FOREX.com

Getting Started 2nd Edition

Currency Trading FOR DUMMIES®

Learn to:

- Capitalize on the growing forex market
- Understand what drives currency movements
- Utilize technical and fundamental analysis to spot trade opportunities
- Manage risk and reward

Brian Dolan

At FOREX.com, we are extremely proud of the pioneering company we have built. We were one of the first firms to open up the world of currency trading to retail investors. And ever since, we have been dedicated to making trading understandable for people who are looking for new financial opportunities in our increasingly global marketplace.

Though we started this company more than ten years ago and many of us have worked in foreign exchange most of our professional lives, we still feel as though we've discovered a whole new world, and the idea of helping people discover it excites us.

We pride ourselves on our customer service and believe that you will feel the difference in attentiveness and follow through. Our goal is to help you understand global markets and become a better, more successful trader. Most importantly, you'll find open and honest people ready to answer your questions and help you anytime of the day or night in many languages from offices located around the globe.

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Sincerely,

Glenn Stevens
Chief Executive Officer
FOREX.com, a division of GAIN Capital Group

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LISTED
NYSE.

Currency Trading FOR DUMMIES®

GETTING STARTED 2ND EDITION

by Brian Dolan

Author of *Currency Trading For Dummies*®, 2nd Edition

WILEY

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About the Author

Brian Dolan has more than a 20-year track record covering the forex markets, having worked as a senior trader and analyst at some of the world's leading international banks, including Dai-Ichi Kangyo, Credit Suisse, American Express, and retail currency provider FOREX.com.

Introduction

The forex market used to be the private domain of hedge funds, global banks, multinational corporations, and wealthy private investors the world over. But that all changed a few years ago when the Internet-based technological revolution of online trading spread over to the forex markets. Today, tens of thousands of individual traders and investors all over the world are discovering the excitement and challenges of trading in the forex market.

No question about it, forex markets can be one of the fastest and most volatile financial markets to trade. Money can be made or lost in a matter of seconds or minutes. At the same time, currencies can display significant trends lasting several days to weeks and even years.

Whether you're an experienced trader in other markets looking to expand into currencies, or a total newcomer to trading looking to start out in currencies, this book is an ideal place to start.

Who This Book Is For

In contrast to the stock market, which is more familiar and relatively intuitive to most investors, the forex market somehow remains more elusive and seemingly complicated to newcomers. I've written *Currency Trading For Dummies,* Getting Started 2nd Edition, to pull back the curtain and strip away the mystique of the forex market for smart, intelligent investors like you who know something about the potential of the forex market but don't know how it actually works. I encourage you to read this book and then, if you like what you've read, put your knowledge and intuition to the test by getting a practice trading account with an online forex brokerage before you put any actual money at risk.

About This Book

I've designed *Currency Trading for Dummies,* Getting Started 2nd Edition, as an easy-access reference guide containing the no-nonsense information you need to take the first step into the world of currency trading.

- **Chapter 1: What is the Forex Market?** This chapter introduces you to the global forex market and gives you an idea of its size and scope. I take you around the world in a currency trading day, highlighting the folks who do most of the currency trading and liquidity in different trading sessions, and I also look at the inter-relationships between the forex market and other major financial markets. At the end of the chapter, I help you in getting started with a practice account.
- **Chapter 2: The Mechanics of Currency Trading.** This chapter examines how currencies are traded in the forex market: which currency pairs are traded, what price quotes mean, how profit and loss is calculated, and how the global trading day flows, just to name a few. I also look at the trading conventions and collateral requirements typical in online margin-based forex trading. If you're ready to start trading now, this chapter has the details for making your first trade. You can catch up on the macro issues in Chapter 1 later.
- **Chapter 3: Choosing Your Trading Style.** Depending on your individual circumstances and your trading temperament, you may decide to pursue one of several overall trading styles. This chapter reviews the various approaches used by professional currency traders and how they influence trading decisions. I also look at how to develop a disciplined trading plan and to stick with it.
- **Chapter 4: Identifying Trade Opportunities.** In order to trade well, you have to analyze the data you gather, and I recommend a mix of both fundamental and technical analysis. This chapter explains both in brief and offers my suggestions for creating a well-balanced analysis strategy.

- **Chapter 5: Managing Your Risk.** This chapter highlights the many risk management considerations a skillful trader factors into his or her trading plan, because — as the chapter explains — risk management entails much more than avoiding losses. The chapter also helps you apply these considerations to your trading strategy.
- **Chapter 6: Managing the Trade.** In this chapter, I put it all together and explain how to get the most out of your trades. I walk you through the various ways of monitoring the market and explain how to manage the trade while it's open, how to close out the position, and how to evaluate your results critically.

Conventions Used in This Book

The forex market has its own lexicon, and while the other parts of this book give you the lowdown on things like pips and one-cancels-the-other orders, you should know upfront that global currencies are known by common, three-letter abbreviations. Here's a list of the currency codes for the most actively traded currencies I focus on in this book:

- USD: U.S. Dollar
- EUR: Eurozone Euro
- JPY: Japanese Yen
- GBP: British Pound
- CAD: Canadian Dollar
- AUD: Australian Dollar
- NZD: New Zealand Dollar
- CHF: Swiss Franc

Icons Used in This Book

Throughout this book, you see icons in the margins, highlighting certain paragraphs. Here are the icons I use and what they mean:

Theories are fine, but anything marked with a Tip icon tells you what currency traders *really* think and respond to. These are the tricks of the trade.

Paragraphs marked with the Remember icon contain the key takeaways from this book and the essence of each subject's coverage.

Achtung, baby! The Warning icon highlights errors and mistakes that can cost you money, your sanity, or both.

You can skip anything marked by the Technical Stuff icon without missing out on the main message, but you may find the information useful for a deeper understanding of the subject.

Want to go deeper? Try the big book

If you want to delve more deeply into currency trading, consider picking up the full version of *Currency Trading For Dummies*, from which this special edition was derived. The full version of *Currency Trading For Dummies* shows you how the forex market really works, what moves it, and how you can actively trade it. I also provide you with the tools to develop a structured game plan you need to trade in the forex market and not lose your shirt.

Chapter 1

What Is the Forex Market?

In This Chapter

- Getting inside the forex market
- Understanding that speculating is the name of the game
- Trading currencies around the world
- Linking other financial markets to currencies
- Getting a feel for currency trading with a practice account

The foreign exchange, or *forex,* market has exploded onto the scene and is the hot new retail financial market. It's been around for years, but advances in electronic trading have now made it available to individual traders on a scale unimaginable just a few years ago. But just because currency trading is more accessible doesn't mean it's widely understood.

I've spent my professional career in the forex market, and I can't think of a better traders' market. In my opinion, nothing quite compares to the speed and exhilaration of the forex market or the intellectual and psychological challenges of trading in it. In this chapter, I show you why.

Defining Currency Trading

At its heart, currency trading is speculation about the value of one currency versus another, the key words being *speculation* and *currency.* Looking at currency trading from those two angles is essential.

On the one hand, currency trading is speculation, pure and simple, just like buying an individual stock or any other financial security in the hope that it will make a profitable return. On the other hand, the securities on which you're speculating are the currencies of various countries. Viewed separately, that means currency trading is both about the dynamics of market speculation, or trading, and the factors that affect the value of currencies. Put them together and, in my opinion, you've got the largest, most dynamic and exciting financial market in the world.

Grasping the Fundamentals of Forex Trading

In short, the foreign exchange market is the largest and most liquid of all international financial markets. I like to think of it as the Big Kahuna of financial markets. This market is the crossroads for international capital, the intersection through which global commercial and investment flows have to move. International trade flows, such as when a Swiss electronics company purchases Japanese-made components, were the original basis for the development of the forex markets.

Today, however, global financial and investment flows dominate trade as the primary non-speculative source of forex market volume. Whether it's an Australian pension fund investing in U.S. Treasury bonds, or a British insurer allocating assets to the Japanese equity market, or a German conglomerate purchasing a Canadian manufacturing facility, each cross-border transaction passes through the forex market at some stage.

As a result, the forex market is, more than anything else, a trader's market without equal. It's a market that's open around the clock from Sunday evening 5 p.m. ET to Friday 5 p.m. ET, enabling traders to act on news and events as they happen. It's a market where half-billion-dollar trades can be executed in a matter of seconds and may not even move prices noticeably. In fact, average daily currency trading volumes are now estimated to $4 trillion per day, according to the 2010 BIS survey of forex volumes. $4,000,000,000,000 — that's a lot of zeros, no matter how you slice it. To give you some perspective on that size, it's about 15 to 20 times the size of daily trading volume on all the world's stock markets *combined.* Try buying or selling a half-billion of anything in another market, and see how prices react.

This section explains a bit more about the forex market and how it works.

Trading for on-the-spot prices

Spot refers to the price where you can buy or sell currencies *now,* as in "on the spot." Technically, the term refers to the nearest settlement date on which a transaction can be made. The forex market is normally traded for settlement in two business days.

Understanding how high liquidity affects market prices

Liquidity refers to the level of *market interest* — the level of buying and selling volume — available at any given moment for a particular asset or security. The higher the liquidity, or the *deeper* the market, the faster and easier it is to buy or sell a security.

From a trading perspective, liquidity is a critical consideration because it determines how quickly prices move between trades and over time. A highly liquid market like forex can see large trading volumes transacted with relatively minor price changes. An illiquid, or *thin,* market will tend to see prices move more rapidly on relatively lower trading volumes. A market that only trades during certain hours (futures contracts, for example) also represents a less liquid, thinner market. For more information on managing liquidity, see Chapter 5.

Speculating based on frequent price fluctuations

Although commercial and financial transactions in the currency markets represent huge nominal sums, they still pale in comparison to amounts based on speculation. By far the vast majority of currency trading volume is based on speculation — traders buying and selling for short-term gains based on minute-to-minute, hour-to-hour, and day-to-day price fluctuations.

Estimates are that upwards of 90 percent of daily trading volume is derived from speculation (meaning, commercial or investment-based FX trades account for less than 10 percent of daily global volume). The depth and breadth of the speculative market means that the liquidity of the overall forex market is unparalleled among global financial markets.

The bulk of spot currency trading, more than 75 percent by volume, takes place in the so-called "major currencies," which represent the world's largest and most developed economies. Trading in the major currencies is largely free from government regulation and takes place outside the authority of any national or international body.

Additionally, activity in the forex market frequently functions on a regional "currency bloc" basis, where the bulk of trading takes place between the USD bloc, JPY bloc, and EUR bloc, representing the three largest global economic regions.

Who Trades Currencies? Meet the Players

Participants in the forex market generally fall into one of two categories: financial transactors and speculators. *Financial transactors* are active in the forex market as part of their overall business but not necessarily for currency reasons. For instance, an electric utility operator in the U.S. may need EUR to buy a German-made turbine for a new generator. *Speculators* are in it purely for the money. In the forex market, speculators are running the show.

Why Trade in the Forex Market?

As much as I like to think of the forex market as the be all and end all of financial trading markets, it doesn't exist in a vacuum. You may even have heard of some of these other markets: gold, oil, stocks, and bonds.

Comparing risk across markets

Generally speaking, currency markets overlap with other major asset markets based on the global investment environment, with *risk sentiment* as the key barometer. Risk sentiment refers to investors' moods and the level of risk appetites they're displaying: Are investors seeking risk, or are they seeking safety? When times are good, risk assets (such as stocks and commodities) tend to appreciate as growth and demand expectations are positive. When times are bad or uncertainty is high, risk assets tend to suffer, and more defensive assets (like government bonds, gold, or the USD) are sought after.

The currency market corollary breaks down by individual major currencies, with the USD, JPY, and CHF typically viewed as the *safe haven* currencies and most others viewed as *risk* currencies. Of course, the overlap between FX and other major assets classes will also be determined by what's happening to other key drivers of individual currencies, such as interest rates or growth expectations.

Gold

Gold (XAU) is commonly viewed as a hedge against inflation, an alternative to the U.S. dollar, and as a store of value in times of economic or political uncertainty. In recent years, gold has also been viewed as an alternative to major fiat currencies, with gold strengthening as both the USD and EUR came under pressure. Over the long term, gold's relationship is mostly inverse to the USD, with a weaker USD generally accompanying a higher gold price, and a stronger USD coming with a lower gold price. However, in the short run, each market has its own dynamics and liquidity, which makes short-term trading relationships more difficult to gauge. Figure 1-1 shows a *dealing box* that indicates the value of currencies — in this case, gold relative to the USD. You often use dealing boxes to determine whether and what to trade, so get used to seeing them. Relationships between gold and currencies also can be portrayed in chart form; Figure 1-2 shows gold versus the Australian dollar.

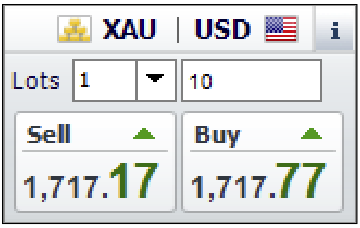


Figure 1-1: Example of a XAU/USD (Gold/USD) dealing box on FOREX.com trading platform.

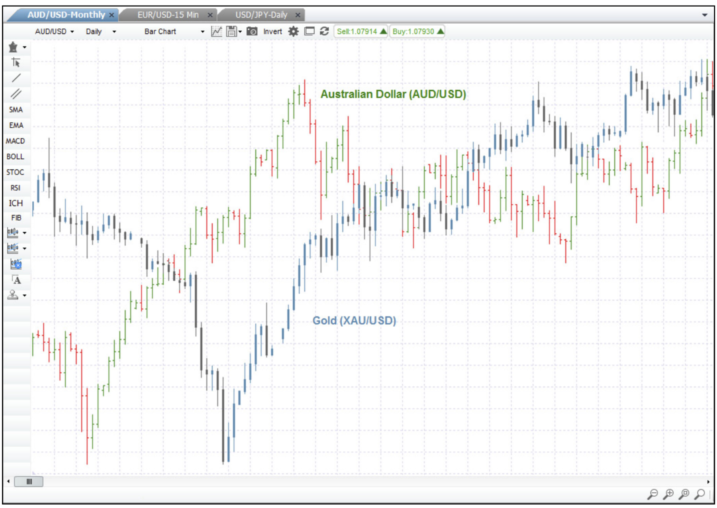


Figure 1-2: Gold tracking vs. the Australian dollar.

Oil

Crude oil is the largest of the global commodity markets and a finely balanced one at that. That means even minor supply disruptions can send oil prices jumping higher, whereas excess supply (seen in weekly inventory data) can send prices dropping quickly.

Oil is usually priced in USD, so there is a tendency for oil prices to trade inversely to the value of the USD. This is especially apparent when the USD is in a weakening phase.

The best way to look at oil is as an inflation input and as a limiting factor on overall economic growth. The higher the price of oil, the higher inflation is likely to be and the slower an economy is likely to grow. The lower the price of oil, the lower inflationary pressures are likely (but not necessarily) to be.

Stocks

Stocks are microeconomic securities, rising and falling in response to individual corporate results and prospects, whereas currencies are essentially macroeconomic securities, fluctuating in response to wider-ranging economic and political developments. As such, there is little intuitive reason that stock markets should be related to currencies.

In recent years, however, risk sentiment (see the "Comparing risk across markets" section, earlier in this chapter) has taken on greater significance in global markets, increasingly driving asset classes from stocks and commodities to currencies and precious metals.

Bonds

Fixed income or bond markets have a more intuitive connection to the forex market because they're both heavily influenced by interest rate expectations. However, short-term market dynamics of supply and demand interrupt most attempts to establish a viable link between the two markets on a short-term basis. Sometimes the forex market reacts first and fastest, depending on shifts in interest rate expectations. At other times, the bond market more accurately reflects changes in interest rate expectations, with the forex market later playing catch-up.

Around the World in a Trading Day

The forex market is open and active 24 hours a day, from the start of business hours on Monday morning in the Asia-Pacific time zone straight through to the Friday close of business hours in New York. At any given moment, depending on the time zone, dozens of global financial centers — such as Sydney, Tokyo, or London — are open, and currency trading desks in those financial centers are active in the market.

In addition to the major global financial centers, many financial institutions operate 24-hour-a-day currency trading desks, providing an ever-present source of market interest. It may be a U.S. hedge fund in Boston that needs to monitor currencies around the clock, or it may be a major international bank with a concentrated global trading operation in Singapore.

The opening of the trading week

There is no officially designated starting time to the trading day or week, but for all intents the market action kicks off when Wellington, New Zealand, the first financial center west of the international dateline, opens on Monday morning local time. Depending on where you live, it roughly corresponds to early Sunday afternoon in North America, Sunday evening in Europe, and very early Monday morning in Asia.

The Sunday open represents the starting point where currency markets resume trading after the Friday close of trading in North America (5 p.m. eastern time [ET]). This is the first chance for the forex market to react to news and events that may have happened over the weekend. Prices may have closed New York trading at one level, but depending on the circumstances, they may start trading at different levels at the Sunday open.

Trading in the Asia-Pacific session

Currency trading volumes in the Asia-Pacific session account for about 22 percent of total daily global volume, according to the 2010 BIS survey. The principal financial trading centers are Wellington, New Zealand; Sydney, Australia; Tokyo, Japan; Hong Kong; and Singapore.

In terms of the most actively traded currency pairs, that means news and data reports from New Zealand, Australia, and Japan are going to be hitting the market during this session.

Also during Asia/Pacific trading, late speakers from the United States, such as Federal Reserve officials speaking on the West Coast of the United States, may offer remarks on the U.S. economy or the direction of U.S. interest rates that affect the value of the U.S. dollar against other major currencies.

Trading in the European/ London session

About midway through the Asian trading day, European financial centers begin to open up, and the market gets into full swing. European financial centers and London account for more than 55 percent of total daily global trading volume, with London alone accounting for more than one-third of total daily global volume, according to the 2010 BIS survey.

The European session overlaps with half of the Asian trading day and half of the North American trading session, which means that market interest and liquidity is at its absolute peak during this session.

News and data events from the Eurozone (and individual countries like Germany and France), Switzerland, and the United Kingdom are typically released in the early-morning hours of the European session. As a result, some of the biggest moves and most active trading take place in the European currencies (EUR, GBP, and CHF) and the euro cross-currency pairs (EUR/CHF and EUR/GBP).

REMEMBER

News events can play a big role in price movements. Make sure that you choose a forex platform that keeps you up-to-date on the latest events. For an example, check out this link: forex.com/latest-forex-research.html.

Trading in the North American session

Because of the overlap of North American and European trading sessions, the trading volumes are much more significant. Some of the biggest and most meaningful directional price movements take place during this crossover period, roughly between 7 a.m. and noon ET. On its own, however, the North American trading session accounts for roughly the same share of global trading volume as the Asia-Pacific market, or just under 20 percent of global daily trading volume.

The North American morning is when key U.S. economic data is released, and the forex market makes many of its most significant decisions on the value of the U.S. dollar. Figure 1-3 shows a EUR/USD dealing box. Most U.S. data reports are released at 8:30 a.m. ET, with others coming out later (between 9 and 10 a.m. ET). Canadian data reports are also released in the morning, usually between 7 and 9 a.m. ET.

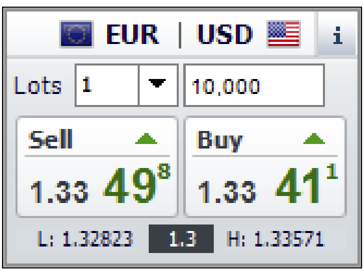


Figure 1-3: Example of the EUR/USD dealing box on the FOREX.com platform.

Getting Started with a Practice Account

Practice accounts give you a great chance to experience the minute-to-minute price movements of the forex market. You'll be able to see how prices change at different times of the day, as well as how various currency pairs may differ from each other.

In addition to witnessing how the forex market really moves, you can

- Start trading in real market conditions without any fear of losing money.
- Experiment with different trading strategies to see how they work.

- Gain experience using different orders and managing open positions.
- Start analyzing charts and following technical indicators.

Test the markets with a FOREX.com practice account. You can open a free practice account today by clicking here:

forex.com/open-account.html?type=practice

If you'd like to know a bit more about the forex market before you open up a practice account, no problem. The other chapters in this book are filled with battle-tested advice from my more than 20 years covering the forex markets as a senior trader and analyst at some of the world's leading international banks.

Chapter 2

The Mechanics of Currency Trading

In This Chapter

- Understanding currency pairs
- Calculating profit and loss
- Executing a trade
- Using different types of orders

The forex market has its own set of trading conventions, like how prices are quoted and orders executed, just like any other financial market. Then there's the forex lingo and some FX-specific transactions. If you're new to currency trading, the mechanics and terminology may take some getting used to. But at the end of the day, you'll see that most currency trade conventions are pretty straightforward. In this chapter, I give you an overview of the basic mechanics of forex trading.

How Currency Trades Work: Simultaneous Buying and Selling

The biggest mental hurdle facing newcomers to currencies, especially traders familiar with other markets, is getting their head around the idea that each currency trade consists of a simultaneous purchase and sale. In the stock market, for instance, if you buy 100 shares of Google, it's pretty clear that you now own 100 shares and hope to see the price go up. When you want to exit that position, you simply sell what you bought earlier. Easy, right?

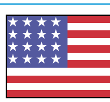
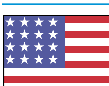
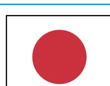
But in currencies, the purchase of one currency involves the simultaneous sale of another currency. This is the *exchange* in *foreign exchange.* To put it another way, if you're looking for the dollar to go higher, the question is "Higher against what?" The answer has to be another currency. In relative terms, if the dollar goes up against another currency, it also means that the other currency has gone down against the dollar. To think of it in stock-market terms, when you buy a stock, you're selling cash, and when you sell a stock, you're buying cash.

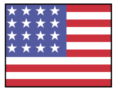
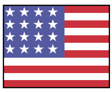
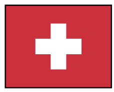
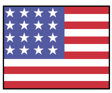
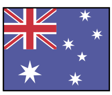
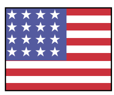
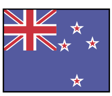
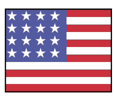
To make matters easier, forex markets refer to trading currencies by pairs, with names that combine the two different currencies being traded against each other, or exchanged for one another. Additionally, forex markets have given most currency pairs nicknames or abbreviations, which reference the pair and not necessarily the individual currencies involved. And the order in which the currencies are listed is important for knowing exactly what you're buying and selling.

Major currency pairs

The major currency pairs all involve the U.S. dollar on one side of the deal. The designations of the major currencies are expressed using International Standardization Organization (ISO) codes for each currency. Table 2-1 lists the most frequently traded currency pairs, what they're called in conventional terms, and what nicknames the market has given them.

Table 2-1 The Major U.S. Dollar Currency Pairs

Symbol		*Currency Pair*	*Countries*	*Long Name*	*Nickname*
		EUR/USD	Eurozone*/ U.S.	Euro-Dollar	Euro
		USD/JPY	U.S./Japan	Dollar-Yen	Yen

Symbol		Currency Pair	Countries	Long Name	Nickname
		GBP/USD	United Kingdom/ U.S.	British Pound-Dollar	Sterling or Cable
		USD/CHF	U.S./ Switzerland	Dollar-Swiss	Swissy
		USD/CAD	U.S./Canada	Dollar-Canada	Loonie
		AUD/USD	Australia/ U.S.	Australian-Dollar	Aussie
		NZD/USD	New Zealand/ U.S.	New Zealand-Dollar	Kiwi

**The Eurozone is made up of all the countries in the European Union that have adopted the euro as their currency.*

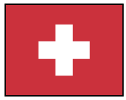
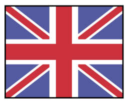
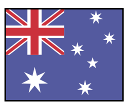
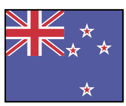
Major cross-currency pairs

Although the vast majority of currency trading takes place in the dollar pairs, cross-currency pairs serve as an alternative to always trading the U.S. dollar. A cross-currency pair, or *cross* or *crosses* for short, is any currency pair that does not include the U.S. dollar.

TIP

The most actively traded crosses focus on the three major non-USD currencies (namely EUR, JPY, and GBP) and are referred to as euro crosses, yen crosses, and sterling crosses. The remaining currencies (CHF, AUD, CAD, and NZD) are also traded in cross pairs. Table 2-2 highlights the key cross pairs in the euro along with their market names.

Table 2-2 The Major Euro Cross-Currency Pairs

Symbol		***Currency Pair***	***Countries***	***Long Name***
		EUR/CHF	Eurozone*/ Switzerland	Euro-Swiss
		EUR/GBP	Eurozone/ United Kingdom	Euro-Sterling
		EUR/CAD	Eurozone/ Canada	Euro-Canada
		EUR/ AUD	Eurozone/ Australia	Euro-Aussie
		EUR/NZD	Eurozone/ New Zealand	Euro-Kiwi

**The Eurozone is made up of all the countries in the European Union that have adopted the euro as their currency.*

Base currencies and counter currencies

When you look at currency pairs, you may notice that the currencies are combined in a seemingly strange order. For instance, if sterling-yen (GBP/JPY) is a yen cross, then why isn't it referred to as "yen-sterling" and written "JPY/GBP"? The answer is that these quoting conventions evolved over the years to reflect traditionally strong currencies versus traditionally weak currencies, with the strong currency coming first.

It also reflects the market quoting convention where the first currency in the pair is known as the *base currency* (see Figure 2-1). The base currency is what you're buying or selling when you buy or sell the pair. It's also the notional, or face, amount of the trade. So if you buy 100,000 EUR/JPY, you've just bought 100,000 euros and sold the equivalent amount in Japanese yen. If you sell 100,000 GBP/CHF, you just sold 100,000 British pounds and bought the equivalent amount of Swiss francs.

Figure 2-1: Currency pairs list the base currency on the left, the counter or secondary currency on the right.

The second currency in the pair is called the *counter currency,* or the *secondary currency.* Hey, who said this stuff was complicated? Most important for you as an FX trader, the counter currency is the denomination of the price fluctuations and, ultimately, what your profit and losses will be denominated in. If you buy GBP/JPY, it goes up, and you take a profit, your gains are not in pounds, but in yen.

Learn more online

If what you're reading piques your interest, check out the videos on FOREX.com's Learning Center. You can find the home page for the videos at forex.com/forex-video-tutorials.html. There you'll find videos on many of the topics in this chapter, including:

- How the forex market works
- Understanding forex quotes
- Understanding what a pip is

The following figure shows the Learning Center home page.

Dealing with Profit and Loss

Profit and loss (P&L) is how traders measure success and failure. You don't want to be looking at the forex market as some academic or thrill-seeking exercise. Real money is made and lost every minute of every day. If you're going to trade currencies actively, you need to get up close and personal with P&L.

Understanding how profit and loss works

In order to understand profit and loss, you absolutely must be aware of two concepts: leverage and margin. These two concepts affect how much you can trade and how much money or collateral you will need to manage your positions.

Leverage amplifies risk and reward

Margin trading is usually based on *leverage,* where the brokerage effectively lets you borrow more money than you have deposited as collateral. Leverage refers to the ratio of that loan to your collateral. A leverage ratio of 50:1, for example, means that your collateral can be leveraged 50 times.

REMEMBER

The real point of leverage is what it does to your trading results: It amplifies any gains or losses equally. If your trade is profitable, great. You just made more than you otherwise could have. But if your trade misses, the result is a larger loss than you may be willing or able to tolerate. Above all, don't be deluded into trying to maximize position size. Stay focused on your P&L targets when devising a trade strategy and what those results mean for your margin balance (more on that topic in the next section).

TIP

Many newcomers to the currency market seek out the highest leverage ratios available, sometimes opening accounts offshore in questionable jurisdictions. Use leverage sparingly; that 50:1 is more than ample to trade actively, yet prudently.

Margin balances and liquidations

When you open a currency trading account, you'll need to fund your account as collateral to support the margin requirements established by your broker. That initial margin deposit becomes your opening *margin balance* and is the basis on which all your subsequent trades are collateralized. Unlike futures markets or margin-based equity trading, forex brokerages do not issue *margin calls* (requests for more collateral to support open positions). Instead, they establish ratios of margin balances to open positions that must be maintained at all times.

WARNING!

Be sure you completely understand your broker's margin requirements and liquidation policies. Requirements may differ depending on account size and whether you're trading standard lot sizes (100,000 currency units) or mini-lot sizes (10,000 currency units). Figure 2-2 shows a sample chart of requirements.

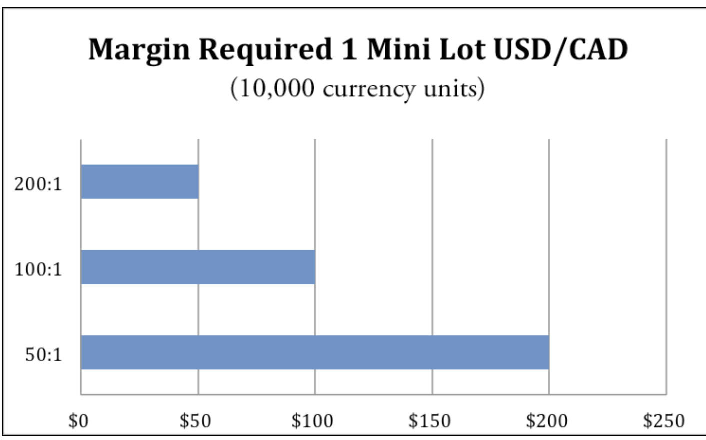


Figure 2-2: Sample chart of leverage ratios and margin collateral required.

Calculating profit and loss with pips

Profit-and-loss calculations are pretty straightforward in terms of math — it's all based on position size and the number of pips you make or lose. A *pip* is the smallest increment of price fluctuation in currency prices. Pips can also be referred to as *points;* I use the two terms interchangeably.

It's unclear where the term *pip* came from. Some say it's an abbreviation for *percentage in point,* but it could also be the FX answer to bond traders' *bips,* which refers to *bps,* or *basis points* (meaning 1/100 of 1 percent). Even the pip has been broken down further to the smaller fractional pip or decimal; for example, EUR/USD can be priced five decimals to the right (EUR/USD 1.33498, with the "9" being a pip and the "8" showing the fractional pip — Figure 2-3 shows these numbers in a sample dealing box). The good news for traders is that fractional pricing may lead to narrower trading spreads. Instead of trading on a whole pip spread of 3 pips, you might see a spread of 2.6 or 2.2 pips, which can lead to lower transaction costs over time.

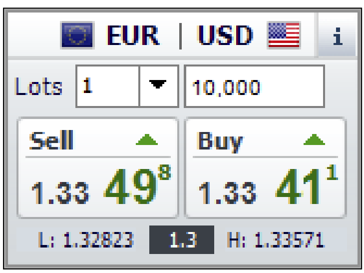


Figure 2-3: A sample dealing box showing pips and fractional pips.

Understanding Currency Prices

Now you're getting down to the brass tacks of actually making trades in the forex market. Before you get ahead of yourself, though, it's critical to understand exactly how currency prices work and what they mean to you as a trader. Here, you look at how brokerages display currency prices and what they mean for trade and order execution.

When you're in front of your screen and looking at a forex broker's trading platform, you'll see two prices for each currency pair. The price on the left-hand side is called the *bid,* and the price on the right-hand side is called the *offer* (some call this the *ask*). Some brokers display the prices above and below each other, with the bid on the bottom and the offer on the top. The easy way to tell the difference is that the bid price will always be lower than the offer price.

The price quotation of each bid and offer you see will have two components: the big figure and the dealing price. The *big figure* refers to the first three digits of the overall currency rate and is usually shown in a smaller font size or even in shadow. The *dealing price* refers to the last three digits of the overall currency price and is brightly displayed in a larger font size. The two big numbers are the last whole pips, and the smaller number is the tenth of a pip.

For example, in Figure 2-4 the full EUR/USD price quotation is 1.40225/1.40246. The 1.40 is called the big figure and is there to show you the full price level at which the market is currently trading. The 225/246 portion of the price is the bid/offer dealing price in pips.

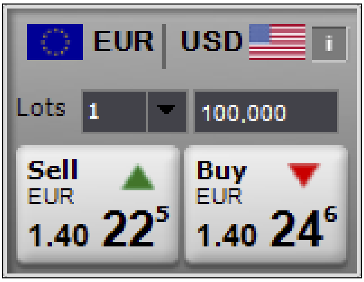


Figure 2-4: A dealing box from the FOREX.com trading platform for EUR/USD.

The *spread* is the difference between the bid price and the offer price. In one sense, you can look at the spread as the commission that the brokers charge for executing your trades. So even if they *say* they're commission free, they may be earning the difference when one trader sells at the bid price and another trader buys at the offer price. Spreads are standard in all financial market trading.

Executing a Trade

There are two main ways of executing trades in the forex market: live trades and orders. If you're an adrenaline junkie, don't focus only on the "Trading live" section — the "orders" section gives you plenty of juice to keep you going, too.

Trading live

Live dealing is how you access the market to buy or sell at current market rates. Knowing exactly what you want to do is important, because when you click the buy or sell button, it's a *done* deal. If you make a mistake, you'll have to make another trade to correct your erroneous trade, and that is very likely going to cost you real money.

Entering orders

Currency traders use orders to catch market movements when they're not in front of their screens. ***Remember:*** The forex market is open from Sunday evening (ET) through Friday afternoon (ET). Orders are how you can act in the market without being there.

Experienced currency traders also routinely use orders to

- Implement a trade strategy from entry to exit
- Capture sharp, short-term price fluctuations
- Limit risk in volatile or uncertain markets
- Preserve trading capital from unwanted losses
- Maintain trading discipline
- Protect profits and minimize losses

I can't stress enough the importance of using orders in currency trading. Forex markets can be notoriously volatile and difficult to predict. Using orders can help you capitalize on short-term market movements, as well as limit the impact of any adverse price moves. A disciplined use of orders can also help you to quantify the risk you're taking and, with any luck, give you peace of mind in your trading. ***Bottom line:*** Although contingent orders will not necessarily limit losses, if you don't use orders, you probably don't have a well-thought-out trading strategy — and that can be a recipe for pain.

There are five types of orders available in the forex market:

- **Take-profit orders:** You'll use these orders to lock in gains when you have an open position in the market.
- **Limit orders:** Technically speaking, a take-profit order is a type of *limit order*. The key difference is that take-profit orders close or reduce open positions, and limit orders open new positions or add to existing positions in the same direction.
- **Stop-loss orders:** The traditional *stop-loss order,* or just *stop order* (I use the terms interchangeably going forward), does just that: It stops losses by closing out an open position that is losing money. You'll use stop orders to limit your losses if the market moves against your position, as shown in Figure 2-5. If you don't, you're leaving it up to the market, and that's always a dangerous proposition.

Figure 2-5: Sample chart from FOREX.com's FOREXTrader PRO trading platform.

- **Trailing stop-loss orders:** This order is a stop-loss order that you set at a fixed number of pips from your entry rate. The trailing stop adjusts the order rate as the market price moves, *but only in the direction of your trade.*

For example, if you're long EUR/CHF at 1.3750 and you set the trailing stop at 30 pips, the stop will initially become active at 1.3720 (1.5750 @ 30 pips). If the EUR/CHF price moves higher to 1.3760, the stop adjusts higher, pip for pip, with the price and will then be active at 1.3730. The trailing stop will continue to adjust higher as long as the market continues to move higher. When the market puts in a top, your trailing stop will be 30 pips (or whatever distance you specify) below that top, wherever it may be. If the market ever goes down by 30 pips, as in this example, your stop will be triggered and your position closed.

- **One-cancels-the-other orders (OCO orders):** This order is a stop-loss order paired with a take-profit order. It's the ultimate insurance policy for any open position. Your position will stay open until one of the order levels is reached by the market and closes your position. When one order level is reached and triggered, the other order automatically cancels. OCO orders are highly recommended for every open position.

Bear in mind that not all order types are available at all brokers, so add order types to your list of questions to ask your prospective forex broker.

Chapter 3

Choosing Your Trading Style

In This Chapter

- Taking an honest look at your lifestyle
- Understanding the different trading styles
- Developing and maintaining market discipline

Before you get involved in actively trading the forex market, it's important to take a step back and think about how you want to approach the market. There is more to this than meets the eye, and I think it's one of the most important determinants of overall trading success.

I'm frequently asked, "What's the best way to trade the forex market?" For starters, that's a loaded question that suggests there's a right way and a wrong way to trade currencies. It also implies that there's some magic formula out there, and if you can just find out what it is, you'll be guaranteed trading success. Unfortunately, there is no easy answer. Better put, there is no *standard* answer — one that applies to everyone.

The forex market's trading characteristics have something to offer every trading style (long-term, medium-term, or short-term) and approach (technical, fundamental, or a blend). So in terms of deciding what style or approach is best suited to currencies, the starting point is not the forex market itself, but your own individual circumstances and way of thinking. After you examine your resources, you can choose a style and create a trading plan — and above all, you need to stick with that plan. We highlight each of those steps in this chapter.

First Things First: Assessing Your Resources

As with many of life's endeavors, when it comes to financial-market trading, there are two main resources that people never seem to have enough of: time and money. Deciding how much of each you can devote to currency trading will help to establish how you pursue your trading goals.

When it comes to money, I can't stress enough that trading capital has to be risk capital and that you should never risk any money that you can't afford to lose. The standard definition of *risk capital* is money that, if lost, will not materially affect your standard of living. It goes without saying that borrowed money is *not* risk capital — you should never use borrowed money for speculative trading. When you determine how much risk capital you have available for trading, you'll have a better idea of what size account you can trade and what position size you can handle.

Surveying the Different Styles

Although there are as many different trading styles and market approaches in FX as there are individuals in the market, most of them can be grouped into three main categories that boil down to varying degrees of exposure to market risk. The two main elements of market risk are time and relative price movements. The longer you hold a position, the more risk you're exposed to. The more of a price change you're anticipating, the more risk you're exposed to.

Short-term, high-frequency day trading

Short-term trading in currencies is unlike short-term trading in most other markets. A short-term trade in stocks or commodities usually means holding a position for a day to several days at least. But the steady and fluid price action in currencies allows for extremely short-term trading by speculators intent on capturing just a few pips on each trade.

Short-term trading in forex typically involves holding a position for only a few seconds or minutes and rarely longer than an hour. But the time element is not the defining feature of short-term currency trading. Instead, the pip fluctuations are what's important. Traders who follow a short-term trading style are seeking to profit by repeatedly opening and closing positions after gaining just a few pips, typically 5 to 10 pips but also as little as 1 or 2 pips.

TIP

Here are some other important guidelines to keep in mind when following a short-term trading strategy:

- **Trade only the most liquid currency pairs, such as EUR/USD, USD/JPY, EUR/GBP, EUR/JPY, and EUR/CHF.** The most liquid pairs will have the tightest trading spreads and will be subject to fewer sudden price jumps.
- **Trade only during times of peak liquidity and market interest.** Market liquidity is deepest during the European session when Asian and North American trading centers overlap with European time zones — about 2 a.m. to noon eastern time (ET).
- **Focus your trading on only one pair at a time.** If you're aiming to capture second-by-second or minute-by-minute price movements, you'll need to fully concentrate on one pair at a time.
- **Preset your default trade size so you don't have to keep specifying it on each deal.**
- **Adjust your risk and reward expectations to reflect the dealing spread of the currency pair you're trading.** With 1- to 4-pip spreads on most major pairs, you probably need to capture 3 to 10 pips per trade to offset losses if the market moves against you.
- **Avoid trading around data releases.** Carrying a short-term position into a data release can be risky because prices may gap sharply after the release, blowing a short-term strategy out of the water.

Medium-term directional trading

Medium-term positions are typically held for periods ranging anywhere from a few hours to a day or two, but usually not much longer. Just as with short-term trading, the key distinction for medium-term trading is not the length of time the position is open, but the amount of pips you're seeking/risking.

Medium-term trading seeks to get the overall direction right and profit from more significant currency rate moves. By the same token, medium-term traders recognize that markets rarely move in one direction for too long, so they approach the market with well-defined trade entry and exit strategies.

REMEMBER

Medium-term category is sometimes referred to as *momentum trading* and *swing trading*.

Unlike short-term trading, medium-term trading demands a broader perspective, greater analytical effort, and a lot more patience.

TIP

Medium-term traders typically pursue one of the following overall approaches, but there's also plenty of room to combine strategies:

- **Trading a view:** Having a fundamental-based opinion on which way a currency pair is likely to move. View trades are typically based on prevailing market themes, like interest rate expectations or economic growth trends. View traders still need to be aware of technical levels as part of an overall trading plan.
- **Trading the technicals:** Basing your market outlook on chart patterns, trend lines, support and resistance levels, and momentum studies. Technical traders typically spot a trade opportunity on their charts, but they still need to be aware of fundamental events, because they're the catalysts for many breaks of technical levels.
- **Trading events and data:** Basing positions on expected outcomes of events, like a central bank rate decision or individual data reports. Event/data traders typically open positions well in advance of events and close them when the outcome is known (also known as buy the rumor/sell the fact, or vice versa).
- **Trading with the flow:** Trading based on overall market direction (trend) or information of major buying and selling (flows). To trade on flow information, look for a broker that offers market flow commentary, like that found in FOREX.com's *Forex Insider,* which you can visit at forex.com/forex_research_overview.html.

Long-term macroeconomic trading

Long-term trading in currencies is generally reserved for hedge funds and other institutional types with deep pockets. Long-term trading in currencies can involve holding positions for weeks, months, and potentially years at a time. Holding positions for that long necessarily involves being exposed to significant short-term volatility that can quickly overwhelm margin trading accounts.

TIP

With proper risk management, individual margin traders can seek to capture longer-term trends. The key is to hold a small enough position relative to your margin that you can withstand volatility of as much as 5 percent or more. Mini accounts, which trade in lot sizes of 10,000 currency units, are a good vehicle to take advantage of longer-term price trends.

TIP

Long-term trading seeks to capitalize on major price trends, which are in turn the result of long-term macroeconomic factors. Before you embark on long-term speculation, you want to see how some of the following macroeconomic chips stack up:

- **Interest rate cycles:** Where are the two currencies' relative interest rates, and where are they likely to go in the coming months? Narrower interest-rate differentials will tend to help the lower-yielding currency and hurt the higher-yielding currency; wider interest-rate differentials will help the higher-yielding currency and hurt the lower-yielding one.
- **Economic growth cycles:** What's the outlook for relative growth over the next several months? An economy that is in an expansionary phase of growth is likely to see higher interest rates in the future, which would support that currency. An economy that is showing signs of slowing may see interest rate expectations lowered, hurting the currency in the process.
- **Currency policies:** Are the currencies considered to be excessively overvalued or undervalued by the major global trading powers? Is the G20 or national government/central bank agitating for changes in a currency's value?
- **Structural deficits or surpluses:** Do the currencies have any major structural issues that tend to see currencies weaken or strengthen, such as fiscal deficits/surpluses or trade deficits/surpluses?

Trading on auto-pilot

The rapid growth of the online forex market has spawned a diverse array of automated trading systems, known as *Expert Advisors* (or EAs for short), for individual traders. EAs represent yet another trading approach and one that can blend many of those outlined in this chapter.

EAs come in all shapes and sizes with varying complexity or number of rules. (EAs are also known as *rules-based trading systems,* meaning whenever the systems' rules are satisfied, a trade signal is generated.) Some are fully automated (nondiscretionary), firing off trades whenever the rules of the program are met by market movements. Others generate trade alerts and require a manual confirmation by the user before executing a trade (discretionary). Some EAs can be bought off the shelf in a ready-to-go, black-box format, meaning you're using a trading model designed by someone else that usually doesn't allow for modifications. Other EAs come in a build-it-yourself format, allowing you to select the rules you'd like to apply to your trading.

If you'd like to see an example of an EA, click the Watch MT4 Video link here: forex.com/metatrader.html.

Developing (and Sticking To) a Trading Plan

REMEMBER

No matter which trading style you decide to pursue, you need an organized trading plan, or you won't get very far. The difference between making money and losing money in the forex market can be as simple as trading with a plan or trading without one. A *trading plan* is an organized approach to executing a trade strategy that you've developed based on your market analysis and outlook.

Here are the key components of any trading plan:

- **Determining position size:** How large a position will you take for each trade strategy? Position size is half the equation for determining how much money is at stake in each trade.

- **Deciding where to enter the position:** Exactly where will you try to open the desired position? What happens if your entry level is not reached?
- **Setting stop-loss and take-profit levels:** Exactly where will you exit the position, both if it's a winning position (take profit) and if it's a losing position (stop loss)? Stop-loss and take-profit levels are the second half of the equation that determines how much money is at stake in each trade.

Developing a trade plan and sticking to it are the two main ingredients of *trading discipline.* Traders who follow a disciplined approach are the ones who survive year after year and market cycle after market cycle. They can even be wrong more often than right and still make money because they follow a disciplined approach. Yet establishing and maintaining trading discipline is an elusive goal for many traders.

You might wonder, then, why it is so hard for many traders to practice trading discipline. The answer is complex, but it usually boils down to a simple case of human emotions getting the better of them. When it comes to trading in any market, don't underestimate the power of emotions to distract and disrupt.

TIP

It's a lot easier said than done, but keep in mind some of the following, and you may find you're better able to keep your emotions in check:

- **Focus on the pips and not the dollars and cents.** Don't be distracted by the exact amount of money won or lost in a trade. Instead, focus on where prices are and how they're behaving. The market has no idea what your trade size is and how much you're making or losing, but it does know where the current price is.
- **It's not about being right or wrong; it's about making money.** At the end of the day, the market doesn't care if you were right or wrong, and neither should you. The only true measure of trading success is dollars and cents.
- **You're going to lose in a fair number of trades.** No trader is right 100 percent of the time. Taking losses is as much a part of the routine as taking profits. You can still be successful over time with a solid risk-management plan.

- **The market is not out to get you.** The market is going to do what it does whether you're involved in it or not, so don't take your trading results personally. Interpret them professionally, just as you would the results of any other business venture.

Chapter 4

Identifying Trade Opportunities

In This Chapter

- Looking at overall economic factors and market influences
- Grasping the major keys to technical analysis
- Choosing a balanced analysis approach

Spotting trade opportunities and applying a trading plan are what it all boils down to. Traders and speculators spend the time and energy to follow the market and know what's going on. They analyze and strategize, persistently scanning the market for trade opportunities, or *setups,* and waiting for the right time to step in and commit their money. And when they step in, they have a well-defined trade plan to guide them through whatever the market throws at them.

There's certainly no shortage of opinions and ideas being voiced by market analysts and commentators, but in the end the trades you make are your decision. It's important, therefore, to consider on what basis you'll make your trading decisions — fundamental analysis or technical analysis?

Followers of each discipline have always debated which approach works better. Rather than take sides, I suggest following an approach that *blends* the two disciplines. This chapter introduces you to both.

Getting Down and Dirty with Fundamental Data

Simply speaking, *fundamental analysis* studies the core underlying elements that influence the economy of a particular entity, like a stock or currency. Fundamental analysis attempts to predict price action and trends by analyzing economic indicators, government policy, and societal and other factors within a business cycle framework.

Fundamental economic data reports are among the most significant information inputs because policy makers and market participants alike use them to gauge the state of the economy, set monetary policy, and make investment decisions. From a trader's perspective, data reports are the routine catalysts that stir up markets and get things moving.

REMEMBER

The significance of individual reports varies depending on the economic environment, the market's current focus, and a host of other factors. Always keep in mind that markets interpret incoming data based on what it means for the big-picture outlook. If a country's economic outlook is generally viewed as promising, data pointing to stronger growth will reinforce that view, while data that disappoints may suggest a more negative reaction. Most important, the market's reaction to data is more important than the data itself.

Finding the data

Before you can start processing all the economic data, you need to know where to find it. The starting point is the economic calendars typically provided by forex brokerages. Be aware that not all calendars are as comprehensive as others, so be sure to look for calendars that show events and speakers and not just data. Also, look for a broker that provides data and event previews, and real-time data and market analysis;

this type of commentary will help you get a sense of what the market is expecting, how it may be positioned for the news, and how it's likely to react.

In addition, forex.com/economic_calendar.html provides excellent data coverage, both before and after it's released, along with event calendars. Read the economic data news stories on these sites to get the inside story of the data reports, such as any subcomponent readings or significant revisions.

Also, many calendars may include some designations of market significance for each data series, like some are *high impact* or *low impact*. Remember it's the big picture that counts, and even a so-called low-impact report can have a big impact if it's big enough of a surprise.

Making sense of economic data: What to consider

If you're like most people, you probably have a decent idea of what certain economic reports mean, like the unemployment rate or the consumer price index (CPI). But like lots of people, you probably don't have a strong idea of how to put the data together to make sense of it all. Having a fundamental model to put the data in perspective is critical to understanding what the data means and how the market is likely to react to the data. The sooner you're able to make sense of what a specific report means and factor it into the bigger picture, the sooner you'll be able to react in the market.

TIP

I suggest a basic model to interpret the deluge of economic indicators you'll encounter in the forex market. By no means is this model the be-all and end-all of economic theory, but I do think it's a solid framework on which to hang the economic indicators and see how they fit together. It comprises reports from the following categories:

- **The labor market:** I place the employment picture first for the simple reason that jobs and job creation are the keys to medium- and long-term economic outlook for any country or economic bloc. No matter what else is going on, always have a picture of the labor market in the back of your mind. From the currency-market point of view, labor-market strength is typically seen as a currency positive, and labor-market weakness is typically viewed as a currency negative.
- **The consumer:** If it weren't for the overarching importance of jobs to long-run economic growth, the consumer would certainly rank first in any model seeking to understand economic data. The economies of the major currencies are driven overwhelmingly by *personal consumption,* which refers to how people spend their money and accounts for 60 to 70 percent or more of overall economic activity in developed economies.

  In a nutshell, are people spending more, or are they spending less? Also, what's the outlook for their spending — to increase, decrease, or stay the same?
- **The business sector:** Businesses and firms make up the other third of overall economic activity after personal spending. (I'm leaving government out of my model to simplify matters.) Firms contribute directly to economic activity through capital expenditures and indirectly through growth. Look at the data reports to see what they suggest about overall sentiment, capital spending, hiring, inventory management, and production going forward.
- **The overall economic environment:** *Structural indicators* are data reports that cover the overall economic environment; they frequently form the basis for currency trends and tend to be most important to medium- and long-term traders. The main structural reports focus on inflation, growth, trade balance, and fiscal balance.

Assessing economic reports from a trading perspective

The data that you find in economic textbooks is very neat and clean — but the data as it actually arrives in the market can be anything *but* neat and clean. I'm talking here not only about the imperfections of economic data gathering, but also about how markets interpret individual data reports. In this section, I look at important data-reporting conventions and how they can also affect market reactions.

When currencies don't react to the headlines of a data report as you would expect, odds are that either prior-period data has been revised, and you need to look more closely at the report to get the true picture, or the *headline* reading (the complete result of the indicator) is less accurate than the *core* reading (the headline reading minus certain categories or excluding certain items), in which case you also need to look more closely at the report.

Cutting the Fog with Technical Analysis

Saying that there is a lot of information to absorb in the forex market is an understatement of major proportions. To help make sense of all the information, a lot of which can be just noise — the fog of the market — professional traders focus on the one piece of information that is not subject to dispute or opinion: prices.

Technical analysis is a subjective approach aimed at bringing a sense of order to seemingly random price movements. Traders use technical analysis to identify trade opportunities, refine their trading strategies (entry and exit levels), and manage their market risk. In this section, I cover the nuts and bolts of this important skill.

What technical analysis is — and is not

In a nutshell, *technical analysis* is the study of historical price movements to predict future price movements. You're probably familiar with the standard disclaimer that "past performance is no guarantee of future results," a statement that tends to call into question the validity of using past price data to forecast future price developments.

But technical analysis is able to get *beyond* those concerns based on two main considerations:

- **Markets are made up of humans.** Human psychology and investing behavior haven't changed very much over the years. The emotional forces that dictate buying and selling decisions are reflected in historical price patterns that appear over and over in all manner of financial markets. As long as humans are still making the decisions, you'll be able to look at past behavior as a guide to what is likely to happen in the future.
- **Technical analysis is widely practiced in all markets.** This is the self-fulfilling-prophecy aspect of technical analysis. The greater the number of traders who focus on technical analysis, the more likely their actions will reflect the interpretations of technical analysis, reinforcing the impact of that analysis.

Technical analysis requires a great deal of patience, practice, and experimentation based on individual preferences and circumstances. Short-term traders focusing on the next few minutes and hours find certain tools and approaches more helpful than long-term traders do. Longer-term traders looking at multi-day or multi-week trades use other tools and indicators entirely. The key is to develop your own approach based on your particular circumstances — time frame, risk appetite, and discipline.

Understanding the three approaches

Technical analysis can be broken down into three main approaches, which may be combined, based on the trader's preferences:

- **Chart analysis:** Visual inspection of price charts to identify price trends, ranges, support, and resistance levels.
- **Pattern recognition:** Identifies chart formations or patterns that provide specific predictive signals, such as a reversal or a breakout.
- **Momentum and trend analysis:** Looks at the rate of change of prices for indications of market sentiment regarding the price movement. Trend indicators seek to determine the presence of a trend and its strength.

Refer to *Currency Trading For Dummies* for detailed how-to guidance on each of these approaches.

Finding support and resistance

One of the basic building blocks of technical analysis is the concept of *support and resistance:*

- *Support* is a price level where buying interest overwhelms selling interest, causing a price decline to stop, bottom out, or pause. Think of support as a floor for prices in a downmove.
- *Resistance* is, quite simply, the opposite of support. Resistance is where selling interest materializes and slows or overpowers buying interest, causing prices to peak, stall, or pause in a price rally. Think of resistance as the ceiling in a price advance.

Support and resistance levels are identified based on prior price action, such as highs and lows and short-term (minutes to hours) *consolidation* or *congestion zones* (where prices get all stopped up and can't move one way or the other for a period of time). Support and resistance can also be determined by drawing trend lines, as shown in Figure 4-1. You can see a real-time chart at forex.com/currency-pairs-public-charts.html?cp=EURUSD.

Figure 4-1: EUR/USD 15-minute chart showing support and resistance levels.

One of the key concepts of support and resistance is that after a support or resistance level is broken, it shifts direction. In other words, after a support level is broken in a move to the downside, it becomes resistance in subsequent price attempts to rally. After a resistance level is broken to the upside, it may later act as support for further price gains.

Waiting for confirmation

I was tempted to title this section "Looking for confirmation," but I thought that sounded too proactive in the sense that if you go looking for something on a chart, odds are you can find it and rationalize it as confirmation. The more disciplined approach involves *waiting* for confirmation, letting market prices provide you with unambiguous signs of a change in direction or break of a chart pattern.

Confirmation refers to price movements that verify, or confirm, a technical observation that suggests a particular outcome. For example, certain chart patterns are useful predictors of a potential reversal in price direction. But note that the starting point in this case is that prices are moving in a trend or steady direction. Blindly following a pattern that suggests that a trend is about to end is very risky. After all, the trend is your friend, so why would you take the risk of going against the trend?

If you're patient and wait for price action to provide you with confirmation that a directional move or trend is indeed reversing, essentially confirming that the observed chart pattern is playing out as you expected, you're reducing the risks of being wrong-sided or premature in your trade. The trade-off is that you may sacrifice a better entry level for a higher degree of certainty in the overall trade setup. Looked at the other way around, you're reducing the risks of getting into a trade setup too soon and being wrong if the setup doesn't play out as you expected. The difference is not making as much money as possible or losing money outright. Which would you prefer?

Combining Fundamental and Technical Analysis

As you develop your overall approach to the market, it's important to ask yourself on what basis you'll make your trading decisions — fundamental analysis or technical analysis? I suggest blending the two disciplines.

In my experience, macroeconomic factors, such as interest rates, relative growth rates, and market sentiment, determine the big-picture direction of currency rates. But currencies rarely move in a straight line, which means there are plenty of short-term price fluctuations to take advantage of — and some of them can be substantial. Technical analysis can provide the guideposts along the route of the bigger price move, allowing traders to more accurately predict the direction and scope of future price changes. Most important, technical analysis is the key to constructing a well-defined trading strategy. For example, your fundamental analysis, data expectations, or plain-old gut instinct may lead you to conclude that EUR/USD is going lower. But where exactly do you get short? Where do you take profit, and where do you cut your losses? I like to use technical analysis to refine trade entry and exit points, and to decide whether and where to add to positions or reduce them.

Sometimes forex markets seem to be more driven by fundamental factors, such as current economic data or comments from a central bank official. In those times, fundamentals provide the catalysts for technical breakouts and reversals. At other times, technical developments seem to be leading the charge — a break of trend-line support or recent daily lows may trigger stop-loss selling by market longs and bring in model systems that are selling based on the break of support. Subsequent economic reports may run counter to the directional breakout, but data be damned — the technical support is gone, and the market is selling.

Fundamental data and events are only one piece of the puzzle. Be aware that forex markets frequently ignore individual reports and do their own thing based on some larger theme or adjustment. That's why I always stress that the market reaction to data is more important than the data itself.

Approaching the market with a blend of fundamental and technical analysis will improve your chances of both spotting trade opportunities and managing your trades more effectively. You'll also be better prepared to handle markets that are alternately reacting to fundamental and technical developments or some combination of the two.

Chapter 5

Managing Your Risk

In This Chapter

- Understanding the different types of risk
- Setting up trade plans in terms of risk

Trading is all about risk, yet it's frequently the last thing many individual traders think about. Too often, they're fixated on the expectation of positive trading results, as in "How much can I make?" To a large extent, that's basic human nature. Why would anyone speculate in anything unless he believed he could win?

When it comes to the risks they're taking, traders should approach the forex market with eyes wide-open. And I'm not talking about some simple risk formula that comes out to dollars and cents. I'm looking at it from the perspective of an overall risk-taking enterprise philosophy. The more aware you are of the risks you face, the more likely you'll be able to avoid them — and the more likely is your success. In this chapter, I provide an overview of the risks as well as ways you might avoid risks by creating strong trades.

Managing Risk Is More Than Avoiding Losses

On the most basic level, *risk* in currency trading is the same as trading in any other financial market — the risk is that you'll lose money. But risk comes in many different forms and from many different sources. Sometimes the biggest risks are the ones that you never knew existed. I believe forewarned, though, is forearmed. In this section, I look at some of the main sources of risk that may not be readily apparent or that are easily overlooked.

Leveraging your capital well

Leverage refers to the multiple applied to your available margin collateral, which translates into the maximum size of your market position. Leverage is typically expressed as a multiplier rate (like 10 times or 20 times) or a ratio (like 10:1 or 20:1). If the leverage rate is 10-times/ratio is 10:1, for example, and you have $1,000 of available margin, you're able to hold a maximum position equal to $10,000.

Leverage is a trading tool, allowing traders with less capital to participate in markets that they couldn't trade otherwise. As with any other tool if you learn how to use it properly, you'll be able to get the job done faster and easier. But if you don't learn how it works, and respect it, you're asking for trouble.

The key here is to avoid being seduced by leverage. Just because you're able to get 100:1 or 50:1 leverage doesn't mean you have to use it all. Trading a larger position may seem sexy, but no one ever said prudent, risk-aware trading was supposed to be sexy. Use leverage as a tool to facilitate your trading strategies, not as an ego booster.

Knowing your margin requirements

Forex brokers require margin posted as collateral to cover any losses on your trading account. To protect themselves from client losses eating up the entire margin (or going negative) in adverse market movements, brokers typically require you to have 100 percent of available margin for any open positions.

WARNING!

Margin balances are typically monitored by computer programs based on current market prices (see Figure 5-1). If a price move causes your available margin to fall below the required level, the position will be closed — no margin call, no notification to you, just a liquidated position. You may think that's unfair, but the reality is that brokers need to liquidate losing positions at some point, or your loss will become theirs.

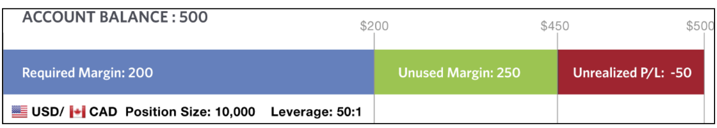


Figure 5-1: Margin requirement example for 1 Mini Lot USD/CAD at 50:1 leverage.

REMEMBER

Read the fine print to know the minimum margin requirements and liquidation policies before you start trading. Regulated forex brokers must disclose their policies in your customer account agreement.

Acknowledging volatility and gap risk

The forex market is routinely described as the most liquid financial market in the world, and that's true. But it doesn't mean that currencies are not subject to varying liquidity conditions.

Liquidity refers to the amount of market interest (the number of active traders and the overall volume of trading) present in a particular market at any given time. From an individual trader's perspective, liquidity is usually experienced in terms of the volatility of price movements. A highly liquid market will tend to see prices move very gradually and in smaller increments. A less liquid market will tend to see prices move more abruptly and in larger price increments.

In short, shifting liquidity conditions (for example, as global financial centers open and close in their respective time zones) can increase volatility. During periods of reduced liquidity and interest, currency rates are prone to drift in wider ranges and are also subject to more sudden and volatile price movements. The catalyst could be a news event, a rumor, or short-term market positioning, and the reduced liquidity sees prices react more abruptly than would be the case during more liquid periods.

In this section, I provide a primer on how volatility can impact trading. When economic data releases or major news events are announced, prices may "gap" as the market reacts and adjusts to the news. Market conditions can be extremely volatile during these times: Prices may move dramatically in one direction, and in some cases there may be no available liquidity for a short period. Gap market conditions are also common when trading resumes after a weekend or holiday. During gap market conditions, stop and limit orders may be executed at prices far away from the requested price.

Getting a handle on volatility

Volatility is a statistical term referring to average price fluctuations (standard deviation) relative to the average price over a specified period of time. Volatility is what makes the trading world go 'round, and without it, speculators would have a lot of time on their hands.

But not all volatility is created equal, and you need to be aware of two main types of volatility that can alter the currency playing field:

- **Market volatility:** Market volatility is the overall level of price volatility in various financial markets at any given time. The VIX S&P 500 volatility index is a good overall barometer of market volatility. Market volatility typically increases during periods of uncertainty or unexpected economic data or monetary policy developments. If you're trading on a short-term basis or using a model that relies on relatively low volatility (for example, mean reverting systems, moving averages, or regression channels), you need to be aware that increased volatility can quickly swamp such strategies. Better to stay on the sidelines and sit out the upheavals than jump in with a strategy unsuited to higher volatility.
- **Currency-pair volatility:** Different currency pairs trade with different volatility characteristics, both in the short and long term. Before you go with a trade setup in a currency pair you've spotted on a chart, make sure you're aware of the pair's relative volatility.

Minding the gap

Gap risk refers to the potential for prices to *gap,* or jump from one price level to another with no tradeable prices in between. Gap risk typically is associated with events such as economic data reports, central bank rate decisions, and other major news events. In that sense, most gap risk is identifiable in advance by looking at data and event calendars. Unexpected news or official comments can also trigger price gaps. Breaks of key technical levels are another source of price gaps.

After the news is out, interbank traders adjust their prices to reflect the news, resulting in a price gap higher or lower. It may be up to 30 seconds (or more depending on the news or event) before normal pricing returns.

WARNING! If you're holding open positions at the time of major data releases or events, you're subject to gap risk. The same goes for stop-loss orders left with brokers — stop-loss executions are subject to gap risk. Depending on market circumstances, stop-loss order executions will see *slippage* (meaning that your stop-loss order may not be filled at the rate you specified). In the case of price gaps, brokers are obligated only to fill your order on a "best efforts" basis.

Protecting your profits

Speculating in the market and getting the direction wrong is one thing. That's good old-fashioned risk-taking, and it's just part of the business of trading. But it's another result entirely to get the direction right and still lose money, or not make as much as you could have, or not keep as much as you'd already made.

REMEMBER Experienced traders know that keeping what you've made is often as hard as making it in the first place, so they guard their profits aggressively. The best way to do that is by adjusting your stop loss in the direction of the trade once it's in the money. You can do this by either using a *trailing stop loss* (a stop-loss order that automatically trails the market at a user-defined distance — say, 40 pips) or by manually changing your original stop loss based on specific price levels being surpassed, keeping in mind that contingent orders may not necessarily limit losses.

Placing your orders effectively

Currency traders rely on orders to take advantage of price movements when they're not able to personally monitor the market and also to protect themselves from adverse price movements. (See Chapter 2 for info on the different types of orders.)

The risk with using orders is that you miss having your take-profit limit or entry orders filled or that your stop-loss orders are triggered at extreme price points. The catch here is that markets have a penchant for going after stop-loss orders and shying away from limit orders in the routine noise of daily fluctuations. That makes where you place your orders a critical factor in your overall trading strategy. Deciding where to place orders is definitely more art than science, and even the most experienced currency traders continually grapple with the question of where to place their orders. This section highlights a couple of major considerations when placing orders.

Factoring in the dealing spread with orders

Currency traders face two other factors: the dealing spread of the currency pairs and the order execution policies of currency trading platforms. Many forex brokers publish their trading statistics, which should provide average execution speed, currency spreads, and so on. For a sample, check out this link: forex.com/trade-execution-statistics.html.

Most online platforms execute on the basis that a limit order to sell is filled when the bid price reaches the order rate and a limit order to buy is filled when the offer price reaches the order rate.

In the case of stop losses, a stop-loss order to sell is triggered if the bid price reaches the order rate, and a stop order to buy is executed if the offer price reaches the order rate. In both cases, the dealing spread works against the order, and traders need to take that into account.

Placing stop-loss orders based on technical or financial levels

There are generally two schools of thought when it comes to the basis for deciding where to place stop-loss orders:

- **Technical stops:** Placing a stop-loss order according to price levels identified through technical analysis. Whatever technical approach you choose to follow, you'll be looking to identify key technical points that, if exceeded, will invalidate the trade setup and signal that it's time to get out of the trade.

- **Financial stops:** Based on the amount of money you're prepared to risk on a given trade. You may base the trade on a fundamental view of future developments, but you're willing or able to risk only a certain amount of money on the trade.

Applying Risk Management to the Trade

When you actually go to make a trade, you need to factor in risk considerations. Whereas the preceding section discusses overall risk considerations to help you understand what risk management really *entails,* this section helps you apply the strategies to your trading plan.

Analyzing the trade setup to determine position size

A *trade setup* is a trade opportunity that you've identified through either fundamental or technical analysis, or a combination of both.

In every trade setup, you need to identify the price point where the setup is invalidated — where the trade is wrong. For example, if you're looking to sell a currency pair based on trend-line resistance above, price gains beyond the trend line would invalidate your rationale for wanting to be short. So the price level of the trend line is the line in the sand for the overall strategy.

So how large a position should you commit to the trade? From a risk standpoint, it all depends where you're able to enter the trade relative to your stop-out level.

Identifying the trade entry points

Winning or losing on a trade is difficult if you never get into the position in the first place, which makes identifying where to get into the trade one of the most important steps in any trading plan.

I like to use technical analysis as the primary means of identifying entry levels. When looking to identify entry points, I focus on the following technical levels:

- Trend lines in various time frames (daily, four-hour, and hourly).
- Hourly highs and lows for short-term intraday position entries.
- Daily highs and lows for medium- to longer-term positions.
- Congestion zones.
- Fibonacci retracements, a popular form of technical analysis involving prior price movements. A *retracement* is a price movement in the opposite direction of the preceding price move, so if EUR/USD rises by 150 pips over the course of two days and declines by 75 pips on the third day, prices are said to have retraced 50 percent. The most important Fibonacci retracement percentages are 38.2 percent and 61.8 percent, with 76.4 percent a secondary — but still important — level. Most charting systems contain an automatic Fibonacci retracement tool that charts these levels and 50 percent.

  For an overview of Fibonacci retracement, check out: forex.com/forex-video-tutorials.html.
- Spike highs and lows.

After you've identified a price point to enter into the trade, double-check the level. Is the entry level realistic? If you're looking to enter a short-term trade, is your entry point likely to be reached in the short-term time frame (minutes to hours)? You can use momentum readings to help gauge the likelihood of an order level being reached.

Establishing stop losses with foresight

The stop-loss level is the starting point in any trade plan from an overall risk perspective. It's the point where the trade setup is negated and the strategy fails.

When considering where to place the stop level, be aware that the currency market, like most financial markets, has a tendency to try to take out levels where stop losses are likely to be located.

To guard against the risk of being unnecessarily whipsawed out of a position, you need to approach selecting your stop-loss level from a defensive point of view. Anticipate that the market *will* test the level where the trade setup is invalidated, such as trend-line support or hourly lows. Then consider if the market tests that level, how far must it go through before it's really considered a break?

Allowing for a margin of error can sometimes prevent a stop loss from being triggered unnecessarily. The margin of error you apply will depend on the general volatility of the currency pair you're trading, as well as on the overall market volatility at the time of the trade.

Above all, you need to balance the risk of being taken out on a false move with the larger risk that your overall strategy is wrong. You can be flexible up to a point, but you still need to set your ultimate stop loss and then stick to it.

Setting take-profit objectives dynamically

When it comes to establishing the take-profit objective, a lot of trading books recommend using some sort of risk/reward ratio, like 2:1 (meaning, if you're prepared to risk 50 points on a trade, you should be aiming to make 100 points). That approach is all well and good in theory, but it fails to account for the realities of the market.

Instead, I suggest using a much more dynamic market-based approach, one that considers where the market is likely to go based on where it's been (technical analysis) and overall market conditions. The idea is to be *realistic* about how much you can take out of the market, not *idealistic* about how much the market will reward you.

Chapter 6

Managing the Trade

In This Chapter

- Staying on top of prices and news
- Updating the trade plan over time
- Ending the trade
- Evaluating your strategy in hindsight

So you've pulled the trigger and opened up the position, and now you're in the market. Time to sit back and let the market do its thing, right? Actively managing a trade when you're in it is just as important as the decision-making that went into establishing the position in the first place.

I hope you'll take to heart my recommendations about always trading with a plan — identifying in advance where to enter and where to exit every trade, on both a stop-loss and take-profit basis. Bottom line: You improve your overall chances of trading success (and minimize the risks involved) by thoroughly planning each trade before getting caught up in the emotions and noise of the market.

Depending on the style of trading you're pursuing (short-term versus medium- to long-term) and overall market conditions (range-bound versus trending), you'll have either more or less to do when managing an open position. If you're following a medium- to longer-term strategy, with generally wider stop-loss and take-profit parameters, you may prefer to go with the "set it and forget it" trade plan you've developed. But a lot can happen between the time you open a trade and prices hitting one of your order levels, so staying on top of the market is still a good idea, even for longer-term trades.

Monitoring the Market While Your Trade Is Active

No matter which trading style you follow, keeping up with market news and price developments while your trade is active pays. Unexpected news that impacts your position may come into the market at any time. News is news; by definition, you couldn't have accounted for it in your trading plan, so fresh news may require making changes to your trading plan.

Following the market with rate alerts

One way to follow the market from a distance is to set rate alerts from either your charting system or your trading platform. A *rate alert* is an electronic message that alerts you when a price you've specified is touched by the market in a currency pair you specify. Rate alerts are a great way to keep tabs on the market's progress.

Some forex brokers, including FOREX.com, can send rate alerts to clients via a variety of channels like e-mail, SMS, and text message among others.

Staying alert for news and data developments

REMEMBER

Every trade strategy needs to take into account upcoming news and data events before the position is opened. Ideally, you should be aware of all data reports and events scheduled to occur during the anticipated time horizon of your trade strategy. You should also have a good understanding of what the market is expecting in terms of event outcomes and anticipate how the market is likely to react.

Speculating based on expected event or data outcomes is perfectly okay. It becomes a problem only if you maintain the trade even after the data/event outcome has come out against your expectations and strategy. Always relate incoming news and data back to the original reason for your trade, and be prepared to adapt your trade strategy accordingly.

Updating Your Trade Plan As Time Marches On

Staying aware of time and its passing is an important skill for traders to develop. You know where the market price is now, so the question is really: Where will the market price be in the future? As soon as you think of the future, it becomes a question of time: *When* will it be there? If you consider these questions as you formulate each trade strategy, you'll go a long way toward incorporating time into your overall trade planning.

Watching moving trend lines

If you're basing your trading strategies on trend-line analysis, you need to be aware that price levels derived from trend lines will change depending on the slope of the trend line. The *slope* of a trend line refers to the angle of a trend line relative to a horizontal line. The steeper the slope of the trend line, the more the relevant price level will change over time; the shallower the slope, the more gradually the price levels will change with time.

Figure 6-1 gives you a good idea of how short-term price levels based on a 15-minute trend line will shift over the course of just a few hours. Note how steeply the trend line is sloping upward. For prices to continue to move higher in line with this trend line, they must stay above the trend line as it rises over time, suggesting price gains of 10 to 15 pips per hour are needed.

Figure 6-1: Trend-line levels can change over time, depending on their slope.

No matter what time frame you're trading, be sure to factor in the shifting levels of trend lines, if they're part of your trade strategy. You may need to adjust your order levels accordingly. In particular, consider the following:

- **Short-term and overnight positions:** Consider where trend-line support or resistance will be over the next 6 to 12 hours, when your position is still active but you may not be able to actively follow the market. You may want to use a trailing stop as a proxy for changes in trend-line-based support/resistance levels.
- **Limit-entry orders:** If your limit buying/selling order is based on a sloping trend line, periodically adjust your order so that it's still in play according to changes in the trend line. You may miss a trade entry if the trend line is eventually touched, but, in the meantime, its level has shifted away from where you first placed the order.
- **Breakouts:** A significant trend line that looks to be a mile away one week may suddenly be within striking distance in the following week or two weeks, substantially altering the market's outlook. Alternatively, the market may be focused on a price high/low as a breakout trigger, when a sloping trend line touching that high/low may actually be the catalyst for a breakout.

Updating order levels as prices progress

Just because you've got a well-developed and considered trade plan doesn't mean it has to be carved in stone. When you're in a position, and the market is moving in your favor, it's important to be flexible in adjusting take-profit targets and amending stop-loss orders to protect your profits.

The key to being flexible in this regard is also being prudent — don't adjust your take-profit targets without also adjusting your stop-loss order in the same direction.

Increasing take-profit targets

Keep an eye out for the following events to consider extending your take-profit targets:

- **Major new information:** More likely than not, the new information will have to come out of left field. If it was a scheduled event, like a data report or speech, the market speculation surrounding it would have sopped up all the interest and muted its impact. *Major* means it has to come from the very top echelons of decision-making, like the Fed chairman, the European Central Bank (ECB) president, or other central bank chiefs; the U.S. Treasury secretary; or, increasingly, China. Surprise interest rate changes or policy shifts are always candidates. The more at odds the information is with current market expectations, the better the chances that it will generate an extensive price move.
- **Thinner-than-usual liquidity:** Reduced liquidity conditions can provoke more extensive price movements than would otherwise occur, because fewer market participants are involved to absorb the price shocks. Reduced liquidity is most evident during national holidays, seasonal periods (late summer, Christmas/New Year's), end of month, end of quarter, and certain Fridays.

- **Breaks of major technical levels:** Trend lines dating back several months or years, Fibonacci retracement levels of major recent directional moves, and recent extreme highs and lows are likely to trigger larger-than-normal price movements.
- **The currency pair:** The more illiquid and volatile the currency pair you're trading, the greater the chances for an extreme move. GBP, CHF, and JPY are the most common culprits among the majors, and the commodity currencies (AUD, CAD, NZD, and ZAR, the South African Rand) are also candidates.

Tightening stop-loss orders to protect profits

When formulating your overall trade plan, always consider what price levels need to be surpassed to justify moving your stop loss. If it happens in the market, you'll be ready and know exactly what to do.

The risk with adjusting stops too aggressively is that the market may come back to test the break level (1.5335, in this example), triggering your adjusted stop loss if it's too close, and then go on to make fresh gains. But the trade-off in that situation is between something and more of something, or potentially nothing and more of nothing. I prefer to have something to show for my efforts.

Closing Out the Trade

If you've embraced the idea of always trading with a plan — and I hope you have — you're way ahead of most of the market. Developing a thorough trading plan, including when and how to get out, is the first step to actively trading in the currency market. Following are the different ways you may close out a trade:

- **Taking profit and stopping out:** On the most basic level, every trade ends with either a profit or a loss. Sure, some trades finish *flat,* which is when you exit the trade at the same price you entered, producing no gain or loss. Most of the time, though, you'll be dealing with the agony of being stopped out or with the ecstasy of taking profit.

- **Letting the market trigger your order:** When you've identified a trade opportunity and developed a risk-aware trading plan, you're going to have active orders out in the market to cover your position one way or the other (stop-loss or take-profit). Depending on your trading style and the trade setup, you can reasonably follow a set-it-and-forget-it trade strategy where your orders will watch the market and your position for you.
- **Squaring up after events have happened:** Depending on the basis of the trade opportunity you've identified, there will be very real hallmarks indicating what, if any, adjustments you should make. Most important, though, is that the basis for your trade strategy — the event — has taken place. If the market doesn't react as you thought it would, you have very little reason to continue to hold onto the position. Always relate your original rationale for holding your position back to the reality on the ground. When events turn out differently from what you expected, start looking for the exit sooner rather than later.
- **Exiting at the right time of day:** In trading, it's frequently said that timing is everything. Truer words were never spoken. But I'm talking about the time on the clock on the wall (in addition to market timing). Staying on top of the time of day is as important a trading consideration as having the right position, because the time of day and the day of the week can frequently influence how prices behave and how your ultimate trade strategy plays out. At the minimum, you may want to make adjustments to your trade strategy to limit any negative impact from session closes, such as reducing your position size, tightening stop losses, or squaring up altogether.

Assessing Your Strategy Post-Trade

Active currency trading is as much a learning process as it is a speculative endeavor. Good traders learn from their mistakes and try to avoid repeating them in the future. Bad traders keep making the same mistakes over and over again until they give up in frustration or are forced to for financial reasons.

Successful trades also represent excellent learning opportunities, both about how different trading strategies work best and about your own personal response to them. Successful traders remember what they did right and try to emulate it in the future, knowing full well that no two trades are ever the same. Bad traders only remember that they won, but they fail to take the lessons of why they won to heart.

The best way to learn from each trading experience — both good and bad — is to make post-trade analysis part of your regular trading routine.

Regardless of the outcome of any trade, you want to look back over the whole process to understand what you did right and wrong. In particular, ask yourself the following questions:

- **How did you identify the trade opportunity?** Was it based on technical analysis, a fundamental view, or some combination of the two? Looking at your trade this way will help identify your strengths and weaknesses as either a fundamental or technical trader. If more of your winning trades are being generated by technical analysis, you'll probably want to devote more energy to that approach. If more of your winning trades are coming from the fundamental approach, you're probably better off concentrating on a fundamental style.

- **How well did your trade plan work out?** Was the position size sufficient to match the risk and reward scenarios, or was it too large or too small? Could you have entered at a better level? What tools might you have used to improve your entry timing? Were you patient enough, or did you rush in thinking you'd never have the chance again? Was your take profit realistic or pie in the sky? Did the market pay any respect to your choice of take-profit levels, such as stopping short of it, or did prices blow right through it? Ask yourself the same questions about your stop-loss level. Use the answers to refine your position size, entry level, and order placement going forward.
- **How well did you manage the trade after it was open?** Were you able to effectively monitor the market while your trade was active? If so, how? If not, why not? The answers to those questions will reveal a lot about how much time and dedication you're able to devote to your trading. Did you modify your trade plan along the way? Did you adjust stop-loss orders to protect profits? Did you take partial profit at all? Did you close out the trade based on your trading plan, or did the market surprise you somehow? Based on your answers, you'll learn what role your emotions may have played and how disciplined a trader you are.

There are no right and wrong answers in this review process; just be as honest with yourself as you can. No one else will ever know your answers, so you have nothing to lose by being candid. On the contrary, you have everything to gain by identifying what you're good at, what you're not so good at, and getting to understand how you as a currency trader should best approach the market.