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THE FOREX TRADING COURSE

A SELF-STUDY GUIDE TO BECOMING A SUCCESSFUL CURRENCY TRADER

SECOND EDITION

ABE COFNAS

WILEY

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ABE COFNAS

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Preface

This edition is more than an update on the first edition. Since the first edition was released in 2008, the world of forex trading has significantly changed. The challenges facing the forex trader are new and greater than ever. The financial collapse of 2008 ushered in a rebalancing of the world economy, with monetary policy and currencies as key instruments. The era of quantitative easing began, and with it, central bank intervention became and remains since a prime mover of currencies. Forex trading became subject to greater spikes and disruptions and, more than ever, sensitive to market emotions. Expectations regarding global growth and inflation have significantly influenced currency movement. These changes underscore the need for a refocus on fundamentals for forex trading.

The significant advances in the Internet since 2007 have also transformed forex trading and its technological environment. The forex trader today has the opportunity to access more information, more quickly than ever before. Also, a popular phenomenon called *social media trading* has emerged where the forex trader can “copy” the trades of other traders. The Internet wraps information flow with rumors and hyperbole, creating herding behavior and swarming patterns.

Since 2008, an entirely new instrument for trading currency directions and market emotions—binary options—has emerged. It is one of the fastest-growing markets in the world. Forex firms are increasingly offering binaries to their customers.

This edition shows how to use binaries in combination with forex trades to strengthen skills in choosing direction, targets, and stops. Most recently, the emergence of crypocurrencies as a potentially hybrid currency/commodity has special significance for the forex trading, because ultimately owners all need to sell their currencies and exchange them into local currency. This edition also provides insight into bitcoin as an alternative currency.

About the Author

Abe Cofnas continues to be a leading-edge trainer and analyst on forex markets. He has pioneered new methods of detecting market emotions and sentiment for improving forex trading. His newsletter, formerly the *Fear and Greed Trader* and now *BinaryDimensions* (www.binarydimensions.com), provides weekly alerts on market direction in currencies, gold, and indices. In addition to founding learn4x.com and being the Forex Trader columnist for *Futures* magazine since 2001, Cofnas has founded Quicksilver Concepts Inc. (www.quicksilveralgos.com), a financial gamification technology firm that designs “smart” financial gamification platforms that generate real-time skills in trading currencies, gold, and indices.

Part I
What Drives the Forex Market?

Part I of this book offers a look at the “big picture” in foreign exchange (forex) trading, that is, what forces influence currency price movements. These forces are accepted by economists and traders around the world as responsible catalysts for changes in the value of currencies. Readers learning to trade forex or trying to improve their trading will benefit from a gain of knowledge of these fundamentals. In fact, as you will see, fundamental forces act as leading indicators of currency movement future direction.

US and global interest rates, economic growth, and market sentiment toward the dollar are the key ingredients that shape trading opportunities. Part I provides basic knowledge on how these factors impact forex prices and how they can be used in selecting trading opportunities.

In getting acquainted with the forex market, most people start by looking only at price charts. This is called *technical analysis*. Those who focus on technical analysis are often called *chartists*. But the study and analysis of what moves those charts is called *fundamental analysis*. The goal of Part I is to identify the components of fundamental analysis in regard to forex and then provide a recipe for developing your own fundamental analysis of a currency pair.

Chapter 1
The Fundamentals of Forex

We begin in this chapter with an exploration of the forces that move the prices: the fundamentals. The reader will learn why fundamentals are important to foreign exchange (forex) traders as well as what kinds of economic activity are most important in affecting price movements. These include interest rates, interest rate differentials, economic growth, and sentiment regarding the US dollar.

Why Fundamentals Are Important

In many ways, forex trading is similar to playing a game. You have an opponent (the market). In games of chance, the key feature is that everyone faces the same odds and therefore the same level of information. In these games, no player can change the odds.

Playing forex, however, is not a game of odds. It might feel like gambling, but it is not gambling. In a fair game, like the roll of a dice, the person rolling the dice does not affect the outcome. Everyone has the same probabilities of winning. However, participants in forex trading do not share the same amount of information. Asymmetry of information results in advantages and disadvantages. Some players have more information than the others. In forex, information about fundamental aspects of economies does not arrive simultaneously to all participants. The important question is, what kind of knowledge and information can improve trading performance? The search for an edge starts with a fundamental understanding of the nature of the forex market. Having a foundation of knowledge in fundamentals is a first step in evolving into a winning trader.

Why take time to look at forex fundamentals? Why should fundamentals matter if a trade is done in a short-term time interval such as the five-minute chart? The short answer is that one cannot separate the fundamentals from the technical analysis without exposing oneself to great distortions in understanding the forex market and avoidable losses. The five-minute trader who is on the side of the longer trend is likely to be more profitable. Foreign exchange is by its nature *both* fundamental and technical and reflects the increased globalization of the world economy.

It is worthwhile to note the comments of the late, great Milton Friedman in a 2005 conversation with Dallas Fed president Richard Fisher:

> *The really remarkable thing about the world is how people cooperate together. How somebody in China makes a little bit of your television set. Or somebody in Malaysia produces some rubber. And that rubber is used by somebody in the United States to put on the tip of a pencil, or in some other way. What has happened has been an enormous expansion in the opportunities for cooperation.*[1]

Consider the following: Every transaction in the world settles in a currency. Whether it is a consumer purchase, an imported or exported item, an investment in an equity, or even cash under the mattress, the world's economic activity is essentially a flow of money. What makes forex fascinating as a market and as a trading vehicle is the fact that currencies provide an intimate linkage to the world economy. The currency trader by putting on a currency trade becomes a participant the world economy. The trader is participating as a speculator looking for a very short-term profit. The forex trader is riding on a global wave. The wave consists of economic, geopolitical, and emotional influences. Some will surf the waves, jumping on and off; others will stay in much longer and face the volatility. Forex trading becomes possible because the world is constantly assessing and reassessing the value of one currency against another. The forex currency trader is looking to tap into this stream of changing values.

The challenge is to find the right combination of tools that can assist the trader in finding high-probability profitable trades. In meeting this challenge, the first step is understanding what moves currencies over time. In putting together a recipe for successful forex trading, knowing the fundamental chemistry of forex is highly recommended. Anyone who doubts this should simply look at daily headlines that evoke names and places that are, and certainly need to be, part of the daily consciousness of a trader. These names should be familiar to all traders: Yellin, Draghi, Kuroda, Carney, Stevens, Poloz, Jordan, and Zhou Xiaochuan.

Notice, these aforementioned names are the current heads of the major central banks in the world. The fact is that the words and decisions of these central bankers of the United States, the Bank of Japan, the European Central Bank, Bank of England, Reserve Bank of Australia, Bank of Canada, Swiss National Bank, and the Bank of China alert the trader to interest rate and monetary policy and news that affect sentiment about the direction of the dollar. Mention the cities of Baghdad, Tehran, Crimea, and Gaza, and they evoke emotions of fear and crises. Detect news about retail giant Wal-Mart's sales, and one starts anticipating a potential reaction in the currency markets. These and other factors mix together and form the chemistry of forex, which results in shifts of sentiment regarding economic growth in the United States, Eurozone, Britain, China, and Japan. These shifts in sentiment cause price reactions and shift the balance between buyers and sellers. Let's look in more detail at these fundamental factors.

The Main Ingredient: Interest Rates and Interest Rate Expectations

Interest rates are the “dough” of the fundamental forex pie. They are one of the most important factors that affect forex prices, as interest rates have been the most used tool that central banks use as a throttle or break on their economies. The central banks of the world do not hesitate to use this important tool. Before the great financial collapse of 2008, almost all of the central banks increased interest rates. The European Central Bank raised interest rates eight times from December 6, 2005, to June 13, 2007, to a level of 4.0 percent to guide a booming European economy to slow down and avoid too-high inflation. The US central bank—the Federal Reserve—increased interest rates 17 times between June 30, 2004, and August 2006, and then paused when it decided the economy no longer needed the brake of interest rate increases.

Then came the financial crisis of 2008. It was so great a collapse that statisticians remarked it was more than 12 standard deviations from the norm. In other words, no one saw it coming. Rather than focus here on the causes of the collapse, we simply need to note that the immediate consequence was a global shift to nearly a zero interest rate environment. That near-zero interest rate environment has prevailed since then, and as a result, central banks ran out of tools to stimulate economies and turned to quantitative easing (QE), which resulted in expanding the money supply in order to stimulate demand.

However, in late 2014, the world central banks began to see the end of a policy of lowering interest rates. The US Federal Reserve Bank ended its quantitative easing policy in October 2014 and put an increase in rates back on the agenda. The Bank of England (BOE) also has provided guidance that an increase in interest rates is due. In late 2014, only New Zealand, among the Western economies, increased rates. However, the world recovery from the collapse of 2008 has not been equal. The Eurozone faced deflationary fears and therefore remains sustaining low interest rates. The Bank of Japan also has remained in a quantitative easing policy, with an official target of reaching a 2 percent inflation rate.

In other words, the forex trader in 2015 and the years beyond will need to recognize that interest rate expectations, whether they are for remaining low or increasing, provide one of the most important fundamental forces moving currencies.

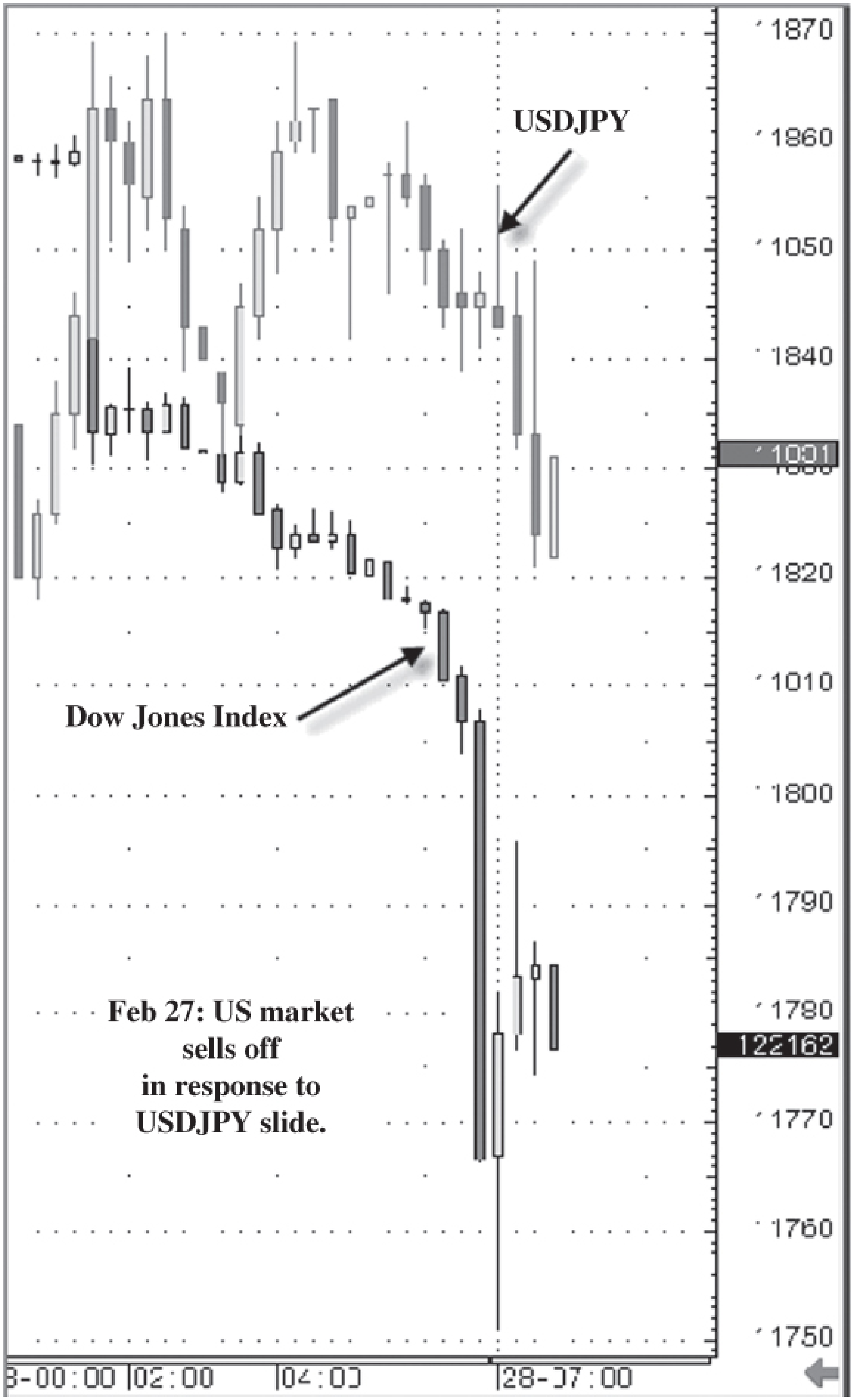
As the globe recovers in growth, the role of interest rate increases is to try to avoid excessive inflation. Inflation is itself a complex set of events. But for the forex trader, there are basically two kinds:

1. *Demand inflation*—consumer spending increasing pushes up prices.
2. *Wage inflation*—the lack of a supply of workers pushes up average wages.

Inflation in wages is increasingly a focus of central banks. In fact, a puzzle is emerging where expectations of wage inflation are increasing, but there is little evidence that it is occurring. The world is in a tectonic shift where economies are experiencing lower annualized growth and lower inflation pressures. This is challenging central banks and monetary policy. The result is an environment of constant focus on economic data and therefore more potential for surprises. It is an exciting time for trading. In the next chapter, we take a closer look at inflation.

Since it is likely that the world is entering an era where interest rate decreases are essentially over, the forex trader should understand the general impact and role of interest rate increase. Interest rate increases do much more than slow down an economy; they also act as a magnet to attract capital to bonds and other interest-bearing instruments. This has been called an *appetite for yield*, and when applied globally the flow of capital in and out of a country can be substantially affected by the difference in interest rates between one country and another. In the coming years, if interest rate increases are not uniform around the world, the phenomenon of the "carry trade" will likely come back into focus. The carry trade is driven by the interest rate differential that exists between currencies—for example, between Japan (0.10%) and New Zealand (3.5%), causing low-cost borrowing in yen to invest in higher-yielding kiwis. Historically the yen was the low-interest-rate currency that was borrowed or sold to finance investments in instruments with higher interest rates. It can lead to market turbulence, however.

Some forex traders learned this lesson, about the consequences of carry trades, when the US stock market sold off on February 27, 2007. It was precipitated by traders getting out of their carry trade positions. Since billions of dollars were sold to be converted back into yen, equity markets were also affected because equity positions had to be sold to buy back the yen positions. In Figure 1.1 we see how the Dow Jones Industrial Index correlated directly with the US dollar–Japanese yen (USDJPY) pair that day. Many traders will find the USDJPY relationship to the US equities highly correlated. When the markets are risk averse, the yen strengthens against the dollar. When the markets are risk-on, the yen weakens. Figure 1.2 shows how the USDJPY weakened while the Dow Jones Industrial Index strengthened.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