CHAPTER 1

Exploring the Currency Market

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Whether you trade stocks, commodities, currencies, or real estate on Mars, it is important to understand the marketplace in which you're working. If you have little market experience, if you're new to currencies, or if you want to brush up on market basics, this chapter is for you. This chapter does not contain an exhaustive history of the modern foreign exchange (forex) market. Instead, we look at the market from the perspective of an active trader. You will learn about the roots of the market, its structure and participants, how currency trades are executed, and the tools used to conduct business. If you have experience trading other markets, this chapter will brief you on the unique attributes of the currency market. If you have little or no experience in trading, the contents of this chapter are an essential part of learning the business of currency trading.

WHAT IS FOREX?

The currency market, or more specifically the forex market, derives its name from the generic term for*eign* ex*change market*. The forex market is a decentralized global network of trading partners, including banks, public and private institutions, retail dealers, speculators, and central banks involved in the business of buying and selling money. The forex market is a *spot market*, which means that it trades at the current market price as determined by supply and demand within the marketplace. This differs from currency futures traded on the commodity exchange in the United States,

which trades a contract price for delivery in the future. In the spot market you are trading cash for cash at the current market price.

The forex market is the largest, fastest-growing financial marketplace in the world. Every trading day the forex market handles a transaction volume of nearly $3.2 trillion, according to a survey done by the Triennial Central Bank in 2007. To put that figure in perspective, the average daily volume on the forex market is nearly 20 times larger than on the New York Stock Exchange. The need for foreign exchange is driven by travelers, multinational corporations, and governments. Tourists from the United States need euros for their European vacations; corporations such as Microsoft exchange profits made overseas into U.S. dollars. Governments hold reserve currencies and manipulate the money supply while they implement their monetary policies. The forex market was created to facilitate the sale of currency to customers who intend to take delivery of the currency; however, the vast majority of trading is done by speculators seeking nothing more than profit.

FOREX ROOTS

The roots of our modern forex market are an interesting topic that has been covered *ad nauseum* by other trading books; however, I do believe it is important to have some knowledge of the market's history, so this section covers the key points. If you have never studied global monetary systems, consider this section an abridged history of the forex market. The modern forex market's roots began with over-the-counter currency trading desks established by banks throughout the 1970s and 1980s, following the collapse of a postwar-era monetary system known as the *Bretton Woods system*. Bretton Woods was established in June 1944, as World War II came to a close. The Allied nations sought to establish a new monetary system to promote global investment and capitalism and to eliminate the challenges of a gold standard system.

Under the Bretton Woods monetary system, member nations agreed to value their currency at parity to gold ±1 percent and then set their exchange rate against the U.S. dollar. In exchange, the United States agreed to peg the dollar against a gold standard of $35 per ounce and guarantee its exchange for gold. This promise by the U.S. government effectively made the dollar a global payment standard instead of using a gold standard. The phrase "good as gold" was frequently used to describe the U.S. dollar under the Bretton Woods monetary system. Although the system worked to foster investment and capitalism, it also encouraged a tremendous outflow of dollars into overseas currency reserves. The world needed dollars to support a global payment system based on the dollar, and the United States

was content printing more money. The United States assumed it could balance the deficit with trade. Unfortunately, the outflow of capital finally caught up to the Unites States in 1950 and the country began posting a negative balance of payments, despite the government's best efforts to increase trade.

As inflationary concerns loomed on the horizon, the United States found itself in a difficult position. Failing to supply the global demand for dollars would bring the monetary system to its knees, whereas continuing to print money would eventually threaten to devalue the dollar. Confidence in the U.S. government's ability to maintain a gold match standard for the dollar began to wane, and speculation grew that a serious devaluation in the world's primary reserve currency was inevitable.

In August 1971, President Richard Nixon finally intervened by suspending the peg dollar had against gold. The Bretton Woods era of a fixed exchange rate system was over. Policy steps were taken to implement a *floating exchange rate system*, which is the cornerstone of today's modern forex market. In the 1970s trading desks were established among major banking institutions to facilitate currency transactions for major clients. This private trading arrangement was known as the *interbank*, a term still used today to describe the electronic trading arrangements among major banks, institutions, and currency dealers. Today prices are determined by the forces of supply and demand within the forex market, allowing traders to capitalize on small swings between the exchange rates of two currencies.

FOREX PARTICIPANTS

Forex has a diverse population of participants, ranging from Japanese housewives to powerful central bankers. The objectives of the participants differ, and their individual actions may have dramatic affects on the market. It is important to remember that the forex market is an off-exchange marketplace; there is no central exchange where all orders are cleared, as on the New York Stock Exchange or the Chicago Mercantile Exchange. The bulk of trading is done between trading partners on the interbank; however, small retail traders are unable to trade directly with partners on the interbank. Therefore, some participants in the forex market exist to create a marketplace for others. Currency dealers create a market for smaller retail speculators and offset their risk by trading with their larger partners on the interbank. The hierarchy of forex participants is illustrated in Figure 1.1. There is a definite food chain among forex market participants, with interbank members on top and retail speculators on the bottom.

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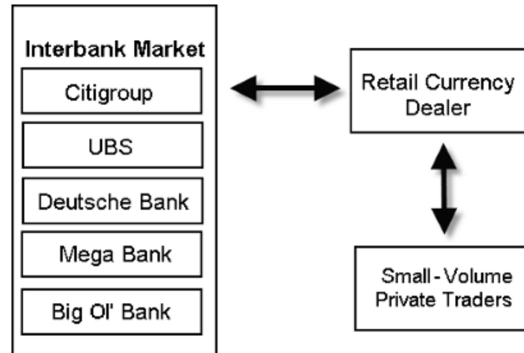

FIGURE 1.1 The Flow of Forex Market Participants

The Interbank

Interbank is a loose term held over from the early days when banks traded for clients and themselves over the telephone. Today trading is conducted electronically, with quotes from buyers and sellers matched up on the interbank market automatically. Many interbank members act as market makers for the currency pairs traded on the spot currency market and offer the quotes that ultimately drive the pricing you see in your trading software. Among the largest market makers on the interbank are banking giants such as Citigroup, UBS, Goldman Sachs, and Deutsche Bank. Lehman Brothers was a major interbank market maker prior to its demise in September 2008.

Participants on the interbank are big-dollar players, since the lowest accepted trade size is set at an even $1 million. It isn't uncommon for orders larger than $100 million to be executed on the spot forex market due to the global size and liquidity of the interbank market. Many banking participants on the interbank fill orders for customers who actually intend to take delivery of the currency being traded; however, most interbank members also trade the bank's money as speculators attempting to make a profit just like any other currency trader. The advantage interbank market makers have over a regular retail trader is access to order flow information. If you are the market maker and you see all the orders, you have insider information about the direction of the prices. Taking a trade against that information provides a significant source of revenue for many financial institutions.

Interbank members trade only with partners with which they have arranged credit agreements. This is an important point to understand because it affects the pricing you receive from your currency dealer. The quotes flowing from interbank trading partners ultimately drive the pricing you see through your currency dealer's trading software. The more trading partners a dealer has, the more quotes at which they can execute a

trade, resulting in more competitive pricing for you. You should look for a currency dealer with multiple liquidity feeds.

Institutional Traders

Institutional traders represent corporations or hedge funds trading directly on the interbank or through retail currency dealers. Hedge funds may participate as speculators while corporations participate to protect their interests against exchange risk. Corporations conducting business globally face a potential issue of fast-moving exchange rates, devaluing their profits made overseas. These corporations may participate in the currency market by hedging their risk directly in the currency market rather than waiting for a bank to exchange the currency for them. Most institutional traders representing corporations are involved in some kind of hedge to protect the value of their goods or services from exchange-related risks. Institutional traders may include professional money managers looking to diversify and hedge against the risk of loss in the equities market.

Central Banks

Central banks play an important role in guiding the forces of supply and demand for a country's currency on the forex market. Their monetary policy statements, interest rate decisions, and ability to intervene in the forex market should make every trader pay close attention to their actions. Central banks are also tasked with controlling the money supply of a nation's currency, which directly affects supply and demand. Low supply and high demand tend to increase the value of a nation's currency, whereas high supply and low demand will devalue it. Balancing growth with inflation is the typical goal of central bank policies. Central banks may also change their overnight lending rates as a tool against inflationary pressures. The interest rate set by a central bank can influence the value of a currency based on yield. The higher the central bank rate, the higher becomes the yield for holding that currency, influencing demand.

Table 1.1 lists the central banks and their Internet addresses for major currencies traded on the forex market.

Retail Currency Dealers

The average retail trader doesn't have the credit or capital required to participate directly with interbank trading partners. Retail currency dealers act as market makers for small-volume currency traders. Currency dealers manage their risk by balancing their portfolios of retail orders among the customers for which they are making a market. When they are overexposed to market risk due to an imbalance of short or long orders, they

TABLE 1.1 Central Banks around the World

Currency	Central Bank	Web site
United States dollar	The Federal Reserve Bank	www.federalreserve.gov
Great Britain pound	Bank of England	www.bankofengland.co.uk
Euro	The European Central Bank	www.ecb.int
Canadian dollar	Bank of Canada	www.bank-banque-canada.ca
Australian dollar	Reserve Bank of Australia	www.rba.gov.au
Japanese yen	Bank of Japan	www.boj.or.jp www.boj.or.jp/en
New Zealand dollar	Reserve Bank of New Zealand	www.rbnz.govt.nz

offset their risk by taking positions with their trading partners on the interbank. It is important to understand that currency dealers do not operate the same way stockbrokers do. The spot currency market does not have an exchange; therefore, the currency dealer often fills a customer's order by itself assuming the risk. This is commonly known as *taking the other side of the trade*. In other words, the currency dealer is betting against your ability to make money. If you lose, the dealer wins and collects the spread for doing the transaction. This is significantly different from a stockbroker, who is paid a commission for brokering your order to the exchange, where it is matched with an anonymous third-party order on the exchange.

There is an inherent conflict of interest when your dealer is profiting by taking the other side of your trade. Traders have historically complained about poor order execution, excessive quoting, or stops being "gunned," and there is probably some basis for these complaints. Forex after all is an unregulated market, and shady dealers do exist. Currency dealers are aware of these perceptions as well and are now marketing *no dealing desk execution* or *direct interbank trading* as an alternative order execution strategy to taking the other side of the trade. These trading platforms suggest the dealer is not involved with your trade, and passes the order directly to a trading partner. Whether every order is matched anonymously or not is a matter of trust, but it doesn't hurt to do business with a dealer who offers an alternative to taking the other side of every trade.

Retail Speculators

Retail speculators may be trading their own account or client funds through a managed account program. Some speculators at the retail level may be trading for clients looking to hedge risks; however, most are looking to generate profit. Retail speculators are too small to trade directly on the interbank and clear their trades through one of the many retail dealers available to make a small-volume market for them. For the most part,

retail speculators represent people like you and me, trading small-volume accounts purely for the sake of making a profit. The number of retail speculators involved in forex worldwide continues to grow as the popularity of currency trading grows.

FOREX VERSUS EXCHANGE MARKETS

The forex market is not structured like a traditional exchange market such as the New York Stock Exchange or the Chicago Mercantile Exchange. Forex is a decentralized global marketplace where trades are cleared one on one between trading partners. There is no central exchange, no pit full of yelling traders, no big board of quotes on a New York street, and no closing bell to ring. The pros and cons of an exchange-based market versus off-exchange currency trading are debatable, but there are obvious differences you should understand before trading in the forex market.

No Transparency

One clear advantage of an exchange-based market over off-exchange currency trading is the transparency the exchange offers traders about the market. Exchanges clear every trade through a central exchange, allowing them to provide traders with a wealth of information about the market activity. Common tools such as order flow and volume data are displayed on trader's charts, allowing them to gauge the strength or weakness of price moves throughout the trading day.

Because the forex market is decentralized, there is little data available on market activity. Market makers and retail dealers typically do not share their order flow data, and those that do only represent their trading desk activity and not the forex market at large. Volume is another popular indicator used by stock and commodity traders on exchange markets that is unavailable in the forex market because there is no central exchange on which to measure volume. Currency traders must learn on their own to read price action through their charts, without the aid of exchange-based indicators.

Little Regulation

The forex market has been known as the "Wild West" of financial markets due to the lack of regulatory oversight. The global nature of the forex market presents a problem for local government agencies to police trading activity around the world. Currently there are no regulatory requirements for an institution to establish itself as an interbank participant; however, any reputable retail currency dealer will register voluntarily with the

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local regulatory agencies. We already pointed out the CFTC has new regulatory authority over the off-exchange retail currency market through the 2009 Farm Bill. As I write this, the CFTC is proposing new regulations that would require all dealers to register as members of the NFA.

In the United States, the National Futures Association (NFA) has begun implementing rules designed to protect currency traders, although some of its recent decisions have been met with skepticism. In 2009, the NFA banned a practice known as *hedging*, which allowed a currency trader to maintain opposite positions in the same currency pair, and implemented order execution rules, forcing changes in some dealers' trading platforms. Although the rules are designed to make trading operate closer to the futures and equity markets, some traders resent the presence of regulators making changes to a market that has been self-regulated since its creation.

No Trading Restrictions

Freedom to trade in whichever direction you see fit at any time you see fit is a key feature of the forex market. For years the Securities and Exchange Commission (SEC) enforced a rule against short-selling stocks known as the *uptick rule*. The uptick rule attempted to prevent speculators from intentionally driving down the value of a stock with relentless short selling. Under the uptick rule a trader could only sell a stock if the current price was above the sale price, or on an "uptick." Once a stock was falling, traders could not sell the stock again until the next uptick. Although the uptick rule was suspended in June 2007, there have been plenty of calls to reinstate it following the relentless stock market selling in 2008 and 2009. The forex market has no restrictions on trading. If you believe the euro will fall against the dollar, you can sell it without restrictions. Currency traders are able to move in and out of positions freely, without an uptick rule or other regulatory restrictions.

Having no restrictions on trading can also be a negative factor of the forex market. Since the market is unregulated and there are no restrictions on trading activity, the environment for manipulation exists. An extreme example of manipulation is the intervention by central banks. *Intervention* is a process of buying or selling tremendous amounts of currency to manipulate the exchange rate. The Bank of Japan has a history of intervening in the yen when its central bankers are displeased with the exchange rate. Manipulation can take many forms, from intervention to requoting a trader's order to favor the dealer's books. You should be aware of the risks involved with trading off-exchange in the spot market before you commit any live money to a trade. It's called the Wild West of trading for good reason.

Contract Flexibility

Trading on exchange-based markets and the forex market is conducted in standard contract or lot sizes. Unlike the exchange-based market, the forex market doesn't set restrictions on the size of a single contract. Theoretically you could place a single trade worth $1,384,284,927,944.01, assuming that you can find someone able and willing to take the other side of your trade—Dr. Evil, perhaps? Currency dealers on the retail market have carved up a standard $1 million interbank lot into three smaller lot sizes accessible to smaller retail traders, known as *standard lots*, *mini lots*, and *micro lots*.

Standard lots on the retail side of the currency market are equal to 100,000 units of the base currency. Mini lots are equal to 10,000 units of the base currency; micro lots are equal to 1,000 units of the base currency. Some currency dealers even offer trades in single units, allowing a trader to place an order for 13,428 units rather than a conventional lot size. This gives the trader very precise position sizing capability that's unavailable in traditional exchange-based markets. A unit might be a single dollar, euro, yen, or whatever the denomination of your account. For example, a trade of 10,000 units is synonymous with a $10,000 position if your account is denominated in U.S. dollars.

Micro accounts offer new traders the ability to trade real money without placing a tremendous amount of money at risk. Typically a micro account measures profit and loss in terms of a single dollar per pip or even less, depending on the margin requirement deployed. These small lots are a great place for a new trader to cut his teeth on live money trading once he has demonstrated he can trade profitably on a demo account. They are also useful accounts for testing theories with a live money account. I keep a micro account with less than $1,000 in it for testing strategies on live markets with live money. Overall, micro accounts are a great option to get started with, even if you have $100,000.

Transaction Costs

Currency dealers heavily advertise that there are no commissions for trading currency, but that doesn't mean the forex market is cheap to trade. Currency dealers earn their money through the *spread*, which is the difference between the price at which a dealer will sell a currency and the price at which the dealer is willing to buy it back. For most major currency pairs, the spread is very small, but the costs associated with that spread vary depending on the margin and leverage your account has used.

You'll learn more about currency pricing shortly, but for now understand that the transaction costs of trading currency on the forex market

TABLE 1.2 Transaction Costs Across Market Types

Trade Type	Commission or Spread	Contracts Traded	Total Transaction Cost
Common stocks	$9.95 per leg	10	$19.90
Options	$12.95 per leg	10	$25.90
Currency futures	$3.50 per contract	10	$35.00
Currency (forex)	Two-pip spread $10.00 per pip	10	$200.00

can be significant. For traders who trade frequently, transaction costs can be a significant amount of money to overcome to reach profitability. Fortunately the forex market is a fast-moving one, and once you clear the price of the spread there are no further transaction costs. The more interbank trading partners a currency dealer has, the better that dealer's pricing will be. Dealers with more than one or two interbank partners are able to take advantage of more quotes and pass them on to you.

Table 1.2 illustrates the difference in transaction costs for trading 10 different contracts across various market types. Although there is no commission, the forex market is certainly not a cheap market to trade. These prices were taken from the published commissions of a major broker's web site. The cost of the currency spread assumes a euro/U.S. dollar transaction using leverage of 100:1.

Trading Hours

The forex market is a global marketplace and trades 24 hours a day, five days a week. This around-the-clock trading environment is not unique to the forex market but certainly does make it easier to manage trades around a schedule that fits your lifestyle rather than certain market hours. In the United States the forex market begins trading Sunday evening as Asian markets open for business and continues to trade until the New York markets close on Friday afternoon. However, just because the market is open 24 hours a day doesn't necessarily mean anything interesting is happening.

There are three major trading sessions that account for the majority of volume seen throughout the trading day. The largest trading session by volume is the London session. London is uniquely positioned in a time zone that's open for business during work hours stretching from Dubai to New York. The London trading session accounts for the most price action and volume in the forex market by a long shot. New York follows London as the second largest trading session; Tokyo, or the Asian trading session, rounds out the top three.

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TABLE 1.3 Trading Session Timetable

Trading Session	Open	Close
London	3:00 a.m.	12:00 p.m.
New York	8:00 a.m.	5:00 p.m.
Tokyo	7:00 p.m.	4:00 a.m.

Table 1.3 lists the three major trading sessions in the forex market and the times during which they are active. The times are listed in Eastern Standard Time.

Many trading strategies depend on the activity seen during the higher-volume trading sessions. For many traders who work at day jobs, it is impractical to trade during a trading session that happens while they sleep or are at work. This book focuses on placing trades around supply and demand levels during the quiet times of the market, around your schedule. It is better to plan and enter long-term trades during the quiet hours of the market and leave the trading sessions to day traders who enjoy staring at charts all day.

TRADE MECHANICS

Trading currency is a process of exchanging one currency for another, so each currency trade is actually two transactions happening at the same time. One currency is bought while the other is sold. The forex market quotes prices as currency pairs to facilitate the ease of trading one currency for another. The quote of a currency pair represents the number of units of one currency that are required to buy or sell the equivalent amount of the other, based on the given exchange rate. For example, if the exchange rate between the U.S. dollar and the Canadian dollar is $1.12, a trader may purchase 1.12 Canadian dollars for every one U.S. dollar, or she can buy one dollar for every 1.12 Canadian dollars. Your goal as a currency trader is to hold the currency you believe will gain value against the other currency quoted in the pair. It really is as simple as that.

Currency Pairs

Each currency pair is made up of two parts: the base currency and the quote currency. For example, the U.S. dollar/Canadian dollar example we just discussed is paired as USD/CAD. The base currency is always to the left of the slash (/) mark; the quoted currency is always to the right of

TABLE 1.4 Currency Pair Basics

Country	Currency	ISO Code	Nickname
United States	Dollar	USD	Buck or greenback
European Union	Euro	EUR	Fiber
Great Britain	Pound	GBP	Cable or sterling
Switzerland	Franc	CHF	Swissy
Australia	Dollar	AUD	Aussie
New Zealand	Dollar	NZD	Kiwi
Canada	Dollar	CAD	Loonie
South Africa	Rand	ZAR	
Singapore	Dollar	SGD	
Denmark	Krone	DKK	
Poland	Zloty	PLN	

the slash. It is the direction of the base currency you consider when deciding whether to buy a currency pair or sell it. If you believe the base currency will appreciate against the quoted currency, you will buy the currency pair. If you believe the base currency will depreciate against the quoted currency, you will sell the currency pair. This is an important distinction for new traders to remember because it is easy to buy by accident when you meant to sell. Currency pairs offered on the forex market are constructed using currency from both developed and emerging markets.

Table 1.4 lists the most common currencies, their countries, and their International Standards Organization (ISO) codes used in the forex market to construct currency pairs.

Major Pairs Major currency pairs are created by pairing currencies from countries with highly developed economies and financial systems. Major currency pairs are the most liquid and heavily traded currency pairs on the forex market. Currencies among the majors include the euro, U.S. dollar, British pound, Swiss franc, Japanese yen, Australian dollar, and Canadian dollar.

Cross-Pairs Some currencies are not directly quoted against each other; rather, they are synthetically traded by combining two different pairs. These pairs, known as *cross-pairs*, include currency pairs such as GBP/JPY, EUR/JPY, EUR/CHF, and GBP/CHF. When a trader executes a trade to buy GBP/JPY, the trade is really constructed by buying GBP/USD and selling USD/JPY. The dollar component of this trade is equaled out and the trader ends up long GBP and short JPY. Because these pairs are constructed with two different currency pairs, the spread or cost to trade a

cross-pair is significantly more than a typical major currency pair, such as EUR/USD.

Currency Lots

Currencies are traded in standard lot sizes to facilitate efficient trading on the forex market. The standard retail lot is 100,000 units of the base currency. Most currency dealers offer 10,000-unit mini lots and 1,000-unit micro lots. Some currency dealers offer a 100-unit nano lot. Positions can be sized larger by purchasing multiple lots. Fortunately, you don't actually need $100,000 in your trading account to buy a single standard currency lot. Currency dealers offer various levels of leverage, allowing you to control full-sized lots with significantly less capital in your account. We discuss margin and leverage later in this chapter.

How a Currency Trade Works

The way a currency is simultaneously bought and sold during a trade is confusing for many new traders, so an example will help clarify what happens under the hood of a currency trade. Assume for a minute that you are interested in buying the British pound against the U.S. dollar, which is listed as GBP/USD in your trading software. The base pair is the British pound; the quoted pair is the U.S. dollar. If the quoted exchange rate is $1.59 and you are trading one standard lot of currency, it will require 159,000 dollars to buy one British pound, or it will require selling 100,000 pounds to buy 159,000 dollars. Since we are interested in buying the pound, we want the exchange rate to increase, allowing us to sell our pounds at a higher rate for more dollars than we sold to buy the original 100,000 pounds. As an example, Table 1.5 illustrates how a currency trader realizes a profit or a loss using a single standard lot GBP/USD currency trade.

What Is a Pip? The term *pip* is an acronym for *percentage in points* and is used to measure the change in exchange rates on the forex market. A single pip represents the smallest possible decimal change a currency quote may move, and it is the standard on which profit and loss are calculated. Currencies are quoted in decimal format to 1/1,000th of a percent unless the currency pair contains the Japanese yen. Currencies quoted against the Japanese yen are in decimal format to 1/100th of a percent. Using a quote for GBP/USD as an example, a change in price from $1.5600 to $1.5650 represents a change of 50 pips.

Long versus Short The terms *long* and *short* simply refer to the position a trader has taken with a trade; the trader has either bought or sold it.

TABLE 1.5 Mechanics of a GBP/USD Currency Trade

Explanation	British Pound Position	U.S. Dollar Position
You believe that the British pound will appreciate against the U.S. dollar, so you purchase one standard GBP/USD lot at an exchange rate of $1.5900.	+100,000 (You've bought 100,000 pounds)	−159,000 (You've sold $159,000 to buy 100,000 pounds using an exchange rate of 1.59 × 100,000)
If the British pound does appreciate to a higher exchange rate, such as $1.6150, you can sell the pound and buy dollars, receiving a profit.	−100,000 (You sold 100,000 pounds)	+161,500 (Because the pound increased in value, you have earned a profit in dollars of $2,500)
If the pound depreciates in value to a lower exchange rate of $1.5650, you can sell the pound but you will receive fewer dollars, resulting in a loss.	−100,000 (You sold 100,000 pounds)	+156,500 (Because the pound decreased in value, you receive fewer dollars, resulting in a loss of $2,500)

The term *long* simply means that you have bought the currency; the term *short* means you have sold it. For example, if a trader decides to buy GBP/USD, it means she has gone long British pounds and short U.S. dollars because she has bought the GBP and sold the USD.

Understanding Currency Quotes

In the forex market, all price quotes are represented by two prices, known as the *bid price* and the *ask price*. Both the bid price and ask price represent the exchange rate of the base currency pair against the quoted pair, except they serve two different functions. The bid price indicates the price at which your currency dealer is willing to buy the base currency from you in exchange for the quoted currency. The ask price indicates the price at which your currency dealer is willing to sell you the base pair in exchange for the quoted currency. There is always a difference between the bid price and the ask price; this difference is known as the *spread*. The spread is

Symbol	Bid	Ask
EUR≠USD	1.4000	1.4002
USD≠JPY	94.80	94.83
GBP≠USD	1.5905	1.5909
USD≠CHF	1.0845	1.0849
USD≠CAD	1.1200	1.1205
AUD≠USD	0.7838	0.7843
NZD≠USD	0.6205	0.6210
EUR≠JPY	132.74	132.78

FIGURE 1.2 Understanding Price Spreads
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

usually less than five pips on major currency pairs. Cross-currency pairs such as GBP/JPY may have much higher spreads. The spread is the way a currency dealer earns money for executing a trade.

Figure 1.2 shows the difference between the bid and ask prices offered in the forex market. The difference between the two prices is known as the *spread*.

Using the prices quoted in Figure 1.2, if a trader wanted to buy EUR/USD, his currency dealer would sell it to him using the ask price of $1.4002. To sell the position at least at breakeven, the trader needs the bid price to move up two pips, to $1.4002. Alternatively, if a trader wanted to sell the EUR/USD, the currency dealer would sell it to him at the bid price of $1.4000 and the trader would need the market to fall by two pips before he could sell it at the ask price for a breakeven trade. The two-pip spread in this EUR/USD example is the cost of doing business with this currency dealer.

ORDER TYPES

At some point you will have to place an order with your dealer to make any money in the currency market. Opening, closing, and managing trades are accomplished through four different order types. Market orders, entry orders, stop orders, and limit orders all serve a specific role in trading on the forex market. The implementation of each order type is slightly different among currency brokers. Ensure that you have a firm grasp on how to use your dealer's software before you trade with real money.

Market Orders

When you need to get in or out of a position quickly, the *market order* is the right tool for the job. Market orders instruct your currency dealer to execute a trade at the current bid or ask price. Execution of market orders is nearly instant on most trading platforms, so a trader must be absolutely sure he wants to enter the market before submitting a market order. Market orders are not a guaranteed price, however, and your order may be filled at another price if the market is moving quickly. Receiving a price at which you did not intend to be filled is known as *slippage*, and though it is quite rare under normal market conditions, it does happen.

If the market is moving quickly, the broker may quote a new price to confirm whether the trader is still interested in filling the order at the new price. This process of submitting an order only to be quoted a new price over and over in a fast-moving market can be frustrating. Some currency dealers offer a *fill at best price* option, which allows the trader to choose a price range that's acceptable to fill the order. Assume that you would like to buy the EUR/USD at $1.4950, but the market price is changing quickly. If you do not want your dealer to quote you again when the price changes, you can specify a price range, allowing your dealer to fill the order at any price within that range. In this case, if you specified a range of 10 pips, your market order could be executed anywhere between $1.4945 and $1.4955.

Entry Orders

Entry orders instruct your currency dealer to buy or sell a currency automatically when the market reaches the price you have specified. The order should be filled at the price specified or better, as long as the new price favors your intended position. Entry orders are an important tool because they allow you to place trades on your own time schedule and have them execute automatically when you are not present. Figure 1.3 demonstrates the use of an entry order to sell the EUR/USD along a line of resistance using the hourly chart. Entry orders come in two flavors, depending on your currency dealer's technology.

Stop Orders

Limiting the amount of money lost when a trade goes bad is critical to your long-term success. *Stop orders* are placed to automatically close a trade that is not going your way. Stop orders are a form of entry order that is executed at the price specified or at the best possible price once the

FIGURE 1.3 Placing Entry Orders
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

specified price has been reached. Stops can also be used to protect profit or reduce risk as a trade moves in your favor.

Figure 1.4 builds on the entry order example shown in Figure 1.3 by illustrating where a stop order could have been placed. Managing risk and using stop orders are discussed in detail in Chapter 4.

Limit Orders

Limit orders function in the opposite way of stop orders. Limit orders are used to close a position at a profit once a specified price has been reached. Limit orders are useful to preserve profit when a trader is unable to manage a position in real time. Figure 1.5 completes our EUR/USD example by taking profit with a limit order near the round number of $1.4700. Using a limit order ensures that this trade will be closed at a profit, even if the trader is unavailable when the market reaches her intended profit target. Many

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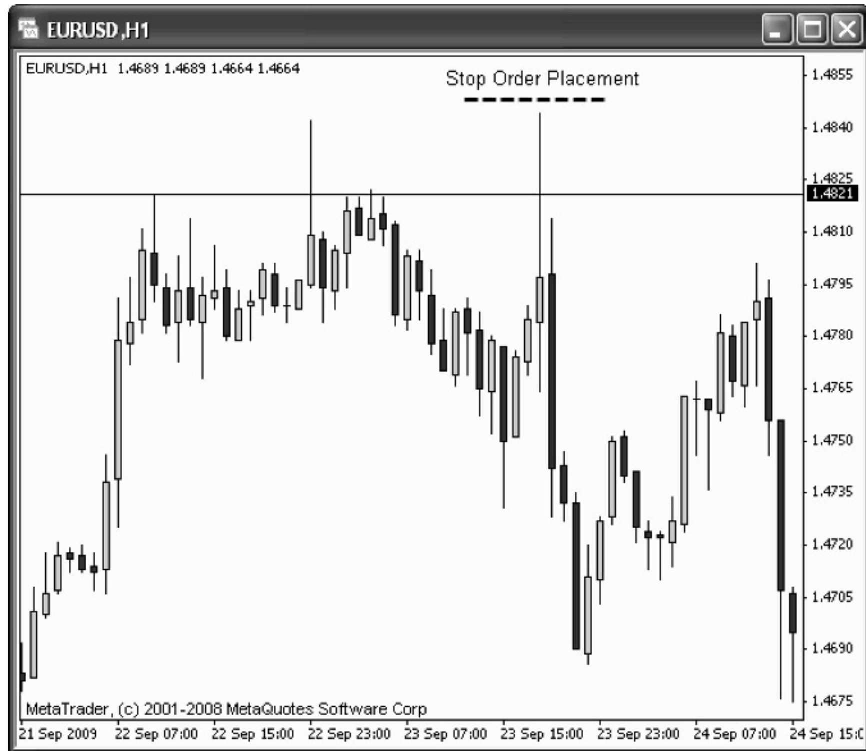

FIGURE 1.4 Placing Stop Orders
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

trading strategies rely on limit orders to manage profits, although some traders balk at the idea of cutting a winning trade short. The use of limit orders and managing profit are discussed thoroughly in Chapter 5.

MARGIN AND LEVERAGE

Currency is traded in lot sizes ranging from 100- to 100,000-unit lots on the retail spot market. Remember that a unit of currency could be a dollar, euro, pound, or whatever your account denomination. By trading multiple lots, a currency trader can hold a position of virtually any size, provided that she has the capital to match it unit for unit. Of course, investing in a single 100,000 lot is not practical for most retail traders, and even if you could, why would you? It would be an extremely inefficient use of capital to tie up 100,000 units in one standard currency lot.

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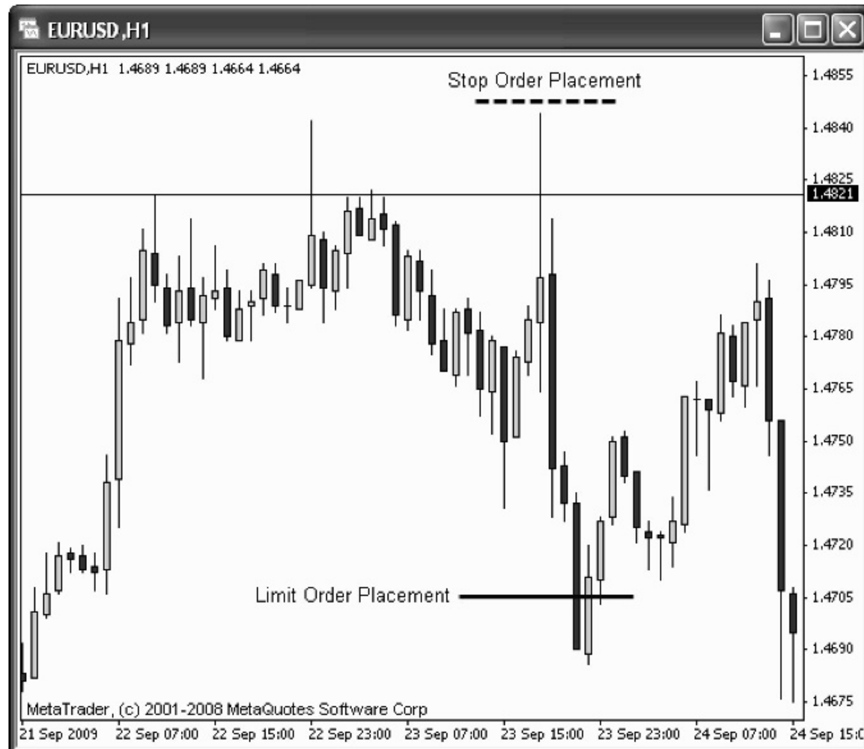

FIGURE 1.5 Placing Limit Orders
MetaTrader, © 2001–2008 MetaQuotes Software Corp.

Currency is typically traded through a *margin account*, which allows you to control a position much larger than the capital you have in your account. Margin and leverage are important tools that are, unfortunately, misunderstood by many traders. In this section we discuss what margin is, how leverage works, and how leverage affects risk.

What Is Margin?

Margin is represented by the percentage of capital required to maintain an open currency position with your currency dealer. The margin amount represents a good-faith deposit to the dealer that you are creditworthy for the full amount of the position you are trading. Many traders believe margin is actually part of the currency you are trading, but it is not. Your currency dealer loans you the full position size in return for your good-faith deposit, represented by the margin amount. The percentage is usually fixed across

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many currency pairs, although some illiquid or exotic currencies may have higher margin requirements. If your currency dealer requires a 1 percent margin and you open a 100,000-unit trade, your margin requirement to keep this position open is 1,000 units of currency in your account.

If your account balance falls below the required margin amount, your currency dealer will usually liquidate all open positions to avoid further losses. This process is known as a *margin call*. Although margin calls are painful, they actually protect you from owing the dealer money on a position that has gone bad. Without automatic margin calls, your account could fall into a negative balance and you would owe the dealer money to cover his losses. Talk about pouring salt in the wound! Maintaining an account balance large enough to manage normal market losses without approaching your margin requirements is a crucial step in money management. Most currency trading platforms will calculate your usable margin and used margin in real time to ensure that you always know where your account stands in relation to the margin requirements on open trades.

What Is Leverage?

Leverage is simply a function of the margin you are required to maintain for each trade. Leverage is measured in a ratio format such as 100:1 or 25:1. For example, if your margin requirement is 1 percent on a $10,000 trade, you must maintain at least $100 in your account to keep that position open. This represents 100:1 leverage because you control $100 for every $1 in your trading account. Some dealers advertise that they allow leverage as high as 700:1; however, using that amount of leverage on every trade might not be suitable for all traders.

Table 1.6 illustrates how leverage and margin work together. Assuming that a trader buys one standard currency lot worth $100,000, the leverage amount varies depending on the trader's margin requirement. As margin requirements are increased, leverage is decreased.

TABLE 1.6 The Relationship between Leverage and Margin Requirements

Margin	Margin Required	Leverage Ratio
0.5%	$500	200:1
1%	$1,000	100:1
5%	$5,000	20:1
10%	$10,000	10:1

TABLE 1.7 The Effect of Margin on Available Account Balances

Account Balance	Open Lots	Margin Required	Available Balance
$500	Four $10,000 lots	$400	$100
$500	Five $1,000 lots	$50	$450
$50,000	Ten $100,000 lots	$10,000	$40,000

The Effects of Margin and Leverage on Risk

Margin and leverage affect risk in different ways. Margin requirements climb as you accumulate open positions, which could leave your account at risk for a margin call, even when the individual positions are small. This is a death-by-1,000-cuts scenario because you have over leveraged your account with small trades to the point that there is no room between margin requirements and your account balance.

Table 1.7 illustrates how fast a trader with a small account can get herself into trouble by opening too many positions. The trader with $500 who opened four $10,000 positions left herself with only $100 to absorb any market losses that occur during the life of that trade. You must understand how much margin will be consumed by a trade before you open it or you could find yourself without sufficient usable capital to maintain it before a margin call occurs.

Smaller accounts should consider using no more than 100:1 leverage, whereas conservative trades may consider raising their margin requirements to bring leverage down to 25:1 or 10:1. Understanding how margin and leverage will affect your positions is crucial to surviving as a currency trader. Opening too many trades or using too much leverage with large trade sizes is sure to wipe out your trading account before winning trades can grow it.

EARNING INTEREST

The currency market is designed to facilitate the trade of money between two parties interested in actually delivering the currency being traded. The contracts traded on the spot market are designed to settle within two business days. Since most currency trades are speculative and traders do not want an armored car full of money to show up at their house, currency dealers automatically expire open positions and roll their settlement date

forward two more business days. This process, known as the *rollover*, takes place at the end of each trading day, around 5:00 P.M. Eastern Time.

Avoiding settlement is just one benefit; the rollover process also settles interest payments to your account, depending on your open positions. Earning interest for simply holding a position open is a benefit of trading money. Each currency pair has an associated *cost-of-carry premium*, which is either positive to your account or negative, depending on whether you are long or short. The premium is determined roughly from the central bank rates in the currency's home country. For example, if you are long AUD/USD while the central bank rate in Australia is 3.5 percent and the central bank rate in the United States is 0.25 percent, you should expect to be paid some of the difference between these two interest rates as calculated on the total size of your open trade. If you were short AUD/USD in this example, you should expect the difference to be debited to your account. There are some variables that affect the actual interest payment paid or charged to your account.

The actual interest rate used to calculate carry premiums is the *London Interbank Offered Rate* (*LIBOR*). This short-term interest rate is a benchmark rate maintained on 10 currencies by the British Bankers Association (BBA). The rates are determined through a survey process conducted by the BBA of 8 to 16 contributing banks per currency. The survey determines the lowest average rate at which banks are willing to borrow funds overnight and performs a calculation on that data to determine the LIBOR. The difference in LIBOR rates between two currencies determines the base cost of carry for your open position in the forex market. If you are interested in the specific details of how LIBOR is calculated, I recommend you visit the LIBOR web site at www.bbalibor.com.

Let's look at an example to understand how the carry premium is calculated using the LIBOR during the nightly rollover.

Assume that you have bought 100,000 units of GBP/USD. In this trade you are buying the British pound and selling the U.S. dollar. If the LIBOR for GBP is 2.4775 percent and the LIBOR for USD is 2.07 percent, the difference between the two currencies is 0.4075 percent. The difference is multiplied by your total position size, in this case, $100{,}000 \times 0.004075$, which equals 407.5 units of currency. LIBOR rates are annual yields; therefore, 407.5 represents the annual yield. Divide 407.5 by 360 days to determine the nightly interest premium, which is 1.13 units of currency. If the base currency in your trade is different than the currency your account is funded in, you must also multiply the interest payment by the currency exchange rate to convert the interest payment to your account's currency. The current GBP/USD exchange rate is $1.5928. The final calculation to convert 1.13 to dollars is 1.13×1.5928, which equals a final nightly premium of 1.79 units of currency.

The amount actually charged or credited to your position may vary by broker because many brokers derive income from the overnight swap payments before passing those rates on to you. Brokers routinely publish their swap rates for each currency and typically post them on their web sites. Traders should be aware of these rates and understand that holding a position against the carry could cause them to pay significant interest if they plan to hold the position open for a long period of time. Finally, traders should be aware that on Wednesdays the interest premium is triple the normal amount. This accounts for positions that are set to be settled on Saturdays or Sundays, when the market is essentially closed, by setting their valuation date to Mondays.

SELECTING A CURRENCY DEALER

The only partner a retail currency trader needs is a retail currency dealer. No two dealers are alike, so care should be taken to select the very best dealer as your trading partner. We discussed earlier that currency dealers are different from stockbrokers because they routinely assume the full risk of your trade and make the market for you rather than simply matching you with a counterparty on the exchange floor. Currency dealers will aggregate the positions they are holding for retail traders and offset their risk by trading with partners on the interbank. This arrangement requires great faith that the dealer is trustworthy and will not manipulate a retail trader's positions in the dealer's favor.

In this section we look at four key attributes you should evaluate before selecting a currency dealer. These attributes include a dealer's product offering, trading technology, regulatory status, and capitalization.

Product Offering

Currency dealers are a competitive bunch, and you will find that most have similar product offerings. Ensure that your broker offers multiple lot sizes, including standard, mini, micro, and even nano lots, but pay close attention to whether your broker allows flexible lot sizes in one single account. Some dealers lock micro accounts in their own group as a discount service and offer reduced customer service. Ensure that you understand which currency pairs are available and whether they are available for your account type. Many dealers do not offer the same currency pairs for a mini account as they do for a standard account.

In this same category, it's important to understand the dealer's policy on interest rate swaps. You may be able to get a better payment on interest

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if you call the dealer and ask for it. Take the time to compare the dealer's spread on each pair you intend to trade. The difference of a single pip can mean a difference of several hundred dollars in transaction costs over the long term. Many dealers also advertise guaranteed stop orders without slippage, but you must check the fine print to understand the restrictions. Many of these guarantees are suspended during times of high market volatility. Make sure that you read the fine print and understand your trading agreement.

No matter how good a dealer looks on paper, you should test-drive his customer service prior to opening an account. Call the dealer's customer service desks, use his online chat capability, and make sure they are prompt and accurate with their answers before sending them a dime of your trading capital. After all, an extra pip on the spread may be worth the added customer service you get from some dealers.

Finally, we already discussed how margin requirements affect your ability to apply leverage to your trading account, potentially increasing profits or losses. Although high leverage and low margin rates may seem attractive, you should be prudent and use good judgment to ensure that your margin is set at a level that allows you to sustain losses without wiping out your entire account. A good currency dealer will allow multiple levels of margin and allow you to customize your account settings as required.

Trading Platform

The trading platform offered by currency dealers varies from custom-built to third-party packages such as Meta Trader. If you are a long-term trader, you might not need many fancy features; however, if you are a day trader, instant execution and information about volume could be useful. You should test drive each currency dealer's platform by trading on a demo account until you find a trading station you're comfortable with and that you enjoy using. Some brokers have technology that's so difficult to use you'll be glad you took the demo account for a spin. Additionally, only a handful of brokers offer mobile trading technology. If you need the capability to trade directly through a handheld device, your choices will be limited to a handful of brokers for now.

Regulation

It is important to remember that forex is an unregulated market. Fortunately, in the United States the National Futures Association is beginning to require that dealers meet certain capital requirements in order to conduct business in the United States. Traders should seek out currency dealers who have registered themselves with the regulatory agency for the

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country in which they operate, ensuring they are trading with a currency dealer interested in regulatory oversight. Three of the major regulatory agencies are the National Futures Association (NFA) in the United States, the Financial Services Authority (FSA) in the United Kingdom, and the Australian Securities and Investments Commission (ASIC) in Australia. Any retail currency dealer worthy of your business will have registered with one of these regulatory agencies. If not, trader beware.

Capitalization

Currency dealers registered with a regulatory agency are required to maintain a minimum level of reserve capital to continue making a market for retail traders. The level of reserve capital maintained by a currency dealer has a direct impact on that dealer's ability to remain solvent. Having visibility to the reserve capital, a currency dealer allows traders to gauge the overall health of that dealer. In the United States the level of capital required was recently increased to $5 million, which helped clean out some undercapitalized and shady currency dealers from the marketplace. The CFTC is proposing these capital limits be increased to $20 million at the time of writing. Currency dealers registered with the NFA are required to report their net capital monthly, and the information is published on the NFA's web site at www.cftc.gov/marketreports/financialdataforfcms/index.htm.

I highly encourage you to visit this site monthly and monitor the health of your currency dealer as part of your plan to manage risk. In the United States, currency dealers are not required to segregate client funds from corporate funds, and many currency dealers have bankruptcy clauses in their trading agreements that will place you as a debtor to the currency dealer in the event of insolvency. Let me repeat that in case you are reading this before bed, because it is very important to understand: If your currency dealer goes bankrupt, your trading account may not be segregated from the general operating capital of the dealer. You will be treated as a creditor in bankruptcy court. You do not want to fight a bankruptcy court to get back your trading capital among a long line of unhappy creditors if your currency dealer goes bankrupt!

It is critical to trade only with well-capitalized dealers who are members of a regulatory agency that requires them to disclose their financial health so that you can gauge the solvency of your dealer. If you have a very large account, it might be in your best interest to trade with more than one broker or consider an account in the United Kingdom, where segregated accounts are required by law. Whatever you decide, read your trading agreement closely and always monitor the financial health of your currency dealer.

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CLOSING BELL

This chapter provided a crash course on the business of trading currency on the spot forex market. You should understand a bit of the market's history, how it is structured, and who the major participants are. The important points of this chapter are ensuring that you understand order types, leverage, and how to select a currency dealer. These three topics form the core mechanics necessary to be a successful trader. Ensure that you understand how to use each order type without stumbling through the dealer's software; it is easy to make a mistake if you are not paying close attention when you're placing a trade. You should understand how leverage works and how it can affect your account before you trade live money. I recommend demo trading using various configurations of leverage to ensure that you truly understand the damage leverage can do to an unmanaged account. Finally, we covered some key attributes you should investigate when you're selecting a currency dealer. The currency dealer is an important partner in the business of trading; selecting a good one who is financially stable is an important part of mitigating risk that many traders gloss over.