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What Is Forex Trading?

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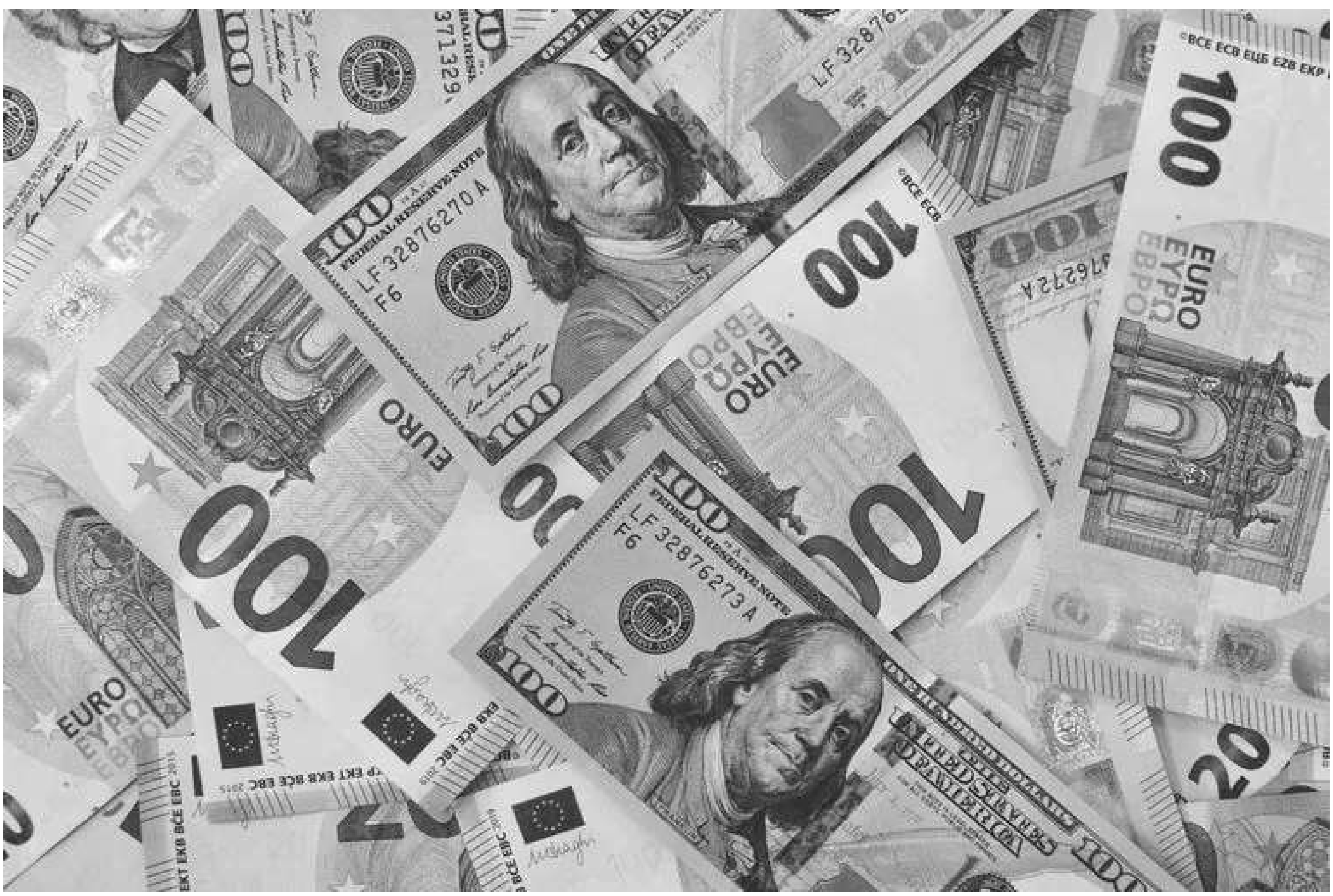

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This piece has been expert reviewed and fact checked by Forbes Advisor Australia Board Member, Tim Waterer, who has more than two decades of experience across FX, stocks, indices, and commodities. He is the chief market analyst at KCM Trade.

Foreign exchange trading, often shortened to 'forex', or 'FX' trading, essentially involves buying and selling currencies to make a profit from international currency movements.

At a simple level, Australians who exchange their dollars for a foreign currency at a money exchange, bank, post office or travel agent before heading off on holiday abroad are carrying out forex transactions. Forex traders do a similar thing, but on a grander, much more complex (and riskier) scale.

The march of technology means it's also a market that offers opportunities, for those with the right aptitude, to private investors and traders. Here's a deeper look at forex and the key points to bear in mind.

What Does Forex Trading Involve?

Forex trading involves the speculative buying and selling of currencies in quest of profit. It can also be used to 'hedge' existing currency bets against a backdrop of exchange rate fluctuations. (Hedging is where you protect a financial position against the potential of making a loss.)

Converting a few hundred dollars of holiday spending money might not seem like a big deal to any of us individually. But FX is not only the largest market in the world, it's also the most actively traded.

The numbers are eye-popping. According to the latest triennial (three-year) report from the Bank for International Settlements, global forex trading stood at $US7.5 trillion per day in April 2022, up 14% from $6.6 trillion three years earlier.

Individual stock exchanges, such as those in London, Frankfurt and Sydney, each work to specific opening hours and are therefore stop-start in nature.

In contrast, forex is an around-the clock market with four main trading hubs working across different time zones: London, New York, Tokyo and Sydney. When trading has stopped in one location, the forex market will continue to operate in another. Forex is also traded in Zurich, Frankfurt, Hong Kong, Singapore and Paris.

Unlike the holidaymaker who needs foreign notes and coins to pay for a cocktail by the pool, forex traders aren't necessarily looking to take physical delivery of the currencies.

Most forex trading takes place between institutional traders working on behalf of individuals, banks and other financial organisations, and multinational companies.

Before the internet, only institutions and wealthy individuals could play the forex market. Times have moved on, however, and private investors now make up a small part of the forex market.

Why Is Forex Traded?

Forex is carried out for a number of reasons, for example, to hedge against international currency and interest rate risk. This is topical at the moment, as world economies grapple with inflation concerns and where interest rate levels have come under particular scrutiny.

Forex is also used to speculate on the impact of geo-political events such as the increase in tensions between Russia and the West over Ukraine. Political events and natural disasters have the potential to alter the strength of a country's currency significantly, leading to potential trading gains or losses.

Companies make use of forex as well. For example, a multinational headquartered in one location might use the forex market to hedge currency risk resulting from transactions carried out by subsidiaries around the world.

Forex is also a means of providing diversification within an investment portfolio. Because the forex market is open 24 hours a day, five days a week, it provides traders with the opportunity to react to news that might not impact a particular country's stock exchange until much later.

Economic indicators used to analyse the forex market include:

- interest rates
- inflation rate
- a country's balance of payments and its economic policies
- a government's attitude towards intervention in currency markets.

Forex trading takes place 'over the counter' (OTC), which means there's no physical exchange of the underlying currency. A global network of banks and other financial institutions effectively oversee the market instead.

In the past, those without the necessary means to trade forex directly may have used a broker to trade currencies on their behalf. But thanks to advances in technology, the evolution of smartphones and a plethora of online trading platforms, it's now possible to trade currencies directly as an individual.

that trades can go against you and that you lose money as a result.

How Does Forex Work?

The main aim of forex trading is to predict if the value of one currency will increase or decrease relative to another.

A trader might buy a currency thinking its value will increase with the aim of selling it at a profit. This is known as 'going long'. Or a trader may sell a currency today on the basis it could decrease in value tomorrow and subsequently be bought back at a cheaper rate. This is known as 'going short'.

How Currencies are Traded

Each of the world's currencies has a three-letter code. These are similar to the symbols used on stock exchanges to identify a particular company, such as NAB for National Australia Bank on the ASX.

The most-traded currency worldwide is the US dollar, which has the ticker USD. The second most popular is the euro (EUR), followed by the Japanese Yen (JPY), the British pound (GBP), the Australian dollar (AUD), Canadian dollar (CAD), Swiss franc (CHF) and the New Zealand dollar (NZD). There are more than 170 currencies in all worldwide.

In forex, currencies are always traded as 'currency pairs'. This is because when you buy one currency, you simultaneously sell the other.

The following currency pairs are known as the 'majors' and account for about three-quarters of all trading in the forex market:

- EUR/USD
- USD/JPY
- GBP/USD
- AUD/USD
- USD/CAD
- USD/CHF
- NZD/USD

'Minors' are all the other combinations of the world's biggest currencies, such as GBP/EUR.

Each currency pair comprises two elements. The first is the 'base currency'. When listed in a trading quote, this part is always equal to 1. The second element is the 'quote currency'.

For example, consider the currency pair GBP/EUR = 1.19. The base currency is pound sterling (GBP) and the quote currency is euros (EUR). The pairing means that £1 is worth 1.19 euros if you decide to buy. Put another way, it would cost €1.19 to buy £1.

When you buy a currency pair, the price you pay is called the 'ask' and when you sell it's called the 'bid'.

Ways to Trade Forex

spot market. This is the main forex market where currency pairs are swapped and exchange rates are evaluated in real-time, based on supply and demand.

forward market. This is where forex traders enter into binding contracts with each other, locking into a particular exchange rate for an agreed amount of currency at a future date.

futures market. In contrast to the forex and spot markets, this is where traders take out a standard contract on a dedicated exchange to buy or sell a pre-agreed amount of currency at a specific exchange rate on a date in the future.

Forex Jargon

Currency pair. In addition to the majors and minors noted above, 'exotics' involve pairs that include less-traded currencies such as the Mexican peso (MXN).

Bid-ask spread. This is the difference between the buying price and selling price of a currency pair. A high spread means a big difference between the bid and ask price. The spread is measured in 'pips'.

Pips. A pip in forex is usually a one-digit movement in the fourth decimal place of a currency pair. So if GBP/EUR moves from €1.19261 to €1.19271 then it has moved by a single pip. A price movement at the fifth decimal place in forex trading is known as a 'pipette'. A key exception to the pip rule is when the Japanese yen is the quote currency. In this case, a pip is calculated as a one-digit move in the second number after the decimal point. If USD/JPY alters from 110.05 to 110.02, this is a three-pip move.

Leverage. Another term for borrowing money, enabling traders to play the forex market for larger amounts of money than they themselves may be willing, or able, to put up.

Margin. The deposit required to use leverage with your trades.

Maximising Opportunities

Another jargon term in forex is 'lot'.

Even a 50-pip move won't earn an FX trader very much if he or she is working in 100 or 500 units of currency. That's why most FX traders buy and sell currencies in 'lots' – batches of currencies that enable them to take advantage of relatively small price moves.

A standard lot is equivalent to trading 100,000 units of currency. Buying one lot of EUR/USD means buying 100,000 euros for their value in US dollars.

This is where traders use leverage (see above) to avoid having to tie up all their capital in a trading position. With leverage, you only have to put up a fraction (the margin) of your position's full value to open a trade.

Leveraged trading is risky, however, because losses can be magnified until they exceed the initial amount borrowed.

Lots also come in micro (1,000) and mini (10,000) batches.

How do I Trade?

You can choose from a number of online platforms run by forex brokers as well as several trading apps. Make sure your provider has an Australian Financial Services Licence with ASIC or is regulated by an overseas authority (although you may not be protected by Australian laws if you opt for the latter). Read the product disclosure statement carefully to ensure you understand your exposure and risks.

Have a clear idea about the sorts of trades you might want to do and find out how much it's going to cost with the provider of your choice. The more obscure the currency pair, the wider the spread is likely to be to execute a trade.

Some of the most popular platforms have forums where you can speak to other users. If you're a novice trader, look out for providers that offer online tutorials or the option to practise trades on demonstration accounts with virtual money.

As the FX market is one that never sleeps (except at the weekend), 24-hour support from your platform provider is extremely useful. Some services will allow you to automatically open and close positions once certain levels of trading have been reached, ensuring your account is not on the receiving end of a nasty surprise.

To have a chance of making a return, it's essential to research your chosen currencies. For example, you'll need to know in advance the dates when countries make public their key economic announcements concerning GDP figures, balance of payments, inflation rates and so on.

Equity markets, interest rates and important news developments also have a role to play in determining a currency's strength or weakness.

Frequently Asked Questions (FAQs)

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