influenced by international trade flows and investment flows, which are the same factors that influence the equity and bond markets:

- Economic and political conditions.
- Interest rates, inflation, and political instability.

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 to protect against adverse movements in the equity and bond markets. Japan is closer to changing its zero-interest rule policy; and when it does, it may attract money back to Japan and boost its currency value

STUDY THE “MACRO” ISSUES

Traders who are new to forex can take comfort in knowing that analyzing and forecasting exchange rate movement rely solely on macroeconomic factors—the “big picture” issues and concepts for which information is readily available and intuitively grasped. Once traders have an understanding of the big picture pertaining to an economic region, they can place trades in the currency market to profit from their analysis. Currency traders who are looking to capture big moves in exchange rate movement definitely should focus on three issues when attempting to assess the value of currencies:

1. *Interest Rates—The Carry-Trade Strategy.* 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 Japan. There is a significant risk exposure to this investment, which requires large capital or a highly leveraged position from an exchange rate fluctuation.
2. *Unemployment Rate.* The unemployment rate is a strong indicator of a country’s economic strength. When unemployment is high, the economy may be weak and, hence, its currency may fall in value. The opposite is true as well. The question that many economists look to answer is what a specific country’s full-employment capacity level is. That knowledge will give clues to the peak in productivity and economic output. That knowledge also helps determine a country’s capital flows and, therefore, is good information for currency traders to follow for longer-term trend identification.
3. *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 re-

spective currency. Turmoil, strikes, and terrorist attacks, as we have witnessed in the new millennium, all play havoc with and cause short-term price shocks in the currency markets. Terms such as “flight to safety,” as traders move money from one country to another, cause shifts in currency values. These events need to be monitored by forex traders as well.

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 what and when reports can cause a shift in currency markets. Knowing what time is best to trade the markets will help you nail down when a potential trade may materialize. As the pie chart in Figure 1.35 showed, the largest percentage value traded against the U.S. dollar was the euro. Therefore, that would represent the European session. The central place of foreign currency dealings is London, where the second-most-active trading volume occurs. Therefore, it is where there are likely to be large range swings in the market, granting day traders an opportunity to profit. The European session runs from 2 A.M. (ET) until 11 A.M. (ET), so a euro currency to U.S. dollar (EU/USD) or euro currency to British pound (EU/BP) or a British pound to U.S. dollar (BP/USD) would be an appropriate pair selection to trade.

The U.S. session opens at 8 A.M. (ET), which overlaps the European session; and these two sessions combined generate the bulk of trading activity. Most major U.S. economic reports are released at 8:30 A.M. (ET); and, as expected, the currency markets generally react off those reports. This offers traders the opportunity to trade off what is normally a violent price spike. Once the U.S. markets close at 5 P.M. (ET), the currency markets are available to trade; but it is not until the Asian session opens at 7 P.M. (ET) that markets will experience potential price swings. The Australian dollar (AUS) and Japanese yen (JY) would be what traders would want to focus on, and the trade opportunities there would be the USD/JY or the USD/AUS or the cross pair trading the JY/AUS. Notice that the Asian markets overlap the European session as well, so a Japanese yen versus euro currency cross (JY/EU) is a popular pair to trade. Here are the time zones a trader wants to focus on when trading spot forex markets.

- European session—2 A.M. (ET) until 11 A.M. (ET).
- U.S. session—8 A.M. (ET) until 5 P.M. (ET).
- Asian session—7 P.M. (ET) until 4 A.M. (ET).

The prime trading periods for day traders are from 12:30 A.M. (ET) until 5:30 A.M. (ET), from 7 A.M. (ET) until 12 P.M. (ET), and from 1:30 P.M. until 5

P.M. (ET). These periods are when peak volumes occur, due to the opening of the European session and economic reporting times in Europe. Then, as the U.S. market opens, you have the window of opportunity to trade off the volatility from the time when U.S. reports are released. In the afternoon of the U.S. session, volume increases as traders rush to balance their positions before the end of the day. These are the select times to trade forex markets (more information can be found at www.fxtriggers.com).

For the most part, day and swing traders use technical analysis to identify opportunities from specific chart patterns that demonstrate frequent re-occurring results. They need to trade in active time periods, trading off trend lines and moving averages, which are a form of trend line analysis that will help in certain market conditions. We will go over a set of moving averages that is different from what is normally written about and that will help identify conditional changes in the market, thereby giving forex traders a better edge. We will also incorporate and show you how to calculate support and resistance levels from mathematical-based models, such as pivot point analysis, and other means, such as Fibonacci corrections and extensions, to identify opportunities and drive trading decisions. These are the methods I will be covering in this book to help you form a trading plan based on specific rules and conditions for trading the forex markets.

