



UNDERSTANDING FOREX CFDS

A Guide to Trading successfully in the world's largest financial market with FX CFDs

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Introduction to FP Markets

FP Markets (FP) is an Australian owned company which commenced trading in 2005 and is part of the First Prudential Markets Investment Group which provides CFDs to retail and wholesale clients both in Australia and Europe.

FP Markets was founded by a team of experienced individuals who have been involved in the Australian CFD industry since its inception.

It soon became apparent that providing CFDs via a Direct Market Access (DMA) model would be the future of CFD trading as this model provides fair and transparent prices to retail clients and aligns the interests of the firm with that of its clients as the firm does not profit from client losses. All Forex CFD trades are hedged so that again our interest are aligned and FP Markets is dedicated to providing clients with the best possible pricing.

With a large offering of equity, FX, Indices and commodity CFDs from international exchanges, we have established ourselves as an award winning global leader for DMA CFDs.

FP Markets has one of the most competitive Forex CFD offerings in Australia, and also covers the widest range of Equity CFDs and Shares from the one platform, shaping the local DMA CFD industry. As well as offering a broad product range in Australia, FP Markets in London provides one of the most competitive CFD offerings throughout Europe.

All our products are offered on the basis of direct market access, enabling you to deal in the actual markets on the same, or almost the same terms as a professional trader. Our single platform, developed in Australia, enables you to trade our full range of products without the need to switch platforms for overseas markets, commodities, currencies, indices and overseas shares.

Our Success

- **Education** – FP Markets strongly believes that the key to successful trading is in a trader's education.
- **Platform** – FP Markets offers its clients the ability to trade from a range of iress based trading platforms that give all clients' access to CFDs with the best execution across Equities, Indexes and Forex.
- **Account Types** – FP Markets offer access to a range of account types so you can tailor your account to your specific needs.
- **CFDs** – FP Markets specialises in Direct Market Access (DMA) CFDs across many markets and products.
- **Safety** – FP Markets has sophisticated and robust risk management systems which have ensured stability through a variety of market conditions.
- **Regulation** – FP Markets (Australia) is regulated by Australian Securities and Investment Commission (ASIC) and FP (United Kingdom) is regulated by the Financial Services Authority (FSA).
- **Support** – FP Markets offers 24 hour trading support.

What is foreign exchange?

Talk to traders about foreign exchange these days and you'll probably find that it's the single financial market they trade most actively. It is estimated that foreign exchange now accounts for more than half the volume of CFDs traded in Australia.

In the world's biggest financial market, trillions of dollars of value are traded every day as banks, fund managers, governments, companies, and anyone buying or selling overseas, move money from place to place to facilitate trade and investment. Without foreign exchange, the world's business would come to a standstill. The advent of the internet means that retail traders can now participate in foreign exchange trading, making profits from currency movements just as they make gains from trading in shares. An advantage of trading foreign exchange compared to shares is that the markets are highly liquid, which means you can execute orders quickly and easily with less slippage (price drift before the order can be executed) than in shares.

Foreign exchange, also called forex for short, is the process of exchanging one currency – like Australian dollars – for another, such as euros or US dollars. When you buy anything from overseas – on the internet, for example – rather than buying it here in Australia, you will be involved in the exchange of one currency for another. The CDs, books or other items you bought online were probably priced in US dollars, euros or British pounds, and sellers need payment in their own currency. You can't spend Australian dollars in the UK any more than you can buy things in Australia with US dollars unless you exchange them first. So your transaction will show a conversion from Australian dollars to the currency in the country of origin.

A fundamental fact about foreign exchange is that a currency can only be spent – exchanged for goods and services – in the country or union of countries where the currency originated.

(Although it may be possible to spend a major currency like US dollars in some countries outside the US, the only reason this

works is that those US dollars are known to be good for value in the US and are easily exchanged for other currencies because they are readily accepted as a temporary store of value).

Ultimately, then, Australian dollars represent wealth in Australia in the form of goods and services Australians can provide. They are like a minuscule portion of Australia's economy – a little like the way a share in a listed company represents a small part of that company. Shares change in value depending on whether the company prospers and on the amount of its estimated future earnings, among other things. The moves in a currency typically reflect the health of the domestic economy. A growing economy with high levels of employment and good yields on investment tends to lead to higher prices for the Australian dollar against the US dollar and other currencies. On the other hand, a slowing or stagnant economy in which unemployment is growing and yields on investment are falling tends to reduce the value of the Australian dollar.

The interbank foreign exchange market

Foreign exchange is unique among financial markets in that there is no central organised exchange on which currencies are traded. Instead, all contracts are made between participants in the interbank foreign exchange market, where deals are done on an over-the-counter basis. The primary participants can see all deals done, the volumes traded and the amounts of foreign currency available for sale or purchase. Deals can be done in this market only between the primary participants, who hold either banking or foreign exchange licenses and are considered by the rest of the market to be capable of fulfilling any obligations they enter into. In other words, they all trust each other and rely on the reputation and experience of counterparties, rather than on official or government regulatory processes, to ensure that contracts are fulfilled.

Interbank market participants sometimes trade currencies for profit, but their primary purpose is to make a market where currencies can be exchanged by those involved in trade and investment. The vast majority of deals made in the interbank

foreign exchange market are done on behalf of those who want to buy foreign currency so that they can buy foreign goods or invest in foreign assets, or who want to buy Australian dollars, either to bring foreign earnings back, or, as foreigners, to buy Australian assets or investments.

It's possible to deal forward in the foreign exchange market – that is, to arrange forward cover for an expected future foreign exchange transaction, perhaps a payment on an overseas loan, for example. A forward contract locks in the exchange rate for the future date so that it is no longer unknown. This is a form of hedging, or protection from the risk of changing exchange rates, and such forward contracts make up a sizeable proportion of foreign exchange dealing.

But most of the contracts in the primary market are for settlement the following day, when the actual foreign currency is exchanged for Australian dollars and settlement is made in full. These are known as spot contracts. A bank or forex dealer that wishes to defer settlement must close that contract before settlement is due and immediately open a new one for settlement the following business day (known as rolling the position or rolling it over). Foreign exchange trading providers, including CFD issuers, who offer continuous contracts to their clients, hedge their positions by buying or selling on the inter-bank forex market and rolling the positions over daily until the client buys or sells back.

Interest on daily rollover

If an interbank forex contract is rolled over to defer settlement until the following day, there will be interest received by the holder of the currency with the higher interest rate on its cash deposits. For some time, the Australian dollar cash rate, at over 4 per cent per annum, has been among the highest in the developed world. So if an interbank currency contract involves buying Australian dollars against, for example, the US dollar, the bank holding Australian dollars receives interest, paid daily at the rollover, while the opposite party – the other bank or forex dealer – must pay interest.

The rate is based on the interest-rate differential between the two currencies for cash deposits. So if, for example, the official Australian cash rate is 4.75 per cent per annum while the US rate

is 0.25 per cent per annum, the daily interest will be based on a rate of 4.50 per cent per annum (4.75 – 0.25 per cent). This daily interest charge is also reflected in CFD positions that are held for longer than 24 hours.

On the other hand, the forex market participant who sells Australian dollars against the US dollar and is now holding US dollars will, if and when the position is rolled over, pay interest based on the interest rate differential of 4.5 per cent per annum.

The major currency pairs

Any currency can be traded on the interbank forex market, but the advantages of high liquidity are available in the ones that trade huge volumes every day. When talking of a currency, we are really describing what is known as a currency pair, which means that there is one currency being valued and another being used to measure its value. So if we are valuing or trading the Australian dollar, for example, then that is the base currency. If we are buying or selling it against the US dollar, then the

US dollar is known as the reference currency. For most of the world's currency trading, the base currency is the US dollar – other currencies are usually valued in terms of how much of the currency one US dollar will buy. For example, in September 2011 the US dollar was valued at about 76.80 Japanese yen. The US dollar is the base currency and the Japanese yen the reference currency.

The exceptions are where another currency is conventionally the base currency and prices are quoted in how many US dollars the base currency will buy. The four notable exceptions are British pounds, euros, Australian dollars and New Zealand dollars, all priced in terms of how many US dollars they will buy.

There are seven major currencies, all traded against the US dollar. Apart from the US dollar itself, the other majors are the British pound, the euro, the Japanese yen, the Swiss franc, the Canadian dollar and the Australian dollar. Each currency has a 3-letter code and the convention is that when a currency pair is referred to, the base currency appears first. The major pairs are:

1. Euros against the US dollar EUR/USD
2. US dollars against the Japanese yen USD/JPY
3. US dollars against the Swiss franc USD/CHF
4. British pounds against the US dollar GBP/USD
5. Australian dollars against the US dollar AUD/USD
6. US dollars against the Canadian dollar USD/CAD
7. New Zealand dollars against the US dollar (NZD/USD)

In each case the first currency listed is the base currency, and the second is the reference currency. The foreign exchange markets always quote the base currencies shown above in terms of the reference currencies listed; in other words the euro is always valued in US dollars when that pair is traded.

Other important pairs include

Euros against British pounds EUR/GBP

Euros against Swiss francs EUR/CHF

Euros against Japanese yen EUR/JPY

British pounds against Japanese yen GBP/JPY

Cross rates

Currencies outside of these groups are generally traded with the US dollar as the base currency, and so the rate for Thai baht, for example, is the number of baht one US dollar will buy. If you wish to buy Thai baht with Australian dollars, you will need to refer to the Australian dollar's value in US dollars first. The rate for US dollars in baht then gives you the number of Baht an Australian dollar will buy. The exchange rate for two currencies where the US dollar is used as a medium of exchange between them is called a cross rate. The Thai baht is not suitable for traders because of its low liquidity, but cross rates in other currencies such as the Swedish kroner may at times present trading opportunities. At present FP Markets forex CFDs are available only in the major currencies.

Commodity currencies

Some of the world's economies depend highly on exports of various raw materials (commodities). Among them are Australia,

New Zealand and Canada. The currencies of these countries are known as commodity currencies because they respond to changes in global commodity prices. At times when commodities such as gold, copper, coal, iron ore, wheat and wool are rising in price, these economies tend to benefit, which in turn tends to increase the value of the currencies against other units.

Currency quotes and pips

Currency prices (that is, exchange rates) are quoted in much the same way as shares, with both a bid price (price at participants can sell) and an ask price (at which participants can buy). As in other markets, the spread, or difference between the bid and the ask price, is part of the cost of trading.

Depending on the currency, quotes are normally given to four decimal places. For example, the bid and ask for Australian dollars may be quoted as:

AUD/USD 1.0590 – 1.0593

This means that one Australian dollar (the base currency) is worth \$US1.0590, based on the price if you were buying -- that is, the ask, or best available selling price. Another way of saying this is that \$A100,000 is worth \$US105,900. This is a typical minimum contract size in the interbank foreign exchange market. Contracts are generally for 100,000 units of the base currency.

Similarly, a quote for Japanese yen, where the US dollar is the base currency, appears as:

USD/JPY 77.13 – 77.18

This means that one US dollar (the base currency) is worth 77.13 yen (the yen being the reference currency) based on the bid price. In other words, 100,000 units of the base currency, US dollars, (\$US100,000) is worth 7,713,000 yen (¥7.713 million = 100K x 77.13). Quotations for the yen are given to only two decimal places because of the yen's comparatively low value, at present less than US1c.

The smallest movement in a currency's value that is recognised in the forex market is a change in the last decimal point, for example a move from \$US1.0500 to \$US1.0501. This smallest

increment is known as one pip. For a CFD over \$A100,000 against the US dollar, a one-pip move represents a change in value from \$US105,000 to \$US105,010, a difference of \$US10. A 1c move, for example from \$US1.05 to \$US1.06, is equal to 100 pips and would represent a change in value of \$US1,000 for this contract size (from \$US105,000 to \$US106,000).

For a CFD over \$A10,000 against the US dollar, a one-pip move represents a change in value from \$US105,000 to \$US105,010, a difference of \$US1.00.

What is a Forex CFD?

Retail traders – that is, those who are not professional bankers or foreign exchange dealers – cannot participate directly in the interbank foreign exchange market. But there is a way they can trade foreign exchange for profit. Forex contracts for difference (CFDs) offer low-cost access to the foreign exchange markets, giving anyone with sufficient funding, a computer and an internet connection a way to profit from movements in one currency's value against another. Your contract is made with FP Markets, which has access to foreign exchange dealers able to give you the actual price in the actual foreign exchange market and which undertakes to match every CFD with an equivalent trade in the actual market. In this way, all client profits are derived from market movements and FP Markets cannot benefit from client losses by leaving any portion of the contracts

it has made unhedged. This is the basis for the Electronic Communications Network (ECN) model.

The ECN model provides a number of clear advantages to traders:

1. ECN providers do not trade against their traders, aligning the goals of both parties
2. Allows traders to become price makers not only price takers e.g. placing orders between the spread
3. Zero dealer intervention or requotes on orders
4. Generally tighter Bid/Offer quotes as prices are derived from several banks
5. Stops are based on market liquidity and price, not intervened by a Market Maker

6. Genuine prices during news or market announcements (FP Markets will never increase the spreads or restrict trading around these periods).

As well as high liquidity and a low trading cost, forex CFDs offer high leverage because it is possible to enter a trade by putting up as little as 1 per cent of the full currency value in cash. This means the ability to trade \$A100,000 worth of Australian dollars against the US dollar with an initial margin (cash deposit) of only \$A1,000.

A forex contract for difference or CFD is an agreement between two parties in which the buyer agrees to receive as profit the amount of any subsequent rise in the value of the base currency in question. The buyer agrees to pay up as a loss the value of any fall. The seller, on the other hand, agrees to receive a profit from any fall in the value of the base currency and to pay up all losses arising from an increase in this value.

So the buyer profits if the base currency rises in value, and the seller profits if the value of the base currency declines. Forex CFD traders seek to profit by buying a currency when it is expected to appreciate, or by selling a currency when it is expected to decline, against another specified currency. If a trader buys CFDs over a currency and it declines in value against the reference currency, there will be losses on the CFDs which must be carefully managed through the use of stop-loss orders.

Advantages of forex CFDs

Liquidity

Forex CFDs offer low-cost, easy access to the foreign exchange market, giving retail traders the opportunity to trade in the fastest-growing financial market. Over the past two years, estimated volume of trading in the foreign exchange market has grown some 33 per cent, from around \$US3 trillion to more than \$US4 trillion each day.

24-hour trading

As well as being highly liquid (more so at certain times than others) the forex market is open for trading 24 hours a day during the week, giving traders who are still working at other jobs the opportunity to trade live in their leisure hours.

Leverage

But perhaps the biggest advantage of CFDs in the foreign exchange market is the ability to trade at a very low initial margin – as little as 1 per cent of the value of the currency being traded. This means that for a \$A100,000 currency contract, your outlay will be, at the minimum initial margin, \$A1,000. For a position size of \$A10,000 -- the smallest available -- the minimum initial margin is \$A100.

New traders who hear this often jump to the conclusion that it's possible to trade \$A10,000 currency position with only \$100 in their trading account, or using a very small account with capital of \$500 or \$1,000. Those who attempt this are almost certainly destined to lose the whole of their small trading capital very quickly. Since such losses tend to put people off trading larger amounts, on the basis that their small account attempt failed, our advice is to adhere to the risk management rules that ensure you do not over-trade and have stop-losses in place to protect your positions (see page 12).

Short selling

Because you are trading one currency against another, your long (bought) position in any base currency is equivalent to a short (sold position) in the reference currency. If you buy Australian dollars against the US dollar you are short (that is, you have sold) US dollars.

Selling short – that is, agreeing to sell currency you don't yet own in the expectation that its value will fall – is just as easy in the foreign exchange markets as it is in CFDs over shares – and there are no short-selling restrictions as there may be in shares. This provides traders with opportunities to profit when, for example, the Australian dollar is in decline. You simply sell CFDs over Australian dollars against the US dollar, buying them back at a profit if their US dollar value falls. The risk of course is that the Australian dollar will rise after you have sold it. This risk must be managed by careful and thoughtful adherence to risk management strategies, in which stop-loss orders play an essential part.

Low cost

The main cost of trading is the buy-sell spread (difference between the buying and selling price). The spread is a cost

because it reduces the selling price and is added to the buying price. But it's tiny – starting from just two pips, equivalent to 0.02 per cent of the trade value. (see Example Trades, p. 15). For clients who want very tight spreads, FP can provide a fixed dollar amount.

Differences between forex CFDs and CFDs over shares

You'll need ways to see the reasons behind the movements of currencies that are different from the analysis you may be used to applying to the share market. Fundamental analysis in the sharemarket, for example, looks at the factors applying to each company in turn, examining its management, earnings, profitability, dividends and prospects in relation to the specific industry and in the context of overall economic conditions.

None of this applies directly to the currency markets, although the government of a country does play a role in economic management and therefore in the outlook for any currency, a function which might be seen as parallel to directing a company although on a larger scale.

One of the big differences between forex and shares is that shares in good companies tend to have an upward bias over time as they grow and prosper through cycles of economic boom and recession. Currencies have no such inherent upward bias, but rise or fall in value according to the desirability of holding them. That in turn depends on how much in demand the investments or assets the country is producing are to other nations.

To illustrate, a US dollar represents a tiny fraction of the wealth and prospects of the whole US economy. The setbacks the US has seen in recent years, including expensive wars, a global financial crisis, a high level of debt and, more recently, chronic unemployment, have resulted in a long-term decline for the US dollar against many other currencies, notably the euro. Although the US dollar is still considered the world's primary reserve currency – the one most nations hold as part of their sovereign assets and the one to turn to when other currencies are falling – this has not prevented the long-term decline. The trend is likely to continue until the US begins to chip away at the mountain of debt it has built up over decades and is able to create fuller

employment. The measures taken to support the economy through the financial crisis and then a period of very slow growth have resulted in an increase in the number of US dollars in existence, which tends to reduce the total value of each through inflation and erosion of purchasing power compared to other currencies. Offsetting this inflationary tendency is the growth slowdown that led to a lack of new employment in the aftermath of the global financial crisis.

So when you are trading a currency you are looking at the big picture of a nation's income, productivity and prospects compared to that of another country. Rising commodity prices, for example, have greatly benefited commodity currencies such as the Australian dollar and the Canadian dollar, since both countries are large producers of basic commodities including mining and agricultural products. That means the upward trend for the Australian dollar against the US dollar is likely to continue as long as commodity prices hold, but any easing of prices for our key exports would make the currency vulnerable.

Trading currencies is different to trading shares because their high liquidity makes it easy to enter and exit the market at the prices you want. Stop-loss orders, for example, are usually executed at or close to the price you specify, which may not always be the case in the sharemarket if it is moving quickly and few shares are being traded.

Unlike the sharemarket, the forex market is open 24 hours a day during the week, which means there is no daily scramble to enter or exit at the close, as there is at times in shares. Because the market trades continuously, it's unusual to see gapping – where prices open at a distance from the previous close or move so quickly on opening that it's difficult to obtain a price without slippage. Slippage happens when you attempt to sell at a price, but other traders have prior bids that are filled before yours, so that you must accept the next traded price. If the price moves before you can trade, that is slippage. It can occur in forex markets but is unusual except in extreme conditions.

Spreads, or the difference between the buy and sell price, are also usually consistent in foreign exchange, although they may at times widen significantly in the sharemarket. That's important, because the spread, or difference between the price at which you buy (the ask price) and price at which you can then sell (the bid price) is a trading cost. It costs you about half the

current spread each time you buy or sell. In the major currencies, spreads are generally about two pips. On your contract of \$A100,000 worth of currency, one pip on a contract this size represents a value of \$US10.00. Two pips represents a cost of about \$US10 to buy and \$US10 to sell, a total of \$US20.

There may be times when the foreign exchange markets experience extraordinary circumstances, and spreads may widen considerably. During the natural disasters in 2011 in Japan, when the country was struck by an earthquake and a tsunami, the spread on the USD/JPY contract widened dramatically from the usual three pips to over 50 pips. But such circumstances are extremely rare.

Margins, risk management, position sizing and stop-losses

Like trading in any market, the goal of trading in currencies is to make profits by taking risk and managing the risk carefully. To do otherwise exposes the trader to the larger risk of erosion of trading capital through unnecessary, or unnecessarily large, losses. Once trading capital is eroded beyond a certain point – generally taken to be about 50 per cent – it is very difficult to trade in such a way that the amount of capital is restored to its starting value. A 50 per cent loss of trading capital requires you to earn a 100 per cent return on your remaining funds in order to recover, and very few traders can achieve such returns consistently. They may double their money or better on some trades, but there will inevitably be losing trades in any trader's book.

A few simple risk management rules, carefully followed, will allow you the best chance to optimise your returns, avoid overtrading, keep losses on losing trades to a minimum, reduce the need to pay up losses in the form of margins, and allow the maximum profit to be gleaned from winning positions. The primary aim – even ahead of making profits – is preservation of capital, since no trading at all can be done, and no profits made, without that.

First, set your stop-loss order before entering any trade.

Your stop-loss order (also called a stop order or just a stop) – is the order you give your broker, or execute yourself, in order to prevent runaway losses. It gets you out of any losing trade quickly and is your first line of defence against unnecessary capital loss. It's an order to quit the trade as soon as the loss reaches a certain known point – a point at which the market has signalled that it is indeed moving against you and giving you the sign to exit. That signal will be recognised through analysis of price charts and indicators, so you need some familiarity with charting and technical analysis. Calculate the placement of the stop using what you know about how far the currency typically moves before it makes a reversal, and how far it tends to move each day. Study the concepts of support and resistance and take these into account when placing stops.

Second, calculate your position size based on the stop-loss

order. Remember that your maximum loss on the trade must not exceed one per cent of your total available trading capital. Suppose your capital is \$200,000 and the stop-loss order is placed 90 pips away from the entry price on a AUD/USD trade. If your stop-loss is triggered (by the market reaching the stop-loss price) then the loss will be \$US10 x 90 or \$US900 for a single \$A100,000 contract. At an exchange rate of, say, \$US1.05 for the Australian dollar, that's a loss of \$A945. Since your maximum acceptable risk on any trade is \$2,000, the number of contracts you can safely trade is \$2000 divided by \$945, or two contracts. Remember that the number of contracts you can trade will change if you move your stop-loss (exit) point. The more room you give the market to move before your stop-loss is triggered, the smaller the position size the rules will allow.

Third, stay in the market as long as possible. You should have a target price that you expect the market to reach, and this should be at least as far in profit as the stop-loss price is in loss. In other words, you should stand to gain at least as much as you stand to lose, and more if possible. This is often stated as a risk-reward ratio, really the ratio of reward to risk, which should be at least 1:1 in the foreign exchange market and preferably 2:1. Your target price should represent a realistic expectation of making twice as much, if possible, as the amount you would lose if the stop-loss were triggered. The target price is calculated using your analysis of the technical position of the currency – its price

charted in terms of the base currency against the reference currency and analysed for trends, reversal patterns, candlestick signals, volatility and the price crossing over the moving averages you are using in your analysis.

But the target price should not necessarily be the exit price, unless the market is telling you it's time to quit a favourable position before it turns around. One way to ensure you maximise profit is to use a trailing stop order. This is a stop order that gets you out of the market on a reversal of a given size, calculated using the daily average price move of the currency and your knowledge of how big a move typically constitutes a reversal of direction. You then quit the market automatically, but only if the currency price is signalling a probable change of direction against you.

Remember that when holding a CFD position, any losses that amount to more than the initial margin must be paid up daily. But if you follow the rules above, and if your stop-loss points are not too far from your entry point (less than 100 points on a AUD/USD trade, for example), the amount at risk should not be more than the amount paid in margins, making margin calls necessary only in unusual situations. For example, if there is slippage on your stop-loss order because unusual volatility in the forex market, your loss on a trade may occasionally amount to more than 1 per cent of your trading capital. This may result in the need to pay a maintenance margin to pay any losses greater than the initial margin.

For long-term traders, running wide stops – that is, allowing the market much more room to move before you exit automatically – may be necessary when markets are volatile, in which case you should expect losses at times to exceed the initial margin, with a consequent need to pay maintenance margins. Remember that widening your stop-loss – that is, moving it further away from your entry price – requires a recalculation of your position size. A wider stop will normally require a reduction in position size because your total risk will increase to potentially more than one per cent of your trading capital.

Factors affecting currency prices

The value of one currency relative to another is constantly shifting due to the forces of supply and demand. In fact, several types of forces can affect a currency's exchange rate, and fall into three categories: market psychology, economic factors and political conditions.

Market psychology

One of the most baffling aspects of the forex markets is the influence market psychology, or sentiment, can have on the price of a currency. Since it doesn't involve financial statements or central bank policy decisions, forex traders have a hard time coming to grips with it.

Sometimes it's no more than an interpretation of the way a central bank phrases its policy statement, or the tone of a speech, but forex traders can quickly turn in their sentiment from positive (bullish) to negative (bearish).

The psychology of markets is one of a tendency to over-react to news events and to price changes themselves. A sudden upward movement in an exchange rate can bring in traders from the sidelines as readily as an announcement about interest rates. Psychology is about what traders think must happen next; they may get it wrong but this doesn't prevent markets from moving in the meanwhile. In the period ahead of big economic announcements likely to affect a currency, traders are often stacked on one side of the market or the other, taking a view on which way an economic indicator like inflation or unemployment might move. If they're right, the market has already taken the news into account by the time the announcement is made. If they're wrong, the scramble to exit those positions may lead the market to move sharply in the other direction. This in turn may lead to a sudden reversal of outlook by traders hoping to profit from the new trend.

Economic factors

- Interest rates: One of the most important factors affecting exchange rates – some would say the most important – is interest rates. When the rate paid on cash deposits in a particular currency changes, this makes the currency more or less attractive to holders of other currencies. At times when markets are relatively stable a popular strategy among fund managers is to sell low-yielding currencies and buy those offering better yields. This is known as a carry trade. The carry trade has been supporting the Australian dollar against other currencies, especially the US dollar, for some years, because Australia's cash deposit rate, officially at 4.75 per cent for loans from the government, is much higher than the corresponding US rate of 0.25 per cent. Although these rates may change, it is likely that Australian yields will be higher than those in the US for some time, but any change in either rate will have an obvious effect on the exchange rate. Any cut in Australian interest rates tends to depress the Australian currency's value, while any increase would lead to a rise in its rate against the US dollar and other currencies.
- National debt policy: This involves government management of national debt and the nation's overall debt position. The US, with rising levels of debt, has seen a decline in its currency as a consequence.
- Economic conditions: economies go through periods when growth is strong, employment is rising, consumer spending is high and productivity and output increase. Such economies are able to reduce debt, although the government may take steps to cool demand, if it becomes inflationary, by raising interest rates. Strongly growing economies tend to have correspondingly strong currency values. On the other hand, slow growth along with rising unemployment and falling interest rates suggests an economy experiencing a slowdown or sluggish period, with the risk of recession. Economies in this phase of the cycle tend to show declining currency values.
- Balance of trade: Forex investors watch balance of trade levels very carefully. A country exporting more than it imports accumulates a surplus, which is favourable for its currency, while a country whose imports are greater than its exports shows a trade deficit, which is negative. Surpluses and deficits are perceived as indicators of the competitiveness of a nation's economy.

Political conditions

Political as well as economic instability can have a significant effect on currency values, as illustrated by the difficulty the European zone has faced since the global financial crisis as the need for austerity has provoked adverse reactions among the populations on which austerity must be imposed. This has hindered the process of resolving the Euro zone's debt problems that have seen a number of European countries facing the apparent prospect of being forced to default on government debt.

Election results and shifts in party power that lead to significant change in economic policy must also be monitored for any country in whose currency you trade.

Technical analysis

Technical analysis is the study of changes in price and volume as a way of working out which way a currency is likely to move next. Markets are unpredictable, but people are not. They tend to over-react, first in one direction and then in another, and charts can help in identifying possible turning points for CFD trades.

Remember that the chart of a currency (or of a share price, index, or a commodity like gold) can't make accurate predictions about future price direction, and is not expected to. CFD traders who use charts do so to get an edge – to lift the number of potential winning trades by identifying possible turning points in share and other market prices.

Such turning points can be elusive, because although traders do tend to respond to similar situations in similar ways, each unfolding of price is different from every other. Technical analysis assumes that the similarities will be enough to indicate, at least as often as not, when a market is likely to turn.

Turning points are also entry and exit points for successful trades, so we want to get as close to them as possible, recognising that it's almost impossible to pick tops and bottoms exactly. We also want to catch the longer-term moves in the time frame we choose – perhaps a few days or a week – without being caught by short-term moves in the opposite direction.

Before entering a trade, we want to know exactly where we should be getting out at a loss if the trade happens to go against us.

If I buy index or commodity CFDs, I need an order to get me out of the trade if the price starts to fall. The question is, how far must it fall before I decide to quit?

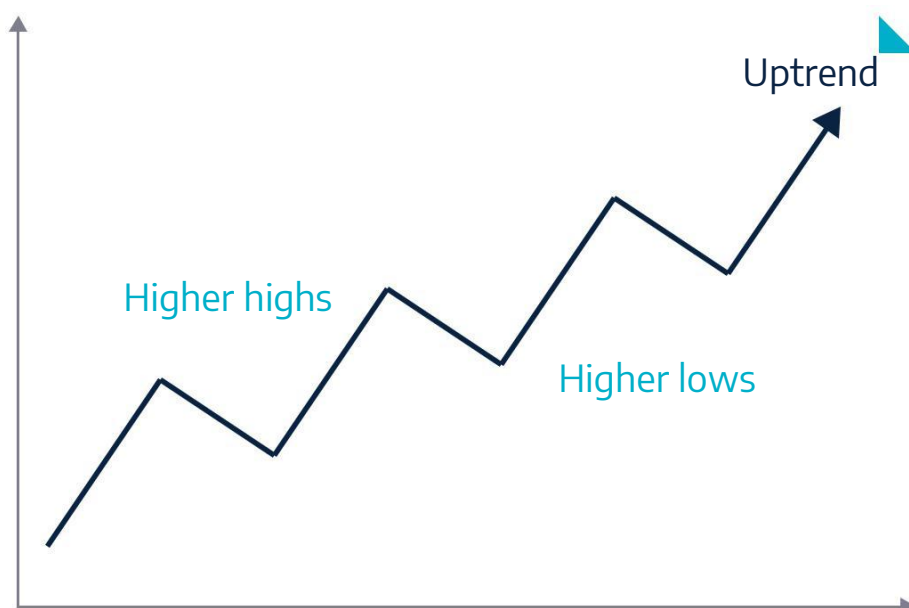
Here is where technical analysis can help, since the answer – as well as the answer to “when should I buy or sell to begin with?” is given by research into how that particular currency has behaved in the past. Technical analysis using past price data shows which patterns and indicators tend to work best for the currency in question.

Although charts are essential for a complete picture of the market, a shift in basic fundamentals – factors that affect supply and demand

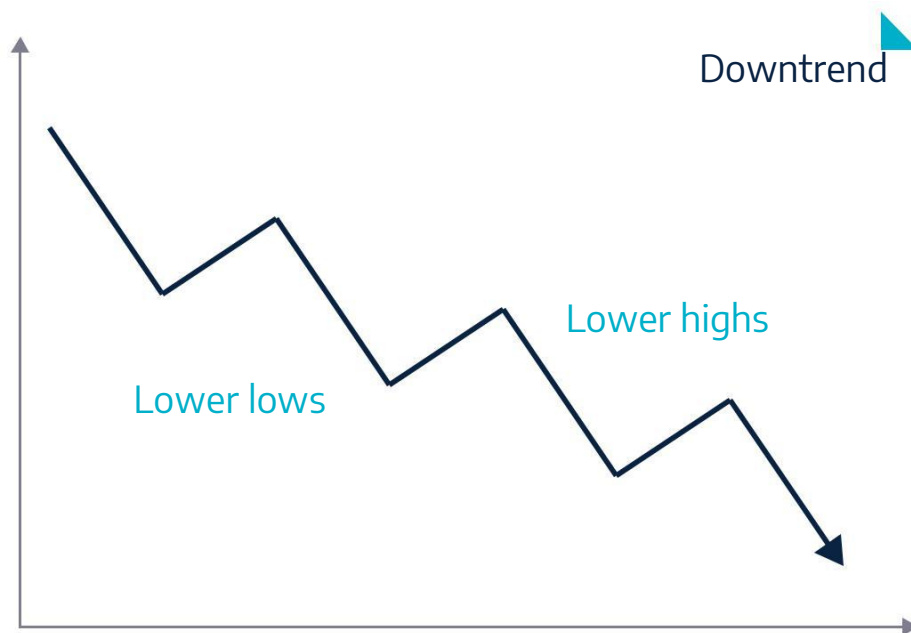
– can make nonsense of a chart’s signals, which is why it’s often advisable to quit the market at times when such news about such fundamentals is expected, and always a good idea to follow the relevant economic and business news and trends.

Uptrend and downtrend lines

The trend line – up or down – is one of the basic chart patterns and one of the most reliable. Markets don’t usually move up or down evenly. After moving up, they often dip to a low, then move much higher before dropping back to another low, higher than the last. If you can join a series of three of these ever higher low points in a straight line, you have a trend. If the price stays above the trend line, the upward movement is likely to continue, but if it falls convincingly below it, a new downward trend is likely in the near future.



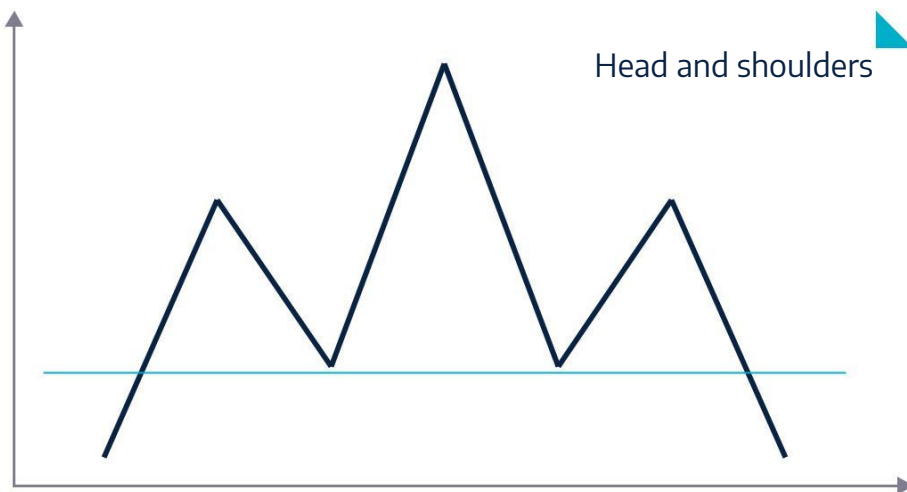
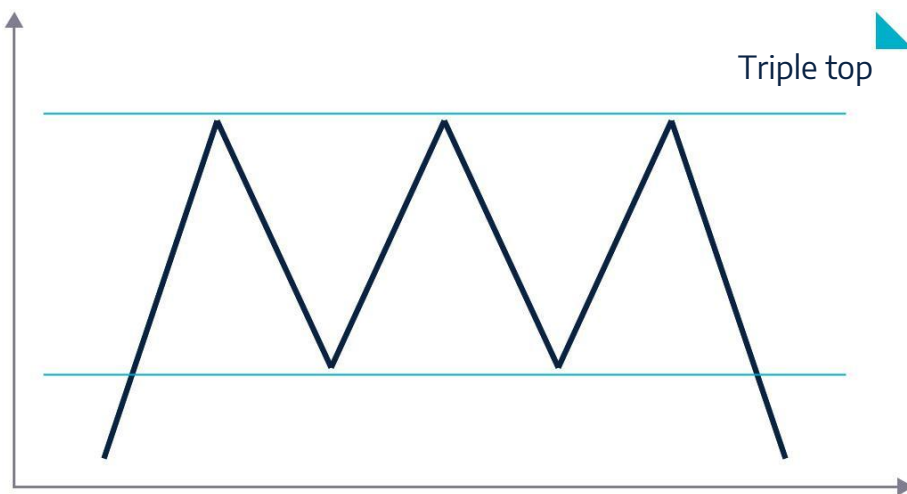
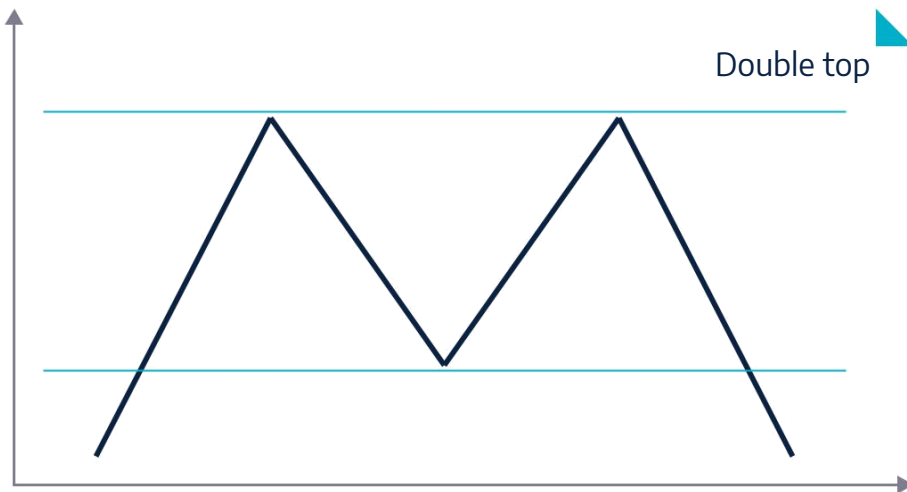
The reverse of this is the downtrend line, in which a series of ever lower peaks are connected, with at least three in a straight line defining a downtrend. The downtrend line forms a downward slope to the right, sitting on the succession of lower peaks, and if the price breaks up firmly through the downtrend, this is a buy signal.



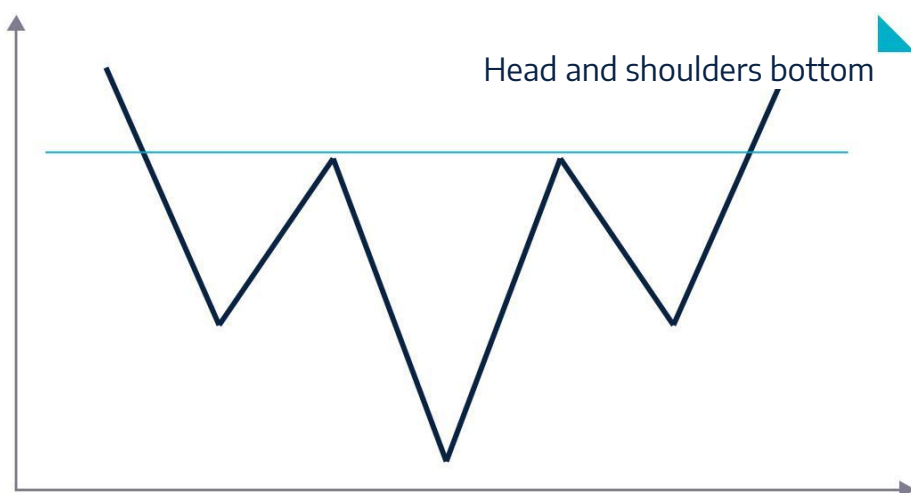
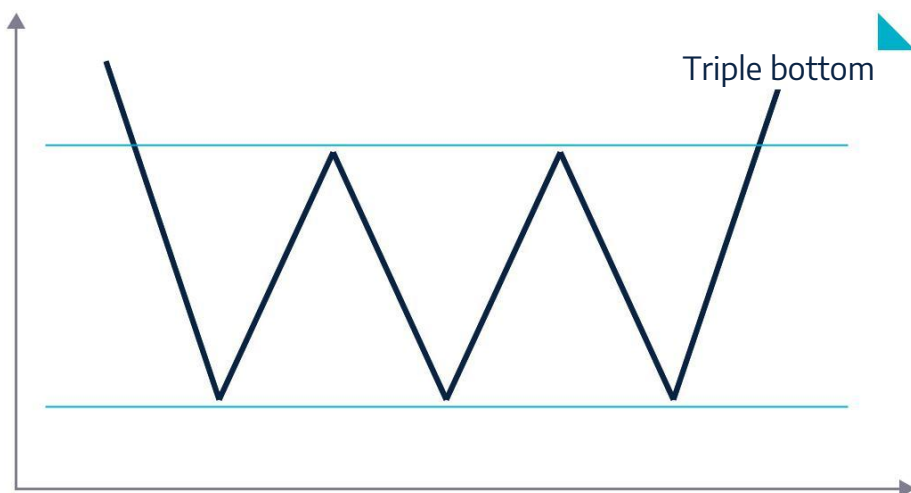
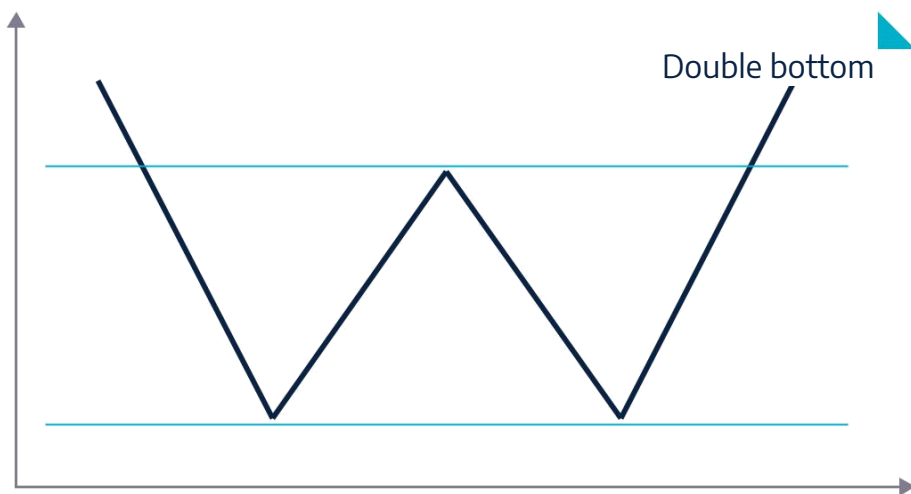
Reversal patterns

There is a variety of standard patterns that indicate the market is about to change direction, and traders need to be familiar with them all – double and triple tops and v-reversals, for example, among others.

The head-and-shoulders top is considered one of the most reliable, although it appears only rarely. A top pattern is one that indicates a likely imminent price fall. A head-and-shoulders top occurs when a market forms a peak (left shoulder) followed by a higher peak (head) and a third peak more or less level with the first (right shoulder). The neckline joins the two low points on either side of the head, and the target price is the same distance below the neckline as the top of the highest peak is above it.

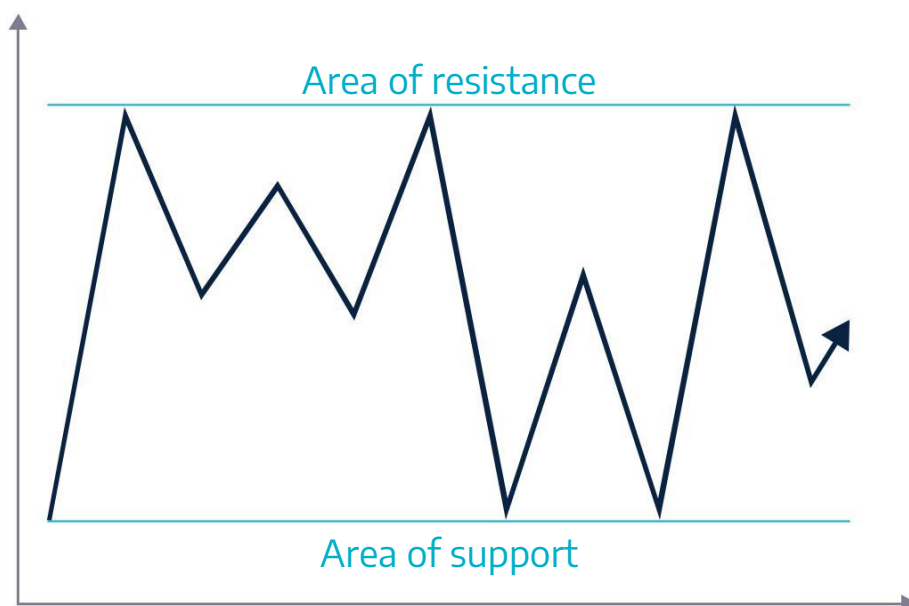


All the top patterns have corresponding bottom reversal patterns, which indicate the market has fallen as far as it's going to, and will now begin to rise. A head-and-shoulders bottom looks like the top variety turned upside down, with the target price the same distance above the neckline as the head is below it.



Support and resistance

Along with a simple trend line, support and resistance are perhaps the most useful indicators for traders seeking entry and exit points and setting stop-loss levels. A support level is where the price has, in the past, been moving down but has run into fresh buying and bounces back up. At a price where this has happened more than once, a support level is considered to be in force, and the price is likely to bounce off the support level if it reaches it again. If a price moves up from a support level and you buy CFDs, place the stop-loss order price just below the support price, since a break through it is likely to result in loss if you hold the position.



On the other hand, if the price repeatedly moves up to a particular level to find that fresh selling halts the upturn and sends the price south, this is known as a resistance level. Place the stop above this level if the market moves down from a previous resistance point and you sell CFDs.

If a downward moving market can convincingly penetrate a support level, or when a rising market easily moves through a resistance level, this is a sign that the current trend is strong and likely to continue. It represents a possible entry point, to be confirmed by other signals.

Moving averages

Take the closing price of one currency against another on each of the past ten days, add them and divide by ten. Plot the figure on the bar chart along with today's prices. Repeat the procedure the next day, dropping the oldest price and inserting the latest, and you're now plotting a ten-day moving average.

Ten days, 30 days and 200 days are among the typical periods used, but moving averages can be calculated for any period. A share index or commodity that has been trading below its moving average and whose price rises above the moving average is giving a possible buy signal. The longer the period of the moving average, the more reliable the signal tends to be; the shorter the period, the earlier the signal. Finding the optimum trade-off between these two for the currency you are trading involves doing some research into its past behaviour.

A popular type of moving average is one that is weighted to give recent prices more effect on the average than prices on earlier days. Technical analysts also calculate moving averages for more than one period and look for places where the longer term average crosses the shorter term or vice versa, or where they diverge. This analysis is known as moving average convergence and divergence, or MACD.

Indicators and oscillators

Chartists use a variety of analysis tools, some of them quite complex. They include relative strength indicators, which attempt to show whether a market is overbought or oversold, momentum indicators, and oscillators based on statistical analysis. The relative strength indicator looks at the size of recent upward movements compared to downward ones and signals an overbought market – one in an uptrend but due for a fall – with an index of 70 per cent or more and an oversold market – one that has been dropping but is likely to rise – with an index of 30 per cent or less. Indicators and oscillators like these should not be used in isolation – they may give poor signals unless these are confirmed by other technical factors.

Example trades

Long trade – AUD/USD \$A100,000

After carefully analysing the fundamental factors affecting the Australian dollar, and studying technical patterns and indicators, you believe the currency is likely to rise in value against the US dollar from its current rate of \$US1.0350 to a level close to \$US1.0550, a 200-pip move, over the next two weeks. You calculate that the best place to place your stop-loss order in the current market conditions is at 95 pips below the entry price. Your trading capital is \$A150,000.

Since you cannot afford to lose more than \$1,500 on a trade, and the stop-loss level implies a possible loss of \$US95 on a \$A10,000 position if it is triggered, your maximum position size is your maximum loss divided by the potential loss, or $\$1500 / \$95 \times \$10,000 = \$A157,894$. You decide on a standard foreign exchange position size of \$A100,000, so you buy CFDs for \$A100,000 value against the US dollar at \$US1.0350.

15 September		
Buy	US\$	Value
\$A100,000	\$US1.0350	\$US103,500
Pay initial margin \$A1,000		

If the value of the Australian dollar moves down initially against the US dollar, your position is at risk only as far as the amount of the stop-loss order. If it is triggered, under most circumstances (barring extraordinarily volatile markets) you will lose no more than the 95-pip distance from the entry point to the stop-loss level, a total of \$US950. The amount of the loss in Australian dollars will be of the order of \$A875 (assuming a 95-pip fall from \$US1.0350). This is well within your maximum allowed loss per trade of \$1500.

But your expectations are fulfilled, and in just a few days the Australian dollar reaches its target price and you keep a watch on the market, ready to exit if it reverses by more than the specified amount you think probably constitutes a change of direction. After moving to just over \$US1.0630, the market falls back to \$US1.0575, triggering your exit. You exit by selling back the CFD you bought.

20 September

Buy	US\$	Value
\$A100,000	\$US1.0575	\$US105,750
Profit \$US2,250		
Initial margin \$A1,000 returned		

Your profit on the transaction is \$US2250, which at the current exchange rate of \$US1.0575 represents a profit, before costs, of \$A2,380.

Your cost will be a spread equivalent to about \$20, less a small amount of interest received.

Short trade – AUD/USD \$A10,000

The short trade is simply a mirror image of a long trade. In this instance your analysis shows that the Australian dollar is likely to fall from its present level of \$US1.0940 to around \$1.0500.

Market conditions are fairly volatile, indicating a 120-point stop distance above the entry point to reduce losses from any unexpected rise in the Australian dollar.

Assuming a smaller account with risk capital of \$A15,000, you can afford a maximum loss of \$A150 per trade, restricting your position size to \$A10,000 (the minimum forex position size). The maximum expected loss is 120 points, or \$US120, equivalent to \$A132.70, while the potential profit, if the target price is reached, will be 440 points, or \$US440, translating into about \$A462.00.

If the Australian dollar rises, your stop-loss will be triggered and your loss will be \$A132.70 plus costs. But the Australian dollar falls as expected to \$US1.0520, close to the target, before turning around and triggering your trailing stop – an order to exit on any price reversal of a given size -- at \$US1.0570.

20 September

Sell	US\$	Value
\$A100,000	\$US1.0575	\$US105,750
Initial margin \$A100		

Your profit before costs is \$A391.00. Costs include the buy-sell spread and a small amount of interest to be paid.

27 September

Buy	US\$	Value
\$A10,000	\$US1.0575	\$US10,570
Profit \$US 370		



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hesitate to contact FP Markets.

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