2 UNDERSTANDING THE FOREX MARKET

Forex is the most liquid market in the world. With a daily trading volume of 6.6 trillion dollars daily, it is about 53 times more than that of the New York Stock exchange. The foreign exchange refers to the buying and selling of currencies in correspondence to another. It is the most traded market in the world. More than 70% of the volume and transactions happen in only seven major currencies EURUSD, USDJPY, GBPUSD, AUDUSD, NZDUSD, USDCAD, USDCHF (Ibeth Rivero, 2020).

2.1 How does the market move?

The primary factor to move any market is the orders of supply and demand. An increase in supply causes the price to rise, while a decrease in demand causes the price to fall.

The second most primary element to impact the price in the forex market is the interest rates and economy of the country. There is a better yield on high-interest rates. Those high rates could improve the economy of a country and better economy encourages investment helping to strengthen the price of the currency of the country. Bad economy of the country results in fewer and limited investment opportunities which could impact and weaken the currency of the country. (Babypips.com, 2021).

Financial and economic news like retail sales, Consumer Price Index (CPI) and Gross Domestic Product (GDP), Central Bank meetings, non-farm payroll, Unplanned news like political speeches, terrorism, etc. will also impact a country's economy, trust in the economy, and its currency (Fxsignal, 2021). Also, the sentiment among the financial investors and traders about the market future price can be impacting the currency as the majority of the investors are investing with the sentiment of the market moving in one direction.

Among all the factors, the most common here is buying and selling in the market. Buying and selling move the price of the market because for every transaction in the market buyers and sellers are needed. More buying pressure causes the market to rise, while the market falls when there is more selling pressure.

2.2 Forex Terms

Forex Terms or Forex terminology is the simple term used in the forex market. These terms must be well known and understood before starting to trade. Forex terms help new investors and traders to get acquainted with the forex market and help them to execute a trade in the currency market. Among several forex terms, some of the most common and important terms are explained below.

2.2.1 Currency Pairs

More than 180 currencies are being used in 195 countries (Finance Magnet, 2019). Forex is traded with the change or performance of one currency in correspondence to another. It is usually traded in pairs and correlation to one another, for example GBP/USD. The base currency here is GBP while the quote currency is USD. If GBP/USD is increasing in price of the exchange rates, then the pound is getting stronger against the dollar while a decrease in the exchange rates indicates the dollar is getting stronger against the pound.

There are more than 55 currency pairs available to trade. Among them, EURUSD, USDJPY, GBPUSD, AUDUSD, NZDUSD, USDCAD, USDCHF are the major currencies pairs where more than 85% of the total forex market are held. (Ibeth Rivero, 2020).

2.2.2 Leverage

Leverage in forex trading refers to the borrowing of money. Leverage happens in the trading account, and it allows a trader to execute a position of bigger lots with a very little balance. It allows a trader to open large position orders with the balance he has. Using high leverage is a very effective method to profit and trade in the currency market without the investment of a huge amount of capital and targeting to earn high profits in a short period.

To open a position of a standard lot in the EUR/USD currency pair, a trader needs to have 120000$ in his account. But using 1:500 leverage he can open the position with just $240 and can control 120000$ worth of position with just 240$. But high leverage also means high risk. With 1:500 leverage, the trader could easily lose all their margin used to open the position if the market moved a little pip against them.

So, it is very important to keep the leverage below 1:100 while starting and then slowly increasing it with experience and time.

2.2.3 Bid/Ask price & Spread

In the forex market, when one currency is bought at the same time the other one is being sold. Bid refers to the highest price the trader has to pay for an asset whereas ask price refers to the lowest price a trader will take for the same asset. The ask price is never lower than the bid price. Spread refers to the difference in the price between ask and bid. Brokers in the forex market earn by the commission charged to open a position or through the spread between the prices. (Elizabeth Belugina, 2021).

When opening the position in the broker platform, every trade starts slightly with a negative pip. This is because of the spread. In forex, spread refers to the difference between ask price and bid price of the broker. Spread in the forex market is not constant and varies a lot with the broker. When entering the long position in the currency pair or buying the base currency in the pair, then the quote currency must be closed to sell it, which causes the price difference. This price difference is called the spread. Spread in the currency pairs depends on various factors like volatility, liquidity, and volume of the currency pairs. (Harion Camargo, 2021).

FIGURE 1. Bid/Ask price (Darwinex).

As can be seen in Figure 1, the first column represents the symbol of the currency pair, the second column represents the bid price, the price at which the sellers are willing to sell the pair of the currency and the third column represents the ask price which is the highest price at which the buyer will buy the pair of the currency for.

2.2.4 Long/Short position

Long and short positions are the trades executed in the forex market. Entering a long position in the forex implies buying the base currency and selling the quote currency of the pair. It implies buying the base currency and expecting the base currency to rise in cost as opposed to quoting currency whereas going short position implies selling the base currency and anticipating the base currency to drop in price in contrast to the quote currency. (Finance Magnet, 2019). For example, in a EUR/USD pair, taking a long position means buying the euro and expecting it to rise in price against the dollar while taking a short position means selling the euro expecting it to drop in value against the dollar.

2.2.5 Margin

Margin is the capital or money the trader needs to open a position in the currency market. It is very important to know about margin when trading with leverage in the currency market. Margin helps the trader to open large order positions in the forex market. It is the amount of capital the trader should invest to execute a trade. Margin trading with the use of leverage is a very effective way to earn profit in a short time as the trader can execute bigger orders. But it is to be considered that margin trading with high leverage can also risk the trader blowing up the account in a short time. (Finance Magnet, 2019). If a trader wants to open a position of standard lot i.e., $200,000, then he should deposit the 1% margin or 2000$ to execute the trade.

2.2.6 Pips

Pips can be defined as the smallest movement a price can have in the currency market. It stands for Percentage in Point. (Adam Hayes, 2021). Pips are 1/100 of the 1%, or the 4th decimal number

(0.0001). (James Chen, 2021). Pips are used to calculate the movement in the forex market. For example, in EUR/USD chart, suppose the latest price is 1.2052. It means with 1 Euro we will be able to buy 1.2052 dollars.

If the trader predicts the market accurately expecting euros to get stronger against the US dollar and buys the Euros for 1.2052 and get out of the position or exit the trade at 1.2080, then he/she will make a total profit of 28 pips. But if the euros weaken against the US dollar and the falls market fall to 1.2022 then he will lose a total of 30 pips.

2.2.7 Lot size

The lot size is the currency unit, or the size of the order or position executed in the trade. In the stock market, the number of stocks bought is calculated in shares like 100 shares, but in the forex market, the contracts are bought in the lot. A standard lot in forex is 100,000 units of currency. Also, there is a mini lot which is 10,000 units of the currency, a micro lot which is 1,000, and a nano lot which is 100 units of the currency. (Finance Magnet, 2019). E.g., in a EUR/USD pair, opening a standard lot position in a dollar will mean the size of the trade is $100,000, where one pip is equal to 10$. Similarly, a 10 pips movement in the favour of a trader means a profit of 100$.

2.2.8 Bullish and Bearish trend

In simple terms, a bullish trend refers to the rising of the price in the market while a bearish trend means falling of the price in the market. These trends are also called the bull and bear trend. This is because bulls often hit upward with their horns and bears try to hit with their paws downward. In a bullish trend, the market makes new highs. (Finance Magnet, 2019).

A bullish trend is a candlestick chart often made by series of blue or green candles moving rapidly upwards while a bearish trend in a candlestick chart is made by series of red or black candles moving downwards quickly.

2.2.9 Stop-loss and Take profit order

Stop loss and take profit order, both refer to signalling the trader when the position of the trade should be closed. A stop-loss order refers to placing the order at a certain position for the risk a trader is willing to take, while take profit order means placing the order in a certain position for the profit the trader wants to make. (Axiory, 2020).

Stop-loss or stop-loss order means protecting the trade executed from further loss by stopping it at a certain price. The order remains even if the trader is not using his trading device. It helps to protect the capital of the trader if the currency fluctuates, or the trade goes against the position executed by the trader. (Axiory, 2020). E.g., if a trader executes a long position at a certain price, then he put a stop-loss at a certain pip below the entry price so that the trade executed closes as soon as the market reaches that price. Similarly, if a trader executes a short position at a certain price, he put a stop-loss at a certain pip above the entry price so that the trade executed closes as soon as the market reaches the level of that price.

Similarly, taking profit or take profit order is the opposite of stop-loss order. It means closing the already executed position by taking some profit. Even a profitable trade can sometimes turn to loss. Take profit order helps to prevent the trader from committing such a loss by placing a pending order. (Axiory, 2020). By placing take profit order the trader will be able to take profit by closing the buy position a few pips above the entry price or taking profit by selling the close position a few pips below the entry price.

2.3 Forex vs Stock markets

Forex and stocks are two of the most popular and the most traded markets. Forex is the buying and selling of currency pairs while stocks are the buying and selling of shares of the company. Forex market does not require a commission to execute an order and the commission is paid in a spread whereas a trader needs to pay a commission to execute an order in the stock market. (Becca Cattlin, 2020).

Forex market operates 24 hours a day for five days a week. The trader can execute his order at any time in this market during these hours. The opening hour of the stock market is quite different and depends on the opening session of the exchanges the stocks of the company are listed on. The most suitable time to trade stock market is when the two sessions in the market overlap and the market is most active. (Becca Cattlin, 2020). Investors and traders in the stock market buy and hold the shares. They sell their shares if they believe the market will fall. But investing in the currency market is a lot different. Traders and investors do not buy and hold the orders bought in the currency market and sell them later. They execute long position if they think the market is going to rise and short position if they think the market is going to fall which could provide the trader with more opportunities to trade.

Supply and demand are the main reasons behind the movement of the price in both markets. But some fundamental factors affect the price too. When trading stocks, it is very important to analyze the performance of the company along with some other important factors like debt, profits, cash flows, etc. which affect the share prices of the company. But with forex, the trader is trading with two currencies and the trader needs to be updated on the economy of the two currencies. So, it is important to be aware of the currency since there is one currency being bought while the other one is being sold. Also, the traders need to be focused on major economic events and news like non-farm payroll, inflation, GDP, political events, etc. (Becca Cattlin, 2020).

The stock market is usually trendier. The majority of the stock market trends upwards, as a result, it is easier to profit in this market simply by buying the share of the good stock. The forex market is more volatile. The volatility in the forex market can provide a lot of trading opportunities, but this volatility also can be very risky. Therefore, risk management is very vital in the forex market. (Becca Cattlin, 2020). Forex is not a simple hold-and-buy market. Either long or short positions should be taken in the market, and there could be more opportunities to enter a trade in this market in comparison to the stock market as the forex market swings a lot.