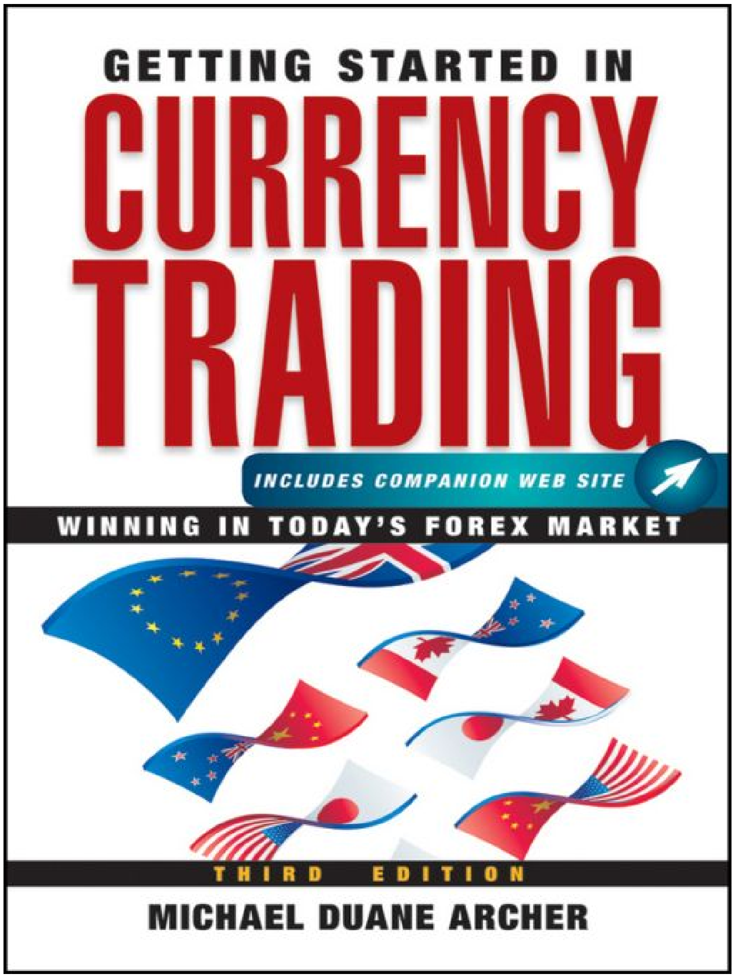
GETTING STARTED IN
CURRENCY TRADING

INCLUDES COMPANION WEB SITE

WINNING IN TODAY'S FOREX MARKET

THIRD EDITION

MICHAEL DUANE ARCHER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To my friend, Frank Semone

Introduction

About This Book

This book is intended to introduce the novice investor to the exciting, complex, and potentially profitable realm of trading world currencies on the foreign exchange markets (FOREX). It also serves as a reference guide for stock and futures traders who wish to explore new trading opportunities. My primary focus is on the rapidly expanding and evolving online trading marketplace for spot currencies, generally referred to as *retail FOREX*.

From the beginning I must emphasize that currency trading may not be to everyone’s disposition. The neophyte investor must be keenly aware of all the risks involved and should never trade on funds he or she deems necessary for survival. Currency trading is a form of speculation—attempting to profit by absorbing a risk that already exists. This differs from gambling in which one creates a risk in order to take it. Savings and investment should be covered before considering speculation.

If you have some experience with leveraged markets such as futures or options, you owe yourself a look at FOREX. Those who have never traded will find it the most laissez-faire of all speculative adventures.

How This Book Is Organized

There are six main parts to this book:

1. Part 1—The Foreign Exchange Markets

   The FOREX Landscape, A Brief History of Currency Trading, Two Ways to Trade FOREX.

   I open the book with a brief overview of the FOREX markets, an event-by-event-based historical overview of currency trading, and the two primary methods for participating in the markets as a retail trader. I hope to dispel any myths the reader has about FOREX.

2. Part 2—Getting Started

   Regulation: Past, Present, and Future, The FOREX Lexicon, Trading Tables, A Guide to FOREX Brokers, Opening a FOREX Account, and Making the Trade.

   Regulation has been slow to come to retail FOREX, but it is making up for lost time.

   Every lucrative industry has its own gamut of highly specialized terms or jargon, and currency trading is no exception. You must thoroughly comprehend this jargon before attempting to initiate any trades. With a little familiarization, the language of currency trading will become second nature.

   I assist the new trader in selecting a reputable online currency dealer and explain the steps involved in opening a trading account. The actual step-by-step processes of initiating and liquidating a trade are examined in detail with a complete explanation of each order type.

This section must be understood before the reader proceeds to the later sections.

3. Part 3—The Tools of the Trade

Fundamental Analysis, Technical Analysis, A Trader's Toolbox, The FOREX Marketplace, and Retail FX Platforms.

Historically, there have been two major schools of thought in analyzing markets whether they are stocks, commodity futures, or currencies: fundamental analysis and technical analysis. I explore the advantages and disadvantages of both schools in the chapters in this section. I offer ideas on selecting from these trading tools to assemble a basic, personal trading approach that you can easily build upon with experience. A full chapter reviews the wealth of FOREX products and services now available from third-party vendors. Detailed study of several popular online trading platforms completes the section.

4. Part 4—The Complete FOREX Trader

The Plan, The Plan!, Money Management Simplified, Psychology of Trading, Improving Your Trading Skills.

The prospective trader is given the outline of a trading plan. I place much emphasis on money management, the art and science of avoiding losses; and I offer a technique the new trader can use easily and effectively.

I expose the trader to the psychology of trading and the stresses that may accompany same. I place much emphasis on money management and psychology—two key topics vital to success but often neglected in the search for the holy grail of trading methods. Improving Your Trading Skills proffers a series of techniques and skills from which you can pick and choose to flesh out your own trading program.

5. Part 5—Extra for Experts

   Options and Exotics, Computers and FOREX.

   A single chapter covers options and exotics, two areas of FOREX trading that have blossomed recently. Computer trading is big business in all the organized markets. A final chapter briefly discusses the use of computers to assist in and automatically execute trading decisions. It is important for even the small retail trader to understand how the “big guns” trade FOREX and to understand the impact of computers on the markets, directly and indirectly.

6. Appendixes

   The appendixes are a ready reference of FOREX-specific information, much of which the trader finds useful to have at hand while learning and trading. I point you to Appendix A, How the FOREX Game Is Played. The web sites in Appendix F are meant to offer a self-guided tour of the world of currency trading.

The author’s attempt has been to make *Getting Started in Currency Trading* an all-in-one introduction as well as a handy computer-side reference guide. Alas, only you, gentle reader, may judge the level of my success.

Companion Web Site

This edition of *Getting Started in Currency Trading* offers a *Getting Started* companion area on the author’s web site, www.goodmanworks.com.

You can find all of the tables in this book in downloadable format. You can customize them to your own needs and either print or work with them in MS Word or MS EXCEL.

A *What's New* section keeps readers up-to-date on the ever-changing retail FOREX landscape and the *Getting Started Blog* offers additional learning ideas from the author.

Disclaimer

Neither the publisher nor the author is liable for any financial losses incurred while trading currencies. FOREX is the ultimate caveat emptor marketplace.

Part 1

The Foreign Exchange Markets

Chapter 1

The FOREX Landscape

Introduction—What Is FOREX?

Foreign exchange is the simultaneous buying of one currency and selling of another. Currencies are traded through a broker or dealer and are executed in currency pairs; for example, the Euro Dollar and the U.S. Dollar (EUR/USD) or the British Pound and the Japanese Yen (GBP/JPY).

The FOReign EXchange Market (FOREX) is the largest financial market in the world, with a volume of more than $2 trillion daily. This is more than three times the total amount of the stocks and futures markets combined.

Unlike other financial markets, the FOREX spot market has neither a physical location nor a central exchange. It operates through an electronic network of banks, corporations, and individuals trading one currency for another. The lack of a physical exchange enables the FOREX market to operate on a 24-hour basis, spanning from one time zone to another across the major financial centers. This fact—that there is no centralized exchange—is important to keep in mind as it permeates all aspects of the FOREX experience.

What Is a Spot Market?

A spot market is any market that deals in the current price of a financial instrument. Futures markets, such as the Chicago Board of Trade, offer commodity contracts whose delivery date may span several months into the future. Settlement of FOREX spot transactions usually occurs within two business days. There are also *futures* and *forwards* in FOREX, but the overwhelming majority of traders use the spot market. I discuss the opportunities to trade FOREX futures on the International Monetary Market.

TABLE 1.1 Major FOREX Currencies

Symbol	***Country***	***Currency***
USD	United States	Dollar
EUR	Euro members	Euro
JPY	Japan	Yen
GBP	Great Britain	Pound
CHF	Switzerland	Franc
CAD	Canada	Dollar
AUD	Australia	Dollar

Which Currencies Are Traded?

Any currency backed by an existing nation can be traded at the larger brokers. The trading volume of the major currencies (along with their symbols) is given in descending order: the U.S. Dollar (USD), the Euro Dollar (EUR), the Japanese Yen (JPY), the British Pound Sterling (GBP), the

Swiss Franc (CHF), the Canadian Dollar (CAD), and the Australian Dollar (AUD). See Table 1.1. All other currencies are referred to as *minors* and those from smaller countries, *exotics*.

FOREX currency symbols are always three letters, where the first two letters identify the name of the country and the third letter identifies the name of that country's currency. (The "CH" in the Swiss Franc acronym stands for Confederation Helvetica.)

A FOREX transaction is always between two currencies. This often confuses new traders coming from the stock or futures markets where every trade is denominated in dollars. The price of a pair is the ratio between their respective values. *Pairs, crosses, majors, minors,* and *exotics* are terms referencing specific combinations of currencies. I discuss these terms in Chapter 5, "The FOREX Lexicon." They are defined in the Glossary.

Who Trades on the Foreign Exchange?

There are two main groups that trade currencies. A minority percentage of daily volume is from companies and governments that buy or sell products and services in a foreign country and must subsequently convert profits made in foreign currencies into their own domestic currency in the course of doing business. This is primarily hedging activity. The majority now consists of investors trading for profit, or speculation. Speculators range from large banks trading 10,000,000 currency units or more and the home-based operator trading perhaps 10,000 units or less. Retail FOREX, as much as it has grown in the past 10 years, still represents a small percentage of the total daily volume but its numbers and significance are growing rapidly.

Today, importers and exporters, international portfolio managers, multinational corporations, high-frequency traders, speculators, day traders, long-term holders, and hedge funds all use the FOREX market to pay for goods and services, to transact in financial assets, or to reduce the risk of currency movements by hedging their exposure in other markets.

A producer of widgets in the United Kingdom is intrinsically *long* the British Pound (GBP). If they sign a long-term sales contract with a company in the United States, they may wish to buy some quantity of the USD and sell an equal quantity of the GBP to *hedge* their margins from a fall in the GBP.

The speculator trades to make a profit by purchasing one currency and simultaneously selling another. The hedger trades to protect his or her *margin* on an international transaction (for example) from adverse currency fluctuations. The hedger has an intrinsic interest in one side of the market or the other. The speculator does not. Speculation is not a bad word. Speculators add *liquidity* to a market, making it easier for everyone to transact business by setting efficient prices. They also absorb risks that exist in the marketplace. This latter differs from the gambler who creates risks in order to take them.

How Are Currency Prices Determined?

Currency prices are affected by a large matrix of constantly changing economic and political conditions, but probably the most important are interest rates, economic conditions, international trade, inflation or deflation, and political stability. Sometimes governments actually participate in the foreign exchange market to influence the value of their currencies. Governments do this by flooding the market with their domestic currency in an attempt to lower the price or, conversely, buying in order to raise the price. This process is known as central bank intervention. Any of these factors, as well as large market orders, can cause high volatility in currency prices. Reports of sudden changes in such factors as unemployment can drive currency prices sharply higher or lower for a short period of time. In fact, news traders specialize in attempting to capitalize on such surprises. Technical factors, such as a well-known chart pattern, may also influence currency prices for brief periods. However, the size and volume of the FOREX market make it impossible for any one entity to drive the market for any length of time. Crowd psychology and expectations also figure in the equation determining the price of a currency relative to another currency. There are an enormous number of correlations between all these factors and they are almost certainly nonlinear in nature. That means they are constantly changing and rearranging themselves, sometimes in nonpredictive ways. Now you see it, now you don't. If you focus on one or a few of them, the others might change unnoticed. Quantum theory comes to mind.

Why Trade Foreign Currencies?

In today's marketplace, the dollar constantly fluctuates against the other currencies of the world. Several factors, such as the decline of global equity markets and declining world interest rates, have forced investors to pursue new opportunities. The global increase in trade and foreign investments has led to many national economies becoming interconnected with one another. This interconnection, and the resulting fluctuations in exchange rates, has created a huge international market: FOREX. For many investors, this has created exciting opportunities and new profit potentials. The FOREX market offers unmatched potential for profitable trading in any market condition or any stage of the business cycle. These factors equate to the following advantages:

- *No commissions.* No clearing fees, no exchange fees, no government fees, no brokerage fees if you trade with a market maker.
- *No middlemen.* Spot currency trading does away with the middlemen and allows clients to interact directly with the market maker responsible for the pricing on a particular currency pair, if you trade with an Electronic Communications Network (ECN).
- *No fixed lot size.* In the futures markets, lot or contract sizes are determined by the exchanges. A standard-sized contract for silver futures is 5,000 ounces. Even a “mini-contract” of silver, 1,000 ounces, represents a value of approximately $17,000. In spot FOREX, *you* determine the lot size appropriate for your grubstake. This allows traders to effectively participate with accounts of well under $1,000. It also provides a significant money management tool for astute traders.
- *Low transaction cost.* The retail transaction cost (the bid/ask spread) is typically less than 0.1 percent under normal market conditions. At larger dealers, the spread could be as low as 0.07 percent. Prices are quoted in *pips* for currencies. Today pip spreads can be zero at some periods for the most actively traded pairs, but typically range from two to five pips.
- *High liquidity.* With an average trading volume of more than $4 trillion per day, FOREX is the most liquid market in the world. It means that a trader can enter or exit the market at will in almost any market condition. I must note that at the time of the first

edition of *Getting Started in Currency Trading* in 2005, the daily volume was slightly less than $2 trillion.

- *Almost instantaneous transactions.* This is an advantageous byproduct of high liquidity.
- *Low margin, high leverage.* These factors increase the potential for higher profits (and losses) and are discussed later. Traders have access to leverage of up to 400 percent although 50 percent to 100 percent is most common. 400:1 leverage means $1 controls $400 of currency.
- *A 24-hour market.* A trader can take advantage of all profitable market conditions at any time. There is no waiting for the opening bell. Markets are closed from Friday afternoon to Sunday afternoon. As the markets transition to the Asian Session, they usually go quiet from 5 P.M. to 7 P.M. Eastern Standard Time.
- *Not related to the stock market.* Trading in the FOREX market involves selling or buying one currency against another. Thus, there is no hard correlation between the foreign currency market and the stock market although both are measures of economic activity in some way and may be correlated in specific respects for a limited period of time. A *bull market* or a *bear market* for a currency is defined in terms of the outlook for its relative value against other currencies. If the outlook is positive, we have a bull market in which a trader profits by buying the currency against other currencies. Conversely, if the outlook is pessimistic, we have a bull market for other currencies and traders take profits by selling the currency against other currencies. In either case, there is always a good market trading opportunity for a trader. Although big price moves occur frequently, a crash is less likely to happen in currencies than stocks because a pair measures relative value. The U.S. Dollar (USD) can be in deep trouble, but so can the European Euro (EUR).