Understanding Forex:
Trading to Win

BY

Abe Cofnas

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Understanding Forex: *Trading to Win*
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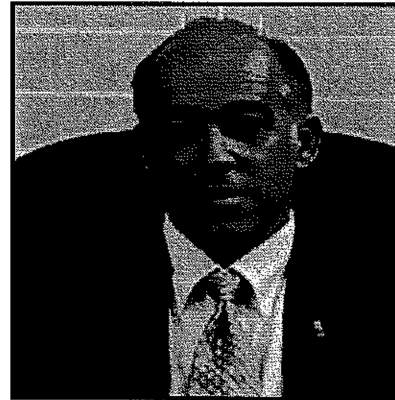
This book is dedicated to Elsie, Paula, Paige and Paul, and the Learn4x students from whom I have learned so much.

About the Author Abe Cofnas



After more than a decade as an equity broker, futures trader, and technical analysis instructor, Abe Cofnas founded Learn4x.com in 2001. Learn4x was one of the first firms in the world to provide web-based interactive training exclusively on forex trading. Building upon expertise in geopolitics and economics, (he holds a Masters Degree in Political Science, and a Masters Degree in Public Policy, both from the University of California); Mr. Cofnas created the Virtual Trading Room in 1998, specializing in training using virtual simulation. When forex trading became accessible to the retail trader on their desktops, the need for effective training in forex developed. Futures Magazine selected Mr. Cofnas to write its Forex Trader column and create Forex Trader, educational content at www.futuresmag.com/. Since 2001 this column has been providing innovative observations and educational tips on forex trading to a worldwide readership of more than 65,000. Mr. Cofnas is also a consultant to several firms on forex education. Learn4x.com continues to develop winning strategies exclusively for forex trading.

PREFACE

To understand the way the universe works, Albert Einstein had to visualize the universe by imagining he was riding a beam of light. Similarly, to understand today's global economy and the world of investments, you have to step outside the "markets" and ride the flow of currencies. Currencies are the light beam of world business and economics.

A dramatic example of the globalization of the market and the role of currencies occurred during the 9/11 period. The U.S. equities markets closed, however, the currency markets did not and provided an important venue for placing capital during this crisis.

Simply put, you cannot escape the importance of currency flows in today's world. Due to the advent of the internet and advanced interactive technology, today any person can trade currencies from their desktop. As a result, at first forex trading seems easy to do. The individual now has access to what was once the domain of the investment elite. Currency trading has a great appeal due to its around-the-clock nature, starting on Sunday evening with the Asian markets opening to the conclusion of the New York markets on Friday afternoon. At the heart of the forex trading revolution is the personal empowerment that forex trading brings to the individual. People from all professions, such as doctors, engineers, carpenters, and housewives, are looking to tap into the potential alternative income and new challenges offered by trading in forex. Currency trading is easy to conduct from office or home. Trading currencies profitably is, however, more challenging.

FOR WHOM IS THIS BOOK WRITTEN?

This book is written to provide a guide to those persons interested in getting started in trading the forex market. Few books focus exclusively on forex. *Understanding Forex: Trading to Win* brings together important knowledge, strategies, and tactics for the beginner. The goal of the book is to provide you answers to the question of what does it take to get started in forex? What does it take to be profitable in this new arena of investments?

To trade forex with confidence, you do not need a background in trading other markets. In fact, previous experience in investments may be counter-productive by allowing a person to bring prior concepts or "baggage" to learning forex trading. This book is designed to build your knowledge base and skills. Whether you are a total novice to trading in any market or coming from experience in equities, futures, or options, this book provides a map of how to navigate through the forex markets. If you have experience but have yet to achieve consistency in profitable trading, you will find many new insights about forex strategies and tactics. This book is designed to provide you with

the information you need to know to get started, and perhaps even more insight into how you personally should approach the forex market. The instructional approach is eclectic, presenting a wide range of information that is too often ignored. This total approach is new and refreshing because most trading books are too theoretical and do not focus on providing a guide to actual trading. This book, instead, focuses on taking you through key steps in evaluating forex markets, identifying trading opportunities, putting on the trade, and then managing your risks.

Trading forex is partly a misnomer. What do we really mean by trading forex? Trading is the final act of putting on an order to buy or sell a currency pair. But the trade is also the result of a process of analysis that combines fundamentals and assessment of charts, as well as one's own psychology. To truly understand how to trade forex, you must take a step back and understand yourself, as well as what the trade is really about. This makes forex trading one of the most interesting and challenging endeavors.

Trading profitably requires more than knowledge. It requires experience. The combination of knowledge and experience results in wisdom. Our goal is to provide you paths of successful thinking that will advance your abilities to trade forex and avoid the wisdom that comes from the pain of unnecessary loss. Losses are part of the business of trading, but trading based on ignorance of technical analysis or misunderstanding how forex reflects global economics and geopolitics results in unnecessary and avoidable losses.

HOW THIS BOOK IS ORGANIZED

To provide continuing support and training to the reader, this book is accompanied by a dedicated web site that contains updated charts, homework, and opportunities to increase your knowledge! You will have a chance to build upon and test your forex intelligence. The web support makes this book an on-going guide to the forex markets, guaranteeing that this book will never be out of date! Go to the following link for exclusive updates.

http:// www.iknowforex.com/book

TEST YOUR KNOWLEDGE

Readers of this book will have a varying degree of familiarity with trading. Some will have no experience at all, while others may have years of experience. This book is designed so it can be read sequentially or you can go to a particular chapter. We also recommend that you test your knowledge by taking our quizzes at our website before you start the book. Then when you have completed the book, take the quiz again to determine how much you have improved. Go to www.iknowforex.com/book to take the quiz.

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PART ONE:
THE BIG PICTURE

Learn how to use fundamentals dealing with news, economics and market psychology to help you develop strategies for trading currencies.

Chapter 1

Focus on Forex Fundamentals

What are fundamentals? Often in the world of trading a person encounters references to fundamental and technical analysis. The fundamental trader looks to economics and factors that cause price movements. In contrast, the technical analyst views the chart as providing the necessary information for trading. We take the view here that both are needed and that, particularly for forex trading, an understanding of what moves forex prices will provide an important base of knowledge to the new trader.

KEY CONCEPT

Forex reflects an Interconnected Global Economy.

Forex and the Global Economy

You do not need a PhD in Economics to get a useful sense of the global economy. Before you start trading forex, you need to understand the "big picture." New traders often want to skip any review and tend to look at where a price is at the moment. This is a mistake because important clues to trading opportunities are embedded in gaining a larger perspective. The knowledge base that contributes to successful trading is not all in the charts.

Let's start with the fact that every transaction in the world is ultimately expressed in a currency. The price you paid may be in U.S. dollars, Euros, Yen, the Aussie, or the Loonie. Inevitably, in this age of globalization, the cup of coffee you purchase, the television you're watching, the computer you're using, the automobile you're driving, the shoes you're wearing all involve a chain of money exchanging hands around the world. For producers to make a product, they have to locate the suppliers and pay the manufacturers and shippers before the consumer gets to buy it in the local economy. Today globalization affects the profitability of every major international firm, and a shift in the value of the dollar can expose a major firm

Weak dollar hangs over U.S. carmakers. The sliding U.S. currency is hurting operations in Europe, a big revenue center for Ford and GM. January 16, 2005 (Reuters)

READ

Nixon's Economy
Allen J. Matusow
1998 University Press of Kansas

to a significant reduction in profits. Firms such as Toyota, Mercedes-Benz, and Nissan all have located manufacturing plants in the United States, not only to improve their market share, but also to minimize currency exposure. For U.S. carmakers, the strenthening of the Euro has the effect of shrinking the earnings from their European operations. The earnings and net profits of almost all multinational companies are directly affected by the U.S. dollar. A recent example is Coke. Its earnings surged because of the U.S. dollar decline. Knowing about U.S. dollar trends can be an advantage for managing equity portfolios! When the dollar is trending weaker, companies that export will tend to have greater earnings. When the U.S. dollar is strong, tourism and industries related to imports will earn rewards...

The Forex Era Began in 1971

But before we go into the world of currencies, let's gain some perspective from history.

Currency trading is not new. It began thousands of years ago when coins were issued to represent an exchange medium instead of barter. The image of Caesar on a coin increased confidence in the currency and transformed the efficiency of trading. During this period the credibility of the money was based on its being backed by precious metals. The value of currencies reflected a set value of a percentage of the metal into which the money would be converted. In fact, the term dollar arose out of the historical circumstance that silver coins were minted in the town of Joachimstaler (Czech Republic). They became known as "talers." The word talers pronounced in Dutch and German sounds like the modern word dollar.

Gold became the accepted standard for calibrating the value of currencies. In the U.S. from 1900 to 1930 the convertibility of the dollar to gold was based on 1/20th of an ounce of gold. During the Roosevelt administration the ratio was changed to 1/35 of an ounce of gold, and private ownership of gold in the U.S. was banned during the Roosevelt administration. In 1946 the Brehton Woods System set gold to a fixed rate of $35 an ounce. But the U.S. dollar was still legally convertible to gold, and that promise of convertibility had great political implications for the upcoming elections.

On August 15, 1971, President Richard Nixon altered the world of money by taking the U.S. off the gold standard and eliminating the convertibility of gold. This created the era of fiat money. By 1973 gold went to $140 an ounce. It was a huge historical moment that few people now understand or remember. It is worth studying and gaining an understanding of why the U.S. decided to leave the gold standard. At that time Europeans held more than 1 trillion U.S. dollars.

The U.S. government feared the risk that at any time a substantial amount of those dollars could be convered into gold, causing severe disruption to the U.S. economy. It was politically and economically a huge risk that hung over the political horizon. Additionally, Nixon wanted to stimulate U.S. growth through a weaker dollar. As a result of Nixon's decision, the world entered a floating rate exchange system and the modern era of currency trading really began at this time. Many people have called for a return to a gold standard since that time.

The Gold Standard and Alan Greenspan

Prior to his appointment as Chairman of the Federal Reserve, Alan Greenspan was Chairman of the Council of Economic Advisors from 1974 to 1977. He wrote the now famous article regarding a return to the gold standard, which It appeared in the *Wall Street Journal* on September 1, 1981. It is worth reading.

READ

Alan Greenspan & Gold
Http://www.gold-eagle.com/greenspan011098.html

If the world ever returned to a gold standard, currency trading would effectively end. In recent years, there were attempts to try to link currencies to gold. The Islamic dinar had emerged, providing the ability to trade using the gold-backed diner currency. Digital currencies are now emerging. They allow for internet transactions in a digital gold format. It is an exciting time to be involved in the world of currency trading.

Until the arrival of the internet, currency trading was the domain of banks and large investors and corporations. The online trading revolution changed all that. Currency trading today is no longer an exotic form of investment. Rather, it affects everyone in the world and currencies can be traded by almost anyone with a computer. It's important to have a sense of the global economy as you consider what currencies to trade. Globalization has truly arrived, and with the power of the internet, the person interested in forex trading is virtually riding the world economy. Understanding the status of the world economy, knowing which countries and regions are growing or in recession, facing increased interest rates or inflation . . . all these factors are important in shaping how you trade currencies.

The Global Economy

For those really interested in getting further into the macro economics of currencies, a very useful site is: http://worldgameofeconomics.com.

How healthy is the world economy? How do you as a currency trader find the answers? How do you measure global economic performance and health? Why is maintaining knowledge about the global economy important for your forex trading? The answer is that when the world economy and its regions are in periods of economic growth, economic stagnation, inflation or deflation, these conditions impact greatly on the direction of the currency reflecting that region or country. Let's see how.

A currency is in many ways a play on the actual direction of an economy or the expected direction. If there is a global sense that a country's economy is growing, it will attract capital for investment in that country. If there is pessimism about the economic prospects of a country or region, capital will flow away from that country or region toward areas that offer a better return. Ultimately, the demand for a currency increases when the demand for the goods and services that are purchased with that currency increases. In a real sense a currency is a commodity subject to the laws of supply and demand. A summary of key economic fundamentals and forex is listed below.

Key Fundamental Concepts and Forex

1. A country with a large population will demand more currency than a country with a small population and vice versa.
2. People will demand more currency from another nation when they find its products to be more appealing.
3. Countries with high and rising incomes will demand more foreign currency than countries with low incomes or those that are in recession.
4. Relatively high domestic inflation in a country will curtail the demand for its currency.
5. If importers expect prices in the exporting country to rise in the future, they will demand more of that currency in the present to beat the price increases.
6. People will demand more of a foreign currency if they can get a higher rate of return on financial investments in that country.

READ
Economic Indicators
Spring 2004
North American Edition
Jean-Luc Beaudry

KEY CONCEPT:

Money goes where it will be perceived to get a better return

7. On the other hand, if foreign investors expect inflation will undermine the real return on their investments in a country, then they will get rid of that currency and move their money to another country.
8. If people expect a currency to appreciate in the future, they will demand more of that currency in the present.
9. Central banks will demand more of a foreign currency if they wish to depreciate their own currency.

Asian Development Bank: http://adb.org

http://www.worldgameofeconomics.com

http://www1.worldbank.org/economicpolicy/globalization

http://www.economicindicators.ca

http://www.economy.com

http://www.newyorkfed.org/research/globalindicaors.html

Global Economic Indicators - How to Track the Health of the Global Economy

When you visit a doctor, how do you know how healthy you are? Basic indicators such as blood pressure, heart rate, cholesterol level, and blood sugar levels provide base-line measurements of your health. Similarly, the forex trader can follow how healthy the global economy is by tracking certain indicators. These include GDP, unemployment rate, consumer price index, interest rates, etc. By reviewing how indicators in different countries are performing, the forex trader will get a measure of the global economy. Tracking global economic indicators is relatively easy.

To prepare trading strategies that match fundamentals, the forex trader needs to compare and contrast the economic health of different countries and regions. Many sites provide updated economic information on countries and regions.

The Impact of Interest Rates and Forex Movements

If interest rates in one region are higher than in another, that means that money will get a higher return there than elsewhere. Higher interest rates generally attract demand for the currency. Higher interest rates can be considered a predictive sign that the currency where the rates are rising will strengthen. Recently, the United States experienced a major decline in its interest rates that led to 40-year lows. During this period it was no accident that the value of the U.S. dollar entered a downward trend. However, a rise in interest rates does not always result in a rise in the currency value. When the Federal Reserve increased interest rates in the United States for the first time in 4 years on June 30, 2004, the U.S. dollar did not increase in value. The increase in U.S. rates occurred in a context of global pessimism regarding the U.S. economy and deficit. The result of this pessimism led to further declines in the U.S. dollar despite the rise in rates

Following global interest rates is important to forex trading to gain insight about which countries' economies are performing better. When New Zealand increased its interest rates, the Australian dollar became weaker because money was getting a better return in New Zealand. The recent era of low rates during in the past few years has also had a profound impact on equity markets. The concept of the "carry trade" comes into effect. Because it is easy to borrow cheaply in currencies that have low interest rates, traders begin to borrow money in that currency and invest it elsewhere, hoping for a greater return. This is similar to borrowing on your credit card to invest in stocks. It is a highly leveraged investment and increases the volatility in the market

The Interest Rate and Inflation Expectation Game

Another key aspect related to interest rates and their impact on forex prices is expectation. Forex prices move not only in response to real changes in interest rates but also to changes of expectations regarding those rates. A perfect example occurred on June 30, 2004, when the Federal Reserve raised interest rates 25 basis points. This was the first increase in rates in 4 years. The action hardly moved currency prices because the action was already expected and priced in the market. The Federal Reserve's Open Market Committee placed in its statement that announced the action a key phrase regarding the future of U.S. interest rate increases. It stated:

With underlying inflation still expected to be relatively low, the committee believes that policy accommodation can be removed at a pace that is likely to be measured.

In this statement the Federal Reserve indicated that a slow rate of increase in rates should be expected. For the forex trader this statement meant to expect future rate increases.

Many other examples demonstrate this linkage between expectations and price changes. Notice the headline that followed remarks by Alan Greenspan on Wednesday, April 21, 2004, indicating growth expectations in the U.S. could lead to higher interest rates . . .

WWW.TRADING-SOFTWARE-COLLECTION.COM

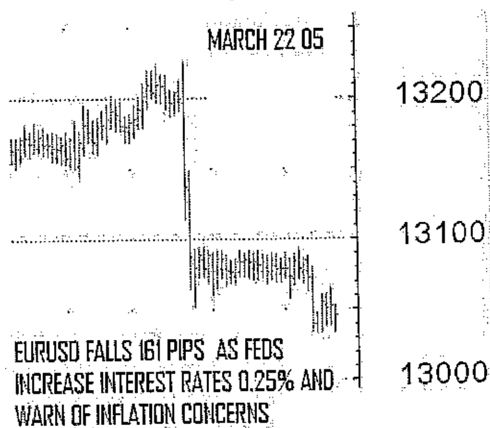
Big News Network.com Wednesday 21st April, 2004

Most stock exchanges in Asia fell Wednesday, while the U.S. dollar rose sharply, following testimony overnight by Federal Reserve Governor Alan Greenspan, who hinted that the United States low interest rate environment may be about to change.

This was the beginning of an attempt by the Federal Reserve to let the market know that higher rates would be coming, as it did on June 30. However, back in April it was a surprise and moved the currency markets considerably.

On March 22, when the Federal Reserve Open Market Cammottee acted to raise interest yet again another 0.25%, the dollar reacted with a huge rally because the FOMC indicated in a statement accompanying this increase, which was no surprise, that inflation was a concern of the Federal Reserve. The statement: *"though longer-term inflation expectations remain well contained, pressures on inflation have picked up in recent months and pricing power is more evident."* provided greater expectation of further rate increases and was a surprise in the emphasis of the fed ereserve. It is a good example where not only what the Fed does, but what it says impacts corrency moves.

The relationship between interest rate expectations and the value of a currency is demonstrated in other countries. When the Governor of the Bank of England on June 26 said that the British housing market "may be more fragile" than expected, the British pound proceeded to fall against the dollar. This was an example of the currency market reacting to a surprise. At first there was an expectation of higher interest rates, and that expectation was dampened by the statements. In reaction to this event, an analyst was quoted by Bloomberg as saying:



Charts by: cqg

READ

FMOC Statement Http://www.federalreserve.gov/boarddocs/press/monetary/2005/20050322

KEY CONCEPT:

Like all other economic phenomena, interest rates, when they are at extremes, generate consequences that do not last. At some point the world trend of lower rates will shift to a trend of higher rates. In late 2004 this trend shift already started. The forex trader will need to monitor the global interest rate environment as well as expectations regarding the future increase or decrease of those rates.

Any confirmation that the housing market has started to cool off and house price inflation is about to decline would lead to a substantial downward revision in the BOE rate hike expectations, prompting a drop in the pound.
http://quote.bloomberg.com/apps/news?pid=email_us&refer=uk&sid=acU3zVUjEYb

Yen Falls as BOJ's Fukui Says It's Too Early to Raise Rates

June 23 (Bloomberg) – The yen fell against the dollar and euro as Bank of Japan Govenor Toshihiko Fukui said it's too soon to consider increasing interest rates after nationwide consumer prices fell more than expected in May.

In yet another example, we see the headline about the yen falling because of an expectation that interest rates would not rise.

The trader needs to gain a measure of the global sentiment regarding the direction of interest rates, not only for one country but across a region. For example, when interest rates in New Zealand started rising and those in Australia did not, the Kiwi, the currency of New Zealand, rose more than 10% from 59.91 to 71. Ultimately, the interest rates between countries slowly try to converge, but while there are differences, money will flow to the areas where interest rates are higher.

As a final example, we can see that the Canadian dollar also reacts to changes in interest rate expectations.

Canadian Dollar Falls as Retail Sales Dim Rate - Rise Prospect

June 25 (Bloomberg) – Canada's dollar fell against the U.S. dollar as retail sales dropped in April, dimming speculation Canada's central bank will raise its target interest rate by September. The benchmark two-year bond rose.

It should be clear by now that interest rate news and news about interest rate expectations are important factors to monitor if you're going to trade the forex market.

The Purchasing Power Parity Concept - PPP

If the United States and Europe had the same economic conditions, each having the same growth rate and inflation, their different currencies would likely be equal. Economists have a concept called PPP (Purchasing Power Parity) that describes a major way to determine whether a currency is undervalued or overvalued. A good way to understand PPP is to think of the example of the Big Mac.

The Big Mac Index

Economist magazine years ago introduced the concept of the Big Mac index to assess whether a currency was overvalued or undervalued. This index has been quite accurate over the years. It's based on the idea that McDonald's Big Mac hamburger should be equal in value throughout the world.

Http://www.economist.com/markets/bigmac

The hamburger standard

	Big Mac price in dollars*	Implied PPP of the dollar	Under (-)/ over (+) valuation against the dollar, %
United States	2.90	-	-
Argentina	1.48	1.50	-49
Austrailia	2.27	1.12	-22
Brazil	1.70	1.86	-41
Britain	3.37	1.54[§]	+16
Canada	2.33	1.10	-20
Chile	2.18	4.83	-25
China	1.26	3.59	-57
Czech Rep.	2.13	19.5	-27
Denmark	4.46	9.57	+54
Egypt	1.62	3.45	-44
Euro area	3.28[**]	1.06[††]	+13
Hong Kong	1.54	4.14	-47
Hungary	2.52	1.83	-13
Indonesia	1.77	5,552	-39
Japan	2.33	90.3	-20
Malaysia	1.33	1.74	-54
Mexico	2.08	8.28	-28
New Zealand	2.65	1.50	-8
Peru	2.57	3.10	-11
Phillippines	1.23	23.8	-57
Poland	1.63	2.17	-44
Russia	1.45	14.5	-50
Singapore	1.92	1.14	-34
South Africa	2.72	4.28	-36
Sweden	3.94	10.3	+36
Switzerland	4.90	2.17	+69
Taiwan	2.24	25.9	-23
Thailand	1.45	20.3	-50
Turkey	2.58	1,362,069	-11
Venezuela	1.48	1,517	-49

When the Big Mac differs in prices between countries, you can determine if a currency is overvalued by comparing the price of the Big Mac in one country vs. another. The most recent Big Mac survey was in May of 2004.

Although PPP is a concept that most traders ignore as too fundamental, it remains important to major institutions and money managers. Here is how it works. Economists around the world come up with a basket of goods to compare the cost differences in each country and form a PPP index. Then they come up with a value that the currency should have to make the PPP equal. This is the estimated PPP, and it is adjusted for differences in inflation between the countries concerned over time. Tracking the PPP and knowing that a currency is at an extreme in terms of its PPP is important because the currency will not stay too overvalued or undervalued. It will tend to return to the point where the currency is valued near what its purchasing power really is.

http://fx.sauder.ubc.ca/fxidx.html
www.consensuseconomics.com
Growth, Recession, the Trade Deficit, and Forex

One of the best sources for analyzing PPP developments and tracking its valuation versus a currency is by using the analysis from Consensus Economics Inc. This institution, based in London, issues a monthly Foreign Exchange Consensus Forecast that tracks the world currency pairs in terms of each currency's major fundamentals, including its PPP, as well as projecting currency trading ranges. Multi-national companies having exposure to currency risks use the Foreign Exchange Consensus Forecast. The forex trader can tap into this valuable information.

The forex trader can't escape constant references to the United States economy as the major focus of the forex market. The fact remains that the health of the global economy is related to what happens to the U.S. economy. The United States remains the engine of global growth. It's a good idea, however, to be aware of the state of the world in terms of growth, recession, and the trade deficit. The forex trader needs to scan the globe constantly for developments in Europe and Asia that may signal fundamental changes in the economies of these regions. For example, if Europe is recovering from a recession and trying to promote growth, this would mean that the European Union economy would need to stimulate exports. But if its currency gets stronger during this period, it will hurt exporters by making the price of European goods more expensive. During the rise of the EUR/USD to record highs in 2004, fears of too strong a Euro arose many times through public statements of monetary officials such as the head of the European Central Bank. European growth rates were nearing 2% annualized GDP and German unemployment levels reached nearly

11%. These economic factors made a fundamental case that a stronger EUR/USD could, if it lasted too long, hurt the prospects for European growth.

Technical patterns ultimately reflect fundamentals. If prices move toward strengthening of a currency in a period of recession or slow growth, a lot of warning bells will go off as pressure to weaken will occur. The central bankers of the United States, Great Britain, the European Union, and Japan want to manage their economies and establish stable targets for the value of the currency. The lesson learned from the dramatic rise of the EUR/USD in 20004 is to realize that trends in prices can break and that warning signs start when key leaders try to talk the currency down. Later in this book we will show you how to track the news more effectively!

The United States economy in 2004 experienced recovery from recession and, in fact, faces fears of the resumption of inflation. The Federal Reserve increased interest rates on June 30, 2004, for the first time in 4 years in part as an attempt to reduce the risks of the U.S. economy overheating and, therefore, to control inflation. The dominant theme of the coming years will be the rhythm of this recovery and its impact on the forex markets.

http://www.treas.gov/tic/mfh.txt

Focusing only on understanding U.S. economic growth is not enough. Capital flows to where growth is expected. Familiarity with the key economies of the world is important. Japan is a key example. Too strong a currency is a threat to the Japanese economy, which went through more than a decade of recession, and experienced a frequent amount of intervention by its central bank in the currency markets. The Bank of Japan wanted to be sure that the value of the yen against the dollar would not be so strong that it would disrupt the ability of the economy to sustain growth. A country like Japan, which does not have a very large consumer economy, must be careful about the health of its export sector. When the U.S. dollar shows weakness against the Yen, it acts to make Japanese exports more expensive. Too strong a Yen ultimately becomes a problem for the economy, and pressures to weaken the Yen start arising during times when the dollar falls against it too quickly.

KEY CONCEPT: Fundamentals Count in Forex Trading

Being informed about the health of the global economy and attention to regional economies help shape trading decisions that reflect the fundamentals. Fundamentals should not be ignored but woven into a strategy for shaping the trade.

Trade deficits

The beginning forex trader will also see a lot of references to trade deficits. A great deal of commentary and news that drives the forex market is reporting on the trade deficit. When a nation has a large trade deficit, it means it's importing more than it's exporting. The United States had 8.3% more imports in 2003 than in 2002. What

makes the deficit important is that it leads to the reduction in the gross national product of that nation. In addition, it means that the deficit needs to be financed. For example, the United States sells Treasury bonds to finance that deficit. To be competitive, these bonds must have high enough interest rates to attract customers. Since the U.S. has been the leading economy of the world, foreign governments have bought a great deal of U.S. Treasury securities. In fact, foreign owners own $1.8 trillion of U.S. Treasuries.

The situation suggests that international investors will eventually adjust their accumulation of dollar assets or, alternatively, seek higher dollar returns to offset concentration risk.

Alan Greenspan

Major Foreign Holders of Treasury Securities
(in billions of Dollars)

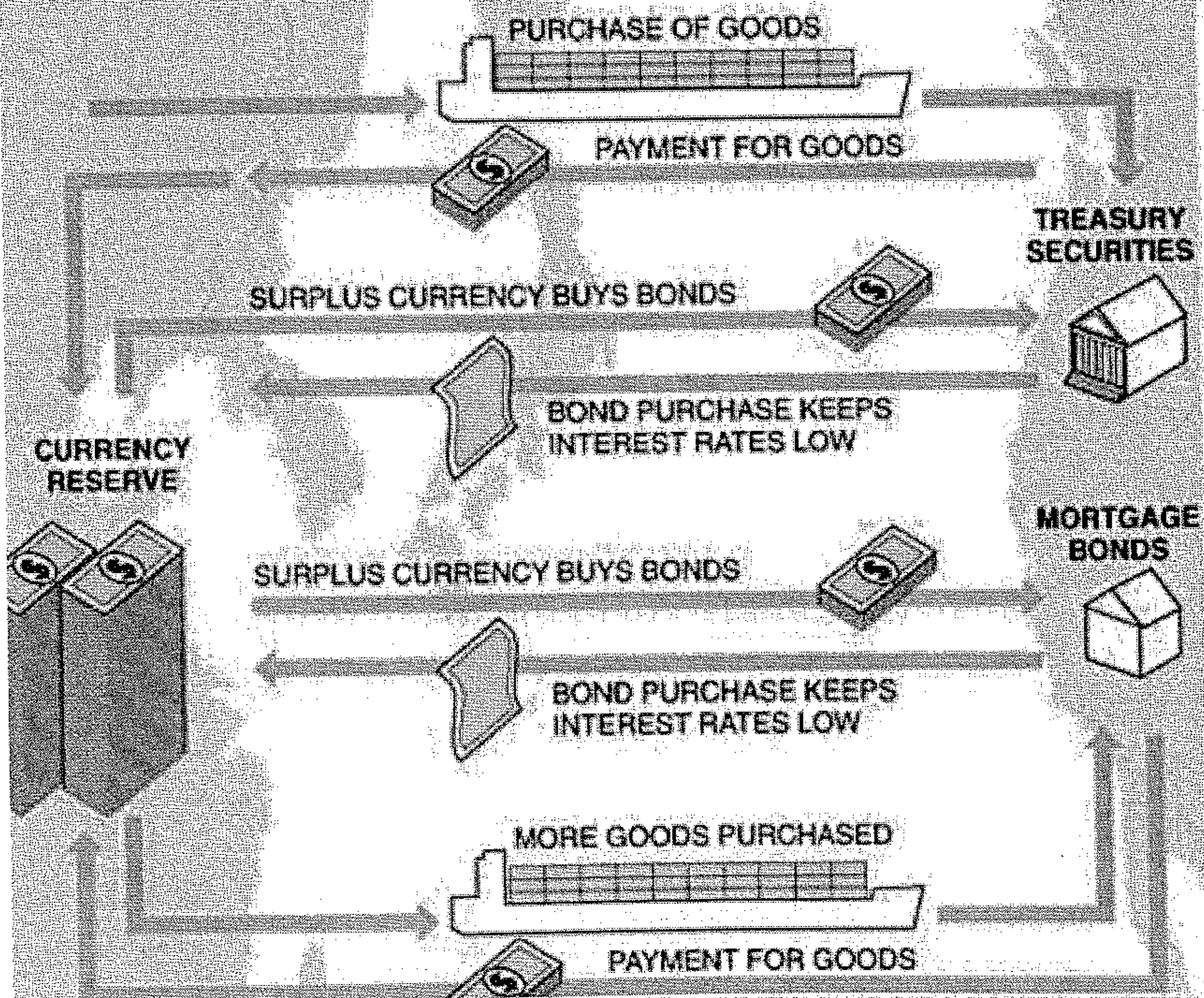
Country	Jan. 2005
Japan	701.6
Mainland China	194.5
United Kingdom	163.0
All Others	1960 (1.9 Trillion Dollars)

The foreign claims on United States assets amounts to almost 25% of the U.S. gross national product. The risk is that the situation can lead to loss of interest in investing in the U.S. If confidence in the U.S. economy declined to a point where there is less willingness to buy U.S. Treasuries, then the interest rates on the bonds will have to go up to enable the sale of the bonds to be successful. More than $1.6 trillion in U.S. bonds is held by foreign governments. Japan is the largest holder with $600 billion, followed by China, $145 billion, and then Great Britain, $137 billion. This proportion of foreign ownership of U.S. Treasuries is considered a major risk to the U.S. dollar and economy. If foreign governments decide not to hold U.S. notes, or to hold less of them, the result could force a surprise increase in interest rates to fund U.S. Treasuries. The result could be severe disruption in the U.S. economy and stock market.

In late 2004 the trade deficit hit the front page of world news when rumors that the Chinese, and even the Japanese, were considering shifting their foreign currency reserves from U.S. dollars to Euros. Before foreign holders decide to shift their debt away from U.S. Treasuries, the question arise for them: Where else can the rest of the world reinvest their dollars? To date, alternative places remain unattractive. For the forex trader the trade deficit and foreign buying of U.S. Treasuries will remain an enduring economic measure to monitor. As long as this worry remains, news relating to the trade deficit will increase volatility in the market.

Central Bank Websites

A good way to follow the world economy is to read the central bank websites and their economic reports at:
http://www.bis.org/cbanks.htm



Source: www.nytimes.com

Chapter 2

The News and Forex - a drop of Greenspan in a base of hesitation

Consider these names: Greenspan, Xiachuan, Trichet ,Fukui. If you are a forex trader and do not know these names, you should. They may not be familiar to all people, but they represent some of the most powerful people in the world. They are heads of the central banks of the United States, China, Europe and Japan. As a result these head bankers have a major impact on the direction of currencies. The way these individuals and institutions impact the forex market is by making decisions on the monetary policies of their countries. When Greenspan gives testimony in front of a congressional committee, the forex markets pause and wait to see if something he says will be a sign to buy or sell the dollar. This is also true of the other heads of the world's central banks. When they speak, everyone in the forex market listens.

Even after Greenspan leaves his position, the comments of his successor will be equally important to follow.

THE WORLD'S KEY BANKERS

David Dodge,	Governor of the Bank of Canada
Zhou Xiachuan,	Governor of the Peoples Bank of China
Jean-Claude Trichet,	European Central Bank
Mervyn Alister King,	Governor of the Bank of England
Alan Greenspan,	Chairman of the Federal Reserve Board, United States
Toshihiko Fukui,	Governor of the Bank of Japan
Ian Macfarlane,	Governor of the Bank of Australia

Often, the market tries to anticipate what will be said, and currency pairs start moving ahead of news. When the anticipation proves to be wrong, a strong reaction occurs. Consider the following headlines on two consecutive days:

KEY CONCEPT-

Do not ignore releases of economic reports!

CURRENCIES:
Dollar gains before Greenspan testimony
Bloomberg, Reuters
Wednesday, April 21, 2004

First, on April 21, 2004, the dollar gained value in anticipation of Greenspan's comments then it sold off because the actual testimony was not what was anticipated! ***Trading Greenspan, before and after he speaks, can be a profession in itself!***

Dollar Falls From Five-Month High After Greenspan Testimony

April 21 (Bloomberg) – The dollar fell from a five-month high versus the euro after Federal Reserve Chairman Alan Greenspan said inflation isn't building yet, tempering speculation on how soon policy makers will lift interest rates.

Futures traders reduced bets on a rate increase by September after Greenspan's comments to Congress's Joint Economic Committee. Those wagers climbed yesterday, when Greenspan told a separate congressional committee that the risk of deflation, a persistent decrease in the level of consumer prices, is "no longer an issue."

"He's not as hawkish as yesterday," said Kenneth Landon, senior currency strategist in New York at Deutsch Bank AG, Europe's second-biggest bank. "We probably have one last major leg down in the dollar."

Economic Calendars and Currency Price Movements

Another important kind of information that forex traders need to follow is economic reports. These are scheduled releases of official government reports on various aspects of the economy. Many of these reports are released in the morning at 8:30 AM. These reports are among the most important factors that move forex markets. Often, beginning forex traders make the mistake of having trades in the market during the release of these reports. As you will see, this is extremely risky when the economic reports result in surprises and the market moves opposite to your expectation. The table below shows an excerpt from an economic calendar.

http://www.briefing.com/Silver/Calendars/EconomicCalendar.htm

Date ET	Release	For	Actual	Briefing.com	Consensus	Prior	Revised From
Jan 21 09:45	Mich Sentiment-Prel.	Jan	95.8	98.0	97.5	97.1	

Week of January 24 - January 29

Date ET	Release	For	Actual	Briefing.com	Consensus	Prior	Revised From
Jan 25 10:00	Existing Home Sales	Dec		6.75M	6.80M	6.94M	
Jan 25 10:00	Consumer Confidence	Jan		100.5	102.0	102.3	
Jan 27 08:30	Durable Orders	Dec		1.2%	0.8%	1.4%	
Jan 27 08:30	Initial Claims	01/22		330K	330K	319K	
Jan 27 10:00	Help-Wanted Index	Dec		37	37	36	
Jan 28 08:30	GDP-Adv.	Q4		3.0%	3.5%	4.0%	
Jan 28 08:30	Chain Deflator-Adv.	Q4		2.4%	2.1%	1.4%	
Jan 28 08:30	Employment Cost Index	Q4		0.8%	0.8%	0.9%	

January 9, 2004- Unemployment Report Moves Forex Market

If you are not convinced that economic reports are critical to watch when you are a forex trader, consider what happened on January 9, 2004. The economic report on employment numbers was released at 8:30 AM, and the results shocked the market.

The surprise employment numbers, showing weaker-than-expected U.S. employment prospects, caused a surge in the EUR/USD. In 3 minutes the EUR/USD moved 100 pips. This translates to a $1,000 move on one contract in a regular account.

May 6, 2004 - Employment Report Impacts Market

Another example occurred on May 6, 2004 at 8:30 a.m. when the U.S. employment report generated a great positive surprise and the Canadian dollar was directly impacted. The U.S. dollar surged against the Canadian dollar that Friday morning as latest U.S. employment data initiated increased demand for the U.S. currency. By 11 a.m. the U.S. dollar was trading at 1.3833 from a low of 1.3696. The report released by the U.S. Labor Department earlier on Friday, showed that the U.S. economy created 288,000 jobs in April, far surpassing analyst's expectations.

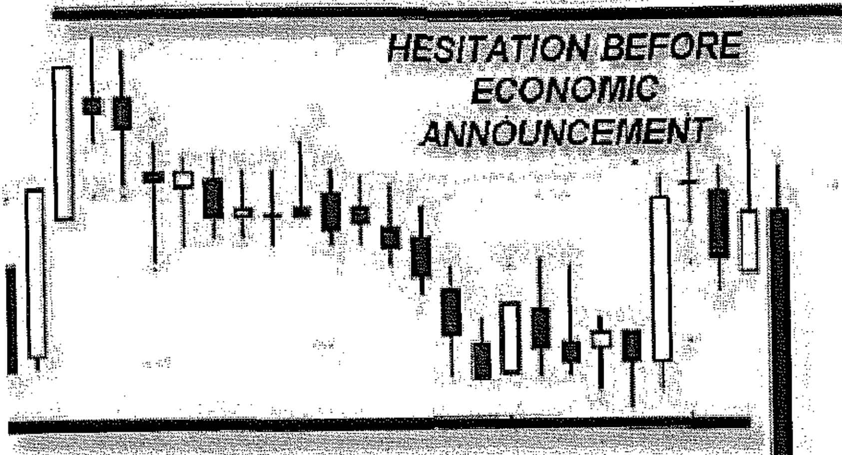
News Moves Forex www.learn4x.com /book

This same May 6 employment report is an example of how more than one currency pair is affected. First came the reaction in the Canadian dollar, then a reaction in the Euro as he EUR/USD reacted with a major decline.

July2, 2004- Job Growth Report Causes US Dollar Sell Off

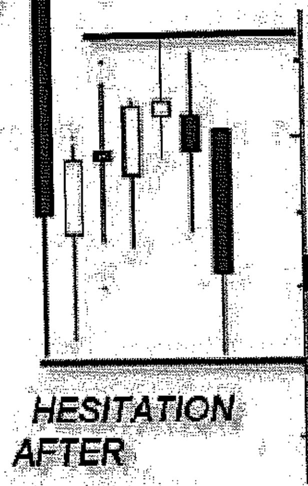
In our final example, on July 2nd the Labor Department report showed a surprise decline in Job growth. This caused a huge surge for the EURO against the dollar, once again demonstrating the power of news and surprise in the market.

The forex trader should follow the economic reports closely as well as scheduled speeches of key central bank officials. A useful way to track them is by accessing economic calendars. These calendars are available at many forex trading firms and at many sites. (see previous page).



TYPICAL FOREX PATTERN OF HESITATION BEFORE ECONOMIC NEWS ANNOUNCEMENT FOLLOWED BY REACTION AND THEN HESITATION

BEGINNING TRADERS SHOULD NOT TRADE BEFORE A NEWS ANNOUNCEMENT



HESITATION AFTER

Chart by: www.xtick.com

Trading Price Patterns and the News

It should be clear that, when an economic report is released, the markets react. At the very minimum the beginning forex trader needs to know when the economic reports are released. As a starting rule for trading, you should avoid being in a trade until the news is realized and enough time is given for the market to react. After the market moves, you one can start analyzing the new patterns that will emerge. Many new to forex make the mistake of trying to predict which way the market will respond. It is far better to avoid predicting and simply let market forces work.

The patterns that do occur before and after a news report is released are repeated a great deal. First, there is hesitation revealed by a sideways action. Then, when the news breaks, there is a sudden move. If the news is a big surprise, the price will move through the sideways range that was shaped before the news. It will be seen as a surge because a lot of people are suddenly joining in the buying or selling. Then there will be a slow down of the move up or down, and a new sideways action will start.

This pattern of hesitation-reaction-hesitation is very similar to what is called a reaction-diffusion chemical process. In fact, studies are being done trying to model forex price movements by studying chemistry.

Professor Andrew Adamsky a leading scientist on artical chemistry at the University of West England, exploring with this author how to model forex prices using the artical chemistry.

Chapter 3

Government Interventions and Forex

Are forex price movements manipulated?

As a forex trader, you need to realize that the currency markets are influenced and sometimes even directly manipulated by governments. The prospects of government intervention to strengthen or weaken a currency are real. Intervention is most likely when currency prices reach extremes in value. When a currency is too strong, it threatens economic growth by making a country's exports more expensive. Countries often depend on exports to increase their economic growth. When a currency is too weak, it creates a potential for inflation and an increase in interest rates. In either case, extremes are what bother governments. There are examples of both kinds of interventions, defined as a time when there is official purchase or sales of currencies through a central bank.

The finance ministers in the group of 7(also now called the G8 since Russia joined) nations provide very useful information about global economic events and sentiment regarding the forex markets. When the G7 meets, it issues a statement that provides an authoritative overview of the status of the world economy and also contains very carefully phrased language designed to impact the currency markets. The forex market waits for these announcements.

More recently, another group called the G20 has become important in regard to currency markets. The G20 represent the finance ministers of the following countries: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, the United Kingdom, the United States and the European Union.

It was formed in 1999 and may become an important player in forming strategies for improving the global economy. In 2004 the G20 agreed to reduce Iraq debt significantly. Forex traders should monitor

the meetings and documents of this group. A good way to keep on top of G20 meetings is this website:

http://www.g7.utoronto.ca/g20/g20backgrounder.htm

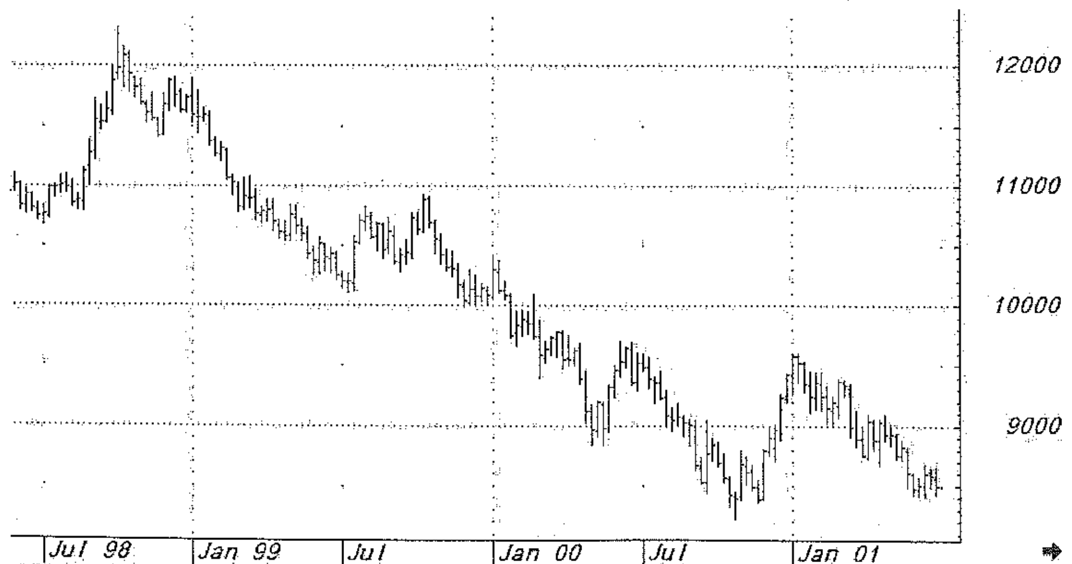
Examples of Recent Key Government Interventions in Currencies

JUNE 1998 -U.S. BUYS YEN

During the week of June 12-19, the U.S. intervened to buy yen. The Japanese economy was in a very deep recession, causing huge lack of confidence in the yen. If the yen kept weakening, Japanese auto manufacturers would be able to export more autos, thereby threatening the U.S. auto industry. There was also fear that a weaker yen would cause China to devalue its currency. The interesting historical note to keep in mind is that in 1998 the impact of China on the currency markets was, for the first time in history, a major topic at the G7 meetings.

September 22, 2000 – EUR/USD IS MASSIVELY SUPPORTED

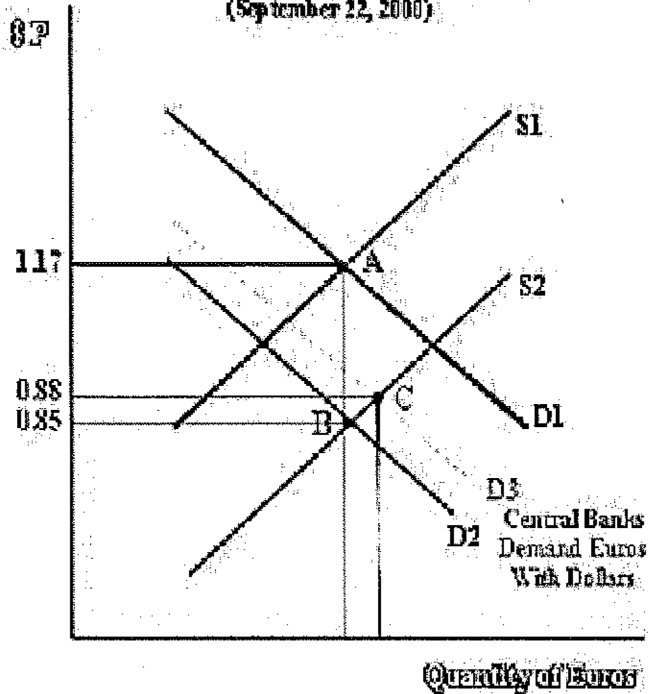
The EUR/USD had been experiencing a severe downtrend as shown in this chart.



Charts by: cqg

The G7 Group intervened on September 22, 2000, to strengthen the price of EUR/USD. All G7 countries, in a concerted effort, bought 2 billion euros. It worked for a while. The Euro, after the intervention, also fell to .83 but then rose again. The following chart shows a classical supply and demand curve analysis of why the intervention worked to appreciate the Euro. Despite manipulation, the laws of supply and demand apply to currencies!

Charts by: cqg



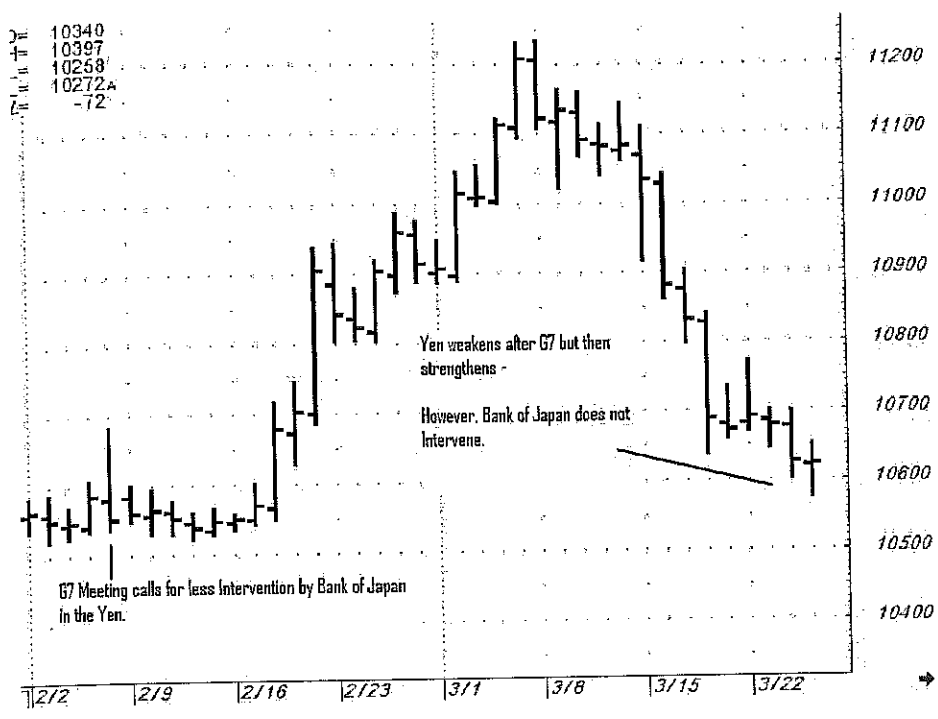
http://www.worldgameofeconomics.com/EuroCurrencyIntervention.htm

The Euro depreciated from $1.17 to $0.85 because the quantity supplied of it [S1 - S2] exceeded the demand for it [D1 - D2]. As it depreciated, European goods and services became increasingly less expensive and more attractive to those who were holding dollars. This helped stimulate European exports and the European economies. However, it also contributed to inflation in Europe, because imports became more expensive. Furthermore, when a country's currency depreciates, its terms of trade deteriorate. That is, it must export more volume to finance a given volume of imports. The central bank intervention attempted to reverse these trends by appreciating the euro from $0.85 to $0.88 [D2 - D3].

Feb 7 2004 – G7 Pressures Japan to Stop Intervening

The G7 met in Boca Raton, Florida, and issued the following statement pressuring Japan to stop intervening to weaken its currency.

We reaffirm that exchange rates should reflect economic fundamentals. Excess volatility and disorderly movements in exchange rates are undesirable for economic growth. We continue to monitor exchange markets closely and cooperate as appropriate. In this context, we emphasize that more flexibility in exchange rates is desirable for major countries or economic areas that lack such flexibility to promote smooth and widespread adjustments in the international financial system, based on market mechanisms. http://www.g7.utoronto.ca/finance/fm040207.htm



The forex markets interpreted the statement as pressure on Japan to stop weakening the yen through intervention, and it led to expectations for a stronger yen. In fact, the yen strengthened much further against the U.S. dollar.

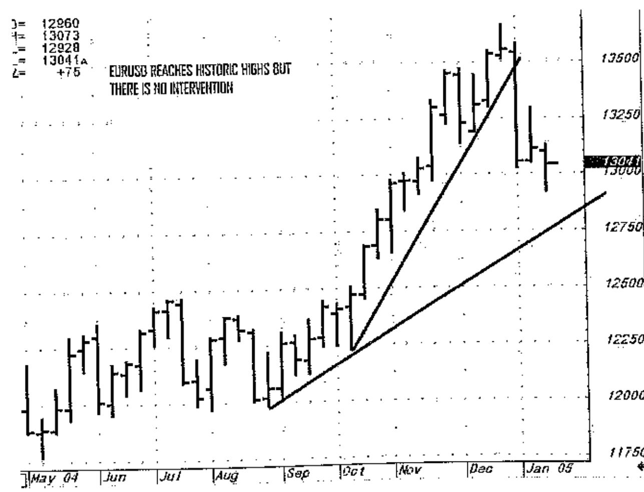
KEY CONCEPT:

Know when the G7 Group is Meeting; It's statements impact currency trading after its meeting on the global economy.

Go to HTTP://WWW.G7.UTORONTO.CA

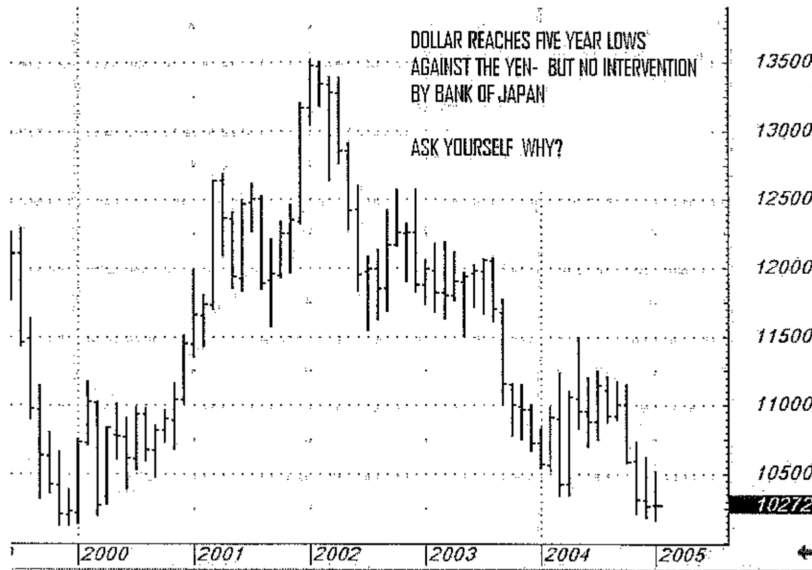
The Interventions that did not happen.

As the year 2004 came to an end, the EUR/USD was reaching all time highs. As a result, a great deal of speculation occurred about potential government intervention to stop the fall of the dollar. It did not happen. The currency markets responded to the fear of too strong a Euro and too weak a dollar and fell off its all-time highs.



Charts by: cqg

In January 2005 the U.S. dollar once again tested 5-year lows against the Yen. This brought forth rumors of intervention by the Bank of Japan. Too strong a Yen fundamentally slows down the potential to grow the Japanese economy. However, intervention is now viewed as a last resort, and global finance policy is promoting allowing the market to set the prices of the currency pairs.



Charts by: cqg

Chapter 4

Don't Forget About China

KEY CONCEPT:

The forex market is essentially dominated by the U.S. DOLLAR, the EURO and the YEN; however, the emergence of China into a player on the world economy will warrant attention by the forex trader.

Http:/www.imf.org/external/pubs/ft/weo/2004/01/pdf/chapter2.pdf

http://www.whitehouse.gov/cea/mankiw_testimony_house_ways_and_means_oct_30.html

In the 1960's a common phrase regarding China was that it was a sleeping giant one could not ignore. Well, today it is no longer sleeping. China's imports of goods are roughly one-quarter of its GDP, well above the same ratio of imports / GDP for the United States and Japan (10 percent). The International Monetary Fund reports that "China is now the sixth-largest economy, at market exchange rates, and the fourth-largest trader in the world." China's increased demand for foreign manufactured goods and raw materials has been particularly dramatic. Chinese imports of both manufactured goods and raw materials have more than doubled over the past seven years. China's effect on all the currencies will be profound.

Exports to China have risen more than 55 percent since 2000, to $27 billion in 2003 (through August at an annual rate). Among the products that the United States exports to China are: $1 billion in oilseeds and grain (roughly 14 percent of all U.S. exports in this category), $1.3 billion in semiconductors and other electronic components, and $1.5 billion in transportation products (with statistics for this year through June).

One cannot escape the impact of China

China's currency, known as the Renimbi, is now pegged to the U.S. dollar at a rate of 8.28. It is managed by the State Administration of Foreign Exchange (SAFE), which implements the management of the value of the Renimbi. This means, in effect, that the Chinese are artificially lowering their costs of goods as the dollar has fallen in value.

If the Chinese allow their Renimbi to strengthen, it will reduce their competitiveness, raise costs of their manufactured goods, potentially

increase their inflation rate, and have cascading effects throughout the world. The attractiveness of China as a source of manufacturing is also based on the fact that the average wage there is 60 cents an hour. This attracts capital flows and investments not only away from the U.S. but also from Japan and other Asian nations, as well as Mexico. For example, China has surpassed Mexico in production of sombrero's!

The Chinese impact reaches throughout the globe and its economy has experienced phenomenal growth at rates exceeding an annualized 9%. One example of the Chinese influence is that 70% of the world's shoes are manufactured in China. The importance of this to those interested in forex trading is that the entire world is interconnected. Even though you can't trade the Chinese currency, what China is doing affects the whole world. For example, Wal-Mart accounts for 1.3% of the U.S. GDP and obtains most of its manufactured items from China. As China grows and as its private consumption economic sector grows, it will import more and more products from the United States and other countries. For example, Volkswagen Ag announced it will build a new automotive plant in China and projects producing 800,000 cars by 2008. ***China has a projected growth rate of 7% per year to the year 2020.***

http://www.adb.org/Documents/Books/ADO/2004/prc.asp

The Asian Development Bank reports that the PRC is the world's biggest consumer of copper, tin, zinc, platinum, steel, and iron ore; second biggest of aluminum and lead; third largest of nickel; and fourth largest of gold. It is now the world's second-largest oil consumer and accounted for 35% of the global rise in oil demand in 2003.

China has a projected growth rate of 7% per year to the year 2020

Table 2.1. Major Economic Indicators, People's Republic of China, 2001-2005, %

Item	2001	2002	2003	2004	2005
GDP Growth	7.3	8.0	9.1	8.3	6.2
Gross dometic Investment/GDP	28.5	40.4	41.3	60.7	40.5
Inflation rate (consumer price Index)	0.7	0.8	1.2	3.0	2.7
Money Supply (M2) growth	17.6	16.9	19.6	18.0	17.0
Fiscal balancea/GDP	2.5	3.0	2.7	2.5	2.3
Merchandise export growth	6.8	22.4	34.6	15.0	15.0
Merchandise import growth	8.1	21.3	41.0	19.0	16.5
Current account	1.5	2.8	2.2	1.3	1.0

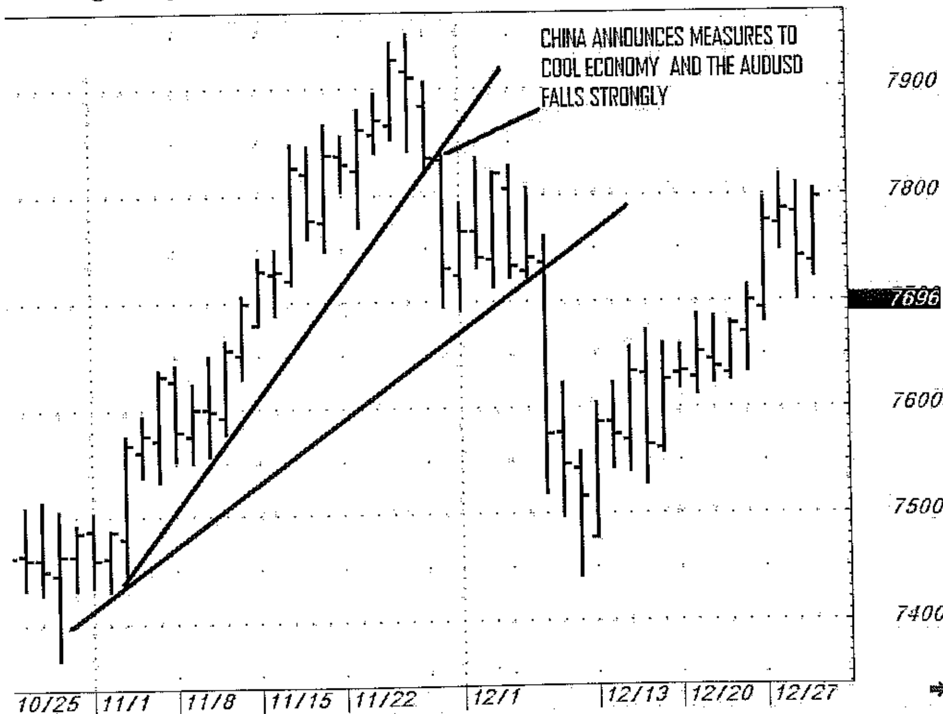
a Central and local government finance.
Sources: National Bureau of Statistics; International Monetary Foundation staff estimates

How Does China's Economic Direction Affect Forex Trading?

China is now Japan's largest importer, exceeding the United States. In effect, Chinese growth fuels the recovery in Japan and for all of Southeast Asia. As China maintains a surplus of exports to imports, it has a huge foreign exchange cash reserve of U.S. dollars and is now reinvesting those dollars into $145 billion of U.S. debt instruments. If, or when, the Chinese economy slows down, it will also impact the rest of the world's currencies and economies.

The impact of Chinese growth on the currency markets is illustrated in the performance of the Australian dollar known as the Aussie. The currency pair AUD/USD had a strong uptrend paralleling Chinese growth and demand for Australian resources. But the trend broke and the perception of a slowdown in China pushed the momentum down for the AUD/USD. The Australian dollar fell to 71.58 U.S. cents its lowest since November 18, after Chinese Premier Wen Jiabao told Reuters that China was committed to forceful measures to cool its dangerously fast-growing economy. That threatened to reduce demand for commodities and sent copper prices spiraling down 5 percent. Aluminum and nickel lost nearly 6 percent, while silver and platinum fell 5 percent. There can be no doubt that the Australian dollar is greatly affected by prospects in China.

http://www.forbes.com/home/newswire/2004/04/29/rtr1352164.html



Charts by: cqg

How to Watch China:

http://www.chinaview.cn
http://www.adb.org
http://english.people.com/cn

Chapter 5

The U.S. Dollar - Closer Look

The U.S. dollar is considered the "reserve" currency of the world because the United States is the largest economy in the world. Before you decide to trade a particular currency pair, it makes sense for you to follow the value of the U.S. dollar and know where to look to track that value.

U.S. Dollar Trade-Weighted Value

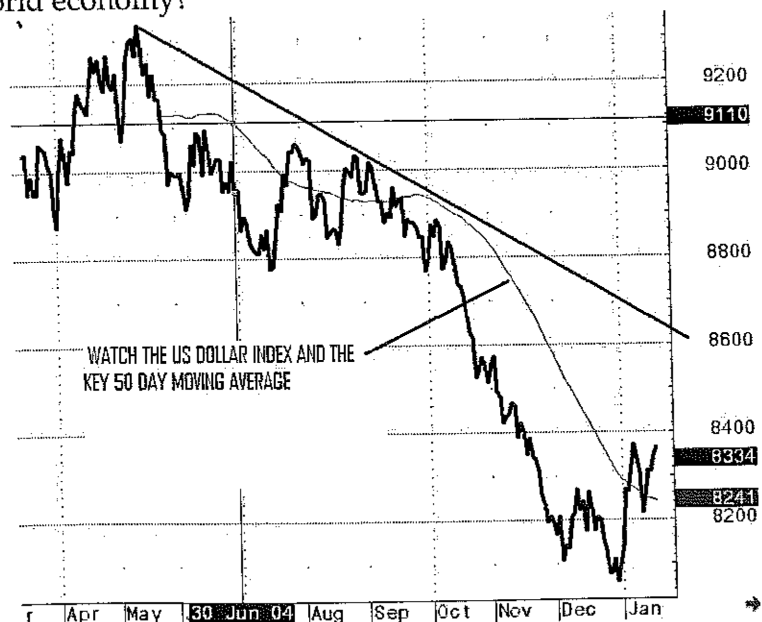
www.federalreserve.gov/releases/h10/summary

www.federalreserve.gov/releases/h10/weights/new2005weights.htm

www.federalreserve.gov/pubs/bulletin/1998/1098lead.pdf

Changes in the value of the U.S. dollar really depend on your perspective. Economists have developed the concept of a trade weighted dollar index to enable measurement of dollar trends based on the mix of imports and exports. It's called weighted because the mix of exports and imports in countries differs greatly. For example, Japan exports 25% of its goods to China, and Canada exports 50% of its goods to the United States. The trade-weighted index more accurately reflects export patterns.

There can be many trade-weighted dollar indexes. In fact, each state can develop its own trade-weighted index to reflect its trading relationships with countries. The California trade-weighted index would be different than that of North Carolina because the states produce different commodities. What is important to realize is not the exact formula that the Fed Reserve uses but the meaning of the chart. The key question is: What is the trend direction of the U.S. dollar in the world economy?



Charts by: cqg

US Dollar Index (USDX)

On a day-to-day basis, forex traders can look to the U.S. Dollar Index (USDX) to gain a sense of global sentiment regarding the dollar.This index, traded on the New York Board of Trade (NYBOT), consists of a trade-weighted geometric average of six currencies. According to the NYBOT, the USDX is currently computed as:

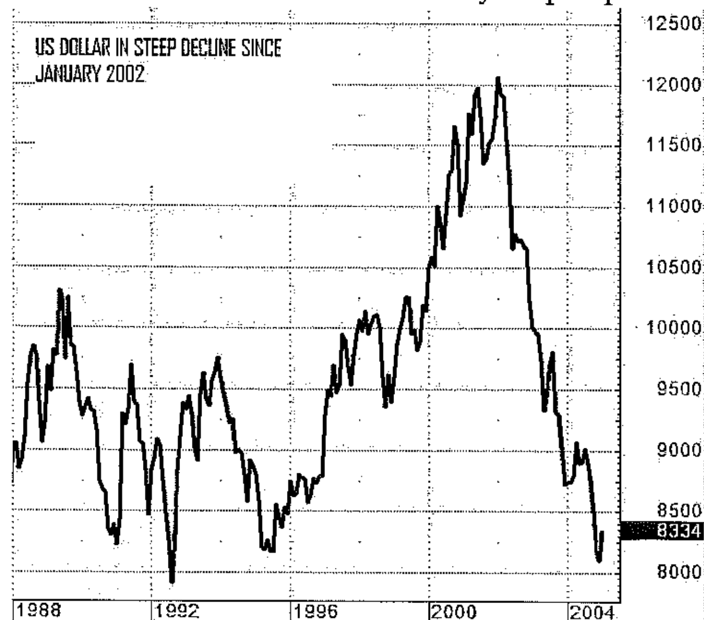
Currency	Currency Weight %
Euro	57.6
Japan/yen	13.6
UK/pound	11.9
Canada/dollar	9.1
Sweden/krona	4.2
Switzerland/franc	3.6

The USDX can be used to ascertain the Global Dollar Sentiment. It is correlated with many other currency values as well as U.S. commodities. The following table demonstrates the actual correlations of the USDX with other currencies.

US Dollar index correlations to other currencies

	Euro	$/JPY	GBP	$/CHF	$/SEK	$/CAD	AUD
DX	-.982	.570	-.523	.964	.950	.528	-.871

Now let's look at the USDX from a multi-year perspective.



Charts by: cqg

Notice that the USDX was in a major downtrend from the highs in the index in January 2002 to the lows at the end of 2004. What is important beyond the obvious downtrend is the fact that this trend, while steep, has periods where there is an attempt to go back up. This is known as a retracement. The forex trader needs to learn how to evaluate when the USDX is retracing. A key tool to use is the 50-day moving average. When the index tests this key moving average, you need to pay particular attention to the potential of a trend reversal. In the next chart we see the significant multiyear downward channel of the USDX, signifying a weak sentiment for the dollar.

TRACK USDX AT: http://quotes.ino.com/chart/?s=NYBOT_DXY0&v=d12

Of particular value during any trading day is comparing and contrasting the movements of the USDX using small intervals of 15 and even 5 minutes against the day trend. These charts will tell you what the world sentiment is at any given time on the U.S. dollar. For example, here is a chart showing the USDX movement during the day on a 5 minute level.

You can see that, even while the U.S. dollar may be trending down, it has a ranging behavior within that trend. This particular pattern is called a downward channel providing trading opportunities for buying and selling when the prices reach either side of the channel.

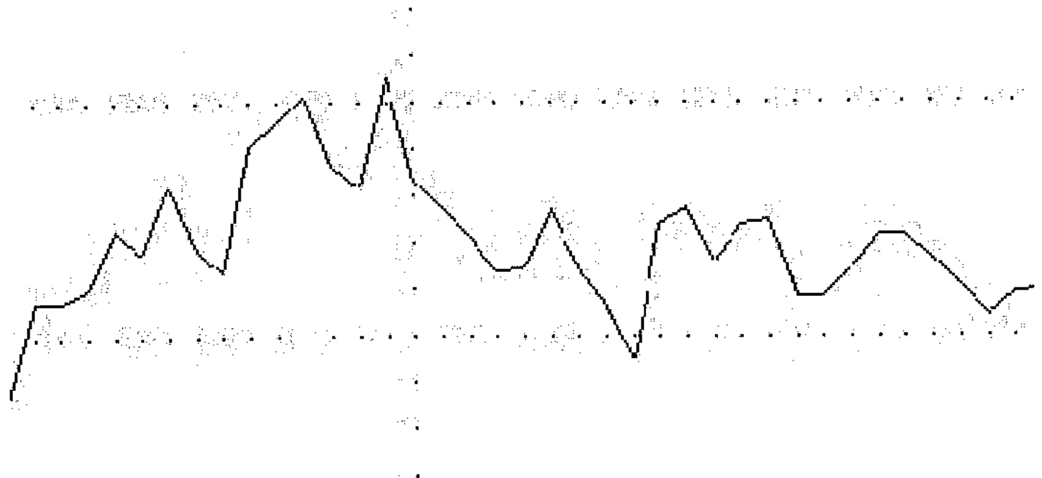
Chapter 6

Types of Charts and How They Are Constructed

We have all heard the phrase, "It's all in the chart".-For the forex trader the charts provide signs for entering and exiting a trade.

Several basic charts are used to represent price movements. They are the line chart, the-bar-chart, and the candlestick chart. More advanced charts are the point and figure chart, the 3-line or 3-point break chart, kagi, and renko charts. Each chart provides a different visualization of what is going on with price movements. Remember that a chart reflects the bid price. Some platforms allow the charts to also reflect the ask or offer price

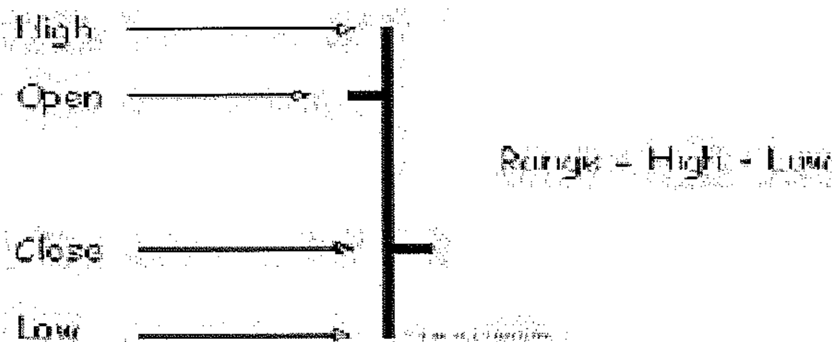
Line Chart - These charts show prices as lines. One of the best uses of this chart is when comparing one currency against another. Typically, lines connect closing prices for the period being plotted.



Bar Chart - These charts represent the price as a bar showing the open, high, low, and close for a specified period.

Bar Chart

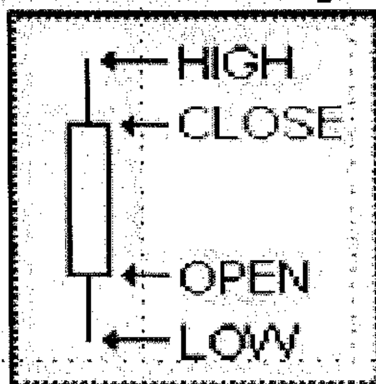
OHLC bar



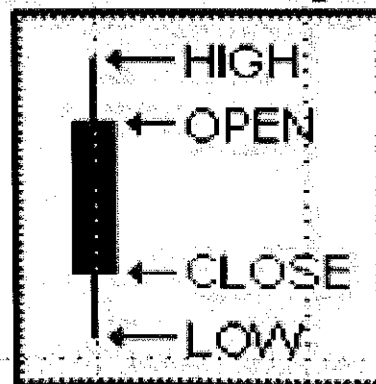
Candlesticks - These originated in Asia and allow for easier visualization of the same information as bar charts. The key to candlesticks is the relationship of the open and close for a specific period.

Structure of Candles

White Body



Black Body

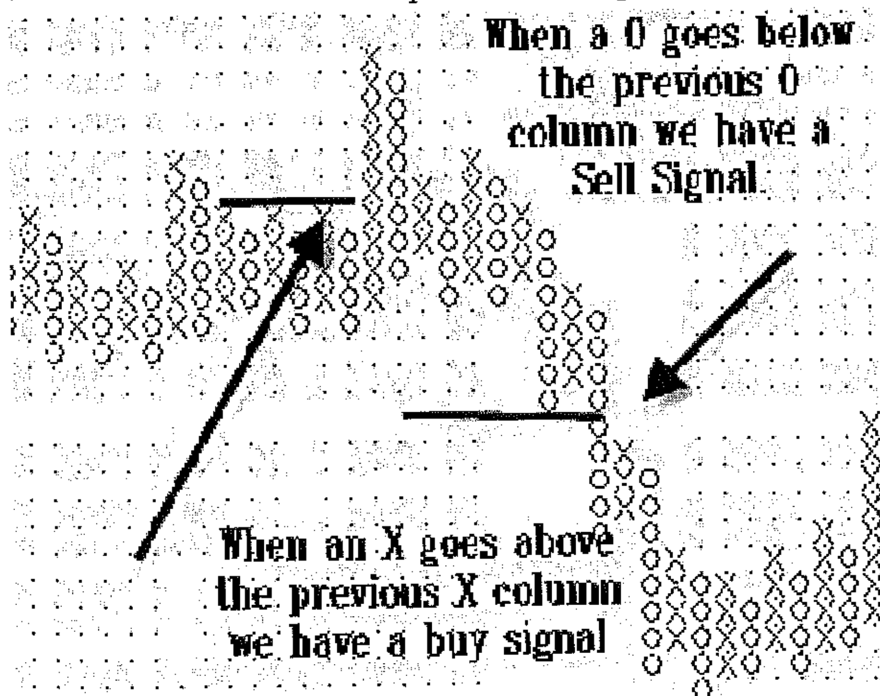


Advanced Charting - Smoothing out the Noise in the Market

Although the line, bar, and candlestick charts track the price movement against time, traders want answers to questions such as: Who is in control, the buyers or sellers? Is the trend pattern stable? Several chart types provide tools to investigate market sentiment and trend direction.

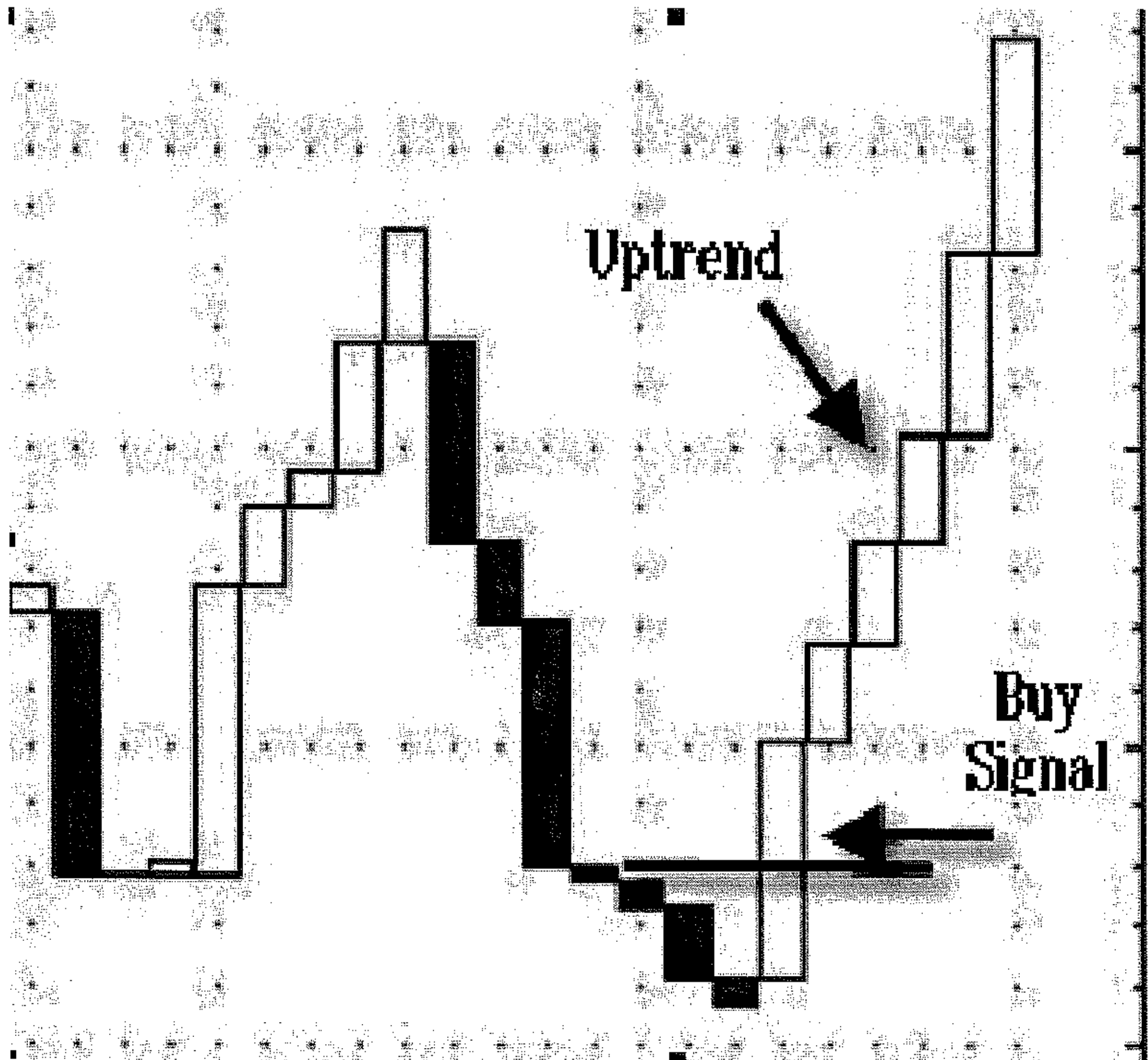
Point and Figure - This chart concept ignores time and focuses on who is in control. If buyers are in control you will see a column of X's. If sellers are in control, you will see a column of O's. The X or O represents a certain fixed amount of movement. If the amount is 10 S, then the price has to move 10 s or more higher to have another X added to it. It takes a 3-box reversal to produce a new column of O's indicating a reversal in price direction.

The advantage of point and figure is it enables a view of key support and resistance areas as well as breakout points. The chart below shows prices are in a sideways range, but the last column of O's shows that the momentum is for the sellers. Looking at this chart, a forex trader would not be willing to be a buyer. Using point-and-figure charts help identify areas of support and resistance. We show some tactical use of this concept in a later chapter.



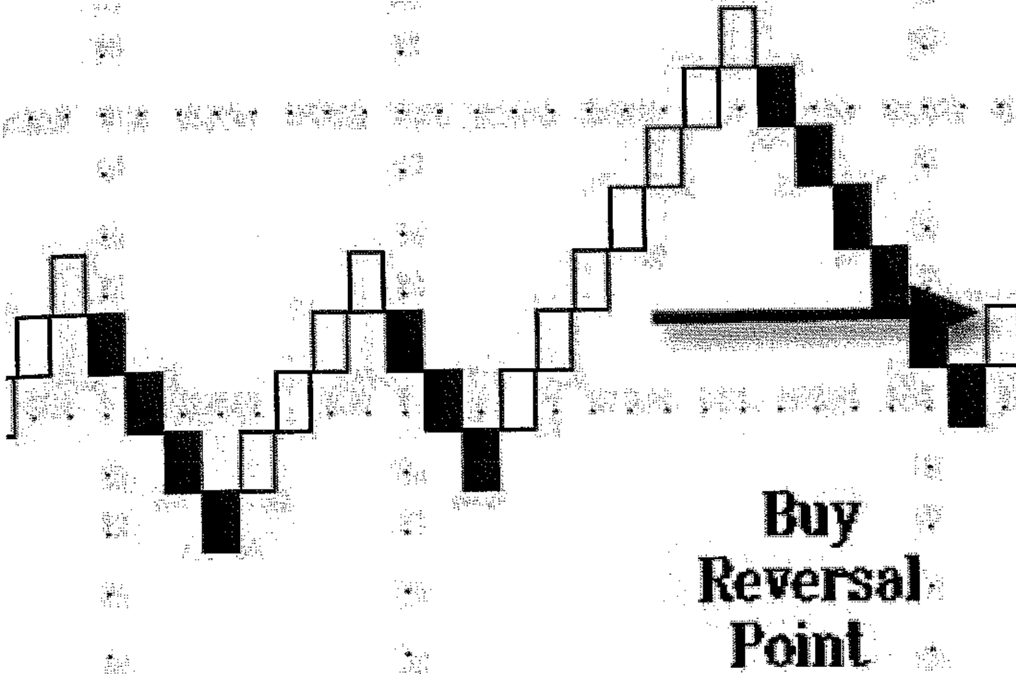
Charts by: www.xtick.com

Three-Line Break – This kind of chart shows only consecutive highs or lows made. We can see clearly the stability of a trend. Three consecutive candles, or lines as they are called, are considered a trend. Three-line break can show trend reversals even at the 1 minute level as seen below. It is an excellent tool for confirming entry signals and managing stops. More companies and charting services are offering this chart type. Three-price break is another term for this type of chart.

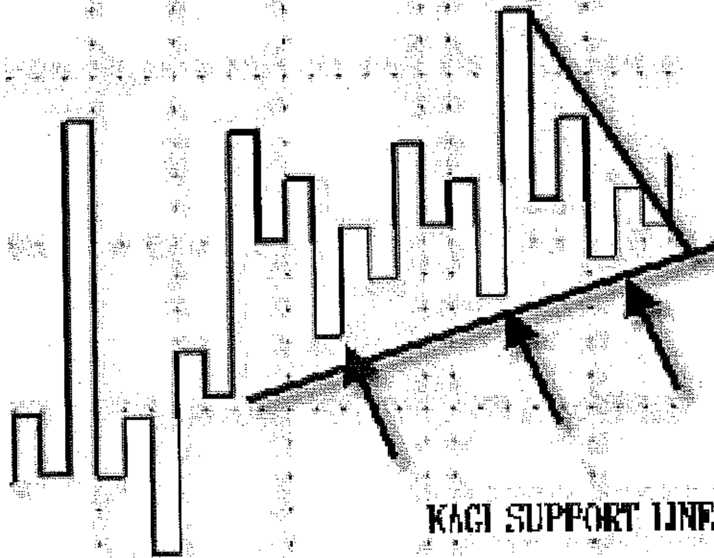


Charts by: xtick.com

Renko - Similar to point and figure, the renko chart (renko means blocks) shows a new block (black down, white up) if the price moves by a certain fixed amount. Otherwise, no new blocks are shown. It is an effective way to map the trend direction and find break areas in any time frame.



Kagi - These charts are designed to show turnarounds in the price. A turnaround amount can be any amount and is usually 10 s for forex. So if the price has moved by 10 s or more, then a thick line (yang) is drawn. If it is lower by the predetermined 10 s, then a thin line (yin) is drawn. If the price moves less than the 10 s, no line is drawn. The general strategy for trading kagi is to watch for the change in lines from thick to thin or from thin to thick. Another aspect of kagi is that it shows who is in control by viewing the length of the lines. If the YANG and the YIN lines are of equal length, it is a demonstration of a balance between buyers and sellers. An entire *range* of strategies and tactics using kagi has been developed.



Charts by: xtick.com

Visualizing a Currency Pair Using Different Types of Charts

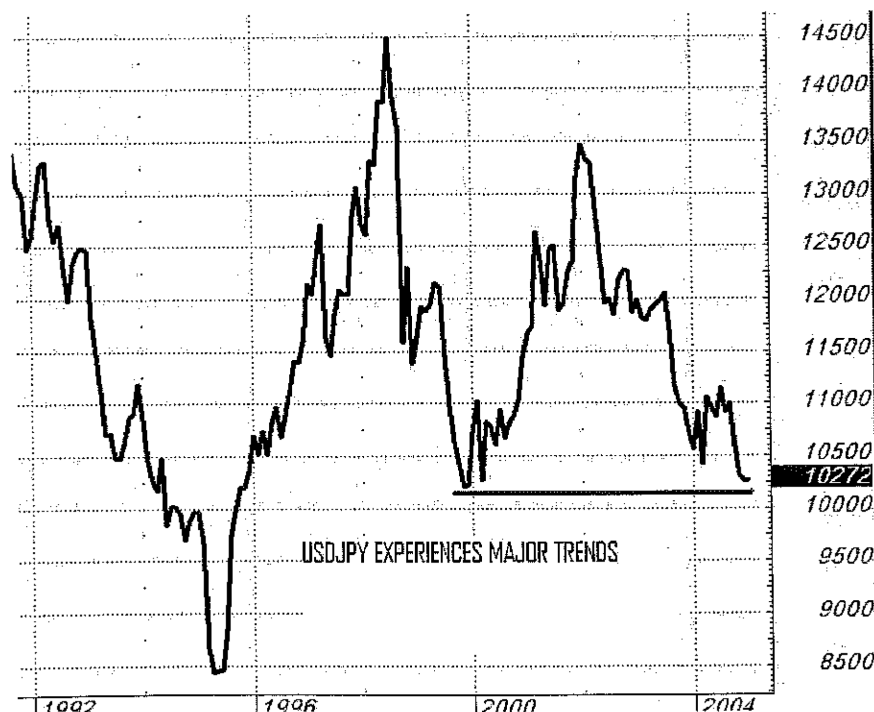
It is a good idea to visualize price movement with different chart types. Each chart type has the potential of providing new insight into what is happening. Candlesticks are very useful for showing the latest sentiment quicky. Point and Figure, Kagi, and Renko charts provide clear views of support and resistance. 3-Line Break or Price charts are powerful tools for providing clues about whether a trend reversal is taking place.

Chapter 7

Currency Pairs - Key Characteristics - A Closer Look

Traders often find themselves predisposed to trading one currency over another. They may like a particular currency pair for a lot of reasons and find that they know one currency better than another. Each currency pair, however, has some characteristics or, in a sense, a personality that a trader should get to know. Let's explore some of these.

USD/JPY - Japan is the world's second largest economy. However, the yen is very volatile and reflects a great deal of the internal economics and politics of Japan. The value of the yen has a tendency to go to extreme lows and highs within the same year. Also, since Japan is in a recovery after a decade of major recession, traders remain very sensitive to any news that may change expectations of economic strength and growth.



Charts by: cqg

Notice this monthly Japanese yen chart. The prices moved from a low near 100 in February 2000 to a high near 135 in January 2002 and back to testing 5-year lows at the end of 2004. Of course, there is a lot of variation in-between. But the trend direction toward strengthening is apparent in this chart.

The Japanese economic recovery of recent years is important for the forex trader because of its role in supporting a strengthening trend in the currency. However, because the recovery is fragile, it can be dislodged easily if oil prices increase and if the costs of raw materials surge. Keep in mind that Japan's economic prospect is also linked to U.S. fortunes. If the U.S. economy falters, this hurts Japanese prospects because U.S. demand for more Japanese goods would decline. This means that any news on the recovery can result in surprise surges in the price. Extra care is necessary in trading this currency pair. It is not for beginners. Those who trade the USD/JPY must know the Tankan Report.

The July 2004 Tankan report was a major breakout of positive sentiment for the direction of the Japanese economy for the first time in 13 years.

Tankan Report

Bank of Japan's quarterly Tankan report is one of the most popular of economic surveys. The report is compiled from data gathered during the previous five weeks, up to the day before the announcement. The Bank of Japan sends questionnaires to more than ten thousand companies, and the response rate is an astonishing 95% or more. The survey reflects the activities and sentiments of private corporations, revealing the activities and plans of real businesses running the economy. The survey results produce a diffusion index to indicate business sentiments which is the core of the report. The report of July 1, 2004, was dramatic. It showed an optimistic sentiment that was the strongest regarding the Japanese economy in 13 years. The effect was positive on the Nikkei Index as well as the yen. The currency market waits for the results of this report, and the information in it can provide a guide for trading the yen throughout the year. The Tankan Report is important. *You can trade with the consensus or become a contrarian and trade against it!*

http://
www.nni.nikkei.co.jp
www.boj.or/jp/en/
www.japantoday.com

June survey of Japanese firms suggests best outlook since deflationary period started in the early 1990s.

BizAsia, by ***da*** - The Japanese quarterly survey, the Tankan survey, is always closely watched, both inside and outside the country.

Its value is that it reflects how Japanese firms view the future in their particular industries. In many respects, it's better than government forecasts and projections because it measures sentiment from the ground up.

In June, the survey shot up to its highest level since August 1991.

Optimism grew strongly among large manufacturing firms with the news pushing the Nikkei share average up 0.6 percent. The Japanese currency also rose strongly to 108 yen to the dollar.

The Tankan survey inquiries of 10,000 businesses spread throughout various sectors of the economy to rate how the road ahead looks. A positive number indicates optimism, a negative one, pessimism.

Unlike the previous quarterly survey, this one showed that even smaller Japanese firms exuded confidence. The small manufacturers' index was +2, the first positive reading since March 1991. Non-manufacturing firms are also exuding a rosy outlook.

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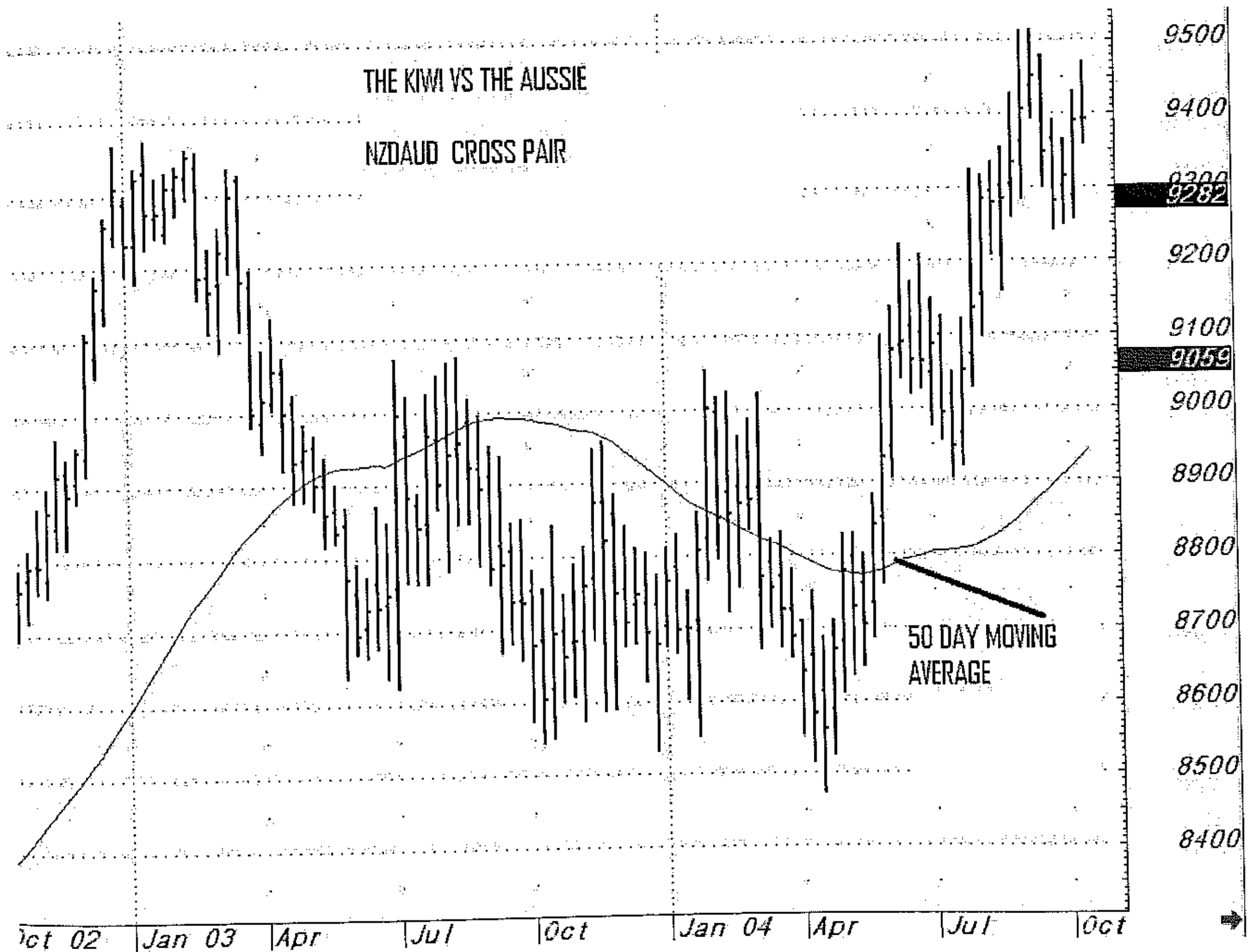
Swiss franc- Although Switzerland is a country with a population of only 7 million people, its currency is unusually important. The USD/CHF acts as a haven for money flow in times of market uncertainty. Traders move into the Swiss franc often in response to bad news. The Swiss franc tends to increase in value when the price of gold increases. A recent JP Morgan study showed that the Swiss franc outperformed U.S. Treasuries and the S& P 500 during the September 11 terrorist attack, the LTCM collapse, and the Thai Bhat crisis . . .

From a monthly perspective you can see a persistent trend direction toward a stronger Swiss franc. This coincides with the dollar downtrend around the world.

Charts by: cqg

AUD/USD - Known as the Aussie, this currency pair is very influenced by other markets such as commodity prices. Also, Chinese economic imports from Australia are important as an influence on the direction of the Aussie. Prospects for Japanese growth will affect the AUD; when news on the Japanese economy comes out, the AUD is a major currency to watch.

This AUD/USD monthly chart clearly shows the long uptrend in the AUD/USD with a key break in early 2004. The start of the downtrend in this currency pair was a result of Chinese economic policy attempting to slow down its economy and thereby having a potential to reduce imports from Australia.



Charts by: cqg

http://rbnz.govt.nz Reserve Bank of New Zealand

The KIWI- The New Zealand dollar is known as the "Kiwi". The currency pair, while often ignored by the forex trader for the more popular pairs, does offer trading opportunities. It often goes into trends of long duration and, particularly when the trend is broken, a trade in the direction of the break can offer large opportunities. The Kiwi is especially affected by what are known as "soft" commodities such as food and non-food agriculture prices. In 2004, the New Zealand dollar achieved 16 year highs.

An additional feature of this currency pair is the ability to trade it against the Australian dollar. Regional economic differences between Australia and New Zealand involve different growth rates between these regional neighbors and different interest rates. At the end of 2004 New Zealand had a 6.45% yield on a 3-month bank bill. In contrast, Australia's rate was 5.25%. This rate differential helped attract demand for Kiwi's against Aussies. New Zealand, like, Australia, is affected by commodity prices. It exports more than 2/3 of its products to Europe. Traders looking to combine fundamental analysis and technical trading should look closely at the Kiwi and follow the economics of the region.

Charts by: cqg

USD/CAD- The "Loonie" or the Canadian dollar is often impacted by commodity markets. Here is a chart that shows how the Canadian dollar tracks the global economy.

EUR/USD - The euro was officially introduced on January 1, 1999, representing the currency of the European Union. The European Central Bank is the key institution for monetary policy.

Charts by: cqg

Since June 2002 a powerful strengthening of the euro against the dollar occurred with retracements to the long-term monthly trend line. Will the EUR bounce against this trendline or break?

This is the most heavily traded currency pair. Most new traders start by trading the EUR/USD. The EUR is in many ways a play on the U.S. economy and stock markets. An upward move in the EUR is often a reflection of a downward selloff in the U.S. markets. It's not a perfect correlation, but when it does occur, it's a moment of opportunity for the trader. It's a great trading instrument but needs to be viewed in total context of what is going on in the global economy and news.

GBP/USD- The "Cable" or The British pound moves similarly to the EUR since the economy of Britain is related closely to the economy of Europe. For traders, the cable provides some good opportunities, particularly when the GBP/USD is diverging from the EUR.

Charts by: cqg

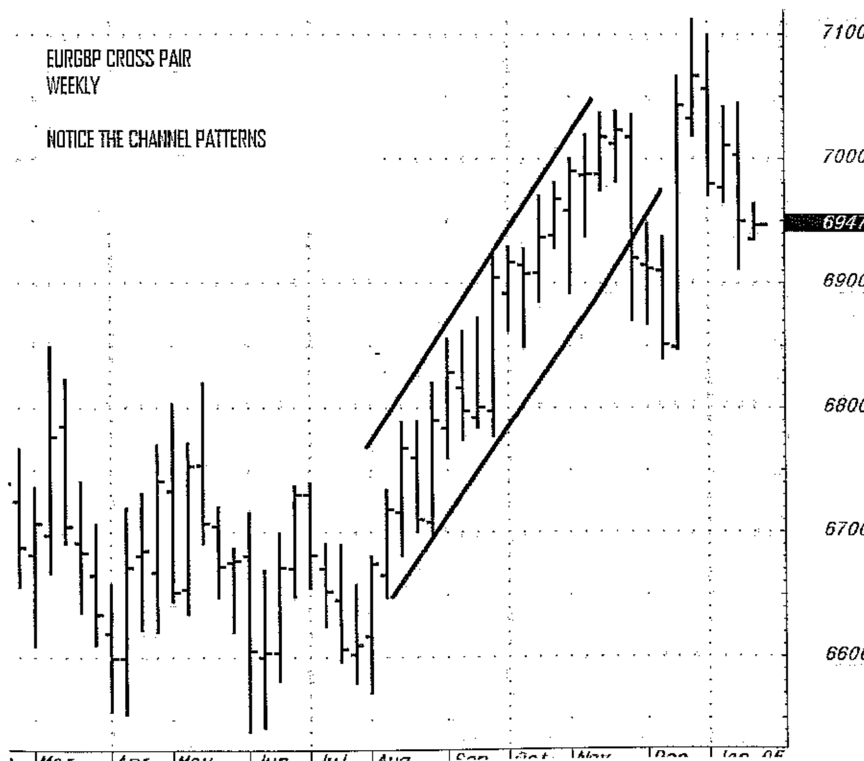
The Mexican peso and Brazilian real are currencies that float against the U.S. dollar and can be traded with some forex platforms. They are important commodity-based currencies. The Brazilian real has an 87% correlation with movements in the Euro.

Cross Pairs - Don't Forget Them

Although most traders pay attention to the EUR/USD and the big 4 currency pairs, the cross pairs are very useful. They should not be forgotten as part of your scanning of the market. They provide frequent sideways ranging behavior that offers trading opportunities in either direction. See our website for updates on many more cross pairs.

EUR/GBP CROSS

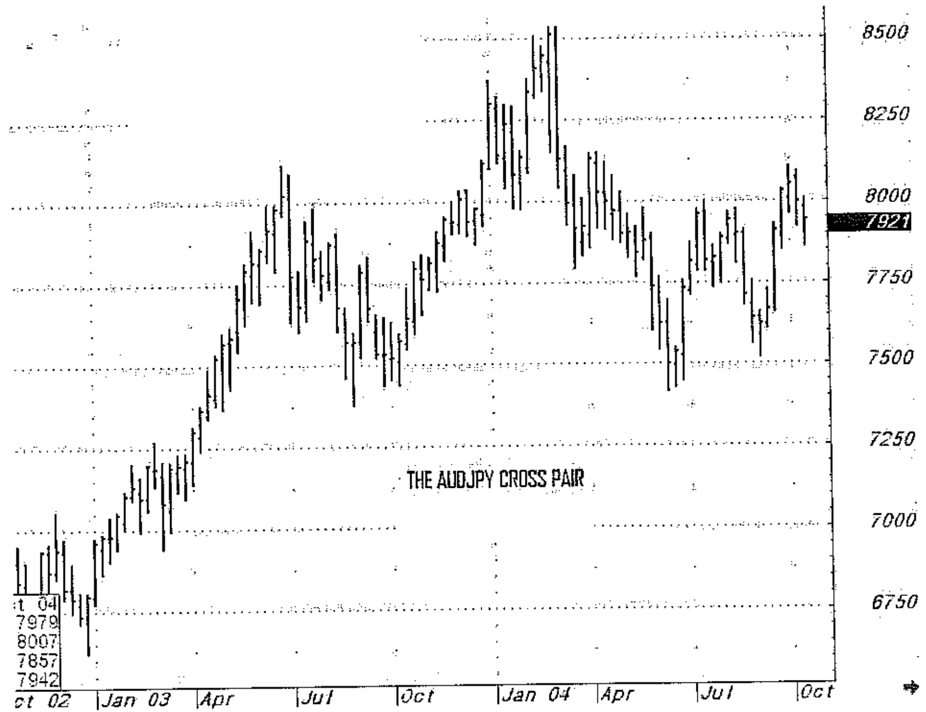
This cross pair places the EUR against the GBP. These two currencies often are in the same trend direction, but at times one currency is moving faster in one direction than the other. When viewed as a cross, the pattern that is common is a zigzag sideways action. When you observe the prices in this pattern, you have opportunities to trade bounce off the sides.



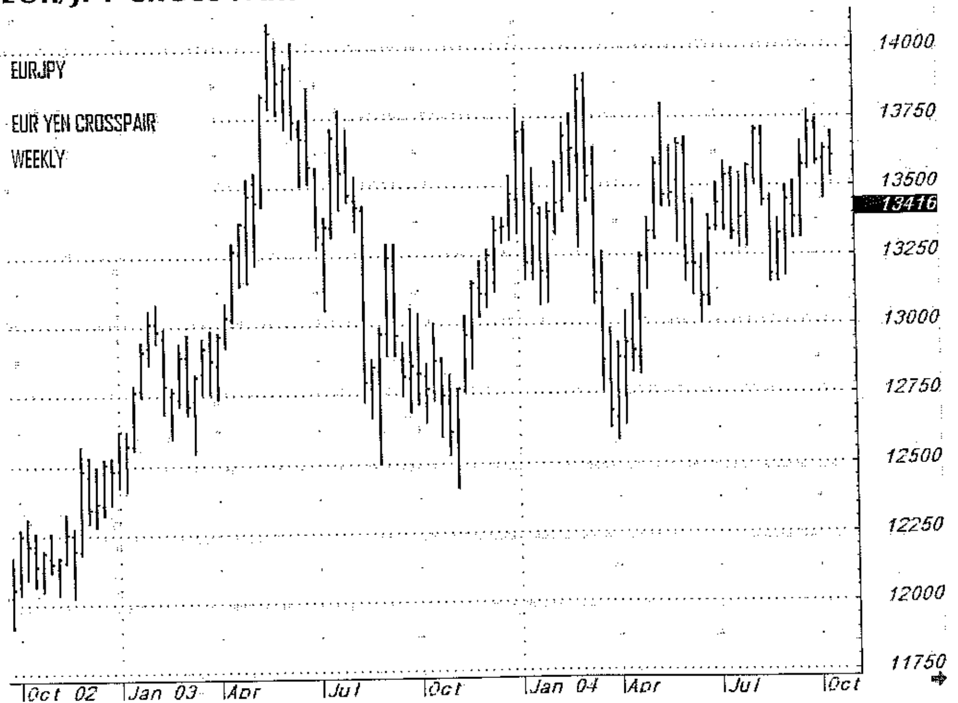
Charts by: cqg

AUD/JPY CROSS PAIR

This pair places the Australian dollar against the Japanese yen. The result is a clear trending behavior with some attempts to break the trend. A trader seeing the price nearing a test of the trend will pay very close attention.



EUR/JPY CROSS PAIR



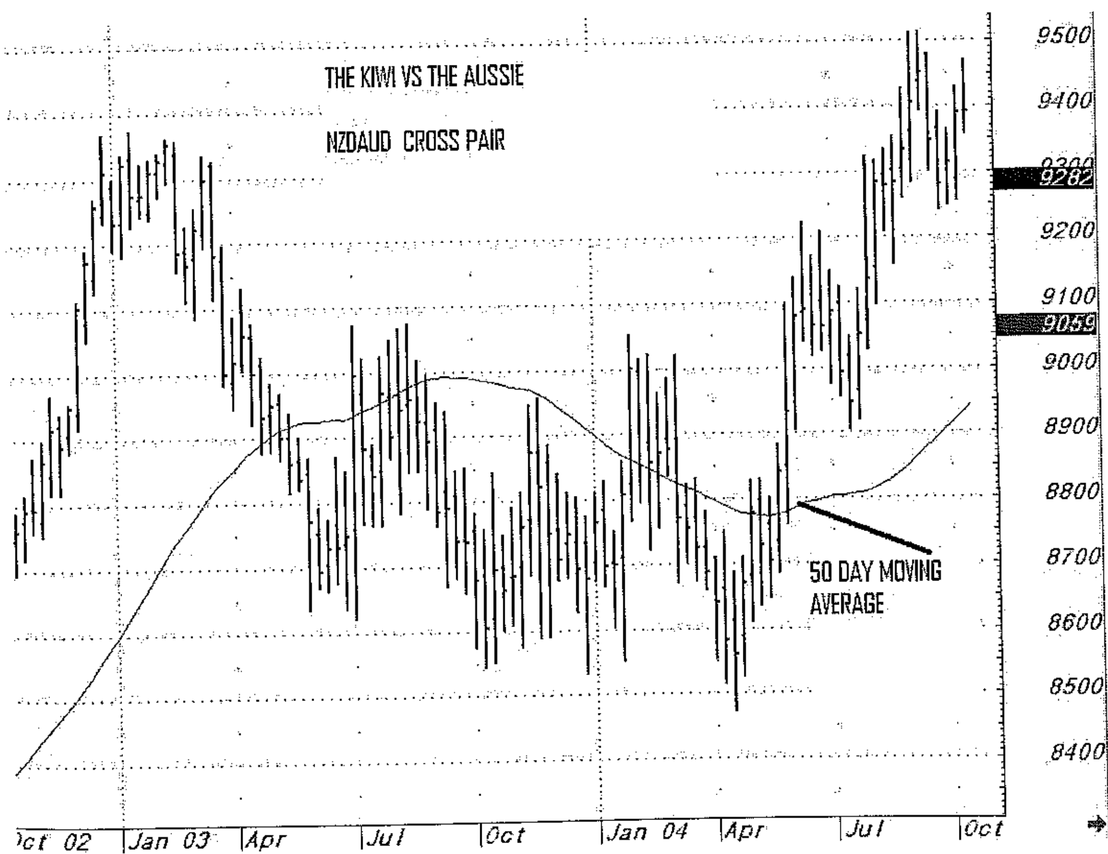
Charts by: cqg

One of the favorite crospairs among forex traders is the EUR/JPY known as the EuroYen. This currency pair often develops enduring patterns that traders can project into the near future.

NZDAUD CROSS PAIR – THE KIWI VS THE AUSSIE

The NZD/AUD is an interesting cross pair that often moves due to fundamental differences between the Australian and New Zealand economies. The zig-zag pattern provides opportunities to trade when the price is bouncing off one of the sides.

Interest rates in New Zealand rose in 2004 against those in Australia, and this has significantly strengthened the New Zealand dollar. Notice in this chart how the uptrend in the NZD passed a key 50-day moving Average. This cross/pair offers good trading oppoortunities because the prices are often trend and channel based.



Charts by: cqg

Chapter 8

Currencies, Commodities and Intermarkets

An important dimension of understanding forex markets is the relationship between currencies, commodities, and other markets. This kind of analysis is known as inter-market analysis. For the beginning trader it's important to be aware of some relationships that are followed by the "big boys" and professionals. In this section we will focus on some fundamental relationships between currencies and commodity markets.

U.S. Dollar and Gold

The headlines on January 15, 2004, tell the story: "Gold plunges, as U.S. dollar rebounds." Gold futures fell more than $13, and money flowed into the U.S. dollar against the other currencies. It's appropriate that gold and currencies seem to be forever in a see-saw. After all, the modern era of floatable foreign exchange started on August 15, 1971, when the U.S. ended the era of the U.S. dollar tied to gold. Gold remains a way for assessing global sentiment about the U.S. dollar The following chart shows this relationship between the U.S. dollar (USDX) and gold.

The chart makes clear that gold vs. the U.S. dollar is often an inverse relationship and a useful guide to trading either. If gold is on an uptrend, forex traders can look to sell the dollar in a particular currency pair.

Finally, a recent research study shows the powerful historical correlation between gold and the USDX.

Table 1: Gold Versus the UDDX: Correlation Coefficients

Date Sample	Time (Years)	Correlation
March 2003 - March 2004	1 Year	-0.91
March 2001 - March 2004	3 Years	-0.95
March 1999 - March 2004	5 Years	-0.75
March 1995 - March 2004	9 Years	-0.82

Charts by: cqg

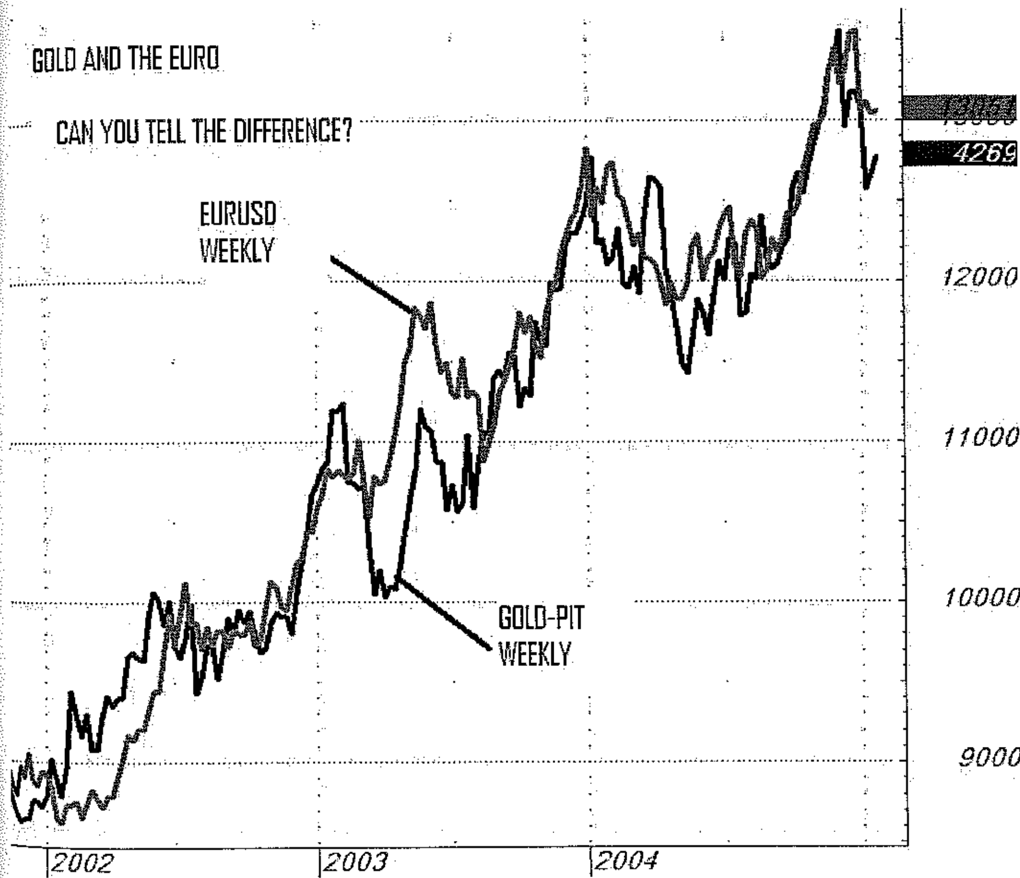
The EURO and Gold

The following chart shows that EUR/USD against gold has frequent periods where the price patterns are almost in exact sync with each other. Seeing this, you can conclude that both are acting as a haven for money coming out of the dollar. This correlation makes sense because a decline in the dollar makes an ounce of gold cheaper in dollars, stimulating demand. A clear example of the relationship of gold and the euro occurred on July 7, 2004. Gold prices moved more than 2.5% to $402.95, and the euro also surged higher–All this in response to trader sentiment that U.S. interest rates would not be going up in the near term.

http://www.goldsheets.com for updates on gold and the dollar.

KEY CONCEPT:

To gain an understanding of global sentiment on the dollar, pay close attention to gold prices.



Charts by: cqg

Oil and Currencies

For those interested in the economics behind the relationship between oil and foreign exchange, the working paper NO 554, by Paul Krugman, National Bureau of Economic Research, Sept. 1980, gives an econometric perspective and the equations behind the relationship.

The concept of valuing currencies as a cross of the currency and a commodity is seen in gold, but it is also valid for oil. Oil, after all, is the world's "black gold." Oil revenues are referred to as petrodollars. The value for the trader in understanding the oil/currency relationship is based on the fact that oil is the major resource for global economic growth. In periods of cheap or stable oil prices, global economic growth is spurred and overall inflation expectations are reduced. In times when oil prices become increasingly volatile, the impact is adverse on growth expectations. For example, if oil is expensive, the Japanese economy, which imports virtually all energy, can be severely impacted, causing a major decline in the yen. A sudden surge in oil prices presents huge discontinuities for the U.S. economy, inflationary pressures, and increased prospects of recession. On the other hand, nations that have oil such as Britain can benefit from the rise of this resource. However, a sudden increase in oil prices causes fear in the futures markets and a flight from the dollar to other havens that offer more stability. We have seen gold benefit in OPEC oil crises.

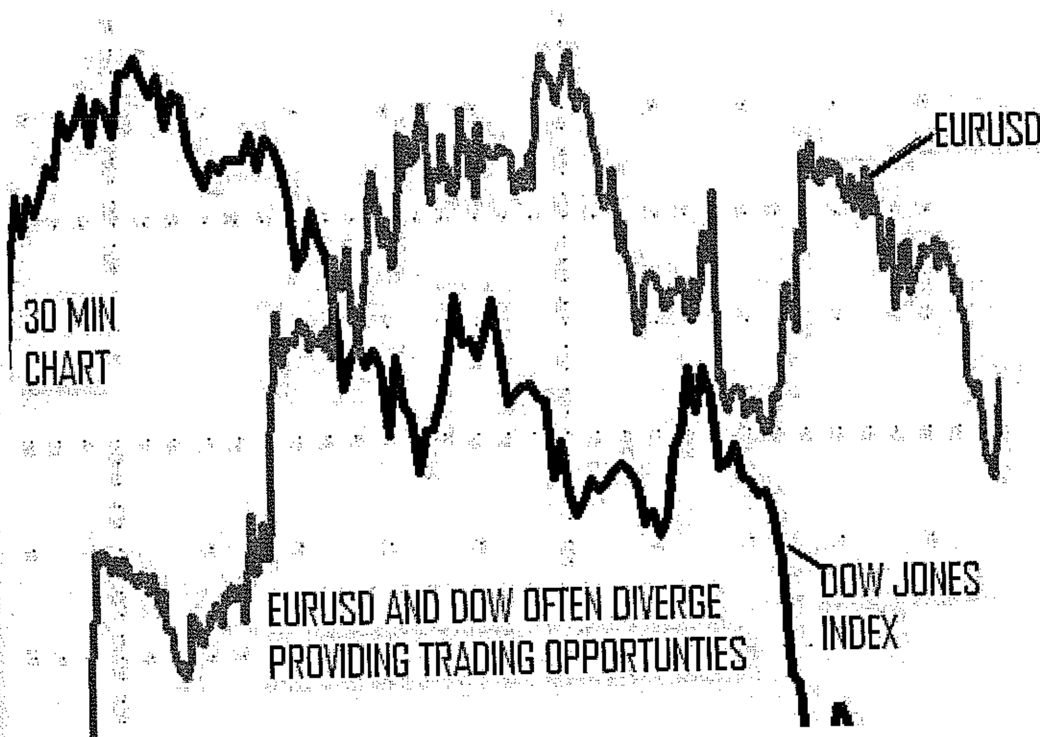
Another key factor is the fact that oil is bought and paid for in U.S. dollars. As the dollar falls in value, the profitability to oil producers declines. A higher price for oil generates more money to OPEC and may drain economic growth of the oil importing nation. But what OPEC does with the surplus revenue is a factor. New oil income in the OPEC nations has to be invested somewhere, and it will go to purchase more goods from the oil importing nations. In a real sense the Gross National Product of the oil producers is shared by the oil importers. Too high a price for oil in dollars may effectively slow the global economy. The price of global grains would increase because shipping the grain requires oil. It is a balancing act of world dimensions. The fundamental fact is the interdependence between oil and the dollar is greater than ever.

For traders of currencies to ignore the price patterns in oil is foolish. As the world encounters tighter oil supplies and continued terrorist disruptions around the world, there will be an oil premium in the value of the currency pairs. An issue that may emerge in the future is a potential shift in the denomination of crude oil contracts from dollars to euros. If such a shift occurred suddenly, there would be a severe decline in the U.S. dollar.

EUR and the DOW-

During the New York session the EUR can often be traded as a play on New York stock market selloffs or surges. Although it is not always the case, you can spot periods when the DOW is moving one way and the EUR moves the other way. This makes sense because a selloff in the DOW causes an outflow of dollars into other venues and into the EUR.

For those traders who follow the DOW or the S&P, or have traded stock indexes, trading the EUR/USD is a closely related instrument.



Charts by: cqg

U.S. Equities and Forex

If you have investments in mutual funds and equities in the U.S. equity markets, learning about forex and even trading forex can be an important tool to improving performance. From the perspective of the long-term investor, forex becomes a legitimate asset category.

For investors who concentrate on developing portfolios of major companies, knowledge of forex can make a difference in which companies you choose and when to rotate your portfolio. The fact is that multinational corporations have significant revenues coming from global sales. Entire sectors provide products that depend on foreign manufactured goods. Nike, Coke, Microsoft, and GM are a few top-of-mind examples of the intimate relationship between the profitability of a firm and the direction of the dollar. Investors armed with knowledge about currency trends can determine if their portfolio is balanced, reflecting global currency realities. During times of a trending weaker U.S. dollar, portfolios should be weighted to corporations that benefit from exports.

Those investors looking to trade forex within an IRA are now able to do so. You can establish within an IRA a FBO (For Benefit Of) account that places funds in the sub account allowing direct forex trading. Several firms have these arrangements established.

Currencies and Agricultural Commodities

What do soybeans have to do with the U.S. dollar? At first glance it appears to be a market that is not about currencies, but think twice. In the United States, roughly 20% of U.S. agricultural products are exported. Compare this to the fact that exports compose about 7% of U.S. GDP.

Changes in the value of the dollar will have an impact on the competitiveness of U.S. agriculture. This means that during periods of a strong dollar, exports are hurt because those countries importing U.S. agricultural product face a price increase because they have to convert their currency to dollars. During the period of a devalued dollar, U.S. agriculture will benefit. When oil prices increase, the costs of shipping agriculture, either being exported or imported, will increase. When China's growth is strong, the demand for U.S. grains is expected to be stronger. When Brazil's currency is unstable, it impacts the soybean markets, both in affecting current as well as future production expectations.

Pork and Currencies

Let's look a the pork industry for another example. In 2003 U.S. pork exports increased by 5%.

Much of this increase can be traced to Japan and South Korea, as these countries accept about half of all U.S. pork exports. Further, part of this increase can be explained by changes in exchange rates. During this five-month period, the dollar held steady versus the Japanese yen but depreciated versus the currencies of other major pork exporters to East Asia. Canada, Brazil, and Denmark.

The other side of the U.S. agricultural relationship with the currency market is in its imports of agricultural products. For U.S. consumers coffee is the most outstanding import. While the weather in coffee growing regions is a critical factor, the costs of a cup of coffee will be significantly impacted by the value of the dollar. Coffee companies such as Starbucks have their own foreign exchange operations to help control exchange risks. The following table shows the general distribution of U.S. imports in agriculture.

http://www.card.iastate.edu/iowa_ag_review/summer_03/article5.aspx

U.S. Imports as a share of Domestic Consumption, 1994.

Commodity	Precentage of Consumption Imported
Coffee	100
Tea	100
Cocoa	100
Bannanas	100
Spices and Herbs	93
Broccoli for Processing	69
Fish and Shellfish	55
Grapes	41
Frozen Orange Juice	24
Beef	10
Pork	4

Knowledge of currency flows is more important than ever before to the farmer or commodity trader. When the U.S. dollar strengthened against the Mexican peso by 50% in 1995, U.S. agricultural exports declined. In 1997 the U.S. dollar rose by 50% against some Asian currencies, and this led to U.S. agricultural export declines.

The inter-market relationship between currencies and agriculture is an area that provides trading opportunities that should not be ignored. In particular for farmers and people whose income is affected by agricultural trade, learning to trade forex as a hedge could be a powerful business tool.

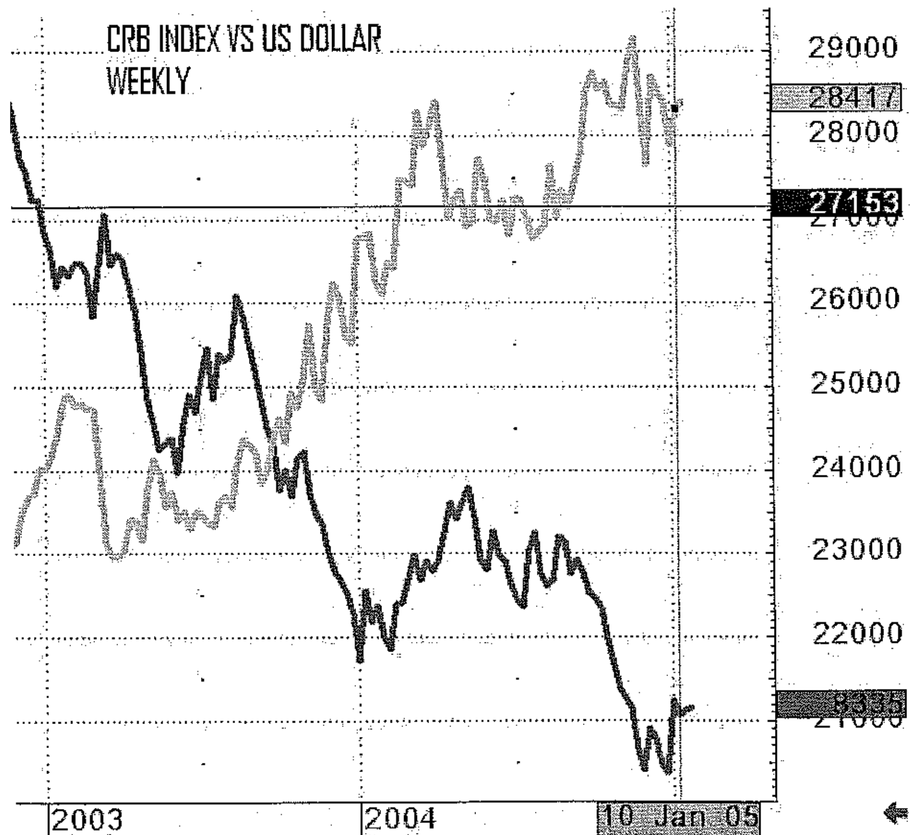
The Commodity Research Bureau Index (CRB) and Forex

Forex traders interested in evaluating further the commodity markets and their impacts on the forex markets can look to the CRB Index. The CRB index is a composite of 17 non-financial commodities and is closely watched as a clue for inflation. Therefore, its relationship to monetary policy and the value of the dollar is important. For those trading currencies that reflect commodity prices more closely such as the Australian dollar, New Zealand dollar, the South African rand and Canadian dollar, this index should be followed.

Chart below compares the CRB and the USDX. Notice how they often diverge.

Key Concept

Forex trading is inherently inter-market and scanning the key commodities (oil, gold, CRB) is helpful in pinpointing opportunities to trade, especially when these indexes are at their extremes.



Charts by: cqg

Cotton , Currencies , and China

The cotton market is really part of a global fibers market involving more than 24 countries. Global demand for cotton is derived from the demand for textiles, as well as man-made fibers.

Traders of cotton follow closely reports on factors such as acreage in production, weather, world ending stocks, etc. However, in recent years, cotton traders increasingly watch more than the weather. They watch the world economy and see income growth in developing countries. In particular, they watch currency markets and especially China's growth rate and exchange policies. China's rapid growth has changed it into a major importer of cotton,while it remains an exporter of textiles. China now accounts for 36% of world consumption, while India, Turkey and Pakistan together account for 30%. It may seem contradictory that China is importing cotton while it is one of the world's biggest producers, but in 2003 China began importing cotton because its stocks were drawn down.

However, the Chinese Renminbi (RBMB) is pegged to the U.S. dollar at a fixed rate of 8.28. This has allowed the Chinese to artificially keep its currency devalued. If its currency were floating, many estimate it would be revalued up by more than 25%. There is a great deal of speculation that China will revalue and allow its currency to float more . The impact on cotton will be significant. An in-depth study of the impact of China revaluataion concluded that the appreciation would increase Chinse cotton imports and lower textile exports.

(Effects of Chinese Currency Appreciation in the World Fiber Markets Cotton Economics Research Institute Oct 2004)

How do you play the China wild card revaluation? This fundamental factor of China revaluation or rumors of revaluation will provide new opportunities for forex traders. In effect, you can play the Chinese revaluation potential by trading cotton futures or options on futures!

Chapter 9

Getting Started

Now that the big picture has been reviewed, it's time to prepare to trade.

KEY CONCEPT

First, find the current direction of the currency pair.

When you first look at a currency chart, one of the first questions that comes to mind is: what is the predominant direction of the currency? You arrive at the answer to this question by looking at the charts. This process is also called technical analysis and is a major skill that takes years to acquire. This book provides a framework for you to start building your knowledge and skills in analyzing forex charts. A great deal of technical analysis uses mathematics to evaluate patterns of price movements. Some analysts have tried to apply advanced concepts such as chaos theory, fractal mathematics; and even quantum physics to gain an edge in trading. Promising new work is also being done to model financial behavior that is similar to a chemical reaction with the ingredients being emotions. As new algorithms are created they will extend technical analysis to new levels. The main point is that if you are new to forex trading, you should not fear that you don't know enough to get started.

4 KEY QUESTIONS:

What direction is the currency trading?

Which direction should your next trade be?

Where should the trade be placed?

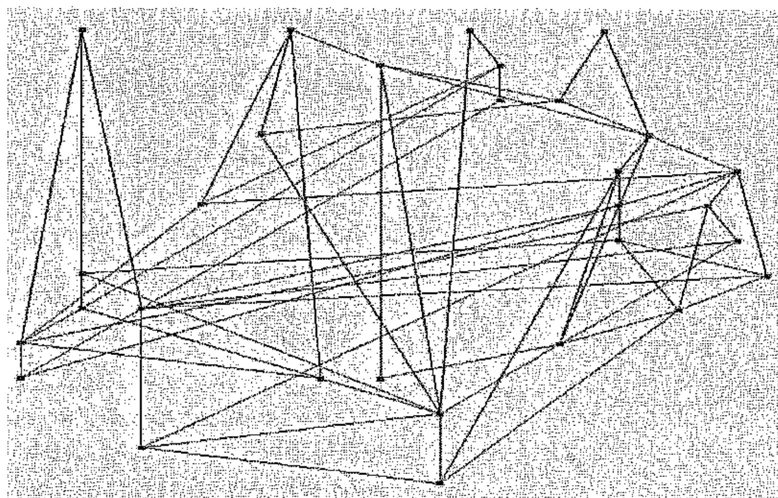
When should the trade be placed?

The first step for the new trader is to become skilled in understanding what the currency pair is doing, rather than trying to predict what it will do. This distinction is profoundly important because prediction is extremely difficult. Instead, you should try to obtain a firm understanding of where prices are and assess where trading opportunities will be. This is quite different from prediction, which has as a goal a specific time and price in the future. Projecting currency prices is really constructing a map of possible routes the currency can take. The effective trader will develop strategies for each possible outcome.

What Direction is the Currency Pair Trading?

Forex prices are not random walks

If forex prices were random, the charts would look like the one below. In this chart there is no apparent pattern or direction. The theory of a random walk, even if applicable to the equity markets, has not been claimed to work in forex. Forex prices reflect global forces and may be chaotic, which is often confused with being random. Forex markets are not random.



http://ftp.cwi.nl/CWIreports/INS/INS-R0005.pdf
National Research Institute for Mathematics and Computer Science, Amsterdam

A currency pair will stay in a pattern until news movest it out

In contrast, forex prices move in patterns, and patterns tend to persist. It is similar to Newton's 3rd law of motion. Restated here for forex: A currency pair will stay in a pattern until news moves it out.

The geometry of the price action reveals what kind of patterns the market is establishing. Understanding patterns leads to an understanding of what the market is doing. Understanding what the market is doing leads to formulating trading strategies.

Let's explore some important patterns that a trader needs to find.

The Importance of Trend Direction
Price Trends and Direction

Prices move in three basic ways: up, down, and sideways. When they move consistently in a direction, it is called a trend. Whether you are viewing a monthly chart or a 5-minute chart, observing which of these three patterns is in place is very important to find out.

The Trend is Your Friend.

We all have heard the phrase *"the trend is your friend."* What is a trend? How do you spot it? How do you know when it's over? Over any period of time a trend is best understood as representing a pattern where prices sustain a sequence of higher highs and higher lows. For example, if you are looking at a daily chart, whether it is a bar chart or candlestick chart, an uptrend can be spotted and drawn. To draw a trend, connect either the lows or the highs and extend the line across the chart. A downtrend connects the highest high to the next lower high and is extended. An uptrend connects the lows of the chart, starting with the lowest low and going to the next higher low. By drawing a trend line, you're asking yourself not only what the pattern is but also can project where the pattern will be broken.

DEFINITION OF TREND:

UPTREND -Higher Highs and Higher Lows

DOWNTREND- Lower Highs and Lower Lows

When a trend pattern is noticed it's a serious development. Consider the following: Each day more than 1.5 trillion dollars is traded in the forex market. If a day trend emerges, the market has decided that the particular currency pair has a range of action. An uptrend means that the global sentiment is such that that there is a dominance of buyers over sellers for a period of time. A downtrend means that the sellers are more powerful and have forced the price highs each day to get lower and lower. This makes the day pattern very important because it reflects the accumulated decisions around the world on the value of that currency. Once a day trend is in effect, the market will continue the trend until some new information on global economic or geopolitical conditions change the trend. Trend direction usually goes from a downtrend to a sideways action to resumption of a downtrend or a reversal of the trend. Following the trends through this never-ending cycle is one of the most fascinating aspects of trading forex.

Trends also exist at lower time frames such as 4 hours, 1 hour, 30 minutes, 5 minutes, and 1 minute. When trends are spotted at these lower time frames, they reflect the psychology of the most recent action. Very often at any particular time of the day the trend at the hour level may be opposite to the trend of the day. When this happens, it's called a divergence. Those individuals trading with the day trend will wait it out until the price returns to the direction of the day trend. Day traders may use intra-day trends as places for trading in and out throughout the day. Which trend is more important, the week trend, day trend, or others? This question is often asked, and the best answer is that the price at any moment can either go up, down, or sideways. However, the probabilities are that the price will continue in the trend that is dominating. So when the hour trend, the 4-hour trend, and the day trend are in the same direction, trading in that direction offers higher odds of being right.

Uptrend Line-

Trend lines can be used in all time intervals

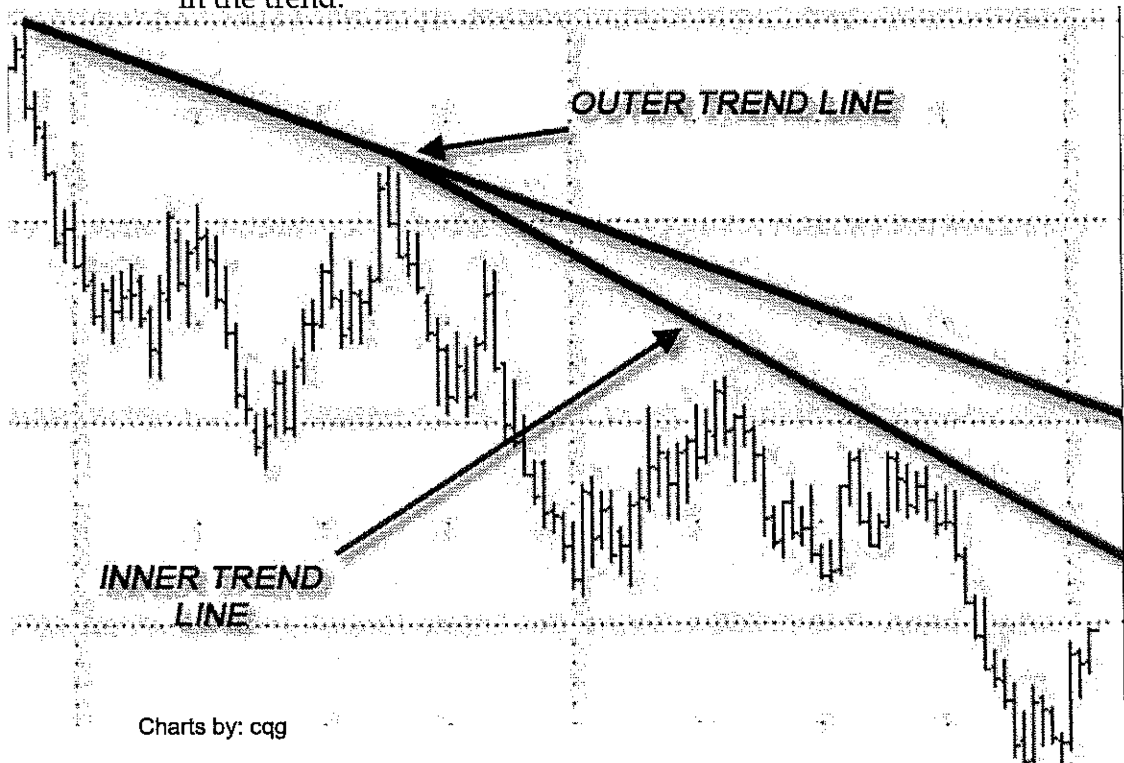
An uptrend means prices are making higher highs and higher lows. Therefore, you want to find the area where the uptrend will stop. This means you have to connect the lows. Start with the lowest low or a significant low on a chart. Then connect a line from the lowest low to the next higher low. At this point extend the line to the right. The more points the lines connect the better the confirmation is that the trend is strong. When a price goes to a trend line and reverses, it is providing evidence that the pattern is continuing and sentiment is strong for the direction of the trend.

Downtrend Line-

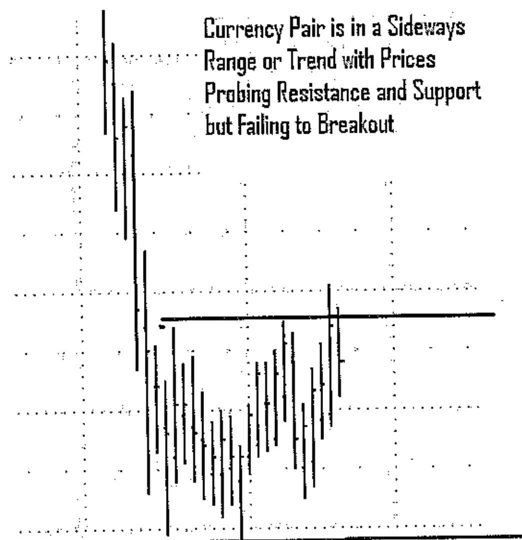
A downtrend is defined as prices making lower highs and lower lows. Therefore you want to find the area where the downtrend will stop. You do the reverse of the uptrend. Find the highest high or the most significant high and then connect it to the next lower high and extend it down and to the right.

Inner and Outer Trend Lines

A chart may have outer trend lines and inner trend lines. When the price action shifts while a trend is in progress, an inner trend line can be drawn. This shows an increase in sentiment and momentum in the trend.



Knowing how mature the trend is also provides locations for your next trade–when the trend is tested or broken. If a price comes up to a trend line and fails to go through it, or goes through it and comes back down in the next bar or candle, you can characterize it as probing or testing the trend line. This price behavior is called a bounce. A failure to break a trend is a signal that the sentiment in the market is still with the trend. The more touches of the trend line, the more confidence you can have that, when a break of the trend line does occur, it will be significant and not short term. When the price breaks a trend line, it's a very good idea not to jump in on the break but to let the price try to come back into the direction of the trend, retest it and confirm the new direction. Price breaks are often called "false" breaks because they are short-lived.



Charts by: cqg

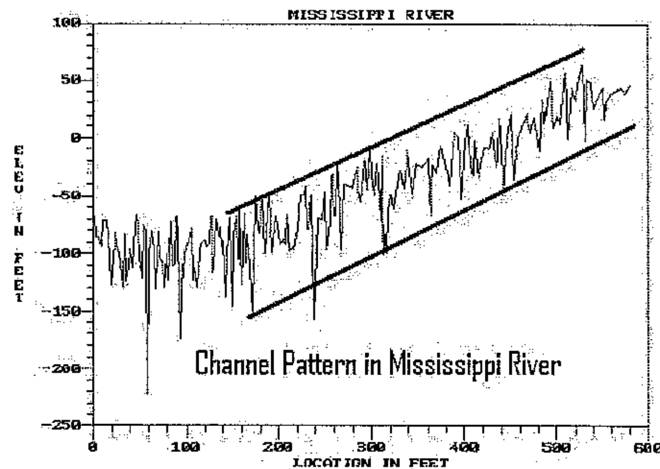
Ranging Patterns

The opposite of the trending pattern is the ranging pattern. This occurs when there are no higher highs, or lower lows to visualize. The result is a trading range between what is called support and resistance. The support line connects the consecutive lows and the resistance line connects the highs. This pattern represents uncertainty in the market. There is no dominant direction. Buyers may dominate at times, pushing the price upward, only to have the sellers take over and succeed in pushing the price back down. The result is a zigzag pattern. There are many variations of the ranging pattern. What is important to know is where the boundaries of the range are. Is the price testing the support or resistance? Is the price breaking through? How wide is the range? Is it getting smaller or wider? If a

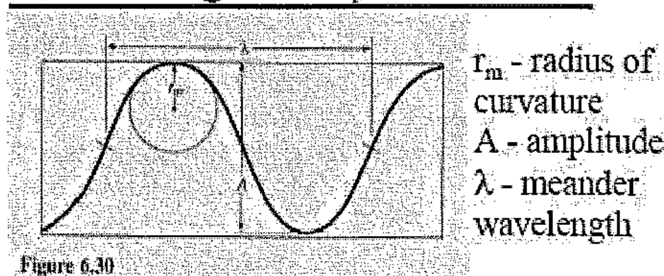
range pattern is in place on the day or 4 hour chart is it getting smaller or wider? These are examples of major considerations in analyzing the ranging pattern.

Uptrend, sideways, and channel patterns are essentially ranging patterns. They provide trading opportunities when support and resistance are tested. The geometry of the channel pattern in forex trading is similar to the geometry of the meandering river. This similarity is not an accident because in both cases there is energy flow. In the meandering river the pattern is stable due to how the energy is dissipated.

The chart below shows the meandering geometry of the Mississippi river and the equasions that describe it. Now after seeing these charts you will recognize many meandering patterns in the river of forex price movements!!



http://www.bossintl.com/online_help/hec-ras/source/roughnesscoefficients3.htm

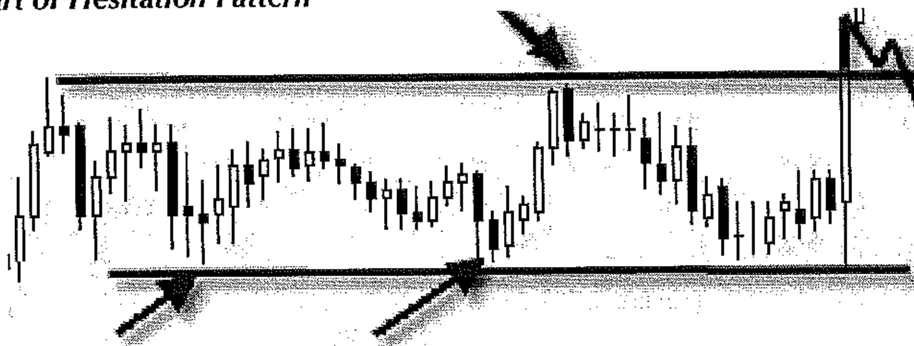


http://www.oswego.edu/Acad_Dept/a_and_s/earth.sci/geo_geochem/geol/ geomorph/rivers3.pdf

Hesitation or Consolidation Pattern

Forex prices move but not randomly. Traders study patterns because patterns reflect agreement and order in the market. After a big move, which is perhaps a response to news, the market goes into a period where it's digesting new information and is hesitating. Hesitation means that it is ranging but it also means that the market is preparing to make a decision. You know this by noticing that the range is getting narrower. The difference between the highs and lows becomes smaller because the buyers and sellers are giving up and have no strong sentiment to keep the range that has existed. Hesitation is a prelude to a shift to a new direction or a confirmation that the prior direction before the hesitation should be resumed. Several hesitation patterns have become useful in trading. You can trade on the bounce of the price, or you can wait for a break but wait further for the price to come back into the sideways channel. This would provide confirmation that the pattern is still in force.

Chart of Hesitation Pattern

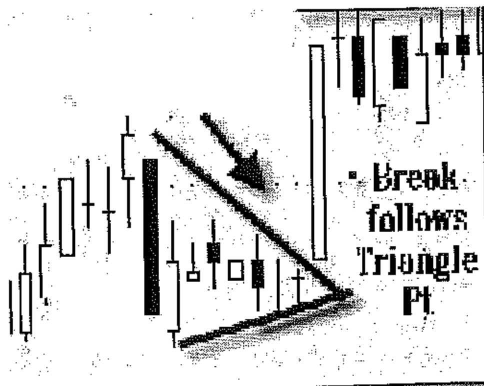


Sideways Channel on a 30 MINUTE CHART showing hesitation

Triangle Patterns

READ
Underground Trader by Russ Lockhart and

These patterns show price action starting at a wide range between the low and high and developing incrementally smaller ranges leading to almost no difference between the low and high. The market is telling the trader that a breakout is about to happen.

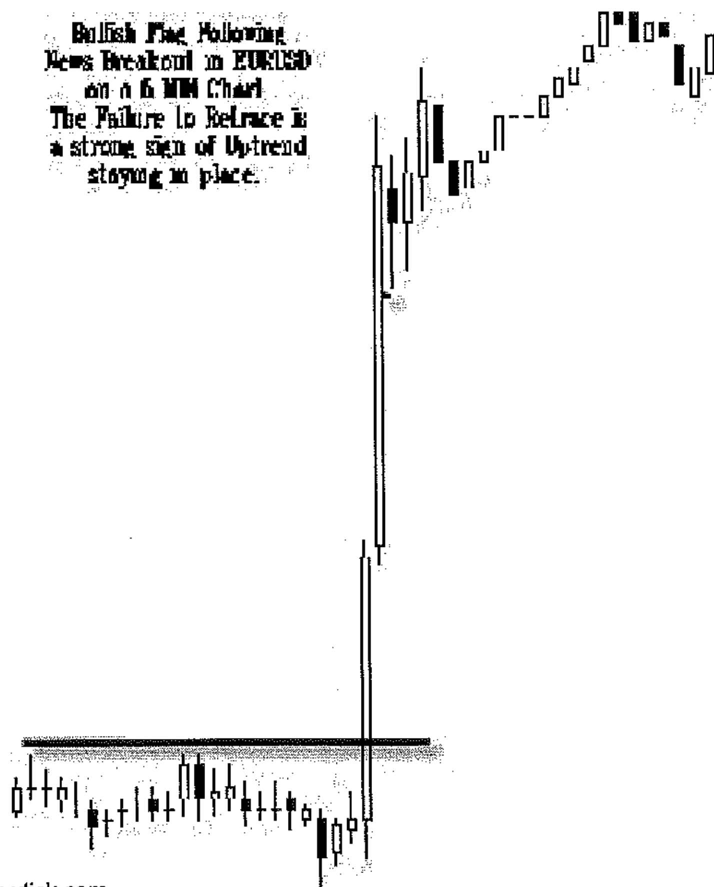


Charts by: xtick.com

Triangles come in a variety of forms. There are ascending triangles, descending triangles, and equilateral triangles.

Spikes, Surges and the Chemistry of Market Surprise

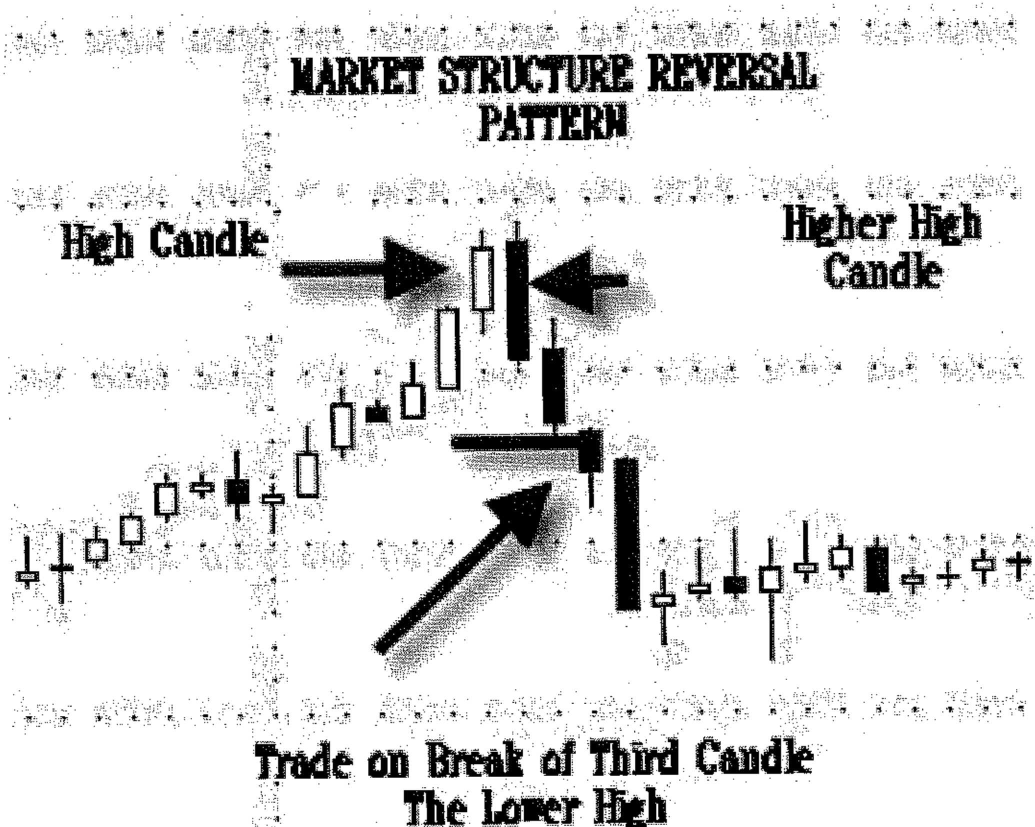
The forex market can be characterized as a massive information machine. It constantly processes information coming in and reacts to that information. The reaction is seen in the pattern. If the reaction is an agreement in direction we see a diffusion of the prices into a trending pattern of up or down. But when the information is new and a surprise, the chemistry of the reaction is more like an emotional contagion and we see a price surge or spike. This occurs because those trading the market fear uncertainty. When a rumor occurs or an event such as a terrorist attack occurs, the trading decision is to get out of the position and move to a safer zone. This has been called "the flight to safety". It is usually short-lived as the market digests the new information and establishes a new pattern. The chart below shows a surge following a news announcement. You also see the formation of an uptrend pattern shortly after the surge. The forex trader needs to learn hc



Charts by: xtick.com

Reversal Patterns

A key part of trading forex is spotting reversal of direction. As we said before, prices in forex are basically in a trend or range-bound behavior. It's important to spot signs when there will be a reversal of the price direction. Several patterns help identify reversals. The candlestick pattern itself forms a variety of reversal setups. One of the most useful is called the market structure high. This was introduced by Larry Williams and is used with great emphasis as a price signal by Russ Lockhart in *Underground Trader.*

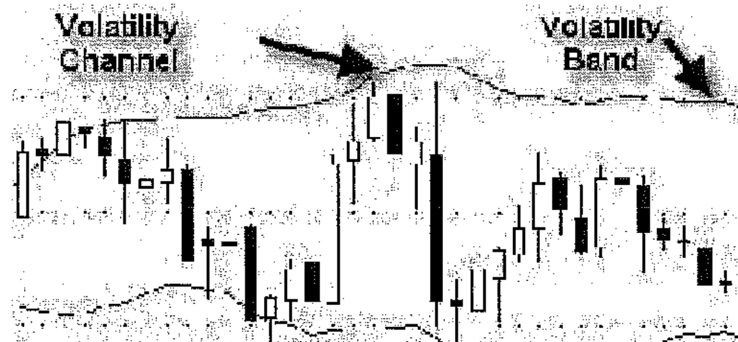


In any time frame, if you see a series of higher candles, then a higher high candle that is followed by a lower high, there is a strong possibility of a reversal. This is a signal that the price is ready to fall. On the other hand a market structure low is a setup where there is a Series of lower candles followed by a lower low and then a third candle with is a higher high. On the other hand, a market structure low is set up where there is a series of lower candles followed by a lower low and then a third candle with a higher low. This suggests a reversal.

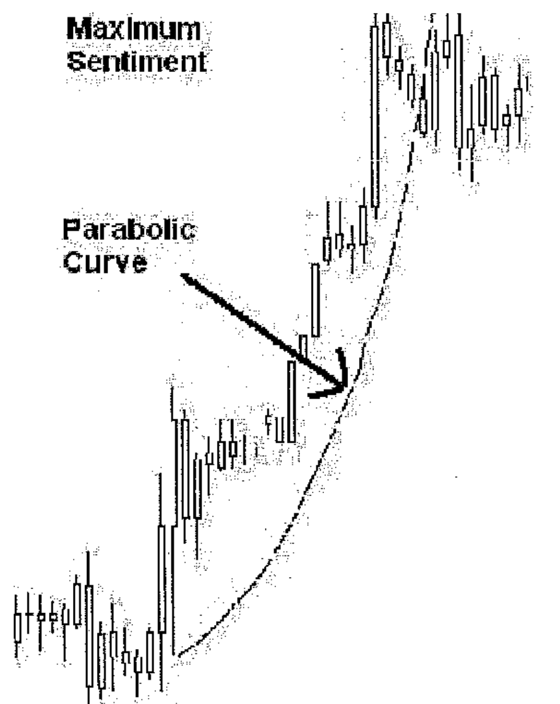
Charts by: xtick.com

Volatility Channels

Prices can move in a sideways channel where resistance and support are volatility bands. By using volatility bands, you get a better idea of whether the prices have reached extremes. By placing an envelope measuring the volatility of the price movement, you can get a better sense of the boundaries of the price action. Prices tend to exhaust themselves. So, in effect, when prices are probing upper and lower volatility bands, it provides an alert for a possible reversal coming.

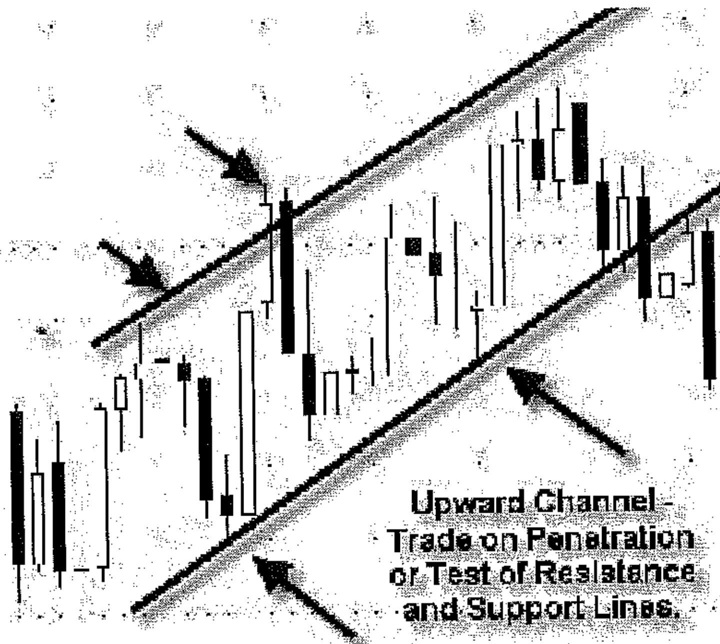


Parabola - This pattern is indicative of increased momentum and projects where the break of the momentum will occur, which is at the apex of the parabola. Here is an example of a parabolic pattern.



Charts by: xtick.com

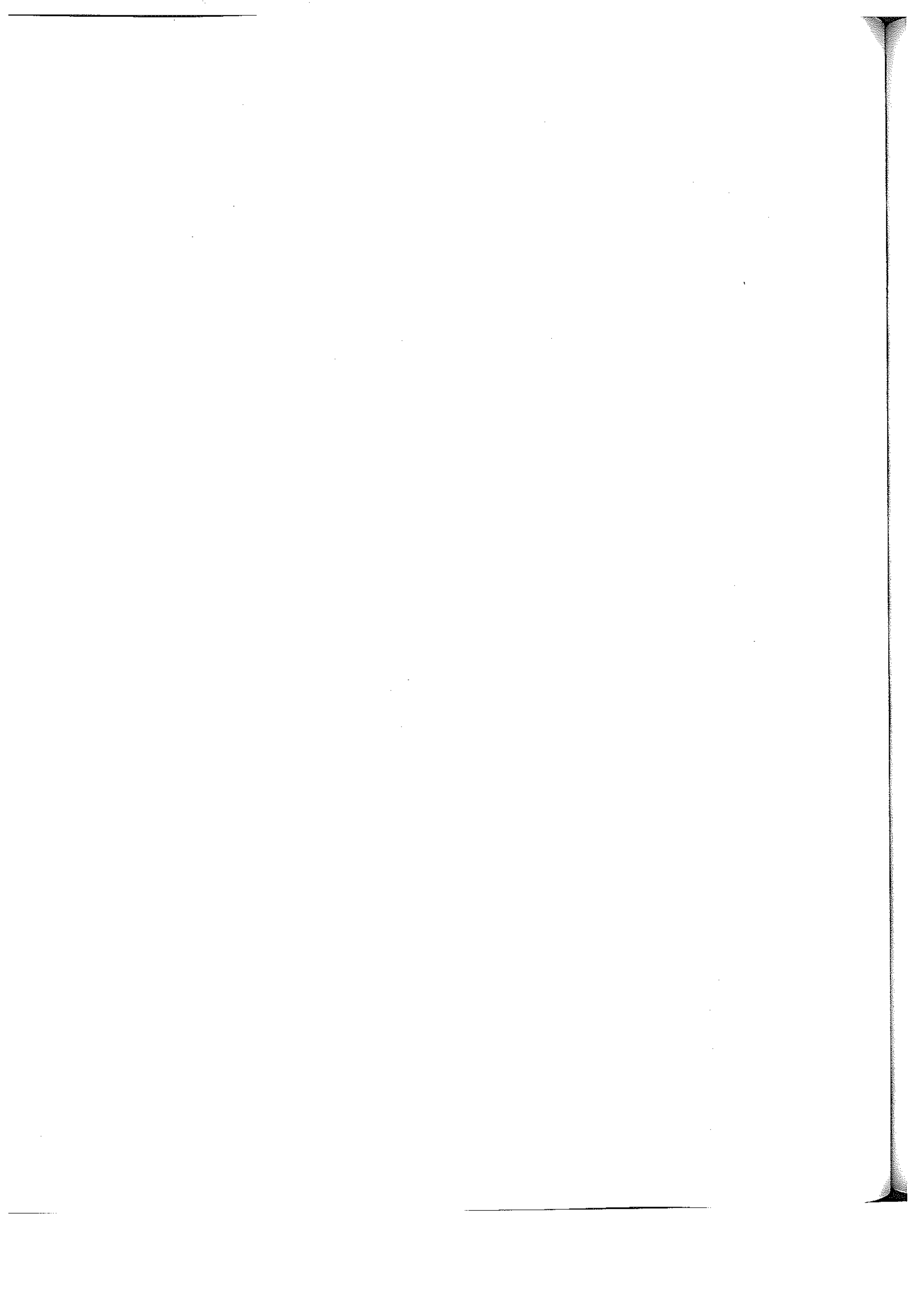
Channels - As charts show, channels can be upward, sideways, or downward. What makes them very powerful is the wave-like behavior. When a currency pair is in a channel pattern, it is likely to stay in that pattern for quite a while. The forex trader can project locations to buy or sell based on the assumption that the sides of the channel offer support and resistance. It is a highly reliable pattern. Also important to note is a a failure to bounce off a side. If a price probes one side of the channel, stays there for a while, and closes above or below the channel line, the forex trader has received a signal of a break and may consider trading in the direction of the break.



Charts by: xtick.com

Part Two:
How to Analyze the Forex Markets

Learn how to scan the Forex charts, identify key trends and sentiment; locate Support and Resistance, and use Key Technical Indicators to help shape your trade.



Chapter 10

Projecting Support and Resistance Points - How to Use Fibonacci Ratios

Trying to predict where the market is going for certain is not easy. But for the new forex trader, the *real job is not to predict where the market is going but to be able to react to what the market is doing.* If you cannot know where the market is going, you do and can know what you will be doing. Once key patterns have been observed, the task of the trader is to prepare a strategy for different price scenarios. If the currency does **A,** then the trader is prepared to buy; If the currency does **B,** then the trader is prepared to sell. An important tool to use in finding where support and resistance levels are likely to be is the use of Fibonacci levels. Learning how to use Fibonacci levels is a key step in becoming a forex trader.

Fib Resistance and Support Levels

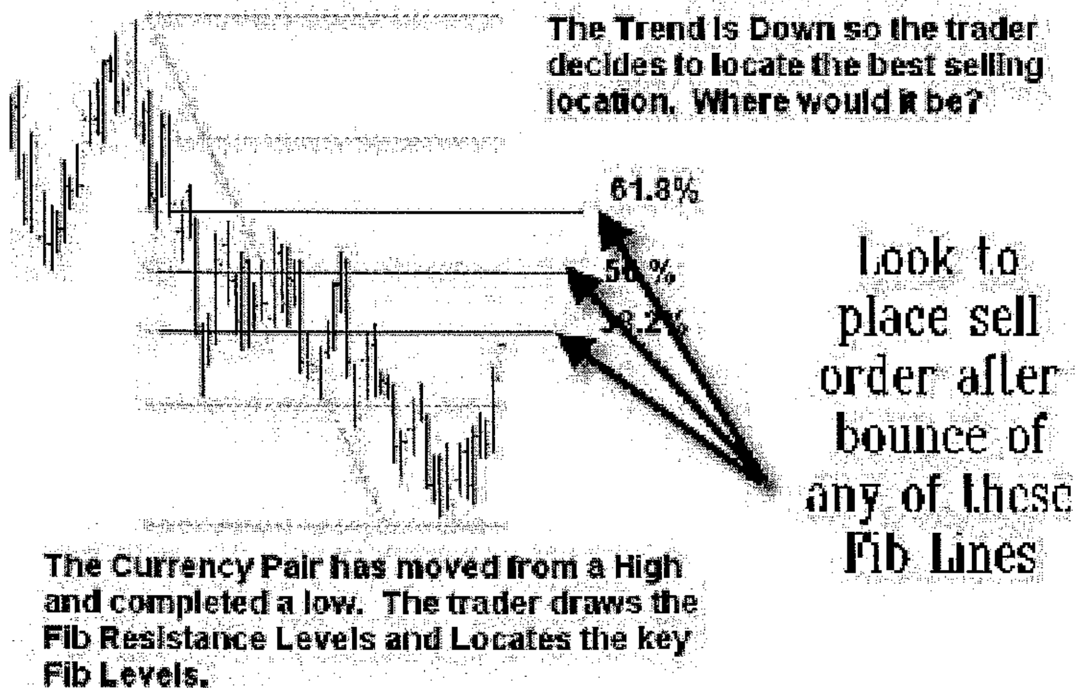
Fibonacci levels are used extensively in trading in general and apply to forex price movements. They provide a projection of where prices are likely to face resistance or support. For example, if a currency pair moves from a low to a high of 200 pips over a period of time and then goes into a sideways action, you can think of the price as trying to move back to where it started at the low. That would represent a 100% retracement. But on the way down, it will encounter areas where it will stop falling and try to come back up. How far back up? This is where Fibonacci levels are useful. No one really knows why, but the pattern of prices retracing to Fib levels applies in all markets. What the trader needs to know is where these Fib levels are to help prepare a strategy for the trade. It is also important to know because the professionals in the markets use them all the time.

A common question asked by beginners is how and where to draw the Fib lines? Most charts have Fibonacci tools that allow the Fib lines to be generated. A good rule of thumb is to start at the day chart period and use it to locate the most recent price. Ask yourself: Is the

price coming from a high or a low? If the price is coming off a low, locate the low. Is it the lowest low? If not, find the lowest low. If it is coming off a high, locate the highest high. Is it the highest high? The Fib resistance line will connect the low to high points and generate the Fib ratios. Let's look at an example:

Applying Fib Strategy

The best use of the Fib lines is to locate where your next trade should be. For example, If a currency is trending up and then forms a top and stops going up, you can project where it is likely to find resistance on the way down by locating the Fib lines. The 50% level and the 61.8% level are considered very strong areas where the price action will pause. So prices will test and bounce off the Fib lines, or break through. The Fib levels are projections into the future location of these key areas of support and resistance. Often weeks and days in advance, you can know that a key Fib level is being tested. Rest assured that the pros know these levels too! That is why when a Fib level is crossed, it often does so with a lot of energy because many other traders are ready to jump into the direction when a Fib level is broken.



Charts by: cqg

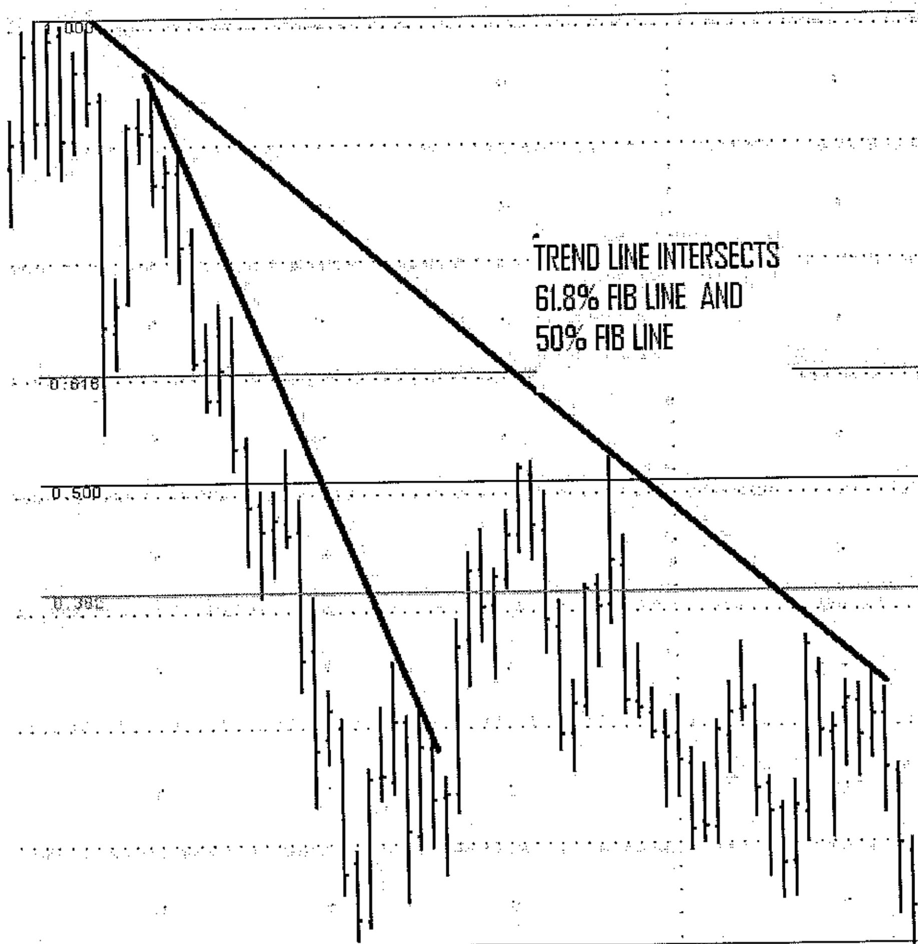
We have focused on the basic Fib resistance level tool. Fibonacci fans and Fibonacci time lines are other applications that deserve attention after you have mastered the Fib resistance lines. More information about Fibonacci levels and trading can be accessed in literally thousands of pages on the web.

A good site for more reading on Fibonacci numbers is:

http://www.mcs.surrey.ac.uk/Personal/R.Knott/Fibonacci/fib.htmlbers is:

FIB Levels Plus Trend Lines

When you combine trend analysis with Fib lines, you get added evidence to identify key areas of resistance and support.



Charts by: cqg

Pivot Points

The pivot point is where major resistance or support is expected. They often are identical to Fib levels. Once you locate the pivot points, they can be excellent locations for placing your stop or limit orders. If the price breaks above the pivot point, it is considered a bullish sentiment; if it goes to the pivot point and fails to break through, bouncing off it; can be considered bearish.

Some chart platforms have built-in calculations for pivot points. There are variations for calculating these points. Here are some equations for it. (http://www.linnsoft.com/tour/techind/pp.htm)

(High + Low + CL.1)/3
(High + Low + CL.1 + OP.1)/4
(High + Low + CL.1 + OP)/4
(High + Low + CL + OP)/4
(High + Low + CL)/3
(High + Low + OP)/3
*(High + Low + 2*OP)/4*

Price, Time and Waves

Read:

Dynamic Trading by Robert C. Minor Traders Press Inc.

The quest for a better understanding of how prices move involves a focus on price and time. Beginning forex traders will see references to Elliott Wave and Gann lines. In fact, the idea of a wave-like behavior to prices is close to being a law of price action. Many of the ideas of Elliott Wave and Gann endure such as the importance of the 45 degree trend lines and how prices form in patterns of five waves. Further study of these concepts is worthy for those first mastering basic forex technical analysis. One of the best studies of these concepts was done by Robert Miner

A good summary is available at:

http://www.aeroinvest.com/about/elliott/index.htm

Chapter 11

How and When to Use Key Technical Indicators

By now, you can see that trading forex involves making a sequence of decisions. You begin by first deciding which direction to take the next trade. This decision is based on assessing sentiment and trend direction. The second step is deciding where to enter the trade. Entering the trade off a trend line or Fib line is an example of the basis for this decision. But the third key step is pulling the trigger-deciding to put on the trade. This is where technical indicators come into play and become a critical tool to confirm your analysis and instincts.

The list of potential indicators used to help shape forex analysis is quite extensive. Many technical indicators used for equity and futures markets do not apply to forex because forex trading does not provide volume data. The new trader is likely to become confused as to which indicators to use. This chapter will guide you.

Technical Indicators are like Cable Television Channels- How many do you really need?

Average True Range
Bollinger Bands
Commodity Channel Index
Envelopes
MACD
MACD Histogram
Momentum
Moving Average
Parabolic
Percent R (Williams %R)
Rate of Change (ROC)
Relative Strength Indicator (RSI)
Standard Deviation (StdDev)
FStoch (Fast Stochastic)
SStochastic (Slow Stochastic)
Volatility

How Many Indicators do You Need?

The supply of indicators is plentiful. But many measure the same phenomenon. The challenge of the forex trader is to use those that provide confirmation of different aspects of the price action. Whatever indicator is used, you need to be able to confirm the volatility, trend direction, and price reversals.

Before you put on the trade, make sure you have checked volatility trend direction, and price reversals

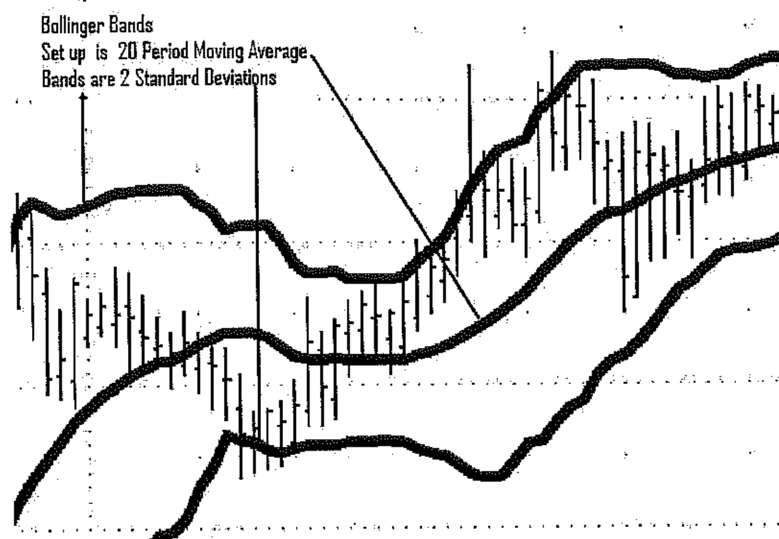
Know the Volatility for Confirming Direction Change

When a price varies between its highs and lows and its open and close, you can measure that movement in terms of its volatility. Zero volatility does not mean no movement in prices. It means that there has been no variation. For example, if the weather in an area had a daily high of 85 and a low of 65 for a week, there would be zero volatility. In forex trading volatility represents great opportunity. During any day, forex prices move 0.5 to 1.7 percent between highs and lows. Prices may range more than 100 points in several hours.

Bollinger Bands provide a measure of volatility

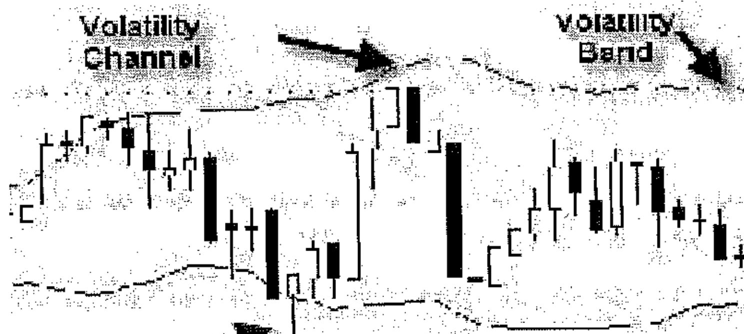
Measuring volatility is important because all price movements start with greater volatility and lose it. So when volatility is at a peak, it's a sign that the ability to keep moving up or down has declined. Therefore, traders who are seeking confirmation to buy a currency pair will find that, when the volatility peaks during a selling trend, it's a sign of a reversal. Those looking to sell a currency pair will look for a peak in volatility while the price is still in an upward trend.

Several volatility indicators are commonly used. Bollinger Bands and volatility envelopes are two of the most useful. Both indicators try to map the variation of prices. Bollinger Bands include three lines-an upper band, a lower band and a center line. The center line is a moving average of the prices, defaulted at 20 periods. The upper and lower band project the price 2x the standard deviation off the center line. The exact settings can be altered. But those who recall statistics will note that two standard deviations include about 96% of the variation and three standard deviations include about 99%.



High volatility is a clue that a reversal is coming

Volatility bands work like Bollinger Bands but measure the percent variation about a moving average and do not project the standard deviation. Both can be used as an effective way to identify when prices have a high volatility or a low volatility. Low volatility often coincides with hesitation and sideways action. High volatility often coincides with a reversal.



Rate of Change (ROC) and Keltner Channels are other commonly used volatility technical indicators.

Charts by: xtick.com

MACD -Confirming Trend Direction and Reversal of Trend

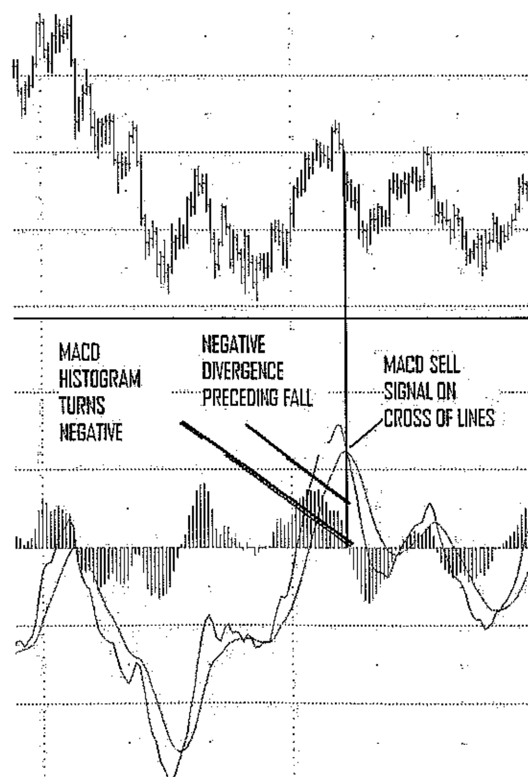
READ
www.chartfinder.com

This indicator is an acronym for Moving Average Convergence Divergence, which was developed by Gerald Appel. It compares a slow moving average and a faster moving average - usually 26 periods for the slow moving average and 12 periods for the fast moving average. A third element is called a signal line. This signal line is a 9-period moving average of the difference between the fast and the slow moving average.

A rule of thumb is that a buying opportunity occurs when the MACD line crosses the signal line and goes above it. A selling opportunity occurs when the MACD line crosses below the signal line. The center line or the 0 line is useful also. When the MACD swings above or below the center line there is another buy or sell potential.

Traders find the MACD complicated. Thomas Aspray introduced a new idea called the MACD Histogram. The MACD histogram is useful in indicating that a trend reversal may be near. What you want to look for is divergence. If the price is going up and the MACD is going down below its signal line, the trend may change.

The histogram version is very useful because the Histogram is a way of showing the distance between the MACD and its signal line. By seeing whether the histogram bars have changed slope, you can see early on if there is a divergence. If the histogram slope is pointing up and the price is flat or still down, this is a sign of a possible reversal.

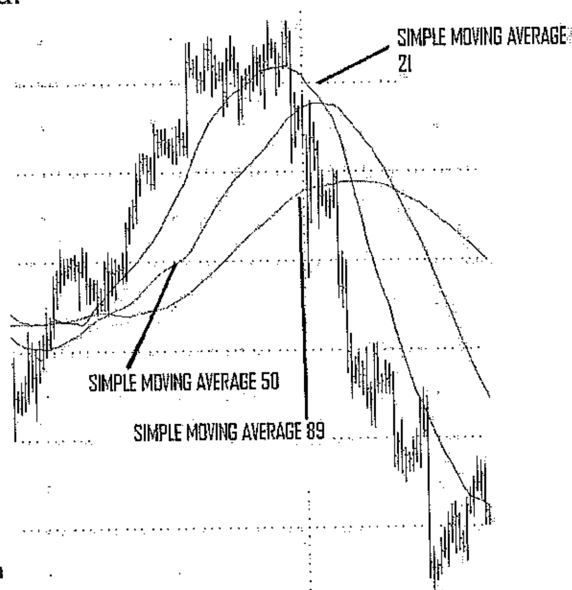


Charts by: chartfinder.com

Confirming Trend Direction with Moving Averange Crosses

Trend lines are independent of time. They project continuity in the sentiment. When the price goes through a trend line or near it, the key is to confirm that the move is not short-lived. A short-lived trend break is often called a "false" break. It's really not false, just short-lived. How can the trader confirm that the trend has changed? How can the trader confirm that the trend is stable?

The use of moving averages helps to accomplish this confirmation. Moving average crosses provide a clue. If a moving average for fewer periods crosses a longer moving average, it may lag price action but shows a potential trend change. Simple or exponential moving averages can be used.



Charts by: xtick.com

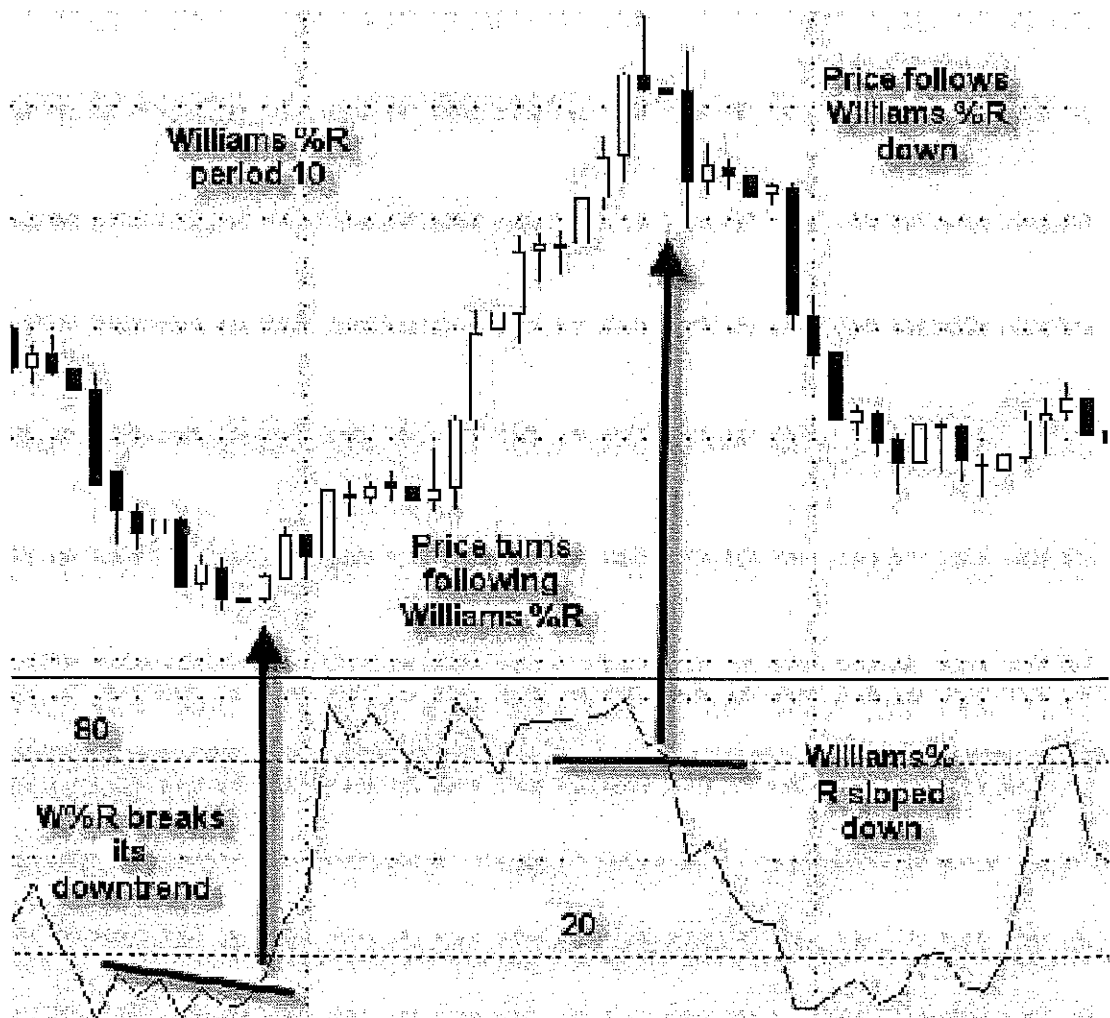
Know How the Price is Oscillating

Oscillator is a fancy word that evokes images of advanced physics experiments where one sees electronic waves on oscilliscopes. Applied to forex, it simply refers to a way to measure how much variation there is in a price movement. Indicators that are oscillators measure price movements within a range of 0 -100. Generally, a reading at or near 100 indicates the price action is at an extreme. High readings can remain the same, but the market is considered overbought. If the oscillator is at a low or near it, the market is considered oversold. It is not in itself a signal, but it is a tool to evaluate what is going on with prices.

Two important oscillators for forex are Williams %R and RSI

Williams % R

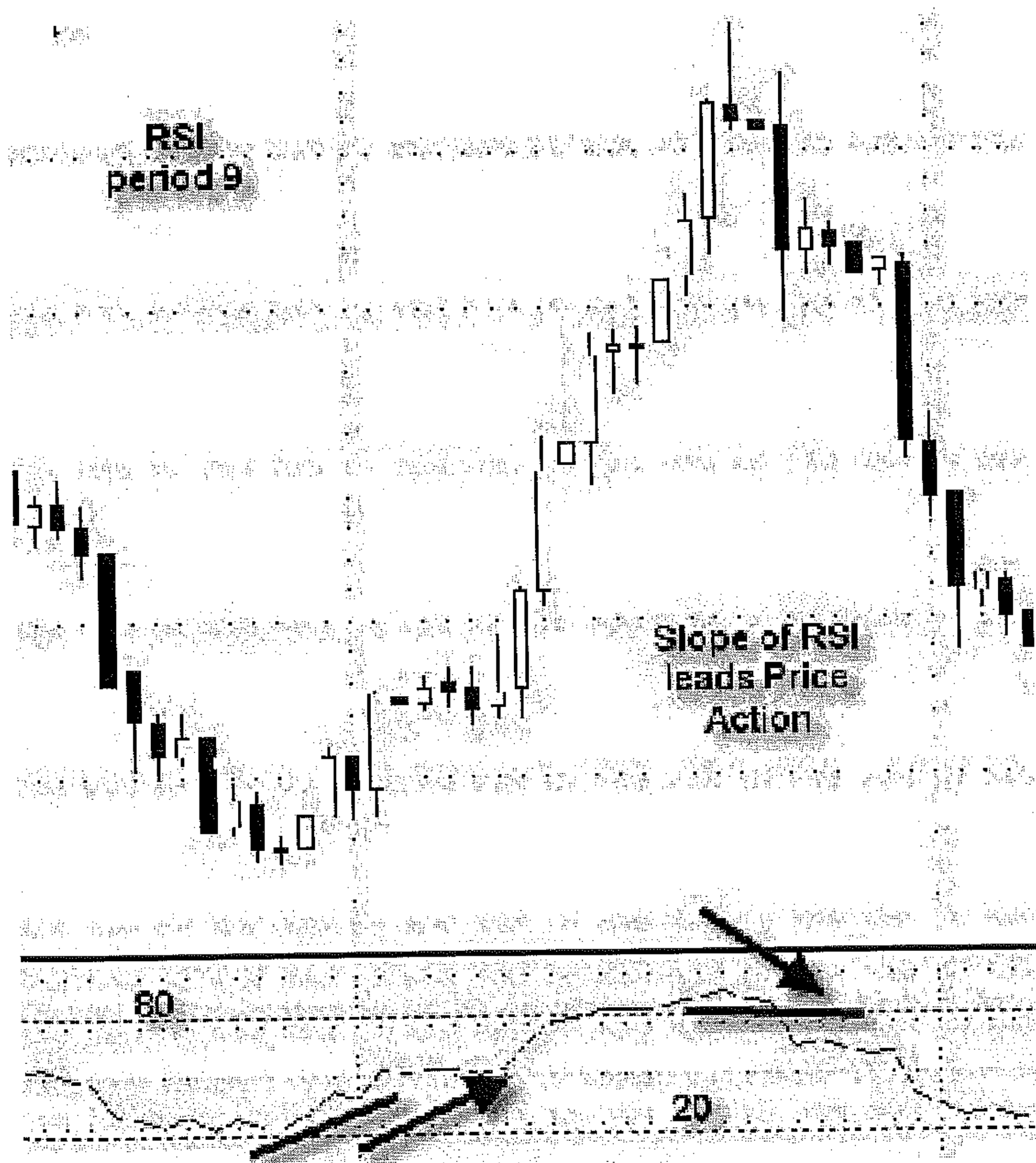
One of the great contributions to technical analysis comes from Larry Williams, who designed the Williams %R. This indicator was developed for commodities but is very useful in forex as well. When the %R line gets close to 90 or 10, you have a situation where the price might be overbought or oversold. Also, when the slope of Williams % R changes, it is a sign anticipating a price reversal.



Charts by: xtick.com

Relative Price Index (RSI)

Relative Price Index (RSI) was developed by J. Welles Wilder. It measures the relative strength of a currency by comparing average positive change in the price for a defined period compared to the average negative price change for the same period.



Charts by: xtick.com

Comparison of Price Action Using Both RSI and Williams %R- Which is Better?

Divergance Analysis

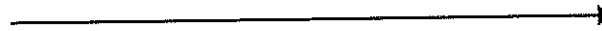
One of the most important concepts when using any technical indicator is to compare the direction of the prices with the direction of the indicator you are using. When there is a divergence between them, you have an alert for a potential reversal or change in the price.

Monitoring Sentiment

Bar charts and candlestick patterns represent the price in terms of its open, high, low, or close, but price action itself can serve as a sentiment indicator. **The advantage of a candlestick chart is that it provides visualization of the price action, and in a sense, a map of sentiment.**

The open, high, low, and close in any time period represents a battle between those who are interested in buying and those who are interested in selling. The buyers and the sellers of the currency pair are placing a bet on the direction of the dollar. Those who are buying the EUR/USD are risking capital that the European currency will get stronger against the dollar. Those who are selling are betting that it will become weaker. Price movement, therefore, can be understood as a signature or reflection of the psychology of the market and a reflection of where the group consensus is.

How can the new trader recognize sentiment by using candlesticks? Does a new forex trader need to memorize all of the candlestick names? Not really. What is necessary is to examine the candles. If the opening and closing price are different, then who won the battle? A closing price that is lower than an opening price is bearish because the price is dropping. A closing price that is higher than an opening price is bullish - buyers had the power. If the opening and closing price are the same or nearly the same, it shows hesitation. Asking who is in control allows you to read sentiment. Some key candlestick patterns associated with sentiment indicators can be seen at:



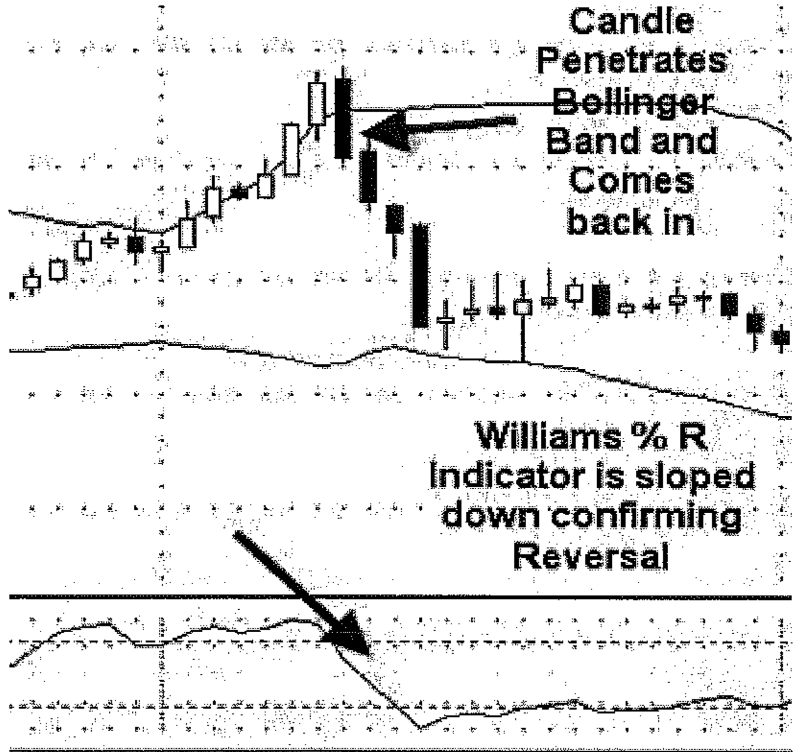
http://www.litwick.com/glossary.html

Confirming Reversal of Prices with Multiple Indicators

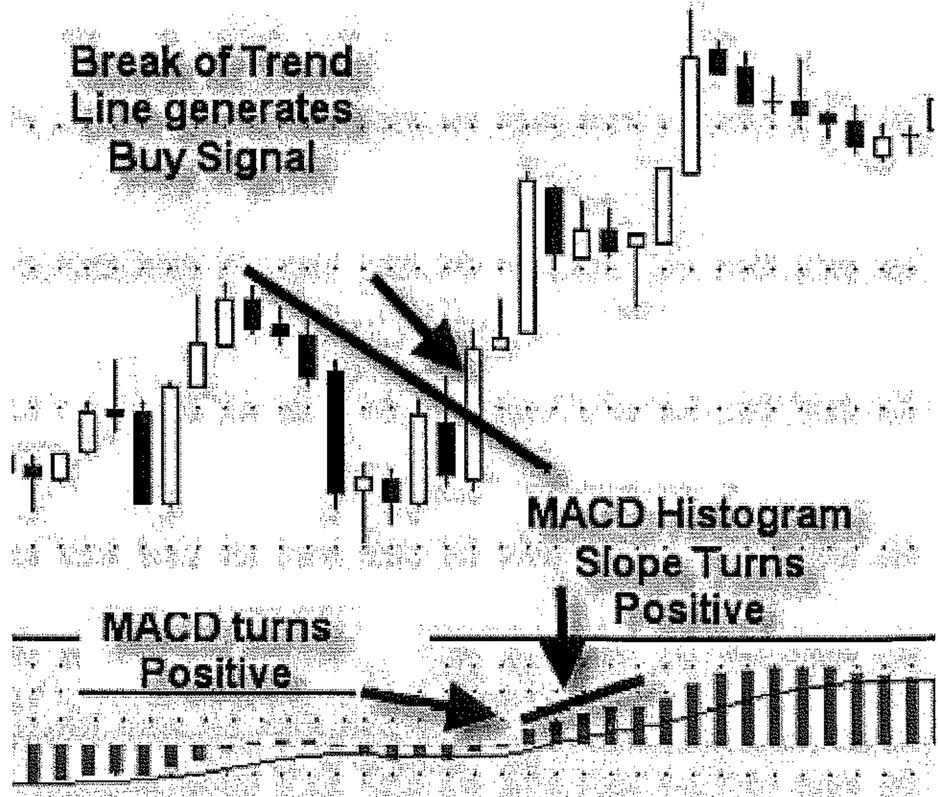
Several indicators can be used together on a price chart to enable multiple confirmations of a decision to trade in a certain direction. We provide several examples. There are many more in our website support.

Reversal of direction using Bollinger bands, MACD, and Williams %R.

When a candle penetrates a Bollinger Band, it may indicate that volatility is at an extreme and, therefore, a reversal of the direction is in order. The probability that a reversal is being set up increases when the Williams % R indicator is also sloped in the direction of the reversal. An excellent time frame for using this is on the 30-and 15-minute charts.



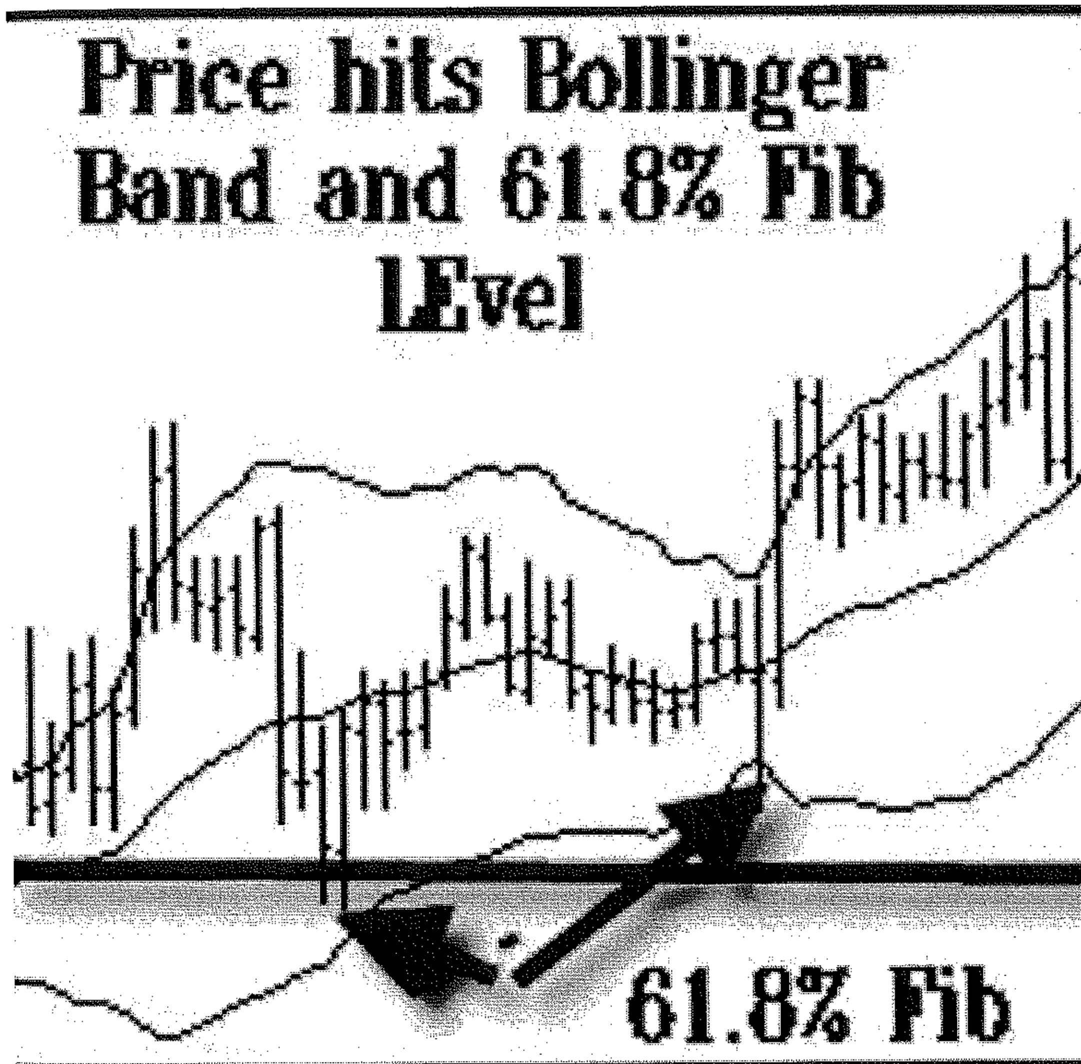
Here we see a break in the downtrend generating a buying signal that is confirmed by the slope of the MACD histogram line.



Charts by: xtick.com

Bollinger Bands Coinciding with Fibonacci Levels

The following chart provides an example of the price action in forex hitting the lower Bollinger band, which coincided with a key Fibonacci resistance/support level. When this occurs, there is greater confidence that, after the bar or candle hits the Bollinger band, it will reverse.



Charts by: xtick.com

Chapter 12

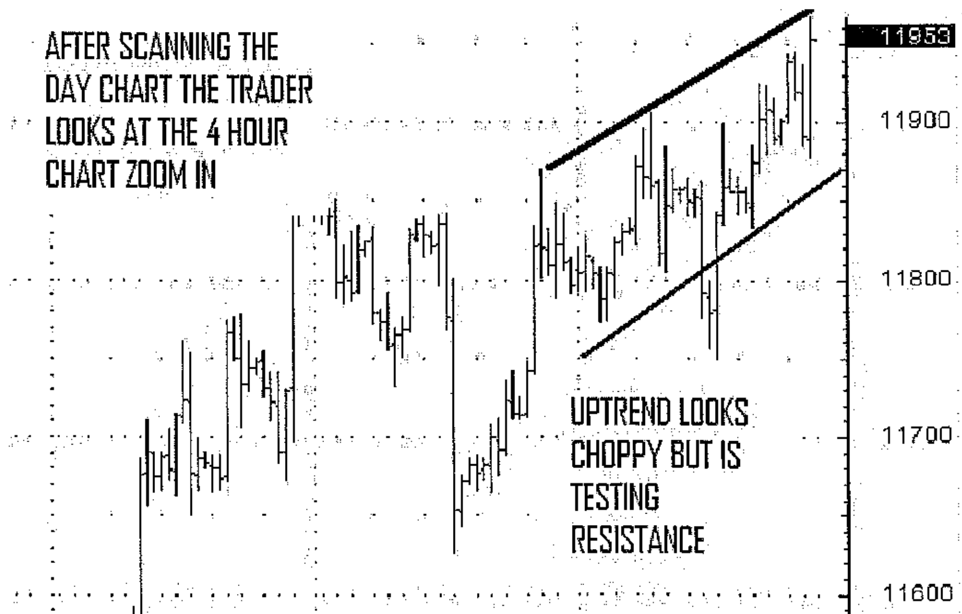
Multiple Time Frame Analysis

Start with the weekly chart to scan the currency pair, proceeding to the day, 4-hour, 30-minute, and 5-minute time charts to shape your next trade.

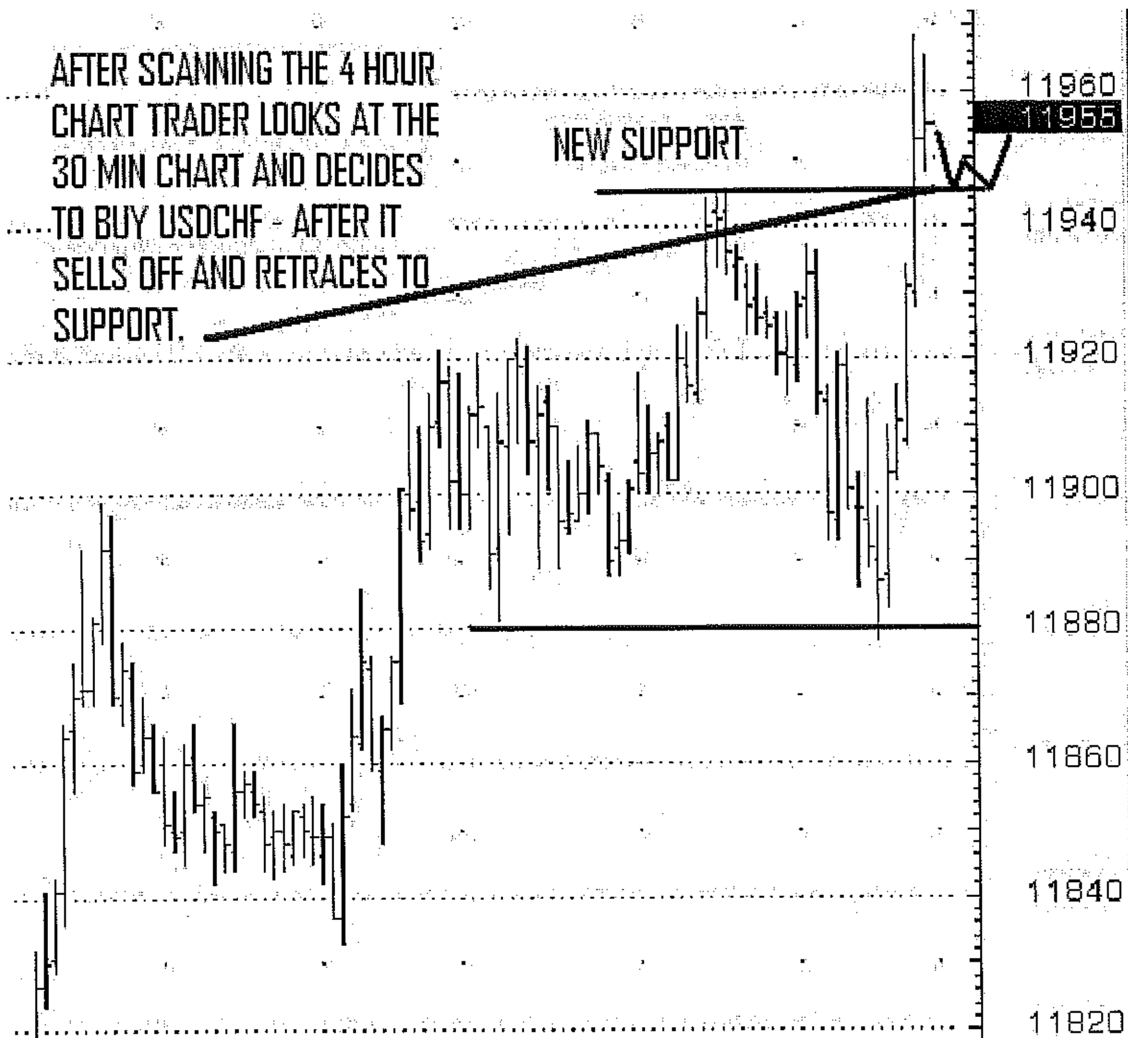
One of the most important techniques in analyzing the forex market and in gaining confidence that the trade you are about to make is a good one, is using more than one time frame to look at price movements. You cannot obtain a full understanding of what the price action is doing by just looking at a day chart or trading on the basis of any single time frame. No matter how many indicators you use, it's always necessary to look at the patterns from multiple time periods. Each time interval generates new information and patterns that may provide new insights about market sentiment. Too often, the new trader adopts a favorite time frame, such as the hour chart, and ignores the others, instead relying on technical indicators. Such an approach is very limited.

Which time frames should you look at? Although there is no definitive rule, you should view at least three different time periods. If you use a day chart for the big picture, a 4-hour and then a 30-minute chart is a good combination. If you use a 4-hour chart to assess major trend directions, then using 1-hour and 15-minute charts makes sense. A good rule of thumb is to shift to a lower time frame until the pattern changes. You can also shift up to a higher time frame to identify larger resistance and support levels. In a real sense, each chart contains its own world of price action. When you compare different time periods, you can see if the same patterns are being sustained. If there is consistency between the day, 4-hour, and 30-minute trend lines, this will be an important indicator in and of itself. When patterns repeat themselves in different time frames, it is not an accident but an example of "self-similarity" behavior, which is a key concept in applied mathematics known as fractal analysis.

The following charts track the effect of zooming in on the price action when comparing different time frames.



Charts by: xtick.com



Charts by: xtick.com

Generally, the function of the longer time frames such as a day chart or 4-hour chart is to clarify the trend direction while the shorter time frames clarify the momentum and sentiment. Of course, confirmation with other indicators is also necessary.

www.pfxtrade.com

Scanning the Professional Commentary

As the forex market matures, an increasing number of web sites are providing top-level commentary. Reading numerous commentaries can be overloading yourself with too much information. There is a tendency among new traders to follow as much commentary as possible. However, a better approach is to develop your own strategy and then see if the commentary supplied by professional analysis agrees with your own decisions. After all, you are the one whose money is at risk.

Chapter 13

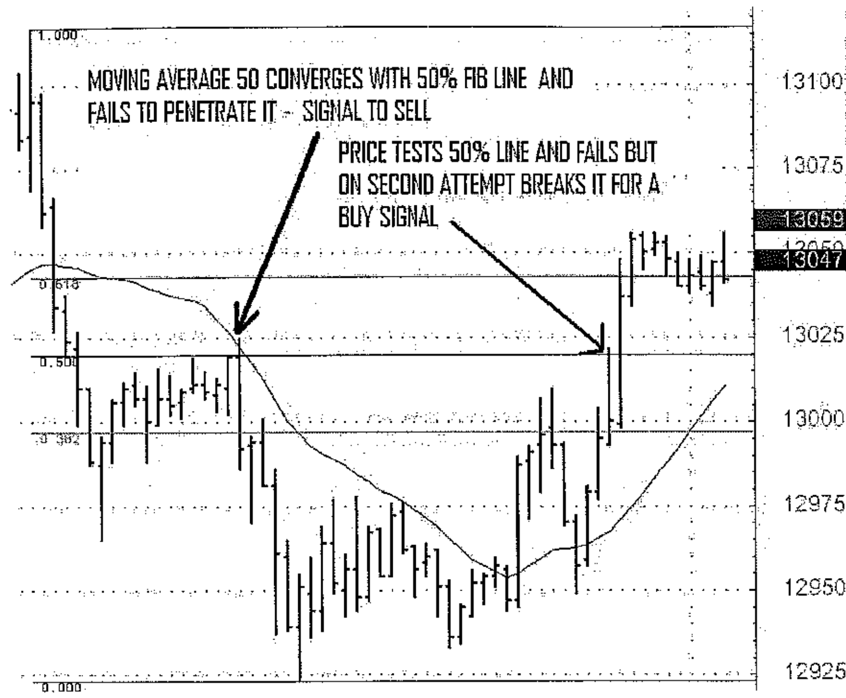
Pulling the Trigger - Where and When to Enter a Trade

Using the common refrain of "Ready- Aim- Fire," you can view the trading decision as a sequence of (1) getting ready, which includes an overview of the markets, evaluation of trends, patterns, etc; (2) taking aim which involves deciding where the trade will occur, will it be near a trend line, key resistance or support? - and (3) actually entering your order.

These parameters involve the geometry of the market. Assessing non-geometric conditions such as volatility or price momentum is also important. But entering on a market order; or an open stop order to execute a trade requires obtaining a **price signal.**

But you should not be delusional. You cannot know with certainty what the market will do. What you can know with certainty is what the market is really doing. Remember Newton's Third Law of Motion that a body will continue in its path unless an outside force intervenes and changes the path. Similarly, the pattern the market is in is likely to be continued, unless something changes. Putting on the trade, the moment of fire, is brought about by seeing a **price signal.** Let's understand what a price signal really is.

At its basic level, a price signal is a break of, or failure to break, a key pattern. For example, when the market is continuing, a trend and the price is not creating a new high or new low but just continuing the trend, we have no new information. What happens if the price creates a new high, or in fact, reverses trend direction and breaks its trend line? That event shows something new has happened and, as a result, is a price signal. Similarly, a failure to break a pattern can be considered a **bounce** off a key support or resistance area. When a price signal occurs, it means something important has changed. It means that the conditions to put on a trade are aligned and in place. When a price signal occurs, the next step is to be sure it's confirmed.



Charts by: xtick.com

Not Trading is a Decision

The notion of a price signal also encompasses the notion of not trading at all. The temptation to put on a trade is strong. But even though the forex market trades around the clock, the conditions for a trade are not the same at all times. Waiting for the market to come to you is a key skill of a successful trader. So when do you trade? When do you pull the trigger?

Pulling the Trigger and Placing the Trade

The successful trader puts on the trade when the key trend direction is selected. This can be weekly, daily or 4 hour, trends. Selecting the trend direction means that the strategy of the trade is determined. The next trade will be in the direction of the trend selected. The location of the trade is based on identifying the next buy or sell zone. You have seen that this can be defined when the price breaks a key trend line or pattern. The price signal is generated by this event. Also the failure to break is a signal. Entering the order to trade can be a market order if you decide to get into the action immediately. It can be an open buy or sell stop order if you want to locate a price above the market for buying and below the market for selling.

Aggressive trading involves making the decision with few confirmations. If a price breaks a 4-hour trend line, you may decide to trade. But when the 4-hour trend line is broken and that break also is a break of a 30-minute sideways pattern and the Williams %R is divergent, you have more confirmation for your decision.15-minute time frames are also very effective in providing identifiable and stable price signals. At less than 5 minutes, price information becomes less reliable

However, before you can actually pull the trigger and place a trade, the last component is the role of psychology your approach to trading.

Chapter 14

Personality, Emotions and the Psychology of the Trader

Tracking Your Confidence Level

Read
The Psychology of the Foreign Exchange Market by Thomas Oberlechner, Wiley Trading

Every trade you enter reflects a personal judgment you are making. Recent research shows that particularly in forex trading a great deal of psychology is involved. Some of the factors that enter into a decision to trade are rational factors resulting from a great deal of analysis. Personal attitudes about risk, reward, and self-esteem are also important. Ultimately, being consistently successful in forex trading requires developing a method that integrates knowledge and judgments.

Getting started in forex trading requires recognizing the role of psychology in the trading decision. A key question that faces the forex trader right at the point of putting on a trade is: How confident are you that the trade is an excellent one? Most people can't answer the question because they are not really evaluating their trades. The ability to improve your trades requires a basis for self-auditing your own performance.

Rate your confidence in your trade.

An effective way of doing this is by applying a rating system. Rate your trade on a scale of 1- 5. A rating of 5 means you believe the conditions are excellent, and you are very confident it will work. A rating of 3 means it's really a hunch trade. A rating of 2 means that you have a hunch, but it is weak. A rating of 1 means there are actually indicators telling you it's not a time to buy or sell.

How valid is this process of ranking your trades? By rating each trade and then comparing the results, you gain valuable insight into mistakes that were made. Are your losses associated with hunch- rated trades receiving a 3? Are your wins more associated with 5-rated trades? Experience using this system has shown that traders can obtain insight into whether their hunch trades work. If they do, then continue to trade because personal intuition or hunches can be effective. But if losses in hunch trades outnumber the losses in high-rated trades then your hunches are not good and you should treat them as contrarian indicators!

Evaluate your own trades

It is a good idea to evaluate your own trading. Most people, however, do not know how. The purpose of evaluating your own performance is to detect weaknesses or errors in startegy. An effective aproach is what we call a Self-Confidence Indicator. Using a self-confidence rating system allows any trader with any level of skills and techniques to evaluate their trades.

Build your own self-confidence indicator

Start by taking each trade and asking yourself ***how confident you are about the trade.*** Which trades look great and which trades look like hunches? If a rating of 3 is assigned to a hunch trade, then what makes a trade get a 4 or 5, or, on the other side, a 1 or 2? Essentially, a 5 is the kind of trade that meets all the technical conditions for entering.

Which trades are hunch trades?

Envision the following scenario: The price action is in the direction of the key trend. The day trend or 4-hour trend is confirmed by lower time frames such as 30 or 15 minutes. The price has tested or penetrated a key Fib line, trend line, or moving average. The volatility is at an extreme. In short, the conditions are aligned to permit the entry. A 4 ranking would mean that it's not meeting every condition but several agree, and there are no contrary indicators. A ranking of a 3 or 2, as we have discussed, is essentially the emotional trade. Your emotions will always be part of trading and needs to be respected. This ranking system allows you to use your intuition, hunches, or other emotional factors to develop a level of confidence for a trade. *Go for it.*

A rating of 1 means that there are important red flags or negative conditions that say don't buy or don't sell. Essentially, you don't do those trades. The use of such a process also improves profitability because high rated trades would receive more lots than lower-rated trades, once you have has really applied this rating to many trades and have established a performance record that lends itself to evaluation. About 20 trades is a good sequence to fine tune the rating system.

When to Stop Trading

It's important to know when not to trade. One of the common problems of new traders is overtrading. Tips to get a handle on this are:

If you have five wrong trades in a row, stop trading for one day.
If you have five right trades in a row, stop trading for one day.

Know Your Trading Personality

Part of the equation of success is the personality of the trader. The personality of the trader shapes the strategy as well as the results. It is impossible to separate emotions from the trade. This is a fact of life, and the challenge is to recognize your own personality, limit the risks associated with your personal style, and channel the emotional energy correctly. How can this be done?

A good beginning is to recognize your own personality as it pertains to trading. There are several personality types, and the field of psychology is devoting a lot of work to modeling what emotions are. In fact, an entire new field of computation psychology and artificial chemistry is working towards mapping how emotions result in behavior. But you don't have to wait until you are at the point where two drops of greed, mixed in a base of fear, results in the predictable market reaction. There is no doubt that the resulting trade is an emotional process that is quite complicated.

To get a handle on how to use emotions, profile your own personality if possible. Translated to trading you can generate several categories. Carl Jung, one of the great contributors to the field of psychology, introduced the concept of archetype, categories that profile types of behavior and personality. There are many ways to characterize personality, and there is no perfect personality for trading forex. Each personality has certain advantages and disadvantages. Here are some forex trading archetypes. Which one describes you?

Archetypes in Forex Trading - Which One Are You?

The Gladiator/Samurai - This person loves to trade even more than winning or losing. Being in the action is the objective. We call it the gladiator type because gladiators had no fear of death and focused on the battle itself. A gladiator type of forex trader has the advantage of focusing on being committed to the trade without being frenetic about the result. The disadvantage of this personality is that it can lead to overtrading and unnecessary losses. Few gladiators survive for long.

The Warrior - Loves trading but wants to win. Avoids trades that are not highly probable and has no allegiance to any one market.

The Gunslinger/Surfer - Relies on emotional and gut feeling to enter or exit a trade. This type of personality often likes to surf and jump from one trading opportunity to another.

The Sniper - Analyzes the market, takes the trade when the market moves only on the conditions that have been have specified. This trading style is similar to swing trading or waiting for a key support or resistance to be tested. Many people do not have the patience or the wisdom to be a sniper trader.

The Lamb - This kind of trader reacts to market moves by running with the crowd. When a lot of such traders come into the market it adds fuel to the momentum of prices and creates emotional contagion. This is a very risky trading style because very often the moment that the trader perceives the crowd behavior, it is too late and the price has been exhausted.

The Black Sheep - The trading behavior of this personality is contrarian. The trader does not join the crowd but seeks an opposite opportunity. It takes courage to be a black sheep. But often it keeps the trader in the "black" in profitability.

What makes forex exciting is that any of theses personalities can result in profitable trading. The forex market provides opportunities for trades that enable each personality style to be applied.

Chapter 15

Strategies for Stop Losses and Profit Limits

One of the most common causes of losses among new traders comes from being stopped out. It almost appears to the forex trader that the market seems to know where your stops are, and takes out those stops and then, adding insult to injury, returns in the direction you originally projected. How can this be avoided? Where should you place stops for optimal effectiveness?

Put a stop where you no longer would be in the trade

The best approach to stop losses is to use them to get out of a trade when it is no longer justified. If you are buying, then a sell stop should be placed where the next sell signal would occur. If one is selling then a buy stop would be placed where the market reverses to justify entering a new buy order. To find the location for the stop loss based on this strategy, ask yourself where would you be placing the opposite trade.

As in all other aspects of forex trading, there is more than one dimension to an answer. If the technical location for a stop loss order is where the price action causes you to do the opposite trade, then what happens if the location is too far away from the entry? An arbitrary amount of 's for a stop can be in direct conflict with the technical situation. One answer is not to do the trade. If the technical location for a stop means too much risk then the trade is not a good trade.

Notice that we have not mentioned a win/loss ratio. If the trade holds a high probability of a win of 40 pips and the best location for a stop loss is 40 pips, the resulting win/risk ratio is 1:1. Is that acceptable? Would it be better to have a win/risk ratio of 3:1 where you are going for 120 pips and risking 40 pips. Of course, trades that have higher win/risk ratios are better than lower ones, but that is true only if the probability of being right is the same for each trade. As a new trader, you need to achieve consistency before you perfect your win/risk ratios.

Using risk management strategies in forex trading provides another layer of control. For example, if each trade risks 2% of your equity and you have $5000 in your account, the risk tolerance level is $100 or 10 pips on the average. This level is very small and will almost guarantee being stopped out. Remember that the forex market has a built-in spread of 3-5 pips. If you raise the risk to 4%, then more tradable situations will arise. The reality, from a money management point of view is that a 4% equity risk per trade means that about 12 losing trades in a row would result in 50% of the account value being drawn down.

Ultimately, there is a balancing act between risk exposure and technical requirements. It is always there. The answer is to maximize the probability of winning by entering trades that have the highest level of confidence. It is also worthwhile to remember that you cannot control what the market will do, but you can control what you will do.

Strategies for Trailing Stops

A dilemma facing the trader occurs after a trade is on and profits are being registered. How do you manage the trade so that the opportunity to lock in profits is seized? Trailing stops become a tool for accomplishing this goal. But where do you put the trailing stop? One approach is to place the stop at a break-even point once profits are being captured. This strategy generates, in effect, a free ride on the remaining lot. Your risk is that the trade doesn't work.

Another strategy for using trailing stops is to move the stop to lock in an arbitrary amount of profits. If you're up 40 pips, move the stop to guarantee 15 pips. A third approach is based on applying technical rules. This means place the stop at the nearest previous resistance or support. If that resistance or support is too far away from the break-even point so that you can't use it, and put the stop on the break-even point. Variations on this approach are to place the stop outside the Bollinger band of the 30-minute or 15-minute period. This strategy essentially uses volatility zones as resistance or support. Additionally, if a Fib level is nearby, using the previous or next Fib level can be a good location for the trailing stop.

Another useful technique is to trail your stop along the trend line. For example, a 5-minute chart provides reliable information on the condition of the trend. If you can draw a 5-minute trend line, then place the stop about 10 's outside the trend line. If the price breaks through its 5-minute trend line, you are stopped out of the position.

For advanced forex traders, very precise trailing stops can be located using 3 Line Break Charts.

Setting Limits

Another common problem for new traders is being right on the trade but pulling out too early, resulting in small profits. So the question arises: where should you set limits for profits? One of the reasons new traders take the trade off is fear of a loss. It is a natural tendency to pull out of a trade when you are watching profits slip away! Its equally difficult to stand aside and not take a profit when you see one. If you obtained a quick $200 on a trade, would it be wrong to take it and run? Such emotional behavior is, in fact, rational.The best approach to setting limits is to trade with three lots and use the following rules:

Rules for Limits

1) Use 3 lots
2) For the first lot, set a profit target or limit of 20 's or $200
3) For the second lot, set a profit target or limit of 60 's or $600
4) For the third lot, leave open with no profit limit

Precise trailing stops can be achieved using 3 Line Break Charts

Three lots allow you to obtain a quick profit if the market moved in the desired direction. The other two lots would enable you to move the stops to either lock in a small gain or a break-even trade. For example, on the second lot the limit would still be 60 's and the trader would leave it on but would adjust the risk to ensure no loss. On the third lot the trader would keep adjusting the stops as the price moved into further profits.

The three-lot strategy allows a higher probability of capturing a big move without sacrificing the potential of a small move.

Chapter 16

Key Principles of Forex Trading

Almost every field has its principles that provide a foundation for performance and prediction. One of the most famous is Isaac Newton's *Philosophiae Naturalis Principia Mathematica* (Mathematical Principles of Natural Philosophy), commonly known as the Principia. It codified and revolutionized the study of physics. Forex traders can only dream about having laws that guide the markets as surely as those that explain the physical world. This book has discussed many dimensions of forex trading, and we can conclude that there are some generally accepted principles that can make your trading less painful.

These principles can help shape the forex trader's develop strategies and tactics for trading. Yet, no matter how many principles are developed, trading forex will always be a combination of technique, art, emotion, and luck.

1 - Asymmetrical Information - In other markets, such as equities and futures, there is a democracy in the distribution of information. price charts for these markets reflect all available information that is relevant to determining whether the market is pricing the instrument logically. Also, these markets have options that ensure the ability of the trader to evaluate sentiment on future values of prices. There is no centralized, accessible option market on spot forex. Options trading is available to the "big boys" who have an advantage by knowing where the calls and puts are concentrated. This represents an asymmetry of information. The average forex trader who believes that everything is in the chart is ignoring a core feature of how forex works. This creates the need to look at longer time frames of monthly and weekly charts that provide more perspective of support and resistance ranges that the market has registered.

The forex trader needs to look beyond the chart for other sources of information to project direction. This leads to the role of fundamental forces.

2 - Fundamentals Cannot Be Ignored - Currencies reflect the status of the world economy. Knowing which countries are in recession, inflation, or stagnation creates the context for long-term currency trends.

3 - News Drives Forex – The word news in everyday usage means surprise. Something you already know is not news. This is true for all markets. But in forex trading, news is always potentially big and reflects global events. Forex traders should know when and how to trade the news.

Straddle trades work well for scheduled news announcements. Many traders wait for news to occur, causing price to go into periods of consolidation. The forex trader knows that the market will move out of this pattern and can prepare for this. This is why mechanical systems have an inherent flaw. They fail to incorporate news and fundamentals. When news shocks occur, the signals are not reliable and will fail.

4 - Prices Reflect Mass Psychology – The value of a currency pair is the cumulative reflection of millions of decisions made by traders around the world. Prices are psychological signatures of sentiment. Traders who understand market psychology will realize that prices and opportunities cluster. For example, if the euro is breaking out, then the Swiss franc and British pound will tend to provide similar patterns. One currency pair may take the lead, but others will follow as momentum toward a trend direction emerges. Accepting the role of psychology reflected in chart patterns is a better understanding of what a "price signal" is. A price signal is a break or failure to break a key pattern or parameter. The task of the trader is to find the multiple parameters that provide evidence that a price signal is being generated.

5 - Trading Involves Emotions and the Use of Emotional Knowledge The concept of trading forex mechanically has a major flaw. It presumes that the forex market can be predicted and modeled. Mechanical systems cannot effectively factor in the news or reflect the complexities of the global economy. But the trader has a more powerful computer, the human brain. The ability to recognize patterns and assess changes in sentiment in the market will significantly improve trading. Successful trading also requires the ability to tap emotional knowledge; the sense of opportunity by using emotions should not be ignored.

6 - Rule of Three – The number three is significant for all traders. A good example is the use of multiple time horizons. While trading, place your trade in the context of three time intervals. Some use four-hour, 30-minute and five-minute charts. There is no set rule for which three time intervals should be used, but using three different charts with large, medium, and small time periods is a key habit of successful traders.

Another important expression of the rule of three is multiple confirmations. When prices break through a key resistance or support line, expect the third breakout to be the defining one. Also, when identifying a trend line, use the rule of three as the criteria that three consecutive candles can compose a trend. In charts such as point and figure and three-line break, three is a key reversal factor. In pivot point analysis, the number three is used to generate the key levels: (Pivot Point = (H + L + O)/3). In placing your trade, you have three components: an entry, stop-loss and profit-limit. Even managing the trade entails three parts: a cash or profit objective, a technical reason for entry or exit, and an emotional judgment on when to get in or out.

7 - Projection, Not Prediction – Forex trading requires a projection of the price patterns, not a prediction. Projection works well because forex prices form patterns as sentiment aggregates together.

8 - Scalability – Forex price patterns often repeat themselves in different time periods. This is also known as a fractal basis of price movements.

9-Multiple Time Comparison – Integrating the big picture with moments of opportunity is a principle of trading in forex that provides one of the most powerful technical tools. When a trend direction of the day is discerned and the trend direction of a smaller time frame like the 15-minute pattern is aligned, then the principle of multiple time comparison is being applied.

10 - Price Signals are Bounces or Breaks of Patterns

This principle focuses on the nature of price action. Bounces are more stable than breaks because prices tend to stay in patterns, trends, ranges, etc. most often, prices will, in fact, be testing the boundaries of those patterns, creating bounce trades. Prices breaking through a pattern will try to return to the previous pattern. This is commonly known as retracement.

11 - Trading Is a Business

Of all the principles of forex trading, the concept that forex trading is a business gets the most neglect. Trading is about choices and costs. The role of the trader is to perceive the huge number of trading possibilities and then perhaps participate in the trades. Not trading is also a rational choice. The more a trader knows why a trade was made and why a trade may have been avoided, the potential for improving trading skills over time will increase. Forex trading, like a business, has built-in costs. Commission-free trading is misleading because the cost of the trade is embedded in the spread charged to the customer. When you see each trade as an input with profits or losses as outputs, you are operating your business with the goal of making money.

Chapter 17

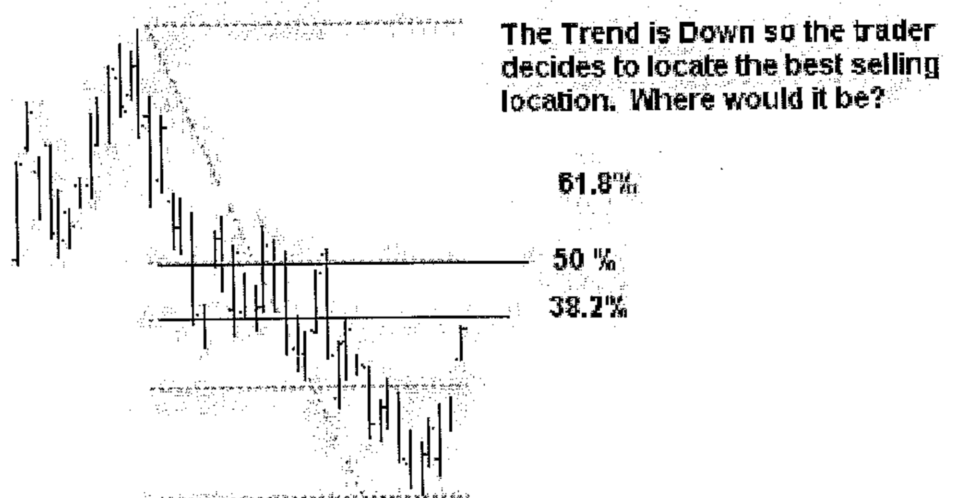
Useful Strategies and Tactics You Should Know

Here are sample trades that illustrate the application of the major analytical technique or indicator involved.

1) Fibonacci Trading

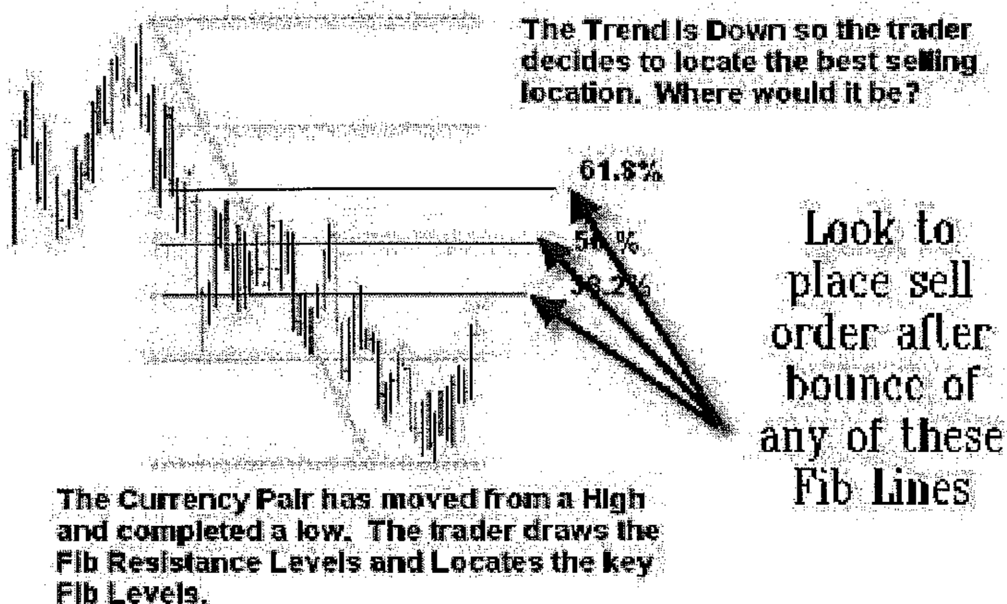
The key strategy is to use Fib levels as targets for your next trade. Here is an example.

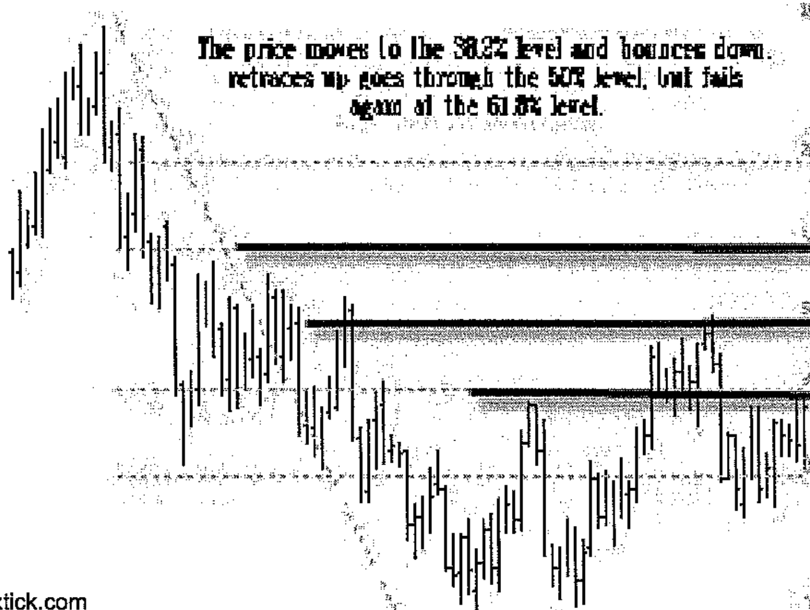
Draw Fibonacci resistance levels when prices make big moves from high to low, or, low to high.



Charts by: xtick.com

A Fib strategy would be to get ready to sell if prices bounce off the key 38.2% Fib line.





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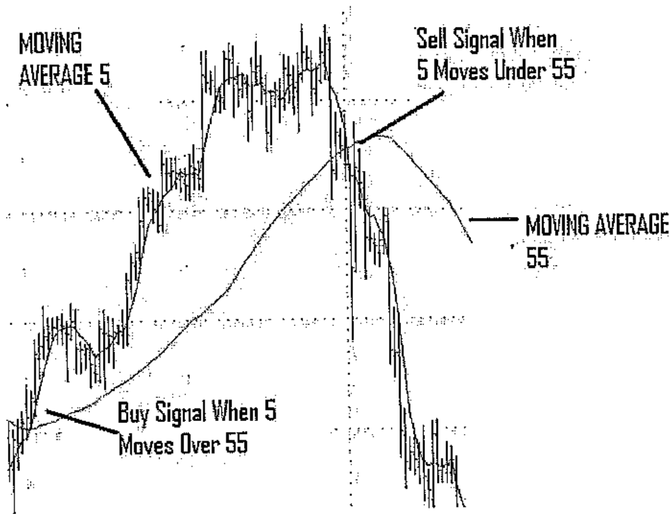
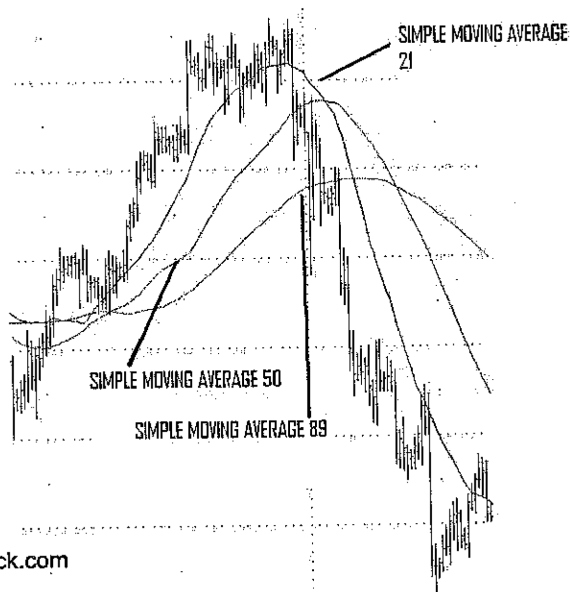
Moving Average Crossover Strategies

It's useful to assess price action with a moving average crossover. The concept is to use a longer moving average period against a shorter one - for example the 55-period simple moving average vs. the 5-period simple moving average. When the shorter moving average, crosses above or below the longer averages it may signify a change in direction. Moving average crossovers are lagging indicators and need to be confirmed by other technical tools.



Multiple Moving Averages

A very useful application of moving averages, championed by Darryl Guppy is the use of multiple moving averages. When you place four multiple moving averages on a chart, it can give you a graphic picture of key support and resistance areas. Also, it provides more information about the momentum. If an area shows moving averages that look like they are compressed close to each other, it is a sign of strong support or resistance and a prelude to a breakout. The example below shows three moving averages that are essentially based on Fibonacci numbers. We have the simple moving averages 89, 50, and 21. Exponential moving averages can also be used.

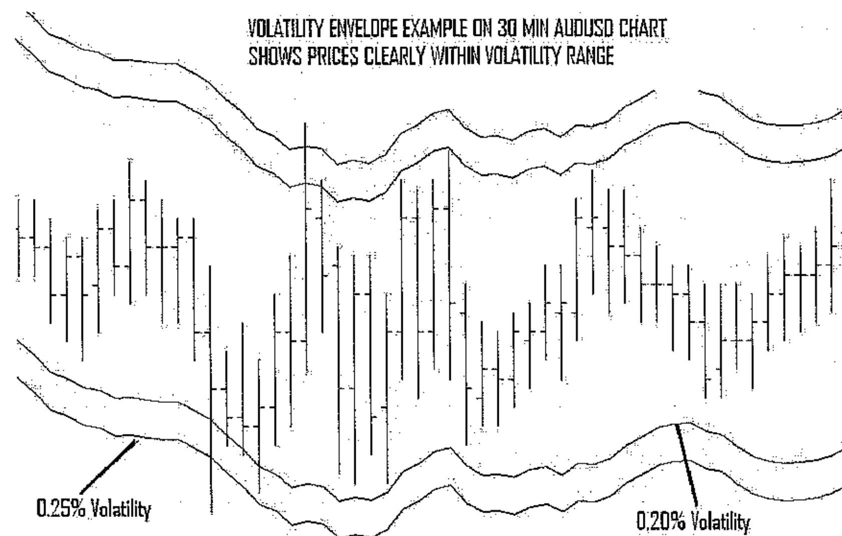


Charts by: xtick.com

Volatility Strategies

Often when prices move significantly, they face the increasing potential of exhausting themselves. Using volatility as a measure provides confirmation of when the volatility is at an extreme and is, therefore a reversal indicator. Volatility can also be used to pinpoint areas of support and resistance.

The 30-minute chart below shows a volatility band with a simple moving average for 10 periods. The band is set to 0.25% volatility. This setting is arbitrary. The key idea is to have the volatility envelope encompass 90 % or more of the price action. The bands provide a good location for stops or limits, because they act as effective support or resistance areas. Combining volatility bands with trends and other indicators is a useful confirmation tool. As the time period shifts, the setting of the volatility bands will need to be changed. For example, on a 4-hour chart, a volatility envelope of 0.75% usually provides a good fit. As a lower time period is used, a lower setting seems to be more effective and useful.



Charts by: xtick.com

Trading News Reports

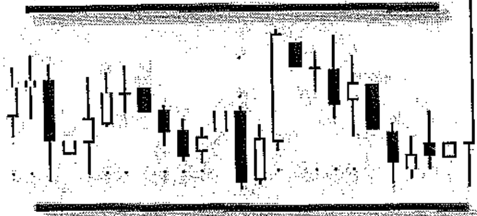
We have seen that when a scheduled economic report comes out, it is usually accompanied by a big move if the news differs significantly from expectations. There are several strategies for trading the news.

Play the Retracement after the News Surge Retracement-

We know that fast price moves often lose their momentum and retrace part some of the move. Often this retracement occurs along Fibonacci resistance and support levels. Often 50% of the initial move is retraced. Therefore, one strategy for trading the news is to step aside and wait for the move to occur and then trade when the market gives back the move. Some news moves take only a few minutes for the retracement to start. Others take a few hours.

Straddling the News

An alternative strategy is to straddle the news. This involves placing orders before the economic announcement. The trade could involve a market order or open stop orders both to buy or to sell. This places you on both sides of the market. If a big move happens, one side will be executed and the other side will be cancelled. The risk in this technique is a whipsaw in the action where the move goes first in one direction and then reverses. This can happen. However, a great deal of the time there may be no movement at all when there is no surprise in the news. Some platforms allow for an OCO order where one side cancels the other when one side is executed. The trader who wants to practice this strategy needs to be sure that the forex platform used for trading, as well as the company processing the trades, will allow straddles. Some firms may seek to disallow open stop orders before a news announcement.



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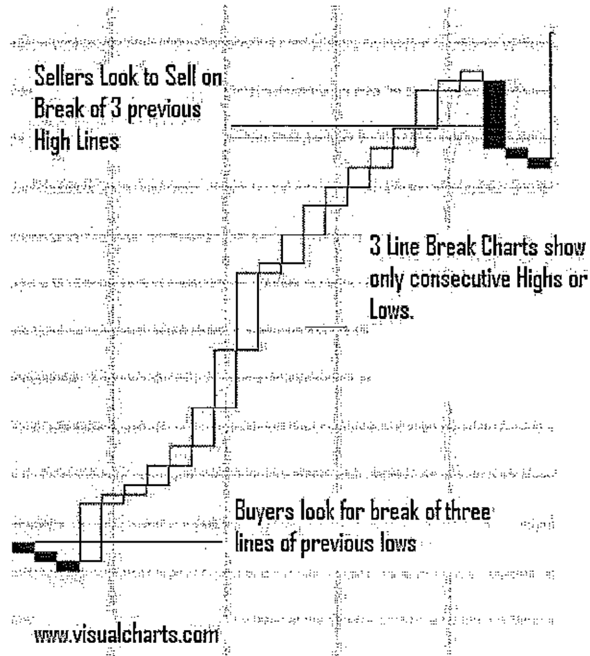
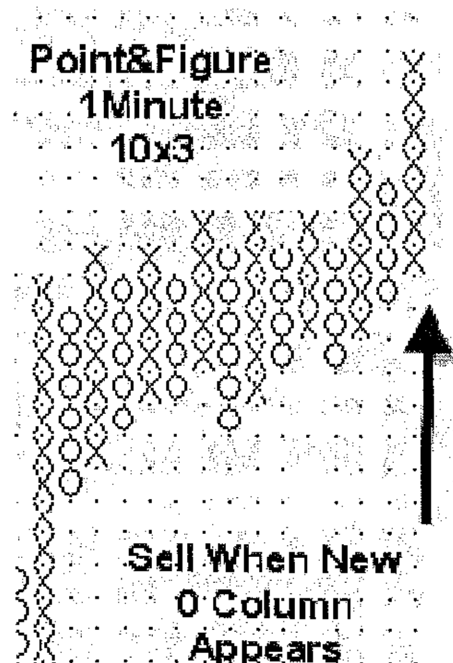
Trend Reversal Trading with Three Line Break Charts



A major potential tool for the trader is 3 line break charts. They help point to where a reversal will occur in any time period and they can be used even at the 1-minute level. Trend reversals are effectively located when prices exceed the prior three high or low lines. When this occurs it provides unambiguous for entry and a tool to confirm your trading decision.



Point and Figure for Sharpening your Trades

Using a point-and-figure chart provides independent confirmation of momentum and trend reversals. The chart shows a trade based on an upward trend direction. After the trade is placed and profits are occurring, you use a point-and-figure chart of 10sx3 to spot a change in the control from buyers (X column) to sellers (O column.) You will wait for a new O column to appear and then get out.

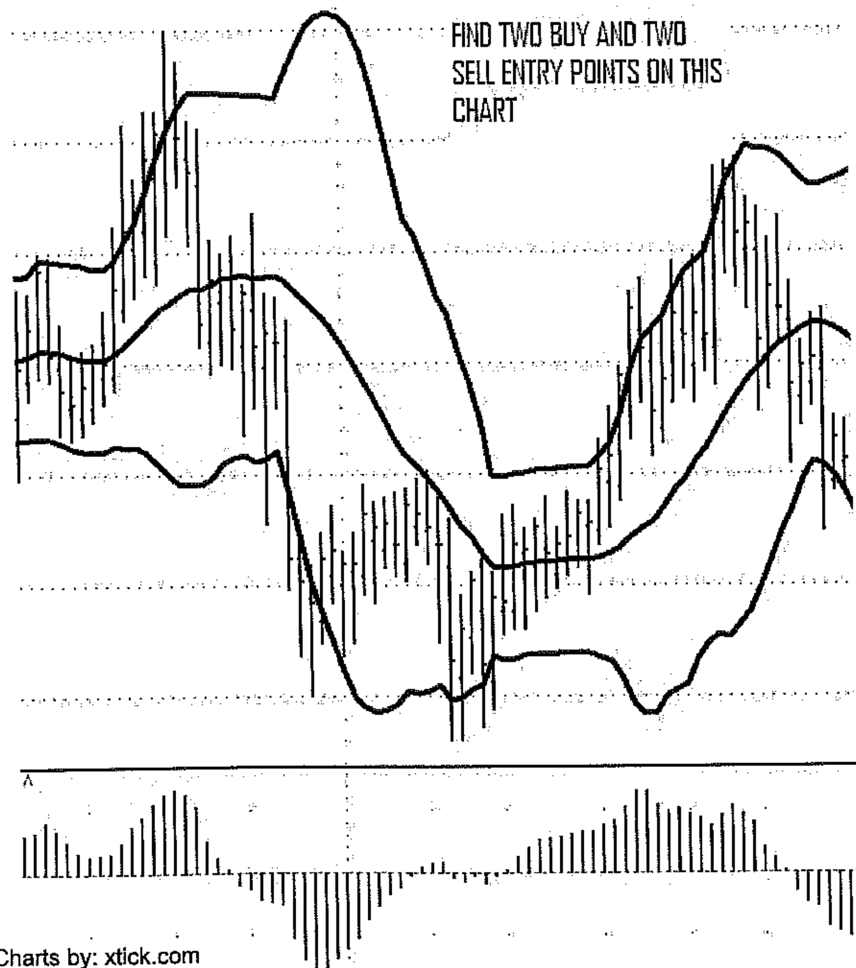
Chapter 18

Chart Challenge - Test Your Knowledge

It's always a good idea to test your knowledge on evaluation of forex markets. Adding to your core skills is an on going activity. In this chapter and in our web support, we provide chart challenges to stimulate your thinking.

Go to www.iknow4x.com/book for 50 more chart challenges!

Each chart has a question for you to consider. Compare your answers to the chart challenge with our answer on our web site.



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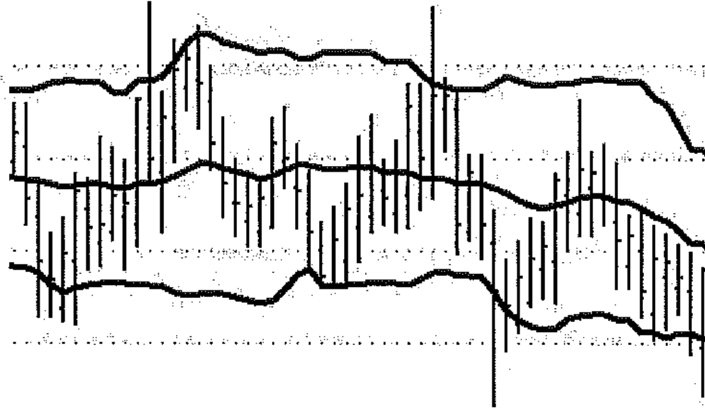
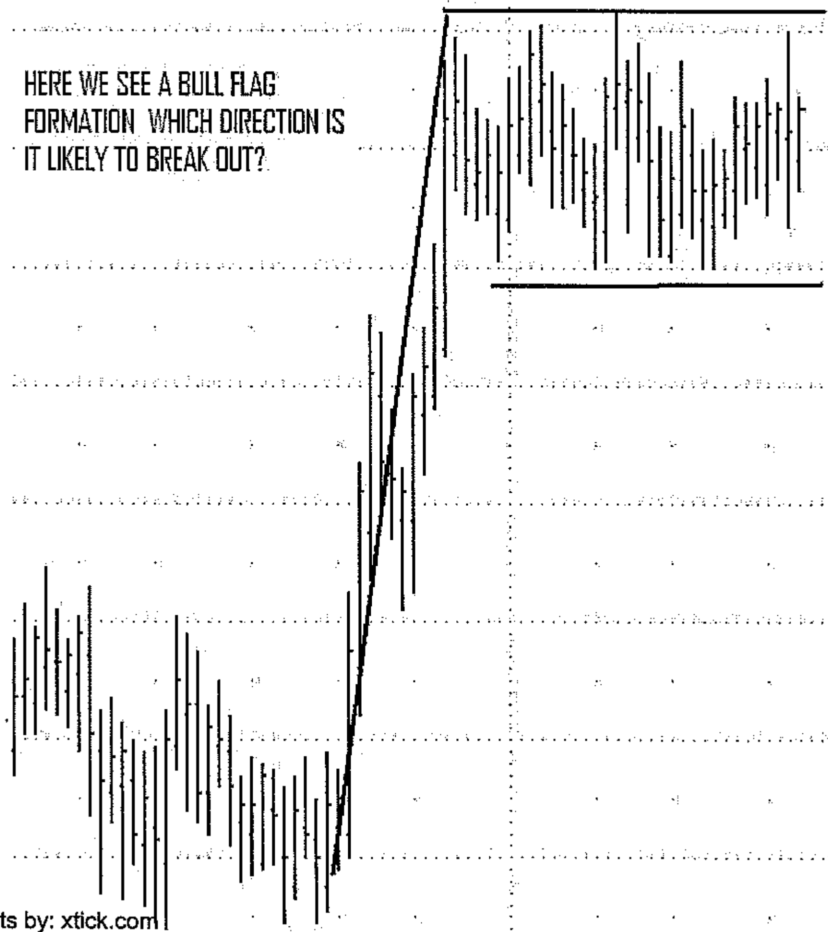
THE CURRENCY PAIR HERE IS A 60 MIN CHART. THE DAY TREND IS DOWN. IF YOU CHOOSE TO SELL, PICK TWO LOCATIONS FOR YOUR NEXT SELL TRADE.





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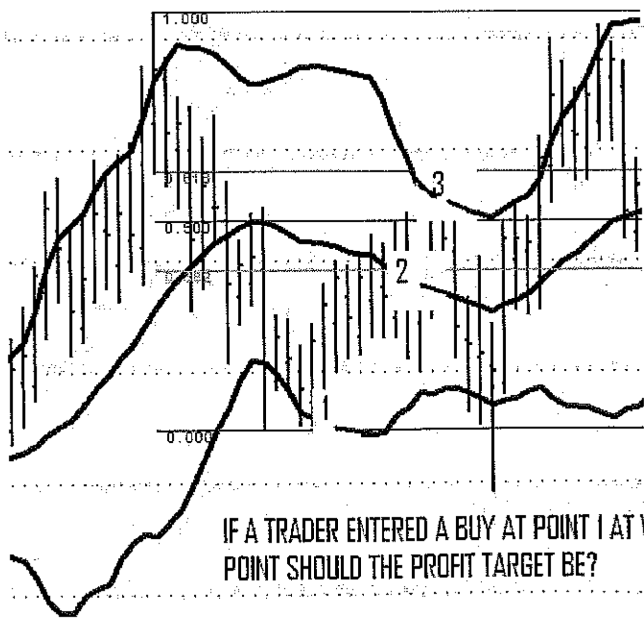

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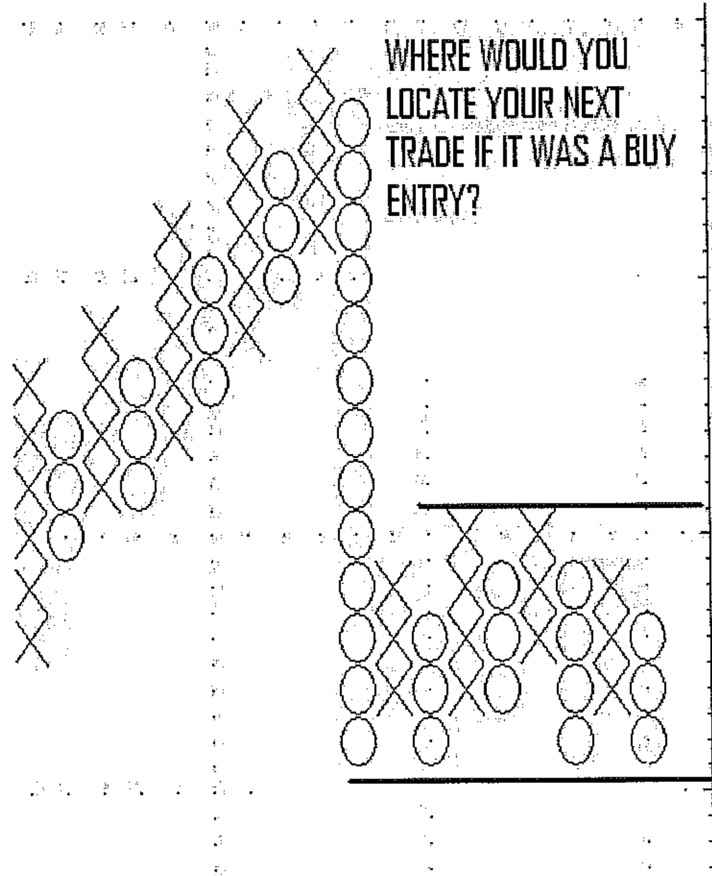

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Chapter 19

Test Drive Your Forex Trading Skills - How to Use a Demo Account to Prepare You For Real Time

All forex firms offer a demo account, but few, if any, have provided direct training on the demo account. This book is designed to remedy this gap and provide a detailed guide to using demo accounts to build forex knowledge and skills so that ultimately the risks of real trading are reduced.

Like many professions where risk is encountered, taking forex trading seriously requires ongoing training. The airline pilot flies in simulation many hours before actually flying passengers. The simulation tests reactions to scenarios that enable practice of risk management. Similarly, a demo forex trading account can become a major tool for improving your trading skills. Misused, it can be useless and actually counterproductive. Many people, after doing very well in a demo account, proceed to lose money in a real account. On the other hand, few people who lose money in a demo account proceed to be profitable in a real account. This is so because the demo account needs to be treated as a serious opportunity to test your knowledge, evaluate your errors, and improve your skills.

Open two demo accounts. One demo account seems the right way to go, but most people actually need two. One account should be used strictly to test ideas and methods. Use the second account to place hunch trades and try out your own ideas. This will allow you to improve your skills more quickly.

Key Demo Exercises That You Should Do Any Time!

These exercises are designed to test the analytical skills you have learned in this book. They are designed to stimulate thinking and for you to observe the market in a structured way.

KEY EXCERCISES FOR YOUR DEMO ACCOUNT

1) Scan the weekly forex charts, put on trend lines, and Fib levels. Find the location for your next trade based on this weekly chart. Would you be a seller or a buyer? Write down the specific reasons that led to your trading decision.

2) Place a 233 period exponential moving average and a 50-period simple moving average on the day chart of the currency pairs. Which currencies have penetrated or tested either one? Do these moving averages cross any key trend line or Fib line?

3) Look at the EUR/USD and the USD/CHF. Now visualize what kind of pattern would be generated by a crosspair that has the EUR/CHF. Will it be a sideways action, uptrend, or downtrend? Generate the EUR/CHF chart on a day, 4-hour and 30-minute chart. Are the patterns on each time frame the same? If different, what does it tell you about the price action emerging?

4) Generate the following charts: EUR/USD DAY, EUR/USD 4 hour, EUR/USD 30 minutes. Draw trend lines on all of them. Decide which way you would trade and where. Now generate a 5-minute chart and draw a trend line on it. Does it confirm your earlier decision?

5) Scan the forex pairs and locate the following patterns on the 30 minute time period:

Ascending Triangle
Descending Triangle
Flag
Uptrend channel
Downtrend channel

Repeat the exercise for the 15-minute pattern. Is there a change in the 15-minute pattern?

6) On your next trade in your simulated account try three lots instead of one lot. This will apply to any size account, whether it is a mini or regular account. Do the following:

Place three lots to open at the market after you have made a decision to trade a currency in either direction. Then for the first lot place a stop loss of 20 's. For the second lot place a stop loss of 50 's. For the third lot do not have any stop. After you have placed your stop loss

orders, do the following: Place a 20's limit for the taking profits on the first lot; place a 50's limit to take profits on the second lot; place a 90 limit to take profits on the third lot. Walk away and come back in two hours and see what happened.

7) Generate a day chart and find the lowest low and highest high. Generate Fib levels, then draw trend lines against it. Now locate where you would look to place your next trade.

8) Generate a 30-minute chart on each currency pair and place on it Bollinger bands and Williams% R. Notice which candles or bars are penetrating the upper or lower Bollinger band. Is the price ready to reverse?

9) Generate a 15-minute pattern and place a 55-period and a 5-period simple moving average on it. When they cross, initiate a trade in the direction of the shorter average crossover. Also place a 25's stop and a 25's limit on the trade. See how many of these trades based on the crossover strategy work out. Let us know!

10) Scan the USDX - (U.S. Dollar) Index and generate a six-month day chart with a 50-day simple moving average. Draw trend lines. Determine the general trend direction of the dollar. Is it up, down, or sideways?

11) Generate a 60-minute chart on any currency pair. Find the support and resistance, find the doji candle, and put a circle on it.

12) Write a description of the price action on any currency day chart. Assume you are working as a bank analyst and write a paragraph describing the price action. Send it to us and we will comment. Email: learn4x@earthlink.com

13) Go to the day chart of any currency and draw a trend line. Which direction is the price going? Go to the 4 hour chart and draw a trend line? Which direction is it going? If both are in agreement, go to the demo account and put on a trade in the direction of the trend. Put on a close or profit limit of 20 's, no stops. Watch what happens. If you are losing in the trade, leave it alone. Let the trade work. Watch how long it takes for the trade to become profitable (this may take a short time or many days).

14) Find a day chart of any currency and locate the key Fibonacci lines. Then take those same lines and shift to a 30-minute chart and select the envelope indicator. Use a 10-period simple average. Notice how 95% of price action is within the volatility band. In your

opinion, about to reverse?

15) Find the economic calendar and locate the date and time for an economic news release on U.S. employment. It usually occurs on a Friday at 8:30 a.m. EST. At that time watch the movement of the prices right after the release. Use a 1 or 5 minute chart. Is it surging up or down?

How many bars or candles did it take to stop surging? As soon as it stops surging and goes sideways or down, draw a Fib line on it to project the next level of resistance. Did it go to that Fib line?

16) When you are putting on a trade in a real dollar account, use the demo account to put on the same trade, but in the demo account vary the trade by widening the stop to 50 's and widening the limit. See what happens.

17) Locate the following cross pair: GBPEUR or EURGBP. Locate the 4 hour pattern. Place Bollinger Bands on the 4 hour pattern. When the price goes to the upper band wait for it to come back under it and then sell atthe market with a stop 50 's above the upper Bollinger Band. Now locate the middle of the Bollinger band and put a close limit order at that location. See what happens.

18) Find the next scheduled testimony of Alan Greenspan and before the testimony put on a trade of buying the EUR/USD on a stop 20 's above the market price and selling the EUR/USD on a stop 20 's below the market price. Watch what happens.

19) Put on 20 demo trades with each trade having 1 lot. While you're putting on the trade, give each trade a ranking of 1-5.5 being the most confident trade and 1 being the least confident trade. Assess the results. Do the losses cluster on the trades ranked below 3? Do the wins cluster on the trades ranked 4 and 5?

Repeat the exercise with the next 20 trades. This time place 2 lots on the trades ranked 4 and 5. The win/loss ratio should be the same, but the average gain/ average loss ratio should be greater.

20) On a day chart put on a Fib level and then also generate a new Fib level by zooming in on an hour chart. The result is a Fib level within a Fib level. What do the results show?

DEMO TRADING WITH REAL ACCOUNTS-

An effective tool to hone your skills is to have a demo account alongside the real dollar account. Use the demo to test variations of your real trades. If you are trading one lot in your real account, put the same trade on in your demo account and add a lot. On the second lot, vary the limit or stop. This provides a sensitivity analysis so you can examine aspects of your trading not readily apparent.

Part Three:
Test Drive Your Knowledge

Learn how to apply the concepts in this book and test your skills.

Chapter 20

Ten Steps Before Trading Forex

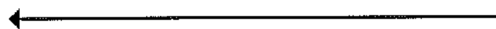
You should trade forex in an environment that is conducive to trading, not in the middle of your bedroom or family room where other members of the family are interrupting. The workstation should allow easy scanning of the markets. Many traders have multiple screens. You don't have to get carried away. A two-or-three screen system helps a lot where one screen is for internet-based scanning, e-mail, etc., and the other two screens are devoted to presenting market charts that are used to evaluate price action.

1. GRAB A CUP OF COFFEE, CHECK BANK REPORTS AND PROFESSIONAL ANALYSIS FOR OVERALL REVIEW

See what the pros think about the currency market

As a forex trader, you can access many daily published reports around the world. Many banks have currency research and release daily commentary. Information portals have developed that enable you to enhance your knowledge. Reading these reports provides a top down look at the world. For the beginner it can bring to light trading opportunities that they would not have noticed otherwise. Reading too many of them, however, is not advisable! The result may be overload and a bit of boredom because they are all very similar. Some good websites that provide excellent professional commentary are:

http://fx.mellon.com/currencyresearch/globalfxdaily.html



www.pfxtrade.com

2. SCAN THE LATEST NEWS ON THE CURRENCIES WITH GOOGLE

Navigating the internet to get the latest news on the U.S. dollar or any currency pair is quite effective. Here is how you do it. Go to **http://news.google.com** . Then enter a term for the currency. You will obtain the latest news on that currency pair. It will even list the time the news came out! In just a few minutes you can read what the latest thinking is around the world on any currency pair. You can also set up automatic tracking of the news on the currency pair you like.

3. ***SCAN WEEKLY AND DAILY CHARTS FOR TREND ANALYSIS AND PATTERNS.***

4. ***SELECT PREVAILING TREND DIRECTION AND TRADE WITH THAT DIRECTION WHEN APRICE SIGNAL OCCURS AND IS CONFIRMED.***

5. ***IDENTIFY THE NEXT BUYING AND SELLING TRADING ZONES***

6. ***ZOOM IN ON PRICE ACTION BY COMPARING THE 30-MINUTE AND 15-MINUTE CHARTS.***

7. ***SHAPE ENTRY AND LIMIT STRATEGIES TO MEET RISK MANAGEMENT GOALS.***

8. ***RANK EACH TRADE FOR CONFIDENCE LEVEL ON A SCALE OF 1- 5. THEN DECIDE ON THE NUMBER OF LOTS TO TRADE***

9. ***PUT ON TRADES WITH OPEN MARKET ORDERS OR OPEN BUY OR SELL STOP ORDERS***

10. ***PUT ON STOP LOSSES AND LIMITS***

This 10-step process is a map or guide that allows you to evaluate global and market conditions to determine what's going on in the market and pulling the trigger when it is time to enter a trade. At the same time, the trader overlays risk management to control the risk. There isn't any one way to accomplish the tasks of trading. Social scientists call this kind of system one that is equipotent, meaning many ways to get to the end result. Every person is different and sees the opportunities differently. But what needs to be consistent is a method. All methods can be improved upon.

A FOREX CHECKLIST AND LOG

Before each trade make sure you can answer these questions:

1) WHICH CURRENCY PAIRS ARE IN A WEEKLY DOWNTREND?

2) WHICH CURRENCY PAIRS ARE IN A DAILY DOWNTREND?

3) WHICH CURRENCY PAIRS ARE TESTING THEIR TRENDLINE (WITHIN 50 S)?

4) WHICH CURRENCY PAIRS ARE ABOVE THE 50-DAY MOVING AVERAGE (SIMPLE)?

5) WHAT IS THE DIRECTION OF THE U.S. DOLLAR INDEX?

6) WHAT IS THE TREND DIRECTION OF GOLD?

7) WHERE IS THE PRICE OF THE U.S. DOLLAR INDEX IN RELATION TO ITS 50-DAY SIMPLE MOVING AVERAGE?

8) FOR THE CURRENCY YOU'RE SELECTING TO TRADE, WHAT ARE THE FIB RESISTANCE LEVELS ON THE WEEKLY CHART OR DAILY CHARTS?

9) IS THE 30-MINUTE PATTERN ALIGNED WITH THE DAY OR 4 HOUR CHART?

10) LOOK AT VOLATILITY USING A VOLATILITY INDICATOR, SUCH AS BOLLINGER BANDS OR WILLIAMS % R. ARE THE BARS OR CANDLES PENETRATING THE UPPER OR LOWER BANDS ON THE 30-MINTUE TIME CHART? IS VOLATILITY AT AN EXTREME?

11) IS THERE A CLEAR CHANNEL, TRIANGLE, OR PARABOLIC PATTERN NOTICEABLE?

12) ARE THERE ANY ANNOUNCEMENTS SCHEDULED WITHIN AN HOUR OF THE TRADE?

13) WHAT ARE THE PROFESSIONAL ANALYSTS SAYING?

Chapter 21

Conclusion: Paths to Success in Forex Trading

Forex trading, it should be clear by now, offers major opportunities and is both challenging and exciting. Yet many people want to start trading Forex without the necessary training. There are many paths to success in trading Forex and many strategies one can use. But successful traders have one thing in common- training and experience. The goal of this book is to provide a framework of knowledge and skills and in-effect a map of what forex trading involves. Another way to characterize the paths to success is to summarize some key steps everyone needs to think through:

Step 1: Learn to Think Clearly and Analytically- Understand how fundamentals and technical analysis works together.

Step 2: Test Your Knowlege and Skills

Always test your knowledge and skills- before you risk capital. You learn how to apply these skills in real-time situation and shape trades.

Step 3: Custom Learning, Private Mentoring, Constant Contact

Everyone learns at a different pace. Don't rush into trading. Explore different courses offered by professionals. The best provide private mentoring to allow one to learn the most effective way.

Step 4: Risk Management

Successful trading requires staying in the game. Learning risk control and managing your trades is a key to moving from the level of beginner to making Forex trading a career. .

The bottom line is you have already started on your journey.

Appendix

Currency Trading Terminology - the Most Important Terms

A person new to currency trading may become confused by the terms involved. Every new field has its own terminology. Forex has its distinctive features. Let's look at a few.

FOREX- really an acronym for (For)eign (Ex)change.

SPOT- the cash price market. Options and futures contracts are on the spot cash price.

CURRENCY PAIR- This may seem complicated at first. A currency pair has a top term and a bottom term. Consider EUR/USD. This is read as Euro vs. dollar. The top term is the value of the currency in terms of the dollar. If the EUR/USD was 1, then the EUR would be equal to a dollar.

A person from Europe coming to the U.S. would exchange 1 Euro for 1 U.S. dollar. If the Euro rose in value and reached 1.25, then the traveler would be able to get 1.25 dollars for his Euro- a nice increase and as a result, a less expensive vacation to Disney World! This also means that an American going to Europe would receive the inverse of this equation or 0.80 euros. So a U.S. traveler would face a comparably more expensive cost of visiting Europe or purchasing a European product requiring an exchange of U.S. dollars into euros.

The top and bottom terms of the currency pair are also given names. The top is called the **Base Currency;** the second is called the **Counter Currency.** The first currency in the pair is referred to as the base currency, and the second currency is the counter or quote currency.

What is important to realize is that prices on a chart, are tracking the top term. So on a chart of the EUR/USD, if the price action is going up, the EUR/USD is getting stronger. This strengthening means a holder of Euro's is able to get more dollars than before for the same Euro they are holding. The currency pairs most traded are: **EUR/USD, GBP/USD, USD/CHF, USD/CAD, AUD/USD, USD/JPY.**

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CROSSPAIRS - simply refers to the comparison of one currency against another when the U.S. dollar is not part of the pair. An example of a crosspair is EUR/JPY, known as the Euro/Yen.

PIP - (Price Interest Point) is an acronym term referring to the minimum move tracked by the market in forex. Currency pairs are expressed in 4 digits-the numeral 1 followed by a decimal and 4 zeros (1.0000.)

BID/ASK - Cash forex prices are not listed on any exchange. The current price is a negotiated price featuring a bid and an ask. The value of any currency pair is, therefore, a representation of where the market is willing to sell and where it is willing to buy. This causes new traders a lot of confusion because the charts that are seen are often not exactly calibrated to the bid/ask quote screens. Some firms do have the charts generated from the actual bid/ask that the dealing platform is using. The charts, first of all, track the bid (some firms allow adjustments to track the ask or some range of the bid and ask.)

SPREAD - This is the difference between the BID/ASK. The firm makes most of its money by keeping the spread. Traders look for the least spread possible. Because of competition, spreads are becoming narrower, and traders can see spreads of 3 pips and even less.

A Currency Trading Account And How it Works.

Several terms describe how a currency account works.

MARGIN AND LEVERAGE - You open a currency account by signing account agreements that are standardized throughout the industry. Trading can begin by depositing an amount of cash into the account. Forex firms vary on what minimum amount is necessary for trading to begin.

This cash is considered *Margin* money, the amount that needs to be in the account to trade 1 lot. A lot is a certain amount of money that is being traded, usually $100,000 in that currency. A margin amount of 1% would mean that $1,000 in cash would need to be in the account to enable 100,000 EUR/USD or other currencies to be traded. That would be leverage of 100:1. Forex firms have varying policies on minimum margin amounts that vary with account size.

Firms are offering a wide range of margin requirements. You can even find 400:1 leverage. But is this a good idea? Trading with high leverage is appealing when you're winning. For example, trading 1 lot of the EUR/USD for a buy at 1.2800 and closing the position at 1.2830 involves a gain of 30 s. In a regular lot size account, the 30 profit would mean a $300 net profit for a return on the margin of 30%. However, when the market has moved against you, the loss can be quite large. Several declines in a row can reduce your account severely. It may be very foolish to start to learn to trade with huge leverage. Until you get a good sense of your capabilities, and your average win/loss ratio, huge margins can distort performance.

ROLLOVER CHARGED - These are charges against the account when a position is held overnight. Firms are charged interest, and the charge is passed along to the account.

Mini Accounts provide an ability to trade smaller-sized lots. A $10,000 size lot is common. This lot size would be valued at $1 per in the EUR/USD. They offer an opportunity to get a feel for trading forex without the exposure to loss that a regular size lot entails. Additionally, mini-sized lots enable you to test out trading strategies as well.

If you are new to forex- do not hold a position overnight!

Choosing Firms With which to Trade With- Key Questions to Ask

Based on recent legislation, the NFA (National Futures Association) regulates forex trading. The trader needs to know that a firm offering forex trading may be just an introducing broker, which is really a marketing agent providing access to a trading platform. These firms must be trading through a FCM (Futures Clearing Merchant.)

Some key questions in comparing firms are:

What are the bid/ask spreads? Are they competitive?

How does the firm approach stops and limits? Some firms are known to "hunt" for stops and try to profit on an internal position on the currency. Other firms with experienced desks can provide good execution. One problem that is being experienced and is associated with the internet is the potential for the forex firm's server going down. If the server at the firm goes down, it may cause trades to be left un-executed. It is important to ask the forex firm what its policy is for recovering a customer's loss if this kind of technological

breakdowns occur. Last, a key question is what kind of training and education is being offered to provide you the ability to improve your forex trading skills.

http://www.goforex.net/forex-broker-comparison.htm

Key Trading Orders

Trading orders are the bullets to reach your targets. They should be used to shape the trade and limit the risks. Too often, beginning traders just jump into the trade with a market order. The more experienced trader doesn't rush into the market and waits for certain conditions to emerge to place a trade. Learning how to use stop orders for entry and risk control and limit orders for profit taking need to be fully understood. Let's explore them now.

Market Order - If you want to guarantee execution, a market order does that for you. A market order invites slippage because the market is always moving, and the order requires the firm to fill the order, at the worst price for the trader. The firm is in the business of making money. When the trader enters a buy market order or a sell market order, the forex firm has taken an opposite position.

Stop Orders - This order is used to locate a position for the opening or closing of a trade. When the price hits the stop, it becomes a market order. This means that the actual price that is filled for the order depends on what the market does at that time. In highly volatile conditions the market may move further away in either direction. Stop orders have this risk of not providing certaintly as to the price that is filled.

There are two kinds of stop orders. The first is to open a position. An open buy stop or an open sell stop is the term used to place an order at a price that is not yet at the market. If the forex trader has more confidence that the stop order location is a better place to enter the trade than at the market, this order will work to achieve this goal.

The second type of stop order is a close stop order. When a trade is opened with a market order or an open stop order, a closed stop order tells the computer system to close the position when the stop price is hit. This enables traders to get out if they are wrong. This is also called a stop loss order.

Limits - Limit orders guarantee an exact price for the fill if the market goes through the limit. A buy or sell limit means that the price has to be executed at the limit price or better. Limit orders are very useful to set a target for a profit. If the price trades through the limit, your profit is achieved.

The use of stop and limit orders provides a discipline to the forex trader by assuring that there is an exit strategy for every trade for profit taking and for controlling risk controls. In short, there really should be three orders to every trade. The first order is an open order at a Stop or at the market; a closed stop order at a price that will limit the loss; and a close limit order at a price that will achieve the profit target of the trader.

OCO (One Cancels Other) - This allows a trader to have two potential working orders if one is executed, the other is cancelled.

TRADING HOURS

The best way to understand currency trading is to track the equity sessions. While currency trading is a 24-hour process from Sunday night to Friday afternoon, the trading volume increases in correlation with the trading of equities. There is no real best time to trade. Opportunities for identifying winning trades occur throughout the day. This means that you do not have to quit your day job to start trading forex seriously . No matter what time zone you live in the market will always be there.

For more information or to ask any questions, please feel free to contact Abe Cofnas at:

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Thank you.

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