When Bad Turns To Good

An FX Strategy For Catching Falling Knives

When there's a considerable decline in a relatively short period of time, can that become a trading opportunity? It's all about timing, and you can't rush it. Here's how to go about it.

by Azeez Mustapha

The markets have a way of giving us surprise moves. That's what they are known for. When something unusual or unanticipated happens, especially if it goes against what the public is expecting, price moves strongly. That's when markets become volatile and can create havoc on your trading results.

This type of price movement is usually referred to as a "falling knife" and sometimes it can create trading opportunities, especially in the currency markets. But these types of moves can also be risky, so when you catch falling knives (as the saying goes), there are some factors you need to consider.

For starters, proper timing is important because, face it, when markets are falling, it is not unusual for traders to think a bottom has been reached. So what often happens is traders end up opening long positions and sometimes find that prices drop even further. How can you avoid getting into such a situation?

After an unusual bear currency market, it makes sense to open a long trade. It's almost like you're getting a deal. But the markets could continue lower, which is why you need to add an effective technical filter to help identify whether a shift in trend is indeed happening.

You need to make sure price has already turned up and is trending upward. I use the 20-period exponential moving average (EMA) on a four-hour chart to help me time my "falling knife" trades. If price is above the EMA 20 on the four-hour chart, it indicates that price is moving up. It's a good idea to look for the falling knife on a daily chart first before drilling down to the four-hour chart. This simple idea has helped me avoid many losing trades and take more winning trades.

Here's how I apply the strategy. A falling knife must have a minimum 1,000-pip drop within a few days, or preferably within 24 hours. Following a falling knife action, on

FALLING KNIFE GRAPHIC: MATTZ90/GBP NOTES: ALEXA ZARI/US BILLS: SVETLANA LUKENKO/ SHUTTERSTOCK/COLLAGE: CHRISTINE MORRISON a four-hour chart, I go long when price crosses the EMA 20 to the upside, closes above it, and forms a subsequent bullish candle.

Trade details

Stop: 250 pips
Target: 500 pips
Risk-to-reward ratio: 1:2
Position sizing: Use 0.01 lots for each $2,000 (that is, 0.05 lots for $10,000); or 0.1 lots for each 20,000 cents in a cent account (0.5 lots for each 100,000 cents).
Breakeven stop: Move stop to breakeven after about a gain of 100.
Trailing stop: No trailing stops used. This is to allow for volatility in the markets.
Max. trade duration: One month for each position
Exit rule: A position is left open until the stop or the breakeven stop or the target is hit; or until a period of one month has elapsed.

FIGURE 1: THE AUSSIE DURING A 2008 BEARISH MOVE. The AUD/USD dropped more than 3,810 pips from a high of 0.9849 to a low of 0.6008, which was followed by a recovery of 3,300 pips the following year. Many pairs and crosses also dropped significantly in 2008, creating opportunities for those who knew how to time good bullish setups.

Examples of falling knives

During the bear market of 2008, the Australian dollar/US dollar (AUD/USD) pair dropped more than 3,810 pips from a high of 0.9849 to a low of 0.6008. This was followed by a recovery of 3,300 pips the following year (Figure 1). A move like this could create opportunities for those who knew how to time good bullish signals.

In 2011 the earthquakes in Japan sent ripples across all financial markets. Forex markets were also hit, and this was evident especially on JPY pairs. In Figure 2, you see that the Canadian dollar/Japanese yen (CAD/JPY) declined by 8,300 pips, after which the market rallied by 12,400 pips.

FIGURE 2: CAD/JPY IN MARCH 2011—ANOTHER FALLING KNIFE. The 2011 earthquakes in Japan impacted the forex markets as can be seen in the Canadian dollar/Japanese yen cross. CAD/JPY declined by 8,300 pips, after which the market rallied by 12,400 pips.

In Figure 3 you see how the effect of the January 15, 2015 decision by the Swiss National Bank (SNB) to allow its currency to trade freely against the euro on CHF pairs. You see the falling knives on the NZDCHF and the EURCHF (down arrows), followed by nice bullish signals as prices crossed the EMA 20 in each instance. The bullish signals are marked by the ovals. The EUR/CHF went upwards to reach the 500-pip target as did the NZD/CHF.

FIGURE 3: UNPRECEDENTED VOLATILITY. On January 15, 2015, the Swiss National Bank made a major decision that impacted currency markets. You can see the effect on the NZD/CHF and EUR/CHF. Falling knives are evident in both charts (see down arrows) and both were followed by bullish signals as prices crossed the EMA 20.

On June 24, 2016, after the Brexit referendum, the British pound (GBP) pairs fell like lead weights. From the four-hour chart of the GBP/USD in Figure 4, it looks like the bulls were making attempts to create a rally in those markets. Even though their efforts may not have worked in their favor, the GBP/USD

FIGURE 4: BREXIT EFFECT. The results of the Brexit referendum in June 2016 saw the GBP/USD decline by 1,700 pips—more falling knives—and later trended further downward within the next several trading days.

is likely to trend upward soon from that point.

If you were following my *catching falling knives* strategy, you would buy GBP/USD when it crossed above the EMA 20 (red line) and is followed by another bullish candle. After entering your long position, you would set a target of 500 pips and a stop of 250 pips.

This simple idea has helped me avoid many losing trades and take more winning trades.

Catch a currency

When you see a forex market drop unexpectedly on a daily chart, confirm it on the four-hour chart as well. Then wait until price crosses and closes above the EMA 20. This is when a long signal is generated. But before you set your targets, place your stops and enter your position, look for another bullish candle after the crossover. When you see this happening on the charts, it's an indication that bulls are now willing to push prices higher.

This is a viable strategy to use in the currency markets since currency pairs and crosses tend to mean-revert. With equities, it's a little different. Companies can go out of business and when that happens, prices will never go back up. Yes, you have to be patient when using the falling knives strategy, but patience is a required skill for all traders of any market.

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