Part 1

The Foreign Exchange Markets

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Chapter 1

The World of FOREX

Introduction—What Is FOREX?

YOU ARE HERE—Before you can test the waters with a demo account, learning basic information about the FOREX markets is essential. Part 1 will accomplish this task with discussions of history, terminology, and regulations.

Foreign exchange is the simultaneous buying of one currency and selling of another. Currencies are traded through a broker or dealer and are executed in currency pairs, for example, the European Euro and the U.S. Dollar (EUR/USD) or the British Pound and the Japanese Yen (GBP/JPY). If you buy the GBP/JPY, you are long the GBP and short the JPY; if you sell the GBP/JPY, you are short the GBP and long the JPY. An account is typically funded with the currency of your resident country. A few FOREX brokers offer the option of funding with a non-local currency.

It is important to understand a FOREX transaction is effectively a spread between two currencies. You cannot simply buy the USD or sell the JPY—the purchase or sale must be in relationship to another currency. This is one of two important facts to remember as we delve into the world of foreign exchange trading.

The FOReign EXchange market (FOREX) is the largest financial market in the world, with a turnover volume of $4 trillion daily. This is more

than three times the total amount of the stocks and futures markets combined and almost a doubling in the past five years.

Unlike other financial markets, the FOREX spot market has neither a physical location nor a central exchange. It operates through an electronic network of banks, corporations, and individuals trading one currency against another. The lack of a physical exchange enables the FOREX market to operate on a 24-hour basis, spanning all time zones across the major financial centers. This fact—that there is no centralized exchange—is the second important fact permeating all aspects of the FOREX experience.

What Is a Spot Market?

A *spot market* is any market that deals in the current price of a financial instrument. Futures markets, such as the Chicago Board of Trade, offer commodity contracts whose delivery date may span several months into the future. Settlement of FOREX spot transactions usually occurs within two business days. There are also *futures* and *forwards* in FOREX, but the overwhelming majority of traders use the spot market. Thanks to the ability to automatically roll over from one trading session to the next, spot FOREX traders may hold a position for as long as they like.

In addition to spot, forward, and futures, options trading in FOREX has become very popular at the retail level. You may also participate in the spot market with spread betting. These all have both advantages and disadvantages, which I discuss in Chapter 3, "Five FOREX Markets."

Which Currencies Are Traded?

In theory, any currency backed by an existing nation can be traded against any other currency. In practice, trading volume of the major currencies dominate the action. Given in descending order (along with their symbols), they are the U.S. Dollar (USD), the Euro Dollar (EUR), the Japanese Yen (JPY), the British Pound Sterling (GBP), the Swiss Franc (CHF), the Canadian Dollar (CAD), and the Australian Dollar (AUD). See Table 1.1. All other currencies are referred to as *minors* and those from smaller countries, *exotics*. The New Zealand Dollar (NZD) is often included with the majors. The Chinese Yuan is the only currency of a major player not represented in the interbank market today. The Chinese have used this to great advantage, but there is a yin and yang in everything. . . .

TABLE 1.1 Major FOREX Currencies

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

There are 21 [6 + 5 + 4 + 3 + 2 + 1] possible pairs to trade with just these seven currencies. Adding the New Zealand dollar—NZD—brings that total to 28.

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

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

Who Trades on the Foreign Exchange?

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

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

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

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

Speculators may trade at different price and time levels. Activity ranges from high frequency (HF) and ultra-high frequency (UHF) trades that may have a duration of just seconds to position trading, which may have a duration of weeks or months. Most speculators at the retail level are in between those two extremes.

Retail refers to the individual trader using one of the many online currency broker-dealers to work the FOREX markets. At one end are small part-timers playing mostly at a hobby with 10,000 mini lots. At the other end are large professional traders trading 250,000 bank lots.

Institutional refers to the big boys and girls trading for banks and hedge funds in lots of 10,000,000 or more. To a degree, they provide the liquidity so you and I can participate at the retail level.

How Are Currency Prices Determined?

Currency prices are affected by a large matrix of constantly changing economic and political conditions, but probably the most important are interest rates, government intervention, economic conditions, international trade, inflation or deflation, political stability, and in some cases, armed conflict. Governments sometimes actually participate in the foreign exchange market to influence the value of their currencies. Governments do this by flooding the market with their domestic currency in an attempt to lower the price or, conversely, buying in an effort to raise the price. This process is known as

central bank intervention and it can result in dramatic, if short-lived, movement for the currency involved. See the USDCHF chart in Figure 1.1 as an example. Prices soared 500 pips in less than one hour.

The USD appreciated over 500 pips in just one hour on September 6, 2011. This represents a $5,000 move on a standard 100,000-lot trade of the USDCHF.

Any of these factors, as well as large market orders, can cause high volatility in currency prices. Reports of sudden changes in such factors as unemployment can drive currency prices sharply higher or lower for a short time. In fact, news traders specialize in attempting to capitalize on such surprises. Technical factors, such as a well-known chart pattern, may also influence currency prices for brief periods. The size and volume of the FOREX market, however, make it impossible for any one entity or factor to drive the market for any length of time. Crowd psychology and expectations also figure in the equation, determining the price of a currency relative to another currency. As in all financial markets, perception may be reality at any given time. A factor that may have traders' attention for weeks may suddenly fall to the side as another factor grabs attention. There are an enormous number of correlations between all these factors and they are almost certainly nonlinear in nature. That means they are constantly changing and rearranging themselves, sometimes in ways simply not quantifiable or predictable. Now you see it,

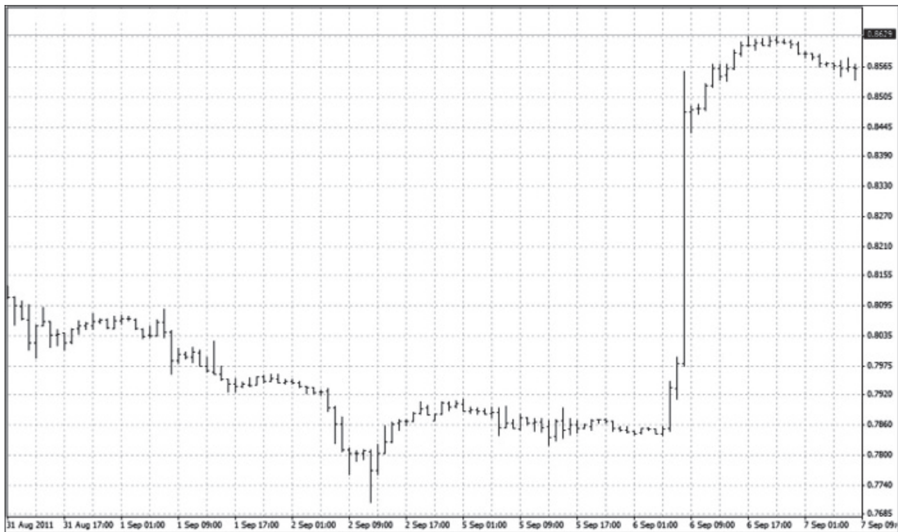

FIGURE 1.1 Swiss Central Bank Intervention in the CHF
Sources: ATC Brokers—www.atcbrokers.com and MetaQuotes—www.metaquotes.net.

now you don't. If you focus on one or a few of them, the others might change unnoticed. Quantum theory comes to mind.

Tip: Money ultimately flows where it can get the best return with the least risk; this is also true of currencies. As the equation changes, the flow moves back and forth, causing prices to move up and down. This also explains why currencies move in bands—however large—rather than trends. Unless a country goes bankrupt, its currency has at least some risk-reward ratio in relation to other currencies and at some point is either overvalued or undervalued.

When Do Currencies Trade?

The global FOREX market trades 24 hours a day, except weekends. The week begins at 5:00 P.M. Eastern Standard Time on Sunday in Asia and ends at 3:00 P.M. Eastern Standard Time on Friday in New York.

The trading day begins in Asia (the Asian session), moves to Europe (the European session), and ends in North America (the North American session).

As a trader, you can participate any time you like, for as long as you like. Most part-time traders try to establish session times to meet their schedule. Others, such as this author, more or less always have their foot in the door. This ability to check in and out any time you like is a great attraction to the part-time trader.

How Is Money Made in FOREX?

In the next section, I list most of the reasons people trade currencies. But the most common reason is the potential to make a large profit with a small grubstake. Note that I said *potential*—there is real risk involved.

Here is a simplified example:

Suppose I buy (go long) 10,000 EURUSD at 1.3550. If I am a U.S. trader, the broker will require me to place 2 percent of the value of the transaction in my account as margin. In some other countries, you might need to place as little .25 percent. If I already have a funded account, that amount will be held aside for this trade—it cannot be used as margin for another trade at the same time. My margin, for the purpose of this example, will be $200.00, which is 2 percent of 10,000.

In the next few days, the price of the EURUSD goes to 1.3650, a not untypical amount of price movement. I decide to liquidate my position. I

have made 100 pips. On a 10,000 mini lot, each pip, the minimum price change, is $1.00. Thus, I profited by $100.00.

Not much in dollars, perhaps. But when margin cost of $200 is factored in, I made a 50 percent profit in a few days.

Leverage, the ability to control a large amount of an investment with a small margin, can be a very powerful tool. But like a fast sports car, it can be very dangerous if you have not acquired the skill set to handle it, or if you simply become careless.

Why Trade Foreign Currencies?

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

- *No commissions.* No clearing fees, no exchange fees, no government fees, and no brokerage fees if you trade with a market maker.
- *No middlemen.* Spot currency trading does away with the middlemen and allows clients to interact directly with the market maker responsible for the pricing on a particular currency pair, if you trade with an electronic communications network (ECN).
- *Multiple lot sizes.* In the futures markets, lot or contract sizes are determined by the exchanges. A standard-size contract for silver futures is 5,000 ounces. Even a mini-contract of silver, 1,000 ounces, represents a value of approximately $30,000. In spot FOREX, the lot size can be appropriate for your grubstake. Common sizes are 1,000 units (micro), 10,000 units (mini), 100,000 units (standard), and 250,000 units (bank). This allows traders to effectively participate with accounts of well under $1,000. It also provides a significant money management tool for astute traders as well as for new participants to step up gradually as they gain skill and confidence. Some retail brokers have no fixed lot sizes at all; you might trade

two units or 12,445 units although almost everyone stays with the sizes mentioned here.

- *Low transaction cost.* The retail transaction cost (the bid-ask spread) is typically less than 0.1 percent under normal market conditions. At larger dealers, the spread could be as low as 0.05 percent. Prices are quoted in *pips* for currencies. Today pip spreads can be zero at some periods for the most actively traded pairs, but typically range from two to five pips for the majors. Pip spreads vary somewhat from broker to broker and also from trading session to trading session. The JPY pairs usually have the lowest during the Asian session, and highest during the North American session. But the variance on major pairs is slight; typically one or two pips.
- *High liquidity.* With an average trading volume of more than $4 trillion per day, FOREX is the most liquid market in the world. It means that a trader can enter or exit the market at will in almost any market condition, instantly. I must note that at the time of the first edition of *Getting Started in Currency Trading* in 2005, the daily volume was slightly less than $2 trillion.
- *Almost instantaneous transactions.* This is an advantageous byproduct of high liquidity. Your online order is filled as quickly as you can hit the buy or sell button on the trading platform.
- *Low margin, high leverage.* These factors increase the potential for higher profits (and losses) and are discussed later. Traders in some countries have access to leverage of up to 400 percent, although 50 percent to 100 percent is most common. 400:1 leverage means $1 controls $400 of currency. In the United States, the maximum leverage is now set to 50:1 for majors and 10:1 for exotics. Leverage was recently lowered for multiple reasons, as I discuss in Chapter 4, "Regulation: Past, Present, and Future."
- *A 24-hour market.* A trader can take advantage of all profitable market conditions at any time. There is no waiting for the opening bell. Markets are closed from Friday afternoon to Sunday afternoon. As the markets transition to the Asian session, they usually go quiet from 5 P.M. to 7 P.M. Eastern Standard Time. This can allow those busy with full-time careers and families to still find a little time here and there to learn and to trade. The author likes very much trading late at night, when it is the height of the European session but quiet as a mouse locally, at his home.
- *Not related to the stock market.* Trading in the FOREX market involves selling or buying one currency against another. Thus,

there is no hard correlation between the foreign currency market and the stock market, although both are measures of economic activity in some way and may be correlated in specific respects for a limited time. A *bull market* or a *bear market* for a currency is defined in terms of the outlook for its relative value against other currencies. If the outlook is positive, we have a bull market, in which a trader profits by buying the currency against other currencies. Conversely, if the outlook is pessimistic, we have a bull market for other currencies and traders take profits by selling the currency against other currencies. In either case, there is always a good market trading opportunity for a trader. Because currencies are relative, one cannot get too far away from another over long periods of time. This results in currency pairs actually trading in large bands. Although big price moves occur frequently, a crash is less likely to happen in currencies than stocks because a pair measures relative value. The U.S. Dollar (USD) can be in deep trouble, but so can the European Euro (EUR). The game is the ratio between the two. The top four traded currencies are: the U.S. Dollar (USD), the Euro Dollar (EUR), the Japanese Yen (JPY), and the British Pound (GBP). Fund managers are beginning to show interest in FOREX because of this lack of correlation with other investable instruments.

- *Interbank market.* The backbone of the FOREX market consists of a global network of dealers. They are mainly major commercial banks that communicate and trade with one another and with their clients through electronic networks and by telephone. There are no organized exchanges to serve as a central location to facilitate transactions the way the New York Stock Exchange serves the equity markets. The FOREX market operates in a manner similar to that of the NASDAQ market in the United States; thus, it is also referred to as an *over-the-counter* (OTC) market. The lack of a centralized exchange permeates all aspects of currency trading.
- *No one can corner the market.* The FOREX market is so vast and has so many participants that no single entity, not even a central bank, can control the market price for an extended time. Even interventions by mighty central banks are becoming increasingly ineffectual and short-lived. Thus, central banks are becoming less and less inclined to intervene to manipulate market prices. (You may remember the oil billionaire Hunt Brothers' attempt to corner the silver futures market in the late 1970s. Such disruptive excess, while not impossible, is much less likely in the FOREX markets.)

- *No insider trading.* Because of the FOREX market's size and decentralized nature, there is virtually no chance for ill effects caused by insider trading. Fraud possibilities, at least against the system as a whole, are significantly less than in any other financial instrument, as the interbank offers considerable redundancy.
- *Limited regulation.* There is but limited governmental influence through regulation in the FOREX markets, primarily because there is no centralized location or exchange. Of course, this is a sword that can cut both ways, but the author believes—with a hearty caveat emptor—less regulation is, on balance, an advantage. Nevertheless, most countries do have some regulatory say and more seems on the way. Regardless, fraud is always fraud wherever it is found and subject to criminal penalties in all countries. Regulatory bodies such as the Commodity Futures Trading Commission (CFTC) and National Futures Association (NFA) are now beginning to get a handle on some limited control of the retail FOREX business, much to the chagrin of many speculators, both large and small.
- *Online trading.* The capability of trading online was the impetus for retail FOREX in the late 1990s. Today, you can select from more than 200 online FOREX broker-dealers. Although none is perfect, the trader has a wide variety of options at his disposal.
- *Time frames.* The charts, which depict real-time currency prices, are usually shown as bars for a certain fixed period of time. The bars' vertical ends are the high and low for that time period. Short-term traders can use charts with five-minute chart bars and a position or long-term traders may use four-hour or one-day chart bars. Combining this capability with being able to trade whenever you want, as long as you want, and in any size you want, makes FOREX a space for just about everyone with an interest in participating in the global economy and financial machinery.
- *Volatility.* Currency pair prices move much—in frequency, rapidity, and duration. This should not be confused with liquidity, which relates to volume of transactions over a specified time. The more price movement in an investment vehicle, the more potential for profit—and loss. Most investors think of long, sustained trends when they imagine profitable opportunities. While these do occur in FOREX, there is actually more to be made in the volatile trading or sideways markets, which dominate the action 70 percent of the time.

- *Third-party products and services.* The immense popularity of retail FOREX has fostered a burgeoning industry of third-party products and services available to the FOREX trader.

What Tools Do I Need to Trade Currencies?

A computer with a reliable, high-speed connection to the Internet, a small grubstake, and the information in this book are all that are needed to begin trading currencies. These are the tools of the trade in retail FOREX. Patience can also be a virtue; something the fast-paced currency-trading world does not particularly foster.

You do not even need the grubstake to practice; a free demo account is offered by all retail FOREX brokers. In fact, I encourage you to open at least one demo account early in this book and use it as a learning tool before committing real funds to the market.

What Does It Cost to Trade Currencies?

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

Position sizing vis-à-vis your grubstake is an inherent learning tool in FOREX. You are encouraged to make good use of it in Chapter 21, "The 30-Trade Campaign Program."

Market-maker brokers take their expenses and profit by marking up the bid-ask spread. ECN brokers charge a flat lot fee to trade and have no spread markup. As an example, if you buy 100,000 EURUSD and the spread is two pips, you pay $20. ECN lot fees vary from $3 to $10 for a 100,000 lot. If you trade a larger lot size or trade often, you will be able to negotiate these costs. Most sophisticated traders prefer the ECN route. But if you trade very short term, a reliable market maker may be better, avoiding the lot fee.

The exact value of a pip varies based on the ratio of the specific currencies that constitute a pair. But $0.10/1,000, $1/10,000, $10/100,000, and

$25/250,000 are good round numbers to use for quick calculation in most instances.

FOREX versus Equities

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

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

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

FOREX versus Futures

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

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

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

The Commodity Futures Trading Commission (CFTC) authorizes futures exchanges to place daily limits on contracts that significantly hamper the ability to enter and exit the market at a selected price and time. No such limits exist in the FOREX market. When a surprise news announcement hits the currency markets, appropriate pairs will move as far as they need to reestablish a buyer-seller equilibrium.

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

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

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

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

Summary

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

Two important points to remember: (1) FOREX has no central clearinghouse and (2) a currency transaction is a spread between two currencies.

There are a wide variety of reasons to consider FOREX trading, including high leverage and low costs. The ability to set one's own trading times, lot sizes, and time frames makes it a something-for-everybody opportunity. Access to the FOREX markets on the Internet has resulted in a great deal of interest by small traders previously locked out of this enormous marketplace. Getting started requires only this book, a review of the FX landscape, a computer and Internet connection, and a small grubstake.