



FOREX FOR BEGINNERS

FOREX GUIDE FOR BEGINNERS

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What is Forex?

Forex is short for Foreign-Exchange, and it is the largest market on the Planet Earth. While many investors, particularly many in Western economies may be more-aware of equity and stock markets, Forex plays a key role in the constantly evolving relationship of global trade.

Even if you don't know it – **you've probably already placed a Forex trade**. Have you ever withdrawn money from an ATM in a foreign country in a foreign currency? Well – that was a Forex trade. If you've flown into an international airport and seen the airport kiosks with flashing rates, those are all bids and offers to place an FX trade. Even if you haven't travelled out of country, you've likely purchased a good or service online from a merchant in another country. Well, there's a Forex transaction behind that sale.

Forex is like oil for the gears of global trade. And as globalization has further taken-hold of the world, the necessity for FX to facilitate those trading relationships has never been more important. If a Japanese automobile manufacturer wants to sell a car in the United States – the USD/JPY exchange rate is going to be pretty important to the success of their business. If the Dollar strengthens, this is good for the Japanese auto manufacturer – as they can now bring back more Yen for every car sold in the United States, given the stronger U.S. Dollar. But if the exchange rate weakens – this auto manufacturer may be forced to take a loss on the sale of that car, and for no fault of their own, as they were simply the victim of a 'bad forex trade'.

But no dialed-in, international company is going to remain vulnerable to such unchecked market forces. Ignoring exchange rates could risk the very success of their business to a factor that they could reasonable control for. So **many companies are actively trading in FX markets in order to address the risk of constantly changing valuations in their local currency**.

But this is just one motivation for one particularly important participant in the market. In many cases, the auto manufacturer themselves are going to outsource this work to one of the major banks with a heavy focus on Foreign Exchange transactions. And given the volatility that can often emanate from these markets, this will also attract many hedge funds or pension funds with some element of a speculative bent.

Collectively, this activity from these 'major' market participants is what makes FX the largest market in the world.

What is FX 2 - How to Trade FX

As we mentioned earlier, many people place Forex trades every single day without ever knowing it. But for those that do knowingly trade FX – the purpose is fairly clear: for profit – just as with any other market-based type of investment.

Let's go back to that airport kiosk example: And let's say that you've just arrived in New York after a red-eye flight from London, and you know that you're going to need to exchange some of your British Pounds into U.S. Dollars in order to have some pocket cash for transactions. But you're unsure of how much you'll need, so you simply take everything out of your wallet and exchange it into U.S. Dollars; and that just happens to be £400.00.

Bid

Ask

1.2400

1.2500

(price at which you can sell)

(price at which you can buy)

At the time of the exchange, the airport kiosk was displaying a rate of 1.2400 x 1.2500 for transactions from the British Pound to the U.S. Dollar. This would be very similar to a Forex quote with a relevant bid and ask, separated by the 'spread' between the two prices. The first price is the amount that the airport kiosk would be willing to buy GBP/USD from you while the higher, or second price is the rate at which they'd be willing to sell. So, you, as the customer, buy at the higher price and sell at the lower price... the airport kiosk always earns the spread.

Another way to read this quote from the airport kiosk would be: 'we are willing to pay 1.2400 in U.S. Dollars for every 1 British Pound you have – but if you want to buy British pounds from us, it's going to be at a rate of 1.2500 for every 1 GBP that you want.' The difference between these two amounts is the 'spread,' and this is vitally important for traders to follow – but we'll get to that in a moment.

You exchange your £400.00 for \$496.00 (400×1.24) and then leave the airport to go and enjoy the beautiful weather in New York City.

But while enjoying all of that beautiful weather, you realize that much of NYC is wired to accept credit cards. So you don't really need any of your cash, and the \$496.00 remains unfettered in your wallet for the duration of your trip. Now it's time to go back home, and you decide you want to get your GBP back so that you can actually use your cash at home. You go to the same airport kiosk – but now prices have changed as the British Pound has dropped in value since when you'd arrived in New York.

GBP/USD Rate

Bid

Ask

1.2200

1.2300

(price at which you can sell)

(price at which you can buy)

Now the airport kiosk reads 1.2200 x 1.2300 for GBP/USD exchanges. And you take out your \$496, and hand it to the agent at the kiosk, and they give you back £403.25 – amounting to a net profit of almost £3.25 on the transaction – and all you had to do was hold that cash in your wallet for a week. Curiously, you pose a befuddled look to the attendant at the airport kiosk currency exchange and explain that they must've made a mistake as you'd only given them £400 and are now getting back a full £3.25 extra – almost a 1% return in just a single week!

You ask the attendant at the kiosk to explain the transaction; and they share that during this week that you were in New York, the British Pound dropped in value by 200 pips (equivalent to 2 cents) against the U.S. Dollar. This means that by having 'invested' in the U.S. Dollar rather than the British Pound, you were able to profit off of the drop in the exchange rate. So, when you traded in your British Pounds, you did so at a rate when every British Pound was worth \$1.2500. But now that the British Pound has fallen in value with each British Pound now returning \$1.2300, you profited off of the transaction. And when the attendant takes your \$496 to exchange it back into British Pounds, the lower rate of 1.2300 means that you're going to get back £403.25 ($496 \times (1/1.2300)$).

At that point, you get the idea that speculating on currencies can be a viable 'endeavor' as the daily movements in a currency's value or price can allow for profit to be had from astute observation and timing.

This is the enterprise that many of the world's largest investors – whether they're banks or insurance companies or auto manufacturers or stay-at-home Mom's or Dad's managing a personal trading account – are all trying to do. The bulk of the \$5 trillion per day exchanged in the FX market comes with a profit-seeking, loss-aversion backdrop.

Why Do So Many Traders Move to or Focus on Forex?

As with equities, the proliferation of computers and subsequently the creation of the internet popularized the field of Foreign-Exchange trading. Some of the unique aspects of the FX market are particularly attractive to market participants, such as:

- **FX Never Sleeps, this is a 24-hour market** because when London closes for business, banks in the United States are furnishing prices. And as the U.S. closes for the day, liquidity begins to flow from New Zealand, Australia and then, eventually, Asia; producing a truly 'always open' market for FX traders.

- Go long or short – there are no shares to borrow and no 'hypothecation' that needs to take place when going 'short' on a Forex-pair. **The two-sided pairing of many FX instruments also affords an extra level of flexibility.** Do you want to short the British Pound? Well, you can choose to do that against the U.S. Dollar or the Japanese Yen or the Euro. You get have many options to choose from.

- this is particularly attractive to professional-level investors as the inevitable costs of placing trades can place a large dent into a trader's profits. Trades are some of the lowest-cost vehicles that investors can work with given the massive liquidity and substantial size and depth that often exists in these markets.

- Un-paralleled liquidity – as mentioned earlier, **over \$5 Trillion per day turns over in the Forex market** and this means that most major FX markets remain widely-offered throughout the day. A lack of liquidity can be a dangerous prospect for a trader as this can increase the 'sharpness' of moves given the thinned number of bids or offers in a market. Such 'violent' price movements can just as surely work against a trader as for them. The additional liquidity that's often available in FX therefore can act as a 'buffer' for price action.

- **Available leverage:** borrowed funds can fast become a detriment if miss-used, and we'll talk about this in more detail later. Leverage gives the trader flexibility for bolstering amplitude. If a trader wants to speculate on a move more aggressively, they can institute more leverage. But this can be dangerous as higher degrees of leverage accelerates the 'velocity' of a trade.

In FX – you get to control your own leverage up to 50x in most jurisdictions. And while most professional traders would agree that 50x leverage is too aggressive for a professional approach – in FX, you get to decide.

Trading FX – What Drives the Forex Market?

Currencies trade on the open market, just like many other asset classes like stocks or bonds or commodities. Throughout the trading day, prices on currencies will fluctuate based on supply and demand. If something ‘good’ happens for an economy, investors will generally respond with more buying. That in turn increases demand at given levels of supply, thereby increasing prices until supply and demand are roughly-balanced again. Or, if something ‘bad’ happens, investors will factor that new information in by selling the currency, which increases supply at this given price. An increase in supply would bring prices lower until buyers stepped-in to add support and, again, we’d have equilibrium in the supply and demand for that currency at that moment in time at that specific price.

Let’s take the Brexit vote in June 2016 as an example. When voters in the U.K. elected to leave the European Union, the immediate response was one of fear as investors sold-out of GBP-based investments. All of those orders to sell (supply) rapidly filtered into price as the quote on GBP/USD fell by more than 15 cents (1,500 pips) against the U.S. Dollar in a single night, from 1.50 all the way down to 1.3500.

The general motivator for currency price movements are interest rates, or implications thereof...

As an economy’s performance improves, interest rates will generally be increased to temper inflationary pressures. But it’s those increasing rates that really get currency traders excited, as this could bring on a synergistic relationship that can, potentially, last for months or even years. As interest rates move-higher, the demand to invest in that economy will generally increase in order to capture the consequently higher rates of return. As this demand builds, so does demand for the native currency, fueling an advance in exchange rates to match local capital markets.

Investors can even earn (or pay) interest while being in a forex trade, reflected in the ‘swap rate’. This is the interest rate differential between representative economies in a Forex quote, and we explain this later in more detail.

The Bulls and the Bears – Deciding What to Buy and Sell

As mentioned above, interest rates are one of the most common drivers for currency prices, but to put it more accurately, it is 'expectations for potential changes in interest rates' that really drives matters. Let's consider an example: if data signaled a remarkably strong development for an economy – let's say that GDP in the U.K. far outpaced what was expected – the speculation will in turn weigh in.

While this one, individual GDP print may not cause the Bank of England to hike interest rates, it can start the ball rolling. The stronger economic figure may in turn raise the prospect of inflation. It is that elevated price pressure that may eventually cause the BoE to hike rates faster than they would have otherwise. So this would generate an increase in expectations for higher interest rates which in turn motivate traders and investors to buy the British Pound (and local assets) on the belief that the rate of return is going to rise in the near future.

The higher prices in the British Pound, at this point, would be 'Bullish', reflecting the burgeoning up-trend that's taking place to account for stronger GDP and rate expectations. Should data continue to come-in stronger, this 'bullish' price action can continue. If persistent enough, the result could be a true 'bullish' up-trend in the price/value of the currency.

If the example were to be reversed – with the expectation for lower interest rates – the result is more likely to drive currency values lower. Such expectations were evidenced after the June 2016 Brexit referendum. After the vote deciding to withdrawal the UK from the European Union, Bank of England Governor Mark Carney warned markets that the BoE was not going to take risks from the referendum lightly. They would proactively look to offset those risks by decreasing interest rates. In short order, sellers returned to drive the value in the British Pound even-lower, from a value of 1.3500 just before the 'warning' to around 1.2000 in the months after. This is clear bearish anticipatory price action.

This is the simplified interpretation of the relationship that drives most buying and selling decisions in the FX market. Do you think that economic prospects in Europe will improve? If so, you could buy the Euro. And as those prospects do indeed improve, prices will likely move up to reflect the increased demand preempting inflationary pressure that could prompt higher rates. Or, if you think that Europe's economic prospects are worsening, you can sell the Euro to take advantage of an eventual slide in rates that promotes a decline in the market.

Reading a Quote

The quote convention for the Forex market is one of the few areas that's markedly different than many other markets, but after a little investigation it often becomes quite simple for most investors.

FX trades take the prospect of detail a step further.... But before we get to that we have to point out an important element of terminology in the FX market, and that's the term 'pip'.

One of the most important terms that's unique to FX: Pip

Pip stands for 'percentage in point,' and this is the primary unit of measurement in a forex quote. In a U.S. Dollar denominated-quote in which USD is the 'quote currency' (any pairing where 'USD' is listed second), the third and fourth digit after the decimal will show the number of 'pips' in that quote.

If GBP/USD is trading at 1.2345, this is the same as saying 'one British pound is worth one dollar, 23 cents, and 45/100th's of a cent'. If the price in GBP/USD increases to 1.2355, that would be a gain of 10 pips (1/10th of a cent). If price were to rise to 1.2445, that would be a 100-pip (one cent) gain from the prior value of 1.2345.

GBP/USD

'The Value of One British Pound, quoted in terms of U.S. Dollars'

GBP is the base, or transaction currency in the pair

USD is the quote, or counter currency in the pair

The price of GBP/USD moving higher means British Pounds are Stronger, and U.S. Dollars weaker

The price of GBP/USD moving down means British Pounds are weaker, and U.S. Dollars stronger

Every Forex quote comes as a pair so that we can see what that base currency's price is being defined against. GBP/USD is one of the more common pairings, and its pairing is the same as saying 'the value of British Pounds, quoted in U.S. Dollars'. EUR/GBP is another common pairing, and this is the value of one Euro, as quoted in British Pounds. Or let's say we wanted to place a trade with an Australian focus: We could look at GBP/AUD, which is the value of one Pound quoted in Australian Dollars.

Two-Sided Pairs, Two-Sided Trades

So, to recap: the first currency in the pair is called the 'base' currency, and this is the instrument being quoted in that price; while the second currency in the pair is the 'counter' currency, and this is what the base currency is being quoted in. So, for example, the quote for GBP/JPY would be the value of one British Pound as quoted in Japanese Yen, reflected as ¥140.00 to show that each British Pound was worth 140 Yen (¥).

While an exchange rises and falls simply enough, the values of both currencies do change independently. Euros are going up and down throughout the day, as are U.S. Dollars and Japanese Yen – and traders should seek pairings that would offer the best leverage to support their view for direction. So, if the investor wanted to buy British Pounds as they are bullish on the currency's outlook, they would want to pair that currency against a counterpart that they expect to be weak.

As an example, if an investor expected the Australian economy to be weaker – they could buy GBP/AUD; or buy British Pounds against Australian Dollars.

Or – alternatively – if the investor was 'bearish' on Europe's economic prospects, they could sell Euros and buy British Pounds. This would be employed by 'going short' EUR/GBP, which is the equivalent of selling Euros in terms of British Pounds.

In this last example, the investor hopes that the EUR/GBP exchange rate (its price) goes lower, at which point they could 'cover' the trade at the lower price, allowing for profit in the short position taking the difference between the higher entry price and the lower exit price.

Going Short

Entering a short position in the stock market can be challenging. Before you can place the trade, you first need to find a broker that will let you borrow the shares in the first place. Following that, executing the short position is usually going to come with some restrictions, such as the 'uptick rule'. And even should you meet all these criteria, you're often going to have to pay interest for 'borrowing' the shares at 'brokers call' rates, which are usually higher than discount or prime rates.

Suffice it to say, betting against stocks usually isn't as easy as buying them.

Forex is quite a bit different because in every quote, in each trade, investors are always 'long' one currency and 'short' another. Let's go back to that GBP/AUD example:

If investors were optimistic on British economic prospects, at least more so than they are on Australian growth prospects, they can look to buy GBP/AUD. But if investors are more-pessimistic on the U.K.'s economic prospects as opposed to Australia's, a short position could be executed in which the investor sells GBP/AUD. Let's say this happens at a price of 1.7000, and you go short for 10 lots or 100k.

In this hypothetical short GBP/AUD position, the investor would be short British Pounds, and long Australian Dollars. Each pip in the quote would be worth approximately 58.8 pence ($1/1.7000 = 0.5882$). And, considering the investor has 10 lots, each pip gained or lost would mean approximately £5.88 of change to the investors account.

Let's say two months later, the investor closes out the trade at a lower level of 1.6000. This would be a total movement of 1,000 pips, and the investor can close the position at the lower price to garner the equivalent gain. Further, given of the pip value of 58.8 pence per pip, each lot would've brought £588.24 to the investor. On a 10 lot position, that would tally a total gain of £5,882.35 on the 'short' trade.

Pip Values

This is an extremely important aspect of the Forex market to understand, and that's the value of a pip from quote to quote. Every currency pair is priced in terms of the counter currency. So if 'USD' is the second currency in the quote, that currency pair is being quoted in terms of U.S. Dollars. As another example, if the Australian Dollar is listed second, as we saw above with GBP/AUD, the trade is being priced in-terms of Australian Dollars.

Again, if you are ever confused, just read the quote aloud as 'the value of (first currency) priced in terms of (second currency)'.

For U.K. traders using a GBP-based account, the pip value for each pip in GBP/USD can be found by dividing '1' by the quote itself. So if GBP/USD is trading at 1.2500, the pip value for GBP-based traders would be $1/1.2500 = 0.8$. So, each pip of movement in GBP/USD would be worth 80 pence, or 0.8 GBP.

If we wanted to find the value of each pip in the GBP/AUD quote, we can follow the same procedure. We can divide '1/GBP/AUD quote'. Let's assume a value of 1.7000 for GBP/AUD, at which point, the pip value would be $1/1.7000 = 0.588$. So, each pip of movement in GBP/AUD would be worth 58.8 pence, or 0.588 GBP.

Lot sizing

As you can probably imagine, traders don't usually get excited by a gain of a few cents or pence. But, with leverage and lot sizing – that movement of only a few cents can really stack up to bring some significant gain (or damage) to a trader's account.

Each currency pair is denominated in a 'base lot size' that carries a 'pip value' for each pip's worth of movement in that specific currency pair, just as we saw above with GBP/AUD carrying a pip value of 0.588 for GBP-based traders. Each lot also carries a 'minimum margin requirement', and this is the amount of risk capital required to maintain the position.

Margin

Margin is the capital that the broker must hold in order to secure a position. This amount will differ from currency pair to currency pair, but will generally be a percentage of the overall size of the trade.

Let's assume a margin factor of 2% for positions.

Let's also assume that the trader wanted to buy 50,000 in GBP/USD. This would be referred to as the 'lot size' of the trade.

And then let's assume a cross rate of 1.2400 in GBP/USD at the time.

As we mentioned earlier, this quote is pricing GBP in terms of the U.S. Dollar. And if the going rate at a given time is 1.2400, that's saying that each British Pound is worth One Dollar and 24 cents. So this trade to transact £50,000 would be worth \$62,000 ($50,000 \times 1.24 = 62,000$). **This is called the notional value of the trade.**

The minimum margin requirement for this trade, if using 2% as a margin factor, would be \$1,240 ($\$62,000 \times .02$).

We can also express this amount in GBP equivalent by using the exchange rate of 1.2400 in GBP/USD. \$1,240 would be worth £1,000 (or 2% of £50,000).

When our trader places the trade, this amount will be drawn from the account and earmarked for this position as 'margin'. Once the trade is closed, this margin comes back to the trader's account and can be used again. But, if in the course of trading, the position loses value to deplete the trader's equity – to where he or she only has the margin securing the trade remaining – this trader will face a 'margin call' as there would not be enough capital in the account to continue supporting the position.

Margin Call – When the trader's account value falls below the margin requirement of held positions. This leads to a liquidation of the account from the broker; known as the dreaded 'Margin Call'.

Leverage

Leverage is the amount of funds borrowed from or used from the broker. Let's assume that our trader in the above position had opened their account with £2,000, and is currently trading a £50,000 position.

The leverage on this trade can be expressed as 25:1. Or, to put it otherwise, the trader is controlling £25 of capital for every £1 in their account.

Remember, margin had to be put up in order to secure the position before it was ever executed, and that amount was \$1,240 (or £1,000). This means that our trader would have £1,000 in 'free margin', or capital that isn't currently tied-up in securing a position. This is capital that can be used to pursue new positions or to support currently-held trades.

Anatomy of a Forex Trade – Start to Finish

To close our New to Forex Guide, we're going to walk through a complete hypothetical trade, from start to finish using EUR/USD.

Let's assume a bid/ask rate of 1.1000 x 1.1005, a margin factor of 2%, and a newly opened account with \$2,000.

Our trader decides that they want to place a short EUR/USD trade for €20,000.

Because the quote is Euro's priced in terms of U.S. Dollars, €20,000 would be the same as \$22,000. We are using the bid price – first in the quote – since our trader is opening a short position). The \$22,000 would be the notional size of the lot.

The margin to open the position would be \$440 ($\$22,000 \times 0.02$). This would leave our trader with \$1,560 in free or 'available' margin.

The pip value on the position would be \$2.00 per pip, since this is a U.S. Dollar denominated account and we're trading a pair based in U.S. Dollars. So, the \$1,560 that the trader has in free margin would allow for 780 pips to be lost before a margin call would happen ($\$1,560 / 2 = 780$).

But let's assume that the hypothetical trade found its way into the money. With a slide, the price on EUR/USD went down to 1.0805 x 1.0810, and the trader decided they wanted to close the lot.

They'd have to buy back to cover the position, which would be done at the second rate in the quote, or the 'ask price'.

Our trader would be covering €20,000 at a rate of 1.0810, for total proceeds of \$21,620; amounting to a net gain of 190 pips.

The original cost of the trade was \$22,000; but now the trader covers the position at a value of \$21,620 – leading to a \$380 difference which would be realized as profit on the trader's short position.

Once the trade is closed, the margin is returned to the account and the trader's net account value is now \$2,380.

Next Steps

By now, you have learned many of the basics that helps a trader familiarize to navigating any market, Forex included. Many professional traders consider markets a life-long learning process, very similar to driving. At first, even driving at low speeds on abandoned roads can be risky and scary. But in time, as the mechanics of operating an automobile become a little more comfortable, we can fly by motorists on the highway without so much as a worry in the world. Experience helps bring familiarity and comfort.

At DailyFX, we're here to share our experience with you. After you've learned the basic mechanics and terminology of the market along with the operable functionality of your trading platform, you're ready to start directing and refining your analysis in order to make better trading decisions.

If you want to further your education of market analysis, our DailyFX University is here to help. This is completely free-of-charge, entirely self-paced, and available to you whenever or however you might want. Just click on the link below to get started: <https://www.dailyfx.com/forex-education>.



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We recommend that you seek independent advice and ensure you fully understand the risks involved before trading.

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