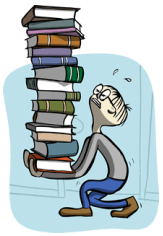
School of Pipsology



Forex education is crucial for beginners.

We, the FX-Men, firmly believe this.

This is why we've come up with the New School of Pipsology. More lessons, more content, and more corny jokes to satisfy your hunger for forex education.

The New School of Pipsology is designed to help you acquire the skills, knowledge, and special abilities to become a successful trader in the foreign exchange market.

Our definition of a successful trader is having the ability to do three things:

1. **Make pips**
2. **Keep pips**
3. **Repeat**

If you can repeatedly do these three things, then you're on your way to being a superstar forex trader! But we warn you, it's no cakewalk.

Remember when you were but a little teeny weeny bopper attending grade school?

No?

Well, according to our memories, here's how it worked.

You start schooling by rolling into pre-school with your chocolate milk and snack pack. The next year, you bring your kiddie backpack to kindergarten. If you pass, you'll join the big boys and girls in elementary school. But don't worry, we still have nap time in Grade 1. If you pass Grade 1, the next year you'll enter Grade 2, and so on, all the way up to Grade 12.

It basically went like this:

- **Kiddie School:** Pre-school and Kindergarten
- **Elementary School:** Grade 1 to Grade 5
- **Middle School:** Grade 6 to Grade 8
- **Summer School**
- **High School:** Grade 9 to 12

This is how our lessons are broken apart, so you can relive the past and also be able to learn and study forex trading techniques at your own pace.

You might have noticed that there's summer school right before high school.

Wait. What's that?

Summer school?

Yep. Summer school.

We think that high school is one of the most important times of your life. It's when you get potty trained and stop using diapers, learn to read and write, and get your very first hugs and kisses from your mom and dad.

Oh wait...that was Forex Gump. Our mistake.

But for you more normal folks, to make sure you are fully prepared for high school and the awkward challenges you will face, we've added summer school classes to at least help ease your academic transition.

As for trying to get a date for the prom, we can't help you there. Even Dr. Pipslow is still looking for one. And he's 600 years old. Too bad he's forgotten that his prom already happened 583 years ago but we feel bad breaking the news to him.

So....shhhhhhhh. It'll be our little secret.

Aside from dating drama, try not to get senioritis in Grade 12.

Why?

Because our high school goes up to Grade 14!

But there's more!

Just like in real life, learning doesn't end in the high school!

If you've done well throughout grade school and high school, you get a full scholarship to our college! All expenses paid!

We won't even require you to fill out any applications or write essays. That's right....we like to hand out scholarships just as much as we like to hand out cute bunnies to Cyclopip for him to eat.



Hey now, don't judge Cyclopip. He's already given up eating soft cuddly cute kittens. He's trying okay?

Let's get back on track...

Our curriculum here at the New School of Pipsology will make a bold attempt to cover all aspects of forex trading.

Yes we are crazy, but that's how we roll yo.

That's also how much we believe in having a solid forex education.

You will learn how to identify trading opportunities, how to time the market (aka smart guessing), and when to take profits or close a trade.

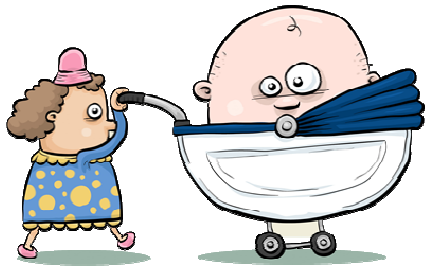
But that's still not all folks. There's more!

You will also learn how to predict the future and never have a losing trade.

Yeah right. In your dreams pal.

Forex trading isn't easy, but with a lot of studying and hard work, you can become a successful trader.

So grab your security blanket and favorite teddy bear and let's head over to Pre-School!



What is Forex?

If you've ever traveled to another country, you usually had to find a currency exchange booth at the airport, and then exchange the money you have in your wallet (if you're a dude) or purse (if you're a lady) or man purse (if you're a metrosexual) into the currency of the country you are visiting.

You go up to the counter and notice a screen displaying different exchange rates for different currencies. You find "Japanese yen" and think to yourself, "WOW! My one dollar is worth 100 yen?! And I have ten dollars! I'm going to be rich!!!" (This excitement is quickly killed when you stop by a shop in the airport afterwards to buy a can of soda and, all of a sudden, half your money is gone.)

When you do this, you've essentially participated in the forex market! You've exchanged one currency for another. Or in forex trading terms, assuming you're an American visiting Japan, you've sold dollars and bought yen.

Before you fly back home, you stop by the currency exchange booth to exchange the yen that you miraculously have left over (Tokyo is expensive!) and notice the exchange rates have changed. It's these changes in the exchanges rates that allow you to make money in the foreign exchange market.

The foreign exchange market, which is usually known as "forex" or "FX," is the largest financial market in the world. Compared to the measly $74 billion a day volume of the New York Stock Exchange, the foreign exchange market looks absolutely ginormous with its **$4 TRILLION** a day trade volume. Forex rocks our socks!

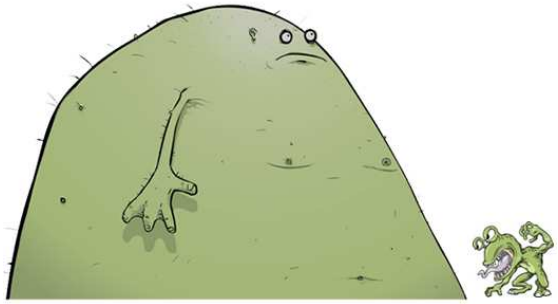
Let's take a moment to put this into perspective using monsters...

The largest stock market in the world, the New York Stock Exchange (NYSE), trades a volume of about $74 billion each day. If we used a monster to represent NYSE, it would look like this...



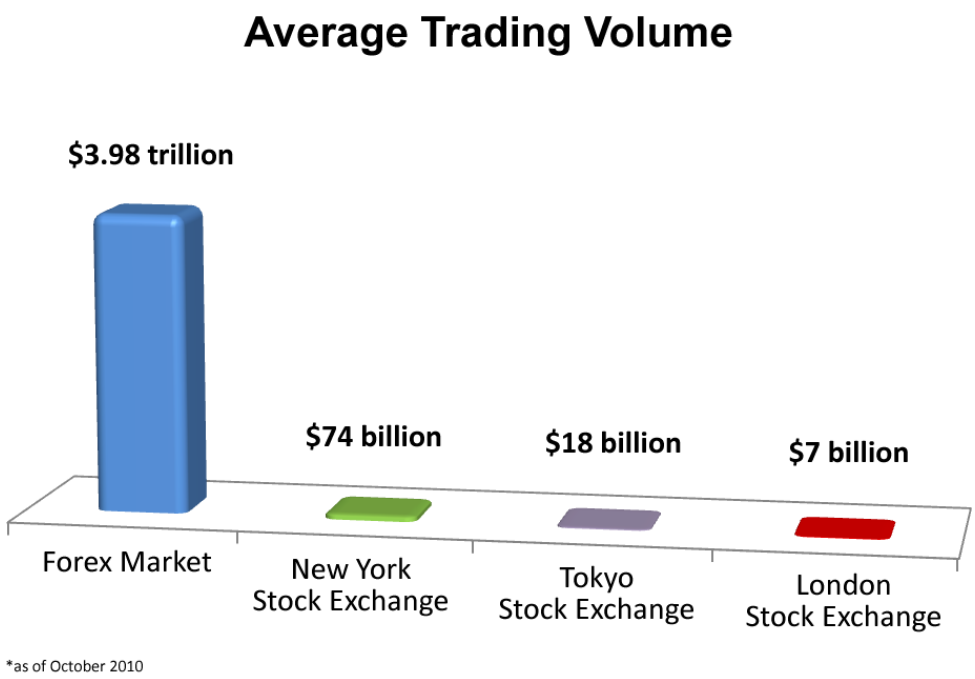
You hear about the NYSE in the news every day... on CNBC... on Bloomberg...on BBC... heck, you even probably hear about it at your local gym. "The NYSE is up today, blah, blah". When people talk about the "market", they usually mean the stock market. So the NYSE sounds big, it's loud and likes to make a lot of noise.

But if you actually compare it to the foreign exchange market, it would look like this...



Oooh, the NYSE looks so puny compared to forex! It doesn't stand a chance!

Check out the graph of the average daily trading volume for the forex market, New York Stock Exchange, Tokyo Stock Exchange, and London Stock Exchange:



The currency market is over 53 times BIGGER! It is HUGE! But hold your horses, there's a catch!

That huge $4 trillion number covers the entire global foreign exchange market, BUT retail traders (that's us) trade the spot market and that's about $1.49 trillion.

So now you know not to be fooled when you read how the stock market is the biggest game out there. It's definitely huge, but not as huge as the media would like you to believe.

What is Traded?



The simple answer is **MONEY**.

Because you're not buying anything physical, this kind of trading can be confusing.

Think of buying a currency as buying a share in a particular country, kinda like buying stocks of a company. The price of the currency is a direct reflection of what the market thinks about the current and future health of the Japanese economy.

When you buy, say, the Japanese yen, you are basically buying a "share" in the Japanese economy. You are *betting* that the Japanese economy is doing well, and will even get better as time goes. Once you sell those "shares" back to the market, hopefully, you will end up with a profit.

In general, the exchange rate of a currency versus other currencies is a reflection of the condition of that country's economy, compared to other countries' economies.

By the time you graduate from this School of Pipsology, you'll be eager to start working with currencies.

Major Currencies

Symbol	Country	Currency	Nickname
USD	United States	Dollar	Buck
EUR	Euro zone members	Euro	Fiber
JPY	Japan	Yen	Yen
GBP	Great Britain	Pound	Cable
CHF	Switzerland	Franc	Swissy
CAD	Canada	Dollar	Loonie
AUD	Australia	Dollar	Aussie
NZD	New Zealand	Dollar	Kiwi

Currency symbols always have three letters, where the first two letters identify the name of the country and the third letter identifies the name of that country's currency.

Take NZD for instance. NZ stands for New Zealand, while D stands for dollar. Easy enough, right?

The currencies included in the chart above are called the "majors" because they are the most widely traded ones.

We'd also like to let you know that "buck" isn't the only nickname for USD.

There's also: greenbacks, bones, benjis, benjamins, cheddar, paper, loot, scrilla, cheese, bread, moolah, dead presidents, and cash money.

So, if you wanted to say, "I have to go to work now."

Instead, you could say, "Yo, I gotta bounce! Gotta make them benjis son!"

Or if you wanted to say, "I have lots of money. Let's go to the shopping mall in the evening."

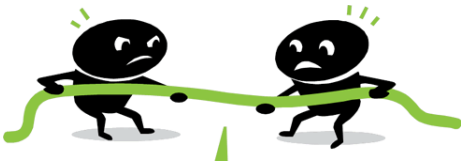
Instead, why not say, ""Yo, I gots mad scrilla! Let's go rock that mall later."

Did you also know that in Peru, a nickname for the U.S. dollar is Coco, which is a pet name for Jorge (George in Spanish), a reference to the portrait of George Washington on the $1 note?

Currencies Are Traded in Pairs

Forex trading is the simultaneous buying of one currency and selling another. Currencies are traded through a broker or dealer, and are traded in pairs; for example the euro and the U.S. dollar (EUR/USD) or the British pound and the Japanese yen (GBP/JPY).

When you trade in the forex market, you buy or sell in currency pairs.



Imagine each pair constantly in a "tug of war" with each currency on its own side of the rope. Exchange rates fluctuate based on which currency is stronger at the moment.

Major Currency Pairs

The currency pairs listed below are considered the "majors". These pairs all contain the U.S. dollar (USD) on one side and are the most frequently traded. The majors are the most liquid and widely traded currency pairs in the world.

Pair	Countries	FX Geek Speak
EUR/USD	Euro zone / United States	"euro dollar"
USD/JPY	United States / Japan	"dollar yen"
GBP/USD	United Kindom / United States	"pound dollar"
USD/CHF	United States/ Switzerland	"dollar swissy"
USD/CAD	United States / Canada	"dollar loonie"
AUD/USD	Australia / United States	"aussie dollar"
NZD/USD	New Zealand / United States	"kiwi dollar"

Major Cross-Currency Pairs or Minor Currency Pairs

Currency pairs that don't contain the U.S. dollar (USD) are known as cross-currency pairs or simply as the "crosses." Major crosses are also known as "minors." The most actively traded crosses are derived from the three major non-USD currencies: EUR, JPY, and GBP.

Euro Crosses

Pair	Countries	FX Geek Speak
EUR/CHF	Euro zone / Switzerland	"euro swissy"
EUR/GBP	Euro zone / United Kingdom	"euro pound"
EUR/CAD	Euro zone / Canada	"euro loonie"
EUR/AUD	Euro zone / Australia	"euro aussie"
EUR/NZD	Euro zone / New Zealand	"euro kiwi"

Yen Crosses

Pair	Countries	FX Geek Speak
EUR/JPY	Euro zone / Japan	"euro yen" or "yuppy"
GBP/JPY	United Kingdom / Japan	"pound yen" or "guppy"
CHF/JPY	Switzerland / Japan	"swissy yen"
CAD/JPY	Canada / Japan	"loonie yen"
AUD/JPY	Australia / Japan	"aussie yen"
NZD/JPY	New Zealand / Japan	"kiwi yen"

Pound Crosses

Pair	Countries	FX Geek Speak
GBP/CHF	United Kingdom / Switzerland	"pound swissy"
GBP/AUD	United Kingdom / Australia	"pound aussie"
GBP/CAD	United Kingdom / Canada	"pound loonie"
GBP/NZD	United Kingdom / New Zealand	"pound kiwi"

Other Crosses

Pair	Countries	FX Geek Speak
AUD/CHF	Australia / Switzerland	"aussie swissy"
AUD/CAD	Australia / Canada	"aussie loonie"
AUD/NZD	Australia / New Zealand	"aussie kiwi"
CAD/CHF	Canada / Switzerland	"loonie swissy"
NZD/CHF	New Zealand / Switzerland	"kiwi swissy"
NZD/CAD	New Zealand / Canada	"kiwi loonie"

Exotic Pairs



No, exotic pairs are not exotic belly dancers who happen to be twins. Exotic pairs are made up of one major currency paired with the currency of an emerging economy, such as Brazil, Mexico, or Hungary. The chart below contains a few examples of exotic currency pairs. Wanna take a shot at guessing what those other currency symbols stand for?

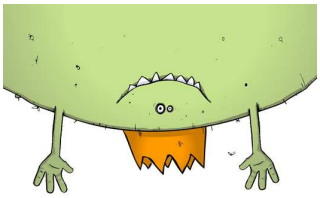
Pair	Countries	FX Geek Speak
USD/HKD	United States / Hong Kong	
USD/SGD	United States / Singapore	
USD/ZAR	United States / South Africa	"dollar rand"
USD/THB	United States / Thailand	"dollar baht"
USD/MXN	United States / Mexico	"dollar peso"
USD/DKK	United States / Denmark	"dollar krone"
USD/SEK	United States / Sweden	
USD/NOK	United States / Norway	

Depending on your forex broker, you may see the following exotic pairs so it's good to know what they are. Keep in mind that these pairs aren't as heavily traded as the "majors" or "crosses," so the transaction costs associated with trading these pairs are usually bigger.

It isn't unusual to see spreads that are two or three times bigger than that of EUR/USD or USD/JPY. So if you want to trade exotics pairs, remember to factor this in your decision.



Market Size and Liquidity



Unlike other financial markets like the New York Stock Exchange, the forex spot market has neither a physical location nor a central exchange.

The forex market is considered an Over-the-Counter (OTC), or "Interbank", market due to the fact that the entire market is run electronically, within a network of banks, continuously over a 24-hour period.

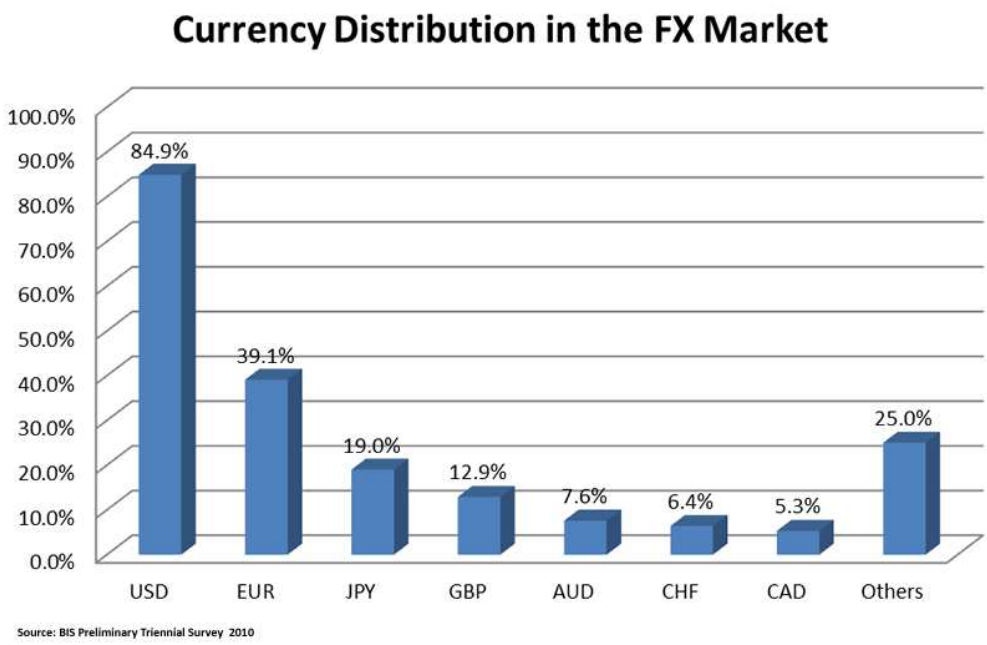
This means that the spot forex market is spread all over the globe with no central location. They can take place anywhere, even at the top of Mt. Fiji!

The forex OTC market is by far the biggest and most popular financial market in the world, traded globally by a large number of individuals and organizations.

In the OTC market, participants determine who they want to trade with depending on trading conditions, attractiveness of prices, and reputation of the trading counterpart.

The chart below shows the ten most actively traded currencies.

The dollar is the most traded currency, taking up 84.9% of all transactions. The euro's share is second at 39.1%, while that of the yen is third at 19.0%. As you can see, most of the major currencies are hogging the top spots on this list!

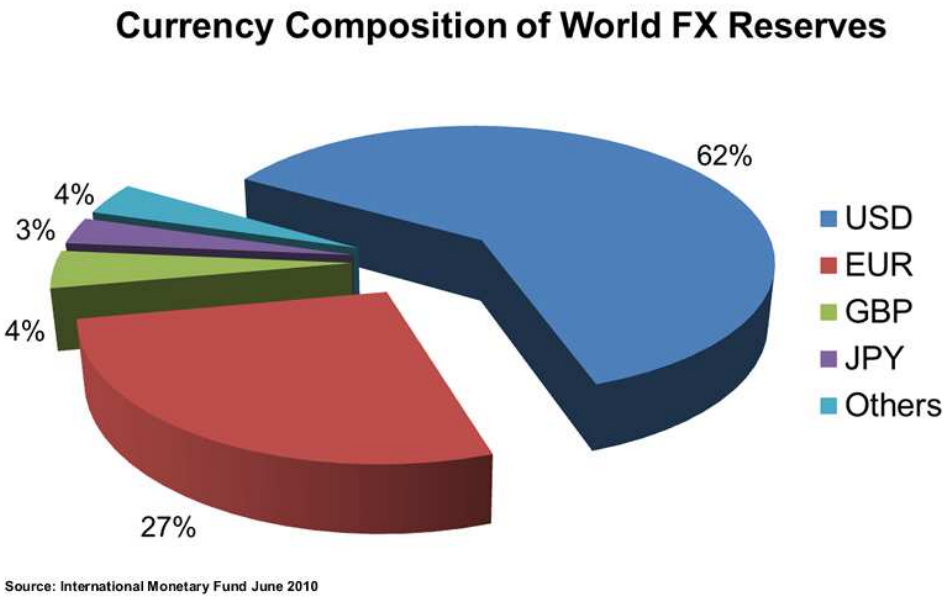


**Because two currencies are involved in each transaction, the sum of the percentage shares of individual currencies totals 200% instead of 100%*

Looking at the chart above shows just how often the U.S. dollar is traded in the forex market. It is on one side of a ridiculous 84.9% of all reported transactions!

The Dollar is King

You've probably noticed how often we keep mentioning the U.S. dollar (USD). If the USD is one half of every major currency pair, and the majors comprise 75% of all trades, then it's a must to pay attention to the U.S. dollar. The USD is king!



In fact, according to the International Monetary Fund (IMF), the U.S. dollar comprises almost 62% of the world's official foreign exchange reserves! Because almost every investor, business, and central bank own it, they pay attention to the U.S. dollar.



There are also other significant reasons why the U.S. dollar plays a central role in the forex market:

- The United States economy is the LARGEST economy in the world.
- The U.S. dollar is the reserve currency of the world.
- The United States has the largest and most liquid financial markets in the world.
- The United States has a super stable political system.
- The United States is the world's sole military superpower.
- The U.S. dollar is the medium of exchange for many cross-border transactions. For example, oil is priced in U.S. dollars. So if Mexico wants to buy oil from Saudi Arabia, it can only be bought with U.S. dollar. If Mexico doesn't have any dollars, it has to sell its pesos first and buy U.S. dollars.

Speculation



One important thing to note about the forex market is that while commercial and financial transactions are part of trading volume, most currency trading is based on speculation.

In other words, most trading volume comes from traders that buy and sell based on intraday price movements.

The trading volume brought about by speculators is estimated to be more than 90%!

The scale of the forex speculative market means that liquidity - the amount of buying and selling volume happening at any given time - is extremely high.

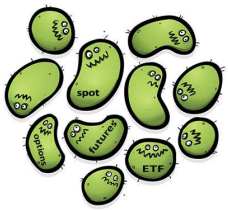
This makes it very easy for anyone to buy and sell currencies.

From the perspective of an investor, liquidity is very important because it determines how easily price can change over a given time period. A liquid market environment like forex enables huge trading volumes to happen with very little effect on price, or price action.

While the forex market is generally very liquid, it could change depending on the currency pair and time of day.

In the "When" lesson, we examine how liquidity and market interest changes throughout the trading day with an eye to what it means for trading in particular currency pairs.

Different Ways to Trade Forex



Because forex is so awesome, traders came up with a number of different ways to invest or speculate in currencies. Among these, the most popular ones are forex spot, futures, options, and exchange-traded funds (or ETFs).

Spot Market

In the spot market, currencies are traded immediately or "on the spot," using the current market price. What's awesome about this market is its simplicity, liquidity, tight spreads, and round-the-clock operations. It's very easy to participate in this market since accounts can be opened with as little as a $25! (Not that we suggest you do. In the Capitalization lesson, you'll learn why!) Aside from that, most brokers usually provide charts, news, and research for free.

Futures

Futures are contracts to buy or sell a certain asset at a specified price on a future date (That's why they're called futures!). Forex futures were created by the Chicago Mercantile Exchange (CME) way back in 1972, when bell bottoms and platform boots were still in style. Since futures contracts are standardized and traded through a centralized exchange, the market is very transparent and well-regulated. This means that price and transaction information are readily available.

Options

An "option" is a financial instrument that gives the buyer the right or the option, but not the obligation, to buy or sell an asset at a specified price on the option's expiration date. If a trader "sold" an option, then he or she would be obliged to buy or sell an asset at a specific price at the expiration date.

Just like futures, options are also traded on an exchange, such as the Chicago Board Options Exchange, the International Securities Exchange, or the Philadelphia Stock Exchange. However, the disadvantage in trading forex options is that market hours are limited for certain options and the liquidity is not nearly as great as the futures or spot market.

Exchange-traded Funds

Exchange-traded funds or ETFs are the youngest members of the forex world.

An ETF could contain a set of stocks combined with some currencies, allowing the trader to diversify with different assets. These are created by financial institutions and can be traded like stocks through an exchange. Like forex options, the limitation in trading ETFs is that the market isn't open 24 hours. Also, since ETFs contain stocks, these are subject to trading commissions and other transaction costs.

Advantages of Forex



There are many benefits and advantages of trading forex. Here are just a few reasons why so many people are choosing this market:

No commissions

No clearing fees, no exchange fees, no government fees, no brokerage fees. Most retail brokers are compensated for their services through something called the "bid-ask spread".

No middlemen

Spot currency trading eliminates the middlemen and allows you to trade directly with the market responsible for the pricing on a particular currency pair.

No fixed lot size

In the futures markets, lot or contract sizes are determined by the exchanges. A standard-size contract for silver futures is 5,000 ounces. In spot forex, you determine your own lot, or position size. This allows traders to participate with accounts as small as $25 (although we'll explain later why a $25 account is a bad idea).

Low transaction costs

The retail transaction cost (the bid/ask spread) is typically less than 0.1% under normal market conditions. At larger dealers, the spread could be as low as 0.07%. Of course this depends on your leverage and all will be explained later.

A 24-hour market

There is no waiting for the opening bell. From the Monday morning opening in Australia to the afternoon close in New York, the forex market never sleeps. This is awesome for those who want to trade on a part-time basis, because you can choose when you want to trade: morning, noon, night, during breakfast, or in your sleep.

No one can corner the market

The foreign exchange market is so huge and has so many participants that no single entity (not even a central bank or the mighty Chuck Norris himself) can control the market price for an extended period of time.

Leverage

In forex trading, a small deposit can control a much larger total contract value. Leverage gives the trader the ability to make nice profits, and at the same time keep risk capital to a minimum.

For example, a forex broker may offer 50-to-1 leverage, which means that a $50 dollar margin deposit would enable a trader to buy or sell $2,500 worth of currencies. Similarly, with $500 dollars, one could trade with $25,000 dollars and so on. While this is all gravy, let's remember that leverage is a double-edged sword. Without proper risk management, this high degree of leverage can lead to large losses as well as gains.

High Liquidity.

Because the forex market is so enormous, it is also extremely liquid. This means that under normal market conditions, with a click of a mouse you can instantaneously buy and sell at will as there will usually be someone in the market willing to take the other side of your trade. You are never "stuck" in a trade. You can even set your online trading platform to automatically close your position once your desired profit level (a limit order) has been reached, and/or close a trade if a trade is going against you (a stop loss order).

Forex vs. Stocks

There are approximately 4,500 stocks listed on the New York Stock exchange. Another 3,500 are listed on the NASDAQ. Which one will you trade? Got the time to stay on top of so many companies?

In spot currency trading, there are dozens of currencies traded, but the majority of market players trade the four major pairs. Aren't four pairs much easier to keep an eye on than thousands of stocks?



Look at Mr. Forex. He's so confident and sexy. Mr. Stocks has no chance!

That's just one of the many advantages of the forex market over the stock markets. Here are a few more:

24-Hour Market

The forex market is a seamless 24-hour market. Most brokers are open from Sunday at 4:00 pm EST until Friday at 4:00 pm EST, with customer service usually available 24/7. With the ability to trade during the U.S., Asian, and European market hours, you can customize your own trading schedule.

Minimal or No Commissions

Most forex brokers charge no commission or additional transactions fees to trade currencies online or over the phone. Combined with the tight, consistent, and fully transparent spread, forex trading costs are lower than those of any other market. Most brokers are compensated for their services through the bid/ask spread.

Instant Execution of Market Orders

Your trades are instantly executed under normal market conditions. Under these conditions, usually the price shown when you execute your market order is the price you get. You're able to execute directly off real-time streaming prices (Oh yeeeaah! Big time!).

Keep in mind that many brokers only guarantee stop, limit, and entry orders under normal market conditions. Trading during a massive alien invasion from outer space would not fall under "normal market" conditions. Fills are instantaneous most of the time, but under extraordinarily volatile market conditions, like during Martian attacks, order execution may experience delays.

Short-Selling without an Uptick

Unlike the equity market, there is no restriction on short selling in the currency market. Trading opportunities exist in the currency market regardless of whether a trader is long or short, or whichever way the market is moving. Since currency trading always involves buying one currency and selling another, there is no structural bias to the market. So you always have equal access to trade in a rising or falling market.

No Middlemen

Centralized exchanges provide many advantages to the trader. However, one of the problems with any centralized exchange is the involvement of middlemen. Any party located in between the trader and the buyer or seller of the security or instrument traded will cost them money. The cost can be either in time or in fees.

Spot currency trading, on the other hand, is decentralized, which means quotes can vary from different currency dealers. Competition between them is so fierce that you are almost always assured that you get the best deals. Forex traders get quicker access and cheaper costs.

Buy/Sell programs do not control the market.

How many times have you heard that "Fund A" was selling "X" or buying "Z"? The stock market is very susceptible to large fund buying and selling.

In spot trading, the massive size of the forex market makes the likelihood of any one fund or bank controlling a particular currency very small. Banks, hedge funds, governments, retail currency conversion houses, and large net worth individuals are just some of the participants in the spot currency markets where the liquidity is unprecedented.

Analysts and brokerage firms are less likely to influence the market

Have you watched TV lately? Heard about a certain Internet stock and an analyst of a prestigious brokerage firm accused of keeping its recommendations, such as "buy," when the stock was rapidly declining? It is the nature of these relationships. No matter what the government does to step in and discourage this type of activity, we have not heard the last of it.

IPOs are big business for both the companies going public and the brokerage houses. Relationships are mutually beneficial and analysts work for the brokerage houses that need the companies as clients. That catch-22 will never disappear.

Foreign exchange, as the prime market, generates billions in revenue for the world's banks and is a necessity of the global markets. Analysts in foreign exchange have very little effect on exchange rates; they just analyze the forex market.

Advantages	Forex	Stocks
24-Hour Trading	YES	No
Minimal or no Commission	YES	No
Instant Execution of Market Orders	YES	No
Short-selling without an Uptick	YES	No
No Middlemen	YES	No
No Market Manipulation	YES	No

It looks like the scorecard between Mr. Forex and Mr. Stocks shows a strong victory by Mr. Forex!

Low Barriers to Entry

You would think that getting started as a currency trader would cost a ton of money. The fact is, when compared to trading stocks, options or futures, it doesn't. Online forex brokers offer "mini" and "micro" trading accounts, some with a minimum account deposit of $25.

We're not saying you should open an account with the bare minimum, but it does make forex trading much more accessible to the average individual who doesn't have a lot of start-up trading capital.

Free Stuff Everywhere!

Most online forex brokers offer "demo" accounts to practice trading and build your skills, along with real-time forex news and charting services.

And guess what?! They're all free!

These are very valuable resources for those who are "financially hampered," but SMART traders who would like to hone their trading skills with "play money" before opening a live trading account and risking real money.

Forex vs. Futures

The forex market also boasts of a bunch of advantages over the futures market, similar to its advantages over stocks. But wait, there's more... So much more!



"Hey Mr. Futures, don't our short shorts look cool?"

Liquidity

In the forex market, $4 trillion is traded daily, making it the largest and most liquid market in the world. This market can absorb trading volume and transaction sizes that dwarf the capacity of any other market. The futures market trades a puny $30 billion per day. Thirty billion? Peanuts!

The futures markets can't compete with its relatively limited liquidity. The forex market is always liquid, meaning positions can be liquidated and stop orders executed with little or no slippage except in extremely volatile market conditions.

24-Hour Market

At 5:00 pm EST Sunday, trading begins as markets open in Sydney. At 7:00 pm EST the Tokyo market opens, followed by London at 3:00 am EST. And finally, New York opens at 8:00 am EST and closes at 4:00 p.m. EST. Before New York trading closes, the Sydney market is back open - it's a 24-hour seamless market!

As a trader, this allows you to react to favorable or unfavorable news by trading immediately. If important data comes in from the United Kingdom or Japan while the U.S. futures market is closed, the next day's opening could be a wild ride. (Overnight markets in futures currency contracts exist, but they are thinly traded, not very liquid, and are difficult for the average investor to access.)

Minimal or no commissions

With Electronic Communications Brokers (more on this later) becoming more popular and prevalent over the past couple of years, there is the chance that a broker may require you to pay commissions. But really, the commission fees are peanuts compared to what you pay in

the futures market. The competition among brokers is so fierce that you will most likely get the best quotes and very low transaction costs.

Price Certainty

When trading forex, you get rapid execution and price certainty under normal market conditions. In contrast, the futures and equities markets do not offer price certainty or instant trade execution. Even with the advent of electronic trading and limited guarantees of execution speed, the prices for fills for futures and equities on market orders are far from certain. The prices quoted by brokers often represent the LAST trade, not necessarily the price for which the contract will be filled.

Guaranteed Limited Risk

Traders must have position limits for the purpose of risk management. This number is set relative to the money in a trader's account. Risk is minimized in the spot forex market because the online capabilities of the trading platform will automatically generate a margin call if the required margin amount exceeds the available trading capital in your account.

During normal market conditions, all open positions will be closed immediately (during fast market conditions, your position could be closed beyond your stop loss level).

In the futures market, your position may be liquidated at a loss bigger than what you had in your account, and you will be liable for any resulting deficit in the account. That sucks.

Advantages	Forex	Stocks
24-Hour Trading	YES	No
Minimal or no Commission	YES	No
Up to 500:1 Leverage	YES	No
Price Certainty	YES	No
Guaranteed Limited Risk	YES	No

Judging by the Forex vs. Futures Scorecard, Mr. Forex looks **UNBEATABLE**! Mr. Forex wins again!

Forex Market Structure

For the sake of comparison, let us first examine a market that you are probably very familiar with: the stock market. This is how the structure of the stock market looks like:



"I have no choice but to go through a centralized exchange!"

By its very nature, the stock market tends to be very monopolistic. There is only one entity, one specialist that controls prices. All trades must go through this specialist. Because of this, prices can easily be altered to benefit the specialist, and not traders.

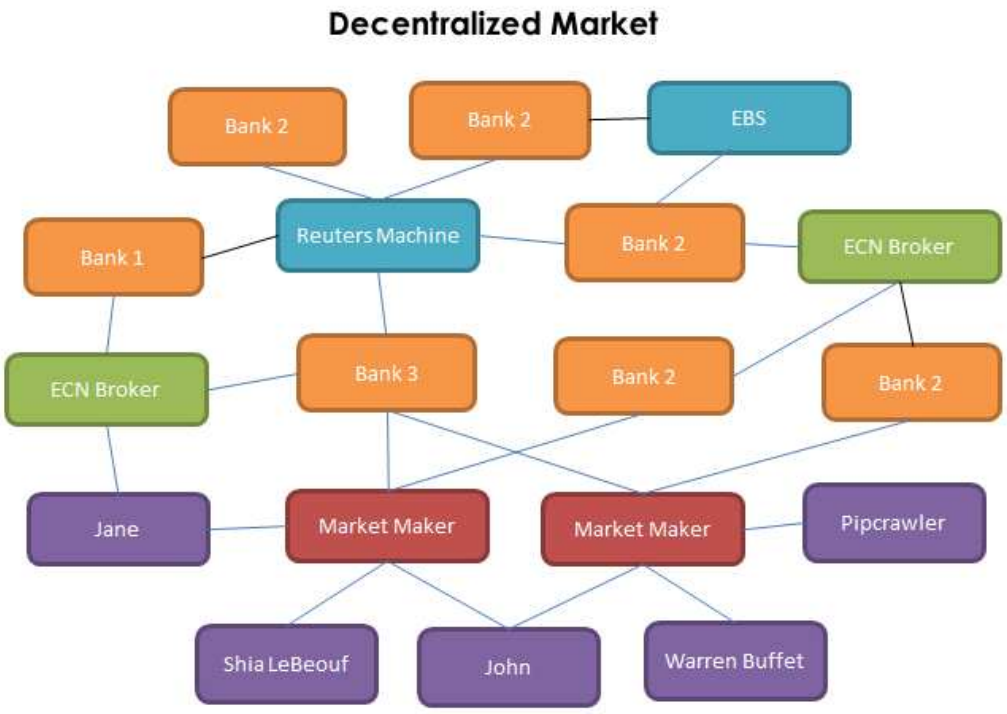
How does this happen?

In the stock market, the specialist is forced to fulfill the order of its clients. Now, let's say the number of sellers suddenly exceed the number of buyers. The specialist, which is forced to fulfill the order of its clients, the sellers in this case, is left with a bunch of stock that he cannot sell-off to the buyer side.

In order to prevent this from happening, the specialist will simply widen the spread or increase the transaction cost to prevent sellers from entering the market. In other words, the specialists can manipulate the quotes it is offering to accommodate its needs.

Trading Spot FX is Decentralized

Unlike in trading stocks or futures, you don't need to go through a centralized exchange like the New York Stock Exchange with just one price. In the forex market, there is no single price that for a given currency at any time, which means quotes from different currency dealers vary.



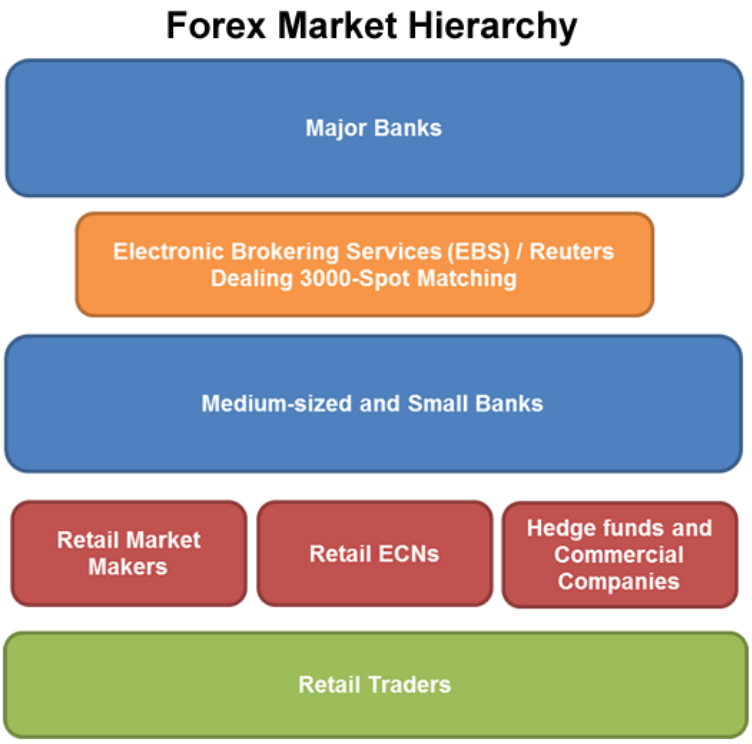
"So many choices! Awesome!"

This might be overwhelming at first, but this is what makes the forex market so freakin' awesome! The market is so huge and the competition between dealers is so fierce that you get the best deal almost every single time. And tell me, who does not want that?

Also, one cool thing about forex trading is that you can do it anywhere. It's just like trading baseball cards. You want that mint condition Mickey Mantle rookie card, so it is up to you to find the best deal out there. Your colleague might give up his Mickey Mantle card for just a Babe Ruth card, but your best friend will only part with his Mickey Mantle rookie card for your soul.

The FX Ladder

Even though the forex market is decentralized, it isn't pure and utter chaos! The participants in the FX market can be organized into a ladder. To better understand what we mean, here is a neat illustration:



At the very top of the forex market ladder is the interbank market. Composed of the largest banks of the world and some smaller banks, the participants of this market trade directly with each other or electronically through the Electronic Brokering Services (EBS) or the Reuters Dealing 3000-Spot Matching.

The competition between the two companies - the EBS and the Reuters Dealing 3000-Spot Matching - is similar to Coke and Pepsi. They are in constant battle for clients and continually try to one-up each other for market share. While both companies offer most currency pairs, some currency pairs are more liquid on one than the other.

For the EBS plaform, EUR/USD, USD/JPY, EUR/JPY, EUR/CHF, and USD/CHF are more liquid. Meanwhile, for the Reuters platform, GBP/USD, EUR/GBP, USD/CAD, AUD/USD, and NZD/USD are more liquid.

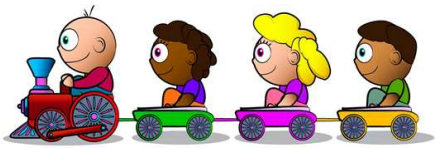
All the banks that are part of the interbank market can see the rates that each other is offering, but this doesn't necessarily mean that anyone can make deals at those prices.

Like in real life, the rates will largely dependent on the established **CREDIT** relationship between the trading parties. Just to name a few, there's the "B.F.F. rate," the "customer rate," and the "ex-wife-you-took-everything rate." It's like asking for a loan at your local bank. The better your credit standing and reputation with them, the better the interest rates and the larger loan you can avail.

Next on the ladder are the hedge funds, corporations, retail market makers, and retail ECNs. Since these institutions do not have tight credit relationships with the participants of the interbank market, they have to do their transactions via commercial banks. This means that their rates are slightly higher and more expensive than those who are part of the interbank market.

At the very bottom of the ladder are the retail traders. It used to be very hard for us little people to engage in the forex market but, thanks to the advent of the internet, electronic trading, and retail brokers, the difficult barriers to entry in forex trading have all been taken down. This gave us the chance to play with those high up the ladder and poke them with a very long and cheap stick.

Market Players



Now that you know the overall structure of the forex market, let's delve in a little deeper to find out who exactly these people in the ladder are. It is essential for you that you understand the nature of the spot forex market and who are the main players.

Until the late 1990s, only the "big guys" could play this game. The initial requirement was that you could trade only if you had about ten to fifty million bucks to start with! Forex was originally intended to be used by bankers and large institutions, and not by us "little guys." However, because of the rise of the internet, online forex trading firms are now able to offer trading accounts to "retail" traders like us.

Without further ado, here are the major market players:

1. The Super Banks

Since the forex spot market is decentralized, it is the largest banks in the world that determine the exchange rates. Based on the supply and demand for currencies, they are generally the ones that make the bid/ask spread that we all love (or hate, for that matter).

These large banks, collectively known as the interbank market, take on a ridonkulous amount of forex transactions each day for both their customers and themselves. A couple of these super banks include UBS, Barclays Capital, Deutsche Bank, and Citigroup. You could say that the interbank market is THE foreign exchange market.

2. Large Commercial Companies

Companies take part in the foreign exchange market for the purpose of doing business. For instance, Apple must first exchange its U.S. dollars for the Japanese yen when purchasing electronic parts from Japan for their products. Since the volume they trade is much smaller than those in the interbank market, this type of market player typically deals with commercial banks for their transactions.

Mergers and acquisitions (M&A) between large companies can also create currency exchange rate fluctuations. In international cross-border M&As, a lot of currency conversations happens that could move prices around.

3. Governments and Central Banks

Governments and central banks, such as the European Central Bank, the Bank of England, and the Federal Reserve, are regularly involved in the forex market too. Just like companies, national governments participate in the forex market for their operations, international trade payments, and handling their foreign exchange reserves.

Meanwhile, central banks affect the forex market when they adjust interest rates to control inflation. By doing this, they can affect currency valuation. There are also instances when central banks intervene, either directly or verbally, in the forex market when they want to realign exchange rates. Sometimes, central banks think that their currency is priced too high or too low, so they start massive sell/buy operations to alter exchange rates.

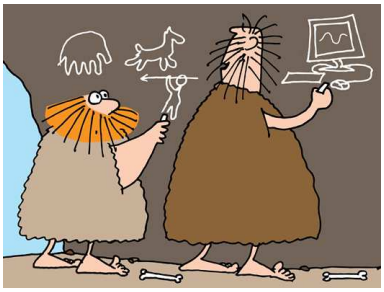
4. The Speculators

"In it to win it!"

This is probably the mantra of the speculators. Comprising close to 90% of all trading volume, speculators come in all shapes and sizes. Some have fat pockets, some roll thin, but all of them engage in the forex simply to make bucket loads of cash.

Don't worry... Once you graduate from the School of Pipsology, you can be part of this cool crowd!

Know Your History!



At the end of the World War II, the whole world was experiencing so much chaos that the major Western governments felt the need to create a system to stabilize the global economy.

Known as the "Bretton Woods System," the agreement set the exchange rate of all currencies against gold. This stabilized exchange rates for a while, but as the major economies of the world started to change and grow at different speeds, the rules of the system soon became obsolete and limiting.

Soon enough, come 1971, the Bretton Woods Agreement was abolished and replaced by a different currency valuation system. With the United States in the pilot's seat, the currency market evolved to a free-floating one, where exchange rates were determined by supply and demand.

At first, It was difficult to determine fair exchange rates, but advances in technology and communication eventually made things easier.

Once the 1990s came along, thanks to computer nerds and the booming growth of the internet (cheers to you Mr. Al Gore), banks began creating their own trading platforms. These platforms were designed to stream live quotes to their clients so that they could instantly execute trades themselves.

Meanwhile, some smart business-minded marketing machines introduced internet-based trading platforms for individual traders.

Known as "retail forex brokers", these entities made it easy for individuals to trade by allowing smaller trade sizes. Unlike in the interbank market where the standard trade size is one million units, retail brokers allowed individuals to trade as little as 1000 units!

Retail Forex Brokers

In the past, only the big speculators and highly capitalized investment funds could trade currencies, but thanks to retail forex brokers and the Internet, this isn't the case anymore.

With hardly any barriers to entry, anybody could just contact a broker, open up an account, deposit some money, and trade forex from the comfort of their own home. Brokers basically come in two forms:

1. Market makers, as their name suggests, "make" or set their own bid and ask prices themselves and
2. Electronic Communications Networks (ECN), who use the best bid and ask prices available to them from different institutions on the interbank market.

Market Makers

Let's say you wanted to go to France to eat some snails. In order for you to transact in the country, you need to get your hands on some euros first by going to a bank or the local foreign currency exchange office. For them to take the opposite side of your transaction, you have to agree to exchange your home currency for euros at the price they set.

Like in all business transactions, there is a catch. In this case, it comes in the form of the bid/ask spread.

For instance, if the bank's buying price (bid) for EUR/USD is 1.2000, and their selling price (ask) is 1.2002, then the bid/ask spread is 0.0002. Although seemingly small, when you're talking about millions of these forex transactions every day, it does add up to create a hefty profit for the market makers!

You could say that market makers are the fundamental building blocks of the foreign exchange market. Retail market makers basically provide liquidity by "repackaging" large contract sizes from wholesalers into bite size pieces. Without them, it will be very hard for the average Joe to trade forex.

Electronic Communications Network

Electronic Communication Network is the name given for trading platforms that automatically match customer's buy and sell orders at stated prices. These stated prices are gathered from different market makers, banks, and even other traders who use the ECN. Whenever a certain sell or buy order is made, it is matched up to the best bid/ask price out there.

Due to ability of traders to set their own prices, ECN brokers typically charge a VERY small commission for the trades you take. The combination of tight spreads and small commission usually make transaction costs cheaper on ECN brokers.

Trading Sessions



Now that you know **what** forex is, **why** you should trade it, and **who** makes up the forex market, it's about time you learned **when** you can trade.

Yes, it is true that the forex market is open 24 hours a day, but that doesn't mean it's always active the whole day.

You can make money trading when the market moves up, and you can even make money when the market moves down.

BUT you will have a very difficult time trying to make money when the market doesn't move at all.

And believe us, there will be times when the market is as still as the victims of Medusa. This lesson will help determine when the best times of the day are to trade.

Market Hours



Before looking at the best times to trade, we must look at what a 24-hour day in the forex world looks like.

The forex market can be broken up into four major trading sessions: the Sydney session, the Tokyo session, the London session, and the New York session. Below are tables of the open and close times for each session:

Summer

Time Zone	EDT	GMT
Sydney Open	6:00 PM	10:00 PM
Sydney Close	3:00 AM	7:00 AM
Tokyo Open	7:00 PM	11:00 PM
Tokyo Close	4:00 AM	8:00 AM
London Open	3:00 AM	7:00 AM
London Close	12:00 PM	4:00 PM
New York Open	8:00 AM	12:00 PM
New York Close	5:00 PM	9:00 PM

Winter

Time Zone	EST	GMT
Sydney Open	4:00 PM	9:00 PM
Sydney Close	1:00 AM	6:00 AM
Tokyo Open	6:00 PM	11:00 PM
Tokyo Close	3:00 AM	8:00 AM
London Open	3:00 AM	8:00 AM
London Close	12:00 PM	5:00 PM
New York Open	8:00 AM	1:00 PM
New York Close	5:00 PM	10:00 PM

You can see that in between each session, there is a period of time where two sessions are open at the same time. From 3:00-4:00 am EDT, the Tokyo session and London session overlap, and from 8:00-12:00 am EDT, the London session and the New York session overlap.

Naturally, these are the busiest times during the trading day because there is more volume when two markets are open at the same time. This makes sense because during those times, all the market participants are wheelin' and dealin', which means that more money is transferring hands.

Now, you're probably looking at the Sydney open and thinking why it shifts two hours. You'd think that Sydney's open would only move one hour when the U.S. adjusts for standard time,

but remember that when the U.S. shifts one hour back, Sydney actually moves forward by one hour (seasons are opposite in Australia). You should always remember this if you ever plan to trade during that time period.

Let's take a look at the average pip movement of the major currency pairs during each trading session.

Pair	Tokyo	London	New York
EUR/USD	76	**114**	92
GBP/USD	92	**127**	99
USD/JPY	51	**66**	59
AUD/USD	77	**83**	81
NZD/USD	62	**72**	70
USD/CAD	57	**96**	96
USD/CHF	67	**102**	83
EUR/JPY	102	**129**	107
GBP/JPY	118	**151**	132
AUD/JPY	98	**107**	103
EUR/GBP	78	**61**	47
EUR/CHF	79	**109**	84

From the table, you will see that the European session normally provides the most movement.

Let's take a more in depth look at each of the session, as well as those periods when the sessions overlap.

Tokyo Session



The opening of the Asian session at 7:00 pm EST marks the start of the forex clock. You should take note that Tokyo session is sometimes referred to as the Asian session, because Tokyo is the financial capital of Asia.

One thing worth noting is that Japan is the third largest forex trading center in the world.

This shouldn't be too surprising since the yen is the third most traded currency, partaking in 16.50% of all forex transactions. Overall, about 21% of all forex transactions take place during this session.

Below is a table of the Asian session pip ranges of the major currency pairs.

Pair	Tokyo
EUR/USD	76
GBP/USD	92
USD/JPY	51
AUD/USD	77
NZD/USD	62
USD/CAD	57
USD/CHF	67
EUR/JPY	102
GBP/JPY	118
AUD/JPY	98
EUR/GBP	79
EUR/CHF	78

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Here some key characteristics that you should know about the Tokyo session:

- Action isn't only limited to Japanese shores. Tons of forex transactions are made in other financial hot spots like Hong Kong, Singapore, and Sydney.
- The main market participants during the Tokyo session are commercial companies (exporters) and central banks. Remember, Japan's economy is heavily export dependent and, with China also being a major trade player, there are a lot of transactions taking place on a daily basis.
- Liquidity can sometimes be very thin. There will be times when trading during this period will be like fishing - you might have to wait a long, long time before getting a nibble.
- It is more likely that you will see stronger moves in Asia Pacific currency pairs like AUD/USD and NZD/USD as opposed to non-Asia Pacific pairs like GBP/USD.
- During those times of thin liquidity, most pairs may stick within a range. This provides opportunities for short day trades or potential breakout trades later in the day.
- Most of the action takes place early in the session, when more economic data is released.
- Moves in the Tokyo session could set the tone for the rest of the day. Traders in latter sessions will look at what happened during the Tokyo session to help organize and evaluate what strategies to take in other sessions.
- Typically, after big moves in the preceding New York session, you may see consolidation during the Tokyo session.

Which Pairs Should You Trade?

Since the Tokyo session is when news from Australia, New Zealand, and Japan comes out, this presents a good opportunity to trade news events. Also, there could be more movement in yen pairs as a lot of yen is changing hands as Japanese companies are conducting business.

Take note that China is also an economic super power, so whenever news comes out from China, it tends to create volatile moves. With Australia and Japan relying heavily on Chinese demand, we could see greater movement in AUD and JPY pairs when Chinese data comes in.

London Session



Just when Asian market participants are starting to close shop, their European counterparts are just beginning their day.

While there are several financial centers all around Europe, it is London that market participants keep their eyes on.

Historically, London has always been at a center of trade, thanks to its strategic location. It's no wonder that it is considered the forex capital of the world with thousands of businessmen making transactions every single minute. About 30% of all forex transactions happen during the London session.

Below is a table of the London session pip ranges of the major currency pairs.

Pair	London
EUR/USD	114
GBP/USD	127
USD/JPY	66
AUD/USD	83
NZD/USD	72
USD/CAD	96
USD/CHF	102
EUR/JPY	129
GBP/JPY	151
AUD/JPY	107
EUR/GBP	61
EUR/CHF	109

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Here are some neat facts about European session:

- Because the London session crosses with the two other major trading sessions--and with London being such a key financial center--a large chunk of forex transactions take place during this time. This leads to high liquidity and potentially lower transaction costs, i.e., lower pip spreads.

- Due to the large amount of transactions that take place, the London trading session is normally the most volatile session.
- Most trends begin during the London session, and they typically will continue until the beginning of the New York session.
- Volatility tends to die down in the middle of the session, as traders often go off to eat lunch before waiting for the New York trading period to begin.
- Trends can sometimes reverse at the end of the London session, as European traders may decide to lock in profits.

Which Pairs Should You Trade?

Because of the volume of transactions that take place, there is so much liquidity during the European session that almost any pair can be traded.

Of course, it may be best to stick with the majors (EUR/USD, GBP/USD, USD/JPY, and USD/CHF), as these normally have the tightest spreads.

Also, it is these pairs that are normally directly influenced by any news reports that come out during the European session.

You can also try the yen crosses (more specifically, EUR/JPY and GBP/JPY), as these tend to be pretty volatile at this time. Because these are cross pairs, the spreads might be a little wider though.

New York Session



Right as European traders are getting back from their lunch breaks, the U.S. session begins at 8:00 am EST as traders start rolling into the office. Just like Asia and Europe, the U.S. session has one major financial center that the markets keep their eyes on. We're talking of course, about the "City That Never Sleeps" - New York City baby! The concrete jungle where dreams are made of!

Below is a table of the New York session pip ranges of the major currency pairs.

Pair	New York
EUR/USD	92
GBP/USD	99
USD/JPY	59
AUD/USD	81
NZD/USD	70
USD/CAD	96
USD/CHF	83
EUR/JPY	107
GBP/JPY	132
AUD/JPY	103
EUR/GBP	47
EUR/CHF	84

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Here are some tips you should know about trading during the U.S. session:

- There is high liquidity during the morning, as it overlaps with the European session.
- Most economic reports are released near the start of the New York session. Remember, about 85% of all trades involve the dollar, so whenever big time U.S. economic data is released, it has the potential to move the markets.
- Once European markets close shop, liquidity and volatility tends to die down during the afternoon U.S. session.
- There is very little movement Friday afternoon, as Asian traders are out singing in karaoke bars while European traders head off to the pub to watch the soccer match.
- Also on Fridays, there is the chance of reversals in the second half of the session, as U.S. traders close their positions ahead of the weekend, in order to limit exposure to any weekend news.

Which Pairs Should You Trade?

Take note that there will be a ton of liquidity as both the U.S. and European markets will be open at the same time. You can bet that banks and multinational companies are burning up the telephone wires. This allows you to trade virtually any pair, although it would be best if you stuck to the major and minor pairs and avoid those weird ones.

Also, because the U.S. dollar is on the other side of the majority of transactions, everybody will be paying attention to U.S. data that is released. Should these reports come in better or worse than expected, it could dramatically shake up the markets, as the dollar will be jumping up and down.

Session Overlaps



Quick pop quiz! What time of the day are TV ratings highest? If you said during prime time, then you would be correct!

What does this have to do with trading sessions? Well, just like TV, "ratings" (a.k.a. liquidity) are at their highest when there are more people participating in the markets.

Logically, you would think that this happens during the overlap between two sessions. If you thought that way, you'd only be half right. Let's discuss some of the characteristics of the two overlap sessions to see why.

Tokyo - London Overlap

Liquidity during this session is pretty thin for a few reasons. Typically, there isn't as much movement during the Asian session so, once the afternoon hits, it's pretty much a snooze fest. With European traders just starting to get into their offices, trading can be boring as liquidity dries up.

This would be an ideal time to take a chill pill, play some putt-putt or look for potential trades to take for the London and New York sessions.

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London - New York Overlap

This is when the real shebang begins! You can literally hear traders crack their knuckles during this time, because they know they have their work cut out for them. This is the busiest time of day, as traders from the two largest financial centers (London and New York) begin duking it out.

It is during this period where we can see some big moves, especially when news reports from the U.S. and Canada are released. The markets can also be hit by "late" news coming out of Europe.

If any trends were established during the European session, we could see the trend continue, as U.S. traders decide to jump in and establish their positions after reading up what happened earlier in the day. You should watch out though, at the end of this session, as some European traders may be closing their positions, which could lead to some choppy moves right before lunch time in the U.S.

Best Days of the Week to Trade

So now we know that the London session is the busiest out of all the other sessions, but there are also certain days in the week where all the markets tend to show more movement.

Below is a chart of average pip range for the major pairs for each day of the week:

Pair	Sunday	Monday	Tuesday	Wednesday	Thursday	Friday
EUR/USD	69	109	142	136	145	144
GBP/USD	73	149	172	152	169	179
USD/JPY	41	65	82	91	124	98
AUD/USD	58	84	114	99	115	111
NZD/USD	28	81	98	87	100	96
USD/CAD	43	93	112	106	120	125
USD/CHF	55	84	119	107	104	116
EUR/JPY	19	133	178	159	223	192
GBP/JPY	100	169	213	179	270	232
EUR/GBP	35	74	81	79	75	91
EUR/CHF	35	55	55	64	87	76

As you can see from the chart above, it would probably be best to trade during the middle of the week, since this is when the most action happens.

Fridays are usually busy until 12:00 pm EST and then the market pretty much drops dead until it closes at 5:00 pm EST. This means we only work half-days on Fridays.

The weekend always starts early! Yippee!

So based on all these, we've learned when the busiest times of the market are. The busiest times are the best times to trade because they give you a higher chance of success.

Managing Yo Time Wisely

Unless you're Edward Cullen, who does not sleep, there is no way you can trade all sessions. Even if you could, why would you? While the forex market is open 24 hours daily, it doesn't mean that action happens all the time!

Besides, sleep is an integral part of a healthy lifestyle!

You need sleep to recharge and have energy so that you can do even the most mundane tasks like mowing the lawn, talking to your spouse, taking the dog for a walk, or organizing your stamp collection. You'll definitely need your rest if you plan on becoming a hotshot trader.

Each trader should learn when to trade.

Actually, scratch that.

Each trader should know when and when **NOT** to trade.

Knowing the optimal times you should trade and the times when you should sit out and just play some Plants vs. Zombies can help save you a pound of moolah (pun intended).

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Here's a quick cheat sheet of the best and worst times to trade:

Best Times to Trade:

- When two sessions are overlapping of course! These are also the times where major news events come out to potentially spark some volatility and directional movements. Make sure you bookmark the Market Hours cheat sheet to take note of the Opening and Closing times.
- The European session tends to be the busiest out of the three.
- The middle of the week typically shows the most movement, as the pip range widens for most of the major currency pairs.

Worst Times to Trade:

- Sundays - everyone is sleeping or enjoying their weekend!
- Fridays - liquidity dies down during the latter part of the U.S. session.
- Holidays - everybody is taking a break.
- Major news events - you don't want to get whipsawed!
- During American Idol, the NBA Finals, or the Superbowl.

Can't seem to trade during the optimal sessions? Don't fret. You can always be a swing or position trader. We'll get back to that later.

How You Make Money in Forex



In the forex market, you buy or sell currencies.

Placing a trade in the foreign exchange market is simple: the mechanics of a trade are very similar to those found in other markets (like the stock market), so if you have any experience in trading, you should be able to pick it up pretty quickly.

The object of forex trading is to exchange one currency for another in the expectation that the price will change, so that the currency you bought will increase in value compared to the one you sold.

Example:

Trader's Action	**EUR**	**USD**

You purchase 10,000 euros at the EUR/USD exchange rate of **1.1800**	+10,000	-11,800
Two weeks later, you exchange your 10,000 euros back into U.S. dollar at the exchange rate of **1.2500**	-10,000	+12,500**
You earn a profit of **$700**	0	+700

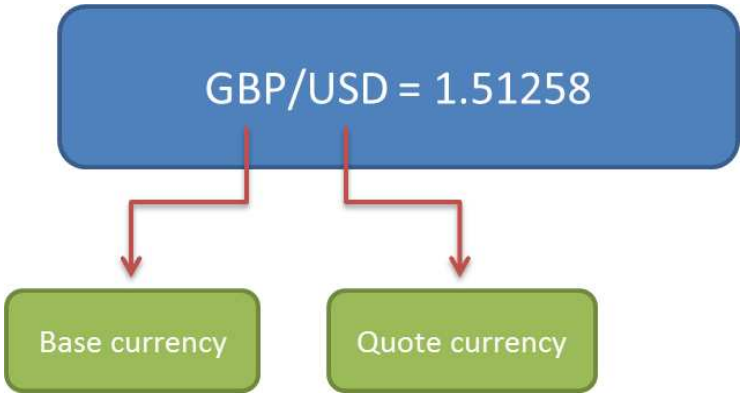
*EUR 10,000 x 1.18 = US $11,800

** EUR 10,000 x 1.25 = US $12,500

An exchange rate is simply the ratio of one currency valued against another currency. For example, the USD/CHF exchange rate indicates how many U.S. dollars can purchase one Swiss franc, or how many Swiss francs you need to buy one U.S. dollar.

How to Read a Forex Quote

Currencies are always quoted in pairs, such as GBP/USD or USD/JPY. The reason they are quoted in pairs is because in every foreign exchange transaction, you are simultaneously buying one currency and selling another. Here is an example of a foreign exchange rate for the British pound versus the U.S. dollar:



The first listed currency to the left of the slash ("/") is known as the **base currency** (in this example, the British pound), while the second one on the right is called the **counter or quote currency** (in this example, the U.S. dollar).

When buying, the exchange rate tells you how much you have to pay in units of the quote currency to buy one unit of the base currency. In the example above, you have to pay 1.51258 U.S. dollars to buy 1 British pound.

When selling, the exchange rate tells you how many units of the quote currency you get for selling one unit of the base currency. In the example above, you will receive 1.51258 U.S. dollars when you sell 1 British pound.

The base currency is the "basis" for the buy or the sell. If you buy EUR/USD this simply means that you are buying the base currency and simultaneously selling the quote currency. In caveman talk, "buy EUR, sell USD."

You would buy the pair if you believe the base currency will appreciate (gain value) relative to the quote currency. You would sell the pair if you think the base currency will depreciate (lose value) relative to the quote currency.

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Long/Short

First, you should determine whether you want to buy or sell.

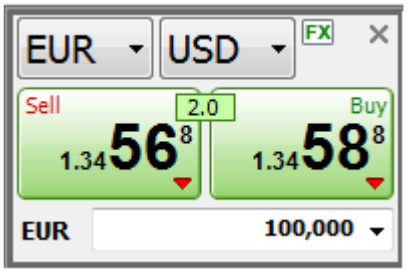
If you want to buy (which actually means buy the base currency and sell the quote currency), you want the base currency to rise in value and then you would sell it back at a higher price. In trader's talk, this is called "going long" or taking a "long position." Just remember: **long = buy.**

If you want to sell (which actually means sell the base currency and buy the quote currency), you want the base currency to fall in value and then you would buy it back at a lower price. This is called "going short" or taking a "short position". Just remember: **short = sell.**



"I'm long AND short."

Bid/Ask



"How come I keep getting quoted with two prices?"

All forex quotes are quoted with two prices: the bid and ask. For the most part, the **bid** is lower than the **ask** price.

The **bid** is the price at which your broker is willing to buy the base currency in exchange for the quote currency. This means the bid is the best available price at which you (the trader) will sell to the market.

The **ask** is the price at which your broker will sell the base currency in exchange for the quote currency. This means the ask price is the best available price at which you will buy from the market. **Another word for ask is the offer price.**

The difference between the bid and the ask price is popularly known as the **spread**.

On the EUR/USD quote above, the bid price is 1.34568 and the ask price is 1.34588. Look at how this broker makes it so easy for you to trade away your money.

If you want to sell EUR, you click "Sell" and you will sell euros at 1.34568. If you want to buy EUR, you click "Buy" and you will buy euros at 1.34588.

Time to Make Some Dough



In the following examples, we are going to use fundamental analysis to help us decide whether to buy or sell a specific currency pair.

If you always fell asleep during your economics class or just flat out skipped economics class, don't worry! We will cover fundamental analysis in a later lesson.

But right now, try to pretend you know what's going on...

EUR/USD

In this example, the euro is the base currency and thus the "basis" for the buy/sell.

If you believe that the U.S. economy will continue to weaken, which is bad for the U.S. dollar, you would execute a **BUY** EUR/USD order. By doing so, you have bought euros in the expectation that they will rise versus the U.S. dollar.

If you believe that the U.S. economy is strong and the euro will weaken against the U.S. dollar you would execute a **SELL** EUR/USD order. By doing so you have sold euros in the expectation that they will fall versus the US dollar.

USD/JPY

In this example, the U.S. dollar is the base currency and thus the "basis" for the buy/sell.

If you think that the Japanese government is going to weaken the yen in order to help its export industry, you would execute a **BUY** USD/JPY order. By doing so you have bought U.S dollars in the expectation that they will rise versus the Japanese yen.

If you believe that Japanese investors are pulling money out of U.S. financial markets and converting all their U.S. dollars back to yen, and this will hurt the U.S. dollar, you would execute a **SELL** USD/JPY order. By doing so you have sold U.S dollars in the expectation that they will depreciate against the Japanese yen.

GBP/USD

In this example, the pound is the base currency and thus the "basis" for the buy/sell.

If you think the British economy will continue to do better than the U.S. in terms of economic growth, you would execute a **BUY** GBP/USD order. By doing so you have bought pounds in the expectation that they will rise versus the U.S. dollar.

If you believe the British's economy is slowing while the United States' economy remains strong like Jack Bauer, you would execute a **SELL** GBP/USD order. By doing so you have sold pounds in the expectation that they will depreciate against the U.S. dollar.

USD/CHF

In this example, the U.S. dollar is the base currency and thus the "basis" for the buy/sell.

If you think the Swiss franc is overvalued, you would execute a **BUY** USD/CHF order. By doing so you have bought U.S. dollars in the expectation that they will appreciate versus the Swiss Franc.

If you believe that the U.S. housing market weakness will hurt future economic growth, which will weaken the dollar, you would execute a **SELL** USD/CHF order. By doing so you have sold U.S. dollars in the expectation that they will depreciate against the Swiss franc.

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Margin Trading

When you go to the grocery store and want to buy an egg, you can't just buy a single egg; they come in dozens or "lots" of 12.

In forex, it would be just as foolish to buy or sell 1 euro, so they usually come in "lots" of 1,000 units of currency (Micro), 10,000 units (Mini), or 100,000 units (Standard) depending on your broker and the type of account you have (more on "lots" later).

"But I don't have enough money to buy 10,000 euros! Can I still trade?"

You can with margin trading!

Margin trading is simply the term used for trading with borrowed capital. This is how you're able to open $1,250 or $50,000 positions with as little as $25 or $1,000. You can conduct relatively large transactions, very quickly and cheaply, with a small amount of initial capital.

Let us explain.

Listen carefully because this is very important!

1. You believe that signals in the market are indicating that the British pound will go up against the U.S. dollar.
2. You open one standard lot (100,000 units GBP/USD), buying with the British pound at 2% margin and wait for the exchange rate to climb. When you buy one lot (100,000

units) of GBP/USD at a price of 1.50000, you are buying 100,000 pounds, which is worth US$150,000 (100,000 units of GBP * 1.50000).

If the margin requirement was 2%, then US$3,000 would be set aside in your account to open up the trade (US$150,000 * 2%). You now control 100,000 pounds with just US$3,000.

We will be discussing margin more in-depth later, but hopefully you're able to get a basic idea of how it works.

3. Your predictions come true and you decide to sell. You close the position at 1.50500. You earn about $500.

Your Actions	**GBP**	**USD**
You buy 100,000 pounds at the exchange rate of **1.5000**	+100,000	-150,000
You blink for two seconds and the GBP/USD exchange rates rises to **1.5050** and you sell.	-100,000	+150,500
You have earned a **profit of $500**.	0	+500

When you decide to close a position, the deposit that you originally made is returned to you and a calculation of your profits or losses is done.

This profit or loss is then credited to your account.

What's even better is that, with the development of retail forex trading, there are some brokers who allow traders to have custom lots. This means that you don't need to trade in micro, mini or standard lots! If 1,542 is your favorite number and that's how many units you want trade, then you can!

Rollover

No, this is not the same as rollover minutes from your cell phone carrier! For positions open at your broker's "cut-off time" (usually 5:00 pm EST), there is a daily rollover interest rate that a trader either pays or earns, depending on your established margin and position in the market.

If you do not want to earn or pay interest on your positions, simply make sure they are all closed before 5:00 pm EST, the established end of the market day.

Since every currency trade involves borrowing one currency to buy another, interest rollover charges are part of forex trading. Interest is paid on the currency that is borrowed, and earned on the one that is bought.

If you are buying a currency with a higher interest rate than the one you are borrowing, then the net interest rate differential will be positive (i.e. USD/JPY) and you will earn funds as a result.

Conversely, if the interest rate differential is negative then you will have to pay.

Ask your broker or dealer about specific details regarding rollover.

Also note that many retail brokers do adjust their rollover rates based on different factors (e.g., account leverage, interbank lending rates). Please check with your broker for more information on rollover rates and crediting/debiting procedures.

Here is a chart to help you out figure out the interest rate differentials of the major currencies. Accurate as of 10/4/2010.

Benchmark Interest Rates

Country	Interest Rate
United States	0.25%
Euro zone	1.00%
United Kingdom	0.50%
Japan	0.10%
Canada	1.00%
Australia	4.50%
New Zealand	3.00%
Switzerland	0.25%

Later on, we'll teach you all about how you can use interest rate differentials to your advantage.

Pips and Pipettes

Here is where we're going to do a little math. You've probably heard of the terms "pips", "pipettes", and "lots" thrown around, and here we're going to explain what they are and show you how they are calculated.

Take your time with this information, as it is required knowledge for all forex traders. Don't even think about trading until you are comfortable with pip values and calculating profit and loss.

What the heck is a Pip? What about a Pipette?

The unit of measurement to express the change in value between two currencies is called a "Pip". If EUR/USD moves from 1.2250 to 1.2251, that is ONE PIP. A pip is the last decimal place of a quotation, given that four decimal places are used for pairs without the Japanese yen. If a pair does include the Japanese yen, then the currency quote goes out two decimal places.

Very Important: There are brokers that quote currency pairs beyond the standard "4 and 2" decimal places to "5 and 3" decimal places. They are quoting **FRACTIONAL PIPS**, also called pipettes. For instance, if GBP/USD moves from 1.51542 to 1.51543, it moved **ONE PIPETTE**.

As each currency has its own value, it is necessary to calculate the value of a pip for that particular currency. In the following examples, we will use quotes with 4 decimal places.

In currencies where the U.S. dollar is quoted first, the calculation would be as follows:

1. **USD/CHF at 1.5250**

   .0001 divided by exchange rate = pip value
   .0001 / 1.5250 = 0.0000655

2. **USD/CAD at 1.4890**

   .0001 divided by exchange rate = pip value
   .0001 / 1.4890 = 0.00006715

3. **USD/JPY at 119.80**

   Notice this currency pair only goes to two decimal places (most of the other currencies have four decimal places). In this case, 1 pip would be .01.

   .01 divided by exchange rate = pip value
   .01 / 119.80 = 0.0000834

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In the case where the U.S. dollar is not quoted first and we want to get the U.S. dollar value, we have to add one more step.

1. **EUR/USD at 1.2200**

   .0001 divided by exchange rate = pip value
   So .0001 / 1.2200 = EUR 0.00008196

   BUT we need to get back to U.S. dollars so we add another calculation which is

   EUR x Exchange rate
   So 0.00008196 x 1.2200 = 0.00009999

   When rounded up it would be 0.0001

2. **GBP/USD at 1.7975**

   .0001 divided by exchange rate = pip value
   So .0001 / 1.7975 = GBP 0.0000556

   BUT we need to get back to U.S. dollars so we add another calculation which is

   GBP x Exchange rate
   So 0.0000556 x 1.7975 = 0.0000998

When rounded up it would be 0.0001

You're probably rolling your eyes back and thinking "Do I really need to work all this out?" Well, the answer is a big fat NO. Nearly all forex brokers will work all this out for you automatically, but it's always good for you to know how they work it out.

If your broker doesn't happen to do this, don't worry - you can use our Pip Value Calculator! Aren't we awesome?

In the next section, we will discuss how these seemingly insignificant amounts can add up.

Lots, Leverage, and Profit and Loss

In the past, spot forex was traded in specific amounts called lots. The standard size for a lot is 100,000 units. There is also a mini, micro, and nano lot sizes that are 10,000, 1,000, and 100 units respectively.

Lot	Number of Units
Standard	100,000
Mini	10,000
Micro	1,000
Nano	100

As you already know, currencies are measured in pips, which is the smallest increment of that currency. To take advantage of these tiny increments, you need to trade large amounts of a particular currency in order to see any significant profit or loss.

Let's assume we will be using a 100,000 unit (standard) lot size. We will now recalculate some examples to see how it affects the pip value.

1. USD/JPY at an exchange rate of 119.80 (.01 / 119.80) x 100,000 = $8.34 per pip
2. USD/CHF at an exchange rate of 1.4555 (.0001 / 1.4555) x 100,000 = $6.87 per pip

In cases where the U.S. dollar is not quoted first, the formula is slightly different.

1. EUR/USD at an exchange rate of 1.1930 (.0001 / 1.1930) X 100,000 = 8.38 x 1.1930 = $9.99734 rounded up will be $10 per pip
2. GBP/USD at an exchange rate or 1.8040 (.0001 / 1.8040) x 100,000 = 5.54 x 1.8040 = 9.99416 rounded up will be $10 per pip.

Your broker may have a different convention for calculating pip value relative to lot size but whichever way they do it, they'll be able to tell you what the pip value is for the currency you

are trading is at the particular time. As the market moves, so will the pip value depending on what currency you are currently trading.

What the heck is leverage?

You are probably wondering how a small investor like yourself can trade such large amounts of money. Think of your broker as a bank who basically fronts you $100,000 to buy currencies. All the bank asks from you is that you give it $1,000 as a good faith deposit, which he will hold for you but not necessarily keep. Sounds too good to be true? This is how forex trading using leverage works.



The amount of leverage you use will depend on your broker and what you feel comfortable with.

Typically the broker will require a trade deposit, also known as "account margin" or "initial margin." Once you have deposited your money you will then be able to trade. The broker will also specify how much they require per position (lot) traded.

For example, if the allowed leverage is 100:1 (or 1% of position required), and you wanted to trade a position worth $100,000, but you only have $5,000 in your account. No problem as your broker would set aside $1,000 as down payment, or the "margin," and let you "borrow" the rest. Of course, any losses or gains will be deducted or added to the remaining cash balance in your account.

The minimum security (margin) for each lot will vary from broker to broker. In the example above, the broker required a one percent margin. This means that for every $100,000 traded, the broker wants $1,000 as a deposit on the position.

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How the heck do I calculate profit and loss?

So now that you know how to calculate pip value and leverage, let's look at how you calculate your profit or loss.

Let's buy U.S. dollars and Sell Swiss francs.

1. The rate you are quoted is 1.4525 / 1.4530. Because you are buying U.S. dollars you will be working on the "ask" price of 1.4530, or the rate at which traders are prepared to sell.
2. So you buy 1 standard lot (100,000 units) at 1.4530.
3. A few hours later, the price moves to 1.4550 and you decide to close your trade.
4. The new quote for USD/CHF is 1.4550 / 1.4555. Since you're closing your trade and you initially bought to enter the trade, you now sell in order to close the trade so you must take the "bid" price of 1.4550. The price traders are prepared to buy at.

5. The difference between 1.4530 and 1.4550 is .0020 or 20 pips.
6. Using our formula from before, we now have (.0001/1.4550) x 100,000 = $6.87 per pip x 20 pips = $137.40
7. Remember, when you enter or exit a trade, you are subject to the spread in the bid/offer quote. When you buy a currency you will use the offer or ask price and when you sell you will use the bid price.

Remember, when you enter or exit a trade, you are subject to the spread in the bid/offer quote. When **you buy a currency, you will use the offer or ask price** and when **you sell, you will use the bid price**.

Impress Your Date with Forex Lingo

As in any new skill that you learn, you need to learn the lingo... especially if you wish to win your love's heart. You, the newbie, must know certain terms like the back of your hand before making your first trade. Some of these terms you've already learned, but it never hurts to do a little review.



Major and Minor Currencies

The eight most frequently traded currencies (USD, EUR, JPY, GBP, CHF, CAD, NZD, and AUD) are called the major currencies or the "majors." These are the most liquid and the most sexy. All other currencies are referred to as minor currencies.

Base Currency

The base currency is the first currency in any currency pair. The currency quote shows how much the base currency is worth as measured against the second currency. For example, if the USD/CHF rate equals 1.6350, then one USD is worth CHF 1.6350.

In the forex market, the U.S. dollar is normally considered the "base" currency for quotes, meaning that quotes are expressed as a unit of 1 USD per the other currency quoted in the pair. The primary exceptions to this rule are the British pound, the euro, and the Australian and New Zealand dollar.

Quote Currency

The quote currency is the second currency in any currency pair. This is frequently called the pip currency and any unrealized profit or loss is expressed in this currency.

Pip

A pip is the smallest unit of price for any currency. Nearly all currency pairs consist of five significant digits and most pairs have the decimal point immediately after the first digit, that is, EUR/USD equals 1.2538. In this instance, a single pip equals the smallest change in the fourth decimal place - that is, 0.0001. Therefore, if the quote currency in any pair is USD, then one pip always equal 1/100 of a cent.

Notable exceptions are pairs that include the Japanese yen where a pip equals 0.01.

Pipette

One-tenth of a pip. Some brokers quote fractional pips, or pipettes, for added precision in quoting rates. For example, if EUR/USD moved from 1.32156 to 1.32158, it moved 2 pipettes.

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Bid Price

The bid is the price at which the market is prepared to buy a specific currency pair in the forex market. At this price, the trader can sell the base currency. It is shown on the left side of the quotation.

For example, in the quote GBP/USD 1.8812/15, the bid price is 1.8812. This means you sell one British pound for 1.8812 U.S. dollars.

Ask/Offer Price

The ask/offer is the price at which the market is prepared to sell a specific currency pair in the forex market. At this price, you can buy the base currency. It is shown on the right side of the quotation.

For example, in the quote EUR/USD 1.2812/15, the ask price is 1.2815. This means you can buy one euro for 1.2815 U.S. dollars. The ask price is also called the offer price.

Bid/Ask Spread

The spread is the difference between the bid and ask price. The "big figure quote" is the dealer expression referring to the first few digits of an exchange rate. These digits are often omitted in dealer quotes. For example, the USD/JPY rate might be 118.30/118.34, but would be quoted verbally without the first three digits as "30/34." In this example, USD/JPY has a 4-pip spread.

Quote Convention

Exchange rates in the forex market are expressed using the following format:
Base currency / Quote currency = Bid / Ask

Transaction Cost

The critical characteristic of the bid/ask spread is that it is also the transaction cost for a round-turn trade. Round-turn means a buy (or sell) trade and an offsetting sell (or buy) trade of the same size in the same currency pair. For example, in the case of the EUR/USD rate of 1.2812/15, the transaction cost is three pips.

The formula for calculating the transaction cost is:

Transaction cost (spread) = Ask Price - Bid Price

Cross Currency

A cross currency is any pair in which neither currency is the U.S. dollar. These pairs exhibit erratic price behavior since the trader has, in effect, initiated two USD trades. For example, initiating a long (buy) EUR/GBP is equivalent to buying a EUR/USD currency pair and selling GBP/USD. Cross currency pairs frequently carry a higher transaction cost.

Margin

When you open a new margin account with a forex broker, you must deposit a minimum amount with that broker. This minimum varies from broker to broker and can be as low as $100 to as high as $100,000.

Each time you execute a new trade, a certain percentage of the account balance in the margin account will be set aside as the initial margin requirement for the new trade based upon the underlying currency pair, its current price, and the number of units (or lots) traded. The lot size always refers to the base currency.

For example, let's say you open a mini account which provides a 200:1 leverage or 0.5% margin. Mini accounts trade mini lots. Let's say one mini lot equals $10,000. If you were to open one mini-lot, instead of having to provide the full $10,000, you would only need $50 ($10,000 x 0.5% = $50).

Leverage

Leverage is the ratio of the amount capital used in a transaction to the required security deposit (margin). It is the ability to control large dollar amounts of a security with a relatively small amount of capital. Leveraging varies dramatically with different brokers, ranging from 2:1 to 500:1.

Types of Orders



The term "order" refers to how you will enter or exit a trade. Here we discuss the different types of orders that can be placed into the foreign exchange market.

Be sure that you know which types of orders your broker accepts. Different brokers accept different types of orders.

There are some basic order types that all brokers provide and some others that sound weird.

Order Types

Market order

A market order is an order to buy or sell at the best available price.

For example, the bid price for EUR/USD is currently at 1.2140 and the ask price is at 1.2142. If you wanted to buy EUR/USD at market, then it would be sold to you at the ask price of 1.2142. You would click buy and your trading platform would instantly execute a buy order at that exact price.

If you ever shop on Amazon.com, it's kinda like using their 1-Click ordering. You like the current price, you click once and it's yours! The only difference is you are buying or selling one currency against another currency instead of buying a Justin Bieber CD.

Limit Entry Order

A limit entry is an order placed to **buy below the market** or **sell above the market** at a certain price.

For example, EUR/USD is currently trading at 1.2050. You want to go short if the price reaches 1.2070. You can either sit in front of your monitor and wait for it to hit 1.2070 (at which point you would click a sell market order), or you can set a sell limit order at 1.2070 (then you could walk away from your computer to attend your ballroom dancing class).

If the price goes up to 1.2070, your trading platform will automatically execute a sell order at the best available price.

You use this type of entry order when you believe price will reverse upon hitting the price you specified!

Stop-Entry Order

A stop-entry order is an order placed to buy above the market or sell below the market at a certain price.

For example, GBP/USD is currently trading at 1.5050 and is heading upward. You believe price will continue with its direction if it hit 1.5060. You can do either one of these things: sit in front of your computer and buy at market when it hits 1.5060 OR set a stop-entry order at 1.5060. You use stop-entry orders when you feel that price will move in one direction!

Stop-Loss Order

A stop-loss order is a type of order linked to a trade for the purpose of preventing additional losses if price goes against you. **REMEMBER THIS TYPE OF ORDER**. A stop-loss order remains in effect until the position is liquidated or you cancel the stop-loss order.

For example, you went long (buy) EUR/USD at 1.2230. To limit your maximum loss, you set a stop-loss order at 1.2200. This means if you were dead wrong and EUR/USD drops to 1.2200 instead of moving up, your trading platform would automatically execute a sell order at 1.2200 the best available price and close out your position for a 30-pip loss (eww!).

Stop-losses are extremely useful if you don't want to sit in front of your monitor all day worried that you will lose all your money. You can simply set a stop-loss order on any open positions so you won't miss your basket weaving class or elephant polo game.

Trailing Stop

A trailing stop is a type of stop-loss order attached to a trade that moves as price fluctuates.

Let's say that you've decided to short USD/JPY at 90.80, with a trailing stop of 20 pips. This means that originally, your stop loss is at 91.00. If price goes down and hits 90.50, your trailing stop would move down to 90.70.

Just remember though, that your stop will STAY at this price. It will not widen if price goes against you. Going back to the example, with a trailing stop of 20 pips, if USD/JPY hits 90.50, then your stop would move to 90.70. However, if price were to suddenly move up to 90.60, your stop would remain at 90.70.

Your trade will remain open as long as price does not move against you by 20 pips. Once price hits your trailing stop, a stop-loss order will be triggered and your position will be closed.

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Weird Orders

"Can I order a grande extra hot soy with extra foam, extra hot split quad shot with a half squirt of sugar-free white chocolate and a half squirt of sugar-free cinnamon, a half packet of Splenda and put that in a venti cup and fill up the "room" with extra whipped cream with caramel and chocolate sauce drizzled on top?"

Ooops, wrong weird order.

Good 'Till Cancelled (GTC)

A GTC order remains active in the market until you decide to cancel it. Your broker will not cancel the order at any time. Therefore it's **your responsibility** to remember that you have the order scheduled.

Good for the Day (GFD)

A GFD order remains active in the market until the end of the trading day. Because foreign exchange is a 24-hour market, this usually means 5:00 pm EST since that's the time U.S. markets close, but we'd recommend you double check with your broker.

One-Cancels-the-Other (OCO)

An OCO order is a mixture of two entry and/or stop-loss orders. Two orders with price and duration variables are placed above and below the current price. When one of the orders is executed the other order is canceled.

Let's say the price of EUR/USD is 1.2040. You want to either buy at 1.2095 over the resistance level in anticipation of a breakout or initiate a selling position if the price falls below 1.1985. The understanding is that if 1.2095 is reached, your buy order will be triggered and the 1.1985 sell order will be automatically canceled.

One-Triggers-the-Other

An OTO is the opposite of the OCO, as it only puts on orders when the parent order is triggered. You set an OTO order when you want to set profit taking and stop loss levels ahead of time, even before you get in a trade.

For example, USD/CHF is currently trading at 1.2000. You believe that once it hits 1.2100, it will reverse and head downwards but only up to 1.1900. The problem is that you will be gone for an entire week because you have to join a basket weaving competition at the top of Mt. Fiji where there is no internet.

In order to catch the move while you are away, you set a sell limit at 1.2000 and at the same time, place a related buy limit at 1.1900, and just in case, place a stop-loss at 1.2100. As an OTO, both the buy limit and the stop-loss orders will only be placed if your initial sell order at 1.2000 gets triggered.

In conclusion...

The basic order types (market, limit entry, stop-entry, stop loss, and trailing stop) are usually all that most traders ever need.

Unless you are a veteran trader (don't worry, with practice and time you will be), don't get fancy and design a system of trading requiring a large number of orders sandwiched in the market at all times.

Stick with the basic stuff first.

Make sure you fully understand and are comfortable with your broker's order entry system before executing a trade.

Also, always check with your broker for specific order information and to see if any rollover fees will be applied if a position is held longer than one day. Keeping your ordering rules simple is the best strategy.

DO NOT trade with real money until you have an extremely high comfort level with the trading platform you are using and its order entry system. Erroneous trades are more common than you think!

Demo Your Way to Success

You can open a demo accounts for FREE with most forex brokers. These "pretend" accounts have the full capabilities of a "real" account.

But why is it free?

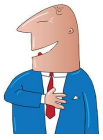
It's because the broker wants you to learn the ins and outs of their trading platform, and have a good time trading without risk, so you'll fall in love with them and deposit real money. The demo account allows you to learn about the forex market and test your trading skills with ZERO risk.

Yes, that's right, ZERO!

YOU SHOULD DEMO TRADE UNTIL YOU DEVELOP A SOLID, PROFITABLE SYSTEM BEFORE YOU EVEN THINK ABOUT PUTTING REAL MONEY ON THE LINE.

WE REPEAT - YOU SHOULD DEMO TRADE UNTIL YOU DEVELOP A SOLID, PROFITABLE SYSTEM BEFORE YOU EVEN THINK ABOUT PUTTING REAL MONEY ON THE LINE.

"Don't Lose Your Money" Declaration


Now, place your hand on your heart and say...

"I will demo trade until I develop a solid, profitable system before I trade with real money."

Now touch your head with your index finger and say...

"I am a smart and patient forex trader!"

Do NOT open a live trading account until you are CONSISTENTLY trading PROFITABLY on a demo account.

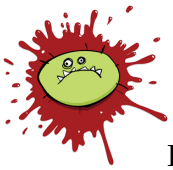
If you can't wait until you're profitable on a demo account, at least demo trade for two months. Hey, at least you were able to hold off losing all your money for two months right? If you can't hold out for two months, just donate that money to your favorite charity or cut your hands off.

Concentrate on ONE major currency pair.

It gets far too complicated to keep tabs on more than one currency pair when you first start trading. Stick with one of the majors because they are the most liquid which makes their spreads cheap.

You can be a winner at currency trading but, as in all other aspects of life, it will take hard work, dedication, a little luck, a lot of common sense, and a whole lot of good judgment.

Protect Yo Self Before You Wreck Yo Self



Before we go any further we are going to be 100% honest with you and tell you the following before you consider trading currencies:

1. **All forex traders, and we do mean ALL traders, LOSE money on trades.**

   Ninety percent of traders lose money, largely due to lack of planning, training, discipline, and having poor money management rules.

   If you hate to lose or are a super perfectionist, you'll also probably have a hard time adjusting to trading because all traders lose a trade at some point or another.

2. **Trading forex is not for the unemployed, those on low incomes, are knee-deep in credit card debt or who can't afford to pay their electricity bill or afford to eat.**

   You should have at least $10,000 of trading capital (in a mini account) that you can afford to lose. Don't expect to start an account with a few hundred dollars and expect to become a gazillionaire.

The forex market is one of the most popular markets for speculation, due to its enormous size, liquidity, and tendency for currencies to move in strong trends. You would think traders all over the world would make a killing, but success has been limited to very small percentage of traders.

The problem is that many traders come with the misguided hope of making a gazillion bucks, but in reality, they lack the discipline required for really learning the art of trading. Most people usually lack the discipline to stick to a diet or to go to the gym three times a week.

If you can't even do that, how do you think you're going to succeed one of the most difficult, but financially rewarding, endeavors known to man?

Short term trading IS NOT for amateurs, and it is rarely the path to "get rich quick". You can't make gigantic profits without taking gigantic risks.

A trading strategy that involves taking a massive degree of risk means suffering inconsistent trading performance and large losses. A trader who does this probably doesn't even have a trading strategy - unless you call gambling a trading strategy!

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Forex Trading is NOT a Get-Rich-Quick Scheme

Forex trading is a SKILL that takes TIME to learn.

Skilled traders can and do make money in this field. However, like any other occupation or career, success doesn't just happen overnight. Forex trading isn't a piece of cake (as some people would like you to believe).

Think about it, if it was, everyone trading would already be millionaires.

The truth is that even expert traders with years of experience still encounter periodic losses.

Drill this in your head: there are NO shortcuts to forex trading.

It takes lots and lots of **PRACTICE** and **EXPERIENCE** to master.

There is no substitute for hard work, deliberate practice, and diligence.

Practice trading on a **DEMO ACCOUNT** until you find a method that you know inside and out, and can comfortably execute objectively. Basically, find the way that works for you!!!

The Big Three

Congratulations! You've gotten through the Pre-School and, with a few boo-boos here and there, you are ready to begin your first day of class!

You did go through the Pre-School, right????

By now you've learned some history about the forex, how it works, what affects the prices, blah blah blah.

ZZZZZZZZZZZZZZZZZZZZZZZZZZZZZZZZZZZZZZZZZZZZZZZ.

We know what you're thinking...

BORING!
SHOW
ME
HOW



TO
MAKE
MONEY
ALREADY!!!!

Well say no more friends because here is where your journey as a forex trader begins...

This is your last chance to turn back...

Take the **red pill**, forget everything, and we'll take you back to where you were before.

You can go back to living your average life in your 9-5 job and work for someone else for the rest of your life...

OR...

You can take the **green pill**, which is fully loaded with the dollar extract, and learn how you can make money for yourself in the most active market in the world, simply by using a little brain power.



Just remember, your education will never stop. Even after you graduate from the School of Pipsology, you must constantly pursue as much knowledge as you can, so that you can become a true FOREX MASTER! The learning never ends!

Are you ready to make that commitment?

Now pop that green pill in, wash it down with some delicious chocolate milk, and grab your lunchbox... the School of Pipsology is now in session!

Note: the green pill was made with a brainwashing serum. You will now obey everything that we tell you to do! Mwuahahaha! <--- evil laugh

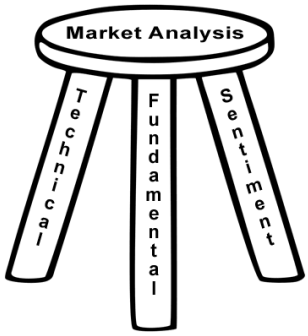
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Three Types of Market Analysis

To begin, let's look at three ways on how you would analyze and develop ideas to trade the market. There are three basic types of market analysis:

1. Technical Analysis
2. Fundamental Analysis
3. Sentiment Analysis

There has always been a constant debate as to which analysis is better, but to tell you the truth, you need to know all three.



It's kind of like standing on a three-legged stool - if one of the legs is weak, the stool will break under your weight and you'll fall flat on your face. The same holds true in trading. If your analysis on any of the three types of trading is weak and you ignore it, there's a good chance that it will cause you to lose out on your trade!

Technical Analysis

Technical analysis is the framework in which traders study price movement.

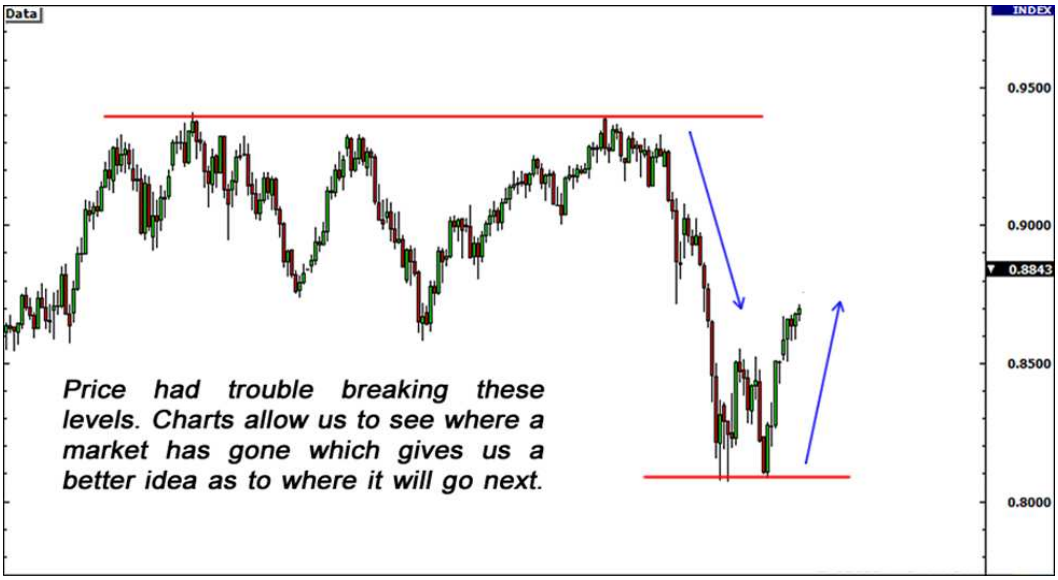
The theory is that a person can look at historical price movements and determine the current trading conditions and potential price movement.

The main evidence for using technical analysis is that, theoretically, all current market information is reflected in price. If price reflects all the information that is out there, then price action is all one would really need to make a trade.

Now, have you ever heard the old adage, "**History tends to repeat itself**"?

Well, that's basically what technical analysis is all about! If a price level held as a key support or resistance in the past, traders will keep an eye out for it and base their trades around that historical price level.

Technical analysts look for similar patterns that have formed in the past, and will form trade ideas believing that price will act the same way that it did before.



In the world of trading, when someone says technical analysis, the first thing that comes to mind is a chart. Technical analysts use charts because they are the easiest way to visualize historical data!

You can look at past data to help you spot trends and patterns which could help you find some great trading opportunities.

What's more is that with all the traders who rely on technical analysis out there, these price patterns and indicator signals tend to become self-fulfilling.

As more and more traders look for certain price levels and chart patterns, the more likely that these patterns will manifest themselves in the markets.

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You should know though that technical analysis is VERY subjective.

Just because Ralph and Joseph are looking at the exact same chart setup or indicators doesn't mean that they will come up with the same idea of where price may be headed.

The important thing is that you understand the concepts under technical analysis so you won't get nosebleeds whenever somebody starts talking about Fibonacci, Bollinger bands, or pivot points.



Fibonacci? Bollinger bands? Pivot points?!

Now we know you're thinking to yourself, "Geez, these guys are smart. They use crazy words like 'Fibonacci' and 'Bollinger'. I can never learn this stuff!"

Don't worry yourself too much. After you're done with the School of Pipsology, you too will be just as... uhmmm... "smart" as us.

By the way, do you feel that green pill kicking in yet? Bark like a dog!

Fundamental Analysis

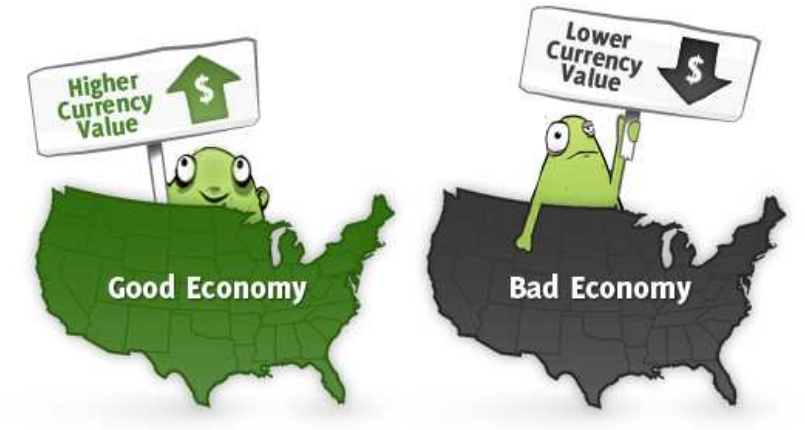
Fundamental analysis is a way of looking at the market by analyzing economic, social, and political forces that affects the supply and demand of an asset. If you think about it, this makes a whole lot of sense! Just like in your Economics 101 class, it is supply and demand that determines price.

Using supply and demand as an indicator of where price could be headed is easy. The hard part is analyzing all the factors that affect supply and demand.

In other words, you have to look at different factors to determine whose economy is rockin' like a Taylor Swift song, and whose economy sucks. You have to understand the reasons of how and why certain events an increase in unemployment affect a country's economy, and ultimately, the demand for its currency.

The idea behind this type of analysis is that if a country's current or future economic outlook is good, their currency should strengthen. The better shape a country's economy is, the more foreign businesses and investors will invest in that country. This results in the need to purchase that country's currency to obtain those assets.

In a nutshell, this is what fundamental analysis is:



For example, let's say that the U.S. dollar has been gaining strength because the U.S. economy is improving. As the economy gets better, raising interest rates may be needed to control growth and inflation.

Higher interest rates make dollar-denominated financial assets more attractive. In order to get their hands on these lovely assets, traders and investors have to buy some greenbacks first. As a result, the value of the dollar will increase.

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Later on in the course, you will learn which economic data drives currency prices, and why they do so. You will know who the Fed Chairman is and how retail sales data reflects the economy. You'll be spitting out interest rates like baseball statistics.

But that's for another lesson for another time. For now, just know that the fundamental analysis is a way of analyzing a currency through the strength or weakness of that country's economy. It's going to be awesome, we promise!

Sentimental Analysis



Earlier, we said that price should theoretically accurately reflect all available market information. Unfortunately for us traders, it isn't that simple. The markets do not simply reflect all the information out there because traders will all just act the same way. Of course, that isn't how things work.

Each trader has his own opinion or explanation of why the market is acting the way they do. The market is just like Facebook - it's a complex network made up of individuals who want to spam our news feeds.

Kidding aside, the market basically represents what all traders - you, Pipcrawler, Celine from the donut shop - feel about the market. Each trader's thoughts and opinions, which are expressed through whatever position they take, helps form the overall sentiment of the market.

The problem is that as traders, no matter how strongly you feel about a certain trade, you can't move the markets in your favor (unless you're one of the GSs - George Soros or Goldman Sachs!). Even if you truly believe that the dollar is going to go up, but everyone else is bearish on it, there's nothing much you can do about it.

As a trader, you have to take all this into consideration. It's up to you to gauge how the market is feeling, whether it is bullish or bearish. Ultimately, it's also up to you to find out how you want to incorporate market sentiment into your trading strategy. If you choose to simply ignore market sentiment, that's your choice. But hey, we're telling you now, it's your loss!

Being able to gauge market sentiment can be an important tool in your toolbox. Later on in school, we'll teach you how to analyze market sentiment and use it to your advantage like Jedi mind tricks.

Which Type of Analysis is Best?

Ahhhh, the million dollar question....

Throughout your journey as an aspiring forex trader you will find strong advocates for each type of analysis. Do not be fooled by these one-sided extremists! One is not better than the other...they are all just different ways to look at the market.

At the end of the day, you should trade based on the type of analysis you are most comfortable and profitable with.

To recap, **technical analysis** is the study of price movement on the charts while **fundamental analysis** takes a look at how the country's economy is doing.

Market sentiment analysis determines whether the market is bullish or bearish on the current or future fundamental outlook.

Fundamental factors shape sentiment, while technical analysis helps us visualize that sentiment and apply a framework for our trades.

Those three work hand-in-hand-in-hand to help you come up with good trade ideas. All the historical price action and economic figures are there - all you have to do is put on your thinking cap and put those analytical skills to the test!

Let me pull out that three-legged stool again just to emphasize the importance of all three types of analysis.

Take out one or two legs of the stool and it's going to be shaky!



In order to become a true forex master you will need to know how to effectively use these three types of analysis.

Don't believe us?

Let us give you an example of how focusing on only one type of analysis can turn into a disaster.

- Let's say that you're looking at your charts and you find a good trading opportunity.

  You get all excited thinking about the money that's going to be raining down from the sky.

  You say to yourself, "Man, I've never seen a more perfect trading opportunity in GBP/USD. I love my charts. Mwah. Now show me the money!"

- You then proceed to buy GBP/USD with a big fat smile on your face (the kind where all your teeth are showing).
- But wait! All of a sudden the trade makes a 100 pip move in the **OTHER DIRECTION**! Little did you know, one of the major banks in London filed for bankruptcy! Suddenly, everyone's sentiment towards Britain's market turns sour and everyone trades in the opposite direction!

- Your big fat smile turns into mush and you start getting angry at your charts. You throw your computer on the ground and begin to pulverize it. You just lost a bunch of money, and now your computer is broken into a billion pieces.

  And it's all because you completely ignored fundamental analysis and sentimental analysis.

(Note: This was not based on a real story. This did not happen to us. We were never this naive. We were always smart traders.... From the overused sarcasm, we think you get the picture.)

Ok, ok, so the story was a little over-dramatized, but you get the point.

Remember how your mother used to tell you as a kid that too much of anything is never good?

Well you might've thought that was just hogwash back then but in forex, the same applies when deciding which type of analysis to use.

Don't rely on just one.

Instead, you must learn to balance the use of all of them. It is only then that you can really get the most out of your trading.

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Where do we go from here?

Now that you're done with Kindergarten and learned a little bit about each type of analysis, it's time to delve much deeper! Here's what's in store for the next few years of your life...

We're kidding, we're kidding! We're talking about the next few school years in the School of Pipsology.

Grade school will be all about basic technical analysis tools.

You'll learn all about the dynamics behind price action, such as support and resistance levels, candlestick formations, and common chart patterns. You'll experiment with leading and lagging indicators and discover how to use them in coming up with trade ideas. Sounds pretty exciting, doesn't it?

The remaining years of middle school and high school are devoted to studying more technical analysis tools.

We'll take a look at the more advanced tools also such as pivot points, divergences, Elliott Wave Theory, and Gartley patterns. Sounds fancy? It's because they are! Bet you can't wait to get started on those!

College will be a bit more complicated since you'll be tackling both fundamental and market sentiment analysis at the same time. Talk about hitting two stones with one bird! You're the bird and the stones are... well, you get the point.

A couple of reasons why we're putting fundamental and market sentiment analysis together:

- By the time you reach college, you'll be so hooked on learning more about forex that one lesson simply won't be enough.
- It is hard to draw the line between fundamental analysis and market sentiment analysis.

As we mentioned earlier, fundamental factors are mostly responsible for shaping market sentiment. Those two types of analysis would take up both freshman and sophomore year of college.

Types of Charts

Let's take a look at the three most popular types of charts:

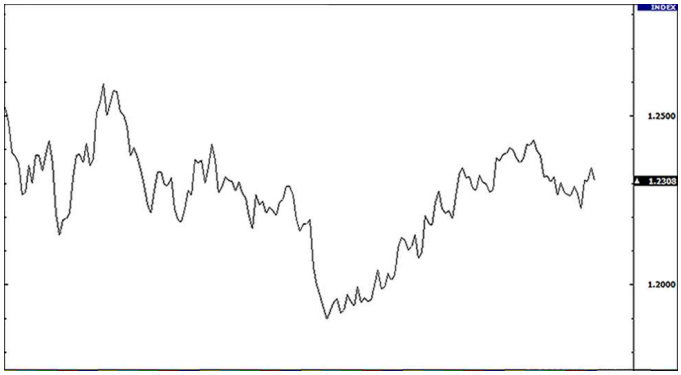
1. Line chart
2. Bar chart
3. Candlestick chart

Now, we'll explain each of the charts, and let you know what you should know about each of them.

Line Charts

A simple line chart draws a line from one closing price to the next closing price. When strung together with a line, we can see the general price movement of a currency pair over a period of time.

Here is an example of a line chart for EUR/USD:



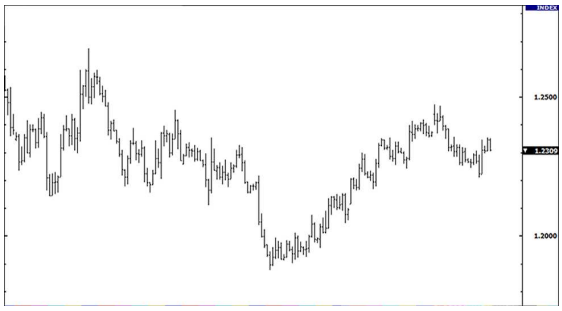
Bar Charts

A bar chart is a little more complex. It shows the opening and closing prices, as well as the highs and lows. The bottom of the vertical bar indicates the lowest traded price for that time period, while the top of the bar indicates the highest price paid.

The vertical bar itself indicates the currency pair's trading range as a whole.

The horizontal hash on the left side of the bar is the opening price, and the right-side horizontal hash is the closing price.

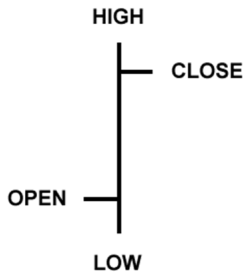
Here is an example of a bar chart for EUR/USD:



Take note, throughout our lessons, you will see the word "bar" in reference to a single piece of data on a chart.

A bar is simply one segment of time, whether it is one day, one week, or one hour. When you see the word 'bar' going forward, be sure to understand what time frame it is referencing.

Bar charts are also called "OHLC" charts, because they indicate the Open, the High, the Low, and the Close for that particular currency. Here's an example of a price bar:



Open: The little horizontal line on the left is the opening price
High: The top of the vertical line defines the highest price of the time period
Low: The bottom of the vertical line defines the lowest price of the time period
Close: The little horizontal line on the right is the closing price

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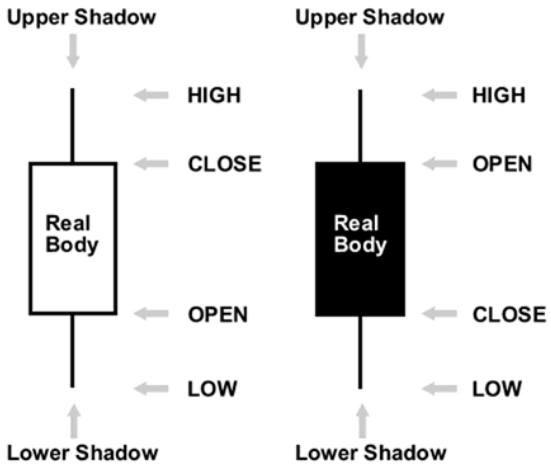
Candlesticks Charts

Candlestick chart show the same information as a bar chart, but in a prettier, graphic format.

Candlestick bars still indicate the high-to-low range with a vertical line.

However, in candlestick charting, the larger block (or body) in the middle indicates the range between the opening and closing prices. Traditionally, if the block in the middle is filled or colored in, then the currency closed lower than it opened.

In the following example, the 'filled color' is black. For our 'filled' blocks, the top of the block is the opening price, and the bottom of the block is the closing price. If the closing price is higher than the opening price, then the block in the middle will be "white" or hollow or unfilled.



Here at BabyPips.com, we don't like to use the traditional black and white candlesticks. They just look so unappealing. And since we spend so much time looking at charts, we feel it's easier to look at a chart that's colored.

A color television is much better than a black and white television, so why not splash some color in those candlestick charts?

We simply substituted green instead of white, and red instead of black. This means that if the price closed higher than it opened, the candlestick would be green.

If the price closed lower than it opened, the candlestick would be red.

In our later lessons, you will see how using green and red candles will allow you to "see" things on the charts much faster, such as uptrend/downtrends and possible reversal points.

For now, just remember that we use red and green candlesticks instead of black and white and we will be using these colors from now on.

Check out these candlesticks...BabyPips.com style! Awww yeeaaah! You know you like that!

Here is an example of a candlestick chart for EUR/USD. Isn't it pretty?



The purpose of candlestick charting is strictly to serve as a visual aid, since the exact same information appears on an OHLC bar chart. The advantages of candlestick charting are:

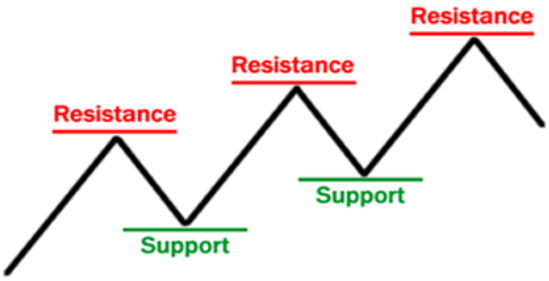
- Candlesticks are easy to interpret, and are a good place for beginners to start figuring out chart analysis.
- Candlesticks are easy to use! Your eyes adapt almost immediately to the information in the bar notation. Plus, research shows that visuals help in studying, it might help with trading as well!
- Candlesticks and candlestick patterns have cool names such as the shooting star, which helps you to remember what the pattern means.
- Candlesticks are good at identifying marketing turning points - reversals from an uptrend to a downtrend or a downtrend to an uptrend. You will learn more about this later.

Now that you know why candlesticks are so cool, it's time to let you know that we will be using candlestick charts for most, if not all of chart examples on this site.

Support and Resistance

Support and resistance is one of the most widely used concepts in trading. Strangely enough, everyone seems to have their own idea on how you should measure support and resistance.

Let's take a look at the basics first.



Look at the diagram above. As you can see, this zigzag pattern is making its way up (bull market). When the market moves up and then pulls back, the highest point reached before it pulled back is now resistance.

As the market continues up again, the lowest point reached before it started back is now support. In this way resistance and support are continually formed as the market oscillates over time. The reverse is true for the downtrend.

Plotting Support and Resistance

One thing to remember is that support and resistance levels are **not exact numbers**.

Often times you will see a support or resistance level that appears broken, but soon after find out that the market was just testing it. With candlestick charts, these "tests" of support and resistance are usually represented by the candlestick shadows.



Notice how the shadows of the candles tested the 1.4700 support level. At those times it seemed like the market was "breaking" support. In hindsight we can see that the market was merely testing that level.

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So how do we truly know if support and resistance was broken?

There is no definite answer to this question. Some argue that a support or resistance level is broken if the market can actually close past that level. However, you will find that this is not always the case.

Let's take our same example from above and see what happened when the price actually closed past the 1.4700 support level.



In this case, price had closed below the 1.4700 support level but ended up rising back up above it.

If you had believed that this was a real breakout and sold this pair, you would've been seriously hurtin'!

Looking at the chart now, you can visually see and come to the conclusion that the support was not actually broken; it is still very much intact and now even stronger.

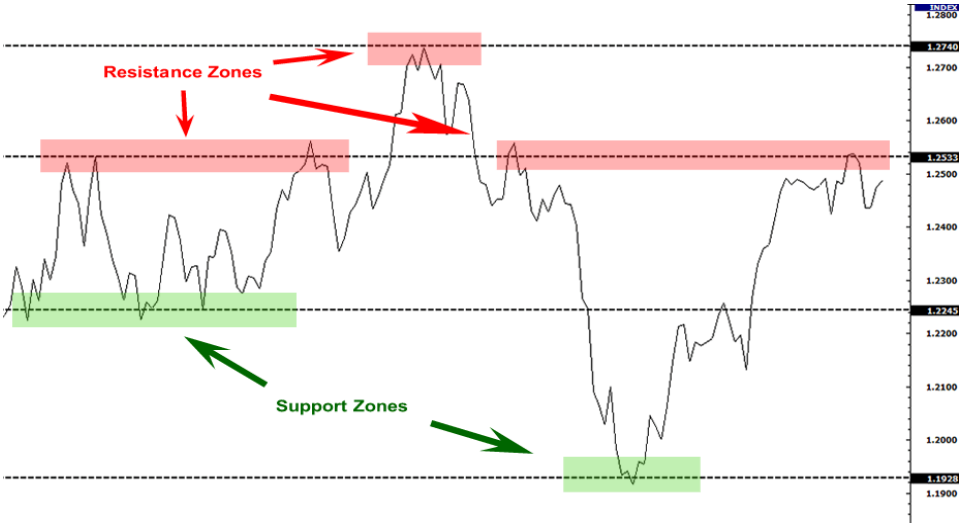
To help you filter out these false breakouts, you should think of support and resistance more of as "zones" rather than concrete numbers.

One way to help you find these zones is to plot support and resistance on a line chart rather than a candlestick chart. The reason is that line charts only show you the closing price while candlesticks add the extreme highs and lows to the picture.

These highs and lows can be misleading because often times they are just the "knee-jerk" reactions of the market. It's like when someone is doing something really strange, but when asked about it, he or she simply replies, "Sorry, it's just a reflex."

When plotting support and resistance, you don't want the reflexes of the market. You only want to plot its intentional movements.

Looking at the line chart, you want to plot your support and resistance lines around areas where you can see the price forming several peaks or valleys.



Other interesting tidbits about support and resistance:

- When the price passes through resistance, that resistance could potentially become support.
- The more often price tests a level of resistance or support without breaking it, the stronger the area of resistance or support is.
- When a support or resistance level breaks, the strength of the follow-through move depends on how strongly the broken support or resistance had been holding.



With a little practice, you'll be able to spot potential support and resistance areas easily. In the next lesson, we'll teach you how to trade diagonal support and resistance lines, otherwise known as trend lines.

Trend Lines

Trend lines are probably the most common form of technical analysis. They are probably one of the most underutilized ones as well.

If drawn correctly, they can be as accurate as any other method. Unfortunately, most traders don't draw them correctly or try to make the line fit the market instead of the other way around.

In their most basic form, an uptrend line is drawn along the bottom of easily identifiable support areas (valleys). In a downtrend, the trend line is drawn along the top of easily identifiable resistance areas (peaks).

How do you draw trend lines?

To draw trend lines properly, all you have to do is locate two major tops or bottoms and connect them.

What's next?
Nothing.
Uhh, is that it?
Yep, it's that simple.

Here are trend lines in action! Look at those waves!



Types of Trends

There are three types of trends:
Uptrend (higher lows)
Downtrend (lower highs)
Sideways trends (ranging)

Here are some important things to remember about trend lines:

- It takes at least two tops or bottoms to draw a valid trend line but it takes THREE to confirm a trend line.
- The STEEPER the trend line you draw, the less reliable it is going to be and the more likely it will break.
- Like horizontal support and resistance levels, trend lines become stronger the more times they are tested.
- And most importantly, **DO NOT EVER** draw trend lines by forcing them to fit the market. If they do not fit right, then that trend line isn't a valid one!

Channels

If we take this trend line theory one step further and draw a parallel line at the same angle of the uptrend or downtrend, we will have created a channel. No, we're not talking about ESPN, ABC, or Cartoon Network.

Still, this doesn't mean that you should walk away like it's a commercial break- channels can be just as exciting to watch as America's Next Top Model or Entourage!

Channels are just another tool in technical analysis which can be used to determine good places to buy or sell. Both the tops and bottoms of channels represent potential areas of support or resistance.



To create an up (ascending) channel, simply draw a parallel line at the same angle as an uptrend line and then move that line to position where it touches the most recent peak. This should be done at the same time you create the trend line.

To create a down (descending) channel, simple draw a parallel line at the same angle as the downtrend line and then move that line to a position where it touches the most recent valley. This should be done at the same time you create the trend line.

When prices hit the bottom trend line, this may be used as a buying area. When prices hit the upper trend line, this may be used as a selling area.

Types of channels

There are three types of channels:

1. Ascending channel (higher highs and higher lows)
2. Descending channel (lower highers and lower lows)
3. Horizontal channel (ranging)

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Important things to remember about trend lines:

- When constructing a channel, both trend lines must be parallel to each other.
- Generally, the bottom of channel is considered a buy zone while the top of channel is considered a sell zone.
- Like in drawing trend lines, **DO NOT EVER** force the price to the channels that you draw! A channel boundary that is sloping at one angle while the corresponding channel boundary is sloping at another is not correct and could lead to bad trades.

Trading the Lines

Now that you know the basics, it's time to apply these basic but extremely useful technical tools in your trading. Because here at BabyPips.com we want to make things easy to understand, we have divided trading support and resistance levels into two simple ideas: the Bounce and the Break.

The Bounce



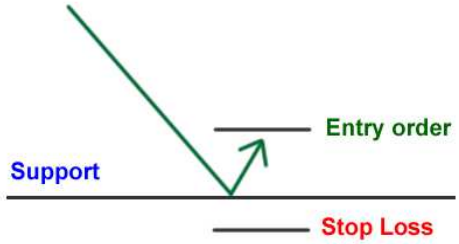
As the name suggests, one method of trading support and resistance levels is right after the bounce.

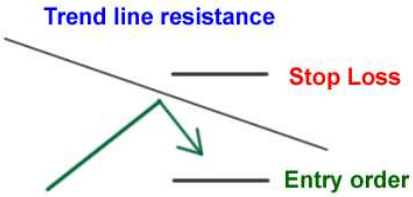
Many retail traders make the error of setting their orders directly on support and resistance levels and then just waiting to for their trade to materialize. Sure, this may work at times but this kind of trading method assumes that a support or resistance level will hold without price actually getting there yet.

You might be thinking, "Why don't I just set an entry order right on the line? That way, I am assured the best possible price."

When playing the bounce we want to tilt the odds in our favor and find some sort of confirmation that the support or resistance will hold. Instead of simply buying or selling right off the bat, wait for it to bounce first before entering. By doing this, you avoid those moments

where price moves fast and break through support and resistance levels. From experience, catching a falling knife can get really bloody...





The Break

In a perfect world, support and resistance levels would hold forever, McDonalds would be healthy, and we'd all have jetpacks. In a perfect trading world, we could just jump in and out whenever price hits those major support and resistance levels and earn loads of money. The fact of the matter is that these levels break... often.

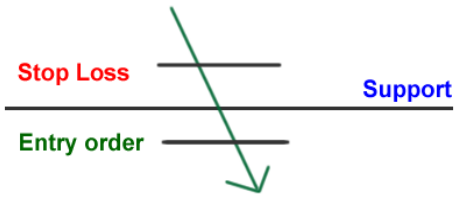
So, it's not enough to just play bounces. You should also know what to do whenever support and resistance levels give way! There are two ways to play breaks: the aggressive way or the conservative way.

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The Aggressive Way

The simplest way to play breakouts is to buy or sell whenever price passes convincingly through a support or resistance zone. The key word here is convincingly because we only want to enter when price passes through a significant support or resistance level with ease.

We want the support or resistance area to act as if it just received a Chuck Norris karate chop: We want it to wilt over in pain as price breaks right through it.



The Conservative Way

Imagine this hypothetical situation: you decided to go long EUR/USD hoping it would rise after bouncing from a support level. Soon after, support breaks and you are now holding on to a losing position, with your account balance slowly falling.

Do you...

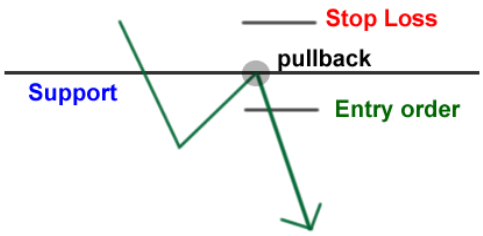
1. Accept defeat, get the heck out, and liquidate your position?

OR

2. Hold on to your trade and hope price rises up again?

If your choice is the second one, then you will easily understand this type of trading method. Remember, whenever you close out a position, you take the opposite side of the trade. Closing your EUR/USD long trade at or near breakeven means you will have to short the EUR/USD by the same amount. Now, if enough selling and liquidiation of losing postions happen at the broken support level, price will reverse and start falling again. This phenomenon is the main reason why broken support levels become resistance whenever they break.

As you would've guessed, taking advantage of this phenomenon is all about being patient. Instead of entering right on the break, you wait for price to make a "pullback" to the broken support or resistance level and enter after the price bounces.



A few words of caution... THIS DOES NOT HAPPEN ALL THE TIME. "RETESTS" OF BROKEN SUPPORT AND RESISTANCE LEVELS DO NOT HAPPEN ALL THE TIME. THERE WILL BE TIMES THAT PRICE WILL JUST MOVE IN ONE DIRECTION AND LEAVE YOU BEHIND. BECAUSE OF THIS, ALWAYS USE STOP LOSS ORDERS AND NEVER EVER HOLD ON TO A TRADE JUST BECAUSE OF HOPE.

Whoops, sorry about that folks, the caps lock key got stuck.

Summary: Support and Resistance

When the market moves up and then pulls back, the highest point reached before it pulls back is now resistance.

As the market continues up again, the lowest point reached before it climbs back is now support.

One thing to remember is that horizontal support and resistance levels are not exact numbers.

To help you filter out these false breakouts, you should think of support and resistance more of as "zones" rather than concrete numbers.

One way to help you find these zones is to plot support and resistance on a line chart rather than a candlestick chart.

Another thing to remember is that when price passes through a resistance level, that resistance could potentially become support. The same could also happen with a support level. If a support level is broken, it could potentially become a resistance level.

Trend Lines

In their most basic form, an uptrend line is drawn along the bottom of easily identifiable support areas (valleys). In a downtrend, the trend line is drawn along the top of easily identifiable resistance areas (peaks).

There are three types of trends:

1. Uptrend (higher lows)
2. Downtrend (lower highs)
3. Sideways trends (ranging)

Channels

To create an up (ascending) channel, simply draw a parallel line at the same angle as an uptrend line and then move that line to position where it touches the most recent peak.

To create a down (descending) channel, simple draw a parallel line at the same angle as the downtrend line and then move that line to a position where it touches the most recent valley.

1. Ascending channel (higher highs and higher lows)
2. Descending channel (lower highers and lower lows)
3. Horizontal channel (ranging)

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Trading support and resistance levels can be divided into two methods: the bounce and the break.

When trading **the bounce** we want to tilt the odds in our favor and find some sort of confirmation that the support or resistance will hold. Instead of simply buying or selling right off the bat, wait for it to bounce first before entering. By doing this, you avoid those moments where price moves so fast that it slices through support and resistance levels like a knife slicing through warm butter.

As for trading **the break**, there is the aggressive way and there is the conservative way. In the aggressive way, you simply buy or sell whenever the price passes through a support or resistance zone with ease. In the conservative way, you wait for price to make a "pullback" to the broken support or resistance level and enter after price bounces.

What is a Japanese Candlestick?

What is a Japanese Candlestick?

While we briefly covered candlestick charting analysis in the previous lesson, we'll now dig in a little and discuss them more in detail. Let's do a quick review first.

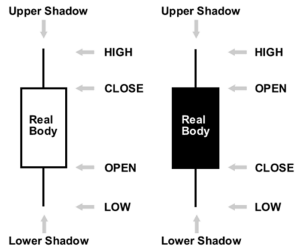
What is Candlestick Trading?

Back in the day when Godzilla was still a cute little lizard, the Japanese created their own old school version of technical analysis to trade rice. That's right, rice.

A westerner by the name of Steve Nison "discovered" this secret technique called "Japanese candlesticks", learning it from a fellow Japanese broker. Steve researched, studied, lived, breathed, ate candlesticks, and began to write about it. Slowly, this secret technique grew in popularity in the 90s. To make a long story short, without Steve Nison, candlestick charts might have remained a buried secret. Steve Nison is Mr. Candlestick.

Okay, so what the heck are forex candlesticks?

The best way to explain is by using a picture:



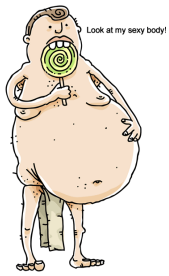
Candlesticks can be used for any time frame, whether it be one day, one hour, 30-minutes - whatever you want! Candlesticks are used to describe the price action during the given time frame.

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Candlesticks are formed using the open, high, low, and close of the chosen time period.

- If the close is above the open, then a hollow candlestick (usually displayed as white) is drawn.
- If the close is below the open, then a filled candlestick (usually displayed as black) is drawn.
- The hollow or filled section of the candlestick is called the "real body" or body.
- The thin lines poking above and below the body display the high/low range and are called shadows.
- The top of the upper shadow is the "high".
- The bottom of the lower shadow is the "low".

Sexy Bodies and Strange Shadows

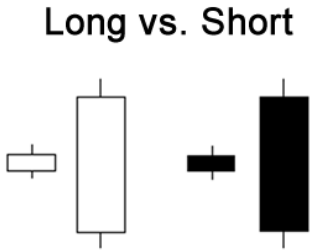


Sexy Bodies

Just like humans, candlesticks have different body sizes. And when it comes to forex trading, there's nothing naughtier than checking out the bodies of candlesticks!

Long bodies indicate strong buying or selling. The longer the body is, the more intense the buying or selling pressure. This means that either buyers or sellers were stronger and took control.

Short bodies imply very little buying or-selling activity. In street forex lingo, bulls mean buyers and bears mean sellers.



Long white candlesticks show strong buying pressure. The longer the white candlestick, the further the close is above the open. This indicates that prices increased considerably from open to close and buyers were aggressive. In other words, the bulls are kicking the bears' butts big time!

Long black (filled) candlesticks show strong selling pressure. The longer the black candlestick, the further the close is below the open. This indicates that prices fell a great deal from the open and sellers were aggressive. In other words, the bears were grabbing the bulls by their horns and body-slamming them.

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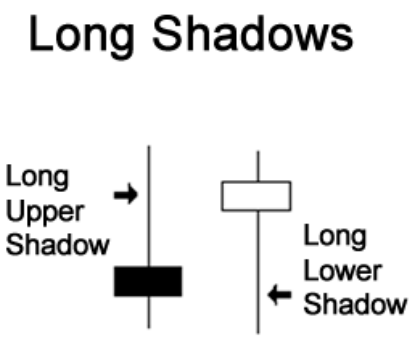
Mysterious Shadows

The upper and lower shadows on candlesticks provide important clues about the trading session.

Upper shadows signify the session high. Lower shadows signify the session low.

Candlesticks with long shadows show that trading action occurred well past the open and close.

Candlesticks with short shadows indicate that most of the trading action was confined near the open and close.



If a candlestick has a *long upper shadow and short lower shadow*, this means that buyers flexed their muscles and bid prices higher, but for one reason or another, sellers came in and drove prices back down to end the session back near its open price.

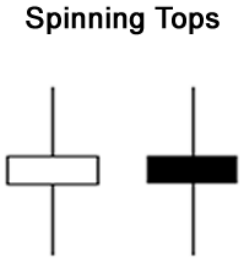
If a candlestick has a *long lower shadow and short upper shadow*, this means that sellers flashed their washboard abs and forced price lower, but for one reason or another, buyers came in and drove prices back up to end the session back near its open price.

Basic Candlestick Patterns

Spinning Tops

Candlesticks with a long upper shadow, long lower shadow and small real bodies are called spinning tops. The color of the real body is not very important.

The pattern indicates the **indecision** between the buyers and sellers.



The small real body (whether hollow or filled) shows little movement from open to close, and the shadows indicate that both buyers and sellers were fighting but nobody could gain the upper hand.

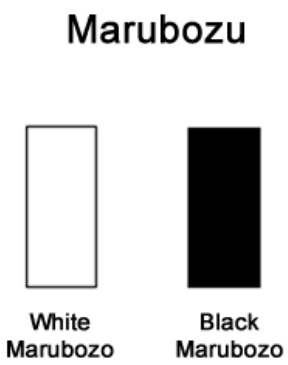
Even though the session opened and closed with little change, prices moved significantly higher and lower in the meantime. Neither buyers nor sellers could gain the upper hand, and the result was a standoff.

If a spinning top forms during an uptrend, this usually means there aren't many buyers left and a possible reversal in direction could occur.

If a spinning top forms during a downtrend, this usually means there aren't many sellers left and a possible reversal in direction could occur.

Marubozu

Sounds like some kind of voodoo magic, huh? "I will cast the evil spell of the Marubozu on you!" Fortunately, that's not what it means. Marubozu means there are no shadows from the bodies. Depending on whether the candlestick's body is filled or hollow, the high and low are the same as its open or close. Check out the two types of Marubozus in the picture below.



A **White Marubozu** contains a long white body with no shadows. The **open price equals the low price** and the **close price equals the high price**. This is a very bullish candle as it shows that buyers were in control the entire session. It usually becomes the first part of a bullish continuation or a bullish reversal pattern.

A **Black Marubozu** contains a long black body with no shadows. The **open equals the high** and the **close equals the low**. This is a very bearish candle as it shows that sellers controlled the price action the entire session. It usually implies bearish continuation or bearish reversal.

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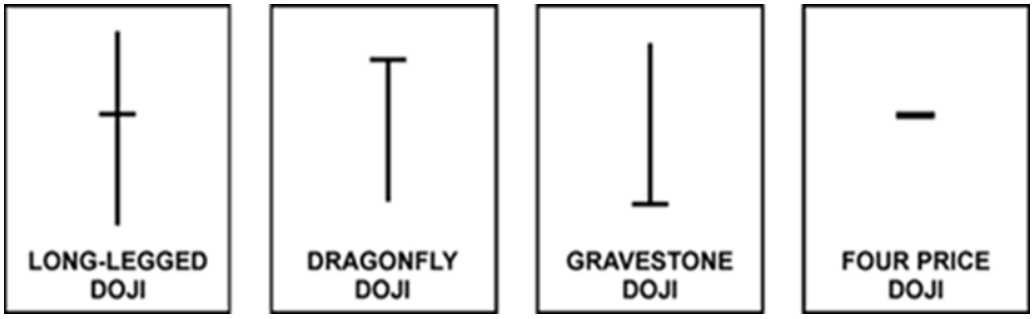
Doji

Doji candlesticks have the **same open and close price** or at least their bodies are extremely short. The Doji should have a very small body that appears as a thin line.

Doji candles suggest indecision or a struggle for turf positioning between buyers and sellers. Prices move above and below the open price during the session, but close at or very near the open price.

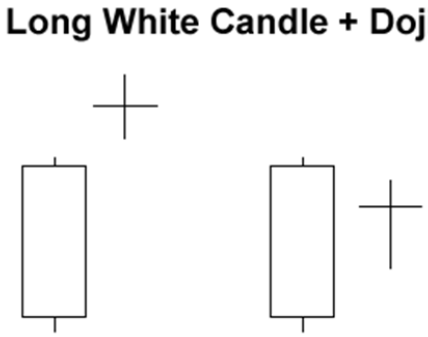
Neither buyers nor sellers were able to gain control and the result was essentially a draw.

There are four special types of Doji candlesticks. The length of the upper and lower shadows can vary and the resulting candlestick looks like a cross, inverted cross or plus sign. The word "Doji" refers to both the singular and plural form.

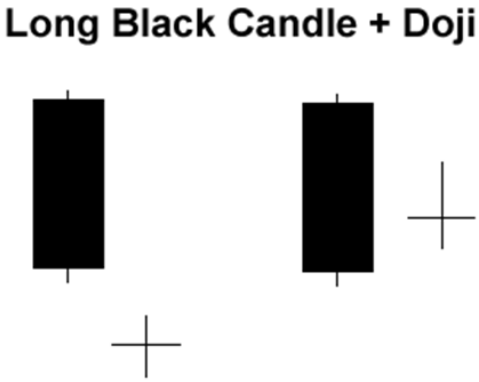


When a Doji forms on your chart, pay special attention to the preceding candlesticks.

If a Doji forms after a series of candlesticks with long hollow bodies (like White Marubozus), the Doji signals that the buyers are becoming exhausted and weakening. In order for price to continue rising, more buyers are needed but there aren't anymore! Sellers are licking their chops and are looking to come in and drive the price back down.



If a Doji forms after a series of candlesticks with long filled bodies (like Black Marubozus), the Doji signals that sellers are becoming exhausted and weak. In order for price to continue falling, more sellers are needed but sellers are all tapped out! Buyers are foaming in the mouth for a chance to get in cheap.



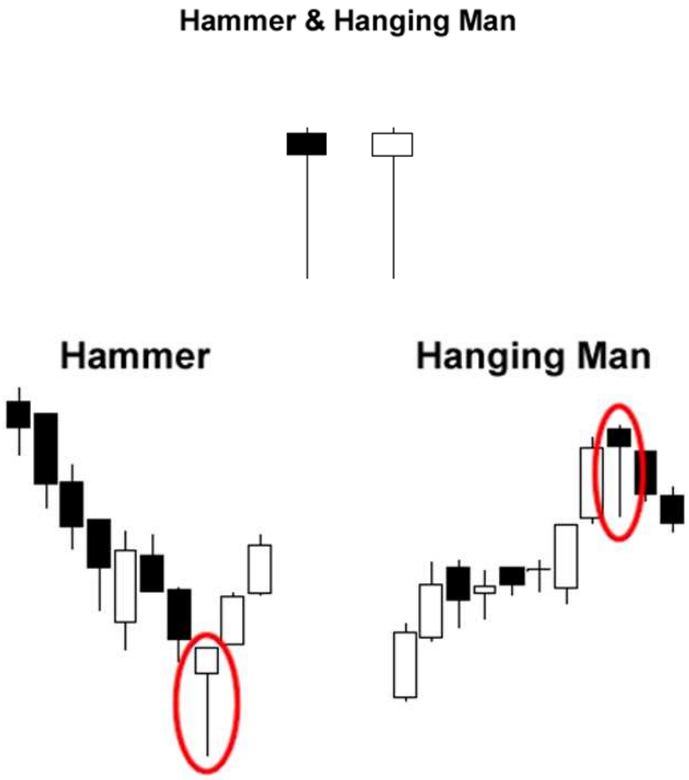
While the decline is sputtering due to lack of new sellers, further buying strength is required to confirm any reversal. Look for a white candlestick to close above the long black candlestick's open.

In the next following sections, we will take a look at specific candlestick formations and what they are telling us. Hopefully, by the end of this lesson on candlesticks, you would know how to recognize candlestick patterns and make sound trading decisions based on them.

Lone Rangers - Single Candlestick Patterns

Hammer and Hanging Man

The hammer and hanging man look exactly alike but have totally different meanings depending on past price action. Both have cute little bodies (black or white), long lower shadows, and short or absent upper shadows.



The **hammer** is a bullish reversal pattern that forms during a downtrend. It is named because the market is hammering out a bottom.

When price is falling, hammers signal that the bottom is near and price will start rising again. The long lower shadow indicates that sellers pushed prices lower, but buyers were able to overcome this selling pressure and closed near the open.

Just because you see a hammer form in a downtrend doesn't mean you automatically place a buy order! More bullish confirmation is needed before it's safe to pull the trigger.

A good confirmation example would be to wait for a white candlestick to close above the open of the candlestick on the left side of the hammer.

Recognition Criteria:

- The long shadow is about two or three times of the real body.
- Little or no upper shadow.
- The real body is at the upper end of the trading range.
- The color of the real body is not important.

The **hanging man** is a bearish reversal pattern that can also mark a top or strong resistance level. When price is rising, the formation of a hanging man indicates that sellers are beginning to outnumber buyers.

The long lower shadow shows that sellers pushed prices lower during the session. Buyers were able to push the price back up some but only near the open.

This should set off alarms since this tells us that there are no buyers left to provide the necessary momentum to keep raising the price.

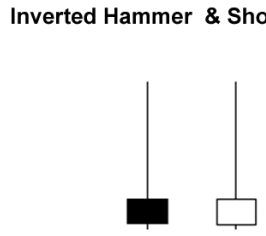
Recognition Criteria:

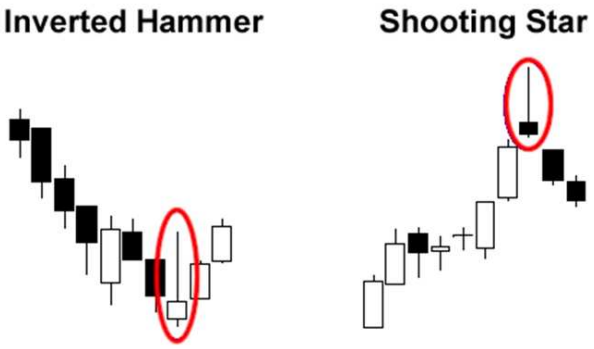
- A long lower shadow which is about two or three times of the real body.
- Little or no upper shadow.
- The real body is at the upper end of the trading range.
- The color of the body is not important, though a black body is more bearish than a white body.

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Inverted Hammer and Shooting Star

The inverted hammer and shooting star also look identical. The only difference between them is whether you're in a downtrend or uptrend. Both candlesticks have petite little bodies (filled or hollow), long upper shadows, and small or absent lower shadows.





The **inverted hammer** occurs when price has been falling suggests the possibility of a reversal. Its long upper shadow shows that buyers tried to bid the price higher.

However, sellers saw what the buyers were doing, said "Oh heck no" and attempted to push the price back down.

Fortunately, the buyers had eaten enough of their Wheaties for breakfast and still managed to close the session near the open.

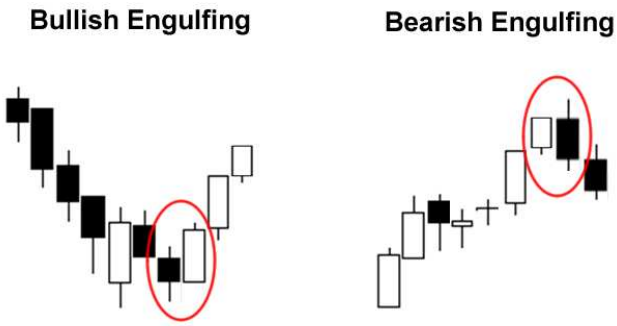
Since the sellers weren't able to close the price any lower, this is a good indication that everybody who wants to sell has already sold. And if there are no more sellers, who is left? Buyers.

The **shooting star** is a bearish reversal pattern that looks identical to the inverted hammer but occurs when price has been rising. Its shape indicates that the price opened at its low, rallied, but pulled back to the bottom.

This means that buyers attempted to push the price up, but sellers came in and overpowered them. This is a definite bearish sign since there are no more buyers left because they've all been murdered.

Double Trouble - Dual Candlestick Patterns

Engulfing Candles



The **bullish engulfing pattern** is a two candle stick pattern that signals a strong up move may be coming. It happens when a bearish candle is immediately followed by a larger bullish candle.

This second candle "engulfs" the bearish candle. This means buyers are flexing their muscles and that there could be a strong up move after a recent downtrend or a period of consolidation.

On the other hand, the **bearish engulfing pattern** is the opposite of the bullish pattern. This type of pattern occurs when bullish candle is immediately followed by a bearish candle that completely "engulfs" it. This means that sellers overpowered the buyers and that a strong move down could happen.

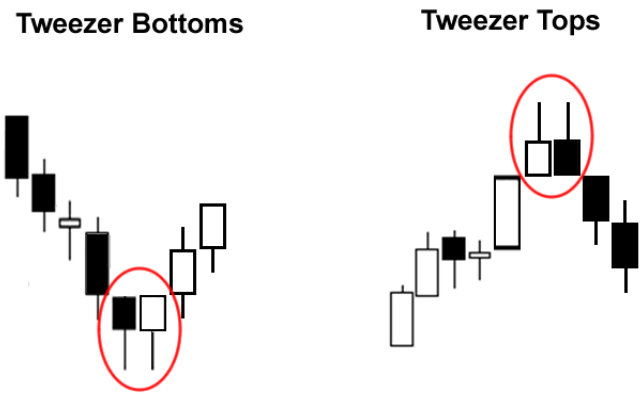
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Tweezer Bottoms and Tops

The tweezers are dual candlestick reversal patterns. This type of candlestick pattern could usually be spotted after an extended up trend or downtrend, indicating that a reversal will soon occur.

Notice how the candlestick formation looks just like a pair of tweezers!

Amazing!

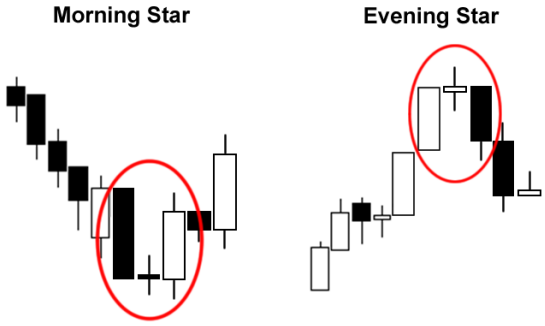


The most effective tweezers have the following characteristics:

- The first candle is the same as the overall trend. If price is moving up, then the first candle should be bullish.
- The second candle is opposite the overall trend. If price is moving up, then the second candle should be bearish.
- The shadows of the candles should be of equal length. Tweezer tops should have the same highs, while tweezer bottoms should have the same lows.

Three's Not A Crowd - Triple Candlestick Patterns

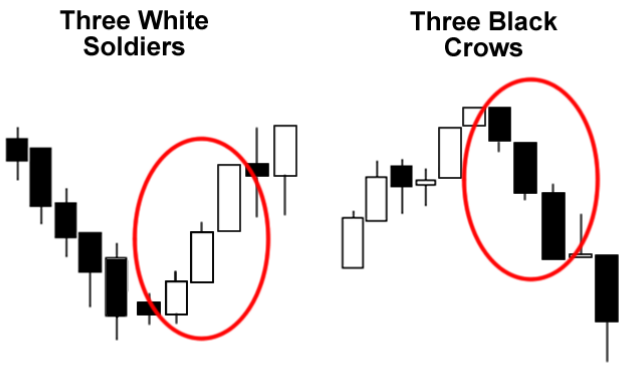
Evening and Morning Stars



The morning star and the evening star are triple candlestick patterns that you can usually find at the end of a trend. They are reversal patterns that can be recognized through these three characteristics:

1. The first stick is a bullish candle, which is part of a recent uptrend.
2. The second candle has a small body, indicating that there could be some indecision in the market. This candle can be either bullish or bearish.
3. The third candle acts as a confirmation that a reversal is in place, as the candle closes beyond the midpoint of the first candle.

Three White Soldiers and Black Crows



The **three white soldiers** pattern is formed when three long bullish candles follow a downtrend, signaling a reversal has occurred. This type of candlestick pattern is considered as one of the most potent in-yo-face bullish signals, especially when it occurs after an extended downtrend and a short period of consolidation.

The first of the three soldiers is called the reversal candle. It either ends the downtrend or implies that the period of consolidation that followed the downtrend is over.

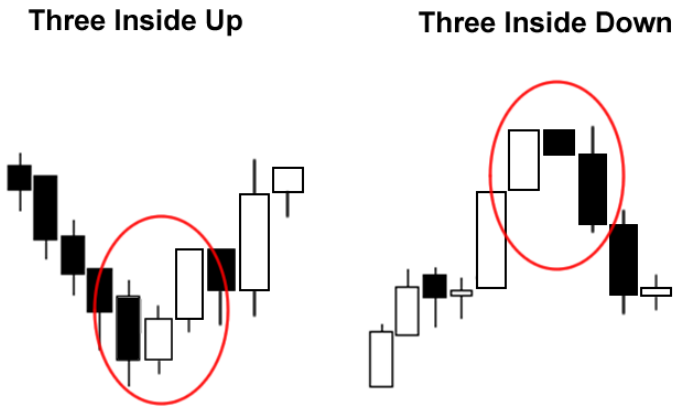
For the pattern to be considered valid, the second candle should be bigger than the previous candle's body. Also, the second candle should close near its high, leaving a small or non-existent upper wick.

For the three white soldiers pattern to be completed, the last candle should be at least the same size as the second candle and have a small or no shadow.

The **three black crows** candlestick pattern is just the opposite of the three white soldiers. It is formed when three bearish candles follow a strong uptrend, indicating that a reversal is in the works.

The second candle's body should be bigger than the first candle and should close at or very near its low. Finally, the third candle should be the same size or larger than the second candle's body with a very short or no lower shadow.

Three Inside Up and Down



The **three inside up** candlestick formation is a trend-reversal pattern that is found at the bottom of a downtrend. It indicates that the downtrend is possibly over and that a new uptrend has started. For a valid three inside up candlestick formation, look for these properties:

1. The first candle should be found at the bottom of a downtrend and is characterized by a long bearish candlestick.
2. The second candle should at least make it up all the way up to the midpoint of the first candle.
3. The third candle needs to close above the first candle's high to confirm that buyers have overpowered the strength of the downtrend.

Conversely, the **three inside down** candlestick formation is found at the top of an uptrend. It means that the uptrend is possibly over and that a new downtrend has started. A three inside down candle stick formation needs have the following characteristics:

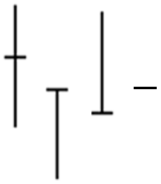
1. The first candle should be found at the top of an uptrend and is characterized by a long bullish candlestick.
2. The second candle should make it up all the way down the midpoint of the first candle.
3. The third candle needs to close below the first candle's low to confirm that sellers have overpowered the strength of the uptrend.

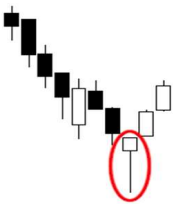
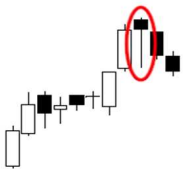
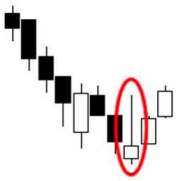
Japanese Candlesticks Cheat Sheet

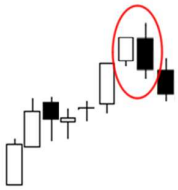
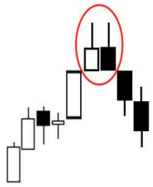
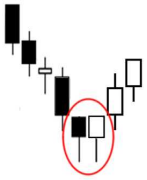
Did you click here first? If you did, stop reading right now and go through the entire Japanese Candlesticks Lesson first!

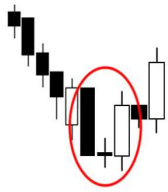
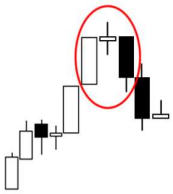
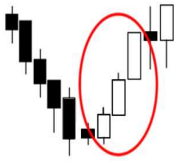
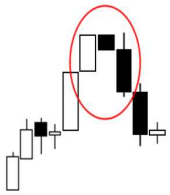
If you're REALLY done with those, here's quick one page reference cheat sheet for single, dual, and triple candlestick formations to easily identify what kind of pattern you are looking at whenever you are trading.

Go ahead and bookmark this page... No need to be shy!

Number of Bars	Name	Bullish or Bearish?	What It Looks Like?
Single	Spinning Top	Neutral	
	Doji	Neutral	
	White Marubozu	Bullish	
	Black Marubozu	Bearish	

	Hammer	Bullish	
	Hanging Man	Bearish	
	Inverted Hammer	Bullish	
	Shooting Star	Bearish	

Number of Bars	Name	Bullish or Bearish?	What it Looks Like?
	Bullish Engulfing	Bullish	
	Bearish Engulfing	Bearish	
Double			
	Tweezer Tops	Bearish	
	Tweezer Bottoms	Bullish	

	Morning Star	Bullish	
	Evening Star	Bearish	
	Three White Soldiers	Bullish	
Triple			
	Three Black Crows	Bearish	
	Three Inside Up	Bullish	
	Three Inside Down	Bearish	

Summary: Japanese Candlesticks

- If the close is above the open, then a hollow candlestick (usually displayed as white) is drawn.
- If the close is below the open, then a filled candlestick (usually displayed as black) is drawn.
- The hollow or filled section of the candlestick is called the "real body" or body.
- The thin lines poking above and below the body display the high/low range and are called shadows.
- The top of the upper shadow is the "high".
- The bottom of the lower shadow is the "low".

Long bodies indicate strong buying or selling. The longer the body is, the more intense the buying or selling pressure.

Short bodies imply very little buying or selling activity. In street forex lingo, bulls mean buyers and bears mean sellers.

Upper shadows signify the session high.

Lower shadows signify the session low.

There are many types of candlestick patterns, but they can be categorized into how many bars make up the candlestick pattern. There are single, dual, and triple candlestick formations. The most common types of candlestick patterns are the following:

Number of Bars	Candlestick Pattern
Single	Spinning Tops, Dojis, Marubozu, Inverted Hammer, Hanging Man, Shooting Star
Double	Bullish and Bearish Engulfing, Tweezer Tops and Bottoms
Triple	Morning and Evening Stars, Three Black Crows and Three White Soldiers, Three Inside Up and Down

Just refer to the Candlestick Cheat Sheet for a quick reference on what these candlestick patterns mean.

Combine candlestick analysis with support and resistance levels for best results.

And finally, here are some words of wisdom.

Just because candlesticks hint at a reversal or continuation, it doesn't mean it will happen for sure! You must always consider market conditions and what price action is telling you.

This is the forex market and nothing is set in stone!

Fibonacci Who?

We will be using Fibonacci ratios a lot in our trading so you better learn it and love it like your mother's home cooking. Fibonacci is a huge subject and there are many different Fibonacci studies with weird-sounding names but we're going to stick to two: retracement and extension.

Let us first start by introducing you to the Fib man himself...Leonardo Fibonacci.



No, Leonardo Fibonacci isn't some famous chef. Actually, he was a famous Italian mathematician, also known as a super duper uber ultra geek.

He had an "Aha!" moment when he discovered a simple series of numbers that created ratios describing the natural proportions of things in the universe.

The ratios arise from the following number series: 1, 1, 2, 3, 5, 8, 13, 21, 34, 55, 89, 144...

This series of numbers is derived by starting with 1 followed by 2 and then adding 1 + 2 to get 3, the third number. Then, adding 2 + 3 to get 5, the fourth number, and so on.

After the first few numbers in the sequence, if you measure the ratio of any number to the succeeding higher number, you get .618. For example, 34 divided by 55 equals .618.

If you measure the ratio between alternate numbers you get .382. For example, 34 divided by 89 = 0.382 and that's as far as into the explanation as we'll go.

These ratios are called the "golden mean". Okay that's enough mumbo jumbo. With all those numbers, you could put an elephant to sleep. We'll just cut to the chase; these are the ratios you HAVE to know:

Fibonacci Retracement Levels
0.236, 0.382, 0.500, 0.618, 0.764

Fibonacci Extension Levels
0, 0.382, 0.618, 1.000, 1.382, 1.618

You won't really need to know how to calculate all of this. Your charting software will do all the work for you. Besides, we've got a nice Fibonacci calculator that can magically calculate those levels for you. However, it's always good to be familiar with the basic theory behind the indicator so you'll have the knowledge to impress your date.

Traders use the Fibonacci retracement levels as potential **support and resistance areas**. Since so many traders watch these same levels and place buy and sell orders on them to enter trades or place stops, the support and resistance levels tend to become a self-fulfilling prophecy.

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Traders use the Fibonacci extension levels as **profit taking levels**. Again, since so many traders are watching these levels to place buy and sell orders to take profits, this tool tends to work more often than not due to self-fulfilling expectations.

Most charting software includes both Fibonacci retracement levels and extension level tools. In order to apply Fibonacci levels to your charts, you'll need to identify Swing High and Swing Low points.

A Swing High is a candlestick with at least two lower highs on both the left and right of itself.

A Swing Low is a candlestick with at least two higher lows on both the left and right of itself.

You got all that? Don't worry, we'll explain retracements, extensions, and most importantly, how to grab some pips using the Fib tool in the following sections.

Fibonacci Retracement

The first thing you should know about the Fibonacci tool is that it works best when the market is trending.

The idea is to go long (or buy) on a retracement at a Fibonacci support level when the market is trending up, and to go short (or sell) on a retracement at a Fibonacci resistance level when the market is trending down.

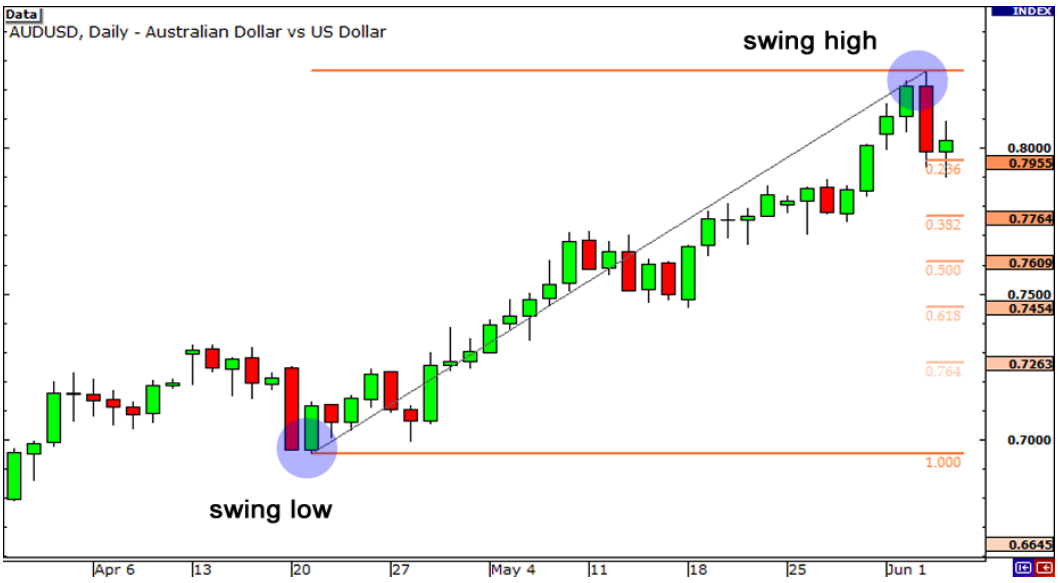
In order to find these retracement levels, you have to find the recent significant Swing Highs and Swings Lows. Then, for downtrends, click on the Swing High and drag the cursor to the most recent Swing Low.

For uptrends, do the opposite. Click on the Swing Low and drag the cursor to the most recent Swing High.

Got that? Now, let's take a look at some examples on how to apply Fibonacci retracements levels in the markets.

Uptrend

This is a daily chart of AUD/USD.



Here we plotted the Fibonacci retracement Levels by clicking on the Swing Low at .6955 on April 20 and dragging the cursor to the Swing High at .8264 on June 3. Tada! The software magically shows you the retracement levels.

As you can see from the chart, the retracement levels were .7955 (23.6%), .7764 (38.2%), .7609 (50.0%), .7454 (61.8%), and .7263 (76.4%).

Now, the expectation is that if AUD/USD retraces from the recent high, it will find support at one of those Fibonacci levels because traders will be placing buy orders at these levels as price pulls back.

Now, let's look at what happened after the Swing High occurred.



Price pulled back right through the 23.6% level and continued to shoot down over the next couple of weeks. It even tested the 38.2% level but was unable to close below it.

Later on, around July 14, the market resumed its upward move and eventually broke through the swing high. Clearly, buying at the 38.2% Fibonacci level would have been a profitable long term trade!

Downtrend

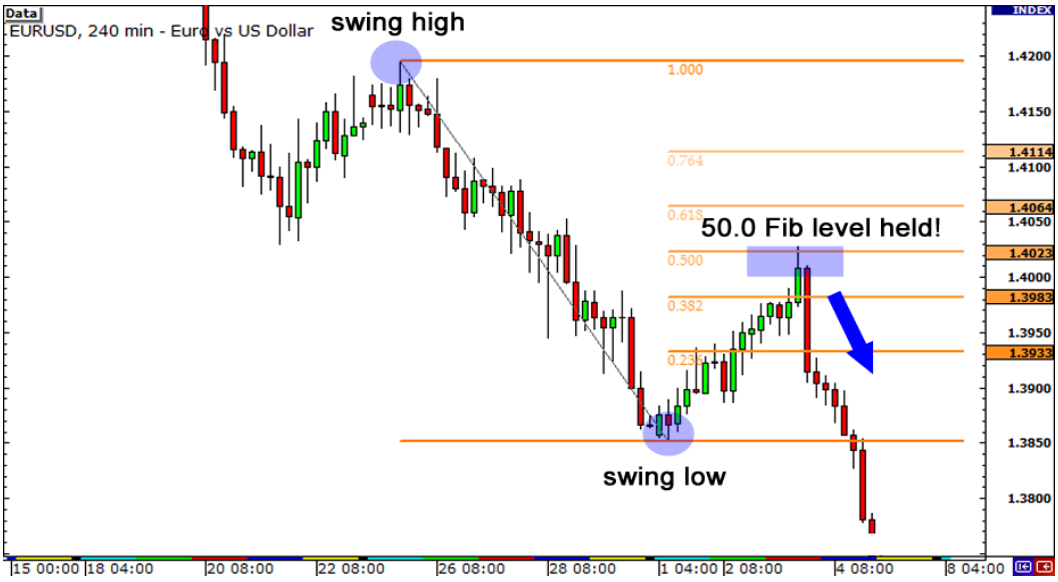
Now, let's see how we would use the Fibonacci retracement tool during a downtrend. Below is a 4-hour chart of EUR/USD.



As you can see, we found our Swing High at 1.4195 on January 26 and our Swing Low at 1.3854 a few days later on February 2. The retracement levels are 1.3933 (23.6%), 1.3983 (38.2%), 1.4023 (50.0%), 1.4064 (61.8%) and 1.4114 (76.4%).

The expectation for a downtrend is that if price retraces from this low, it will encounter resistance at one of the Fibonacci levels because traders will be ready with sell orders there.

Let's take a look at what happened next.



Yowza, isn't that a thing of beauty?! T

he market did try to rally, stalled below the 38.2% level for a bit before testing the 50.0% level. If you had some orders either at the 38.2% or 50.0% levels, you would've made some mad pips on that trade.

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In these two examples, we see that price *found* some temporary support or resistance at Fibonacci retracement levels. Because of all the people who use the Fibonacci tool, those levels become self-fulfilling support and resistance levels.

One thing you should take note of is that price won't always bounce from these levels. They should be looked at as *areas of interest*, or as Cyclopip likes to call them, "**KILL ZONES!**" We'll teach you more about that later on.

For now, there's something you should always remember about using the Fibonacci tool and it's that they are not always simple to use! If they were that simple, traders would always place their orders at Fib levels and the markets would trend forever.

In the next lesson, we'll show you what can happen when Fibonacci levels fail.

When Fibonacci Fails

Back in Grade 1, we said that support and resistance levels eventually break. Well, seeing as how Fibonacci levels are used to find support and resistance levels, this also applies to Fibonacci!

Now, let's go through an example when the Fibonacci retracement tool fails.

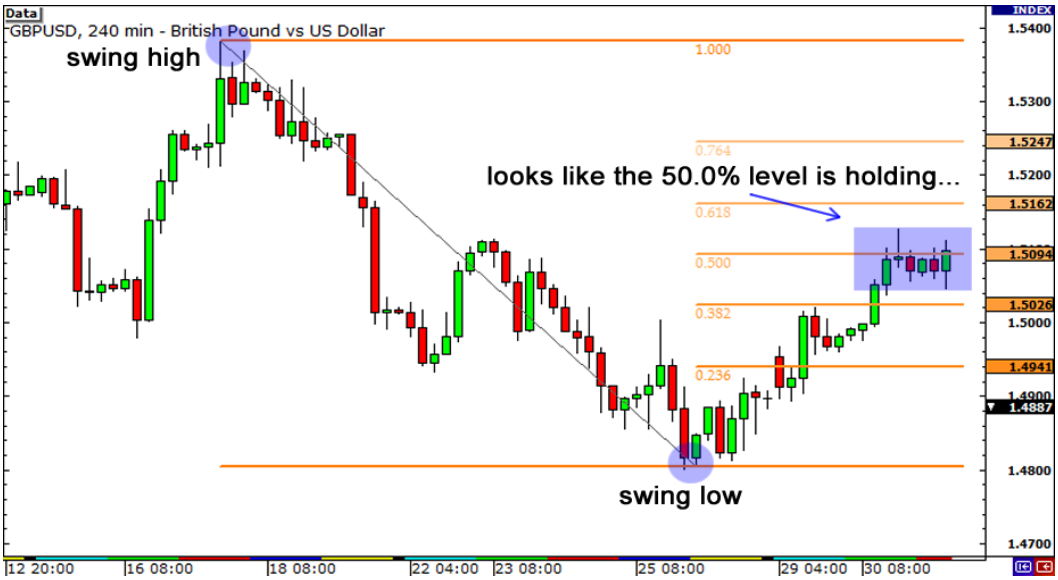
Below is a 4-hour chart of GBP/USD.

Here, you see that the pair has been in downtrend, so you decided to take out your Fibonacci tool to help you spot a good entry point. You use the Swing High at 1.5383, with a swing low at 1.4799.

You see that the pair has been stalling at the 50.0% level for the past couple of candles.

You say to yourself, "Oh man, that 50.0% Fib level! It's holding baby! Time to short this sucka!"

You short at market and start day dreaming that you'll be driving down Rodeo Drive in your new Maserati with Scarlett Johansson (or if you're a lady trader, Robert Pattinson) in the passenger seat...



Now, if you really did put an order at that level, not only would your dreams go up in smoke, but your account would take a serious hit if you didn't manage your risk properly!

Take a look at what happened.



It turns out that that Swing Low was the bottom of the downtrend and market began to rally above the Swing High point.

What's the lesson here?

While Fibonacci levels give you a higher probability of success, like other technical tools, they don't always work. You don't know if price will reverse to the 38.2% level before resuming the trend.

Sometimes it may hit 50.0% or the 61.8% levels before turning around. Heck, sometimes price will just ignore Mr. Fibonacci and blow past all the levels just like how Lebron James bullies his way through the lane with sheer force.

Remember, the market will not always resume its uptrend after finding temporary support or resistance, but instead continue to go past the recent Swing High or Low.

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Another common problem in using the Fibonacci tool is determining which Swing Low and Swing High to use.

People look at charts differently, look at different time frames, and have their own fundamental biases. It is likely that Stephen from Pipbuktu and the girl from Pipanema have different ideas of where the Swing High and Swing Low points should be.

The bottom line is that there is no absolute right way to do it, especially when the trend on the chart isn't so clear. Sometimes it becomes a guessing game.

That's why you need to hone your skills and combine the Fibonacci tool with other tools in your forex toolbox to help give you a higher probability of success.

In the next lesson, we'll show you how to use the Fibonacci tool in combination with other forms of support and resistance levels and candlesticks.

Combining Fibs with Support and Resistance

Like we said in the previous section, using Fibonacci levels can be very subjective. However, there are ways that you can help tilt the odds in your favor.

While the Fibonacci tool is extremely useful, it shouldn't be used all by its lonesome self.

It's kinda like comparing it to NBA superstar Kobe Bryant. Kobe is one of the greatest basketball players of all time, but even he couldn't win those titles by himself. He needs some backup.

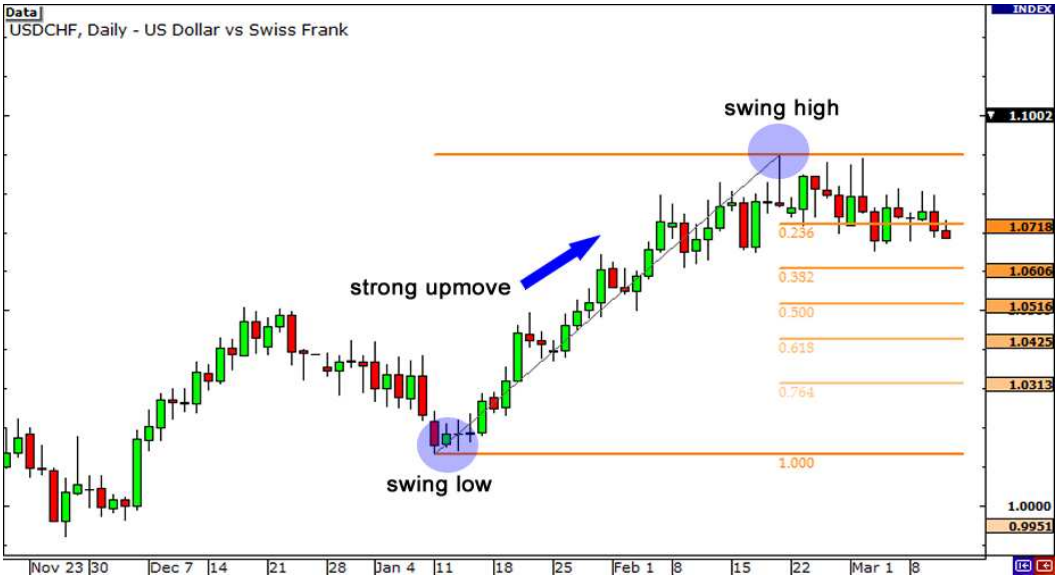
Similarly, the Fibonacci tool should be used in combination with other tools. In this section, let's take what you've learned so far and try to combine them to help us spot some sweet trade setups.

Are y'all ready? Let's get this pip show on the road!

One of the best ways to use the Fibonacci tool is to spot potential support and resistance levels and see if they line up with Fibonacci retracement levels.

If Fib levels are already support and resistance levels, and you combine them with other price areas that a lot of other traders are watching, then the chances of price bouncing from those areas are much higher.

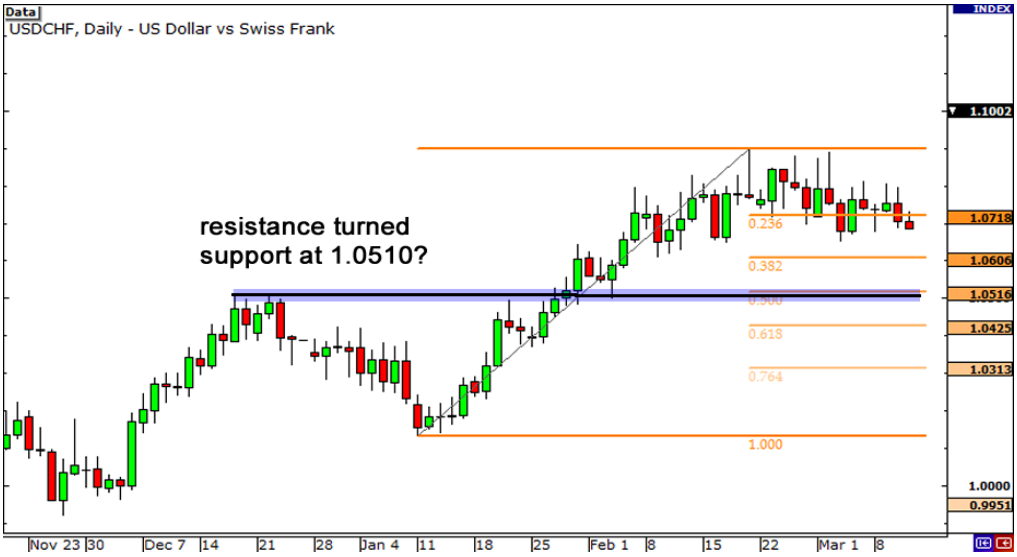
Let's look at an example of how you can combine support and resistance levels with Fib levels. Below is a daily chart of USD/CHF.



As you can see, it's been on an uptrend recently. Look at all those green candles! You decide that you want to get in on this long USD/CHF bandwagon.

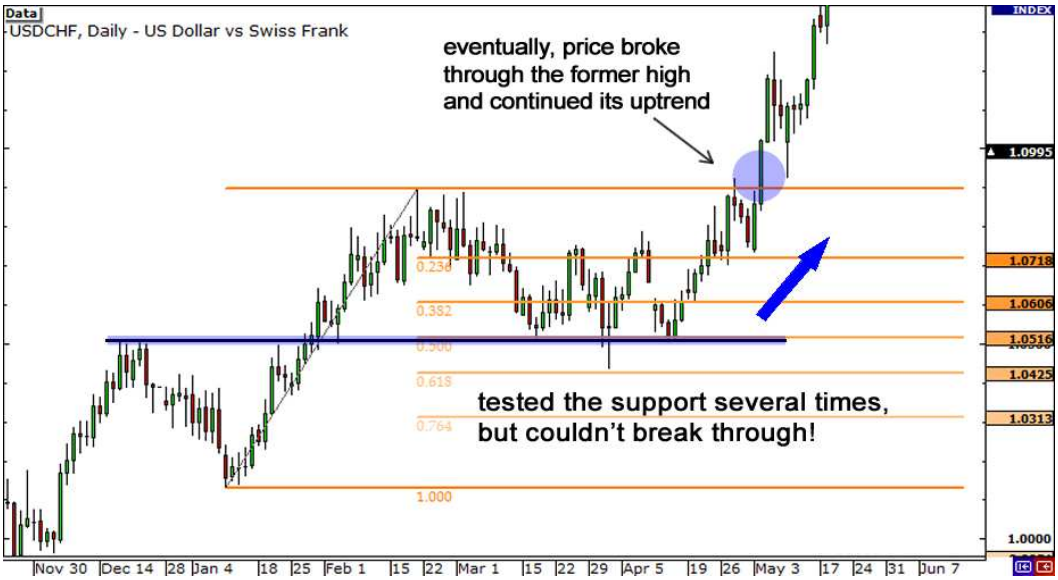
But the question is, "When do you enter?" You bust out the Fibonacci tool, using the low at 1.0132 on January 11 for the Swing Low and the high at 1.0899 on February 19 for the Swing High.

Now your chart looks pretty sweet with all those Fib levels.



Now that we have a framework to increase our probability of finding solid entry, we can answer the question "Where should you enter?"

You look back a little bit and you see that the 1.0510 price was good resistance level in the past and it just happens to line up with the 50.0% Fib retracement level. Now that it's broken, it could turn into support and be a good place to buy.



If you did set an order somewhere around the 50.0% Fib level, you'd be a pretty happy camper!

There would have been some pretty tense moments, especially on the second test of the support level on April 1. Price tried to pierce through the support level, but failed to close below it. Eventually, the pair broke past the Swing High and resumed its uptrend.

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You can do the same setup on a downtrend as well. The point is you should look for price levels that seem to have been areas of interest in the past. If you think about it, there's a higher chance that price will bounce from these levels.

Why?

First, as we discussed in Grade 1, previous support or resistance levels would be good areas to buy or sell because other traders will also be eyeing these levels like a hawk.

Second, since we know that a lot of traders also use the Fibonacci tool, they may be looking to jump in on these Fib levels themselves.

With traders looking at the same support and resistance levels, there's a good chance that there are a ton of orders at those price levels.

While there's no guarantee that price will bounce from those levels, at least you can be more confident about your trade. After all, there is strength in numbers!

Remember that trading is all about probabilities. If you stick to those higher probability trades, then there's a better chance of coming out ahead in the long run.

Combining Fibs with Trend Lines

Another good tool to combine with the Fibonacci tool is trend line analysis. After all, Fibonacci levels work best when the market is trending, so this makes a lot of sense!

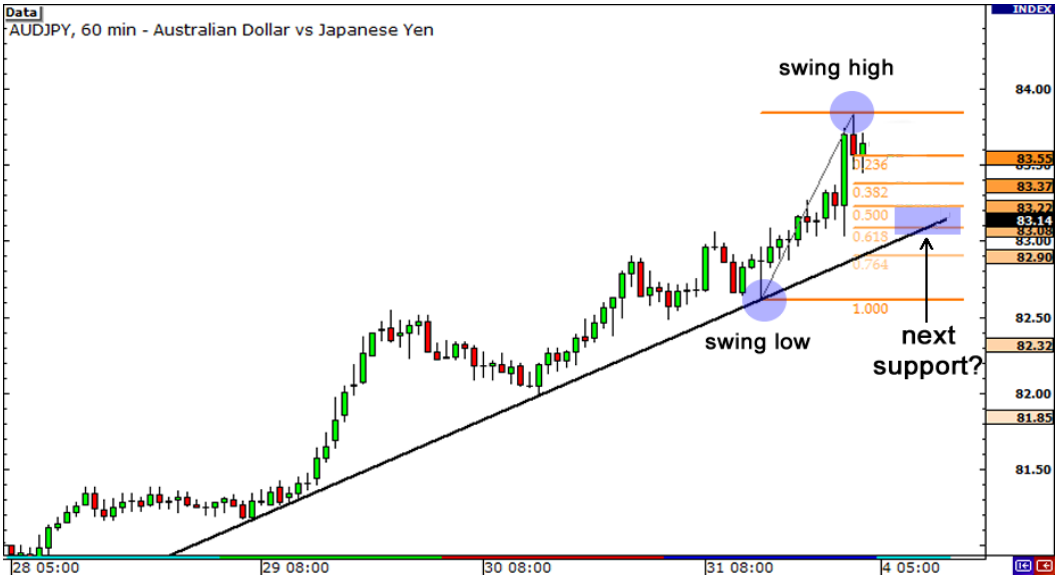
Remember that whenever a pair is in a downtrend or uptrend, traders use Fibonacci retracement levels as a way to get in on the trend. So why not look for levels where Fib levels line up right smack with the trend?

Here's a 1-hour chart of AUD/JPY. As you can see, price has been respecting a short term rising trend line over the past couple of days.



You think to yourself, "Hmm, that's a sweet uptrend right there. I wanna buy AUD/JPY, even if it's just for a short term trade. I think I'll buy once the pair hits the trend line again."

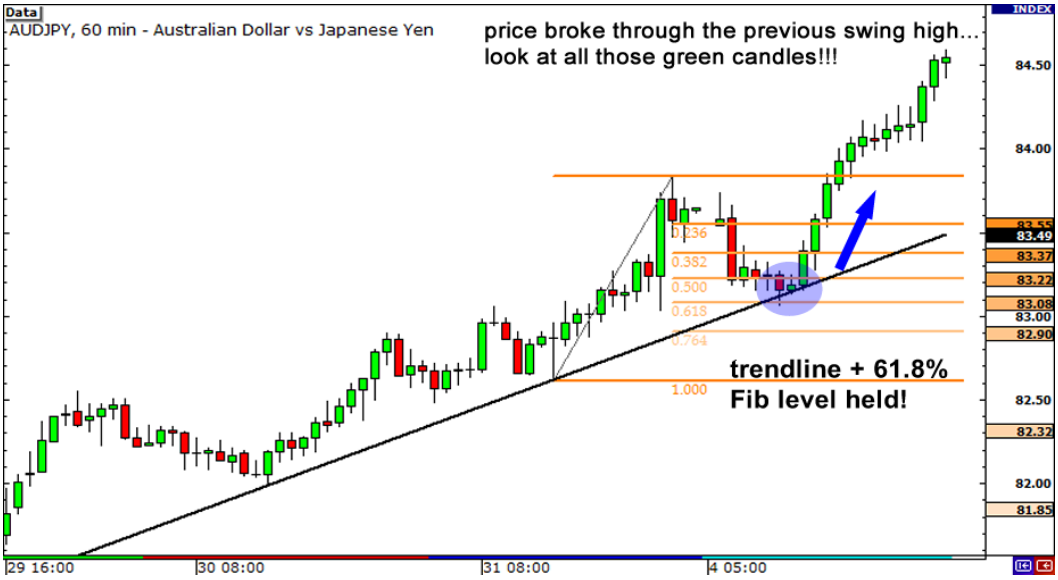
Before you do that though, why don't you reach for your forex tool box and get that Fibonacci tool out? Let's see if we can get a more exact entry price.



Here we plotted the Fibonacci retracement levels by using the Swing low at 82.61 and the Swing High at 83.84.

Notice how the 50.0% and 61.8% Fib levels are intersected by the rising trend line.

Could these levels serve as potential support levels? There's only one way to find out!



Guess what? The 61.8% Fib level held, as price bounced there before heading back up. If you had set some orders at that level, you would have had a perfect entry!

A couple of hours after touching the trend line, price zoomed up like Astroboy on Red Bull, bursting through the Swing High.

Aren't you glad you've got this in your forex toolbox now?

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As you can see, it does pay to make use of the Fibonacci tool, even if you're planning to enter on a retest of the trend line. The combination of both a diagonal and a horizontal support or resistance level could mean that other traders are eying those levels as well.

Take note though, as with other drawing tools, drawing trend lines can also get pretty subjective.

You don't know exactly how other traders are drawing them, but you can count on one thing - that there's a trend!

If you see that a trend is developing, you should be looking for ways to go long to give you a better chance of a profitable trade. You can use the Fibonacci tool to help you find potential entry points.

Combining Fibs with Candlesticks

If you've been paying attention in class, you'd know by now that you can combine the Fibonacci tool with support and resistance levels and trend lines to create a simple but super awesome trading strategy.

But we ain't done yet! In this lesson, we're going to teach you how to combine the Fibonacci tool with your knowledge of Japanese candlestick patterns that you learned in Grade 2.

In combining the Fibonacci tool with candlestick patterns, we are actually looking for exhaustive candlesticks. If you can tell when buying or selling pressure is exhausted, it can give you a clue of when price may continue trending.

We here at BabyPips.com like to call them "Fibonacci Candlesticks," or "Fib Sticks" for short. Pretty catchy, eh? Let's take a look at an example to make this clearer.

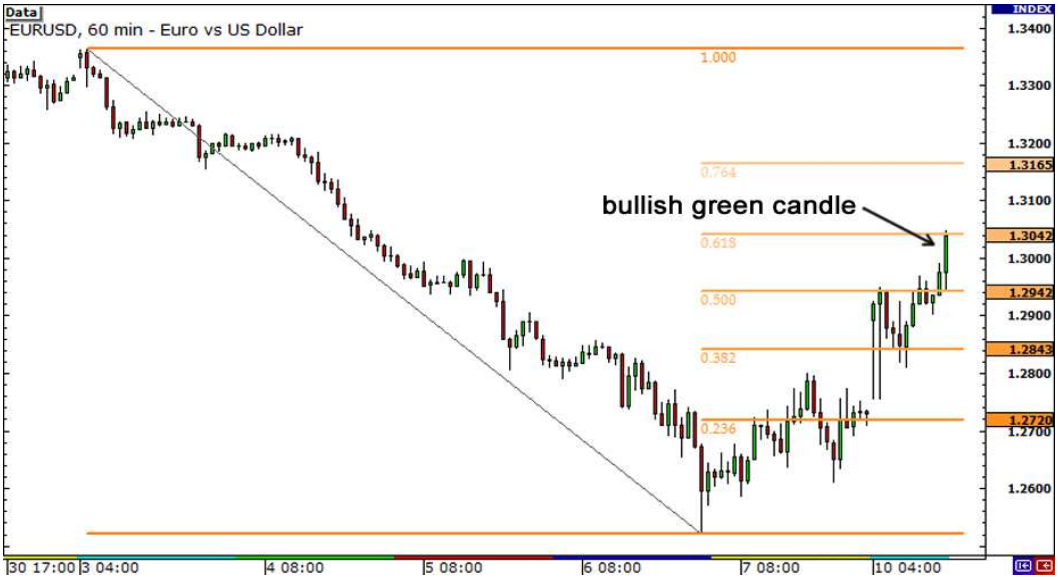
Below is a 1-hour chart of EUR/USD.



The pair seems to have been in a downtrend the past week, but the move seems to have paused for a bit. Will there be a chance to get in on this downtrend? You know what this means. It's time to take the Fibonacci tool and get to work!

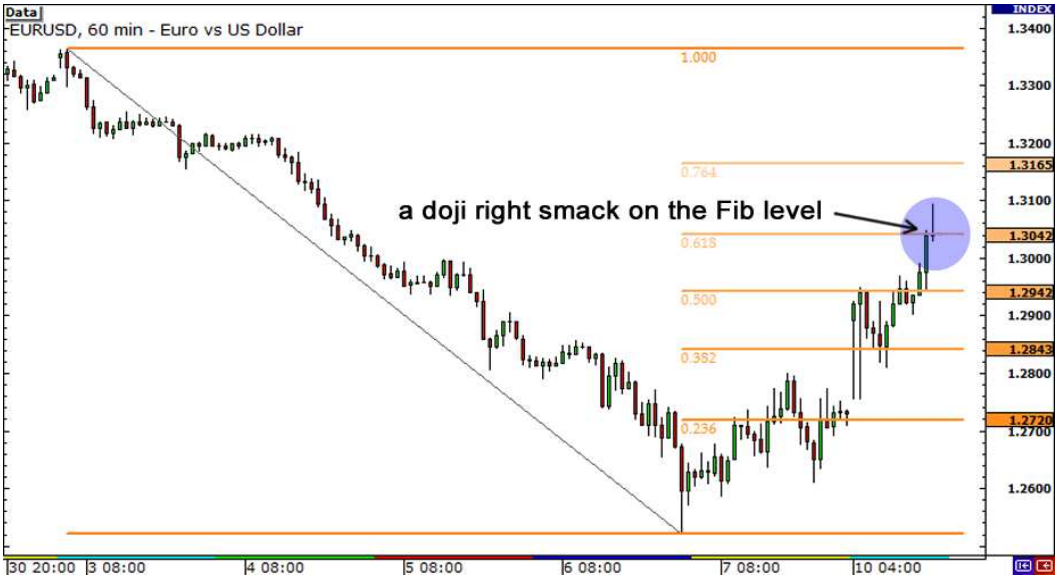
As you can see from the chart, we've set our Swing High at 1.3364 on March 5, with the Swing Low at 1.2523 on March 7.

Since it's a Friday, you decided to just chill out, take an early day off, and decide when you wanna enter once you see the charts after the weekend.



Whoa! By the time you popped open your charts, you see that EUR/USD has shot up quite a bit from its Friday closing price.

While the 50.0% Fib level held for a bit, buyers eventually took the pair higher. You decide to wait and see whether the 61.8% Fib level holds. After all, the last candle was pretty bullish! Who knows, price just might keep shooting up!



Well, will you look at that? A long legged doji has formed right smack on the 61.8% Fib level. If you paid attention in Grade 2, you'd know that this is an "exhaustive candle." Has buying pressure died down? Is resistance at the Fib level holding? It's possible. Other traders were probably eyeing that Fib level as well.

Is it time to short? You can never know for sure (which is why risk management is so important), but the probability of a reversal looks pretty darn good!



If you had shorted right after that doji had formed, you could have made some serious profits. Right after the doji, price stalled for a bit before heading straight down. Take a look at all those red candles!

It seems that buyers were indeed pretty tired, which allowed sellers to jump back in and take control. Eventually, price went all the way back down to the Swing Low. That was a move of about 500 pips! That could've been your trade of the year!

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Looking for "Fib Sticks" can be really useful, as they can signal whether a Fib level will hold.

If it seems that price is stalling on a Fib level, chances are that other traders may have put some orders at those levels. This would act as more confirmation that there is indeed some resistance or support at that price.

Another nice thing about Fib Sticks is that you don't need to place limit orders at the Fib levels. You may have some concerns whether the support or resistance will hold since we are looking at a "zone" and not necessarily specific levels.

This is where you can use your knowledge of candlestick formations.

You could wait for a Fib Stick to form right below or above a Fib level to give you more confirmation on whether you should put in an order.

If a Fib stick does form, you can just enter a trade at market price since you now have more confirmation that level could be holding.

Fibonacci Extensions

The next use of Fibonacci will be using them to find targets.

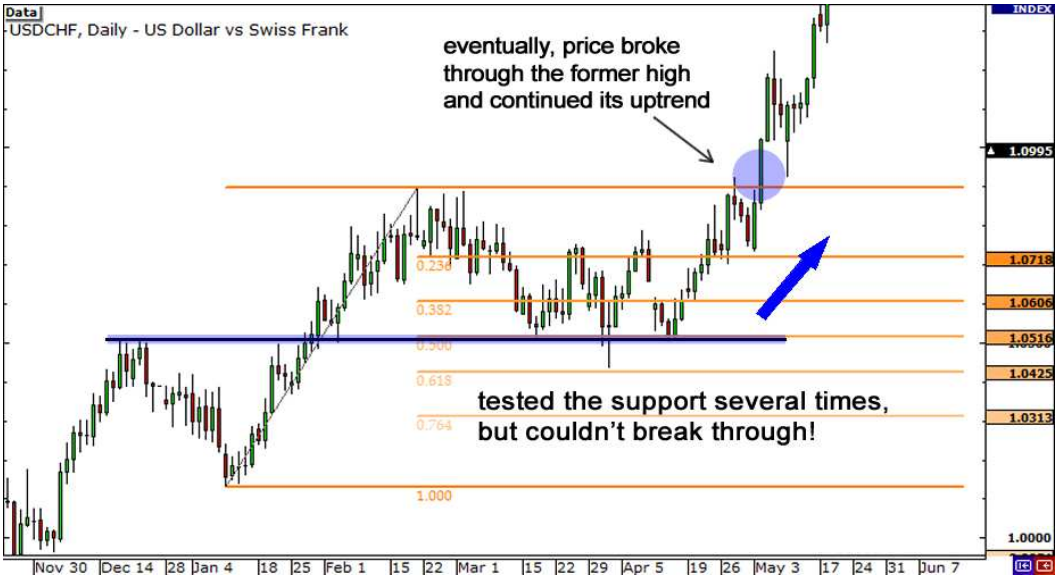
Gotta always keep in mind "Zombieland Rules of Survival #22" - When in doubt, know your way out! Let's start with an example in an uptrend.

In an uptrend, the general idea is to take profits on a long trade at a Fibonacci Price Extension Level. You determine the Fibonacci extension levels by using three mouse clicks.

First, click on a significant Swing Low, then drag your cursor and click on the most recent Swing High. Finally, drag your cursor back down and click on any of the retracement levels.

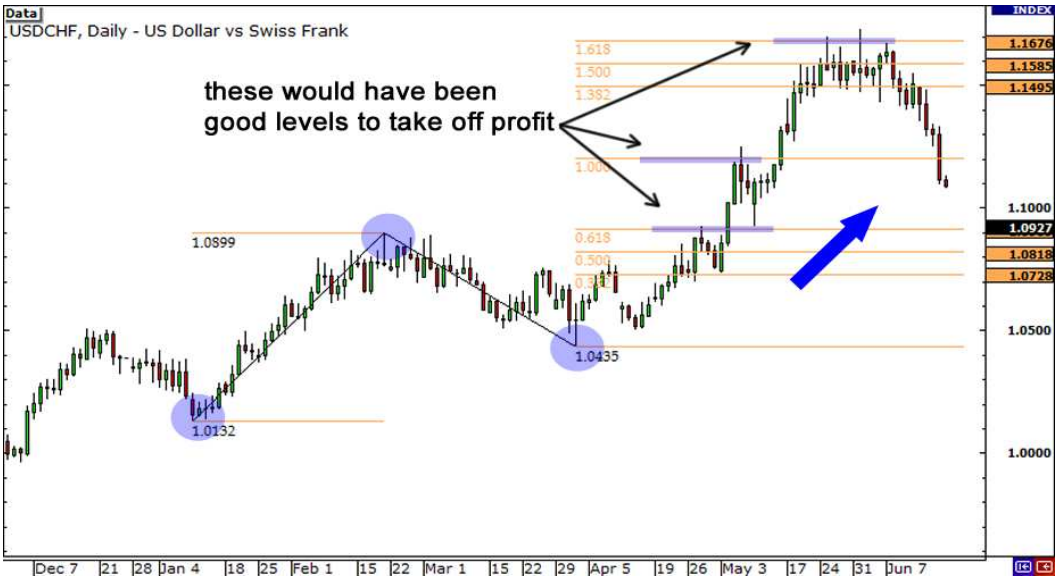
This will display each of the Price Extension Levels showing both the ratio and corresponding price levels. Pretty neat, huh?

Let's go back to that example with the USD/CHF chart we showed you in the previous lesson.



The 50.0% Fib level held strongly as support and, after three tests, the pair finally resumed its uptrend. In the chart above, you can even see price rise above the previous Swing High.

Let's pop on the Fibonacci extension tool to see where would have been a good place to take off some profits.



Here's a recap of what happened after the retracement Swing Low occurred:

- Price rallied all the way to the 61.8% level, which lined up closely with the previous Swing High.
- It fell back to the 38.2% level, where it found support
- Price then rallied and found resistance at the 100% level.
- A couple of days later, price rallied yet again before finding resistance at the 161.8% level.

As you can see from the example, the 61.8%, 100% and 161.8% levels all would have been good places to take off some profits.

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Now, let's take a look at an example of using Fibonacci extension levels in a downtrend.

In a downtrend, the general idea is to take profits on a short trade at a Fibonacci extension level since the market often finds support at these levels.

Let's take another look at that downtrend on the 1-hour EUR/USD chart we showed you in the Fib Sticks lesson.



Here, we saw a doji form just under the 61.8% Fib level. Price then reversed as sellers jumped back in, and brought price all the way back down to the Swing Low.

Let's put up that Fib Extension tool to see where would have been some good places to take profits had we shorted at the 61.8% retracement level.



Here's what happened after price reversed from the Fibonacci retracement level:

- Price found support at the 38.2% level
- The 50.0% level held as initial support, then became an area of interest
- The 61.8% level also became an area of interest, before price shot down to test the previous Swing Low
- If you look ahead, you'll find out that the 100% extension level also acted as support

We could have taken off profits at the 38.2%, 50.0%, or 61.8% levels. All these levels acted as support, possibly because other traders were keeping an eye out for these levels for profit taking as well.

The examples illustrate that price finds at least some temporary support or resistance at the Fibonacci extension levels - not always, but often enough to correctly adjust your position to take profits and manage your risk.

Of course, there are some problems to deal with here.

First, there is no way to know which exact Fibonacci extension level will provide resistance. Any of these levels may or may not act as support or resistance.

Another problem is determining which Swing Low to start from in creating the Fibonacci extension levels.

One way is from the last Swing Low as we did in the examples; another is from the lowest Swing Low of the past 30 bars. Again, the point is that there is no one right way to do it, but with a lot of practice, you'll make better decisions of picking Swing points.

You will have to use your discretion in using the Fibonacci extension tool. You will have to judge how much longer the trend will continue. Later on, we will teach you methods to help you determine the strength of a trend.

For now, let's move on to stop loss placement!

Placing Stops with Fibs

Probably just as important as knowing where to enter or take off profits is knowing where to place your stop loss.

You can't just enter a trade based on Fib levels without having a clue where to exit. Your account will just go up in flames and you will forever blame Fibonacci, cursing his name in Italian.

In this lesson, you'll learn a couple of techniques to set your stops when you decide to use them trusty Fib levels. These are simple ways to set your stop and the rationale behind each method.

The first method is to set your stop just past the next Fibonacci level.

If you were planning to enter at the 38.2% Fib level, then you would place your stop beyond the 50.0% level. If you felt like the 50.0% level would hold, then you'd put your stop past the 61.8% level and so on and so forth. Simple, right?

Let's take another look at that 4-hour EUR/USD chart we showed you back in the Fibonacci retracement lesson.



If you had shorted at the 50.0%, you could have placed your stop loss order just past the 61.8% Fib level.

The reasoning behind this method of setting stops is that you believed that the 50.0% level would hold as a resistance point. Therefore, if price were to rise beyond this point, your trade idea would be invalidated.

The problem with this method of setting stops is that it is entirely dependent on you having a perfect entry.

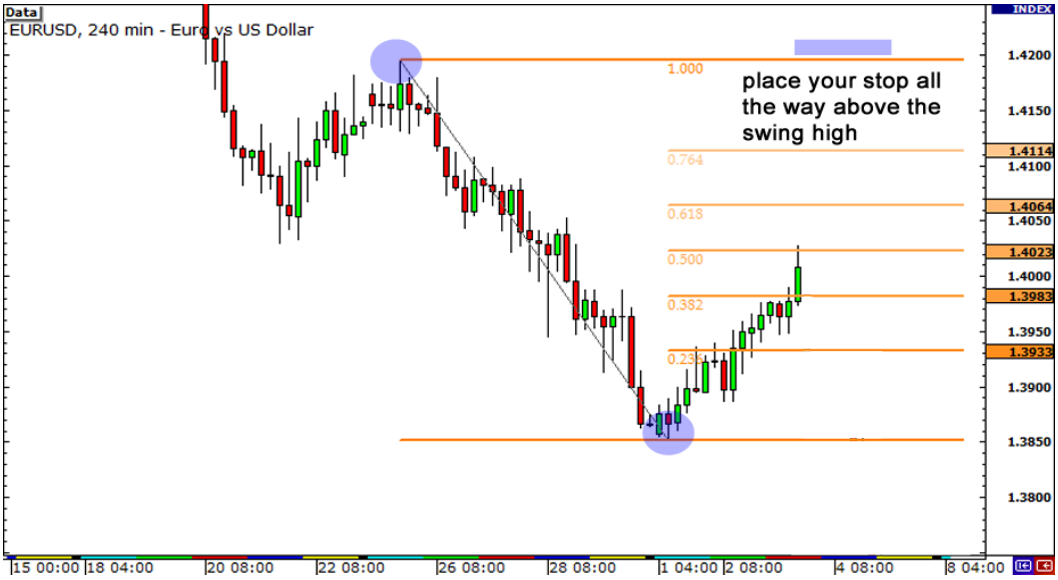
Setting a stop just past the next Fibonacci retracement level assumes that you are really confident that the support or resistance area will hold. And, as we pointed out earlier, using drawing tools isn't an exact science.

The market might shoot up, hit your stop, and eventually go in your direction. This is usually when we'd go to a corner, and start hitting our head on the wall.

We're just warning you that this might happen, sometimes a few times in a row, so make sure you limit your losses quickly and let your winners run with the trend. It might be best if you used this type of stop placement method for short term, intraday trades.

Now, if you want to be a little safer, another way to set your stops would be to place them past the recent Swing High or Swing Low.

This type of stop loss placement would give your trade more room to breathe and give you a better chance for the market to move in favor of your trade.



If the market price were to surpass the Swing High or Swing Low, it may indicate that a reversal of the trend is already in place. This means that your trade idea or setup is already invalidated and that you're too late to jump in.

Setting larger stop losses would probably be best used for longer term, swing-type trades, and you can also incorporate this into a "scaling in" method, which you will learn later on in this course.

Of course, with a larger stop, you also have to remember to adjust your position size accordingly.

If you tend to trade the same position size, you may incur large losses, especially if you enter at one of the earlier Fib levels.

This can also lead to some unfavorable reward-to-risk ratios, as you may have a wide stop that isn't proportional to your potential reward.

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So which way is better?

The truth is, just like in combining the Fibonacci retracement tool with support and resistance, trend lines, and candlesticks to find a better entry, it would be best to use your knowledge of these tools to analyze the current environment to help you pick a good stop loss point.

As much as possible, you shouldn't rely solely on Fib levels as support and resistance points as the basis for stop loss placement.

Remember, stop loss placement isn't a sure thing, but if you can tilt the odds in your favor by combining multiple tools, it could help give you a better exit point, more room for your trade to breathe, and possibly a better reward-to-risk ratio trade.

Summary: Fibonacci

The key Fibonacci retracement levels to keep an eye on are the 23.6%, 38.2%, 50.0%, 61.8%, and 76.4%. The ones that seem to hold the most weight are the 38.2%, 50.0%, and 61.8% levels. These are normally included in the default settings of any Fibonacci retracement software.

If your trading software doesn't have a Fib tool, no worries - we've got a Fibonacci calculator that will do all the work for you!

Traders use the Fibonacci retracement levels as potential **support and resistance**. Since plenty of traders watch these same levels and place buy and sell orders on them to enter trades or place stops, the support and resistance levels may become a self-fulfilling prophecy.

They key Fibonacci extension levels are the 38.2%, 50.0%, 61.8%, 100%, 138.2% and 161.8%.

Traders use the Fibonacci extension levels as potential support and resistance areas to set profit targets. Again, since so many traders are watching these levels and placing buy and sell orders to take profits, this tool tends to work due self-fulfilling expectations.

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In order to apply Fibonacci levels to your charts, you'll need to identify Swing High and Swing Low points.

A Swing High is a candlestick with at least two lower highs on both the left and right of itself.

A Swing Low is a candlestick with at least two higher lows on both the left and right of itself.

Because many traders use the Fibonacci tool, those levels tend to become self-fulfilling support and resistance levels or areas of interest.

When using the Fibonacci tool, probability of success could increase when using the Fib tool with other support and resistance levels, trend lines, and candlestick patterns for spotting entry and stop loss points.

Silky Smooth Moving Averages

A moving average is simply a way to smooth out price action over time. By "moving average", we mean that you are taking the average closing price of a currency pair for the last 'X' number of periods. On a chart, it would look like this:



Like every indicator, a moving average indicator is used to help us forecast future prices. By looking at the slope of the moving average, you can better determine the potential direction of market prices.

As we said, moving averages smooth out price action.

There are different types of moving averages and each of them has their own level of "smoothness".

Generally, the smoother the moving average, the slower it is to react to the price movement.

The choppier the moving average, the quicker it is to react to the price movement. To make a moving average smoother, you should get the average closing prices over a longer time period.

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Now, you're probably thinking, "C'mon, let's get to the good stuff. How can I use this to trade?"

In this section, we first need to explain to you the two major types of moving averages:

1. Simple
2. Exponential

We'll also teach you how to calculate them and give the pros and cons of each. Just like in every other lesson in the BabyPips.com School of Pipsology, you need to know the basics first!

After you've got that on lockdown like Argentinian soccer player Lionel Messi's ball-handling skills, we'll teach you the different ways to use moving averages and how to incorporate them into your trading strategy.

By the end of this lesson, you'll be just as smooth as Messi's!

Are you ready?

If you are, give us a "Heck yeah!"

If not, go back and reread the intro.

Once you're pumped and ready to go, head to the next page.

Simple Moving Averages

A simple moving average is the simplest type of moving average (DUH!). Basically, a simple moving average is calculated by adding up the last "X" period's closing prices and then dividing that number by X.

Confused???

Don't worry, we'll make it crystal clear.

If you plotted a 5 period simple moving average on a 1-hour chart, you would add up the closing prices for the last 5 hours, and then divide that number by 5. Voila! You have the average closing price over the last five hours! String those average prices together and you get a moving average!

If you were to plot a 5-period simple moving average on a 10-minute chart, you would add up the closing prices of the last 50 minutes and then divide that number by 5.

If you were to plot a 5 period simple moving average on a 30 minute chart, you would add up the closing prices of the last 150 minutes and then divide that number by 5.

If you were to plot the 5 period simple moving average on the 4 hr. chart... Okay, okay, we know, we know. You get the picture!

Most charting packages will do all the calculations for you. The reason we just bored you (yawn!) with a "how to" on calculating simple moving averages is because it's important to understand so that you know how to edit and tweak the indicator.

Understanding how an indicator works means you can adjust and create different strategies as the market environment changes.

Now, just like almost any other indicator out there, moving averages operate with a delay. Because you are taking the averages of past price history, you are really only seeing the general path of the recent past and the general direction of "future" short term price action.

Disclaimer: Moving averages will not turn you into Ms. Cleo the psychic!

Here is an example of how moving averages smooth out the price action.



On chart above, we've plotted three different SMAs on the 1-hour chart of USD/CHF. As you can see, the longer the SMA period is, the more it lags behind the price.

Notice how the 62 SMA is farther away from the current price than the 30 and 5 SMAs.

This is because the 62 SMA adds up the closing prices of the last 62 periods and divides it by 62. The longer period you use for the SMA, the slower it is to react to the price movement.

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The SMAs in this chart show you the overall sentiment of the market at this point in time. Here, we can see that the pair is trending.

Instead of just looking at the current price of the market, the moving averages give us a broader view, and we can now gauge the general direction of its future price. With the use of SMAs, we can tell whether a pair is trending up, trending down, or just ranging.

There is one problem with the simple moving average and it's that they are susceptible to spikes. When this happens, this can give us false signals. We might think that a new trend may be developing but in reality, nothing changed.

In the next lesson, we will show you what we mean, and also introduce you to another type of moving average to avoid this problem.

Exponential Moving Average

As we said in the previous lesson, simple moving averages can be distorted by spikes. We'll start with an example.

Let's say we plot a 5-period SMA on the daily chart of EUR/USD.



The closing prices for the last 5 days are as follows:

Day 1: 1.3172
Day 2: 1.3231
Day 3: 1.3164
Day 4: 1.3186
Day 5: 1.3293

The simple moving average would be calculated as follows:

(1.3172 + 1.3231 + 1.3164 + 1.3186 + 1.3293) / 5 = 1.3209

Simple enough, right?

Well what if there was a news report on Day 2 that causes the euro to drop across the board. This causes EUR/USD to plunge and close at 1.3000. Let's see what effect this would have on the 5 period SMA.

Day 1: 1.3172
Day 2: **1.3000**
Day 3: 1.3164
Day 4: 1.3186
Day 5: 1.3293

The simple moving average would be calculated as follows:

(1.3172 + **1.3000** + 1.3164 + 1.3186 + 1.3293) / 5 = **1.3194**

The result of the simple moving average would be a lot lower and it would give you the notion that the price was actually going down, when in reality, Day 2 was just a one-time event caused by the poor results of an economic report.

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The point we're trying to make is that sometimes the simple moving average might be too simple. If only there was a way that you could filter out these spikes so that you wouldn't get the wrong idea. Hmm... Wait a minute... Yep, there is a way!

It's called the **Exponential Moving Average**!

Exponential moving averages (EMA) give more weight to the most recent periods. In our example above, the EMA would put more weight on the prices of the most recent days, which would be Days 3, 4, and 5.

This would mean that the spike on Day 2 would be of lesser value and wouldn't have as big an effect on the moving average as it would if we had calculated for a simple moving average.

If you think about it, this makes a lot of sense because what this does is it puts more emphasis on what traders are doing recently.

Let's take a look at the 4-hour chart of USD/JPY to highlight how an SMA and EMA would look side by side on a chart.



Notice how the red line (the 30 EMA) seems to be closer price than the blue line (the 30 SMA). This means that it more accurately represents recent price action. You can probably guess why this happens.

It's because the EMA places more emphasis on what has been happening lately. When trading, it is far more important to see what traders are doing NOW rather what they were doing last week or last month.

SMA vs. EMA

By now, you're probably asking yourself, which is better? The simple or the exponential moving average?

First, let's start with the exponential moving average. When you want a moving average that will respond to the price action rather quickly, then a short period EMA is the best way to go.

These can help you catch trends very early (more on this later), which will result in higher profit. In fact, the earlier you catch a trend, the longer you can ride it and rake in those profits (boo yeah!).

The downside to using the exponential moving average is that you might get faked out during consolidation periods (oh no!).

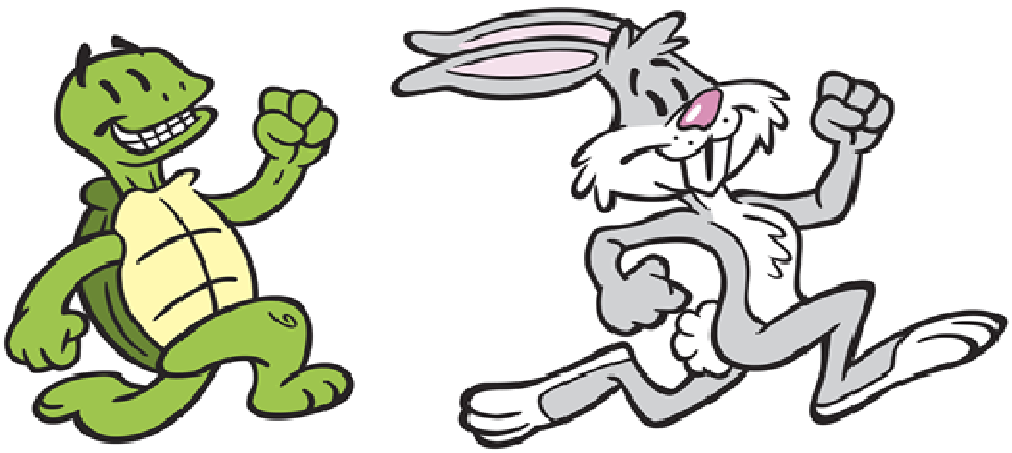
Because the moving average responds so quickly to the price, you might think a trend is forming when it could just be a price spike. This would be a case of the indicator being too fast for your own good.

With a simple moving average, the opposite is true. When you want a moving average that is smoother and slower to respond to price action, then a longer period SMA is the best way to go.

This would work well when looking at longer time frames, as it could give you an idea of the overall trend.

Although it is slow to respond to the price action, it could possibly save you from many fake outs. The downside is that it might delay you too long, and you might miss out on a good entry price or the trade altogether.

An easy analogy to remember the difference between the two is to think of a hare and a toirtoise.



SMA EMA

The tortoise is slow, like the SMA, so you might miss out on getting in on the trend early. However, it has a hard shell to protect itself, and similarly, using SMAs would help you avoid getting caught up in fakeouts.

On the other hand, the hare is quick, like the EMA. It helps you catch the beginning of the trend but you run the risk of getting sidetracked by fakeouts (or naps if you're a sleepy trader).

Below is a table to help you remember the pros and cons of each.

	SMA	EMA
Pros	Displays a smooth chart which eliminates most fakeouts.	Quick Moving and is good at showing recent price swings.
Cons	Slow moving, which may cause a a lag in buying and selling signals	More prone to cause fakeouts and give errant signals.

So which one is better?

It's really up to you to decide.

Many traders plot several different moving averages to give them both sides of the story. They might use a longer period simple moving average to find out what the overall trend is, and then use a shorter period exponential moving average to find a good time to enter a trade.

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There are a number of trading strategies that are built around the use of moving averages. In the following lessons, we will teach you:

1. How to use moving averages to determine the trend
2. How to incorporate the crossover of moving averages into your trading system
3. How moving averages can be used as dynamic support and resistance

Time for recess! Go find a chart and start playing with some moving averages! Try out different types and try experimenting with different periods. In time, you will find out which moving averages work best for you.

Using Moving Averages

One sweet way to use moving averages is to help you determine the trend.

The simplest way is to just plot a single moving average on the chart. When price action tends to stay above the moving average, it would signal that price is in a general uptrend.

If price action tends to stay below the moving average, then it would indicate that it is in a downtrend.



The problem with this is that it's too simplistic.

Let's say that USD/JPY has been in a downtrend, but a news report comes out causing it surge higher.



You see that the price is now above the moving average. You think to yourself:

"Hmmm... It looks like this pair is about to shift direction. Time to buy this sucker!"

So you do just that. You buy a billion units cause you're confident that USD/JPY is going to rise.

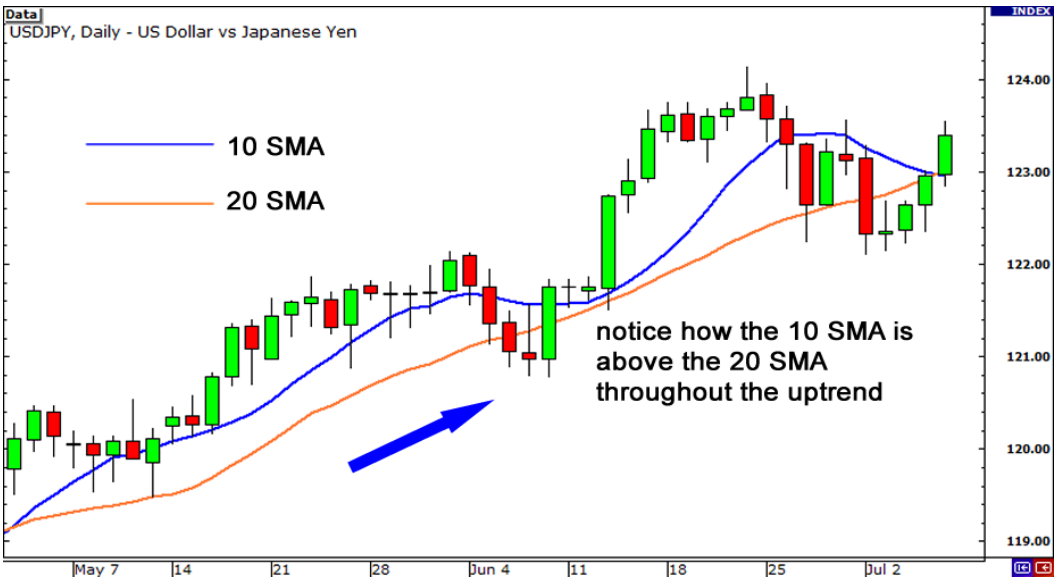


Bammm! You got faked out! As it turns out, traders just reacted to the news but the trend continued and price kept heading lower!

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What some traders do - and what we suggest you do as well - is that they plot a couple of moving averages on their charts instead of just one. This gives them a clearer signal of whether the pair is trending up or down depending on the order of the moving averages. Let us explain.

In an uptrend, the "faster" moving average should be above the "slower" moving average and for a downtrend, vice versa. For example, let's say we have two MAs: the 10-period MA and the 20-period MA. On your chart, it would look like this:



Above is a daily chart of USD/JPY. Throughout the uptrend, the 10 SMA is above the 20 SMA. As you can see, you can use moving averages to help show whether a pair is trending up or down. Combining this with your knowledge on trend lines, this can help you decide whether to go long or short a currency.

You can also try putting more than two moving averages on your chart. Just as long as lines are in order (fastest to slowest in an uptrend, slowest to fastest in an uptrend), then you can tell whether the pair is in an uptrend or in a downtrend.

Moving Average Crossover Trading

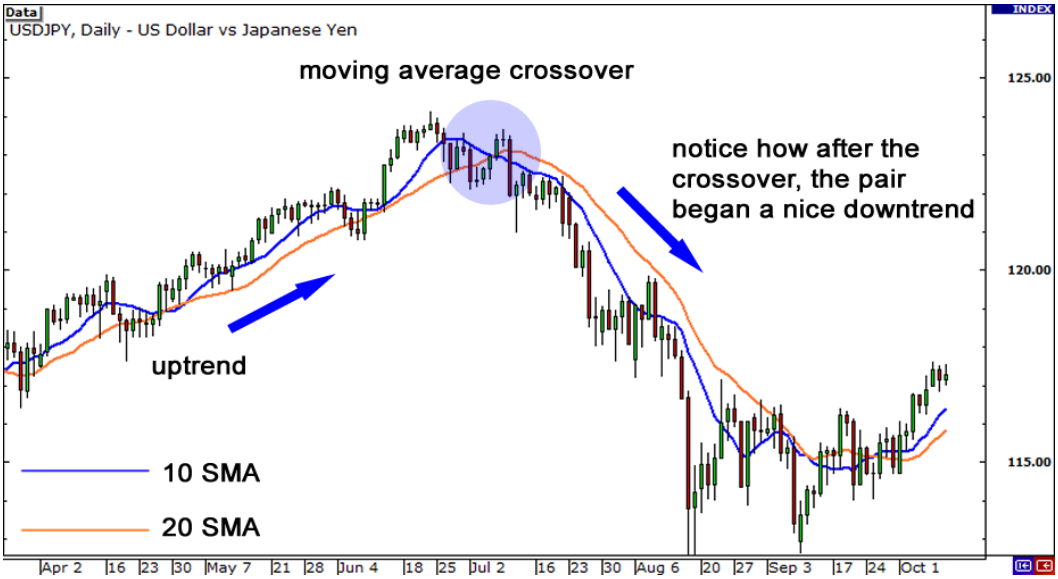
By now, you know how to determine the trend by plotting on some moving averages on your charts. You should also know that moving averages can help you determine when a trend is about to end and reverse.

All you have to do is plop on a couple of moving averages on your chart, and wait for a crossover. If the moving averages cross over one another, it could signal that the trend is about to change soon, thereby giving you the chance to get a better entry. By having a better entry, you have the chance to bag mo' pips!

If Allen Iverson made a living by having a killer crossover move, why can't you?



Let's take another look at that daily chart of USD/JPY to help explain moving average crossover trading.



From around April to July, the pair was in a nice uptrend. It topped out at around 124.00, before slowly heading down. In the middle of July, we see that the 10 SMA crossed below the 20 SMA.

And what happened next?

A nice downtrend!

If you had shorted at the crossover of the moving averages you would have made yourself almost a thousand pips!

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Of course, not every trade will be a thousand-pip winner, a hundred-pip winner, or even a 10-pip winner.

It could be a loser, which means you have to consider things like where to place your stop loss or when to take profits. You just can't jump in without a plan!

What some traders do is that they close out their position once a new crossover has been made or once price has moved against the position a predetermined amount of pips.

This is what Huck does in her HLHB system. She either exits when a new crossover has been made, but also has a 150-pip stop loss just in case.

The reason for this is you just don't know when the next crossover will be. You may end up hurting yourself if you wait too long!

One thing to take note of with a crossover system is that while they work beautifully in a volatile and/or trending environment, they don't work so well when price is ranging.

You will get hit with tons of crossover signals and you could find yourself getting stopped out multiple times before you catch a trend again.

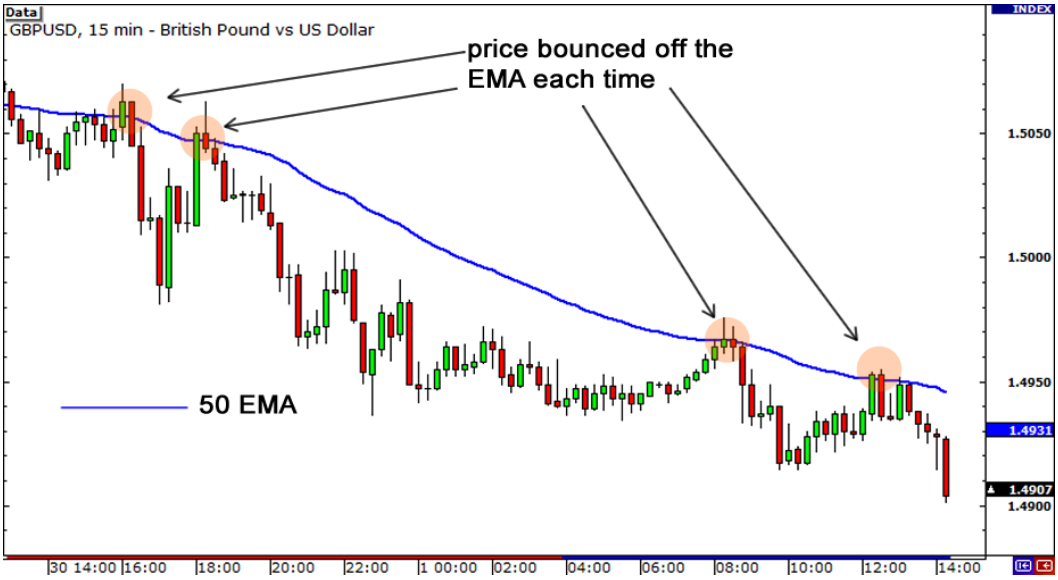
Dynamic Support and Resistance

Another way to use moving averages is to use them as dynamic support and resistance levels.

We like to call it dynamic because it's not like your traditional horizontal support and resistance lines. They are constantly changing depending on recent price action.

There are many traders out there who look at these moving averages as key support or resistance. These traders will buy when price dips and tests the moving average or sell if price rises and touches the moving average.

Here's a look at the 15-minute chart of GBP/USD and pop on the 50 EMA. Let's see if it serves as dynamic support or resistance.



It looks like it held really well! Every time price approached 50 EMA and tested it, it acted as resistance and price bounced back down. Amazing, huh?

One thing you should keep in mind is that these are just like your normal support and resistance lines.

This means that price won't always bounce perfectly from the moving average. Sometimes it will go past it a little bit before heading back in the direction of the trend.

There are also times when price will blast past it altogether. What some traders do is that they pop on two moving averages, and only buy or sell once price is in the middle of the space between the two moving averages.

You could call this area "the zone".

Let's take another look at that 15-minute chart of GBP/USD, but this time let's use the 10 and 20 EMAs.



From the chart above, you see that price went slightly past the 10 EMA a few pips, but proceeded to drop afterwards.

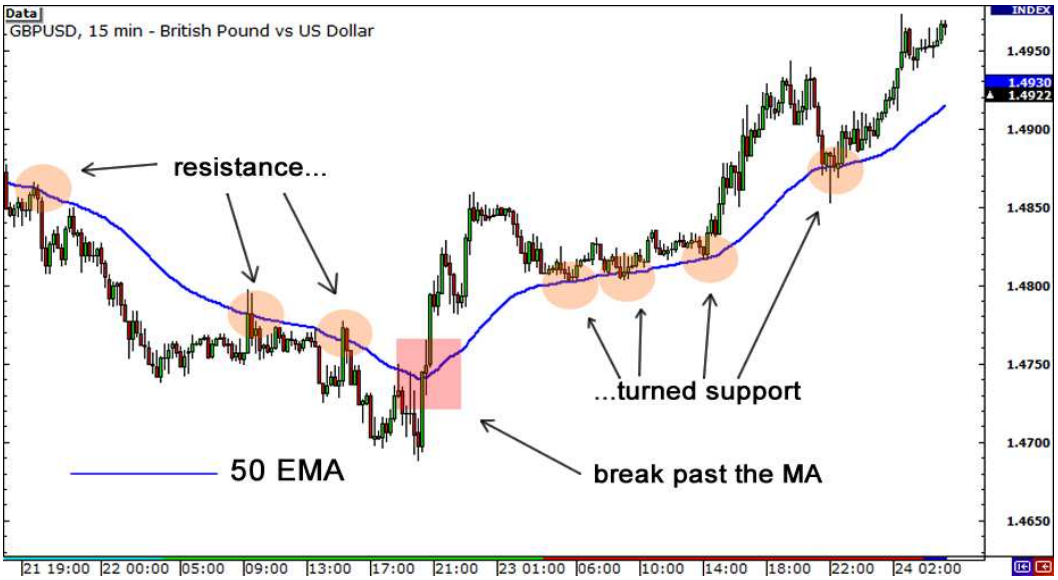
There are some traders who use intraday strategies just like this. The idea is that just like your horizontal support and resistance areas, these moving averages should be treated like zones or areas of interest.

The area between moving averages could therefore be looked upon as a zone of support or resistance.

Breaking through Dynamic Support and Resistance

Now you know that moving averages can potentially act as support and resistance. Combining a couple of them, you can have yourself a nice little zone. But you should also know that they can break, just like any support and resistance level!

Let's take another look at the 50 EMA on GBP/USD's 15-min chart.



In the chart above, we see that the 50 EMA held as a strong resistance level for a while as GBP/USD repeatedly bounced off it.

However, as we've highlighted with the red box, price finally broke through and shot up. Price then retraced and tested the 50 EMA again, which proved to be a strong support level.

So there you have it folks!

Moving averages can also act as dynamic support and resistance levels.

One nice thing about using moving averages is that they're always changing, which means that you can just leave it on your chart and don't have to keep looking back in time to spot potential support and resistance levels.

You know that the line most likely represent a moving area of interest. The only problem of course is figuring out which moving average to use!

Summary: Moving Averages

- There are many types of moving averages. The two most common types are a simple moving average and an exponential moving average.
- Simple moving averages are the simplest form of moving averages, but they are susceptible to spikes.
- Exponential moving averages put more weight to recent price, which means they place more emphasis on what traders are doing now.
- It is much more important to know what traders are doing now than to see what they did last week or last month.
- Simple moving averages are smoother than exponential moving averages.
- Longer period moving averages are smoother than shorter period moving averages.
- Using the exponential moving average can help you spot a trend faster, but is prone to many fake outs.
- Smooth moving averages are slower to respond to price action but will save you from spikes and fake outs. However, because of their slow reaction, they can delay you from taking a trade and may cause you to miss some good opportunities.
- You can use moving averages to help you define the trend, when to enter, and when the trend is coming to an end.
- Moving averages can be used as dynamic support and resistance levels.
- One of the best ways to use moving averages is to plot different types so that you can see both long term movement and short term movement.

You got all of that? Why don't you open up your charting software and try popping up some moving averages.

Remember, using moving averages is easy. The hard part is determining which one to use!

That's why you should try them out and figure out which best fits your style of trading. Maybe you prefer a trend-following system. Or maybe you want use them as dynamic support and resistance.

Whatever you choose to do, make sure you read up and do some testing to see how it fits into your overall trading plan.

Bollinger Bands

Congratulations on making it to the 5th grade! Each time you make it to the next grade you continue to add more and more tools to your trader's toolbox.

"What's a trader's toolbox?" you ask.

Simple!

Let's compare trading to building a house. You wouldn't use a hammer on a screw, right? Nor would you use a buzz saw to drive in nails. There's a proper tool for each situation.

Just like in trading, some trading tools and indicators are best used in particular environments or situations. So, the more tools you have, the better you can adapt to the ever changing market environment.

Or if you want to focus on a few specific trading environments or tools, that's cool too. It's good to have a specialist when installing your electricity or plumbing in a house, just like it's cool to be a Bollinger band or Moving Average expert.

There are a million different ways to grab some pips!

For this lesson, as you learn about these indicators, think of each as a new tool that you can add to that toolbox of yours.

You might not necessarily use all of these tools, but it's always nice to have plenty of options, right? You might even find one that you understand and comfortable enough to master on its own. Now, enough about tools already!

Let's get started!

Bollinger Bands

Bollinger bands are used to measure a market's volatility.

Basically, this little tool tells us whether the market is quiet or whether the market is **LOUD**! When the market is quiet, the bands contract and when the market is **LOUD**, the bands expand.

Notice on the chart below that when price is quiet, the bands are close together. When price moves up, the bands spread apart.



That's all there is to it. Yes, we could go on and bore you by going into the history of the Bollinger band, how it is calculated, the mathematical formulas behind it, and so on and so forth, but we really didn't feel like typing it all out.

In all honesty, you don't need to know any of that junk. We think it's more important that we show you some ways you can apply the Bollinger bands to your trading.

Note: If you really want to learn about the calculations of a Bollinger band, then you can go to www.bollingerbands.com.

The Bollinger Bounce

One thing you should know about Bollinger bands is that price tends to return to the middle of the bands. That is the whole idea behind the Bollinger bounce. By looking at the chart below, can you tell us where the price might go next?



If you said down, then you are correct! As you can see, the price settled back down towards the middle area of the bands.



What you just saw was a classic Bollinger bounce. The reason these bounces occur is because Bollinger bands act like dynamic support and resistance levels.

The longer the time frame you are in, the stronger these bands tend to be. Many traders have developed systems that thrive on these bounces and this strategy is best used when the market is **ranging** and there is no clear trend.

Now let's look at a way to use Bollinger bands when the market **does** trend.

Bollinger Squeeze

The Bollinger squeeze is pretty self-explanatory. When the bands squeeze together, it usually means that a breakout is getting ready to happen.

If the candles start to break out above the top band, then the move will usually continue to go up. If the candles start to break out below the lower band, then price will usually continue to go down.



Looking at the chart above, you can see the bands squeezing together. The price has just started to break out of the top band. Based on this information, where do you think the price will go?



If you said up, you are correct again!

This is how a typical Bollinger squeeze works.

This strategy is designed for you to catch a move as early as possible. Setups like these don't occur every day, but you can probably spot them a few times a week if you are looking at a 15-minute chart.

There are many other things you can do with Bollinger bands, but these are the 2 most common strategies associated with them. It's time to put this in your trader's toolbox before we move on to the next indicator.

Moving Average Convergence Divergence (MACD)

MACD is an acronym for **M**oving **A**verage **C**onvergence **D**ivergence. This tool is used to identify moving averages that are indicating a new trend, whether it's bullish or bearish. After all, our top priority in trading is being able to find a trend, because that is where the most money is made.



With an MACD chart, you will usually see three numbers that are used for its settings.

- The first is the number of periods that is used to calculate the faster moving average.
- The second is the number of periods that is used in the slower moving average.
- And the third is the number of bars that is used to calculate the moving average of the difference between the faster and slower moving averages.

For example, if you were to see "12, 26, 9" as the MACD parameters (which is usually the default setting for most charting packages), this is how you would interpret it:

- The 12 represents the previous 12 bars of the faster moving average.
- The 26 represents the previous 26 bars of the slower moving average.
- The 9 represents the previous 9 bars of the difference between the two moving averages. This is plotted by vertical lines called a histogram (the green lines in the chart above).

There is a common misconception when it comes to the lines of the MACD. The two lines that are drawn are NOT moving averages of the price. Instead, they are the moving averages of the **DIFFERENCE** between two moving averages.

In our example above, the faster moving average is the moving average of the difference between the 12 and 26-period moving averages. The slower moving average plots the average

of the previous MACD line. Once again, from our example above, this would be a 9-period moving average.

This means that we are taking the average of the last 9 periods of the faster MACD line and plotting it as our slower moving average. This smoothens out the original line even more, which gives us a more accurate line.

The histogram simply plots the difference between the fast and slow moving average. If you look at our original chart, you can see that, as the two moving averages separate, the histogram gets bigger.

This is called divergence because the faster moving average is "diverging" or moving away from the slower moving average.

As the moving averages get closer to each other, the histogram gets smaller. This is called convergence because the faster moving average is "converging" or getting closer to the slower moving average.

And that, my friend, is how you get the name, **M**oving **A**verage **C**onvergence **D**ivergence! Whew, we need to crack our knuckles after that one!

Ok, so now you know what MACD does. Now we'll show you what MACD can do for YOU.

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How to Trade Using MACD

Because there are two moving averages with different "speeds", the faster one will obviously be quicker to react to price movement than the slower one.

When a new trend occurs, the fast line will react first and eventually cross the slower line. When this "crossover" occurs, and the fast line starts to "diverge" or move away from the slower line, it often indicates that a new trend has formed.



From the chart above, you can see that the fast line crossed under the slow line and correctly identified a new downtrend. Notice that when the lines crossed, the histogram temporarily disappears.

This is because the difference between the lines at the time of the cross is 0. As the downtrend begins and the fast line diverges away from the slow line, the histogram gets bigger, which is good indication of a strong trend.

Let's take a look at an example.



In EUR/USD's 1-hour chart above, the fast line crossed above the slow line while the histogram disappeared. This suggested that the brief downtrend would eventually reverse.

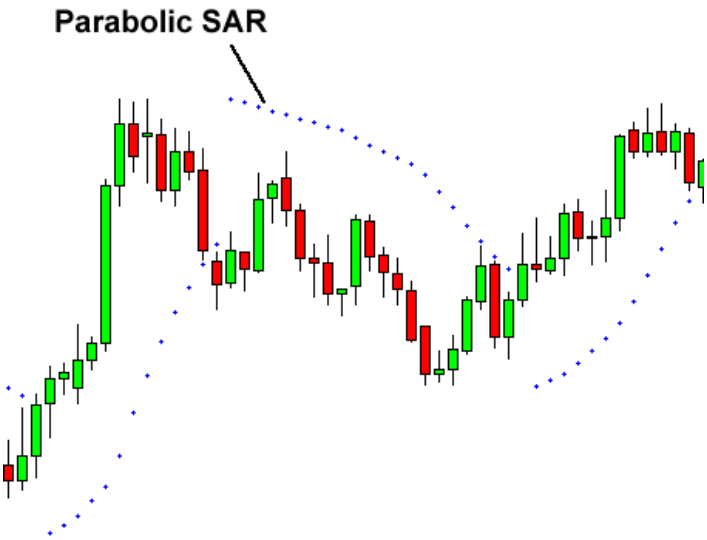
From then, EUR/USD began shooting up as it started a new uptrend. Imagine if you went long after the crossover, you would've gained almost 200 pips!

There is one drawback to MACD. Naturally, moving averages tend to lag behind price. After all, it's just an average of historical prices.

Since the MACD represents moving averages of **other** moving averages and is smoothed out by another moving average, you can imagine that there is quite a bit of lag. However, MACD is still one of the most favored tools by many traders.

Parabolic SAR

Up until now, we've looked at indicators that mainly focus on catching the beginning of new trends. Although it is important to be able to identify new trends, it is equally important to be able to identify where a trend ends. After all, what good is a well-timed entry without a well-timed exit?



One indicator that can help us determine where a trend might be ending is the Parabolic SAR (**S**top **A**nd **R**eversal). A Parabolic SAR places dots, or points, on a chart that indicate potential reversals in price movement.

From the image above, you can see that the dots shift from being below the candles during the uptrend to above the candles when the trend reverses into a downtrend.

How to Trade Using Parabolic SAR

The nice thing about the Parabolic SAR is that it is really simple to use. We mean REALLY simple.

Basically, when the dots are below the candles, it is a buy signal; and when the dots are above the candles, it is a sell signal.



Simple?

Yes, we thought so.

This is probably the easiest indicator to interpret because it assumes that the price is either going up or down. With that said, this tool is best used in markets that are trending, and that have long rallies and downturns.

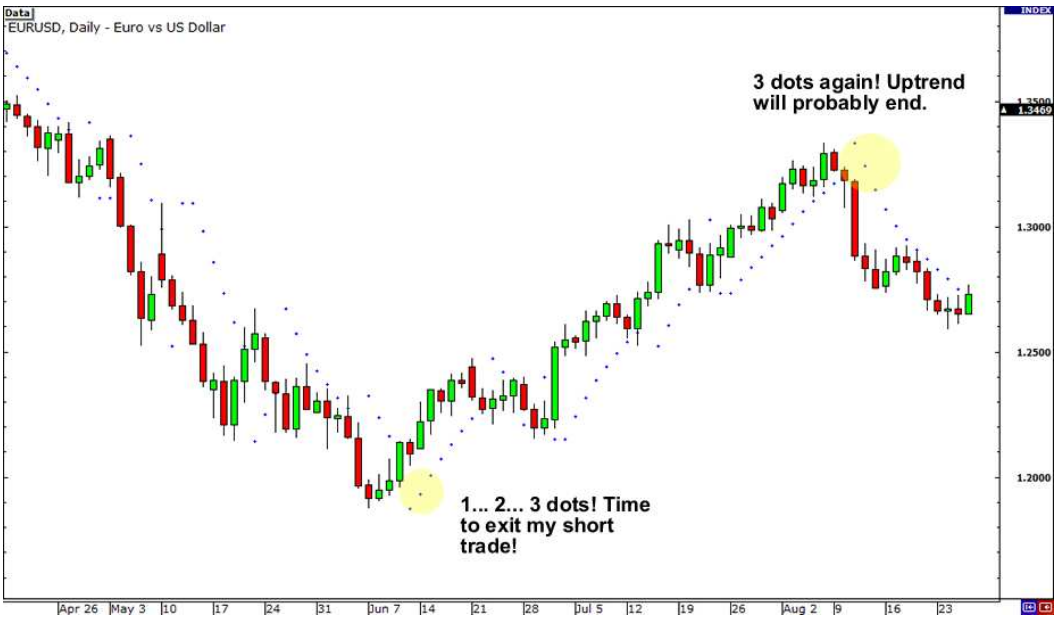
You DON'T want to use this tool in a choppy market where the price movement is sideways.

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Using Parabolic SAR to exit trades

You can also use Parabolic SAR to help you determine whether you should close your trade or not.

Check out how the Parabolic SAR worked as an exit signal in EUR/USD's daily chart above.



When EUR/USD started sliding down in late April, it seemed like it would just keep droppin' like it's hot. A trader who was able to short this pair has probably wondered how low it can go.

In early June, three dots formed at the bottom of the price, suggesting that the downtrend was over and that it was time to exit those shorts.

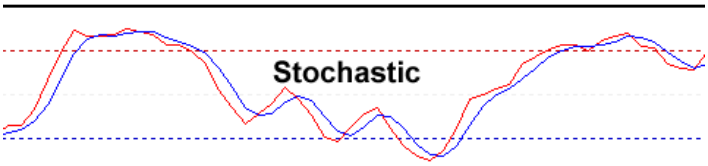
If you stubbornly decided to hold on to that trade thinking that EUR/USD would resume its drop, you would've probably erased all those winnings since the pair eventually climbed back near 1.3500.

Stochastic

The Stochastic is another indicator that helps us determine where a trend might be ending.

By definition, a Stochastic is an oscillator that measures overbought and oversold conditions in the market. The 2 lines are similar to the MACD lines in the sense that one line is faster than the other.





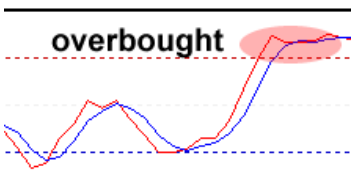
How to Trade Using the Stochastic



As we said earlier, the Stochastic tells us when the market is overbought or oversold. The Stochastic is scaled from 0 to 100.

When the Stochastic lines are above 80 (the red dotted line in the chart above), then it means the market is overbought. When the Stochastic lines are below 20 (the blue dotted line), then it means that the market is oversold.

As a rule of thumb, we buy when the market is oversold, and we sell when the market is overbought.



Looking at the chart above, you can see that the Stochastic has been showing overbought conditions for quite some time. Based on this information, can you guess where the price might go?



If you said the price would drop, then you are absolutely correct! Because the market was overbought for such a long period of time, a reversal was bound to happen.

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That is the basics of the Stochastic. Many traders use the Stochastic in different ways, but the main purpose of the indicator is to show us where the market conditions could be overbought or oversold.

Over time, you will learn to use the Stochastic to fit your own personal trading style.

Okay, let's move on to RSI.

Relative Strength Index

Relative Strength Index, or RSI, is similar to the stochastic in that it identifies overbought and oversold conditions in the market. It is also scaled from 0 to 100. Typically, readings below 30 indicate oversold, while readings over 70 indicate overbought.



How to Trade Using RSI

RSI can be used just like the stochastic. We can use it to pick potential tops and bottoms depending on whether the market is overbought or oversold.

Below is a 4-hour chart of EUR/USD.



EUR/USD had been dropping the week, falling about 400 pips over the course of two weeks.

On June 7, it was already trading below the 1.2000 handle. However, RSI dropped below 30, signalling that there might be no more sellers left in the market and that the move could be over. Price then reversed and headed back up over the next couple of weeks.

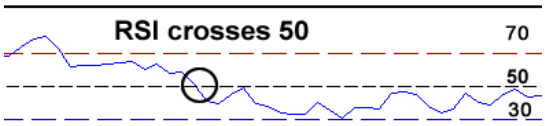
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Determining the Trend using RSI

RSI is a very popular tool because it can also be used to confirm trend formations. If you think a trend is forming, take a quick look at the RSI and look at whether it is above or below 50.

If you are looking at a possible uptrend, then make sure the RSI is above 50. If you are looking at a possible downtrend, then make sure the RSI is below 50.





In the beginning of the chart above, we can see that a possible uptrend was forming. To avoid fake outs, we can wait for RSI to cross above 50 to confirm our trend. Sure enough, as RSI passes above 50, it is a good confirmation that an uptrend has actually formed.

Average Directional Index

The Average Directional Index, or ADX for short, is another example of an oscillator. It fluctuates from 0 to 100, with readings below 20 indicating a weak trend and readings above 50 signaling a strong trend.

Unlike the stochastic, ADX doesn't determine whether the trend is bullish or bearish. Rather, it merely measures the strength of the current trend. Because of that, ADX is typically used to identify whether the market is ranging or starting a new trend.

Take a look at these neat charts we've pulled up:



In this first example, ADX lingered below 20 from late September until early December. As you can see from the chart, EUR/CHF was stuck inside a range during that time. Beginning in January though, ADX started to climb above 50, signaling that a strong trend could be waiting in the wings.

And would you look at that! EUR/CHF broke below the bottom of the range and went on a strong downtrend. Ooh, that'd be around 400 pips in the bag.

Book it, baby!

Now, let's look at this next example:



Just like in our first example, ADX hovered below 20 for quite a while. At that time, EUR/CHF was also ranging. Soon enough, ADX rose above 50 and EUR/CHF broke above the top of its range.

Tada!

A strong uptrend took place. That'd be 300 pips, signed, sealed, and delivered!

Looks simple enough, right?

If there's one problem with using ADX, it's that it doesn't exactly tell you whether it's a buy or a sell. What it does tell you is whether it'd be okay to jump in an ongoing trend or not.

Once ADX starts dropping below 50 again, it could mean that the uptrend or downtrend is starting to weaken and that it might be a good time to lock in profits.

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How to Trade Using ADX

One way to trade using ADX is to wait for breakouts first before deciding to go long or short. ADX can be used as confirmation whether the pair could possibly continue in its current trend or not.

Another way is to combine ADX with another indicator, particularly one that identifies whether the pair is headed downwards or upwards.

ADX can also be used to determine when one should close a trade early.

For instance, when ADX starts to slide below 50, it indicates that the current trend is losing steam. From then, the pair could possibly move sideways, so you might want to lock in those pips before that happens.

Ichimoku Kinko Hyo

Yes, you're still in the right place. You're still in the School of Pipsology and not in some Japanese pop fan girl site (although Huck may disagree with the rest of the FX-Men on that). No, "Ichimoku Kinko Hyo" ain't Japanese for "May the pips be with you," but it can help you grab those pips nonetheless.

Ichimoku Kinko Hyo (IKH) is an indicator that gauges future price momentum and determines future areas of support and resistance. Now that's 3-in-1 for y'all! Also know that this indicator is mainly used on JPY pairs.

To add to your Japanese vocab, the word *ichimoku* translates to "a glance", *kinko* means "equilibrium", while *hyo* is Japanese for "chart." Putting that all together, the phrase *ichimoku kinko hyo* stands for "a glance at a chart in equilibrium." Huh, what does all that mean?

A chart might make things easier to explain...



Whoops. That didn't help. A few more lines and this'll resemble a seismograph.

Before you go off and call this gibberish, let's try to find out what each of the lines is for.

Kijun Sen (blue line): Also called standard line or base line, this is calculated by averaging the highest high and the lowest low for the past 26 periods.

Tenkan Sen (red line): This is also known as the turning line and is derived by averaging the highest high and the lowest low for the past nine periods.

Chikou Span (green line): This is called the lagging line. It is today's closing price plotted 26 periods behind.

Senkou Span (orange lines): The first Senkou line is calculated by averaging the Tenkan Sen and the Kijun Sen and plotted 26 periods ahead. The second Senkou line is determined by averaging the highest high and the lowest low for the past 52 periods and plotted 26 periods ahead.



Got it? Well, it's not really necessary for you to memorize how each of the lines is computed. What's more important is for you to know how to interpret these fancy lines.

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How to Trade Using Ichimoku Kinyo Hyo

Let's take a look at the Senkou span first.

If the price is above the Senkou span, the top line serves as the first support level while the bottom line serves as the second support level.

If the price is below the Senkou span, the bottom line forms the first resistance level while the top line is the second resistance level. Got it?

Meanwhile, the Kijun Sen acts as an indicator of future price movement. If the price is higher than the blue line, it could continue to climb higher. If the price is below the blue line, it could keep dropping.

The Tenkan Sen is an indicator of the market trend. If the red line is moving up or down, it indicates that the market is trending. If it moves horizontally, it signals that the market is ranging.

Lastly, if the Chikou Span or the green line crosses the price in the bottom-up direction, that's a buy signal. If the green line crosses the price from the top-down, that's a sell signal.

Here's that line-filled chart once more, this time with the trade signals:



It sure looks complicated at first but this baby's got support and resistance levels, crossovers, oscillators, and trend indicators all in one go! Amazing, right?

Okey dokey, we've already covered a smorgasbord of indicators. Let's see how we can put all of what you just learned together...

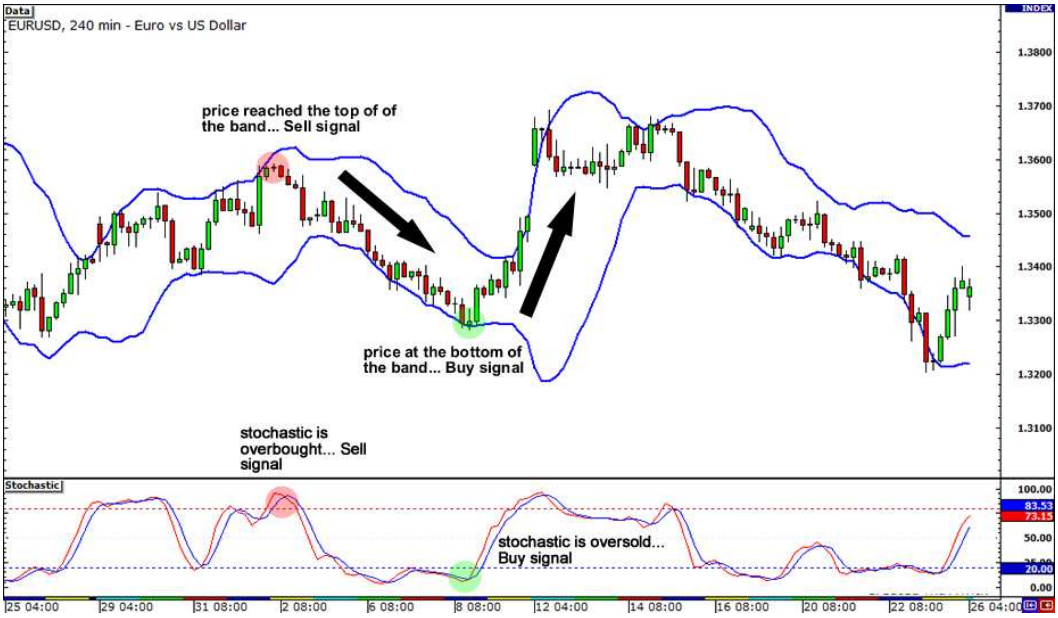
Putting It All Together

Now that you know how some of the most common chart indicators work, you're ready to get down and dirty with some examples. Better yet, let's combine some of these indicators and see how their trade signals pan out.

In a perfect world, we could take just one of these indicators and trade strictly by what that indicator told us. The problem is that we DON'T live in a perfect world, and each of these indicators has imperfections.

That is why many traders combine different indicators together so that they can "screen" each other. They might have 3 different indicators and they won't trade unless all 3 indicators give them the same signal.

In this first example, we've got the Bollinger bands and the Stochastic on EUR/USD's 4-hour chart. Since the market seems to be ranging or moving sideways, we'd better watch out for the Bollinger bounce.



Check out that those sell signals from the Bollinger bands and the Stochastic. EUR/USD climbed until the top of the band, which usually acts as a resistance level.

At the same time, the Stochastic reached the overbought area, suggesting that the price could drop down soon.

And what happened next?

EUR/USD fell by around 300 pips and you would've made a hefty profit if you took that short trade.

Later on, the price made contact with the bottom of the band, which usually serves as a support level. This means that the pair could bounce up from there. With the Stochastic in the oversold area, it means we should go long.

If you took that trade, you would have gotten around 400 pips! Not bad!

Here's another example, with the RSI and the MACD this time.



When the RSI reached the overbought area and gave a sell signal, the MACD soon followed with a downward crossover, which is also a sell signal. And, as you can see, the price did move downhill from there.

Hooray for our indicators!

Later on, the RSI dipped to the oversold region and gave a buy signal. A few hours after, the MACD made an upward crossover, which is also a buy signal. From there, the price made a steady climb. More pips for us, yipee!

You probably noticed in this example that the RSI gives signals ahead of the MACD. Because of the various properties and magic formulas for the technical indicators, some really do give early signals while others are a bit delayed.

You'll learn more about this in sixth grade.

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As you continue your journey as a trader, you will discover which indicators work best for you. We can tell you that we like using MACD, the Stochastic, and RSI, but you might have a different preference.

Every trader out there has tried to find the "magic combination" of indicators that will give them the right signals all the time, but the truth is that there is no such thing.

We urge you to study each indicator on its own until you know the tendencies of how it behaves relative to price movement, and then come up with your own combination that **you** understand and that fits your trading style.

Later on in the course, we will show you an example of a system that combines different indicators to give you an idea of how they can complement each other.

Summary: Common Chart Indicators

Everything you learn about trading is like a tool that is being added to your trader's toolbox. Your tools will give you a better chance of making good trading decisions when you use the right tool at the right time.

Bollinger Bands.

- Used to measure the market's volatility.
- They act like mini support and resistance levels.

Bollinger Bounce

- A strategy that relies on the notion that price tends to always return to the middle of the Bollinger bands.
- You buy when the price hits the lower Bollinger band.
- You sell when the price hits the upper Bollinger band.
- Best used in ranging markets.

Bollinger Squeeze

- A strategy that is used to catch breakouts early.
- When the Bollinger bands "squeeze", it means that the market is very quiet, and a breakout is eminent. Once a breakout occurs, we enter a trade on whatever side the price makes its breakout.

MACD

- Used to catch trends early and can also help us spot trend reversals.
- It consists of 2 moving averages (1 fast, 1 slow) and vertical lines called a histogram, which measures the distance between the 2 moving averages.
- Contrary to what many people think, the moving average lines are NOT moving averages of the price. They are moving averages of other moving averages.
- MACD's downfall is its lag because it uses so many moving averages.
- One way to use MACD is to wait for the fast line to "cross over" or "cross under" the slow line and enter the trade accordingly because it signals a new trend.

Parabolic SAR

- This indicator is made to spot trend reversals, hence the name Parabolic Stop And Reversal (SAR).
- This is the easiest indicator to interpret because it only gives bullish and bearish signals.
- When the dots are above the candles, it is a sell signal.
- When the dots are below the candles, it is a buy signal.
- These are best used in trending markets that consist of long rallies and downturns.

Stochastic

- Used to indicate overbought and oversold conditions.

- When the moving average lines are above 80, it means that the market is overbought and we should look to sell.
- When the moving average lines are below 20, it means that the market is oversold and we should look to buy.

Relative Strength Index (RSI)

- Similar to the stochastic in that it indicates overbought and oversold conditions.
- When RSI is above 70, it means that the market is overbought and we should look to sell.
- When RSI is below 30, it means that the market is oversold and we should look to buy.
- RSI can also be used to confirm trend formations. If you think a trend is forming, wait for RSI to go above or below 50 (depending on if you're looking at an uptrend or downtrend) before you enter a trade.

Average Directional Index (ADX)

- The ADX measures how strong a trend is.
- It fluctuates from 0 to 100, with readings below 20 indicating a weak trend and readings above 50 signaling a strong trend.
- ADX can be used as confirmation whether the pair could possibly continue in its current trend or not.
- ADX can also be used to determine when one should close a trade early. For instance, when ADX starts to slide below 50, it indicates that the current trend is losing steam.

Ichimoku Kinko Hyo

- Ichimoku Kinko Hyo (IKH) is an indicator that gauges future price momentum and determines future areas of support and resistance.
- *Ichimoku* translates to "a glance", *kinko* means "equilibrium", while *hyo* is Japanese for "chart". Putting that all together, the phrase ichimoku kinko hyo stands for "a glance at a chart in equilibrium."
- If the price is above the Senkou span, the top line serves as the first support level while the bottom line serves as the second support level. If the price is below the Senkou span, the bottom line forms the first resistance level while the top line is the second resistance level.
- The Kijun Sen acts as an indicator of future price movement. If the price is higher than the blue line, it could continue to climb higher. If the price is below the blue line, it could keep dropping.
- The Tenkan Sen is an indicator of the market trend. If the red line is moving up or down, it indicates that the market is trending. If it moves horizontally, it signals that the market is ranging.
- The Chikou Span is the lagging line. If the Chikou line crosses the price in the bottom-up direction, that's a buy signal. If the green line crosses the price from the top-down, that's a sell signal.

Each indicator has its imperfections. This is why traders combine many different indicators to "screen" each other. As you progress through your trading career, you will learn which indicators you like the best and can combine them in a way that fits **your** trading style.

Leading vs. Lagging Indicators



We've already covered a lot of tools that can help you analyze potential trending and range bound trade opportunities. Still doing great so far? Awesome! Let's move on.

In this lesson, we're going to streamline your use of these chart indicators.

We want you to fully understand the strengths and weaknesses of each tool, so you'll be able to determine which ones work for you and which ones don't.

Let's discuss some concepts first. There are two types of indicators: **leading** and **lagging**.

A **leading** indicator gives a signal **before** the new trend or reversal occurs.

A **lagging** indicator gives a signal **after** the trend has started and basically informs you "Hey buddy, pay attention, the trend has started and you're missing the boat."

You're probably thinking, "Ooooh, I'm going to get rich with leading indicators!" since you would be able to profit from a new trend right at the start.

You're right.

You would "catch" the entire trend every single time, IF the leading indicator was correct every single time. But it won't be.

When you use leading indicators, you will experience a lot of fakeouts. Leading indicators are notorious for giving bogus signals which could "mislead" you.

Get it? Leading indicators that "mislead" you?

Haha. Man we're so funny we even crack ourselves up.

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The other option is to use lagging indicators, which aren't as prone to bogus signals.

Lagging indicators only give signals after the price change is clearly forming a trend. The downside is that you'd be a little late in entering a position.

Often the biggest gains of a trend occur in the first few bars, so by using a lagging indicator you could potentially miss out on much of the profit. And that sucks.

It's kinda like wearing bell-bottoms in the 1980s and thinking you're so cool and hip with fashion....

For the purpose of this lesson, let's broadly categorize all of our technical indicators into one of two categories:

1. Leading indicators or oscillators

2. Lagging, trend-following, or momentum indicators

While the two can be supportive of each other, they're more likely to conflict with each other. We're not saying that one or the other should be used exclusively, but you must understand the potential pitfalls of each.

Leading Indicators (Oscillators)

An oscillator is any object or data that moves back and forth between two points.

In other words, it's an item that is going to always fall somewhere between point A and point B. Think of when you hit the oscillating switch on your electric fan.

Think of our technical indicators as either being "on" or "off". More specifically, an oscillator will usually signal "buy" or "sell", with the only exception being instances when the oscillator is not clearly at either end of the buy/sell range.

Does this sound familiar? It should!

The Stochastic, Parabolic SAR, and Relative Strength Index (RSI) are all oscillators. Each of these indicators is designed to signal a possible reversal, where the previous trend has run its course and the price is ready to change direction.

Let's take a look at a couple of examples.

We've slapped on all three oscillators on GBP/USD's daily chart shown below. Remember when we discussed how to work the Stochastic, Parabolic SAR, and RSI?

If you don't, we're sending you back to fifth grade!

Anyway, as you can see on the chart, all three indicators gave buy signals towards the end of December. Taking that trade would've yielded around 400 pips in gains. Ka-ching!



Then, during the third week of January, the Stochastic, Parabolic SAR, and RSI all gave sell signals. And, judging from that long 3-month drop afterwards, you would've made a whole lot of pips if you took that short trade.

Around mid-April, all three oscillators gave another sell signal, after which the price made another sharp dive.

Now let's take a look at the same leading oscillators messing up, just so you know these signals aren't perfect.

In the chart below, you can see that the indicators could give conflicting signals.

For instance, the Parabolic SAR gave a sell signal in mid-February while the Stochastic showed the exact opposite signal. Which one should you follow?

Well, the RSI seems to be just as undecided as you are since it didn't give any buy or sell signals at that time.



Looking at the chart above, you can quickly see that there were a lot of false signals popping up.

During the second week of April, both the Stochastic and the RSI gave sell signals while the Parabolic SAR didn't give one. The price kept climbing from there and you could've lost a bunch of pips if you entered a short trade right away.

You would've had another loss around the middle of May if you acted on those buy signals from the Stochastic and RSI and simply ignored the sell signal from the Parabolic SAR.

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What happened to such a good set of indicators?

The answer lies in the method of calculation for each one.

Stochastic is based on the high-to-low range of the time period (in this case, it's hourly), yet doesn't account for changes from one hour to the next.

The Relative Strength Index (RSI) uses the change from one closing price to the next.

Parabolic SAR has its own unique calculations that can further cause conflict.

That's the nature of oscillators. They assume that a particular price movement always results in the same reversal. Of course, that's hogwash.

While being aware of why a leading indicator may be wrong, there's no way to avoid them.

If you're getting mixed signals, you're better off doing nothing than taking a "best guess". If a chart doesn't meet all your criteria, don't force the trade!

Move on to the next one that does meet your criteria.

Lagging Indicators (Momentum Indicators)

So how do we spot a trend?

The indicators that can do so have already been identified as MACD and moving averages.

These indicators will spot trends once they have been established, at the expense of delayed entry.

The bright side is that there's less chance of being wrong.



On GBP/USD's daily chart above, we've put on the 10 EMA (blue), 20 EMA (red), and the MACD.

Around October 15, the 10 EMA crossed above the 20 EMA, which is a bullish crossover.

Similarly, the MACD made an upward crossover and gave a buy signal.

If you jumped in on a long trade back then, you would've enjoyed that nice uptrend that followed.

Later on, both the moving averages and MACD gave a couple of sell signals.

And judging from the strong downtrends that occurred, taking those short trades would've given huge profits.

We can see those dollar signs flashing in your eyes!

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Now let's look at another chart so you can see how these crossover signals can sometimes give false signals. We like to call them "fakeouts."



On March 15, the MACD made a bullish crossover while the moving averages gave no signal whatsoever.

If you acted on that buy signal from the MACD, you just suffered a fake out, buddy.

Similarly, the MACD's buy signal by the end of May wasn't accompanied by any moving average crossover. If you entered a long trade right then and there, you might've set yourself up for a loss since the price dipped a bit after that.

Bummer!

Summary: Leading and Lagging Indicators

Here's a quick recap of what we discussed in this lesson:

There are two types of indicators: **leading** and **lagging**.

1. A **leading** indicator or an oscillator gives a signal **before** the new trend or reversal occurs.

2. A **lagging** indicator or a momentum indicator gives a signal **after** the trend has started.

If you're able to identify the type of market you are trading in, you can pinpoint which indicators could give accurate signals and which ones are worthless at that time.

So, how do you figure out when to use oscillators or momentum indicators, or both?

That's another million dollar question! After all, we know they don't always work in tandem.

We'll give you a million dollars really soon...

Oh wait! We meant the million dollar answer!

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For now, just know that once you're able to identify the type of market you are trading in, you will then know which indicators will give accurate signals, and which ones are worthless at that time.

This is no piece of cake. But it's a skill you will slowly improve upon as your experience grows.

Besides...

You're not at it alone!

In the future sections, we're going to teach you how to correctly identify the market environment you are trading in to better use these indicators!

Chart Patterns Schmatterns

By now you have an arsenal of weapons to use when you battle the market. In this lesson, you will add yet another weapon: **CHART PATTERNS!**

Think of chart patterns as a land mine detector because, once you finish this lesson, you will be able to spot "explosions" on the charts before they even happen, potentially making you a lot of money in the process.

Chart patterns are like that funny feeling you get in your tummy right before you let a fart explode.



Don't you wish you had a chart to detect this explosion?

In this lesson, we will teach you basic chart patterns and formations. When correctly identified, it usually leads to an explosive breakout, so watch out!

Remember, our goal is to spot big movements before they happen so that we can ride them out and rake in the cash. After all, who doesn't want to have a pool of cash to swim in like Richie Rich?

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Chart formations will greatly help us spot conditions where the market is ready to break out. They can also indicate whether the price will continue in its current direction or reverse so we'll also be devising some nifty trade strategies for these patterns.

Don't worry, we'll give you a neat little cheat sheet to help you remember all these cool patterns and strategies!

Here's the list of patterns that we're going to cover:

- Double Top and Double Bottom
- Head and Shoulders and Inverse Head and Shoulders
- Rising and Falling Wedges
- Bullish and Bearish Rectangles
- Bearish and Bullish Pennants
- Triangles (Symmetrical, Ascending, and Descending)

Doubles

Double Top

A double top is a reversal pattern that is formed after there is an extended move up. The "tops" are peaks which are formed when the price hits a certain level that can't be broken.

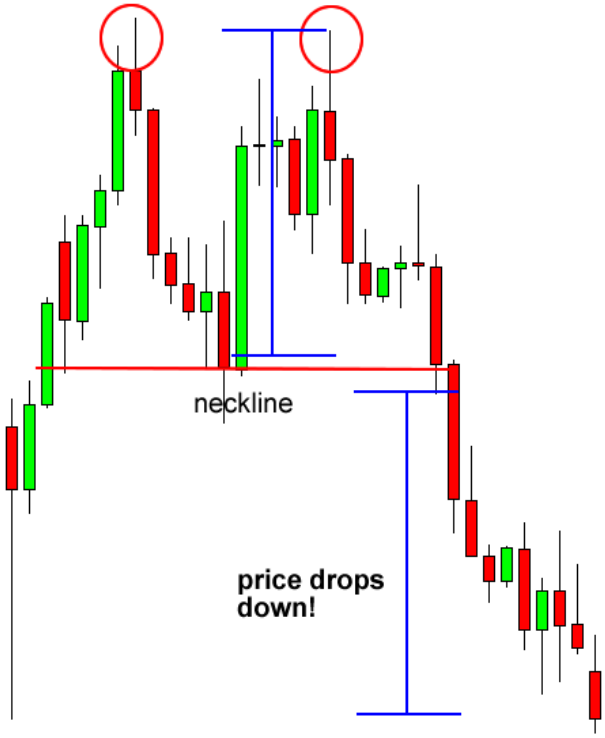
After hitting this level, the price will bounce off it slightly, but then return back to test the level again. If the price bounces off of that level again, then you have a DOUBLE top!



In the chart above you can see that two peaks or "tops" were formed after a strong move up.

Notice how the second top was not able to break the high of the first top. This is a strong sign that a reversal is going to occur because it is telling us that the buying pressure is just about finished.

With the double top, we would place our entry order below the neckline because we are anticipating a reversal of the uptrend.



Wow! We must be psychic or something because we always seem to be right!

Looking at the chart you can see that the price breaks the neckline and makes a nice move down. Remember that double tops are a trend reversal formation so you'll want to look for these after there is a strong uptrend.

You'll also notice that the drop is approximately the same height as the double top formation. Keep that in mind because that'll be useful in setting profit targets.

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Double Bottom

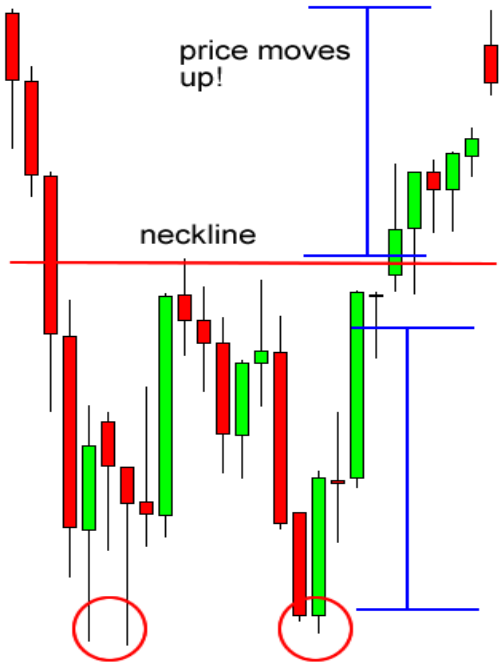


The double bottom is also a trend reversal formation, but this time we are looking to go long instead of short. These formations occur after extended downtrends when two valleys or "bottoms" have been formed.



You can see from the chart above that after the previous downtrend, the price formed two valleys because it wasn't able to go below a certain level.

Notice how the second bottom wasn't able to significantly break the first bottom. This is a sign that the selling pressure is about finished, and that a reversal is about to occur.



Will you look at that!

The price broke the neckline and made a nice move up.

See how the price jumped by almost the same height as that of the double bottom formation?

Remember, just like double tops, double bottoms are also trend reversal formations. You'll want to look for these after a strong downtrend.

Head and Shoulders

Head and Shoulders

A head and shoulders pattern is also a trend reversal formation.

It is formed by a peak (shoulder), followed by a higher peak (head), and then another lower peak (shoulder). A "neckline" is drawn by connecting the lowest points of the two troughs. The slope of this line can either be up or down. Typically, when the slope is down, it produces a more reliable signal.

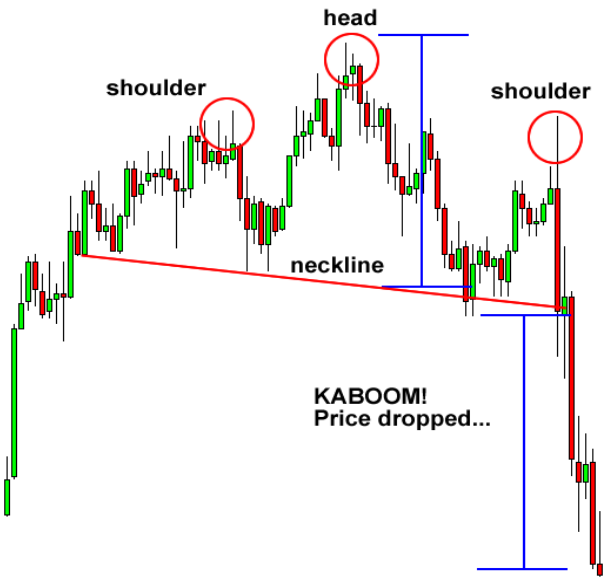


In this example, we can easily see the head and shoulders pattern.

The head is the second peak and is the highest point in the pattern. The two shoulders also form peaks but do not exceed the height of the head.

With this formation, we put an entry order below the neckline.

We can also calculate a target by measuring the high point of the head to the neckline. This distance is approximately how far the price will move after it breaks the neckline.



You can see that once the price goes below the neckline it makes a move that is at least the size of the distance between the head and the neckline.

We know you're thinking to yourself, "the price kept moving even after it reached the target."

And our response is, "**DON"T BE GREEDY!**"

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Inverse Head and Shoulders

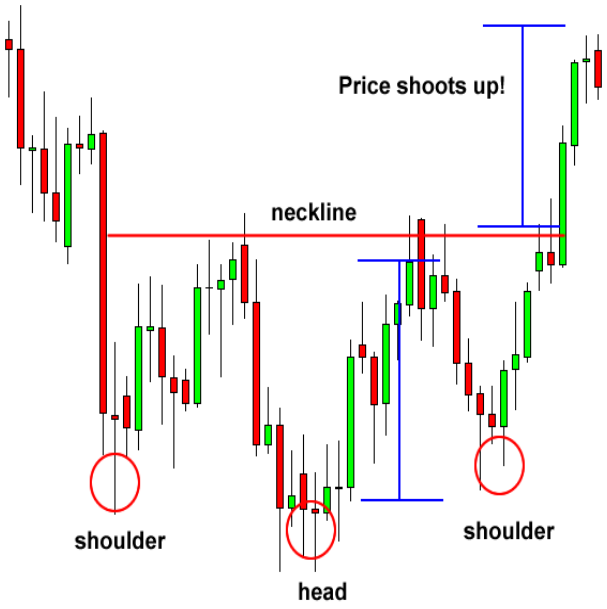
The name speaks for itself. It is basically a head and shoulders formation, except this time it's upside down.

A valley is formed (shoulder), followed by an even lower valley (head), and then another higher valley (shoulder). These formations occur after extended downward movements.



Here you can see that this is just like a head and shoulders pattern, but it's flipped upside down. With this formation, we would place a long entry order above the neckline.

Our target is calculated just like the head and shoulders pattern. Measure the distance between the head and the neckline, and that is approximately the distance that the price will move after it breaks the neckline.



You can see that the price moved up nicely after it broke the neckline.

If your target is hit, then be happy with your profits. However, there are trade management techniques where you can lock in some of your profits and still keep your trade open in case the price continues to move your way.

You will learn about those later on in the course.

Wedges

Wedges signal a pause in the current trend. When you encounter this formation, it signals that traders are still deciding where to take the pair next.

Wedges could serve as either continuation or reversal patterns.

Rising Wedge

A rising wedge is formed when price consolidates between upward sloping support and resistance lines.

Here, the slope of the support line is steeper than that of the resistance. This indicates that higher lows are being formed faster than higher highs. This leads to a wedge-like formation, which is exactly where the chart pattern gets its name from!

With prices consolidating, we know that a big splash is coming, so we can expect a breakout to either the top or bottom.

If the rising wedge forms after an uptrend, it's usually a bearish reversal pattern.

On the other hand, if it forms during a downtrend, it could signal a continuation of the down move.

Either way, the important thing is that, when you spot it, you're ready with your entry orders!



In this first example, a rising wedge formed at the end of an uptrend. Notice how price action is forming new highs, but at a much slower pace than when price makes higher lows.



See how price broke down to the downside? That means there are more traders desperate to be short than be long!

They pushed the price down to break the trend line, indicating that a downtrend may be in the cards.

Just like in the other chart patterns we discussed earlier, the price movement after the breakout is approximately the same magnitude as the height of the formation.

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Now let's take a look at another example of a rising wedge formation. Only this time it acts as a bearish continuation signal.



As you can see, the price came from a downtrend before consolidating and sketching higher highs and even higher lows.



In this case, the price broke to the down side and the downtrend continued. That's why it's called a continuation signal yo!

See how the price made a nice move down that's the same height as the wedge?

What did we learn so far?

A rising wedge formed after an uptrend usually leads to a reversal (downtrend) while a rising wedge formed during a downtrend typically results in a continuation (downtrend).

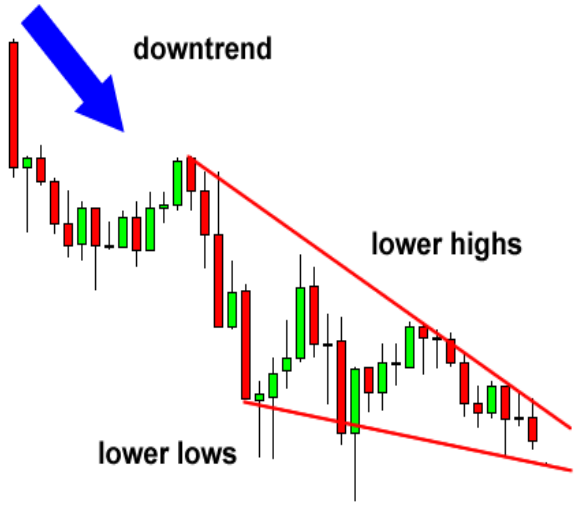
Simply put, a rising wedge leads to a downtrend, which means that it's a bearish chart pattern!

Falling Wedge

Just like the rising wedge, the falling wedge can either be a reversal or continuation signal.

As a reversal signal, it is formed at a bottom of a downtrend, indicating that an uptrend would come next.

As a continuation signal, it is formed during an uptrend, implying that the upward price action would resume. Unlike the rising wedge, the falling wedge is a bullish chart pattern.



In this example, the falling wedge serves as a reversal signal. After a downtrend, the price made lower highs and lower lows.

Notice how the falling trend line connecting the highs is steeper than the trend line connecting the lows.



Upon breaking above the top of the wedge, the pair made a nice move upwards that's approximately equal to the height of the formation. In this case, the price rally went a few more pips beyond that target!

Let's take a look at an example where the falling wedge serves as a continuation signal. Like we mentioned earlier, when the falling wedge forms during an uptrend, it usually signals that the trend will resume later on.



In this case, the price consolidated for a bit after a strong rally. This could mean that buyers simply paused to catch their breath and probably recruited more people to join the bull camp.

Hmm, it looks like the pair is revving up for a strong move. Which way would it go?

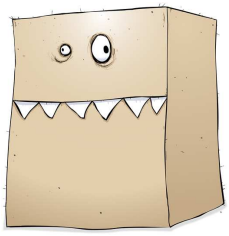


See how the price broke to the top side and went on to climb higher?

If we placed an entry order above that falling trend line connecting the pair's highs, we would've been able to jump in on the strong uptrend and caught some pips! A good upside target would be the height of the wedge formation.

If you want to go for more pips, you can lock in some profits at the target by closing down a portion of your position, then letting the rest of your position ride.

Rectangles



A rectangle is a pattern formed when price is bounded by parallel support and resistance levels.

A rectangle exhibits a period of consolidation or indecision between buyers and sellers as they take turns throwing punches but neither has taken over.

The price will "test" the support and resistance levels several times before eventually breaking out. From there, the price could trend in the direction of the breakout, whether it is to the upside or downside.



In the example above, we can clearly see that the pair was bounded by two key price levels which are parallel to one another. We just have to wait until one of these levels breaks and go along for the ride! Remember, when you spot a rectangle: **THINK OUTSIDE THE BOX!**

Bearish Rectangle

A bearish rectangle is formed when the price consolidates for a while during a downtrend. This happens because sellers probably need to pause and catch their breath before taking the pair any lower.



In this example, price broke the bottom of the rectangle and continued to shoot down. If we had a short order just below the support level, we would have made a nice profit on this trade.

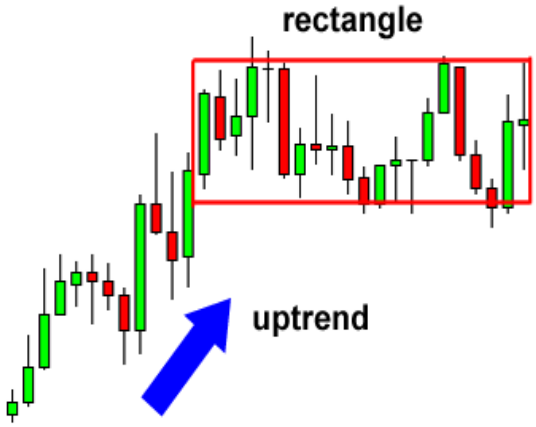


Here's a tip: Once the pair falls below the support, it tends to make a move that is about the size of the pattern. In the example above, the pair moved beyond the target so there would have been a chance to catch more pips!

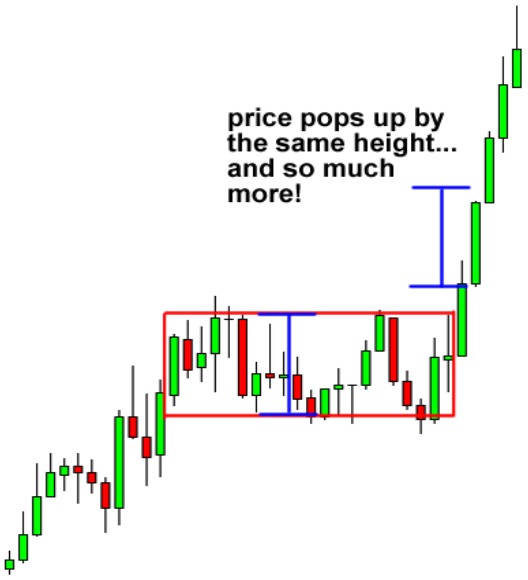
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Bullish Rectangle

Here's another example of a rectangle, a bullish one this time. After an uptrend, the price paused to consolidate for a bit. Can you guess where the price is headed next?



If you answered up, then you're right! Check out that nice upside breakout right there!



Notice how the price moved all the way up after breaking above the top of the rectangle. If we had a long order on top of the resistance level, we would've caught some pips on the trade!

Just like in the bearish rectangle example, once the pair breaks, it will usually make a move that's AT LEAST the size of its previous range.

Pennants

Bearish Pennants

Similar to rectangles, pennants are continuation patterns formed after strong moves.

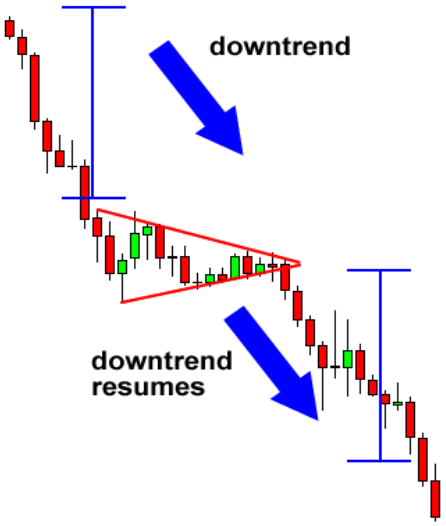
After a big upward or downward move, buyers or sellers usually pause to catch their breath before taking the pair further in the same direction. Because of this, the price usually consolidates and forms a tiny symmetrical triangle, which is called a pennant.

While the price is still consolidating, more buyers or sellers usually decide to jump in on the strong move, forcing the price to bust out of the pennant formation.

A bearish pennant is formed during a steep, almost vertical, downtrend. After that sharp drop in price, some sellers close their positions while other sellers decide to join the trend, making the price consolidate for a bit.



As soon as enough sellers jump in, the price breaks below the bottom of the pennant and continues to move down.



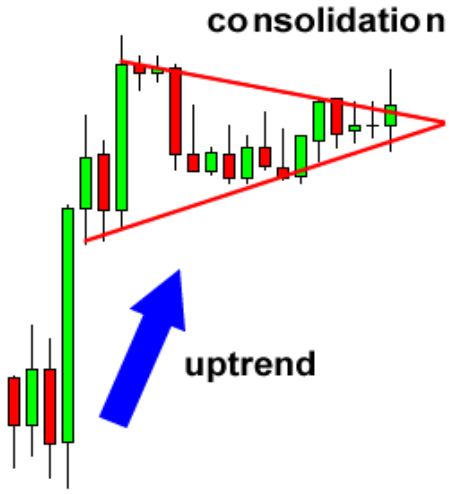
As you can see, the drop resumed after the price made a breakout to the bottom. To trade this chart pattern, we'd put a short order at the bottom of the pennant with a stop loss above the pennant. That way, we'd be out of the trade right away in case the breakdown was a fake out.

Unlike the other chart patterns wherein the size of the next move is approximately the height of the formation, pennants signal much stronger moves. Usually, the height of the earlier move (also known as the mast) is used to estimate the size of the breakout move.

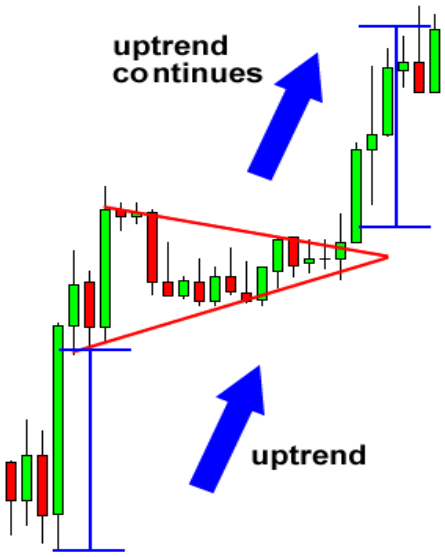
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Bullish Pennant

Bullish pennants, just like its name suggests, signals that bulls are about to go a-chargin' again. This means that the sharp climb in price would resume after that brief period of consolidation, when bulls gather enough energy to take the price higher again.



In this example, the price made a sharp vertical climb before taking a breather. I can hear the bulls stomping and revving up for another run!



Just like we predicted, the price made another strong move upwards after the breakout. To play this, we'd place our long order above the pennant and our stop below the bottom of the pennant to avoid fake outs.

Like we discussed earlier, the size of the breakout move is around the height of the mast (or the size of the earlier move). You see, pennants may be small in size but they could signal huge price moves so don't underestimate 'em!

Triangles

Symmetrical Triangle

A symmetrical triangle is a chart formation where the slope of the price's highs and the slope of the price's lows converge together to a point where it looks like a triangle.

What's happening during this formation is that the market is making lower highs and higher lows. This means that neither the buyers nor the sellers are pushing the price far enough to make a clear trend.

If this were a battle between the buyers and sellers, then this would be a draw.

This is also a type of consolidation.



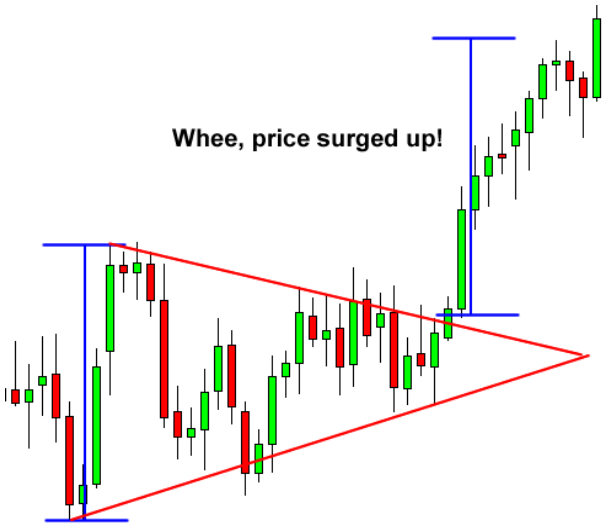
In the chart above, we can see that neither the buyers nor the sellers could push the price in their direction. When this happens we get lower highs and higher lows.

As these two slopes get closer to each other, it means that a breakout is getting near. We don't know what direction the breakout will be, but we do know that the market will **most likely** break out. Eventually, one side of the market will give in.

So how can we take advantage of this?

Simple.

We can place entry orders above the slope of the lower highs and below the slope of the higher lows. Since we already know that the price is going to break out, we can just hitch a ride in whatever direction the market moves.



In this example, if we placed an entry order above the slope of the lower highs, we would've been taken along for a nice ride up.

If you had placed another entry order below the slope of the higher lows, then you would cancel it as soon as the first order was hit.

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Ascending Triangle

This type of formation occurs when there is a resistance level and a slope of higher lows.

What happens during this time is that there is a certain level that the buyers cannot seem to exceed. However, they are gradually starting to push the price up as evident by the higher lows.



In the chart above, you can see that the buyers are starting to gain strength because they are making higher lows. They keep putting pressure on that resistance level and as a result, a breakout is bound to happen.

Now the question is, "Which direction will it go? Will the buyers be able to break that level or will the resistance be too strong?"

Many charting books will tell you that in most cases, the buyers will win this battle and the price will break out past the resistance.

However, it has been our experience that this is not always the case. Sometimes the resistance level is too strong, and there is simply not enough buying power to push it through.

Most of the time, the price will in fact go up. The point we are trying to make is that you should not be obsessed with which direction the price goes, but you should be ready for movement in EITHER direction.

In this case, we would set an entry order above the resistance line and below the slope of the higher lows.



In this scenario, the buyers lost the battle and the price proceeded to dive! You can see that the drop was approximately the same distance as the height of the triangle formation.

If we set our short order below the bottom of the triangle, we could've caught some pips off that dive.

Descending Triangle

As you probably guessed, descending triangles are the exact opposite of ascending triangles (we knew you were smart!). In descending triangles, there is a string of lower highs which forms the upper line. The lower line is a support level in which the price cannot seem to break.

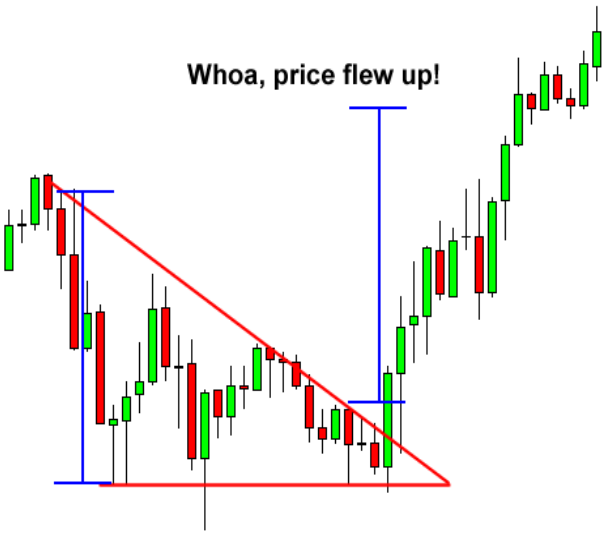


In the chart above, you can see that the price is gradually making lower highs which tell us that the sellers are starting to gain some ground against the buyers.

Now most of the time, and we do say MOST, the price will eventually break the support line and continue to fall.

However, in some cases the support line will be too strong, and the price will bounce off of it and make a strong move up.

The good news is that we don't care where the price goes. We just know that it's about to go somewhere. In this case, we would place entry orders above the upper line (the lower highs) and below the support line.



In this case, the price ended up breaking above the top of the triangle. After the upside breakout, it proceeded to surge higher, by around the same vertical distance as the height of the triangle.

Placing an entry order above the top of the triangle and going for a target as high as the height of the formation would've yielded nice profits.

How to Trade Chart Patterns

That's a whole lot of chart patterns we just taught you right there. We're pretty tired so it's time for us to take off and leave it to you from here...

Just playin'! We ain't leaving you till you're ready!

In this section, we'll discuss a bit more how to use these chart patterns to your advantage.

It's not enough to just know how the tools work, we've got to learn how to use them. And with all these new weapons in your arsenal, we'd better get those profits fired up!

Let's summarize the chart patterns we just learned and categorize them according to the signals they give.

Reversal

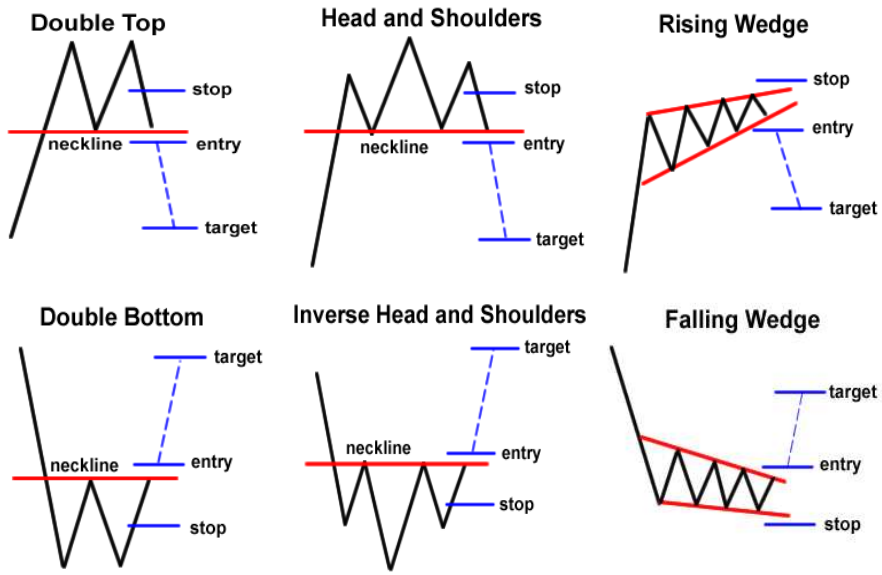
Reversal patterns are those chart formations that signal that the ongoing trend is about to change course.

If a reversal chart pattern forms during an uptrend, it hints that the trend will reverse and that the price will head down soon. Conversely, if a reversal chart pattern is seen during a downtrend, it suggests that the price will move up later on.

In this lesson, we covered six chart patterns that give reversal signals. Can you name all six of them?

1. Double Top
2. Double Bottom
3. Head and Shoulders
4. Inverse Head and Shoulders
5. Rising Wedge
6. Falling Wedge

If you got all six right, brownie points for you!



To trade these chart patterns, simply place an order beyond the neckline and in the direction of the new trend. Then go for a target that's almost the same as the height of the formation.

For instance, if you see a double bottom, place a long order at the top of the formation's neckline and go for a target that's just as high as the distance from the bottoms to the neckline.

In the interest of proper risk management, don't forget to place your stops! A reasonable stop loss can be set around the middle of the chart formation.

For example, you can measure the distance of the double bottoms from the neckline, divide that by two, and use that as the size of your stop.

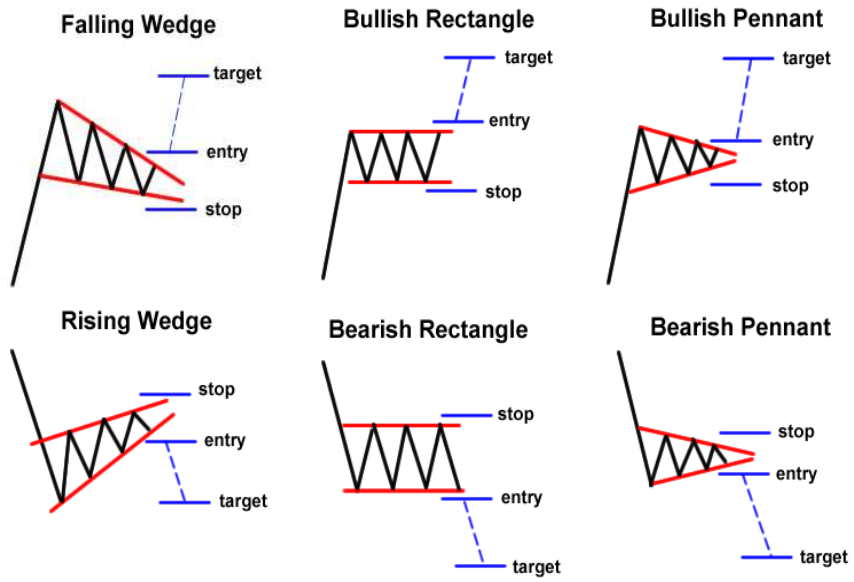
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Continuation

Continuation patterns are those chart formations that signal that the ongoing trend will resume.

Usually, these are also known as consolidation patterns because they show how buyers or sellers take a quick break before moving further in the same direction as the prior trend.

We've covered several continuation patterns, namely the wedges, rectangles, and pennants. Note that wedges can be considered either reversal or continuation patterns depending on the trend on which they form.



To trade these patterns, simply place an order above or below the formation (following the direction of the ongoing trend, of course). Then go for a target that's at least the size of the chart pattern for wedges and rectangles.

For pennants, you can aim higher and target the height of the pennant's mast.

For continuation patterns, stops are usually placed above or below the actual chart formation.

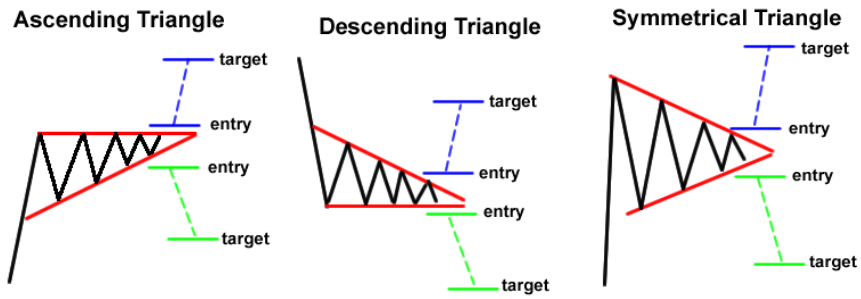
For example, when trading a bearish rectangle, place your stop a few pips above the top or resistance of the rectangle.

Bilateral

Bilateral chart patterns are a bit more tricky because these signal that the price can move either way.

Huh, what kind of a signal is that?!

This is where triangle formations fall in. Remember when we discussed that the price could break either to the topside or downside with triangles?



To play these patterns, you should consider both scenarios (upside or downside breakout) and place one order on top of the formation and another at the bottom of the formation.

If one order gets triggered, you can cancel the other one. Either way, you'd be part of the action.

Double the possibilities, double the fun!

The only problem is that you could catch a false break if you set your entry orders too close to the top or bottom of the formation.

So be careful and don't forget to place your stops too!

Chart Patterns Cheat Sheet

Like we promised, here's a neat little cheat sheet to help you remember all those chart patterns and what they signal.

We've listed most of the chart patterns, when they are formed, what type of signal they give, and what the next price move will be. Check it out!

Chart Pattern	Forms During	Type of Signal	Next Move
Double Top	Uptrend	Reversal	Down
Double Bottom	Downtrend	Reversal	Up
Head and Shoulders	Uptrend	Reversal	Down
Inverse Head and Shoulders	Downtrend	Reversal	Up
Rising Wedge	Downtrend	Continuation	Down
Rising Wedge	Uptrend	Reversal	Down
Falling Wedge	Uptrend	Continuation	Up
Falling Wedge	Downtrend	Reversal	Up
Bearish Rectangle	Downtrend	Continuation	Down
Bullish Rectangle	Uptrend	Continuation	Up
Bearish Pennant	Downtrend	Continuation	Down
Bullish Pennant	Uptrend	Continuation	Up

You also might want to add this page to your bookmarks in case you need to double-check those chart patterns' signals before you risk your hard-earned cash on a trade.

You never know when you're gonna need to cheat, hah! Bookmark this thing yo!

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As you probably noticed, we didn't include the triangle formations (symmetrical, ascending, and descending) in this cheat sheet.

That's because these patterns can form either on an uptrend or downtrend and can signal either a continuation or reversal.

Like we mentioned, it's tough to tell where the price will breakout.

What's important is that you have your entry orders ready so that you can be part of the action either way!

Forex Pivot Points

Are you all excited? It's your last year in junior high before you head off to high school!

Professional traders and market makers use pivot points to identify potential support and resistance levels. Simply put, a pivot point and its support/resistance levels are areas at which the direction of price movement can possibly change.

The reason why pivot points are so enticing?

It's because they are **OBJECTIVE**.

Unlike some of the other indicators that we've taught you about already, there's no discretion involved.

In many ways, pivot points are very similar to Fibonacci levels. Because so many people are looking at those levels, they almost become self-fulfilling.

The major difference between the two is that with Fibonacci, there is still some subjectivity involved in picking Swing Highs and Swing Lows. With pivot points, traders typically use the same method for calculating them.

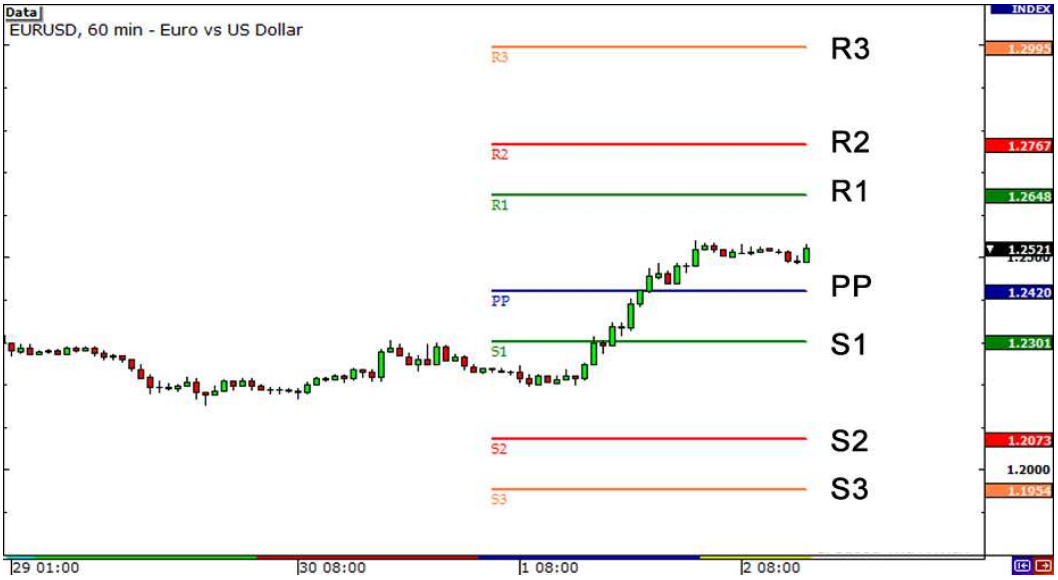
Many traders keep an eye on these levels and you should too.

Pivot points are especially useful to short-term traders who are looking to take advantage of small price movements. Just like normal support and resistance levels, traders can choose to trade the bounce or the break of these levels.

Range-bound traders use pivot points to identify reversal points. They see pivot points as areas where they can place their buy or sell orders.

Breakout traders use pivot points to recognize key levels that need to be broken for a move to be classified as a real deal breakout.

Here is an example of pivot points plotted on a 1-hour EUR/USD chart:



As you can see here, horizontal support and resistance levels are placed on your chart. And look - they're marked out nicely for you! How convenient is that?!

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Here's quick rundown on what those acronyms mean:

PP stands for Pivot Point.

S stands for Support.

R stands for Resistance.

But don't get too caught up in thinking "S1 has to be support" or "R1 has to be resistance." We'll explain why later.

In the following lessons, you will learn how to calculate pivot points, the different types of pivot points and most importantly, how you can add pivot points to your trading toolbox!

How to Calculate Pivot Points

The first thing you're going to learn is how to calculate pivot point levels.

The pivot point and associated support and resistance levels are calculated by using the last trading session's open, high, low, and close. Since forex is a 24-hour market, most traders use the New York closing time of 4:00pm EST as the previous day's close.

The calculation for a pivot point is shown below:

Pivot point (PP) = (High + Low + Close) / 3

Support and resistance levels are then calculated off the pivot point like so:

First level support and resistance:

First resistance (R1) = (2 x PP) - Low
First support (S1) = (2 x PP) - High

Second level of support and resistance:

Second resistance (R2) = PP + (High - Low)
Second support (S2) = PP - (High - Low)

Third level of support and resistance:

Third resistance (R3) = High + 2(PP - Low)
Third support (S3) = Low - 2(High - PP)

Keep in mind that some charting software plot intermediate levels or mid-point levels. These are basically mini levels between the main pivot point and support and resistance levels.



If you hated algebra, have no fear because you don't have to perform these calculations yourself. Most charting softwares will automatically do this for you. Just make sure you configure your settings so that it uses the correct closing time and price.

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We here at BabyPips.com also have our very own Pivot Point Calculator!

The awesome part is, just like everything on the website, it's FREE!

The calculator can come in handy, especially if you want to do a little back testing to see how pivot point levels have held up in the past. Remember, one of the advantages of using pivot points is that it is objective, so it's very to test how price reacted to them.

Next up, we'll teach you the various ways in which you can incorporate pivot points into your trading strategy.

Range Trading with Pivot Points

The simplest way to use pivot point levels is to use them just like your regular support and resistance levels. Just like good ole support and resistance, price will test the levels repeatedly.

The more times a currency pair touches a pivot level then reverses, the stronger the level is. Actually, "pivoting" simply means reaching a support or resistance level and then reversing.

If you see that a pivot level is holding, this could give you some good trading opportunities.

If price is nearing the upper resistance level, you could sell the pair and place a stop just above the resistance.

If price was nearing a support level, you would buy and put your stop just below the level.

See? Just like you're regular support and resistance! Nothing hard about that!

Let's take a look at an example so you can visualize this. Here's a 15-minute chart of GBP/USD.



In the chart above, you see that price is testing the S1 support level. If you think it will hold, what you can do is buy at market and then put a stop loss order past the next support level.

If you're conservative, you can set a wide stop just below S2. If price reaches past S2, chances are it won't be coming back up, as both S1 and S2 could become resistance levels.

If you're a little more aggressive and confident that support at S1 would hold, you can set your stop just below S1.

As for your take profit points, you could target PP or R1, which could also provide some sort of resistance. Let's see what happened if you bought at market.



And bam! Looks like S1 held as support! What's more, if you had targeted PP as your take profit point, you would have hit your PT! Woohoo! Ice cream and pizza for you!

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Of course, it ain't always that simple. You shouldn't rely only on the pivot point levels. You should note whether pivot point levels line up with former support and resistance levels.

You can also incorporate candlestick analysis and other types of indicators to help give you more confirmation.

For example, if you see that a doji has formed over S1, or that the stochastic is indicating oversold conditions, then the odds are higher that S1 will hold as support.

Also, most of the time, trading normally takes place between the first support and resistance levels. Occasionally, price will test the second levels and every once in a while, the third levels will be tested.

Lastly, you should also fully understand that sometimes, price will just break through all the levels like how Roger Federer breezes through the competition in Wimbledon.

What will you do when that happens? Continue to hold onto your trade and be a sucker and watch your account dwindle away? Or will you take advantage and get back some pips?

In the next lesson, we'll teach you how to take advantage when these levels break down.

Playing the Breaks with Pivot Points

Just like your normal support and resistance levels, pivot point levels won't hold forever.

Using pivot points for range trading will work, but not all the time. In those times that these levels fail to hold, you should have some tools ready to take advantage of the situation!

As we showed you earlier, there are two main ways to trade breakouts: the aggressive way or the safe way.

Either method will work just fine. Just always remember that if you take the safe way, which means waiting for a retest of support or resistance, you may miss out on the initial move.

Let's take a look at a chart to see potential breakout trades using pivot points. Below is a 15-minute chart of EUR/USD.



Here we see EUR/USD made a strong rally throughout the day. We see that EUR/USD opened by gapping up above the pivot point. Price made a strong move up, before pausing slightly at R1.

Eventually, resistance broke and the pair jumped up by 50 pips!

If you had taken the aggressive method, you would have caught the initial move and been celebrating like you just won the Super Bowl.

On the other hand, if you had taken the safe way and waited for a retest, you would have been one sad little trader. The price did not retest after breaking R1. In fact, the same thing happened for both R1 and R2!

Notice how EUR/USD bulls tried to make a run for R3 as well.

However, if you had taken the aggressive method, you would have gotten caught up in a fake out as the price failed to sustain the initial break. If your stop was too tight, then you would have gotten stopped out.

Later on though, you'll see that the price eventually broke through. Notice how there was also a retest of the broken resistance line.

Also, observe how when the pair reversed later in the day and broke down past R3. There was an opportunity to take a short on the retest of resistance-turned support - turned resistance (read that again if you have to!).

Remember that, when support levels break, they usually turn into resistance levels.

This concept of "**role reversal**" also applies for broken resistance levels which become support levels. These would have been good opportunities to take the "I think I'll play it safe" method.

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Placing stops and targets with breakouts

One of the difficult things about taking breakout trades is picking a spot to place your stop. Unlike range trading where you are looking for breaks of pivot point support and resistance levels, you are looking for strong fast moves.

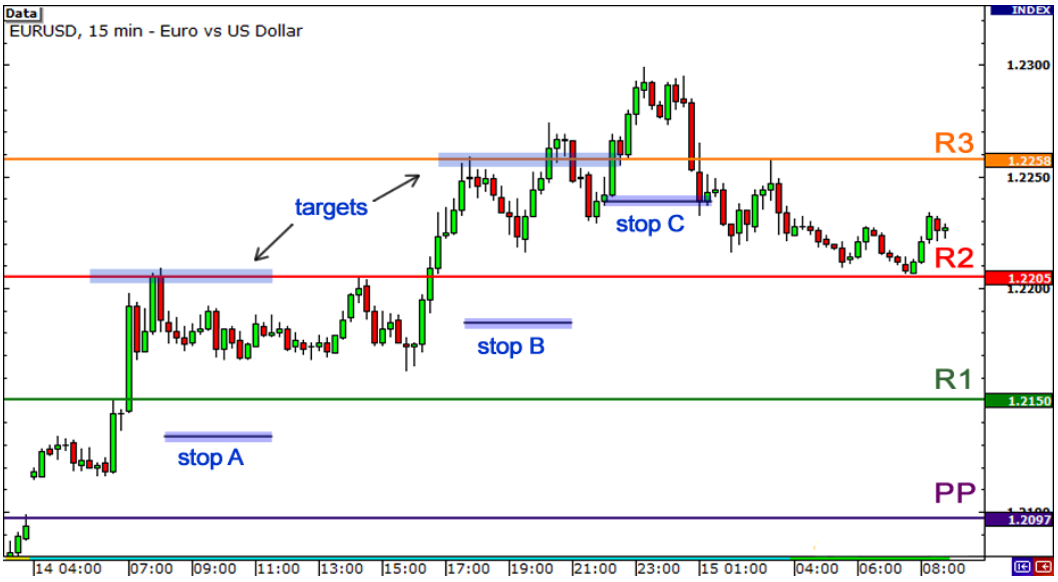
Once a level breaks, in theory, that level will likely become "support-turned-resistance" or "resistance-turned-support."

If you were going long and price broke R1, you could place your stop just below R1.

Let's go back to that EUR/USD chart to see where you could place your stops.

As for setting targets, you would typically aim for the next pivot point support or resistance level as your take profit point. It's very rare that price will break past all the pivot point levels, unless a big economic event or surprise news comes out.

Let's go back to that EUR/USD chart to see where you would put those stops and take profit points.



In this example, once you saw price break R1, you would have set your stop just below R1. If you believed that price would continue to rise, you could keep your position and move your stop manually to see if move would continue. You'd have to watch carefully and adjust accordingly. You'll learn more about this in later lessons.

As with any method or indicator, you have to be aware of the risks with taking breakout trades.

First of all, you have no idea whether or not the move will continue. You might enter thinking that price will continue to rise, but instead you catch a top or bottom, which means that you've been faked out!

Second, you won't be sure if it's a true breakout, or just wild moves caused by the release of important news. Spikes in volatility are a common occurrence during news events, so be sure to keep up with breaking news and be aware of what's on the forex calendar for the day or week.

Lastly, just like in range trading, it would be best to pop on other key support and resistance levels. You might be thinking that R1 is breaking, but you failed to notice a strong resistance level just past R1. Price may break past R1, test the resistance and just fall back down.

You should make use of your knowledge of support and resistance, candlestick patterns, and momentum indicators to help you give stronger signals as to whether the break is for real or not.

Using Pivot Points to Determine Market Sentiment

There is one other way to incorporate pivot points into your trading strategy, and that's to use it to gauge **market sentiment**.

What this means is that you can tell whether traders are more inclined to buy or sell the pair. All you would need to do is to keep an eye on the pivot point. You could treat it like the 50 yard line of a football field. Depending on which side the ball (in this case, price) is on, you can tell whether buyers or sellers have the upper hand.

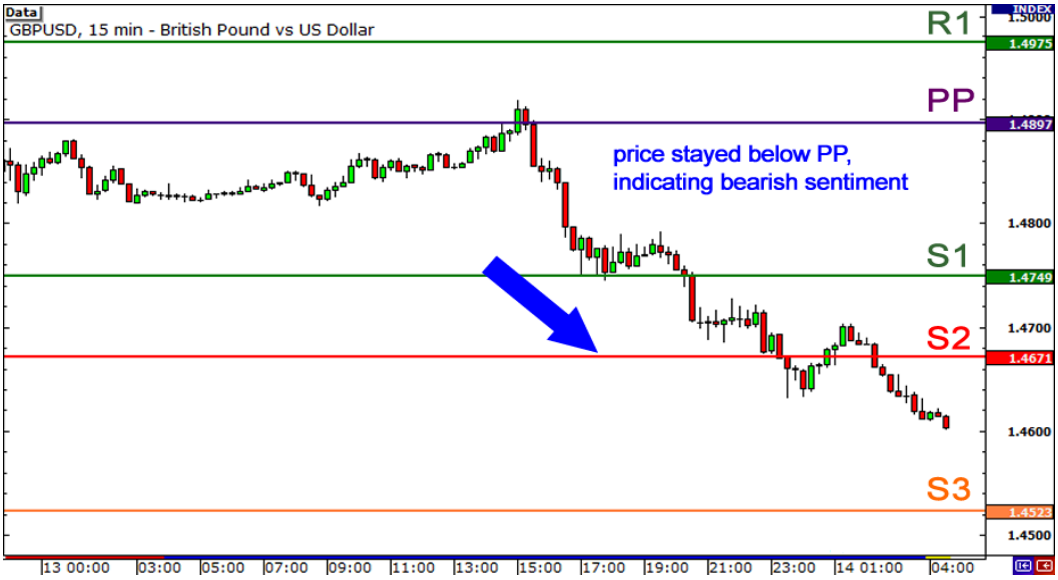
If the price breaks through the pivot point to the top, it's a sign that traders are bullish on the pair and you should start buying the pair like it's a Krispy Kreme donut. Here's an example of what happened when the price stayed above the pivot point.



In this example, we see that EUR/USD gapped up and opened above the pivot point. The price then rose higher and higher, breaking through all the resistance levels.

Now, if price breaks through the pivot point to the bottom, then you should start selling the pair like it's Enron stock. The price being below the pivot point would signal bearish sentiment and that sellers could have the upper hand for the trading session.

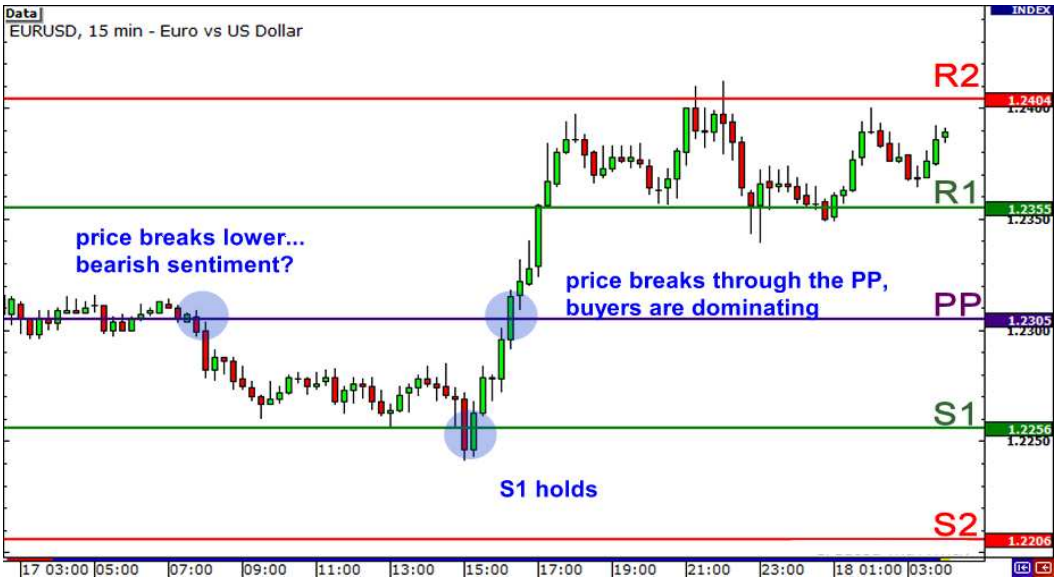
Let's take a look at a chart of GBP/USD.



In the chart above, we see that the price tested the pivot point, which held as a resistance level. Next thing you know, the pair keeps going lower and lower. If you had taken the clue that price remained below the pivot point and sold the pair, you would have made some nice moolah. GBP/USD dropped almost 300 pips!

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Of course, it doesn't always work out like this. There are times when you think that traders are bearish on a pair, only to see that the pair reverses and breaks through to the top!



In this example, if you saw price breaking lower from the pivot point and sold, you would have had a sad, sad day. Later on during the European session, EUR/USD popped higher,

eventually breaking through the pivot point. What's more, the pair stayed above the pivot point, showing how buyers were rockin' away.

The lesson here?

Traders are fickle!

How traders feel about a currency can shift dramatically day to day, even session to session. This is why you cannot simply buy when price is above the pivot point or sell when it is below it.

Instead, if you choose to use pivot point analysis in this way, you should combine it with other indicators to help you determine overall market sentiment.

Other Pivot Point Calculation Methods

While we suggest that you stick to the standard method of calculating pivot points, you should know that there are other ways to calculate for pivot points. In this lesson, we will talk about these other methods, as well as give you the formulas on how to calculate for these levels.

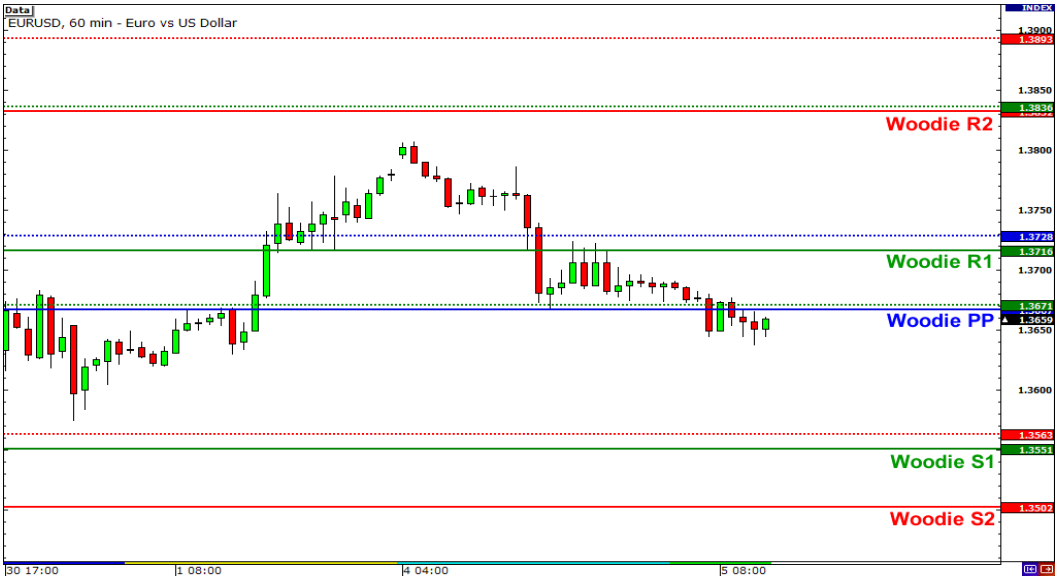
Woodie Pivot Point

R3 = C + (High - Low)
R2 = C + (High - Low)
R1 = C + (High - Low)
PP = (H + L + 2C) / 4
S1 = C - (High - Low)
S2 = C - (High - Low)
S3 = C - (High - Low)
C - Closing Price, H - High, L - Low

In the formulas above, you'll notice that the pivot point calculation is very different from the standard method.

Also, in order the calculate for the corresponding support and resistance levels, you would use the difference between the previous day's high and low, otherwise known as the range.

Here's a chart example of the Woodie pivot point calculation applied on EURUSD. The Woodie pivot point, support levels, and resistance levels are the solid lines while the dotted lines represent the levels calculated through the standard method.



Because they have different formulas, levels obtained through the Woodie calculations are very different from those gotten through the standard method.

Some traders prefer to use the Woodie formulas because they give more weight to the closing price of the previous period. Others prefer the standard formulas because many traders make use of those, which could make them self-fulfilling.

In any case, since resistance turns into support (and vice versa), if you choose to use the Woodie formulas, you should keep an eye on these levels as they could become areas of interest. Whatever floats your boat!

Camarilla Pivot Point

R4 = C + ((H-L) x 1.5000)
R3 = C + ((H-L) x 1.2500)
R2 = C + ((H-L) x 1.1666)
R1 = C + ((H-L) x 1.0833)
PP = (H + L + C) / 3
S1 = C - ((H-L) x 1.0833)
S2 = C - ((H-L) x 1.1666)
S3 = C - ((H-L) x 1.2500)
S4 = C - ((H-L) x 1.5000)
C - Closing Price, H - High, L - Low

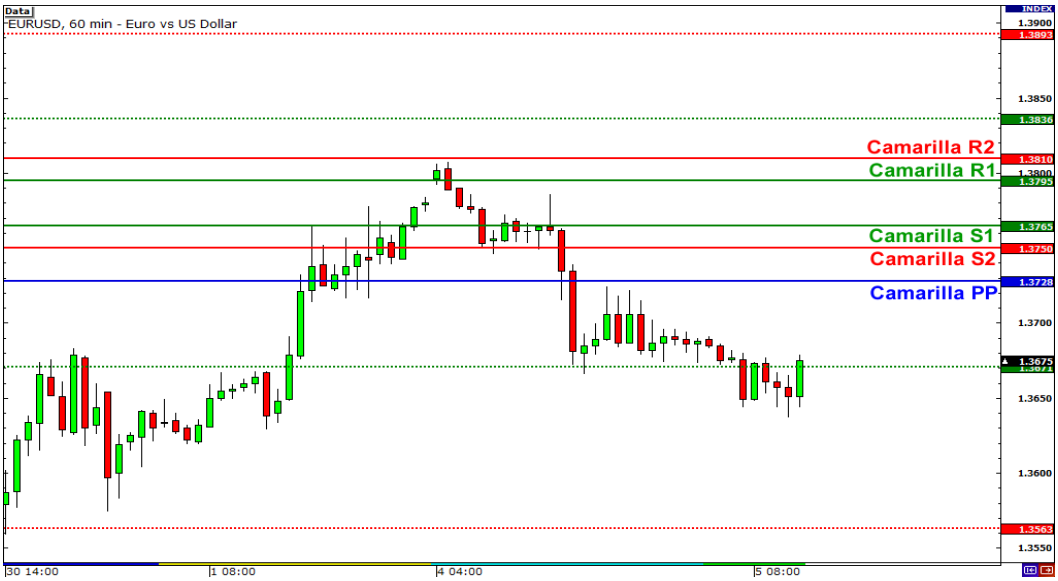
The Camarilla formulas are similar to the Woodie formula. They also use the previous day's close and range to calculate the support and resistance levels.

The only difference is that you should calculate for 8 major levels (4 resistance and 4 support), and each of these levels should be multiplied by a multiplier.

The main concept of Camarilla pivot points is that it is based on the idea that price has a natural tendency to revert back to the mean (sound familiar?), or in this case, the previous day's close.

The idea is that you should buy or sell when price reaches either the third support or resistance level. However, if price were to burst through S4 or R4, it would mean that the intraday trend is strong, and it's about time you jump on that bandwagon!

Check out how the Camarilla calculation gives different levels (solid lines) compared to the standard method's levels (dotted lines)!



As you can see from the chart above, **more emphasis is given to the closing price as opposed to the pivot point**. Because of this, it's possible that resistance levels could be below the pivot point or support levels could be above it.

See how all the support and resistance levels are above the Camarilla pivot point?

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Fibonacci Pivot Point

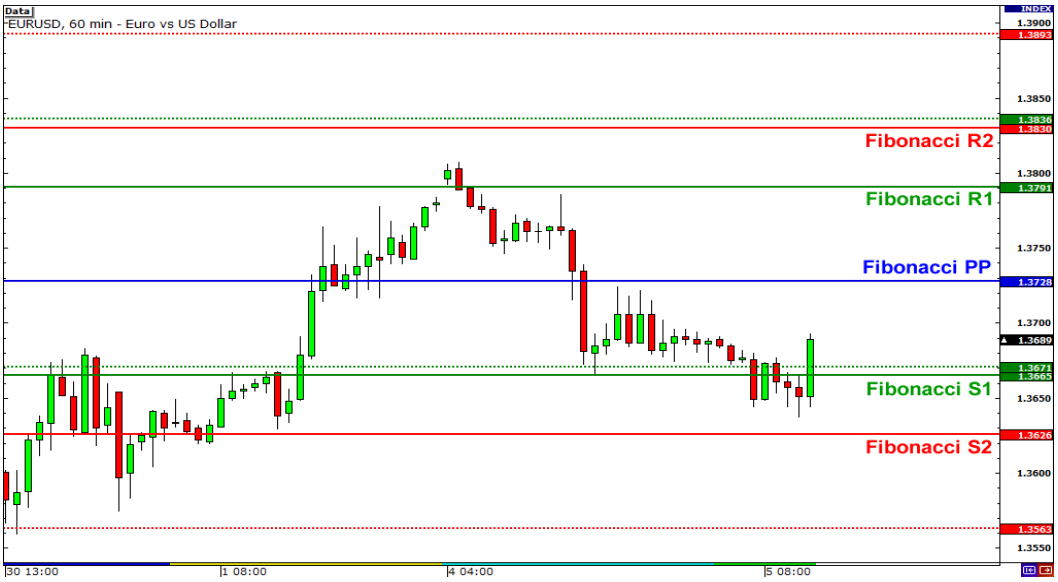
R3 = PP + ((High - Low) x 1.000)
R2 = PP + ((High - Low) x .618)
R1 = PP + ((High - Low) x .382)
PP = (H + L + C) / 3
S1 = PP - ((High - Low) x .382)
S2 = PP - ((High - Low) x .618)
S3 = PP - ((High - Low) x 1.000)
C - Closing Price, H - High, L - Low

Fibonacci pivot point levels are determined by first calculating the pivot point like you would the standard method.

Next, multiply the previous day's range with its corresponding Fibonacci level. Most traders use the 38.2%, 61.8% and 100% retracements in their calculations.

Finally, add or subtract the figures you get to the pivot point and voila, you've got your Fibonacci pivot point levels!

Look at the chart below to see how the levels calculated through the Fibonacci method (solid lines) differ from those calculated through the standard method (dotted lines).



The logic behind this is that many traders like using the Fibonacci ratios. People use it for retracement levels, moving averages, etc.

Why not use it for pivot points as well?

Remember that both Fibonacci and pivot points levels are used to find support and resistance. With so many traders looking at these levels, they can actually become self-fulfilling.

Which method is best?

The truth is, just like all the variations of all the other indicators that you've learned so far, there is no single best method. It really all depends on how you combine your knowledge of pivot points with all the other tools in your trading toolbox.

Just know that most charting software that do automatic calculations normally use the standard method in calculating for the pivot point levels.

But now that you know how to calculate for these levels on your own, you can give them all a swing and see which one works best for you. Pivot away!

Summary: Pivot Points

Here are some easy-to memorize tips that will help you to make smart pivot point trading decisions:

- Pivot points are a technique used by traders to help determine potential support and resistance areas.
- There are four main ways to calculate for pivot points: Standard, Woodie, Camarilla, and Fibonacci.
- Pivots can be extremely useful in forex since many currency pairs usually fluctuate between these levels. Most of the time, price ranges between R1 and S1.

- Pivot points can be used by range, breakout, and trend traders.
- Range-bound traders will enter a buy order near identified levels of support and a sell order when the pair nears resistance.
- Pivot points also allow breakout traders to identify key levels that need to be broken for a move to qualify as a strong momentum move.

- Sentiment (or trend) traders use pivot points to help determine the bullishness or bearishness of a currency pair.
- The simplicity of pivot points definitely makes them a useful tool to add to your trading toolbox. It allows you to see possible areas that are likely to cause price movement. You'll become more in sync to market movements and make better trading decisions.
- Using pivot point analysis alone is not always enough. Learn to use pivot points along with other technical analysis tools such as candlestick patterns, MACD crossover, moving averages crossovers, the stochastic, RSI, etc. The greater the confirmation, the greater your probability of a successful trade!

Summer School

Elliott Wave Theory



Back in the old school days of the 1920-30s, there was this mad genius and professional accountant named Ralph Nelson Elliott.

By analyzing closely 75 years worth of stock data, Elliott discovered that stock markets, thought to behave in a somewhat chaotic manner, actually didn't.

When he hit 66 years old, he finally gathered enough evidence (and confidence) share his discovery with the world.

He published his theory in the book entitled *The Wave Principle*.

According to him, the market traded in repetitive cycles, which he pointed out were the emotions of investors caused by outside influences (ahem, CNBC, Bloomberg, ESPN) or the predominant psychology of the masses at the time.

Elliott explained that the upward and downward swings in price caused by the collective psychology always showed up in the same repetitive patterns.

He called these upward and downward swings "waves".

He believes that, if you can correctly identify the repeating patterns in prices, you can predict where price will go (or not go) next.

This is what makes Elliott waves so appealing to traders. It gives them a way to identify precise points where price is most likely to reverse. In other words, Elliott came up with a system that enables traders to catch tops and bottoms.

So, amidst all the chaos in prices, Elliott found order. Awesome, huh?

Of course, like all mad geniuses, he needed to claim this observation and so he came up with a super original name: The Elliott Wave Theory.

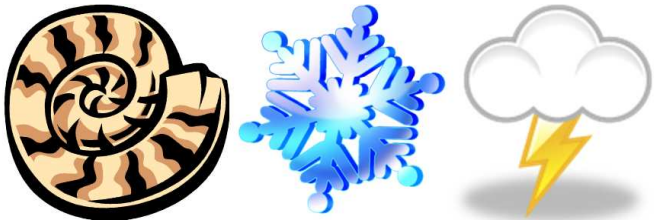
But before we delve into the Elliott waves, you need to first understand what **fractals** are.

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Fractals

Basically, fractals are structures that can be split into parts, each of which is a very similar copy of the whole. Mathematicians like to call this property "self-similarity".

You don't need to go far to find examples of fractals. They can found all over nature!



A sea shell is a fractal. A snow flake is a fractal. A cloud is a fractal. Heck, a lightning bolt is a fractal.

So why are fractals important?

One important quality of Elliott waves is that they are fractals. Much like sea shells and snow flakes, Elliott waves could be further subdivided into smaller Elliot waves.

Ready to be an Elliottician now? Read on!

The 5 - 3 Wave Patterns

Mr. Elliott showed that a trending market moves in what he calls a 5-3 wave pattern.

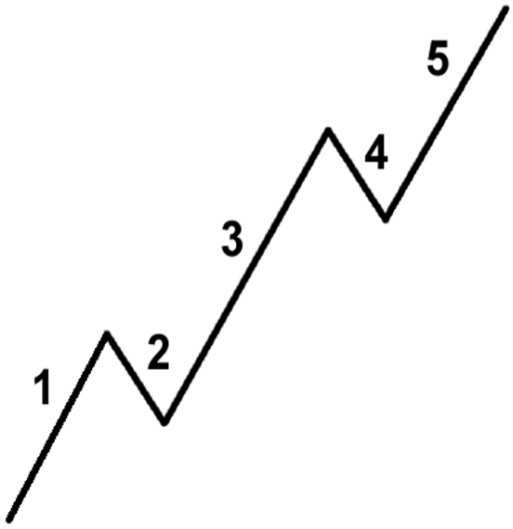
The first 5-wave pattern is called **impulse waves**.

The last 3-wave pattern is called **corrective waves**.

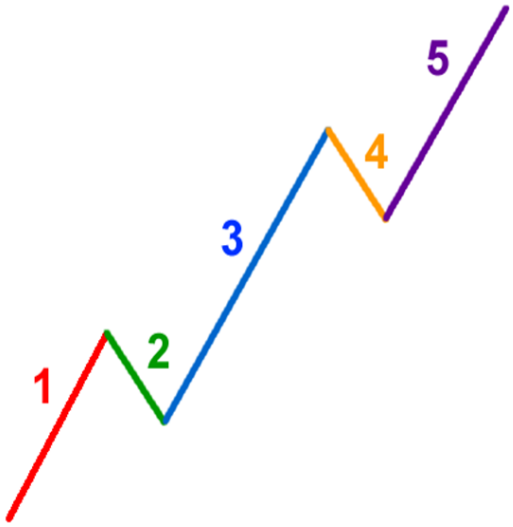
In this pattern, Waves 1, 3, 5 are **motive**, meaning they go along with the overall trend, while Waves 2 and 4 are **corrective**.

Do not confuse Waves 2 and 4 with the ABC corrective pattern (discussed in the next section) though!

Let's first take a look at the 5-wave impulse pattern. It's easier if you see it as a picture:



That still looks kind of confusing. Let's splash some color on this bad boy.



Ah magnifico! It's so pretty! We like colors, so we've color-coded each wave along with its wave count.

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Here is a short description of what happens during each wave.

We're going to use stocks for our example since stocks are what Mr. Elliott used but it really doesn't matter what it is. It can easily be currencies, bonds, gold, oil, or Tickle Me Elmo dolls. The important thing is the Elliott Wave Theory can also be applied to the foreign exchange market.

Wave 1

The stock makes its initial move upwards. This is usually caused by a relatively small number of people that all of the sudden (for a variety of reasons, real or imagined) feel that the price of the stock is cheap so it's a perfect time to buy. This causes the price to rise.

Wave 2

At this point, enough people who were in the original wave consider the stock overvalued and take profits. This causes the stock to go down. However, the stock will not make it to its previous lows before the stock is considered a bargain again.

Wave 3

This is usually the longest and strongest wave. The stock has caught the attention of the mass public. More people find out about the stock and want to buy it. This causes the stock's price to go higher and higher. This wave usually exceeds the high created at the end of wave 1.

Wave 4

Traders take profits because the stock is considered expensive again. This wave tends to be weak because there are usually more people that are still bullish on the stock and are waiting to "buy on the dips."

Wave 5

This is the point that most people get on the stock and is most driven by hysteria. You usually start seeing the CEO of the company on the front page of major magazines as the Person of the Year. Traders and investors start coming up with ridiculous reasons to buy the stock and try to choke you when you disagree with them. This is when the stock becomes the most overpriced. Contrarians start shorting the stock which starts the ABC pattern.

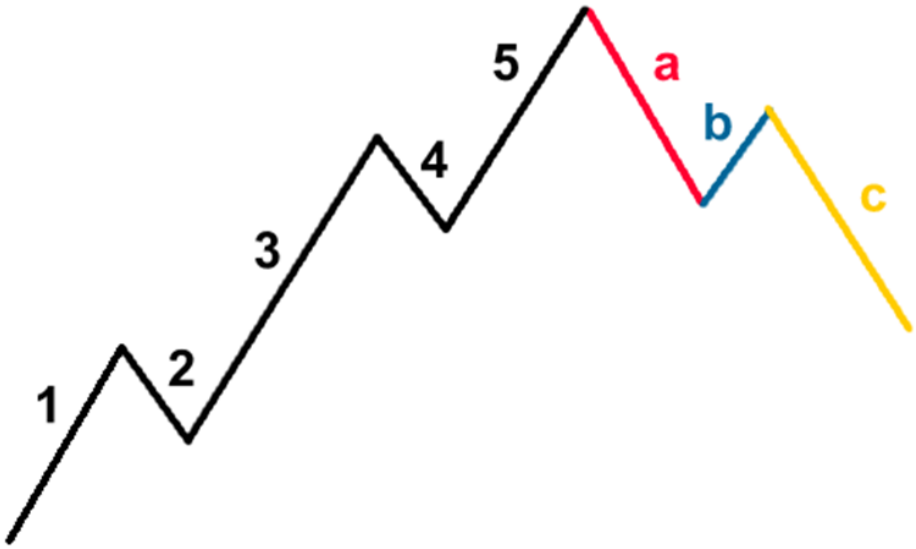
Extended Impulse Waves

One thing that you also need to know about the Elliott Wave Theory is that one of the three impulse waves (1, 3, or 5) will always be "extended". Simply put, there will always be one wave that is longer than the other two, regardless of degree.

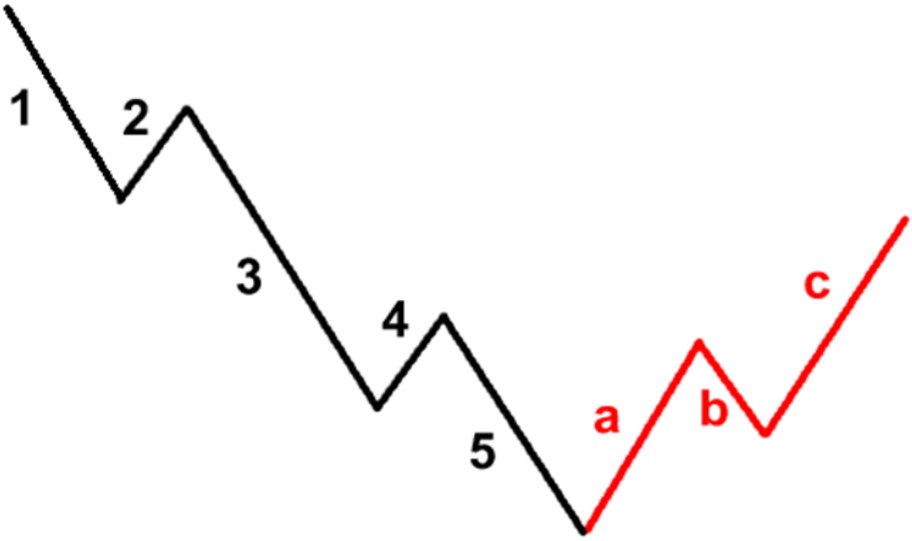
According to Elliott, it is usually the fifth wave which is extended. As time went by, this old school style of wave labeling has changed because more and more people started labeling the third wave as the extended one.

ABC Correction

The 5-wave trends are then corrected and reversed by 3-wave countertrends. Letters are used instead of numbers to track the correction. Check out this example of a smokin' hot corrective 3-wave pattern!



Just because we've been using a bull market as my primary example doesn't mean the Elliott Wave Theory doesn't work on bear markets. The same 5-3 wave pattern can look like this:



Types of Corrective Wave Patterns

According to Elliott, there are 21 corrective ABC patterns ranging from simple to complex.

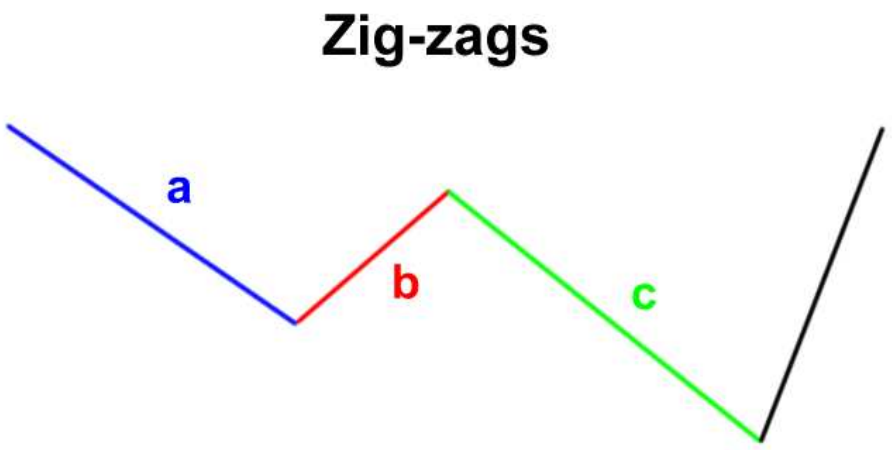
"Uh 21? I can't memorize all of that! The basics of the Elliott Wave Theory are already mind-blowing!"

Take it easy, young padawan. The great thing about Elliott Wave is you don't have to be above the legal drinking age to trade it! You don't have to get a fake ID or memorize all 21 types of corrective ABC patterns because they are just made up of three very simple easy-to-understand formations.

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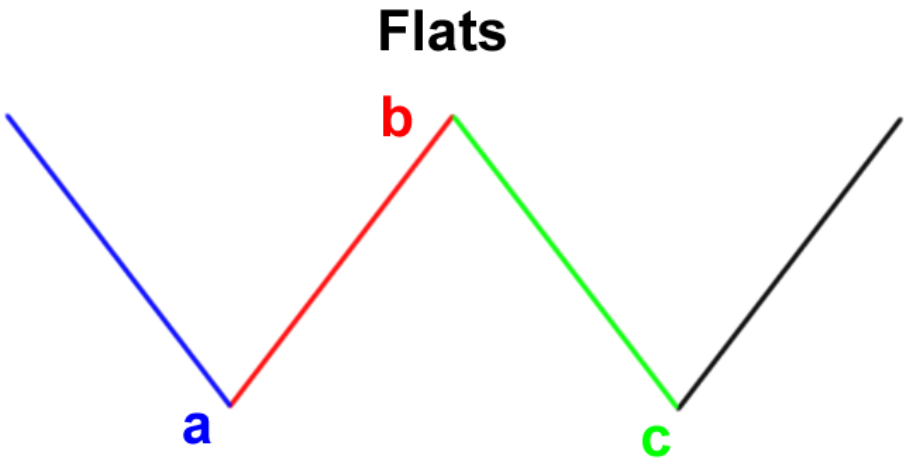
Let's take a look at these three formations. The examples below apply to uptrends, but you can just invert them if you're dealing with a downtrend.

The Zig-Zag Formation



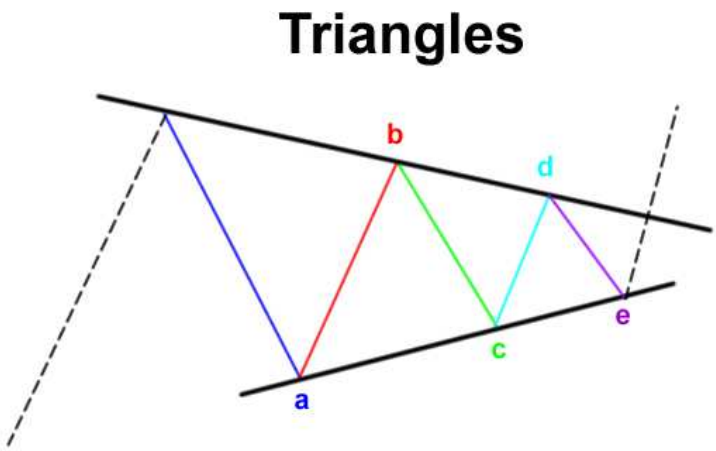
Zig-zag formations are very steep moves in price that goes against the predominant trend. Wave B is typically shortest in length compared to Waves A and C. These zig-zag patterns can happen twice or even thrice in a correction (2 to 3 zig-zag patterns linked together). Like with all waves, each of the waves in zig-zag patterns could be broken up into 5-wave patterns.

The Flat Formation



Flat formations are simple sideways corrective waves. In flats, the lengths of the waves are **GENERALLY** equal in length, with wave B reversing wave A's move and wave C undoing wave B's move. We say generally because wave B can sometimes go beyond the beginning of wave A.

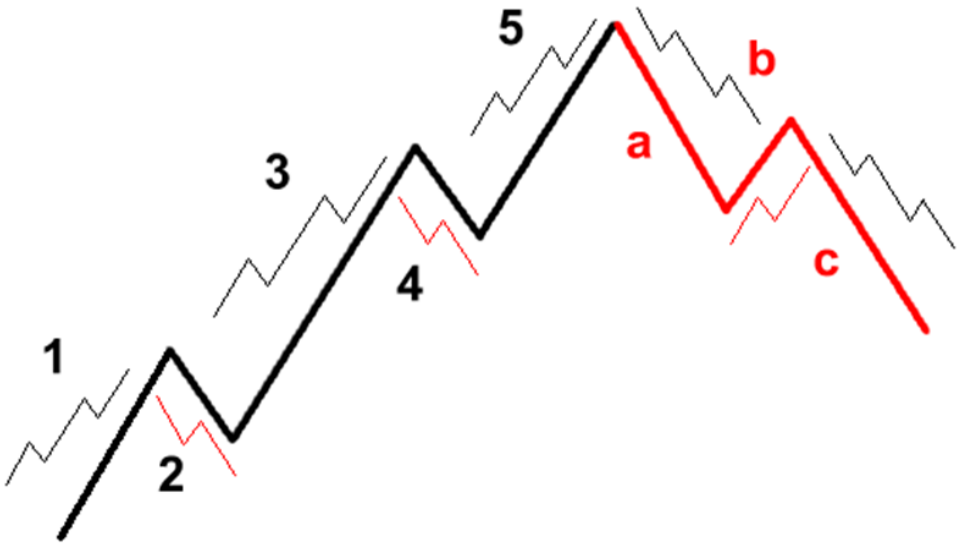
The Triangle Formation



Triangle formations are corrective patterns that are bound by either converging or diverging trend lines. Triangles are made up of 5-waves that move against the trend in a sideways fashion. These triangles can be symmetrical, descending, ascending, or expanding.

Waves Within a Wave

Like we mentioned earlier, Elliott waves are fractals. Each wave is made of sub-waves. Huh? Let me show you another picture. Pictures are great, aren't they? Yee-haw!



Do you see how Waves 1, 3, and 5 are made up of a smaller 5-wave impulse pattern while Waves 2 and 4 are made up of smaller 3-wave corrective pattern?

Always remember that each wave is comprised of smaller wave patterns. This pattern repeats itself...

FOREVER!

To make it easy to label these waves, the Elliott Wave Theory has assigned a series of categories to the waves in order of the largest to the smallest. They are:

- Grand Supercycle
- Supercycle
- Cycle
- Primary
- Intermediate
- Minor
- Minute
- Minuette
- Sub-Minuette

A Grand Supercycle is made up of Supercycle waves which is made up of Cycle waves which is made up Primary waves, which is made up of Intermediate waves which is made up of Minor waves which is made up of Minute waves which is made up of Minuette waves which is made up of Sub-Minuette waves. Did you get all that?

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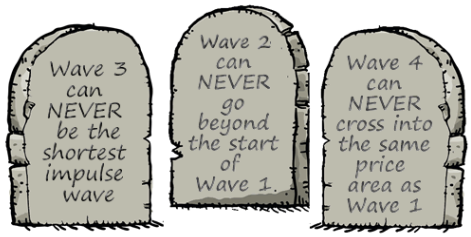
Okay, to make things much clearer, let's see how an Elliott Wave looks in real life.



As you can see, waves aren't shaped perfectly in real life. You'll also learn it's sometimes difficult to label waves. But the more you stare at charts the better you'll get.

Besides, we're not going to let you go at it alone! In the following sections, we'll give you some tips on how to correctly and easily identify waves as well as teach you how to trade using Elliott Waves. Surf's up!

The 3 Cardinal Rules and Some Guidelines



As you may have guessed, the key in using the Elliott Wave Theory in trading is all about being able to correctly identify waves.

By developing the right eye in recognizing what wave the market is in, you will be able to find out which side of the market to trade on, long or short.

There are three cardinal cannot-be-broken rules in labeling waves. So, before you jump right in to applying the Elliott Wave Theory to your trading, you must take note of the rules below.

Failing to label wave correctly can prove disastrous to your account.

3 Cardinal Rules of the Elliott Wave Theory

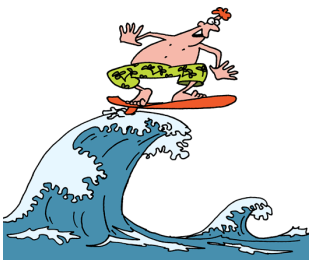
- Rule Number 1: Wave 3 can NEVER be the shortest impulse wave
- Rule Number 2: Wave 2 can NEVER go beyond the start of Wave 1
- Rule Number 3: Wave 4 can NEVER cross in the same price area as Wave 1

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Then, there are the guidelines that help you in correctly labeling waves. Unlike the three cardinal rules, these guidelines can be broken. Here they are:

- Conversely, sometimes, Wave 5 does not move beyond the end of wave 3. This is called truncation.
- Wave 5, more often than not, goes beyond or "breaks through" the trend line drawn off Wave 3 parallel to a trend line connecting the start of Waves 3 and 5.
- Wave 3 tends to be very long, sharp, and extended.
- Waves 2 and 4 frequently bounce off Fibonacci retracement levels.

Riding Elliott's Waves



This is probably what you all have been waiting for - drumroll please - using the Elliott Wave Theory in trading! In this section, we will look at some setups and apply our knowledge of Elliott Wave to determine entry, stop loss, and exit points. Let's get it on!

Hypothetical, will-most-probably-be-right scenario:

Let's say you wanted to begin your wave count. You see that price seems to have bottomed out and has began a new move upwards. Using your knowledge of Elliott Wave, you label this move up as Wave 1 and the retracement as Wave 2.



In order to find a good entry point, you head back to the School of Pipsology to find out which of the three cardinal rules and guidelines you could apply. Here's what you found out:

- Rule Number 2: Wave 2 can NEVER go beyond the start of Wave 1
- Waves 2 and 4 frequently bounce off Fibonacci retracement levels

So, using your superior Elliott Waving trading skillz, you decide to pop the Fibonacci tool to see if price is at a Fib level. Holy mama! Price is just chillin' like ice cream fillin' around the 50% level. Hmm, this could be the start of Wave 3, which is a very strong buy signal.



Since you're a smart trader, you also take your stop into consideration.

Cardinal rule number 2 states that Wave 2 can never go beyond the start of Wave 1 so you set your stop below the former lows.

If price retraces more than 100% of Wave 1, then your wave count is wrong.

Let's see what happens next...



Your Elliott Wave analysis paid off and you caught a huge upward move! You go to Vegas (or Macau), blow all your profits on roulette, and end right back where you started. Lucky for you we have another hypothetical scenario where you can earn imaginary money again...

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Scenario 2:

This time let's use your knowledge on corrective waves pattterns to grab those pips.



You begin counting the waves on a downtrend and you notice that the ABC corrective waves are moving sideways. Hmm, is this a flat formation in the works? This means that price may just begin a new impulse wave once Wave C ends.



Trusting your Elliott Wave skills, you go ahead and sell at market in hopes of catching a new impulse wave.

You place your stop just a couple of pips above the start of Wave 4 just incase your wave count is wrong.



Because we like happy endings, your trade idea works out and nets you a couple thousand pips on this day, which is not always the case.

You have also learned your lesson this time around so you skip Vegas and decide to use your profits to grow your trading capital instead.

Summary: Elliott Wave Theory

- Elliott Waves are fractals. Each wave can be split into parts, each of which is a very similar copy of the whole. Mathematicians like to tall this property "self-similarity".
- A trending market moves in a 5-3 wave pattern.
- The first 5-wave pattern is called impulse wave.
- One of the three impulse waves (1, 3, or 5) will always be extended. Wave 3 is usually the extended one.
- The second 3-wave pattern is called corrective wave. Letters are used instead of numbers to track the correction.
- Waves 1, 3 and 5, are made up of a smaller 5-wave impulse pattern while Waves 2 and 4 are made up of smaller 3-wave corrective pattern.
- There are 21 types of corrective patterns but they are just made up of three very simple, easy-to-understand formations.
- The three fundamental corrective wave patterns are zig-zags, flats, and triangles.

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- There are three cardinal rules in labeling waves:

  - Rule Number 1: Wave 3 can NEVER be the shortest impulse wave
  - Rule Number 2: Wave 2 can NEVER go beyond the start of Wave 1
  - Rule Number 3: Wave 4 can NEVER cross in the same price area as Wave 1

- If you look hard enough at a chart, you'll see that the market really does move in waves.
- Because the market never moves in text book perfect fashion, it will take many, many hours of practice analyzing waves before you start to get comfortable with Elliott waves. Stay diligent and never give up!

Harmonic Price Patterns



Now that you've got the basic chart patterns down, it's time to move on and add some more advanced tools to your trading arsenal.

In this lesson, we'll be looking at harmonic price patterns. These bad boys may be a little harder to grasp but once you spot these setups, it can lead to some very nice profits!

The whole idea of these patterns is that they help people spot possible retracements of recent trends. In fact, we'll make use of other tools we've already covered - the Fibonacci retracement and extensions!

Combining these wonderful tools to spot these harmonic patterns, we'll be able to distinguish possible areas for a continuation of the overall trend.

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In this lesson, we're going to discuss the following Harmonic Price Patterns:

- ABCD Pattern
- Three-Drive Pattern
- Gartley Pattern
- Crab Pattern
- Bat Pattern
- Butterfly Pattern

Phew! That's quite a lot to cover!

But don't you worry... Once you get the hang of things, it'll be as easy as 1-2-3! We'll start off with the more basic ABCD and three-drive patterns before moving on to Gartley and the animals.

After learning about them, we'll take a look at the tools you need in order to trade these patterns successfully.

For all these harmonic patterns, the point is to wait for the entire pattern to complete before taking any short or long trades. You'll see what we're talking about later on so let's get started!

The ABCD and the Three-Drive

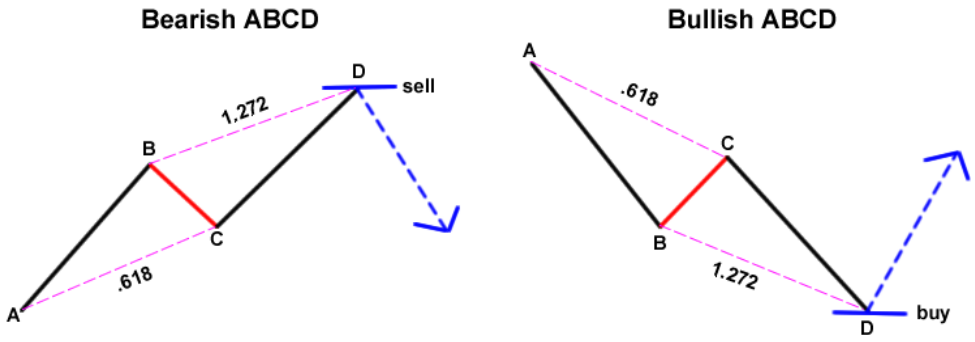
The ABCD

Let's start this lesson with the simplest harmonic pattern, and what could be more basic than your good ole ABC's? We'll just pop in another letter right there (because we're cool like that) and we've got the ABCD chart pattern!

To spot this chart pattern, all you need are ultra-sharp hawk eyes and the handy-dandy Fibonacci tool.

For both the bullish and bearish versions of the ABCD chart pattern, the lines AB and CD are known as the legs while BC is called the correction or retracement. If you use the Fibonacci retracement tool on leg AB, the retracement BC should reach until the 0.618 level. Then, the line CD should be the 1.272 Fibonacci extension of BC.

Simple, right? All you have to do is wait for the entire pattern to complete (reach point D) before taking any short or long positions.



Oh, but if you want to be extra strict about it, here are a couple more rules for a valid ABCD pattern:

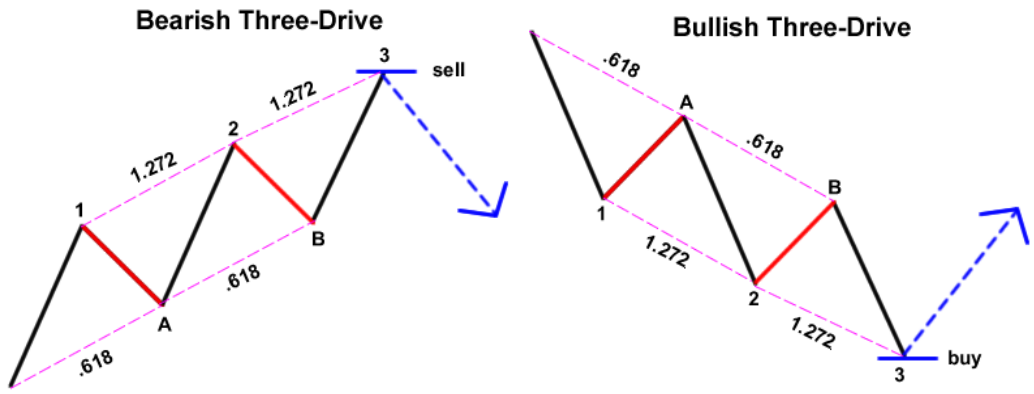
- The length of line AB should be equal to the length of line CD.
- The time it takes for the price to go from A to B should be equal to the time it takes for the price to move from C to D.

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Three-Drive

The three-drive pattern is a lot like the ABCD pattern except that it has three legs (now known as drives) and two corrections or retracements. Easy as pie! In fact, this three-drive pattern is the ancestor of the Elliott Wave pattern.

As usual, you'll need your hawk eyes, the Fibonacci tool, and a smidge of patience on this one.



As you can see from the charts above, point A should be the 61.8% retracement of drive 1. Similarly, point B should be the 0.618 retracement of drive 2. Then, drive 2 should be the 1.272 extension of correction A and drive 3 should be the 1.272 extension of correction B.

By the time the whole three-drive pattern is complete, that's when you can pull the trigger on your long or short trade. Typically, when the price reaches point B, you can already set your short or long orders at the 1.272 extension so that you won't miss out!

But first, it'd be better to check if these rules also hold true:

- The time it takes the price to complete drive 2 should be equal to the time it takes to complete drive 3.
- Also, the time to complete retracements A and B should be equal.

The Gartley and the Animals

Once upon a time, there was this insanely smart trader dude named Harold McKinley Gartley.

He had a stock market advisory service in the mid-1930s with a huge following. This service was one of the first to apply scientific and statistical methods to analyze the stock market behavior.

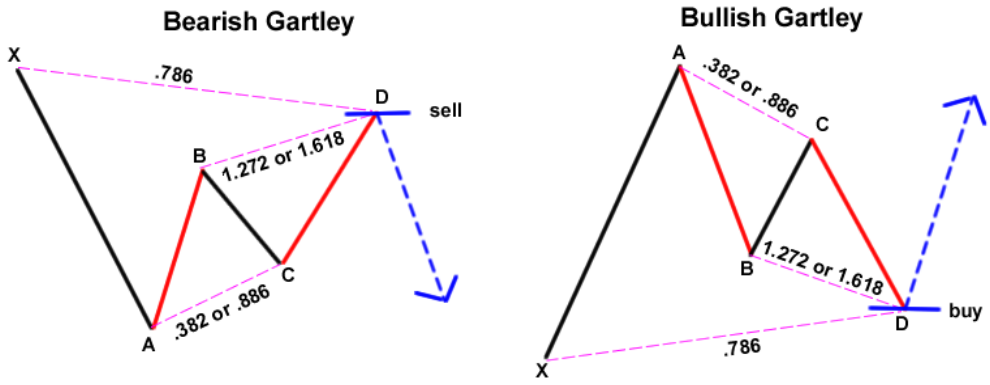
According to Gartley, he was finally able to solve two of the biggest problems of traders: what and when to buy.

Soon enough, traders realized that these patterns could also be applied to other markets. Since then, various books, trading software, and other patterns (discussed below) have been made based on the Gartleys.

Gartley a.k.a. "222" Pattern

The Gartley "222" pattern is named for the page number it is found on in H.M. Gartleys book, *Profits in the Stock Market*. Gartleys are patterns that include the basic ABCD pattern we've already talked about, but are preceded by a significant high or low.

Now, these patterns normally form when a correction of the overall trend is taking place and look like 'M' (or 'W' for bearish patterns). These patterns are used to help traders find good entry points to jump in on the overall trend.



A Gartley forms when the price action has been going on a recent uptrend (or downtrend) but has started to show signs of a correction.

What makes the Gartley such a nice setup when it forms is the reversal points are a Fibonacci retracement and Fibonacci extension level. This gives a stronger indication that the pair may actually reverse.

This pattern can be hard to spot and once you do, it can get confusing when you pop up all those Fibonacci tools. The key to avoiding all the confusion is to take things one step at a time.

In any case, the pattern contains a bullish or bearish ABCD pattern, but is preceded by a point (X) that is beyond point D. The "perfect" Gartley pattern has the following characteristics:

1. Move AB should be the .618 retracement of move XA.
2. Move BC should be either .382 or .886 retracement of move AB.
3. If the retracement of move BC is .382 of move AB, then CD should be 1.272 of move BC. Consquently, if move BC is .886 of move AB, then CD should extend 1.618 of move BC.
4. Move CD should be .786 retracement of move XA

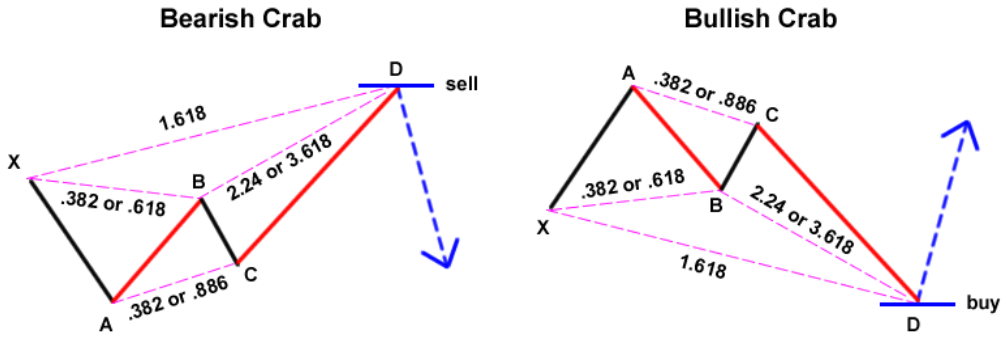
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The Animals

As time went by, the popularity of the Gartley pattern grew and people eventually came up with their own variations.

For some odd reason, the discoverers of these variations decided to name them after animals (Maybe they were part of PETA?).Without further ado, here comes the animal pack...

The Crab



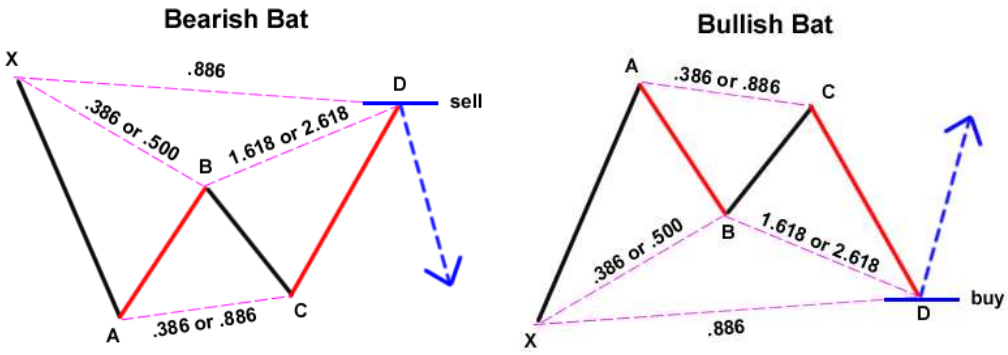
In 2000, Scott Carney, a firm believer in harmonic price patterns, discovered the "Crab".

According to him, this is the most accurate among all the harmonic patterns because of how extreme the Potential Reversal Zone (sometimes called "price better reverse or imma gonna lose my shirt" point) from move XA.

This pattern has a high reward-to-risk ratio because you can put a very tight stop loss. The "perfect" crab pattern must have the following aspects:

1. Move AB should be the .382 or .618 retracement of move XA.
2. Move BC can be either .382 or .886 retracement of move AB.
3. If the retracement of move BC is .382 of move AB, then CD should be 2.24 of move BC. Consquently, if move BC is .886 of move AB, then CD should be 3.618 extension of move BC.
4. CD should be 1.618 extension of move XA.

The Bat

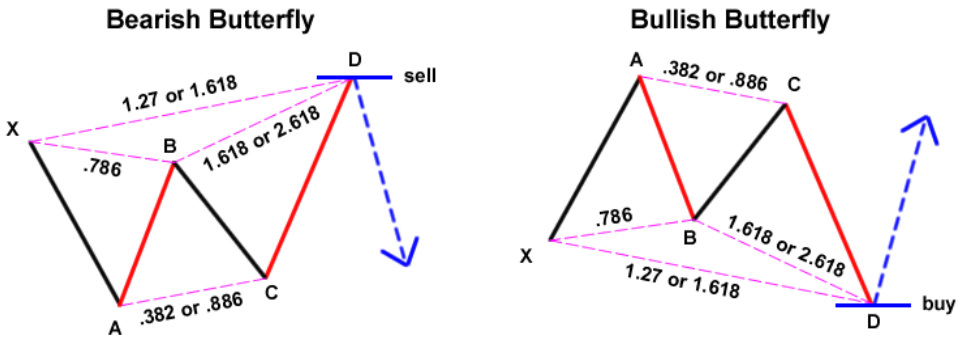


Come 2001, Scott Carney founded another Harmonic Price Pattern called the "Bat." The Bat is defined by the .886 retracement of move XA as Potential Reversal Zone. The Bat pattern has the following qualities:

1. Move AB should be the .382 or .500 retracement of move XA.
2. Move BC can be either .382 or .886 retracement of move AB.

3. If the retracement of move BC is .382 of move AB, then CD should be 1.618 extension of move BC. Consquently, if move BC is .886 of move AB, then CD should be 2.618 extension of move BC.
4. CD should be .886 retracement of move XA.

The Butterfly



Then, there is the Butterfly pattern. Like Muhammad Ali, if you spot this setup, you'll surely be swinging for some knockout-sized pips!

Created by Bryce Gilmore, the perfect Butterfly pattern is defined by the .786 retracement of move AB with respect to move XA. The Butterfly contains these specific characteristics:

1. Move AB should be the .786 retracement of move XA.
2. Move BC can be either .382 or .886 retracement of move AB.
3. If the retracement of move BC is .382 of move AB, then CD should be 1.618 extension of move BC. Consquently, if move BC is .886 of move AB, then CD should extend 2.618 of move BC.
4. CD should be 1.27 or 1.618 extension of move XA.

3 Steps in Trading Harmonic Price Patterns

As you may have guessed, profiting off Harmonic Price Patterns is all about being able to spot those "perfect" patterns and buying or selling on their completion.

There are three basic steps in spotting Harmonic Price Patterns:

- **Step 1: Locate a potential Harmonic Price Pattern**
- **Step 2: Measure the potential Harmonic Price Pattern**
- **Step 3: Buy or sell on the completion of the Harmonic Price Pattern**

By following these three basic steps, you can find high probability setups that will help you grab those oh-so-lovely pips.

Let's see this process in action!

Step 1: Locate a potential Harmonic Price Pattern



Oh wow, that looks like a potential Harmonic Price Pattern! At this point in time, we're not exactly sure what kind of pattern that is. It LOOKS like a three-drive, but it could be a Bat or a Crab...

Heck, it could even be a Moose! In any case, let's label those reversal points.

Step 2: Measure the potential Harmonic Price Pattern

Using the Fibonacci tool, a pen, and a piece of paper, let us list down our observations.



1. Move BC is .618 retracement of move AB.
2. Move CD is 1.272 extension of move BC.
3. The length of AB is roughly equal to the length of CD.

This pattern qualifies for a bullish ABCD pattern, which is a strong buy signal.

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Step 3: Buy or sell on the completion of the Harmonic Price Pattern



Once the pattern is complete, all you have to do is respond appropriately with a buy or sell order.

In this case, you should buy at point D, which is the 1.272 Fibonacci extension of move CB, and put your stop loss a couple of pips below your entry price.

Is it really that easy?

Not exactly.

The problem with harmonic price patterns is that they are so perfect that they are so difficult to spot, kind of like a diamond in the rough.

More than knowing the steps, you need to have hawk-like eyes to spot potential harmonic price patterns and a lot of patience to avoid jumping the gun and entering before the pattern is completed.

Summary: Harmonic Price Patterns

Harmonic price patterns enable us to distinguish possible areas for a continuation of the overall trend.

There are six harmonic price patterns:

- The ABCD Pattern
- The Three-Drive Pattern
- The Gartley Pattern
- The Crab Pattern
- The Bat Pattern
- The Butterfly Pattern

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The three basic steps in spotting harmonic price patterns are the following

- Step 1: Locate a potential harmonic price pattern
- Step 2: Measure the potential harmonic price pattern
- Step 3: Buy or sell on the completion of the harmonic price pattern

Again, harmonic price patterns are so perfect that they are very difficult to spot.

More than knowing the steps, you need to have hawk-like eyes to spot potential harmonic price patterns and a lot of patience to avoid jumping the gun and entering before the pattern is completed.

With enough practice and experience, trading using harmonic price patterns can yield a lot of pips!

High School

Divergence Trading

What if there was a low risk way to sell near the top or buy near the bottom of a trend?

What if you were already in a long position and you could know ahead of time the perfect place to exit instead of watching your unrealized gains, a.k.a your potential Aston Martin down payment, vanish before your eyes because your trade reverses direction?

What if you believe a currency pair will continue to fall but would like to short at a better price or a less risky entry?

Well guess what? There is a way! It's called **divergence trading**.

In a nutshell, divergence can be seen by comparing price action and the movement of an indicator. It doesn't really matter what indicator you use. You can use RSI, MACD, the stochastic, CCI, etc.

The great thing about divergences is that you can use them as a leading indicator, and after some practice it's not too difficult to spot.

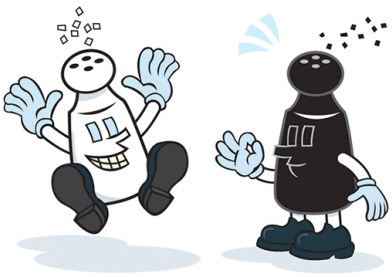
When traded properly, you can be consistently profitable with divergences. The best thing about divergences is that since you're usually buying near the bottom or selling near the top. This makes the risk on your trades are very small relative to your potential reward.

Cha-ching!

Higher Highs and Lower Lows

Just think "higher highs" and "lower lows".

Price and momentum normally move hand in hand like Hansel and Gretel, Batman and Robin, Serena and Venus Williams, salt and pepper...You get the point.



If price is making **higher highs**, the oscillator should also be making **higher highs**. If price is making **lower lows**, the oscillator should also be making **lower lows**.

If they are NOT, that means price and the oscillator are diverging from each other. And that's why it's called "divergence."

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Divergence trading is an awesome tool to have in your toolbox because divergences signal to you that something fishy is going on and that you should pay closer attention.

Using divergence trading can be useful in spotting a weakening trend or reversal in momentum. Sometimes you can even use it as a signal for a trend to continue!

There are **TWO** types of divergence:

1. Regular
2. Hidden

In this grade, we will teach you how to spot these divergences and how to trade them. We'll even have a sweet surprise for you at the end.

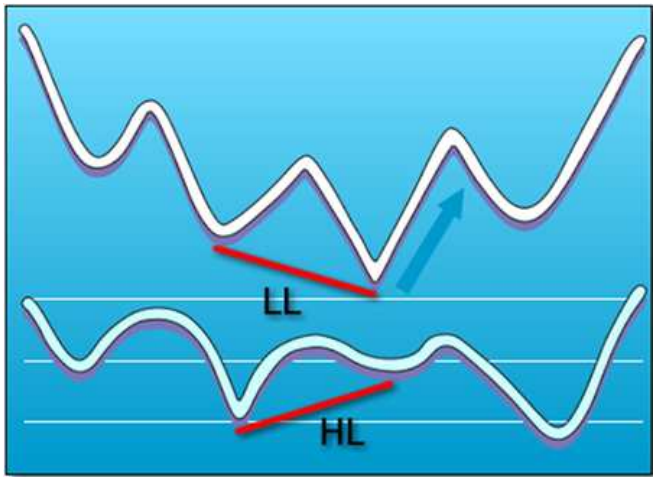
Regular Divergence

A regular divergence is used as a possible sign for a trend reversal.

If price is making lower lows (LL), but the oscillator is making higher lows (HL), this is considered to be regular bullish divergence.

This normally occurs at the end of a down trend. After establishing a second bottom, if the oscillator fails to make a new low, it is likely that the price will rise, as price and momentum are normally expected to move in line with each other.

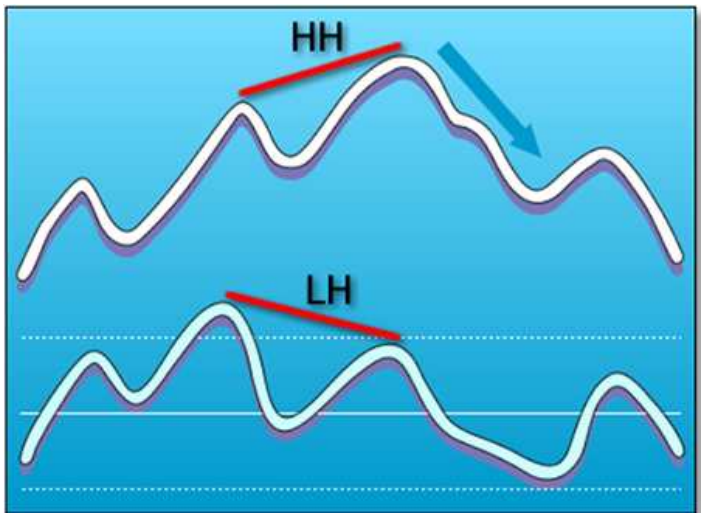
Below is an image that portrays regular bullish divergence.



Now, if the price is making a higher high (HH), but the oscillator is lower high (LH), then you have regular bearish divergence.

This type of divergence can be found in an uptrend. After price makes that second high, if the oscillator makes a lower high, then you can probably expect price to reverse and drop.

In the image below, we see that price reverses after making the second top.



As you can see from the images above, the regular divergence is best used when trying to pick tops and bottoms. You are looking for an area where price will stop and reverse.

The oscillators signal to us that momentum is starting to shift and even though price has made a higher high (or lower low), chances are that it won't be sustained.

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Did you get all of that? Pretty simple eh?

Now that you've got a hold on regular divergence, it's time to move and learn about the second type of divergence - hidden divergence.

Don't worry, it's not super concealed like the Chamber of Secrets and it's not that tough to spot. The reason it's called "hidden" is because it's hiding inside the current trend.

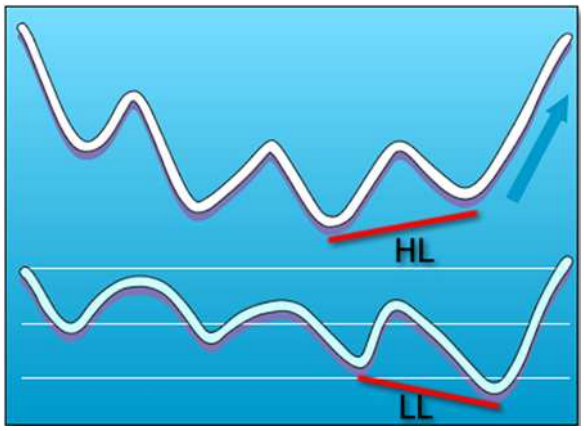
We'll explain more in the next section. Read on!

Hidden Divergence

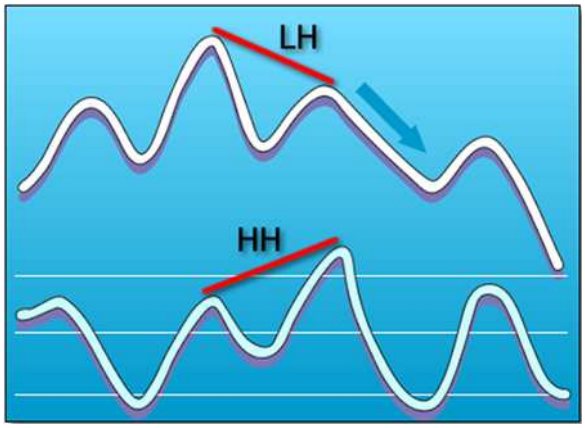
Divergences not only signal a potential trend reversal; they can also be used as a possible sign for a trend continuation. Always remember, the trend is your friend, so whenever you can get a signal that the trend will continue, then good for you!

Hidden bullish divergence happens when price is making a higher low (HL), but the oscillator is showing a lower low (LL).

This can be seen when the pair is in an uptrend. Once price makes a higher low, look and see if the oscillator does the same. If it doesn't and makes a lower low, then we've got some hidden divergence in our hands.



Lastly, we've got hidden bearish divergence. This occurs when price makes a lower high (LH), but the oscillator is making a higher high (HH). By now you've probably guessed that this occurs in a downtrend. When you see hidden bearish divergence, chances are that the pair will continue to shoot lower and continue the downtrend.



Let's recap what you've learned so far about hidden divergence.

If you're a trend follower, then you should dedicate some time to spot some hidden divergence.

If you do happen to spot it, it can help you jump in the trend early.

Sounds good, yes?

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Okay, now you know about both regular and hidden divergence.

We hope you got it all down pat. Keep in mind that regular divergences are possible signals for trend reversals while hidden divergences signal trend continuation.

In the next lesson we'll show you some real-world examples of when divergences existed and how you could have traded them.

How To Trade Divergences

Now it's time to put those Jedi-divergence mind tricks to work and force the markets to give you some pips!

Here we'll show you some examples of when there was divergence between price and oscillator movements.

First up, let's take a look at regular divergence. Below is a daily chart of USD/CHF.



We can see from the falling trend line that USD/CHF has been in a downtrend. However, there are signs that the downtrend will be coming to an end.

While price has registered lower lows, the stochastic (our indicator of choice) is showing a higher low.

Something smells fishy here. Is the reversal coming to an end? Is it time to buy this sucker?



If you had answered yes to that last question, then you would have found yourself in the middle of the Caribbean, soaking up margaritas, as you would have been knee deep in your pip winnings!

It turns out that the divergence between the stochastic and price action was a good signal to buy. Price broke through the falling trend line and formed a new uptrend. If you had bought near the bottom, you could have made more than a thousand pips, as the pair continued to shoot even higher in the following months.

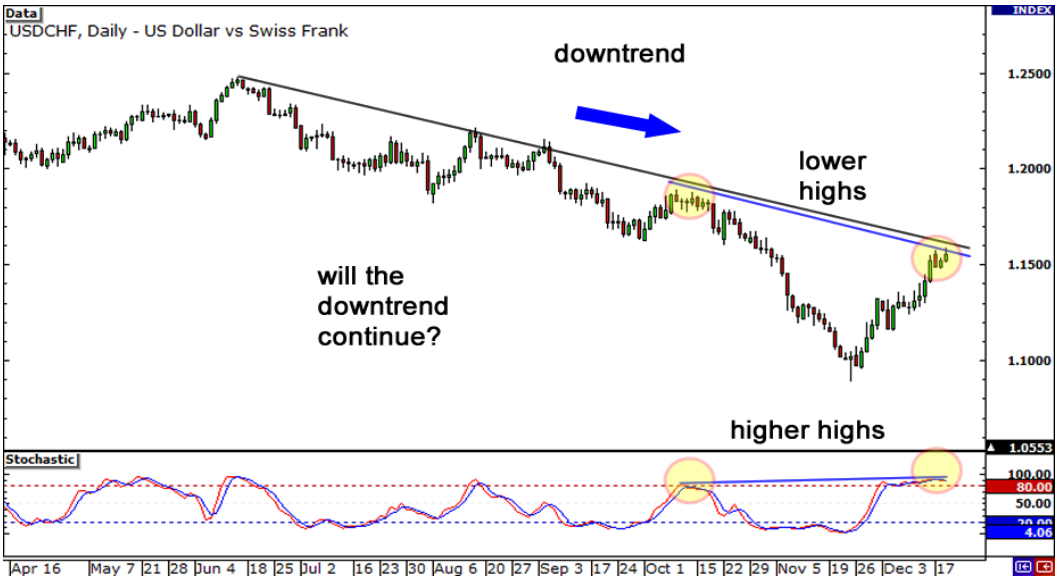
Now can you see why it rocks to get in on the trend early?!

Before we move on, did you notice the tweezer bottoms that formed on the second low?

Keep an eye out for other clues that a reversal is in place. This will give you more confirmation that a trend is coming to an end, giving you even more reason to believe in the power of divergences!

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Next, let's take a look at an example of some hidden divergence. Once again, let's hop on to the daily chart of USD/CHF.



Here we see that the pair has been in a downtrend. Notice how price has formed a lower high but the stochastic is printing higher highs.

According to our notes, this is hidden bearish divergence! Hmmm, what should we do? Time to get back in the trend?

Well, if you ain't sure, you can sit back and watch on the sidelines first.



If you decided to sit that one out, you might be as bald as Professor Xavier because you pulled out all your hair.

Why?

Well the trend continued!

Price bounced from the trend line and eventually dropped almost 2000 pips!

Imagine if you had spotted the divergence and seen that as a potential signal for a continuation of the trend?

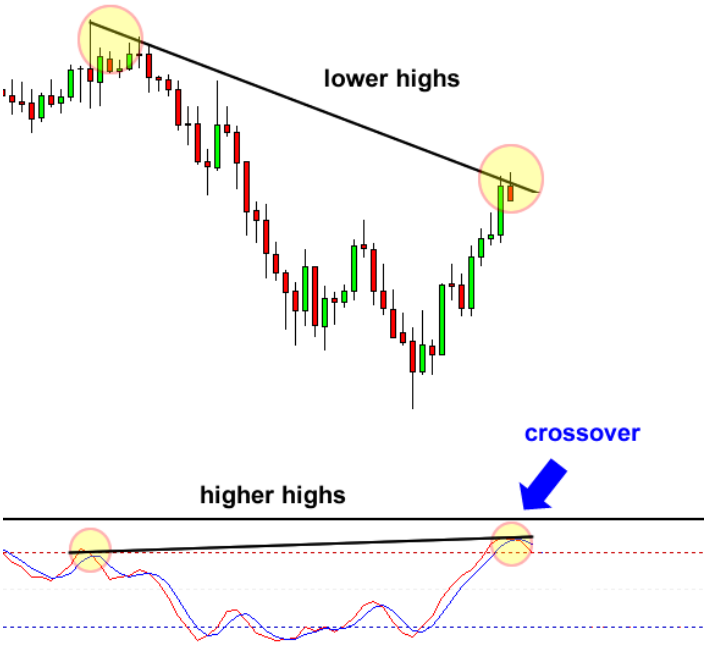
Not only would you be sipping those margaritas in the Caribbean, you'd have your own pimpin' yacht to boot!

Momentum Tricks

While using divergences is a great tool to have in your trading toolbox, there are times when you might enter too early because you didn't wait for more confirmation. Below are a couple of tricks that you can make use of so that you have more confirmation that the divergence will work out in your favor.

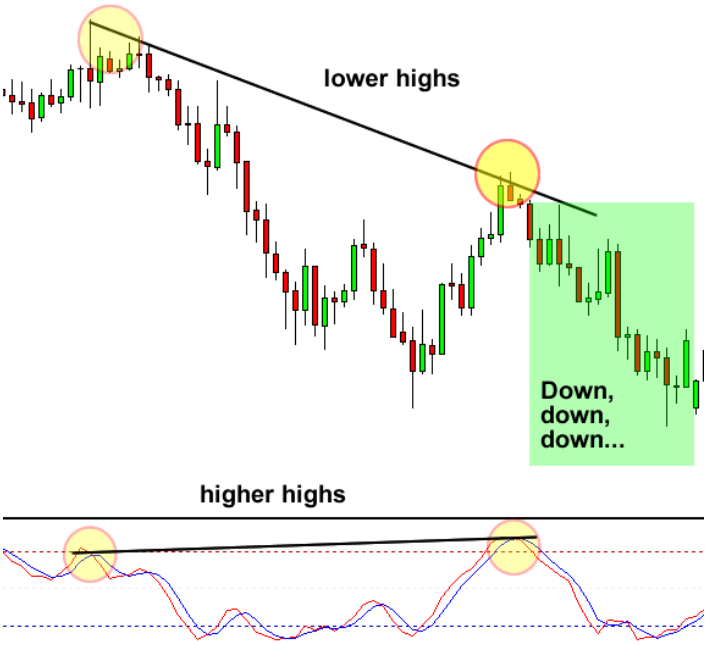
Wait for a crossover

This ain't so much a trick as it is a rule. Just wait for a crossover of the momentum indicator. This would indicate a potential shift in momentum from buying to selling or vice versa. The main reasoning behind this is that you are waiting for top or bottom and these can't be formed unless a crossover is made!



In the chart above, the pair showed lower highs while the stochastic already made higher highs. Now that's a bearish divergence there and it sure is tempting to short right away.

But, you know what they say, patience is a virtue. It'd be better to wait for the stochastic to make a downward crossover as confirmation that the pair is indeed headed down.



A couple of candles later, the stochastic did make that crossover. Playing that bearish divergence would've been pip-tastic!

What's the main point here? Just be patient! Don't try to jump the gun because you don't quite know when momentum will shift! If you aren't patient, you might just get burned as one side keeps dominating!

Moving out of overbought / oversold

Another trick would be to wait for momentum highs and lows to hit overbought and oversold conditions, and wait for the indicator to move out of these conditions.

The reason for doing this is similar to that of waiting for a crossover - you really don't have any idea when momentum will begin to shift.

Let's say you're looking at a chart and you notice that the stochastic has formed a new low while price hasn't.



You may think that it's time to buy because the indicator is showing oversold conditions and divergence has formed. However, selling pressure may remain strong and price continues to fall and make a new low.

You would have been pretty bummed out as trend didn't continue. In fact, a new downtrend is probably in place as the pair is now forming lower highs. And if you were stubborn, you might have missed out on this down move too.

If you had waited patiently for more confirmation that the divergence had formed, then you could have avoided losing and realized that a new trend was developing.

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Draw trend lines on the momentum indicators themselves

This might sound a little ridiculous since you would normally draw trend lines only on price action. But this is a nifty lil' trick that we wanna share with you. After all, it doesn't hurt to have another weapon in the holster right? You never know when you might use it!

This trick can be particularly useful especially when looking for reversals or breaks from a trend. When you see that price is respecting a trend line, try drawing a similar trend line on your indicator.



You may notice that the indicator will also respect the trend line. If you see both price action and the momentum indicator break their respective trend lines, it could signal a shift in power from buyers to sellers (or vice versa) and that the trend could be changing. Oh yeah! Break it down like a Michael Jackson video!

9 Rules for Trading Divergences

Before you head out there and start looking for potential divergences, here are nine cool rules for trading divergences.

Learn 'em, memorize 'em (or keep coming back here), apply 'em to help you make better trading decisions. Ignore them and go broke.

1. Make sure your glasses are clean

In order for divergence to exist, price must have either formed one of the following:

- Higher high than the previous high
- Lower low than the previous low
- Double top
- Double bottom

Don't even bother looking at an indicator unless ONE of these four price scenarios have occurred. If not, you ain't trading a divergence, buddy. You're just imagining things. Immediately go see your optometrist and get some new glasses.



2. Draw lines on successive tops and bottoms

Okay now that you got some action (recent price action that is), look at it. Remember, you'll only see one of four things: a higher high, a flat high, a lower low, or a flat low.

Now draw a line backward from that high or low to the previous high or low. It HAS to be on successive major tops/bottom. If you see any little bumps or dips between the two major highs/lows, do what you do when your significant other shouts at you - ignore it.

3. Do Tha Right Thang - Connect TOPS and BOTTOMS only

Once you see two swing highs are established, you connect the TOPS. If two lows are made, you connect the BOTTOMS.

Don't make the mistake of trying to draw a line at the bottom when you see two higher highs. It sounds dumb but really, peeps regularly get confused.





4. Eyes on the Price

So you've connected either two tops or two bottoms with a trend line. Now look at your preferred indicator and compare it to price action. Whichever indicator you use, remember you are comparing its TOPS or BOTTOMS. Some indicators such as MACD or Stochastic have multiple lines all up on each other like teenagers with raging hormones. Don't worry about what these kids are doing.



5. Be Fly like Pip Diddy

If you draw a line connecting two highs on price, you MUST draw a line connecting the two highs on the indicator as well. Ditto for lows also. If you draw a line connecting two lows on price, you MUST draw a line connecting two lows on the indicator. They have to match!





6. Keep in Line

The highs or lows you identify on the indicator MUST be the ones that line up VERTICALLY with the price highs or lows. It's just like picking out what to wear to the club - you gotta be fly and matchin' yo!



7. Ridin' the slopes

Divergence only exists if the SLOPE of the line connecting the indicator tops/bottoms DIFFERS from the SLOPE of the line connection price tops/bottoms. The slope must either be: Ascending (rising) Descending (falling) Flat (flat)



8. If the ship has sailed, catch the next one

If you spot divergence but the price has already reversed and moved in one direction for some time, the divergence should be considered played out. You missed the boat this time. All you can do now is wait for another swing high/low to form and start your divergence search over.



9. Take a step back

Divergence signals tend to be more accurate on the longer time frames. You get less false signals. This means fewer trades but if you structure your trade well, then your profit potential can be huge. Divergences on shorter time frames will occur more frequently but are less reliable.

We advise only look for divergences on 1-hour charts or longer. Other traders use 15-minute charts or even faster. On those time frames, there's just too much noise for our taste so we just stay away.

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So there you have it kiddos - 9 rules you MUST follow if you want to seriously consider trading using divergences. Trust us, you don't wanna be ignoring these rules. Your account will take more hits than BabyPips.com's Facebook fan page.

Follow these rules, and you will dramatically increase the chances of a divergence setup leading to a profitable trade.

Now go scan the charts and see if you can spot some divergences that happened in the past as a great way to begin getting your divergence skills up to par!

Divergence Cheat Sheet

Let's review!

There are two types of divergences:

1. Regular divergence
2. Hidden divergence

Each type of divergence will contain either a bullish bias or a bearish bias.

Since you've all be studying hard and not been cutting class, we've decided to help y'all out (cause we're nice like that) by giving you a cheat sheet to help you spot out regular and hidden divergences quickly.

Type	Bias	Price	Oscillator	Description	Example
Regular	Bullish	Lower Low	Higher Low	Indicates underlying strength. Bears are exhausted. Warning of possible trend direction change from downtrend to uptrend.	
	Bearish	Higher High	Lower High	Indicates underlying weakness. Bulls are exhausted. Warning of possible trend direction change from uptrend to downtrend.	
Hidden	Bullish	Higher Low	Lower Low	Indicates underlying strength. Good entry or re-entry. Occurs during retracements in an uptrend. Nice to see during price retest of previous lows. "Buy the dips"	
	Bearish	Lower High	Higher High	Indicates underlying weakness. Found during retracements in a downtrend. Nice to see during price retests of previous highs. "Sell the rallies"	

Whew! That's quite a lot to remember, isn't it? We'll give you two options:

1. You can write this all down in your palm and look back on it while trading. If you're the type who gets sweaty palms when you're nervous, we wouldn't recommend this.
2. You can simply bookmark this page and just revisit it when you mix up those higher lows, lower highs, lower lows, and higher highs. You don't want to make a wild guess while coming up with a trade, do you?

Summary: Divergences

Please keep in mind that we use divergence as an indicator, not a signal to enter a trade!

It wouldn't be smart to trade basely solely on divergences since too many false signals are given. It's not 100% foolproof, but when used as a setup condition and combined with additional confirmation tools, your trades have a high probability of winning with relatively low risk.

There are a bunch of ways to take advantage of those divergences.

One way is to look at trend lines or candlestick formations to confirm whether a reversal or continuation is in order.

Another way is to make use of momentum tricks by watching out for an actual crossover or waiting for the oscillator to move out of the overbought/oversold region. You can also try drawing trend lines on the oscillator too.

With these nifty tricks, you can guard yourself against false signals and filter out those that'll be very profitable.

On the flip side, it is just as dangerous trade against this indicator.



If you're unsure about which direction to trade, chill out on the sidelines.

Remember that taking no position is a trading decision in itself and it's better to hold on to your hard-earned cash than bleed Benjamins on a shaky trade idea.

Divergences don't appear that often, but when they do appear, it'd behoove you to pay attention.

Regular divergences can help you collect a big chunk of profit because you're able to get in right when the trend changes.

Hidden divergences can help you ride a trade longer resulting in bigger-than-expected profits by keeping you on the correct side of a trend.

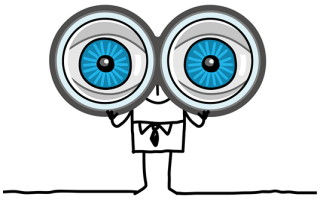
The trick is to train your eye to spot divergences when they appear AND choose the proper divergences to trade.

Just because you see a divergence, it doesn't necessarily mean you should automatically jump in with a position. Cherry pick your setups and you'll do well.

Trendspotting

When two people go to war, the foolish man always rushes blindly into battle without a plan, much like a starving man at his favorite buffet spot.

The wise man, on the other hand, will always get a situation report first to know the surrounding conditions that could affect how the battle plays out.



Like in warfare, we must also get a situation report on the market we are trading. This means we need to know what kind of market environment we are actually in. Some traders cry saying that their system sucks.

Sometimes the system does in fact, suck. Other times, the system is potentially profitable, but it is being utilized in the wrong environment.

Seasoned traders try to figure out the appropriate strategy for the current market environment they are trading in.

Is it time to bust out those Fibs and look for retracements? Or are ranges holding?

Just as the coach comes up with different plays for particular situations or opponents, you should also be able to decide which strategy to use depending on market environment.

By knowing what market environment we are trading in, we can choose a trend-based strategy in a trending market or a range-bound strategy in a ranging market.

Are you worried about not getting to use your beastly range-bound strategy? How about your Bring-Home-Da-Bacon trend-based system?

Have no fear!

The forex market provides many trending and ranging opportunities across different time frames wherein these strategies can be implemented.

By knowing which strategies are appropriate, you will find it easier to figure out which indicators to pull out from your toolbox.

For instance, Fibs and trend lines are useful in trending markets while pivot points, support and resistance levels are helpful when the market is ranging.

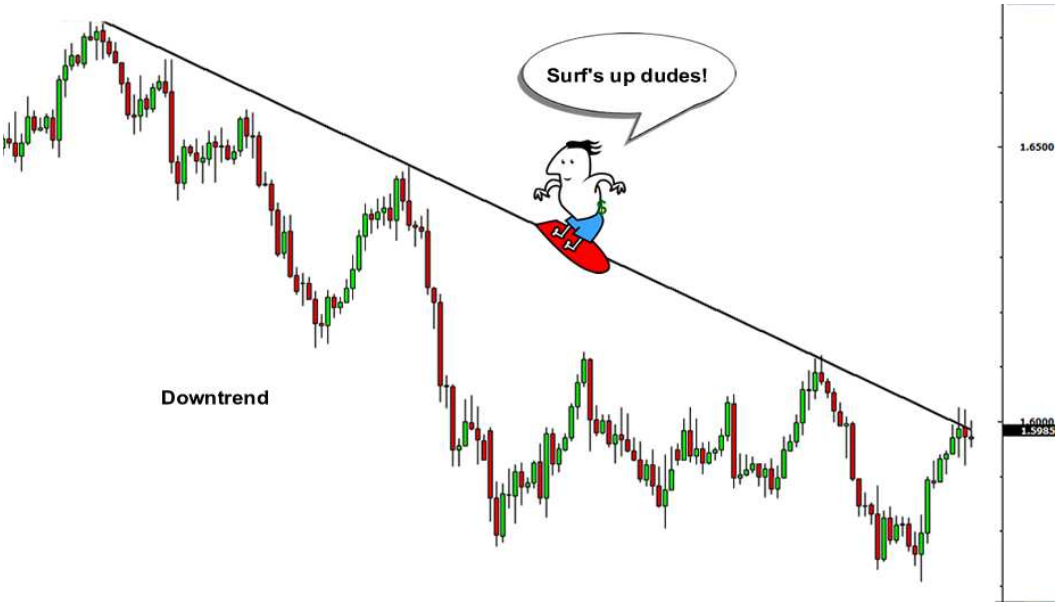
Before spotting those opportunities, you have to be able to determine the market environment. The state of the market can be classified into three scenarios:

- Trending up
- Trending down
- Ranging

What is a Trending Market?

A **trending** market is one in which price is generally moving in one direction.

Sure, price may go against the trend every now and then, but looking at the longer time frames would show that those were just retracements.



Trends are usually noted by "higher highs" and "higher lows" in an **uptrend** and "lower highs" and "lower lows" in a **downtrend**.

When trading a trend-based strategy, traders usually pick the major currencies as well as any other currency utilizing the dollar because these pairs tend to trend and be more liquid than other pairs.

Liquidity is important in trend-based strategies. The more liquid a currency pair, the more movement (a. k. a. **volatility**) we can expect.

The more movement a currency exhibits, the more opportunities there are for price to move strongly in one direction as opposed to bouncing around within small ranges.

Other than eyeballing price action, you can also make use of technical tools you have learned in previous sections to determine whether a currency pair is trending or not.

ADX in a Trending Market

A way to determine if the market is trending is through the use of the Average Directional Index indicator or ADX for short.

Developed by J. Welles Wilder, this indicator uses values ranging from 0-100 to determine if price is moving strongly in one direction, i.e. trending, or simply ranging.

Values more than 25 usually indicate that price is trending or is already in a strong trend.

The higher the number is, the stronger the trend.

However, the ADX is a lagging indicator which means that it doesn't necessarily predict the future. It also is a non-directional indicator, which means it will report a positive figure whether price is trending up or down.

Take a look at this example. Price is clearly trending downwards even though ADX is greater than 25.

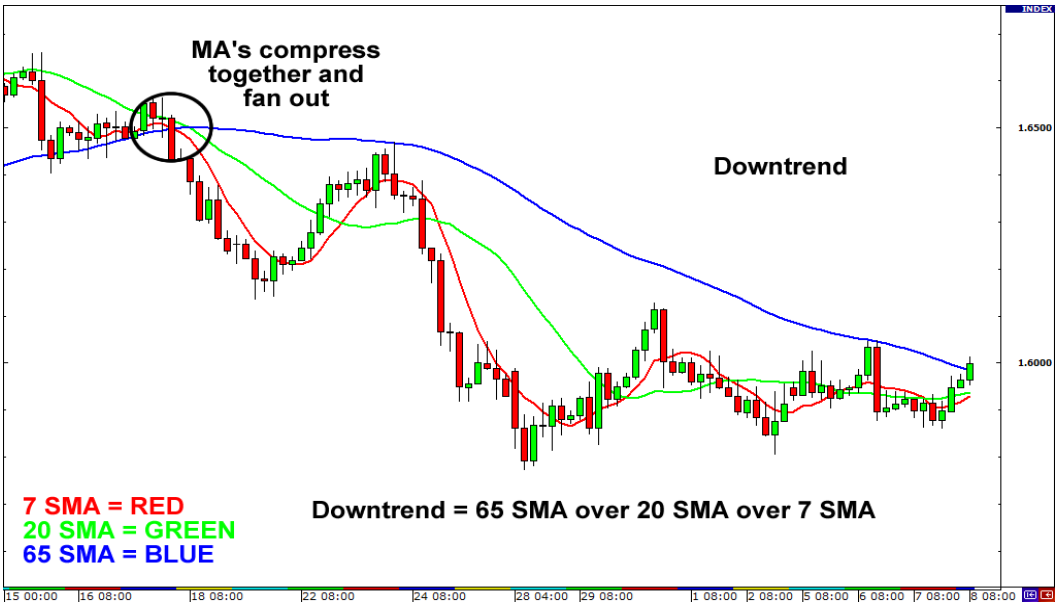


Moving Averages in a Trending Market

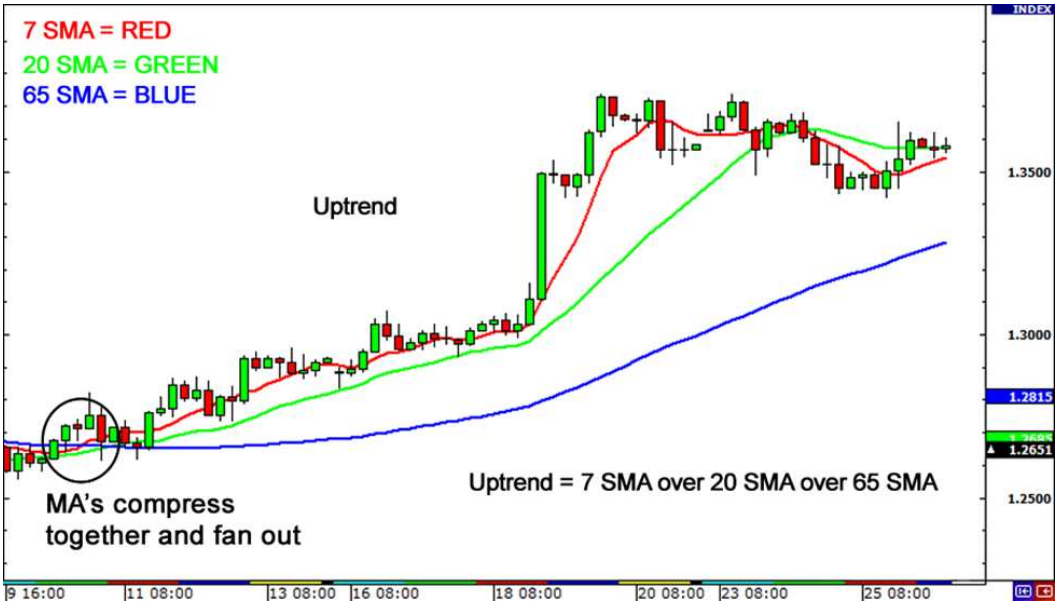
If you're not a fan of the ADX, you can also make use of simple moving averages. Check this out!

Place a 7 period, a 20 period, and a 65 period Simple Moving Average on your chart. Then, wait until the three SMA's compress together and begin to fan out.

If the 7 period SMA fans out on top of the 20 period SMA, and the 20 SMA on top of the 65 SMA, then price is trending up.



On the other hand, if the 7 period SMA fans out below the 20 period SMA, and the 20 SMA is below the 65 SMA, then price is trending down.



Bollinger Bands in a Trending Market

One tool that is often used for range-bound strategies can also be helpful in trend discovery. We're talking about Bollinger bands or just Bands.

One thing you should know about trends is that they are actually quite rare. Contrary to what you might think, prices really range 70-80 percent of the time. In other words, it is the norm for price to range.

So, if prices deviate from the "norm" then they must be in a trend right? What is one of the best technical tools we have mentioned in the previous grades that measure deviation?

If you said a ruler, we give you mad props for effort.

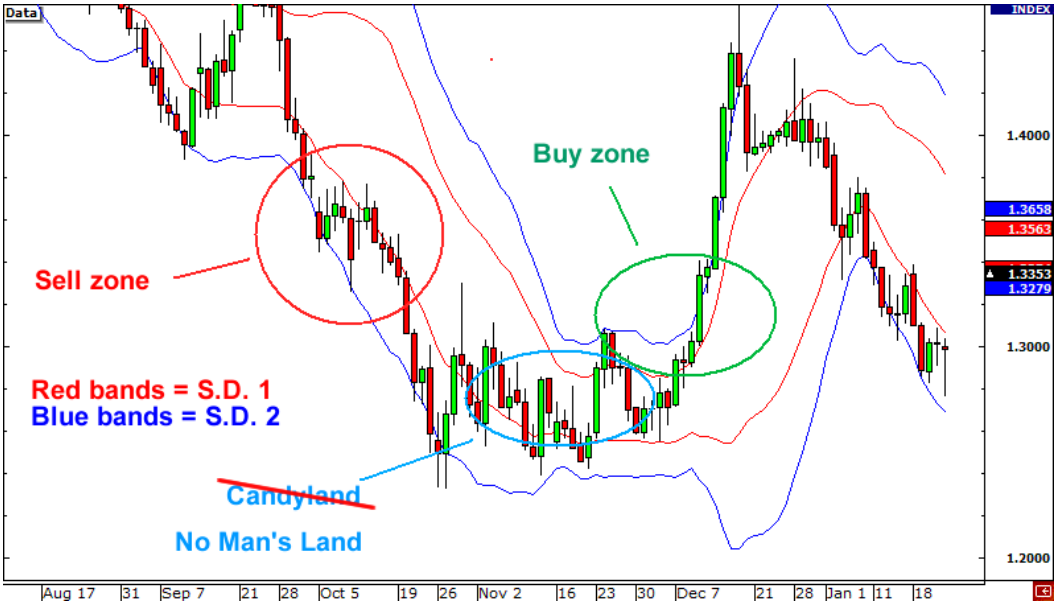
If you said Bollinger bands, we'll give you cyber milk and cookies! Here, take some.



Bollinger bands actually contain the standard deviation formula. But don't worry about being a nerd and figuring out what that is.

Here's how we can use Bollinger bands to determine the trend! Prepare for the craziness.

Place Bollinger bands with a standard deviation of 1 and another set of bands with a standard deviation of 2. You will see three set of price zones: the sell zone, the buy zone, and the "No-man's Land."



The **sell zone** is the area between the two bottom bands of the standard deviation 1 (SD 1) and standard deviation 2 (SD 2) bands. Bear in mind that price has to close within the bands in order to be considered in the sell zone.

The **buy zone** is the area between the two top bands of the SD 1 and SD 2 bands. Like the sell zone, price has to close within the two bands in order to be considered in the buy zone.

The area in between the standard deviation 1 bands is an area in which the market struggles to find direction. Price will close within this area if price is really in **"No-Man's Land".** Price direction is pretty much up for grabs.

The Bollinger bands make it easier to confirm a trend visually.

Downtrends can be confirmed when price is in the sell zone.

Uptrends can be confirmed when price is in the buy zone.

What is a Ranging Market?

A **ranging** market is one in which price bounces in between a specific high price and low price. The high price acts as a major resistance level in which price can't seem to break through.

Likewise, the low price acts as major support level in which price can't seem to break as well. Market movement could be classified as horizontal or sideways.



ADX in a Ranging Market

One way to determine if the market is ranging is to use the same ADX that we discussed earlier. A market is said to be ranging when the ADX is below 25. Remember, as the value of the ADX diminishes, the weaker trend is.



Bollinger Bands in a Ranging Market

In essence, Bollinger bands contract when there is less volatility in the market and expand when there is more volatility. Because of that, Bollinger bands provide a good tool for breakout strategies.

When the bands are thin and contracted, volatility is low and there should be little movement of price in one direction. However, when bands start to expand, volatility is increasing and more movement of price in one direction is likely.

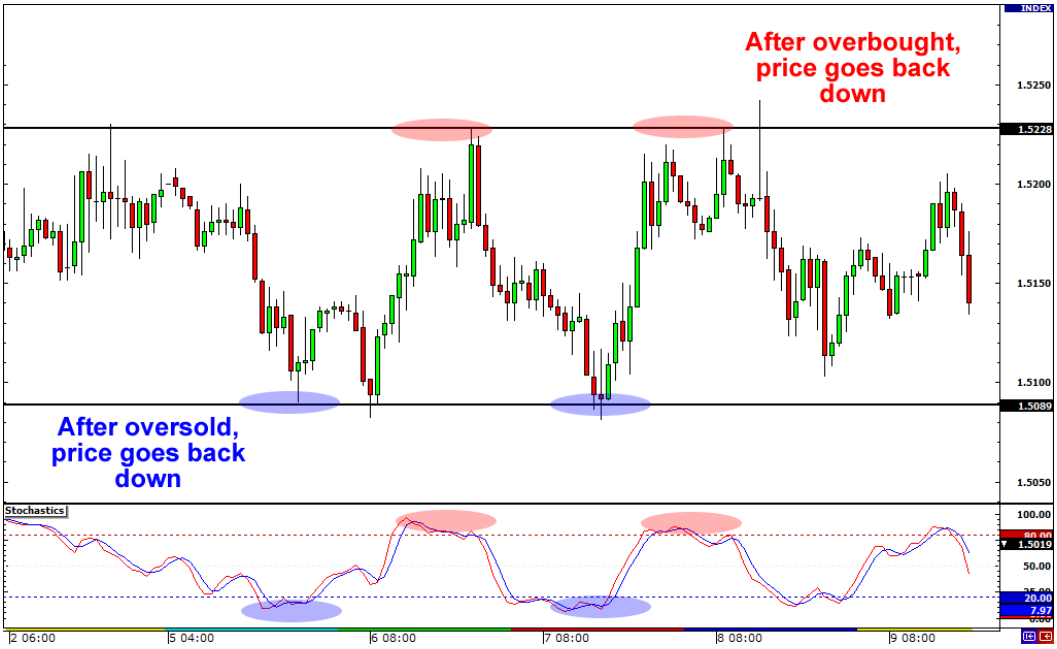


Generally, range trading environments will contain somewhat narrow bands compared to wide bands and form horizontally. In this case, we can see that the Bollinger bands are contracted, as price is just moving within a tight range.

The basic idea of a range-bound strategy is that a currency pair has a high and low price that it normally trades between.

By buying near the low price, the trader is hoping to take profit around the high price. By selling near the high price, the trader is hoping to take profit around the low price. Popular tools to use are channels such as the one shown above and Bollinger bands.

Using oscillators, like Stochastic or RSI, will help increase the odds of you finding a turning point in a range as they can identify potentially oversold and overbought conditions. Here's an example using GBP/USD.



Bonus tip: The best pairs for trading range-bound strategies are currency crosses. By crosses, we mean those pairs that do not include the USD as one of the currencies in the pair.

One of the most well-known pair for trading ranges is the EUR/CHF. The similar growth rates shared by the European Union and Switzerland pretty much keep the exchange rate of the EUR/CHF stable.

Conclusion

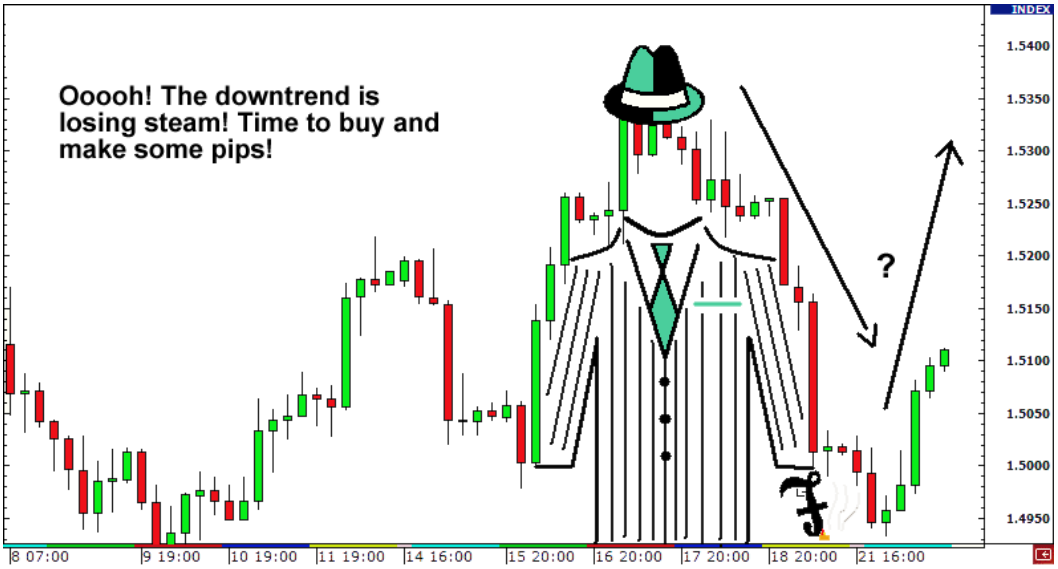
Whether you're trading a pair that's in a trending or ranging environment, you should take comfort in knowing that you can profit whatever the case may be.

By knowing what a trending environment and a ranging environment are and what they look like, you'll be able to employ a specific strategy for each.

As the old wise man in Central Park says, "Only a fool dips his cookies in habanero salsa!"

Retracement or Reversal?

Have you ever been in this situation before?



It looks as though price action may be rallying and a buy trade is in order.

WRONG!



You've been hit by the "Smooth Retracement!"

Nobody likes to be hit the "Smooth Retracement" but, sadly, it does happen.
Why?

In the above example, the trader failed to recognize the difference between a retracement and a reversal. Instead of being patient and riding the overall downtrend, the trader believed that a reversal was in motion and set a long entry. Whoops, there goes his money!

In this lesson, you will learn the characteristics of retracements and reversals, how to recognize them, and how to protect yourself from false signals.

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What are Retracements?

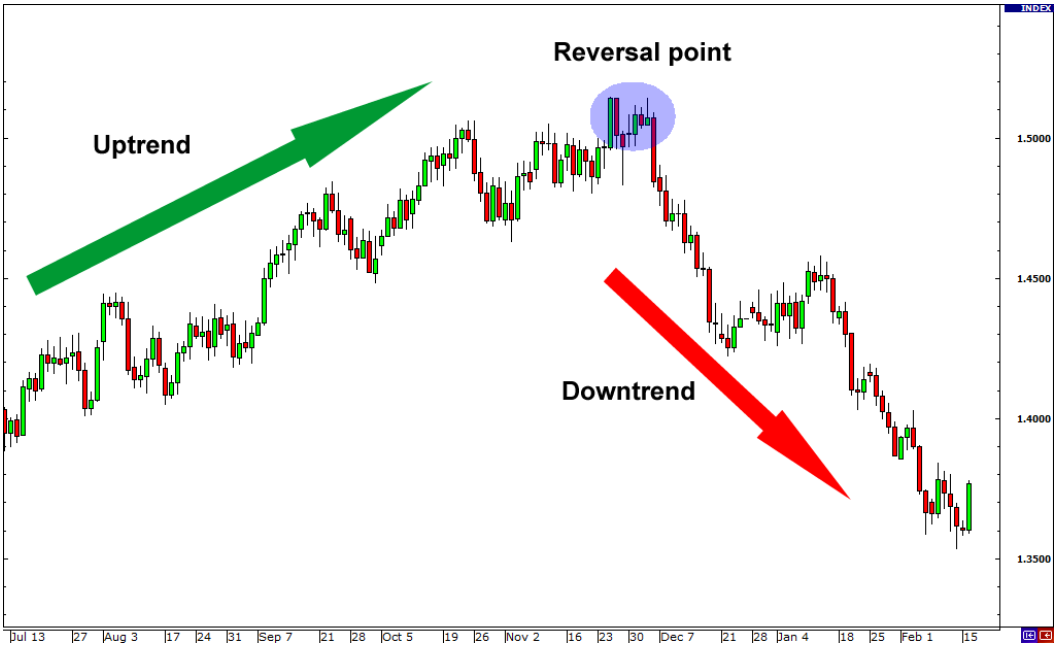
A retracement is defined as a temporary price movement against the established trend. Another way to look at it is an area of price movement that moves against the trend but returns to continue the trend.



Easy enough? Let's move on...

What are Reversals?

Reversals are defined as a change in the overall trend of price. When an uptrend switches to a downtrend, a reversal occurs. When a downtrend switches to an uptrend, a reversal also occurs. Using the same example as above, here's how a reversal looks like.



What Should You Do?

When faced with a possible retracement or reversal, you have three options:

1. If in a position, you could **hold** onto your position. This could lead to losses if the retracement turns out to be a longer term reversal.
2. You could **close your position** and **re-enter** if the price starts moving with the overall trend again. Of course there could be a missed trade opportunity if price sharply moves on one-direction. Money is also wasted on spreads if you decide to re-enter.
3. You could **close permanently**. This could result in a loss (if price went against you) or a huge profit (if you closed at a top or bottom) depending on the structure of your trade and what happens after.

Because reversals can happen at any time, choosing the best option isn't always easy. This is why using trailing stop loss points can be a great risk management technique when trading with the trend. You can employ it to protect your profits and make sure that you will always walk away with some pips in the event that a long-term reversal happens.

Identifying Reversals

Properly distinguishing between retracements and reversals can reduce the number of losing trades and even set you up with some winning trades.

Classifying a price movement as a retracement or a reversal is very important. It's up there with paying taxes *cough*.

There are several key differences in distinguishing a temporary price change retracement from a long-term trend reversal. Here they are:

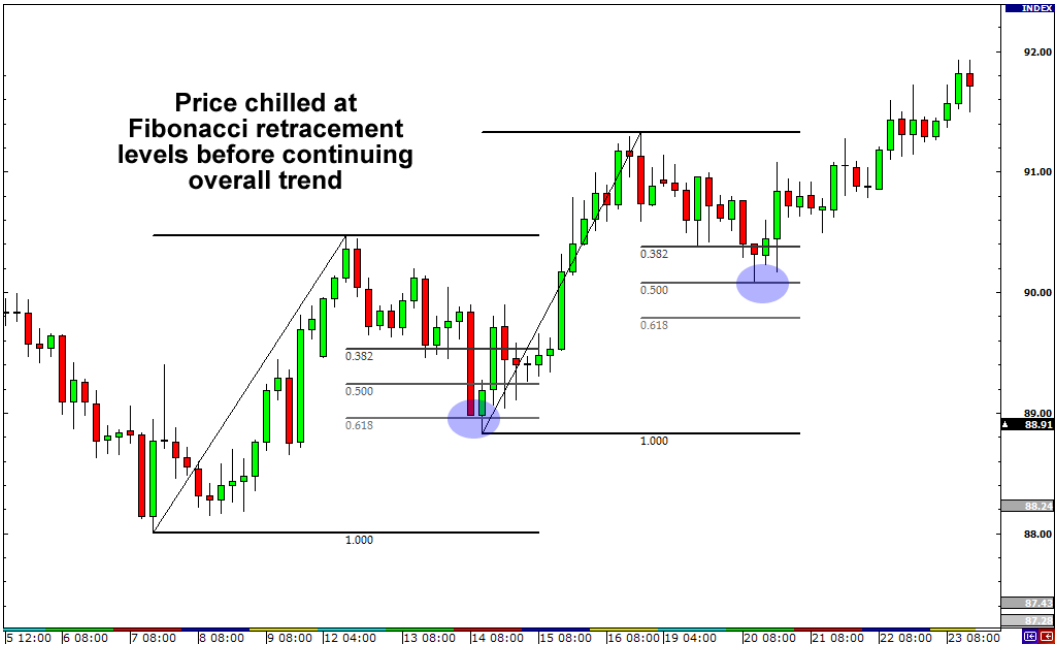
Retracements	Reversals
Usually occurs after huge price movements.	Can occur at anytime.
Short-term, short-lived reversal.	Long-term price movement
Fundamentals don't change.	Fundamentals DO change, which is usually the catalyst for the long-term reversal.
In an uptrend, buying interest is present, making it likely for price to rally. In a downtrend, selling interest is present, making it likely for price to decline.	In an uptrend, there is very little buying interest forcing the price to fall lower. In a downtrend, there is very little selling interest forcing the price to rise further.

Identifying Retracements

A popular way to identify retracements is to use Fibonacci levels.

For the most part, price retracements hang around the 38.2%, 50.0% and 61.8% Fibonacci retracement levels before continuing the overall trend.

If price goes beyond these levels, it may signal that a reversal is happening. Notice how we didn't say will. As you may have figured out by now, technical analysis isn't an exact science, which means nothing certain... especially in forex markets.



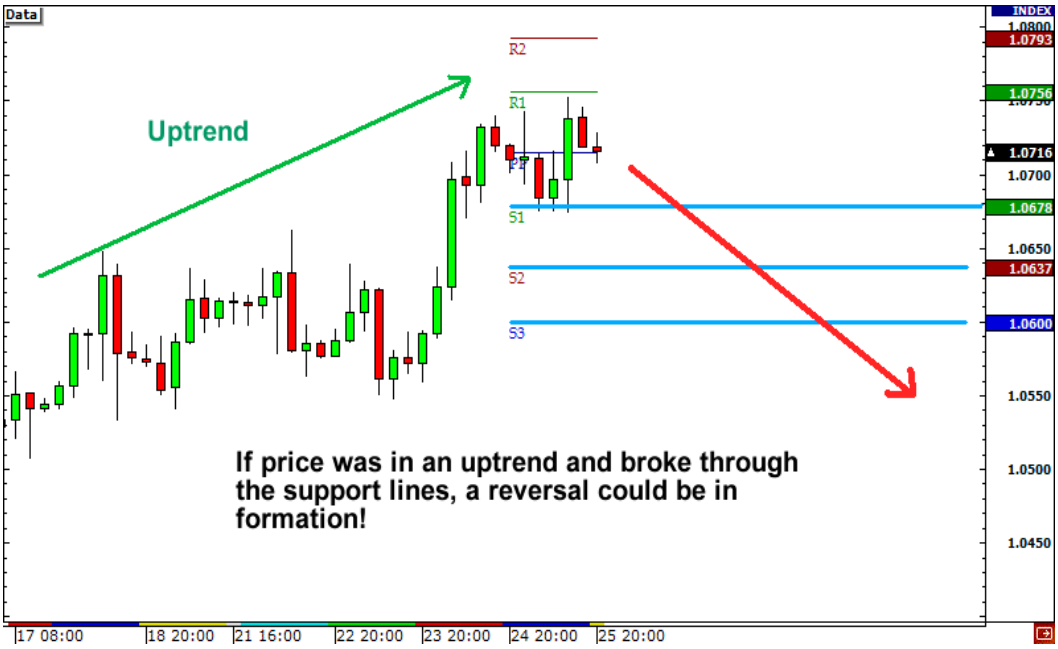
In this case, price took a breather and rested at the 61.8% Fibonacci retracement level before resuming the uptrend. After a while, it pulled back again and settled at the 50% retracement level before heading higher.

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Another way to see if price is staging a reversal is to use pivot points.

In an uptrend, traders will look at the lower support points (S1, S2, S3) and wait for it to break. In a downtrend, traders will look at the higher resistance points (R1, R2, R3) and wait for it to break.

If broken, a reversal could be in the making! For more information or another refresher, check out the Pivot Points Lesson!



The last method is to use trend lines. When a major trend line is broken, a reversal may be in effect.

By using this technical tool in conjunction with candlestick chart patterns discussed earlier, a trader may be able to get a high probability of a reversal.



While these methods can identify reversals, they aren't the only way. At the end of the day, nothing can substitute for practice and experience.

With enough screen time, you can find a method that suits your trading personality in identifying retracements and reversals.

Protect Yo Self From Reversals

Whenever Happy Pip goes swimming at the beach or the pool, she always wears her hot pink rubber ducky floaters. Whenever she trades retracements, she uses stop loss points.

Pink rubber ducky floaters are **life savers**. Stop loss points are **capital savers**.



As we said before, reversals can happen at any time. Retracements can turn into reversals without warning.

This makes using trailing stops in trending environments very important. With trailing stop loss points, you can effectively prevent yourself from exiting a position too early during a retracement and exit a reversal in a pinch.

Conclusion

You don't have to be shot down by the "Smooth Retracement". You don't have to lose all those pips. And you most certainly don't need to wear pink arm floaties (although if pink's your favorite color, it's okay - we don't judge).

Just know how to distinguish retracements from reversals. This is part of growing up as a trader. Having the ability to do so will effectively reduce your losses and prevent winners from turning into losers.

With lots of practice and experience, you'll find yourself being able to trade accordingly to retracements and exit with a profit more times than not.

Trading Breakouts

What are breakouts and how can I take advantage of them?



Unlike the breakouts you might have had as a teenager, a breakout in the trading world is a little different!

A breakout occurs when the price "breaks out" (get it?) of some kind of consolidation or trading range.

A breakout can also occur when a specific price level is breached such as support and resistance levels, pivot points, Fibonacci levels, etc.

With breakout trades, the goal is to enter the market right when the price makes a breakout and then continue to ride the trade until volatility dies down.

Volatility, Not Volume



You'll notice that unlike trading stocks or futures, there is no way for you to see the volume of trades made in the forex market.

With stock or future trades, volume is essential for making good breakout trades so not having this data available in the forex leaves us at a disadvantage.

Because of this disadvantage, we have to rely not only on good risk management, but also on certain criteria in order to position ourselves for a good potential breakout.

If there is large price movement within a short amount of time then volatility would be considered high.

On the other hand, if there is relatively little movement in a short period of time then volatility would be considered low.

While it's tempting to get in the market when it is moving faster than a speeding bullet, you will often find yourself more stressed and anxious; making bad decisions as your money goes in and then goes right back out.

This high volatility is what attracts a lot of traders, but it's this same volatility that kills a lot of them as well.

The goal here is to use volatility to your advantage.

Rather than following the herd and trying to jump in when the market is super volatile, it would be better to look currency pairs with volatility that is very low.

This way, you can position yourself and be ready for when a breakout occurs and volatility flies out the roof!

Ways to Measure Volatility

Volatility is something that we can use when looking for good breakout trade opportunities.

Volatility measures the overall price fluctuations over a certain time and this information can be used to detect potential breakouts.

There are a few indicators that can help you gauge a pair's current volatility. Using these indicators can help you tremendously when looking for breakout opportunities.

1. Moving Average

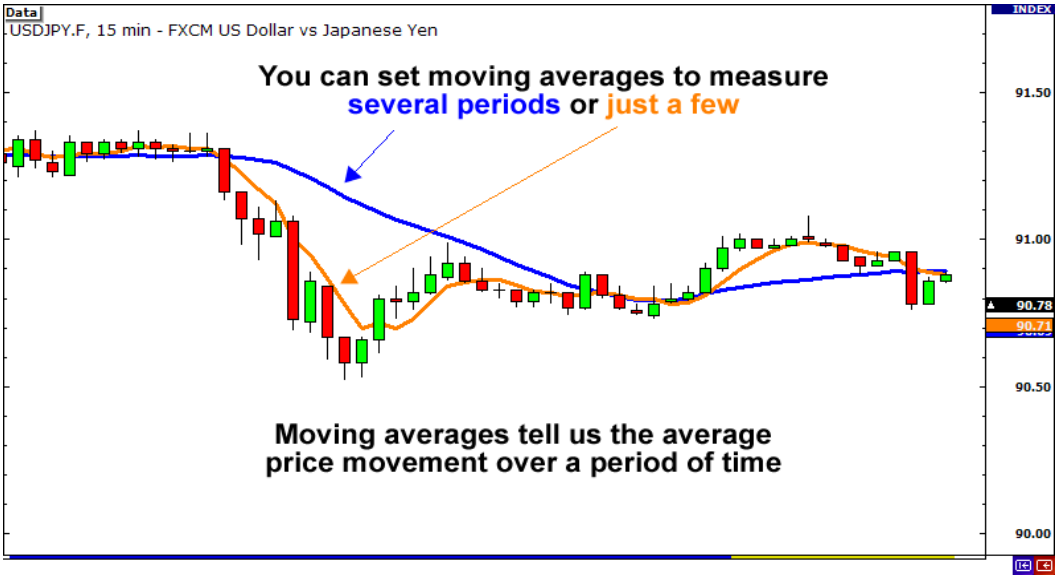
Moving averages are probably the most common indicator used by traders and although it is a simple tool, it provides invaluable data.

Simply put, moving averages measures the average movement of the market for an X amount of time, where X is whatever you want it to be.

For example if you applied a 20 SMA to a daily chart, it would show you the average movement for the past 20 days.

There are other types of moving averages such as exponential and weighted, but for the purpose of this lesson we won't go too much in detail on them.

For more information on moving averages or if you just need to refresh yourself on them, check out our lesson on moving averages.



2. Bollinger Bands

Bollinger bands are excellent tools for measuring volatility because that is exactly what it was designed to do.

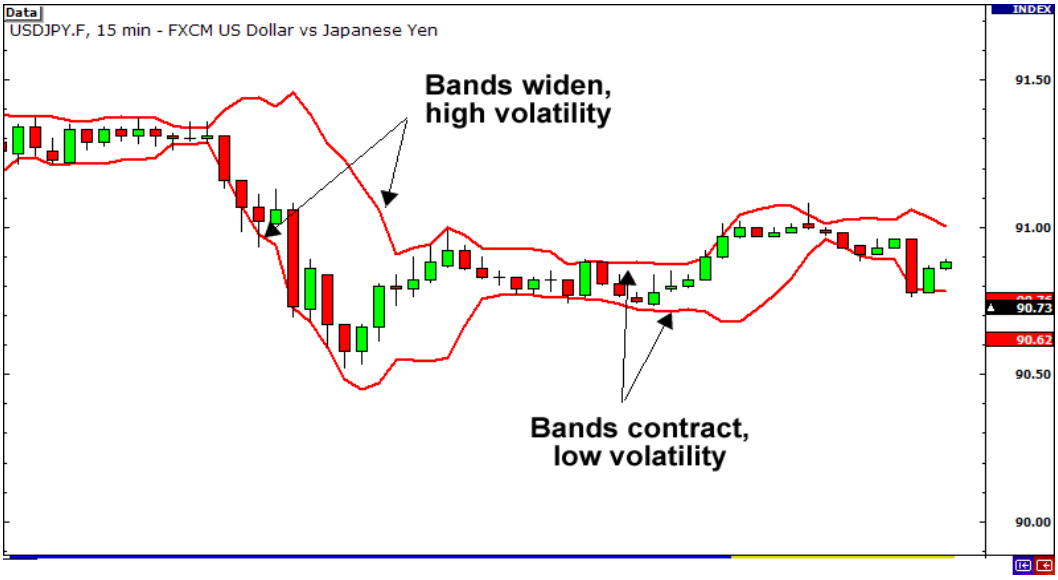
Bollinger bands are basically 2 lines that are plotted 2 standard deviations above and below a moving average for an X amount of time, where X is whatever you want it to be.

So if we set it at 20, we would have a 20 SMA and two other lines. One line would be plotted +2 standard deviations above it and the other line would be plotted -2 standard deviations below.

When the bands contract, it tells us that volatility is low.

When the bands widen, it tells us that volatility is high.

For a more thorough explanation, check out our Bollinger bands lesson.

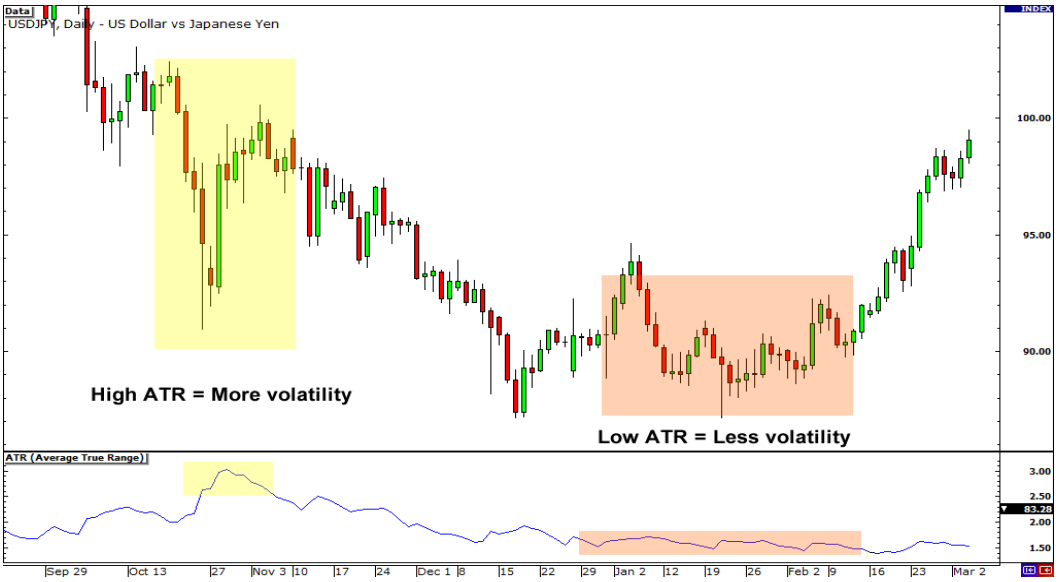


3. Average True Range (ATR)

Last on the list is the ATR.

The ATR is an excellent tool for measuring volatility because it tells us the average trading range of the market for X amount of time, where X is whatever you want it to be.

So if you set ATR to 20 on a daily chart, it would show you the average trading range for the past 20 days.



When ATR is falling, it is an indication that volatility is decreasing. When ATR is rising, it is an indication that volatility has been on the rise.

Types of Breakouts

When trading breakouts it is important to realize that there are two main types:

1. Continuation breakouts
2. Reversal breakouts

Knowing what type of breakout you are seeing will help you make sense of what is actually happening in the big picture of the market.

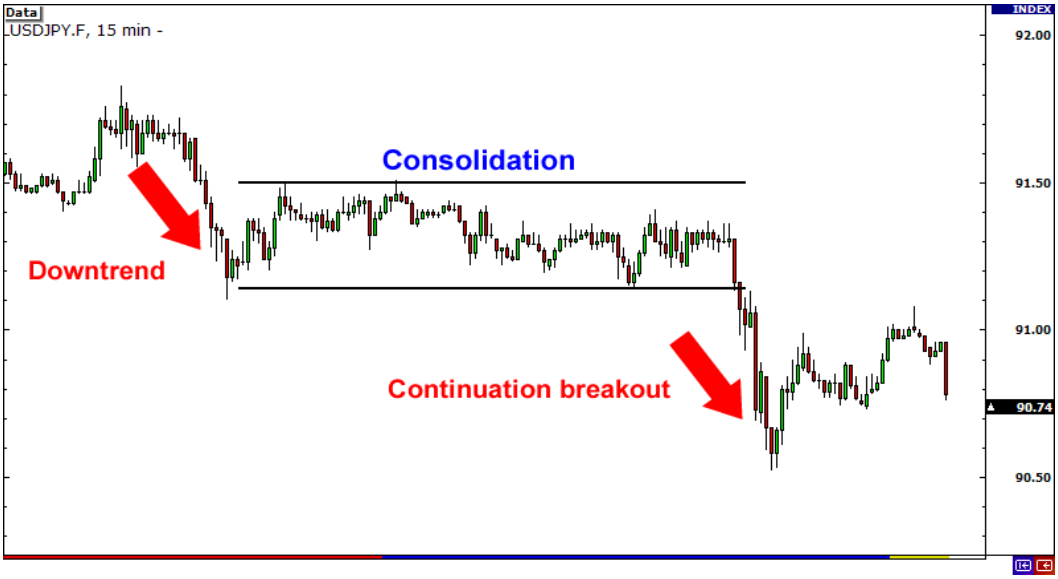
Breakouts are significant because they indicate a change in the supply and demand of the currency pair you are trading. This change in sentiment can cause extensive moves that provide excellent opportunities for you to grab some pips.

Continuation Breakouts

Sometimes when there is an extensive move in one direction the market will often take a breather. This occurs when buyers and sellers pause to see what they should do next. As a result, you will see a period of range-bound movement called consolidation.



If traders decide that the initial trend was the right decision, and continue to push the price in the same direction, the result is a continuation breakout. Just think of it as a "continuation" of the initial trend.... You're so smart!



Reversal Breakouts

Reversal breakouts start off the same way as continuation breakouts in the fact that after a long trend, there tends to be a pause or consolidation.



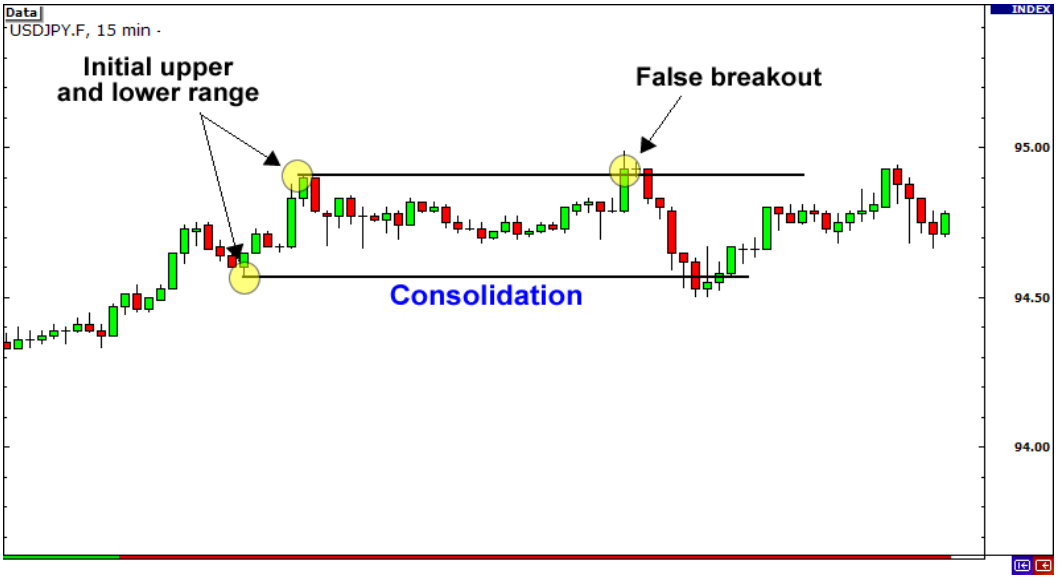
The only difference is that after this consolidation, traders decide that the trend is exhausted and push the price in the opposite or "reverse" direction. As a result, you have what is called a "reversal breakout". You catch on quick!



False Breakouts

Now we know by now you are super excited to start trading breakouts (please tell us you haven't already started trading!) but you also have to be careful. Just like Kobe Bryant can fake out defenders in the NBA, the market can fake you out as well producing false breakouts.

False breakouts occur when the price breaks past a certain level (support, resistance, triangle, trend line, etc.) but doesn't continue to accelerate in that direction. Instead, what you might've seen was a short spike followed by the price moving back into its trading range.



A good way to enter on a breakout is to wait until the price retraces back to the original breakout level and then wait to see if it bounces back to create a new high or low (depending on which direction you are trading).



Another way to combat fake outs is by not taking the first breakout you see. By waiting to see if the price will continue to move in your intended direction, you give yourself a better chance of taking a profitable trade. The downside to this is that you may miss out on some trades in which the price moves quickly without any hesitation.

Spotting Breakouts

Just like breakouts on your face, the nice thing about breakout trading is that opportunities are pretty easy to spot with the naked eye! Unlike the former, you don't even have to look in the mirror!

Once you start getting used to the signs of breakouts, you'll be able to spot good potential trades fairly quickly.

Chart Patterns

By now you should be accustomed to looking at charts and recognizing familiar patterns that indicate a reversal breakout. Here are just a few:

- Double Top/Bottom
- Head and Shoulders
- Triple Top/Bottom

For more information check out our lesson on chart patterns.

In addition to chart patterns there are several tools and indicators you can use to supplement your case for a reversal breakout.

Trend Lines

The first way to spot a possible breakout is to draw trend lines on a chart. To draw a trend line you simply look at a chart and draw a line that goes with the current trend.



When drawing trend lines it is best if you can connect at least two tops or bottoms together. The more tops or bottoms that connect, the stronger the trend line.

So how can you use trend lines to your advantage? When the price approaches your trend line, only two things can happen. The price could either bounce off the trend line and continue the trend OR price could breakout through the trend line and cause a reversal. We want to take advantage of that breakout!

Looking at the price is not enough however. This is where using one or more of the indicators mentioned earlier in this lesson could help you tremendously.



Notice that as EUR/USD broke the trend line MACD was showing bearish momentum. Using this information we can safely say that the breakout will continue to push the euro down and as traders, we should short this pair.

Channels

Another way to spot breakout opportunities is to draw trend channels. Drawing trend channels are almost the same as drawing trend lines except that after you draw a trend line you have to add the other side.



Channels are useful because you can spot breakouts on either direction of the trend. The approach is similar to how we approach trend lines in that we wait for the price to reach one of the channel lines and look at the indicators to help us make our decision.



Notice that the MACD was showing strong bearish momentum as EUR/USD broke below the lower line of the trend channel. This would've been a good sign to go short!

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Triangles

The third way you can spot breakout opportunities is by looking for triangles. Triangles are formed when the market price starts off volatile and begins to consolidate into a tight range. Our goal is to position ourselves when the market consolidates so that we can capture a move when a breakout occurs.

There are 3 types of triangles:

1. Ascending triangle
2. Descending triangle
3. Symmetrical triangle

Ascending Triangles

Ascending triangles form when there is a resistance level and the market price continues to make higher lows. This is a sign that the bulls are slowly starting to gain momentum over the bears.

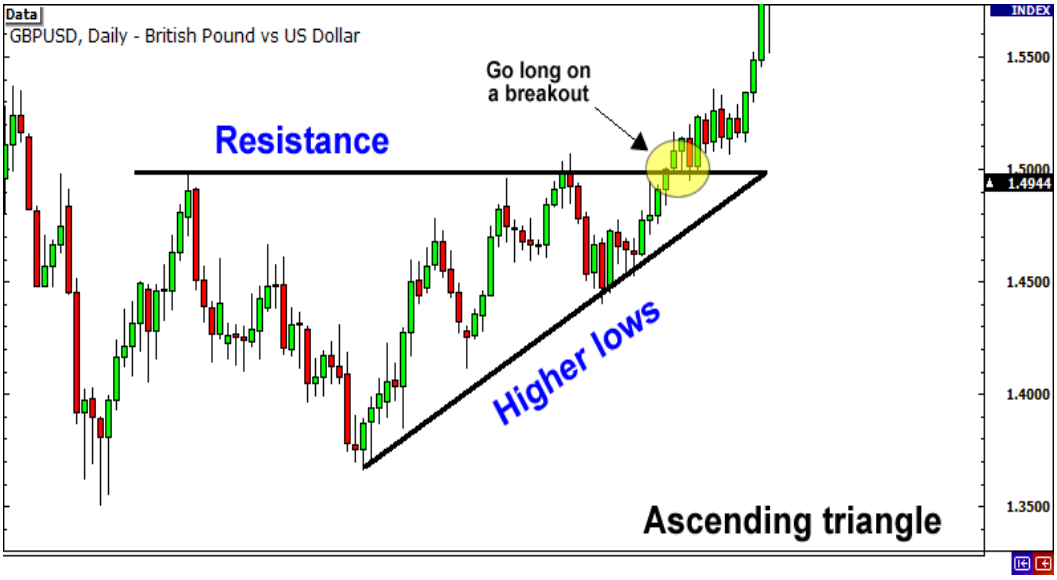


The story behind an ascending triangle is that each time the price reaches a certain high, there are several traders who are convinced about selling at that level, resulting in the price dropping back down.

On the other side, there are several traders who believe the price should be higher, and as the price begins to drop, buy higher than its previous low. The result is a struggle between the bulls and bears which ultimately converges into an ultimate showdown...

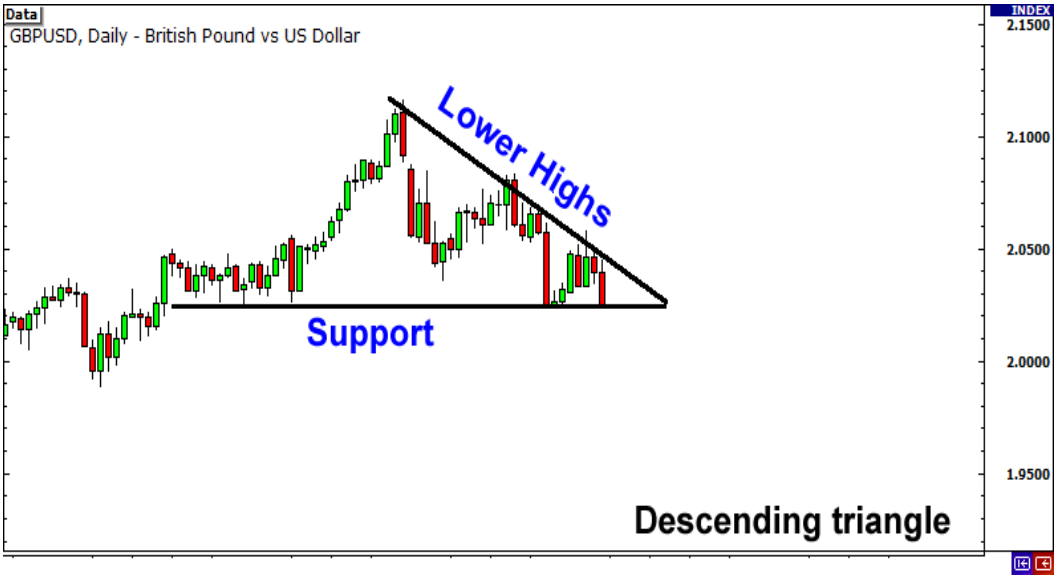


What we are looking for is a breakout to the upside since ascending triangles are generally bullish signals. When we see a breach of the resistance level the proper decision would be to go long.

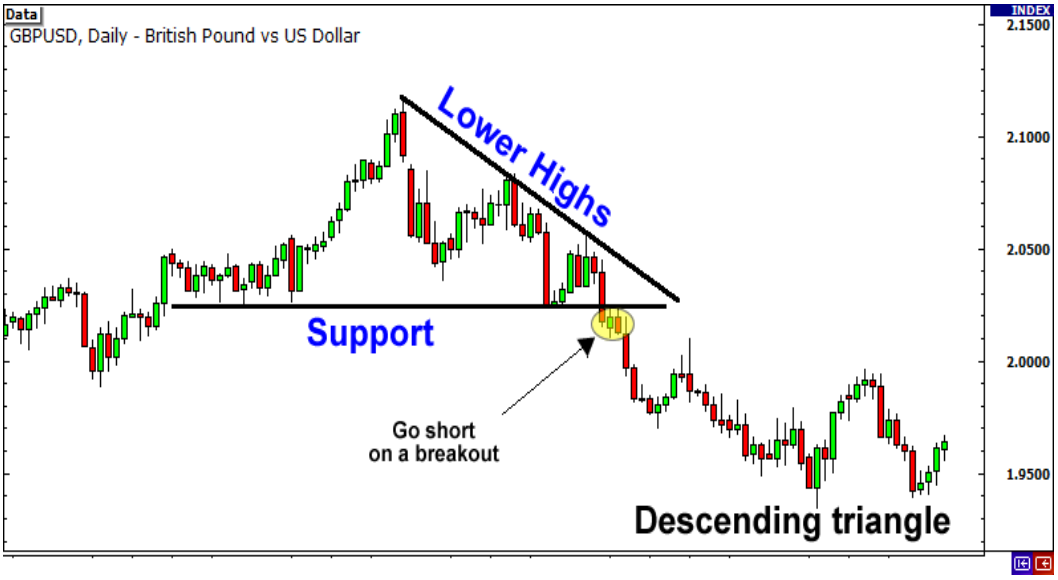


Descending Triangles

Descending triangles are basically the opposite of ascending triangles. Sellers are continuing to put pressure on the buyers, and as a result, we start to see lower highs met by a strong support level.

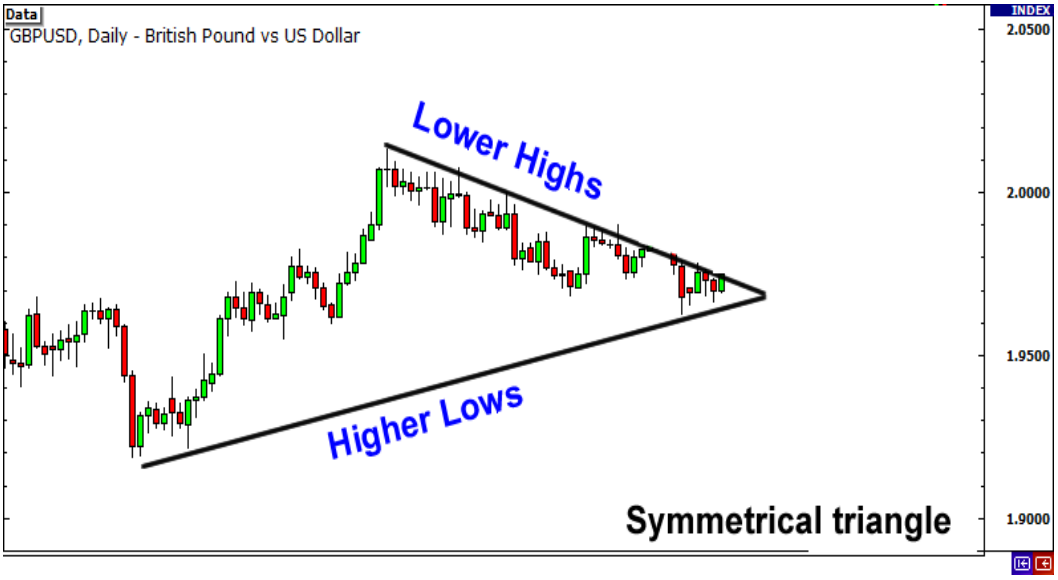


Descending triangles are generally bearish signals. To take advantage of this, our goal is to position ourselves to go short if the price should breakout below the support level.

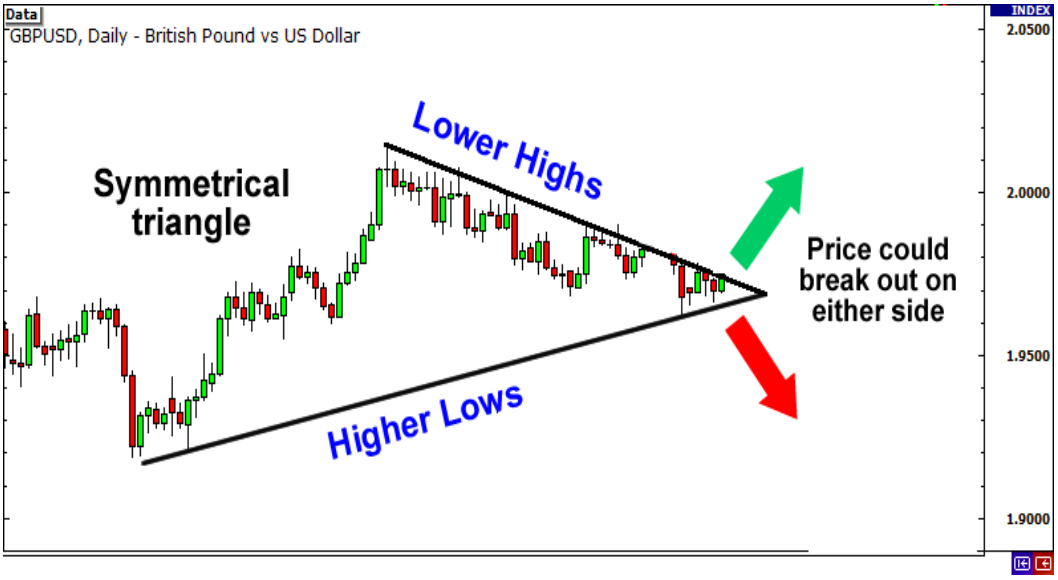


Symmetrical Triangles

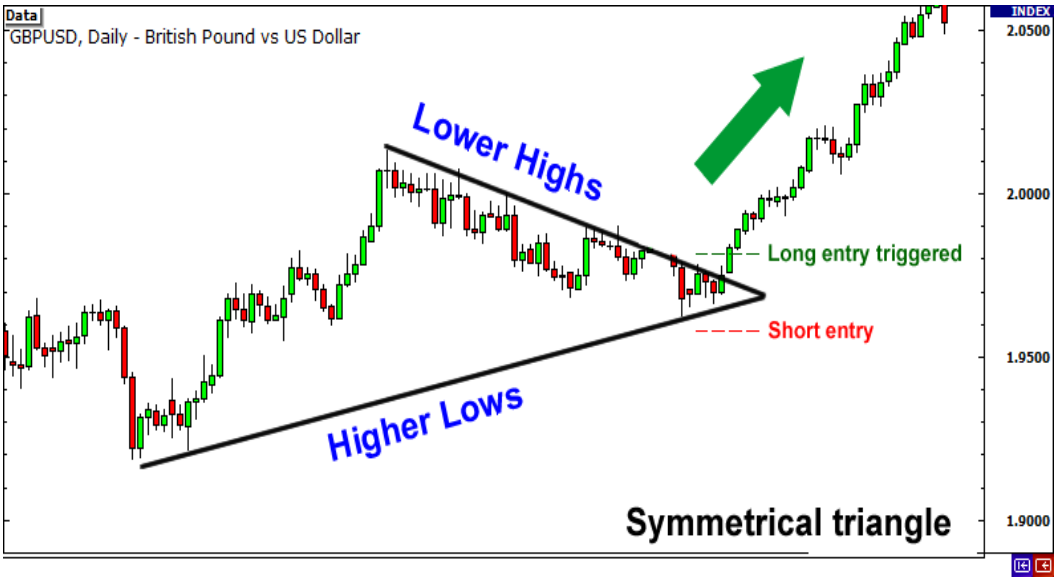
The third type of triangle is the symmetrical triangle. Rather than having a horizontal support or resistance level, both the bulls and the bears create higher lows and lower highs and form an apex somewhere in the middle.



Unlike the ascending and descending triangles which are generally bullish and bearish signals, symmetrical triangles have NO directional bias. You must be ready to trade a breakout on either side!



In the case of the symmetrical triangle, you want to position yourself to be ready for both an upside or downside breakout. A perfect time to use the one-cancels-the-other (OCO) order! Don't remember what an OCO order is? Go review your types of orders!



In this scenario, GBP/USD broke out on the upside and our long entry was triggered.

Breaking down the Triangle Breakouts

To help you memorize the different types of triangle breakouts, just think of facial breakouts.

Ascending triangles usually breakout to the upside. So when you think of ascending triangles, think of breaking out on your forehead.

Descending triangles usually breakout to the downside. So when you think of descending triangles, think of breaking out on your chin.

Symmetrical triangles can break either to the upside or the downside. So when you think of symmetrical triangles, think of breaking out on both your chin and forehead.



Here's a quick and disgusting memory tickler:

Ascending triangle = Forehead breakout

Descending triangle = Chin breakout

Symmetrical triangle = Forehead OR chin breakout

EWWWW!!!!

Gross eh? But we bet you'll remember it!

Measuring the Strength of the Breakout

As you learned earlier, when a trend moves for an extended period of time and it starts to consolidate, one of two things could happen:

1. The price could continue in the same direction (continuation breakout)
2. The price could reverse in the opposite direction (reversal breakout)

Wouldn't it be nice if there was a way to know to confirm a breakout? If only there was a way to avoid fake outs...

Hmmm...

You guessed it.... THERE IS A WAY!

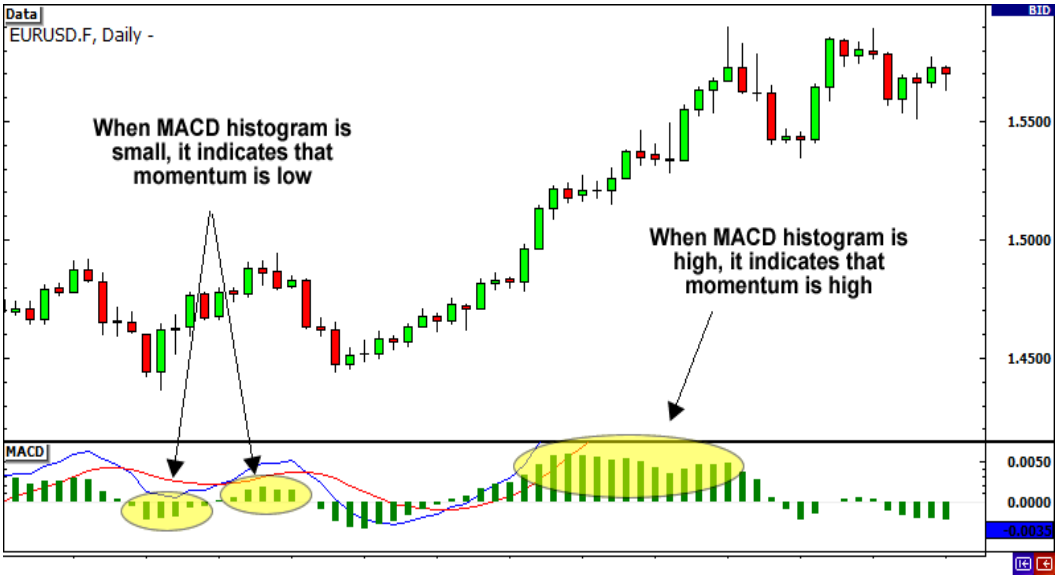
In fact, there are a couple of ways to tell whether or not a trend seems to be nearing its demise and a reversal breakout is in order.

Moving Average Convergence/Divergence (MACD)

By now you should have a good foundation of the MACD indicator. If you don't, you might want to check out our lesson on MACD.

MACD is one of the most common indicators used by traders and for good reason. It is simple yet dependable and can help you find momentum, and in this case, the lack of momentum!

MACD can be displayed in several ways but one of the "sexiest" ways is to look at it as a histogram. What this histogram does is actually show the difference between the slow and fast MACD line. When the histogram gets bigger, it means momentum is getting stronger. When the histogram gets smaller, it means momentum is getting weaker.



So how can we use this when trying to spot a trend reversal? Glad you asked!

Remember that trading signal we talked about earlier called divergences and how it occurs when the price and indicators move in the opposite direction? Since MACD shows us momentum it would make sense that momentum would increase as the market makes a trend. However, if MACD begins to decrease even when the trend is continuing, you can deduce that momentum is decreasing and this trend could be close to an end.



You can see from the picture that as price was moving higher, MACD was getting smaller. This meant that even as the price was still trending, momentum was beginning to fade out. From this information, we can conclude that a trend reversal is highly likely.

Relative Strength Index (RSI)

RSI is another momentum indicator that is useful for confirming reversal breakouts. Basically this indicator tells us the changes between higher and lower closing prices for a given period of time. We won't go into too much detail about it but if you would like to know more check out our lesson on RSI.

RSI can be used in a similar way to MACD in that it also produces divergences. By spotting these divergences, you can find possible trend reversals.



However, RSI is also good for seeing how long a trend has been overbought of oversold. A common indication of whether a market is overbought is if the RSI is above 70. On the flipside, a common indication of whether a market is oversold is if the RSI is below 30.

Because trends are movements in the same direction for an extended period of time, you will often see RSI move into overbought/oversold territory, depending on the direction of the trend.

If a trend has produced oversold or overbought readings for an extended period of time and begins to move back within the range of the RSI, it is a good indication that the trend may be reversing.



In the same example as before, the RSI showed that the market was overbought for a billion days (ok not that long). Once RSI moved back below 70, it was good indication that the trend was about to reverse.

Trading Fakeouts

Breakouts are popular among traders.

It makes sense right?

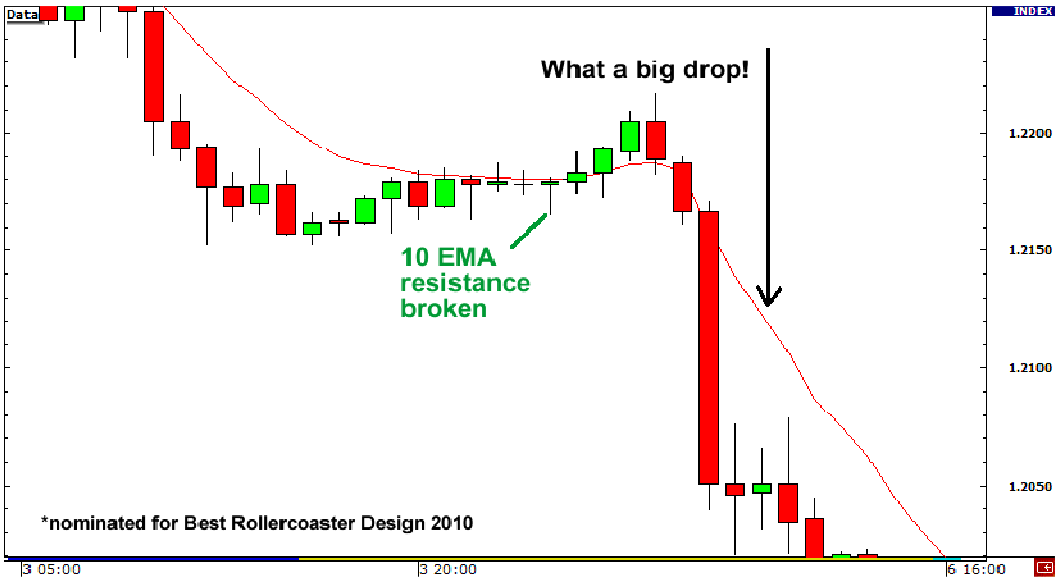
When price finally "breaks" out of that support or resistance level, one would expect price to keep moving in the same direction of the break. There must have been enough momentum building up in order for price to have broken out of the level, right?

It's time to hop aboard that train. It's all smooth sailing now. All you have to do is just wait for it...

Yes, wait for it...



Wait for it... Just a few more moments... Too see price inch one direction... Then suddenly move miles in the opposite direction!



Huh?!? What the heck?! What happened to "the bread and butter and the end of world hunger" strategy?

End of story: You are left eating ketchup packets and crackers like Tom Hanks in The Terminal.

One thing you should remember to note about support and resistance levels is that they are areas in which a predictable price response can be expected.

Support levels are areas where buying pressure is just enough to overcome selling pressure and halt or reverse a downtrend.

A strong support level is more likely to hold up even if price breaks the support level and it provides traders a good buying opportunity.

Resistance levels are just like support levels but work in the opposite way. They tend to halt or even reverse uptrends.

Resistance levels are areas in which selling pressure is just enough to overcome buying pressure and force price back down.

Strong resistance levels are more like to hold up even if price breaks the resistance level and it provides traders a good selling opportunity.

In the next section, we will dive deeper into fakeouts and discuss why we should trade them and how to profit off them.

It's not enough learning about breakout strategies because there will be times that breakouts fail. We have to know what to do in case of fake outs.

This is part of your Jedi forex training. To be a Jedi master, you must be able to master fakeouts.

Are you up for it?

Fade the Breakout

Fade the breakout you say? Was that just a typo? Did you mean to say, "trade the breakout"?

Nope!

Fading breakouts simply means trading in the opposite direction of the breakout.

Fading breakouts = trading false breakouts.

You would fade a breakout if you believe that a breakout from a support or resistance level is false and unable to keep moving in the same direction. In cases in which the support or resistance level broken is significant, fading breakouts may prove to be smarter than trading the breakout.

Keep in mind that fading breakouts is a great short-term strategy. Breakouts tend to fail at the first few attempts but may succeed eventually.

REPEAT: Fading breakouts is a great short-term strategy. It is not a great one to use for longer term traders. By learning trade false breakouts, also known as fakeouts, you can avoid getting whipsawed.

Trading breakouts appeal to many independent traders. Why?

Support and resistance levels are supposed to be price floors and ceilings. If these levels are broken, one would expect for price to continue in the same direction as the breakage.

If a support level is broken, that means that the general price movement is downwards and people are more likely to sell than buy.

Conversely, if a resistance level is broken, then the crowd believes that price is more likely to rally even higher and will tend to buy rather than sell.

Independent retail traders have greedy mentalities. They believe in trading in the direction of the breakout. They believe in huge gains on huge moves. Catch the big fish, forget the small fries.

In a perfect world, this would be true. But the world is not perfect. Frogs and princesses do not live happily ever after. What does in fact happen is that most breakouts FAIL.

Breakouts fail simply because the smart minority has to make money off the majority. Don't feel so bad. The smart minority tends to be comprised of the big players with huge accounts and buy/sell orders.

In order to sell something, there must be a buyer. However, if everyone wants to buy above a resistance level or sell below a support level, the market maker has to take the other side of the equation. And let us warn you: the market maker ain't no fool.



Retail traders like to trade breakouts.

The smart minority, the institutional, more seasoned traders, prefer to fade breakouts.

The smarter traders take advantage of the collective thinking of the crowd or inexperienced traders and win at their expense. That is why trading alongside the more experienced traders could be very profitable as well.

Which would you rather be part of: the smart minority that fades breakouts or the losing majority that gets caught in false breakouts?

How to Trade Fakeouts

In order to fade breakouts, you need to know where potential fake outs can occur.

Potential fake outs are usually found at support and resistance levels created through trend lines, chart patterns, or previous daily highs or lows.

Trend lines

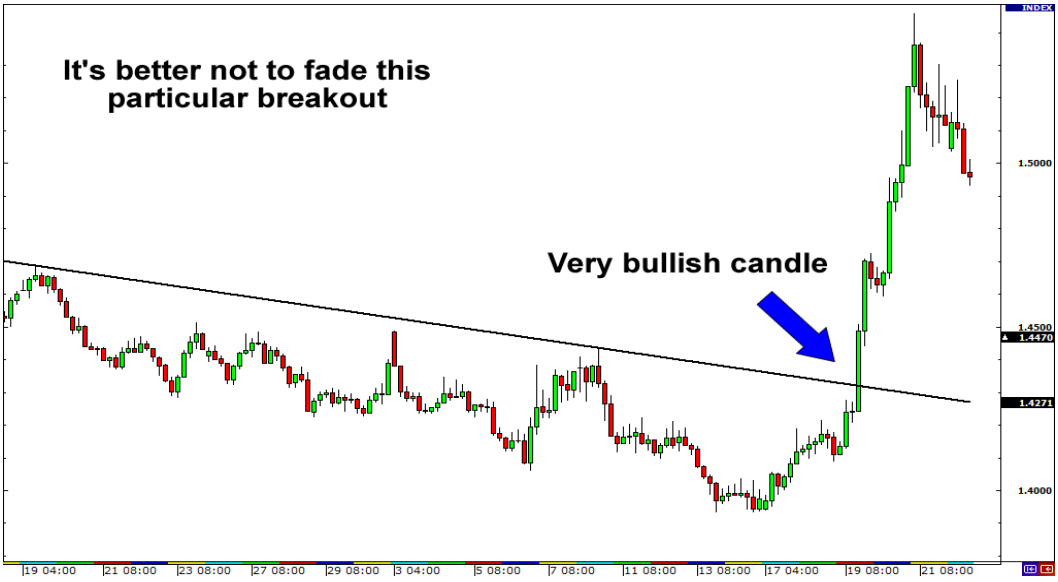
In fading breakouts, always remember that there should be SPACE between the trend line and price.

If there is a gap between the trend line and price, it means price is heading more in the direction of the trend and away from the trend line. Like in the example below, having space between the trend line and price allows price to retrace back towards the trend line, perhaps even breaking it, and provide fading opportunities.



The SPEED of price movement is also very important.

If price is inching like a caterpillar towards the trend line, a false breakout may be likely. However, a fast price movement towards the trend line could prove to be a successful breakout. With a high price movement speed, momentum can carry price past the trend line and beyond. In this situation, it is better to step back from fading the breakout.



How do we fade trend line breaks?

It's very simple actually. Just enter when price pops back inside.

This will allow you to take the safe route and avoid jumping the gun. You don't want sell above or below a trend line only to find out later that the breakout was real!

Using the first chart example, let's point out possible entry points by zooming in a little.



Chart Patterns

Chart patterns are physical groupings of price you can actually see with your own eyes. They are an important part of technical analysis and also help you in your decision-making process.

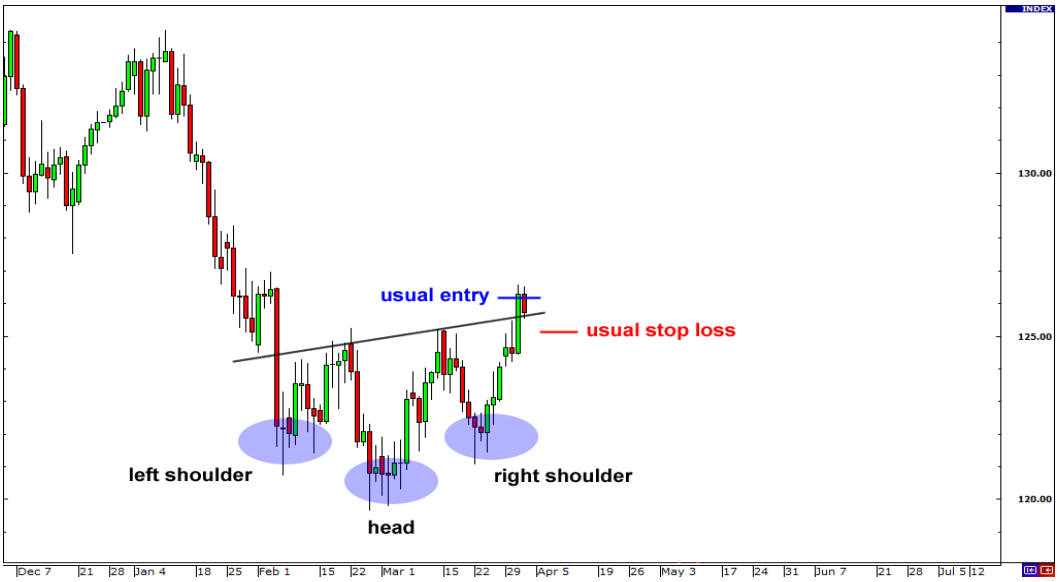
Two common patterns where false breakouts tend to occur are:

- Head and Shoulders
- Double Top/Bottom

The **head and shoulders** chart pattern is actually one of the hardest patterns for new traders to spot. However, with time and experience, this pattern can become an instrumental part of your trading arsenal.

The head and shoulders pattern is considered a reversal. If formed at the end of an uptrend, it could signal a bearish reversal. Conversely, if it is formed the end of a downtrend, it could signal a bullish reversal. Head and shoulders are known for generating false breakouts and creating perfect opportunities for fading breakouts.

False breakouts are common with this pattern because many traders who have noticed this formation usually put their stop loss very near the neckline.



When the pattern experiences a false breakout, prices will usually rebound. Traders who have sold the downside breakout or who have bought the upside breakout will have their stops triggered when prices move against their positions. This usually is caused by the institutional traders who want to scrape money from the hands of individual traders.



In a head and shoulders pattern, you can assume that the first break tends to be false.

You can fade the breakout with a limit order back in the neckline and just put your stop above the high of the fake out candle.

You could place your target a little below the high of the second shoulder or a little above the low of the second shoulder of the inverse pattern.

The next pattern is the **double top** or the **double bottom**.

Traders just love these patterns! Why you ask? Well it is because they're the easiest to spot!

When price breaks below the neckline, it signals a possible trend reversal. Because of this, plenty of traders place their entry orders very near the neckline in case of a reversal.



The problem with these chart patterns is that countless traders know them and place orders at similar positions. This leaves the institutional traders open to scrape money from the commoner's hands.



Similar to the head and shoulders pattern, you can place your order once price goes back in to catch the bounce. You can set your stops just beyond the fake out candle.

What kind of market should I fade breakouts?

The best results tend to occur in a **range-bound market**. However, you cannot ignore market sentiment, major news events, common sense, and other types of market analysis.

Financial markets spend a lot time bouncing back and forth between a range of prices and do not deviate much from these highs and lows.

Ranges are bound by a support level and a resistance level, and buyers and sellers continually push prices up and down within those levels. Fading the breakouts in these range-bound environments can prove to be very profitable. However at some point, one side is eventually going to take over and a new trending stage will form.

Summary: Trading Breakouts and Fakeouts

Trading Breakouts

With breakout trades, the goal is to enter the market right when the price makes a breakout and then continue to ride the trade until volatility dies down.

Breakouts are significant because they indicate a change in the supply and demand of the currency pair you are trading.

You'll notice that unlike trading stocks or futures, there is no way for you to see the volume of trades made in the forex. Because of this, we need to rely on volatility.

Volatility measures the overall price fluctuations over a certain time and this information can be used to detect potential breakouts.

There are a few indicators that can help you gauge a pair's current volatility. Using these indicators can help you tremendously when looking for breakout opportunities.

- Moving Averages
- Bollinger Bands
- Average True Range (ATR)

There are two types of breakouts:

- Continuation
- Reversal

To spot breakouts, you can look at:

- Chart Patterns
- Trend lines
- Channels
- Triangles

You can measure the strength of a breakout using the following:

- Moving Average Convergence/Divergence (MACD)
- RSI

Finally, breakouts usually work best and FOR REAL with some kind of economic event or news catalyst. Always be sure to check the forex calendar and news before figuring out whether or not a breakout trade is the right play for the situation.

Trading Fakeouts

Institutional traders like to fade breakouts. So we must like to fade breakouts also.
Are you going to follow the crowd, or are you going to follow the money?

Think, act, eat, sleep, and watch the same movies as these guys do. If we can trade in the same way the institutional players do, success is just a glimpse away.

Fading breakouts simply means trading in the opposite direction as the breakout. You would fade a breakout if you believe that a breakout from a support or resistance level is false and unable to keep moving in the same direction.

In cases in which the support or resistance level broken is significant, fading breakouts may prove to be smarter than trading the breakout.

Potential fake outs are usually found at support and resistance levels created through **trend lines**, **chart patterns**, or **previous daily highs** or **lows**.

The best results tend to occur in a **range-bound market**. However, you cannot ignore market sentiment, common sense, and other types of market analysis.

Financial markets spend a lot time bouncing back and forth between a range of prices and do not deviate much from these highs and lows.

Finally, the odds of a fake out are higher when there is no major economic event or news catalyst to shift traders' sentiment in the direction of the break.

What is Fundamental Analysis?

Along your travels, you've undoubtedly come across Gulliver, Frodo, and the topic of fundamental analysis.

Wait a minute...

We've already given you a teaser about fundamental analysis during Kindergarten! Now let's get to the nitty-gritty!

What is it exactly and will I need to use it? Well, fundamental analysis is the study of fundamentals! That was easy, wasn't it? Ha! Gotcha!

There's really more to it than that. Soooo much more.

Whenever you hear people mention fundamentals, they're really talking about the economic fundamentals of a currency's host country or economy.

Economic fundamentals cover a vast collection of information - whether in the form of economic, political or environmental reports, data, announcements or events.

Fundamental analysis is the use and study of these factors to forecast future price movements of currencies.

It is the study of what's going on in the world and around us, economically and financially speaking, and it tends to focus on how macroeconomic elements (such as the growth of the economy, inflation, unemployment) affect whatever we're trading.

Fundamental Data and Its Many Forms

In particular, fundamental analysis provides insight into how price action "should" or may react to a certain economic event.

Fundamental data takes shape in many different forms.

It can appear as a report released by the Fed on U.S. existing home sales. It can also exist in the possibility that the European Central Bank will change its monetary policy.

The release of this data to the public often changes the economic landscape (or better yet, the economic mindset), creating a reaction from investors and speculators.

There are even instances when no specific report has been released, but the anticipation of such a report happening is another example of fundamentals.

Speculations of interest rate hikes can be "priced in" hours or even days before the actual interest rate statement.

In fact, currency pairs have been known to sometimes move 100 pips just moments before major economic news, making for a profitable time to trade for the brave.

That's why many traders are often on their toes prior to certain economic releases and you should be too!

Generally, economic indicators make up a large portion of data used in fundamental analysis. Like a fire alarm sounding when it detects smoke or feels heat, economic indicators provide some insight into how well a country's economy is doing.

While it's important to know the numerical value of an indicator, equally as important is the market's anticipation and prediction of that value.

Understanding the resulting impact of the actual figure in relation to the forecasted figure is the most important part. These factors all need consideration when deciding to trade.

Phew!

Don't worry. It's simpler than it sounds and you won't need to know rocket science to figure it all out.

Fundamental analysis is a valuable tool in estimating the **future conditions of an economy**, but not so much for **predicting currency price direction**.

This type of analysis has a lot of gray areas because fundamental information in the form of reports releases or monetary policy change announcements is vaguer than actual technical indicators.

Analysis of economic releases and reports of fundamental data usually go something like this:

"An interest rate increase of that percentage MAY cause the euro to go up."

"The U.S. dollar SHOULD go down with an indicator value in that range."

"Consumer confidence dipped 2% since the last report."

Here's an Economic Report, Now What?

The market has a tendency to react based on how people feel. These feelings can be based on their reaction to economic reports, based on their assessment of current market conditions.

And you guessed it - there are tons of people, all with different feelings and ideas.

You're probably thinking "Geez, there's a lot of uncertainty in fundamental analysis!"

You're actually very right.

There's no way of knowing 100% where a currency pair will go because of some new fundamental data.

That's not saying that fundamental analysis should be dismissed.

Not at all.

Because of the sheer volume of fundamental data available, most people simply have a hard time putting it all together.

They understand a specific report, but can't factor it into the broader economic picture. This simply takes time and a deeper understanding of the data.

Also, since most fundamental data are reported only for a single currency, fundamental data for the other currency in the pair would also be needed and would then have to be compared to get an accurate picture.

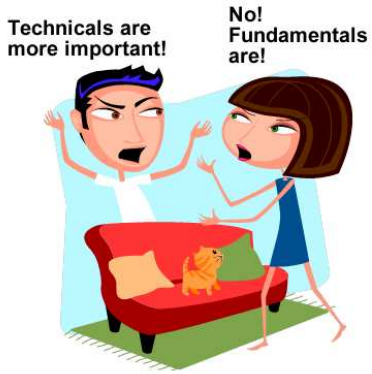
As we mentioned from the get-go, it's all about pairing a strong currency with a weak one.

At this point, you're probably still waiting for the answer to "Will I ever need to use fundamental analysis to become a successful trader?"

We totally understand that there are purists on both sides.

Technical analysis seems to be the preferred methodology of short-term traders, with price action as their main focus.

Intermediate or medium traders and some long-term traders like to focus on fundamental analysis too because it helps with currency valuation.



We like to be a little crazy by saying you should use BOTH!

Technically-focused strategies are blown to bits when a key fundamental event occurs. In the same respect, pure fundamental traders miss out on the short term opportunities that pattern formations and technical levels bring.

A mix of technical and fundamental analysis covers all angles. You're aware of the scheduled economic releases and events, but you can also identify and use the various technical tools and patterns that market players focus on.

There's your answer!

Happy?!

In this lesson, we'll discuss the major fundamental factors that affect currencies. These are interest rates, monetary policies, and market-moving economic reports.

Interest Rates 101

Simply put, interest rates make the forex world go 'round! In other words, the forex market is ruled by interest rates.

A currency's interest rate is probably the biggest factor in determining the perceived value of a currency. So knowing how a country's central bank sets its monetary policy, such as interest rate decisions, is a crucial thing to wrap your head around.

One of the biggest influences on a central bank's interest rate decision is price stability, or "inflation".

Inflation is a steady increase in the prices of goods and services.

Inflation is the reason why your parents or your parents' parents paid a nickel for a soda pop in the 1920's, but now people pay twenty times more for the same product.

It's generally accepted that moderate inflation comes with economic growth.

However, too much inflation can harm an economy and that's why central banks are always keeping a watchful eye on inflation-related economic indicators, such as the CPI and PCE.

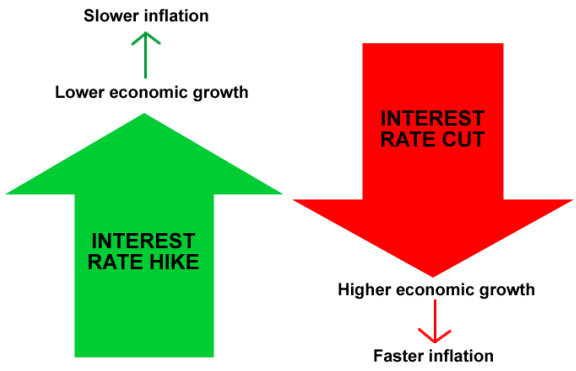
Country	Central Bank
Australia	Reserve Bank of Australia (RBA)
Canada	Bank of Canada (BOC)
European Union	European Central Bank (ECB)
Japan	Bank of Japan (BOJ)
New Zealand	Reserve Bank of New Zealand (RBNZ)
Switzerland	Swiss National Bank (SNB)
United Kingdom	Bank of England (BOE)
United States	Federal Reserve (Fed)

In an effort to keep inflation at a comfortable level, central banks will mostly likely increase interest rates, resulting in lower overall growth and slower inflation.

This occurs because setting high interest rates normally forces consumers and businesses to borrow less and save more, putting a damper on economic activity. Loans just become more expensive while sitting on cash becomes more attractive.

On the other hand, when interest rates are decreasing, consumers and businesses are more inclined to borrow (because banks ease lending requirements), boosting retail and capital spending, thus helping the economy to grow.

Yippee!



What does this have to do with the forex market?

Well, currencies rely on interest rates because these dictate the flow of global capital into and out of a country. They're what investors use to determine if they'll invest in a country or go elsewhere.

For instance, if you had your choice between a savings account offering 1% interest and another offering .25%, which would you choose?

Neither, you say?

Yea, we're inclined to go the same route - keep the money under the mattress, ya know what we mean? - but that's not an option.

Ha! You would pick the 1%, right?

We hope so... because 1 is bigger than 0.25. Currencies work the same way!

The higher a country's interest rate, the more likely its currency will strengthen. Currencies surrounded by lower interest rates are more likely to weaken over the longer term.

Pretty simple stuff.

The main point to be learned here is that domestic interest rates directly affect how global market players feel about a currency's value relative to another.

Interest rate expectations

Markets are ever-changing with the anticipation of different events and situations. Interest rates do the same thing - they change - but they definitely don't change as often.

Most traders don't spend their time focused on current interest rates because the market has already "priced" them into the currency price. What is more important is where interest rates are **EXPECTED** to go.

It's also important to know that interest rates tend to shift in line with monetary policy, or more specifically, with the end of monetary cycles.

If rates have been going lower and lower over a period a time, it's almost inevitable that the opposite will happen.

Rates will have to increase at some point.

And you can count on the speculators to try to figure out when that will happen and by how much.

The market will tell them; it's the nature of the beast. A shift in expectations is a signal that a shift in speculation will start, gaining more momentum as the interest rate change nears.

While interest rates change with the gradual shift of monetary policy, market sentiment can also change rather suddenly from just a single report.

This causes interest rates to change in a more drastic fashion or even in the opposite direction as originally anticipated.

So you better watch out!

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Rate Differentials

Pick a pair, any pair.

Many forex traders use a technique of comparing one currency's interest rate to another currency's interest rate as the starting point for deciding whether a currency may weaken or strengthen.

The difference between the two interest rates, known as the "interest rate differential," is the key value to keep an eye on. This spread can help you identify shifts in currencies that might not be obvious.

An interest rate differential that increases helps to reinforce the higher-yielding currency, while a narrowing differential is positive for the lower-yielding currency.

Instances where the interest rates of the two countries move in opposite directions often produce some of the market's largest swing.

An interest rate increase in one currency combined with the interest rate decrease of the other currency is a perfect equation for sharp swings!

Nominal vs. Real

When people talk about interest rates, they are either referring to the nominal interest rate or the real interest rate.

What's the difference?

The nominal interest rate doesn't always tell the entire story. The nominal interest rate is the rate of interest before adjustments for inflation.

real interest rate = nominal interest rate - expected inflation

The nominal rate is usually the stated or base rate that you see (e.g., the yield on a bond).

Markets, on the other hand, don't focus on this rate, but rather on the real interest rate.

If you had a bond that carried a nominal yield of 6%, but inflation was at an annual rate of 5%, the bond's real yield would be 1%.

Boohoo!

That's a huge difference so always remember to distinguish between the two.

411 on Monetary Policy

As we mentioned earlier, national governments and their corresponding central banking authorities formulate monetary policy to achieve certain economic mandates or goals.

Central banks and monetary policy go hand-in-hand, so you can't talk about one without talking about the other.

While some of these mandates and goals are shared by the different central banks. Central banks have their own unique set of goals brought on by their distinctive economies.

Ultimately, monetary policy boils down to promoting and maintaining price stability and economic growth.

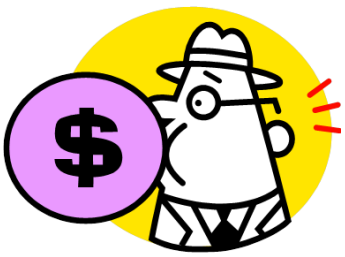
To achieve their goals, central banks use monetary policy mainly to control the following:

- the interest rates tied to the cost of money,
- the rise in inflation,
- the money supply,
- reserve requirements over banks,
- and discount window lending to commercial banks

Types of Monetary Policy

Monetary policy can be referred to in a couple different ways. **Contractionary** or **restrictive monetary policy** takes place if it reduces the size of the money supply. It can also occur with the raising of interest rates.

The idea here is to slow economic growth with the high interest rates. Borrowing money becomes harder and more expensive, which reduces spending and investment by both consumers and businesses.



Expansionary monetary policy, on the other hand, expands or increases the money supply, or decreases the interest rate.

The cost of borrowing money goes down in hopes that spending and investment will go up.

Accommodative monetary policy aims to create economic growth by lowering the interest rate, whereas tight monetary policy is set to reduce inflation or restrain economic growth by raising interest rates.

Finally, neutral monetary policy intends to neither create growth nor fight inflation.

The important thing to remember about inflation is that central banks usually have an inflation target in mind, say 2%.

They might not come out and say it specifically, but their monetary policies all operate and focus on reaching this comfort zone.

They know that some inflation is a good thing, but out-of-control inflation can remove the confidence people have in their economy, their job, and ultimately, their money.

By having target inflation levels, central banks help market participants better understand how they (the central bankers) will deal with the current economic landscape.

Let's take a look at an example.

Back in January of 2010, inflation in the U.K. shot up to 3.5% from 2.9% in just one month. With a target inflation rate of 2%, the new 3.5% rate was well above the Bank of England's comfort zone.

Mervyn King, the governor of the BOE, followed up the report by reassuring people that temporary factors caused the sudden jump, and that the current inflation rate would fall in the near term with minimal action from the BOE.

Whether or not his statements turned out to be true is not the point here. We just want to show that the market is in a better place when it knows why the central bank does or doesn't do something in relation to its target interest rate.

Simply put, traders like stability.

Central banks like stability.

Economies like stability. Knowing that inflation targets exist will help a trader to understand why a central bank does what it does.

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Round and Round with Policy Cycles

For those of you that follow the U.S. dollar and economy (and that should be all of you!), remember a few years back when the Fed increased interest rates by 10% out of the blue?

It was the craziest thing to come out of the Fed ever, and the financial world was in an uproar!

Wait, you don't remember this happening?

It was all over the media.

Petroleum prices went through the roof and milk was priced like gold.

You must have been sleeping!

Oh wait, we were just pulling your leg!

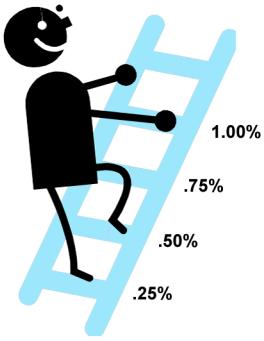
We just wanted to make sure you were still awake. Monetary policy would never dramatically change like that.

Most policy changes are made in small, incremental adjustments because the bigwigs at the central banks would have utter chaos on their hands if interest rates changed too radically.

Just the idea of something like happening would disrupt not only the individual trader, but the economy as a whole.

That's why we normally see interest rate changes of .25% to 1% at a time. Again, remember that central banks want price stability, not shock and awe.

Part of this stability comes with the amount of time needed to make these interest rate changes happen. It can take several months to even several years.



Just like traders who collect and study data to make their next move, central bankers do a similar job, but they have to focus their decision-making with the entire economy in mind, not just a single trade.

Interest rate hikes can be like stepping on the accelerator while interest rate cuts can be like hitting the brakes, but bear in mind that consumers and business react a little more slowly to these changes.

This lag time between the change in monetary policy and the actual effect on the economy can take one to two years.

The Who's Who of the Central Bank

We just learned that currency prices are affected a great deal by changes in a country's interest rates.

We now know that interest rates are ultimately affected by a central bank's view on the economy and price stability, which influence monetary policy.

Central banks operate like most other businesses in that they have a leader, a president or a chairman. It's that individual's role to be the voice of that central bank, conveying to the market which direction monetary policy is headed. And much like when Steve Jobs or Michael Dell steps to the microphone, everyone listens.

So by using the Pythagorean Theorem (where $a^2 + b^2 = c^2$), wouldn't it make sense to keep an eye on what those guys at the central banks are saying?

Using the Complex conjugate root theorem, the answer is yes!

Yes, it's important to know what's coming down the road regarding potential monetary policy changes. And lucky for you, central banks are getting better at communicating with the market.

Whether you actually understand what they're saying, well that's a different story.

So the next time Ben Bernanke or Jean-Claude Trichet are giving speeches, keep your ears open. Better yet, use the trusty BabyPips.com Economic Calendar to prepare yourself before the actual speech.



While the central bank Chairman isn't the only one making monetary policy decisions for a country or economy, what he or she has to say is only not ignored, but revered like the gospel.

Okay, maybe that was a bit dramatic, but you get the point.

Not all central bank officials carry the same weight.

Central bank speeches have a way of inciting a market response, so watch for quick movement following an announcement.

Speeches can include anything from changes (increases, decreases or holds) to current interest rates, to discussions about economic growth measurements and outlook, to monetary policy announcements outlining current and future changes.

But don't despair if you can't tune in to the live event. As soon as the speech or announcement hits the airwaves, news agencies from all over make the information available to the public.

Currency analysts and traders alike take the news and try to dissect the overall tone and language of the announcement, taking special care to do this when interest rate changes or economic growth information are involved.

Much like how the market reacts to the release of other economic reports or indicators, currency traders react more to central bank activity and interest rate changes when they don't fall in line with current market expectation.

It's getting easier to foresee how a monetary policy will develop over time, due to an increasing transparency by central banks.

Yet there's always a possibility that central bankers will change their outlook in greater or lesser magnitude than expected. It's during these times that marketing volatility is high and care should be taken with existing and new trade positions.

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Los Angeles Hawks vs. the New York Doves

Yes, you're in the right place.

Tonight's match puts the L.A. Hawks up against the N.Y. Doves.

You're in for a treat. Wait, what?!

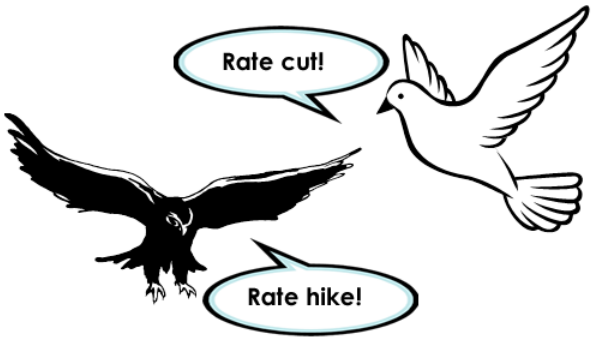
Whoops sorry, wrong subject.

We really just meant hawks versus doves, central bank hawks versus central bank doves that is. Central bankers can be viewed as either hawkish or dovish, depending on how they approach certain economic situations.

Central bankers are described as "hawkish" when they are in support of the raising of interest rates to fight inflation, even to the detriment of economic growth and employment.

For example, "The Bank of England suggests the existence of a threat of high inflation." The Bank of England could be described as being hawkish if they made an official statement leaning towards the increasing of interest rates to reduce high inflation.

Dovish central bankers, on the other hand, generally favor economic growth and employment over tightening interest rates. They also tend to have a more non-aggressive stance or viewpoint regarding a specific economic event or action.



And the winner is.... It's a tie!

Well, sort of.

You'll find many a banker "on the fence", exhibiting both hawkish and dovish tendencies. However, true colors tend to shine when extreme market conditions occur.

Long-term Market Movers

There are several fundamentals that help shape the long term strength or weakness of the major currencies. We've included what we think are the most important, for your reading pleasure:

Economic Growth and Outlook

We start easy with the economy and outlook held by consumers, businesses and the governments. It's easy to understand that when consumers perceive a strong economy, they feel happy and safe, and they spend money. Companies willingly take this money and say, "Hey, we're making money! Wonderful! Now... uh, what do we do with all this money?"

Companies with money spend money. And all this creates some healthy tax revenue for the government. They jump on board and also start spending money. Now everybody is spending, and this tends to have a positive effect on the economy.

Weak economies, on the other hand, are usually accompanied by consumers who aren't spending, businesses who aren't making any money and aren't spending, so the government is the only one still spending. But you get the idea. Both positive and negative economic outlooks can have a direct effect on the currency markets.

Capital Flows

Globalization, technology advances and the internet have all contributed to the ease of investing your money virtually anywhere in the world, regardless of where you call home. You're only a few clicks of the mouse away (or a phone call for you folks living in the Jurassic era of the 2000's) from investing in the New York or London Stock exchange, trading the Nikkei or Hang Seng index, or from opening a forex account to trade U.S. dollars, euros, yen, and even exotic currencies.

Capital flows measure the amount of money flowing into and out of a country or economy because of capital investment purchasing and selling. The important thing you want to keep track of is capital flow balance, which can be positive or negative.

When a country has a positive capital flow balance, foreign investments coming into the country are greater than investments heading out of the country. A negative capital flow balance is the direct opposite. Investments leaving the country for some foreign destination are greater than investments coming in.

With more investment coming into a country, demand increases for that country's currency as foreign investors have to sell their currency in order to buy the local currency. This demand causes the currency to increase in value.
Simple supply and demand.

And you guessed it, if supply is high for a currency (or demand is weak), the currency tends to lose value. When foreign investments make an about-face, and domestic investors also wants to switch teams and leave, and then you have an abundance of the local currency as everybody is selling and buying the currency of whatever foreign country or economy they're investing in.

Foreign capital love nothing more than a country with high interest rates and strong economic growth. If a country also has a growing domestic financial market, even better! A booming stock market, high interest rates... What's not to love?! Foreign investment comes streaming in. And again, as demand for the local currency increases, so does its value.

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Trade Flows & Trade Balance

We're living in a global marketplace. Countries sell their own goods to countries that want them (exporting), while at the same time buying goods they want from other countries (importing). Have a look around your house. Most of the stuff (electronics, clothing, doggie toys) lying around are probably made outside of the country you live in.

Every time you buy something, you have to give up some of your hard-earned cash.

Whoever you buy your widget from has to do the same thing.

U.S. importers exchange money with Chinese exporters when they buy goods. And Chinese imports exchange money with European exporters when they buy goods.

All this buying and selling is accompanied by the exchange of money, which in turn changes the flow of currency into and out of a country.



Trade balance (or balance of trade or net exports) measures the ratio of exports to imports for a given economy. It demonstrates the demand of that country's good and services, and ultimately it's currency as well. If exports are higher than imports, a trade surplus exists and the trade balance is positive. If imports are higher than exports, a trade deficit exists, and the trade balance is negative.

So:

Exports > Imports = Trade Surplus = Positive (+) Trade Balance
Imports > Exports = Trade Deficit = Negative (-) Trade Balance

Trade deficits have the prospect of pushing a currency price down compared to other currencies. Net importers first have to sell their currency in order to buy the currency of the foreign merchant who's selling the goods they want. When there's a trade deficit, the local currency is being sold to buy foreign goods. Because of that, the currency of a country with a trade deficit is less in demand compared to the currency of a country with a trade surplus.

Net exporters, countries that export more than they import, see their currency being bought more by countries interested in buying the exported goods. It is in more demand, helping their currency to gain value. It's all due to the demand of the currency. Currencies in higher demand tend to be valued higher than those in less demand.

It's similar to pop stars. Because she's more in demand, Lady Gaga gets paid more than Britney Spears. Same thing with Justin Bieber versus Vanilla Ice.

The Government: Present and Future

The years 2009 and 2010 have definitely been the years where more eyes were glaringly watching their respective country's governments, wondering about the financial difficulties being faced, and hoping for some sort of fiscal responsibility that would end the woes felt in our wallets. Instability in the current government or changes to the current administration can have a direct bearing on that country's economy and even neighboring nations. And any impact to an economy will most likely affect exchange rates.

News and Market Data

A quick Yahoogleing (that's Yahoo, Google, plus Bing) search of "forex + news" or "forex + data" returns a measly 30 million results combined.

30 MILLION! That's right! No wonder you're here to get some education! There's just way too much information to try to process and way too many things to confuse any newbie trader. That's some insane information overload if we've ever seen it.

But information is king when it comes to making successful trades.

Price moves because of all of this information: economic reports, a new central bank chairperson, and interest rate changes.

News moves fundamentals and fundamentals move currency pairs!

It's your goal to make successful trades and that becomes a lot easier when you know why price is moving that way it is. Successful traders weren't born successful; they were taught or they learned.

Successful traders don't have mystical powers (well, except for Pipcrawler, but he's more weird than he is mystical) and they can't see the future.

What they can do is see through the blur that is forex news and data, pick what's important to traders at the moment, and make the right trading decisions.

Where to Go for Market Information

Market news and data is made available to you through a multitude of sources.

The internet is the obvious winner in our book, as it provides a wealth of options, at the speed of light, directly to your screen, with access from almost anywhere in the world. But don't forget about print media and the good old tube sitting in your living room or kitchen.

Individual traders will be amazed at the sheer number of currency-specific websites, services, and TV programming available to them. Most of them are free of charge, while you may have to pay for some of the others. Let's go over our favorites to help you get started.

Websites

Our top pick of a forex news-specific website is **FreshPips.com**. Make a mental note that the name of the website is eerily similar to the one you're currently on. Strange...

Oh wait, FreshPips.com is just another apple out of the basket of "Pips.com" websites (see all of them here).

We're not ashamed about promoting **FreshPips.com**.

Put on this planet to help you unearth and share interesting and useful forex news and research, handpicked from the web by forex traders, from the biggest news sites to little known blogs, **FreshPips.com** reveals the finest materials as voted on by our users to help you become a smarter forex trader. It covers the areas of analysis, commentary, economic indicators, psychology, and specific currencies.

Traditional Financial News Sources

While there are tons of financial news resources out there, we advise you to stick with the big names.

These guys provide around-the-clock coverage of the markets, with daily updates on the big news that you need to be aware of, such as central bank announcements, economic report releases and analysis, etc. Many of these big players also have institutional contacts that provide explanations about the current events of the day to the viewing public.

- Reuters
- The Wall Street Journal
- Bloomberg
- MarketWatch.com

Real-time Feeds



If you're looking for more immediate access to the movements in the currency market, don't forget about that 65-inch flat screen TV in your bathroom!

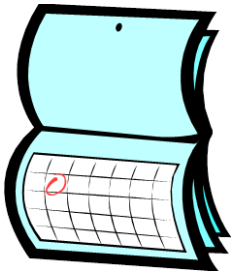
Financial TV networks exist 24 hours a day, seven days a week to provide you up-to-the-minute action on all of the world's financial markets.

In the U.S., the top dogs are (in random order), Bloomberg TV, Fox Business, CNBC, MSNBC, and even CNN. You could even throw a little BBC in there.

Another option for real-time data comes from your trading platform.

Many brokers include live newsfeeds directly in their software to give you easy and immediate access to events and news of the currency market. Check your broker for availability of such features not all brokers features are created equally.

Economic Calendars



Wouldn't it be great if you could look at the current month and know exactly when the Fed is making an interest rate announcement, what rate is forecasted, what rate actually occurs , and what type of impact this change has on the currency market? It's all possible with an economic calendar.

The good ones let you look at different months and years, let you sort by currency, and let you assign your local time zone. 3:00 pm where you're sitting isn't necessarily 3:00 pm where we're sitting, so make use of the time zone feature so that you're ready for the next calendar event!

Yes, economic events and data reports take place more frequently than most people can keep up with. This data has the potential to move markets in the short term and accelerate the movement of currency pairs you might be watching.

Lucky for you, most economic news that's important to forex traders is scheduled several months in advance.

So which calendar do we recommend?

We look no further than our very own BabyPips.com forex Economic Calendar to provide all that goodness!

If you don't like ours (which we highly doubt), a simple Yahoogleing search will offer up a nice collection for you to examine.

Market Information Tips

Keep in mind the timeliness of the reports you read. A lot of this stuff has already occurred and the market has already adjusted prices to take the report into account.

If the market has already made its move, you might have to adjust your thinking and current strategy. Keep tabs on just how old this news is or you'll find yourself "yesterday's news."

You also have to be able to determine whether the news you're dealing with is fact or fiction, rumor or opinion.

Economic data rumors do exist, and they can occur minutes to several hours before a scheduled release of data. The rumors help to produce some short-term trader action, and they can sometimes also have a lasting effect on market sentiment.

Institutional traders are also often rumored to be behind large moves, but it's hard to know the truth with a decentralized market like spot forex. There's never a simple way of verifying the truth.

Your job as a trader is to create a good trading plan and quickly react to such news about rumors, after they've been proven true or false. Having a well-rounded risk management plan in this case could save you some moolah!

And the final tip: Know who is reporting the news.



Are we talking analysts or economists, economist or the owner of the newest forex blog on the block? Maybe a central bank analyst?

The more reading and watching you do of forex news and media, the more finance and currency professionals you'll be exposed to.

Are they offering merely an opinion or a stated fact based on recently released data?

The more you know about the "Who", the better off you will be in understanding how accurate the news is. Those who report the news often have their own agenda and have their own strengths and weaknesses.

Get to know the people that "know", so YOU "know". Can you dig it?

Market Reaction

There's no one "All in" or "Bet the Farm" formula for success when it comes to predicting how the market will react to data reports or market events or even why it reacts the way it does.

You can draw on the fact that there's usually an initial response, which is usually short-lived, but full of action.

Later on comes the second reaction, where traders have had some time to reflect on the implications of the news or report on the current market.

It's at this point when the market decides if the news release went along with or against the existing expectation, and if it reacted accordingly.

Was the outcome of the report expected or not? And what does the initial response of the market tell us about the bigger picture?

Answering those questions gives us place to start interpreting the ensuing price action.

Consensus Expectations



A consensus expectation, or just consensus, is the relative agreement on upcoming economic or news forecasts. Economic forecasts are made by various leading economists from banks, financial institutions and other securities related entities.

Your favorite news personality gets into the mix by surveying her in-house economist and collection of financial sound "players" in the market.

All the forecasts get pooled together and averaged out, and it's these averages that appear on charts and calendars designating the level of expectation for that report or event.

The consensus becomes ground zero; the incoming, or actual data is compared against this baseline number. Incoming data normally gets identified in the following manner:

- **"As expected"** - the reported data was close to or at the consensus forecast.
- **"Better-than-expected"**- the reported data was better than the consensus forecast.
- **"Worse-than-expected"** - the reported data was worse than the consensus forecast.

Whether or not incoming data meets consensus is an important evaluation for determining price action. Just as important is the determination of how much better or worse the actual data is to the consensus forecast. Larger degrees of inaccuracy increase the chance and extent to which the price may change once the report is out.

However, let's remember that forex traders are smart, and can be ahead of the curve. Well the good ones, anyway.

Many currency traders have already "priced in" consensus expectations into their trading and into the market well before the report is scheduled, let alone released.

As the name implies, pricing in refers to traders having a view on the outcome of an event and placing bets on it before the news comes out.

The more likely a report is to shift the price, the sooner traders will price in consensus expectations. How can you tell if this is the case with the current market?

Well, that's a tough one.

You can't always tell, so you have to take it upon yourself to stay on top of what the market commentary is saying and what price action is doing before a report gets released. This will give you an idea as to how much the market has priced in.

A lot can happen before a report is released, so keep your eyes and ears peeled. Market sentiment can improve or get worse just before a release, so be aware that price can react with or against the trend.

There is always the possibility that a data report totally misses expectations, so don't bet the farm away on the expectations of others. When the miss occurs, you'll be sure to see price movement occur.

Help yourself out for such an event by anticipating it (and other possible outcomes) to happen.

Play the "what if" game.

Ask yourself, "What if A happens? What if B happens? How will traders react or change their bets?"

You could even be more specific.

What if the report comes in under expectation by half a percent? How many pips down will price move? What would need to happen with this report that could cause a 40 pip drop? Anything?

Come up with your different scenarios and be prepared to react to the market's reaction. Being proactive in this manner will keep you ahead of the game.

What the Deuce? They Revised the Data? Now what?

Too many questions... in that title.

But that's right, economic data can and will get revised.

That's just how economic reports roll!

Let's take the monthly Non-Farm Payroll employment numbers (NFP) as an example. As stated, this report comes out monthly, usually included with it are revisions of the previous month's numbers.

We'll assume that the U.S. economy is in a slump and January's NFP figure decreases by 50,000, which is the number of jobs lost. It's now February, and NFP is expected to decrease by another 35,000.

But the incoming NFP actually decreases by only 12,000, which is totally unexpected. Also, January's revised data, which appears in the February report, was revised upwards to show only a 20,000 decrease.

Non-Farm Payrolls			
	Actual	Forecast	Previous
January	-50,000	-30,000	-80,000
February	-12,000	-35,000	-20,000

Better than expected Feb NFP

Upward revision in Jan NFP

As a trader you have to be aware of situations like this when data is revised.

Not having known that January data was revised, you might have a negative reaction to an additional 12,000 jobs lost in February. That's still two months of decreases in employment, which ain't good.

However, taking into account the upwardly revised NFP figure for January and the better than expected February NFP reading, the market might see the start of a turning point.

The state of employment now looks totally different when you look at incoming data **AND** last month's revised data.

Be sure not only to determine if revised data exists, but also note the scale of the revision. Bigger revisions carry more weight when analyzing the current data releases.

Revisions can help to affirm a possibly trend change or no change at all, so be aware of what's been released.

What is a Currency Cross Pair?

A "currency cross pair", also known as "cross-currency pair" or simply as a "cross", is a pair of currencies that doesn't involve the U.S. dollar.

Back in the ancient days, if someone wanted to change currencies, they would first have to convert their currencies into U.S. dollars, and only then could they convert their dollars into the currency they desired.



For example, if a person wanted to change their U.K. sterling into Japanese yen, they would first have to convert their sterling into U.S. dollars, and then convert these dollars into yen.

With the invention of currency crosses, individuals can now bypass the process of converting their currencies into US dollars and simply convert it directly into their desired currency. Some examples of crosses include: GBP/JPY, EUR/JPY, EUR/CHF, and EUR/GBP.

Calculating Cross Rates



Warning: This part is a little boring...unless you like numbers. It's not difficult but it can be kind of dry. The good news is that this section really isn't necessary anymore since most broker platforms already calculate cross rates for you.

However, if you are the type that likes to know how everything works, then this section is for you! And besides, it's always good to know how things work right? In this section, we will show you how to calculate the bid (buying price) and ask (selling price) of a currency cross.

Let's say we want to find the bid/ask price for GBP/JPY. The first thing we would do is look at the bid/ask price for both GBP/USD and USD/JPY.

Why these 2 pairs?

Because both of them have the U.S. dollar as their common denominator.

These 2 pairs are called the "legs" of GBP/JPY because they are the U.S. dollar pairs associated with it.

Now let's say we find the following bid/ask prices:

GBP/USD: 1.5630 (bid) / 1.5635 (ask)

USD/JPY: 89.38 (bid) / 89.43 (ask)

To calculate the bid price for GBP/JPY, you simply multiply the bid prices for GBP/USD and USD/JPY.

If you got 139.70, good job! Your calculator is working properly, yipee!

To get the ask price for GBP/JPY, just multiply the ask prices for GBP/USD and USD/JPY and we get 139.82. Easy as pie!

Crosses Present More Trading Opportunities

Over 90% of the transactions in the forex market involve the U.S. dollar. This is because the U.S. dollar is the reserve currency in the world. You may be asking yourself, "Why the U.S. dollar and not the sterling, or euro?"

Most agricultural and industrial commodities such as oil are priced in U.S. dollars. If a country needs to purchase oil or other agricultural goods, it would first have to change its currency into U.S. dollars before being able to buy the goods. This is why many countries

keep a reserve of U.S. dollars on hand. They can make purchases much faster with Greenbacks already in their pocket.

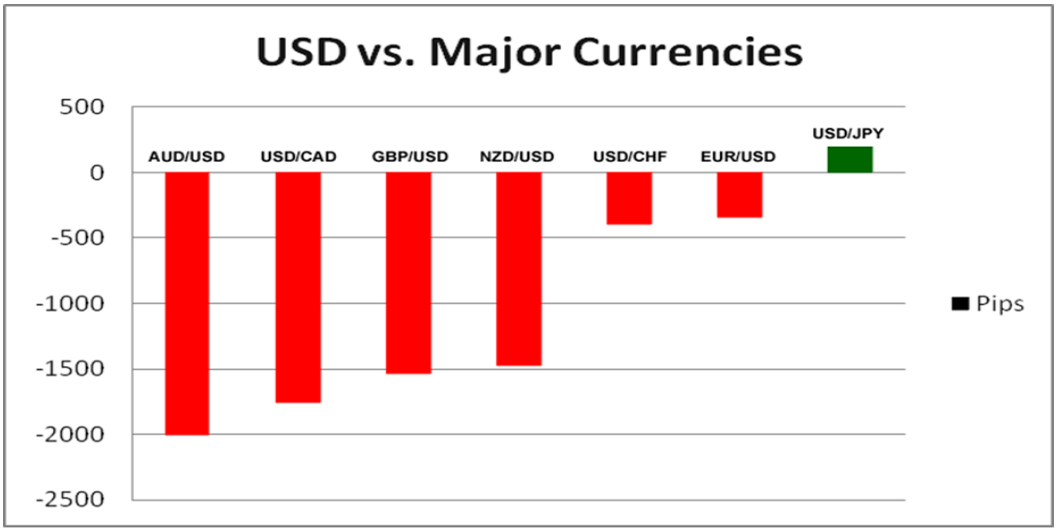
Countries such as China, Japan, and Australia are examples of heavy importers of oil, and as a result, they keep huge reserves of U.S. dollars in their central banks. In fact, China has almost a **trillion U.S. dollars** in its reserve stockpile!

So what does this all have to do with trading currency crosses? Well since most of the world is glued to the U.S. dollar, a majority of trading speculation will be based on one question:

"Is the U.S. dollar weak or strong today?"

This one question will affect many of the most liquid currency pairs:
The majors: GBP/USD, EUR/USD, USD/CHF, USD/JPY
The commodity pairs: AUD/USD, USD/CAD, NZD/USD

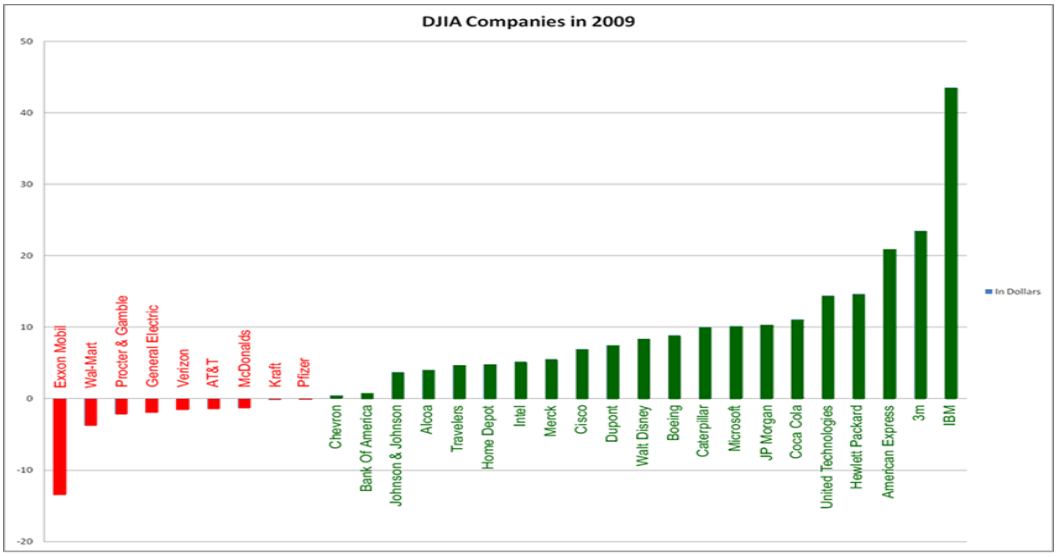
Notice that all of these pairs are tied to the U.S. dollar. This doesn't give a trader many options when most of their trading decisions are based on this one speculation.



In 2009, the Dollar was negative across the board.
Notice how the Dollar move was universal in almost every major currency pair.

You can see that by trading any of the 7 most popular currencies, you are basically taking either an anti-U.S. dollar or pro-U.S. dollar stance. This one speculation affects these pairs in almost the same way across the board.

Conversely in the stock market, traders have multiple companies to choose from and are not bound to one major speculation idea.



Although the DJIA was up over 1400 points in 20009, 9 of the 30 companies that make up the index were still negative

With stocks, you can see that even though the overall market was positive, there are still plenty of other trading opportunities. There isn't just one kind of speculation that affects the entire basket of stocks.

Instead of just looking at the seven "major" dollar-based pairs, currency crosses provide more currency pairs for you to find profitable opportunities!

By trading currency crosses, you give yourself more options for trading opportunities because these currencies are not bound to the U.S. dollar, thus possibly having different price movement behaviors. So while the majority of the markets will only trade on anti-U.S. dollar or pro-U.S. dollar sentiments, you can find new opportunities in currency crosses.

For example, all the dollar-based pairs might be trading sideways or in some uglier fashion where it would be smart to just sit on the sidelines and wait for better trade setups, but if you knew to switch your charts to look at currency crosses, you might just find trading opportunities galore!

Be different! The majority of traders just trade the majors. Now you can be part of the minority that trades the crosses.

Cleaner Trends and Ranges

Since a majority of the forex market will deal with the U.S. dollar, you can imagine that many of the news reports will cause U.S. dollar-based currency pairs to spike. The US has the largest economy in the world, and as a result, speculators react strongly to U.S. news reports, even if it doesn't cause a huge fundamental shift in the long run.

What this means for your charts is that you will see several "spikes" even if there is a trend emerging. This can make it harder to spot trend or range indications.



The day to day economic activities of the U.S. can keep U.S. dollar based currencies such as EUR/USD (above) from making smooth trends.



Conversely, we can see that during the same date range EUR/JPY made a much, much smoother ride to the top. This was probably due to less spikes that came from U.S. data. So as you can see, both charts showed the euro rise during the same time period, but the one without the U.S. dollar (EUR/JPY) made for a much easier trade.

If you are a trend following kinda dude, then currency crosses may be easier to trade than the major pairs. It will be easier for you to spot the trend and be more confident in your entry points because you know that the these technical levels hold more than they do for the majors.

In the next section, we'll discuss how playing with crosses can also allow you to take advantage of the interest rate differentials. Now that's like a cherry on top of a sundae!

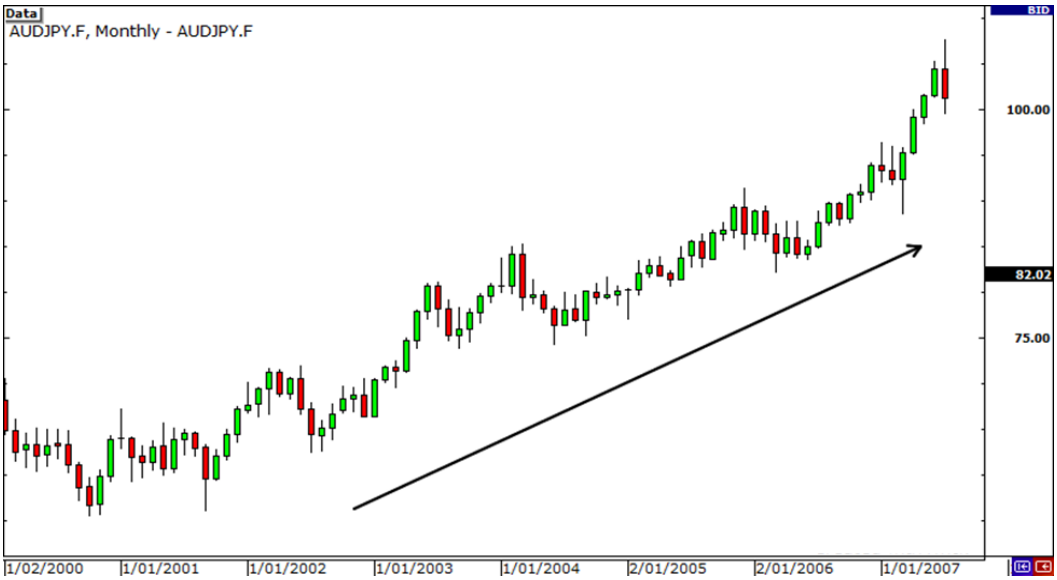
Taking Advantage of Interest Rate Differential

By selling currencies whose country has a lower interest rate against currencies whose country has a higher interest rate, you can profit from the interest rate differential (known as a carry trade) as well as price appreciation.

That's like being able to get a frosted cupcake with sprinkles on top! That talks to you! Imagine how delicious that would taste!



Currency crosses offer many pairs with high interest rate differentials that are prime for these types of trades.

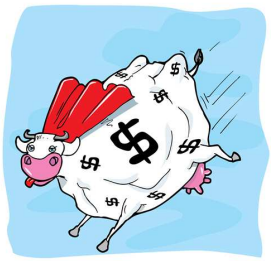


For example, take a look at the nice uptrend on AUD/JPY. If you had a long position on this pair, you would've made a hefty profit.

On top of that, the interest rate differential between AUD and JPY was huge. From 2002 to 2007, the Reserve Bank of Australia had raised rates to 6.25% while the BOJ kept their rates at 0%.

That means you made profits off your long position AND the interest rate differential on that trade!

Now that'd be an awesome cash cow right there!



Later on in college (if your brain hasn't exploded with all this forex knowledge by then), we'll teach you more about carry trade. We'll teach you which ones will work and which ones won't. We'll even teach you about a lil' something called risk aversion. But that's for a later lesson.

Obscure Crosses

While the euro and yen crosses are the most liquid crosses, more crosses exist don't even include the U.S. dollar, euro, or the yen! We'll call these the "Obscure Crosses"!

If we were in school - come to think of it, we actually are in school! - the major pairs would be the jocks while the obscure crosses would be the eccentric emo kids.



That's because most traders would rather hang out with the cool crowd than the obscure crosses!

We're talking about really weird combinations like AUD/CHF, AUD/NZD, CAD/CHF, and GBP/CHF. That's why we call them obscure crosses (duh!).

Trading in these pairs is more difficult and riskier than trading euro or yen crosses. Since very few traders trade them, transaction volume is much lower and liquidity can be difficult at times.

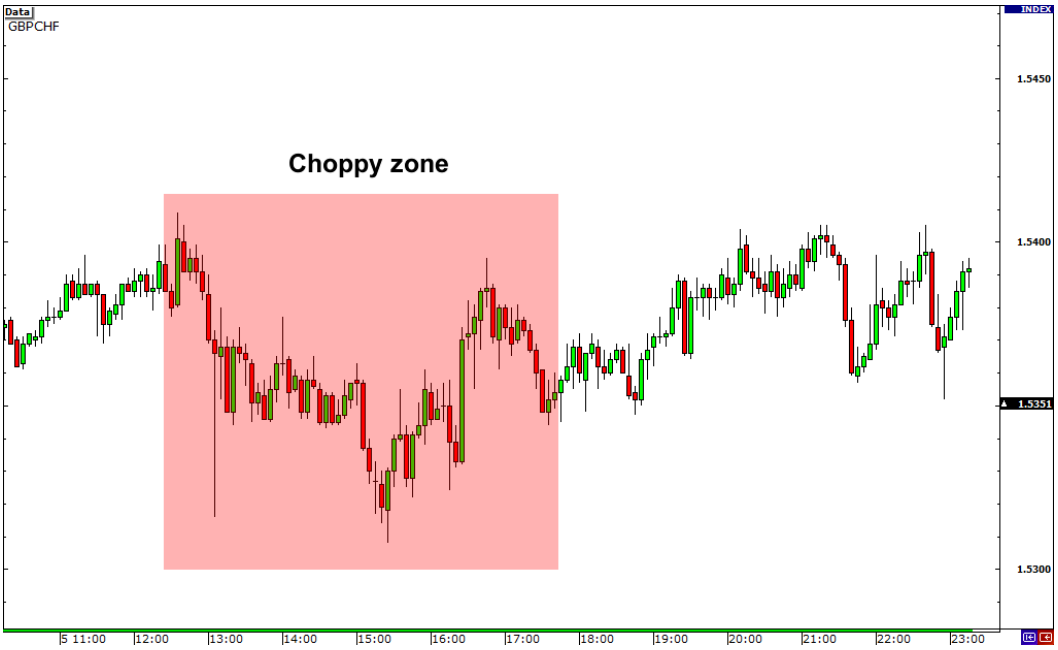
Due to the illiquid markets for these crosses, their prices can become quite volatile, so being stopped out on whipsaws can become a common occurrence.

Check out these screenshots of AUD/CHF and GBP/CHF:



You don't want to get stopped out by those nasty spikes, do you? That's why most traders usually put wider stops when trading these pairs.

But judging from the choppy movement of obscure crosses, it would really be tough to catch a good trade on these pairs. Unless you're a currency cross guru like Cyclopip, of course!



See what we mean?

Also, since these pairs aren't traded too much, the spreads on these pairs can be pretty big.

If you want to trade these crosses, just be ready for some wild price swings and be willing to pay the price of the massive spread!

Planning Around News and Fundamentals

If strong economic data comes out of Australia, you might want to look at buying the AUD. Your first reaction might be to buy AUD/USD.

But what if at the same time, recent data also show the United States experiencing strong economic growth? Price action of AUD/USD may be flat.

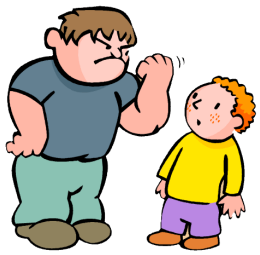
One option that you have is to match the AUD against the currency of an economy that isn't doing so well.... Hmmmm... what could you do?

Ah! Thank the forex gods for currency crosses!

Let's say you did some analysis, checked the BabyPips.com economic calendar (shameless plug!) or Pip Diddy's daily economic roundup (another shameless plug!) and you notice that the Japanese economy isn't doing so good right now.

What do you do?

Of course, like any self-respecting bully, you jump all over this opportunity and go long AUD/JPY!



There's nothing wrong with being a bully, at least not here at the School of Pipsology.

It's your job as a trader to take advantage of certain opportunities so that you can put some silver dollars into your piggy bank.

Because of currency crosses, you now have the opportunity to match the currency of the best performing economy against that of the weakest economy without having to deal with the U.S. dollar.

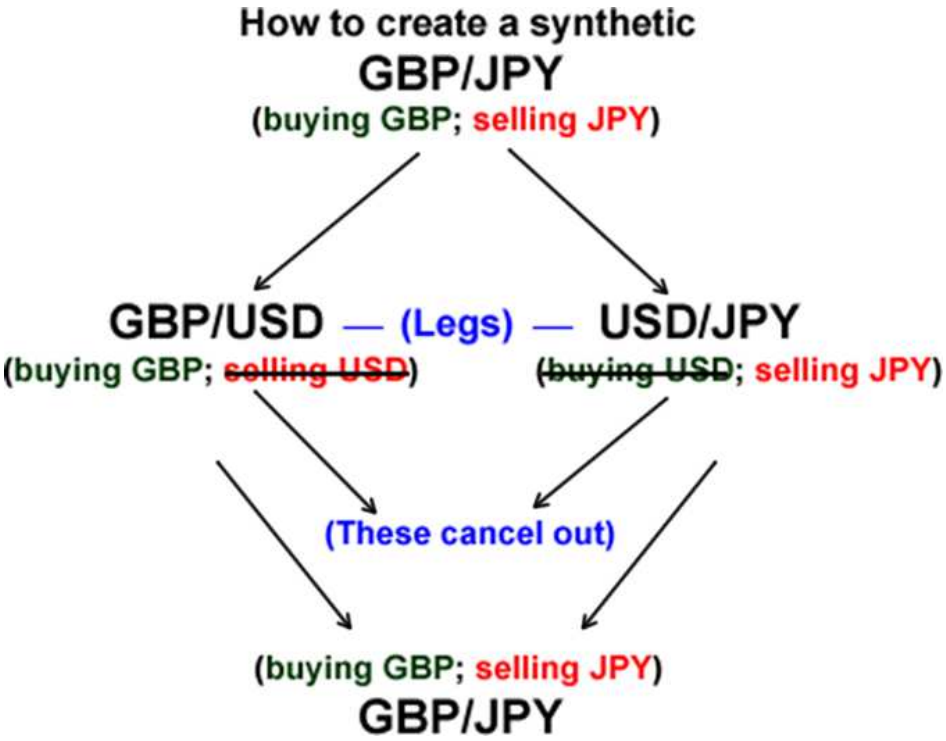
Creating Synthetic Pairs

Sometimes institutional traders can't trade certain currency crosses because they trade in such high volume that there isn't enough liquidity to execute their order.

In order to execute their desired trade, they have to create a "synthetic pair".

Let's say that an institutional trader wants to buy GBP/JPY but can't because there isn't enough liquidity. To execute this trade, they would have to buy GBP/USD and sell USD/JPY (earlier in this lesson, we learned that these pairs are called its legs).

They are able to do this because there is plenty of liquidity in GBP/USD and USD/JPY which means they can make large orders.



If you're a retail trader, and you wanted to pretend to trade like an institutional trader, then you could technically trade synthetic pairs as well. But it wouldn't be too smart.

Ever since the great Al Gore invented the internet, technology has improved to the point now that even weird crosses like GBP/NZD or CHF/JPY can now be traded on your broker's platform. Aside from having access to a larger "menu" of currency pairs to trade, the spreads would be tighter on the crosses compared to the synthetic pair you'd create.

And let's not forgot about margin use! Creating a synthetic pair requires you to open two separate positions and each position requires its own margin. This locks up unnecessary capital in your trading account when you can simply trade the cross-currency and save on margin.

So unless you're trading yards (slang term for one BILLION units), forget synthetic pairs and stick to crosses. You will be savings yourself some pips (thanks to a tighter spread) as well as freeing up your capital so you can take on more trades.

Euro and Yen Crosses

After the U.S. dollar, the euro and yen are the most traded currencies. And like the U.S. dollar, the euro and yen are also held as reserve currencies by different countries. So this makes the euro and yen crosses the most liquid outside of the U.S. dollar-based "majors".

Trading the Euro Crosses

The most popular EUR crosses are EUR/JPY, EUR/GBP, and EUR/CHF.

News that affects the euro or Swiss franc will be felt more in EUR crosses than EUR/USD or USD/CHF.

U.K. news will greatly affect EUR/GBP.

Oddly enough, U.S. news plays a part in the movement of the EUR crosses. U.S. news makes strong moves in GBP/USD and USD/CHF. This not only affects the price of the GBP and CHF against the USD, but it could also affect the GBP and CHF against the EUR.

A big move higher in the USD will tend to see a higher EUR/CHF and EUR/GBP and the same goes for the opposite direction.

Confused? Ok ok...let's break this down.

Let's say that the US shows positive economic data causing the USD to rise. This means that GBP/USD would fall, driving the price of the GBP down. At the same time USD/CHF would rise, also driving the price of the CHF down.

The drop in GBP price would then cause EUR/GBP to rise (since traders are selling off their GBP).

The drop in CHF price would also cause EUR/CHF to rise (since traders are selling of their CHF).

Conversely, this would also work in the opposite direction if the U.S. showed negative economic data.

Trading the Yen Crosses

The JPY is one of the more popular cross currencies and it is basically traded against all of the other major currencies.

EUR/JPY has the highest volume of the JPY crosses as of February 2010.

GBP/JPY, AUD/JPY, and NZD/JPY are attractive carry trade currencies because they offer the highest interest rate differentials against the JPY.

When trading JPY cross pairs, you should always keep an eye out on the USD/JPY. When key levels are broken or resisted on this pair, it tends to spill over into the JPY cross pairs. For example, if USD/JPY breaks out above a key resistance area, it means that traders are selling off their JPY. This could prompt the selling of the JPY against other currencies. Therefore you could expect to see EUR/JPY, GBP/JPY, and other JPY crosses to rise as well.

The CAD/JPY

Over recent years, this currency cross has become very popular, becoming highly correlated with the price of oil.

Canada is second largest owner of oil reserves and has benefited with the rise of oil prices.

On the other hand, Japan is heavily reliant on the importing of oil. In fact, over 99% of Japan's crude is imported as it has almost no native oil reserves.

These two factors have caused an 87% positive correlation between the price of oil and CAD/JPY.

How to Use Crosses to Trade the Majors

Even if you don't ever want to trade the crosses and simply stick to trading the majors, you can use crosses to help you make better trading decisions.

Here's an example...

Currency crosses can provide clues about the relative strength of each major currency pair.

Let's say you see a buy signal for EUR/USD and GBP/USD but you can only take one trade.

Which one do you take?

Simply looking at your crystal ball and guessing isn't likely to result in the right answer.

To find the right answer, you would look at EUR/GBP cross. If EUR/GBP is trending downward, this indicates that the pound is relatively stronger than the euro at the moment.

So the right answer would be to buy GBP/USD instead of EUR/USD due to the pound's relative strength against the euro.

Since the euro is weaker, relative to the pound, if it proves to strengthen against the U.S. dollar, it is likely to strengthen LESS than the pound.

If the U.S. dollar weakens across the board, GBP/USD you would make more pips since it would rally higher than EUR/USD.

So GBP/USD is the better trade.



You can do this relative strength analysis on any of the major pairs...

Let's say you're bearish on the U.S. dollar. How will you trade?

- Can't decide whether to buy EUR/USD or sell USD/CHF? Look at EUR/CHF.
- Can't decide whether to buy USD/CHF or USD/JPY? Look at CHF/JPY.
- Can't decide whether to buy EUR/USD or sell USD/JPY? Look at EUR/JPY.
- Can't decide whether to buy GBP/USD or sell USD/CHF? Look at GBP/CHF.
- Can't decide whether to buy GBP/USD or sell USD/JPY? Look at GBP/JPY.

So always remember, iooking at cross pairs could give you an idea of the relative strength of a particular currency.

How Cross Currency Pairs Affect Dollar Pairs

Let's pretend the Fed announces they will raise interest rates. The market quickly starts buying the U.S. dollar across all major currencies....EUR/USD and GBP/USD fall while USD/CHF and USD/JPY rise.

You were short EUR/USD and were pleased to see price move in your favor making you some pips, but right before you were about to break out the cigar, you notice your friend who was long USD/JPY made a lot more pips than you.



You're like "What's up with that yo?"

You compare the charts of EUR/USD and USD/JPY and see that USD/JPY made the bigger move. It broke through a major technical resistance level and shot up 200 pips while EUR/USD barely shot down 100 pips and failed to break a major support level.

You're thinking to yourself, "If the U.S. dollar was being bought across the board, then how come my EUR/USD trade looks so weak compared to my friend's USD/JPY trade?"

This is due to the currency crosses! In this particular example, EUR/JPY.

When USD/JPY broke through its major resistance level, the combination of stop losses being hit and breakout traders jumping on the bandwagon pushed it even higher.
Since buying more USD/JPY weakens the yen, this would cause EUR/JPY (and possibly other yen-based pairs) to break through its major resistance level, once again hitting stops and attracting breakout traders, pushing EUR/JPY even higher.



This causes the euro to strengthen and slows down the descent of your EUR/USD trade. The EUR/JPY cross buying acts a "parachute" and this is why EUR/USD didn't move as much or as fast as the USD/JPY.

So even if you only trade the major currencies, currency crosses still have an effect on your trades!

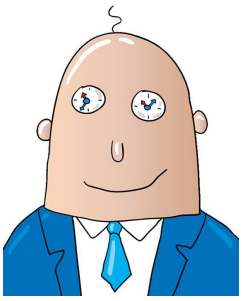
Summary: Currency Crosses

As you can see, there are many, many trade opportunities presenting themselves in the foreign exchange market other than figuring out what the Greenback will do any given day - and now you know how to find them! Here are a couple of things to remember:

- Crosses give traders more pairs to trade, which means more trading opportunities.
- We normally see cleaner trends and ranges on currency crosses than we do on majors.
- You can take advantage of interest rate differentials by trading currency crosses.
- Do your due diligence / analysis and match the strong currencies against the weak ones.
- If the pair you are looking to trade isn't available with your broker, don't worry. You know how to create a synthetic pair by simultaneously going long or short two major pairs to create one currency cross.

- The most popular euro crosses are the EUR/JPY, EUR/GBP, and EUR/CHF.
- GBP/JPY, AUD/JPY, and NZD/JPY are attractive carry trade currencies because they offer the highest interest rate differentials against the JPY.
- When trading obscure crosses, watch out for wild price swings and wider spreads.
- Even if you wanna stick to the majors, you can make use of currency crosses to help you decide between which pairs to trade as crosses can signal which currency is stronger.
- Don't forget that moves in currency cross pairs can have an effect on the majors.
- Last tip; please be conscientious of the pip value of the cross you are trading. Some crosses will have a higher or lower pip value than the majors. This information is good to know for your risk analysis.
- So, on the days you may not see any opportunities in the major pairs, or if you want to avoid the volatility of a US news event, check out some the currency crosses. You may never know what you may find! Good luck!

Multiple Time Frame Analysis



What the heck is multiple time frame analysis?

Multi-time frame ana... WHAT?! Chill out young padawan, it ain't as complicated as it sounds! You're almost done with high school - now's not the time to get senioritis, although you probably got that way back in Grade 12. Ha!

Multiple time frame analysis is simply the process of looking at the same pair and the same price, but on different time frames.

Remember, a pair exists on several time frames - the daily, the hourly, the 15-minute, heck, even the 1-minute!

This means that different traders can have their different opinions on how a pair is trading and both can be completely correct.

Phoebe may see that EUR/USD is on a downtrend on the 4-hour chart. However, Sam trades on the 5-minute chart and sees that the pair just ranging up and down. And they could both be correct!

As you can see, this poses a problem. Trades sometimes get confused when they look at the 4-hour, see that a sell signal, then they hop on the 1-hour and see price slowly moving up.

What are you supposed to do?

Stick with one time frame, take the signal and completely ignore the other time frame?

Flip a coin to decide whether you should buy or sell?

Luckily for you, we here at BabyPips.com aren't about to let you graduate without knowing how to use multiple time frame analysis to your advantage.

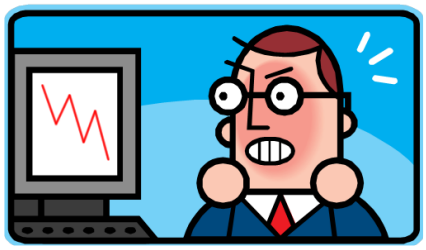
First, we'll try to help you determine which time frame you should focus on. Each trader should trade a specific time frame that fits his or her own personality (more on this later).

Secondly, we'll also teach you how to look at different time frames of the same currency pair to help you make better, more educated trading decisions.

What Time Frame Should I Trade?

One of the reasons newbie traders don't do as well as they could is because they're usually trading the wrong time frame for their personality.

New traders will want to get rich quick so they'll start trading small time frames like the 1-minute or 5-minute charts. Then they end up getting frustrated when they trade because the time frame doesn't fit their personality.



For some traders, they feel most comfortable trading the 1-hour charts.

This time frame is longer, but not too long, and trade signals are fewer, but not too few. Trading on this time frame helps give more time to analyze the market and not feel so rushed.



On the other hand, we have a friend who could never, ever, trade in a 1-hour time frame.

It would be way too slow for him and he'd probably think he was going to rot and die before he could get in a trade. He prefers trading a 10-minute chart. It still gives him enough time (but not too much) to make decisions based on his trading plan.

Another buddy of ours can't figure out how traders trade on a 1-hour chart because he thinks it's too fast! He trades only daily, weekly, and monthly charts.

Okay, so you're probably asking what the right time frame is for you.

Well buddy, if you had been paying attention, it depends on your personality. You have to feel comfortable with the time frame you're trading in.

You'll always feel some kind of pressure or sense of frustration when you're in a trade because real money is involved. That's natural.

But you shouldn't feel that the reason for the pressure is because things are happening so fast that you find it difficult to make decisions or so slowly that you get frustrated.

When we first started trading, we couldn't stick to a time frame.

We started with the 15-minute chart.

Then the 5-minute chart.

Then we tried the 1-hour chart, the daily chart, and the 4-hour chart.

This is natural for all new traders until you find your comfort zone and why we suggest that you **DEMO** trade using different time frames to see which fits your personality the best.

Time Frame Breakdown

Well, just like everything in life, it all depends on YOU.

Do you like to take things slowly, take your time on each trade? Maybe you're suited for trading longer time frames.

Or perhaps you like the excitement, quick, fast paced action? Perhaps you should take look at the 5-min charts.

In the table below, we've highlighted some of the basic time frames and the differences between each.

Time Frame	Desciption	Advantage	Disadvantages
Long-term	Long-term traders will usually refer to daily and weekly charts. The weekly charts will establish the longer term perspective and assist in placing entries in the shorter term daily. Trades usually from a few weeks to many months, sometimes years.	Don't have to watch the markets intraday Fewer transactions mean less times to pay the spread More time to think through each trade	Large swings Usually 1 or 2 two goods a year so PATIENCE is required. Bigger account needed to ride longer term swings Frequent losing months
Short-term (Swing)	Short-term traders use hourly time frames and hold trades for several hours to a week.	More opportunities for trades Less chance of losing months Less reliance on one or two trades a year to make money	Transaction costs will be higher (more spreads to pay) Overnight risk becomes a factor
Intraday	Intraday traders use minute charts such as 1-minute or 15-minute. Trades are held intraday and exited by market	Lots of trading opportunities Less chance of losing months No overnight risk	Transaction costs will be much higher (more spreads to pay) Mentally more

close.	difficult due to the need to change biases frequently Profits are limited by needing to exit at the end of the day.

You also have to consider the amount of capital you have to trade.

Shorter time frames allow you to make better use of margin and have tighter stop losses.

Larger time frames require bigger stops, thus a bigger account, so you can handle the market swings without facing a margin call.

The most important thing to remember is that whatever time frame you choose to trade, it should naturally fit your personality.

If you feel a little uptight like you're undies are loose or your pants are little too short, then maybe it's just not the right fit.

This is why we suggest demo trading on several time frames for a while to find your comfort zone. This will help you determine the best fit for you to make the best trading decisions you can.

When you finally decide on your preferred time frame, that's when the fun begins. This is when you start looking at multiple time frames to help you analyze the market.

Long or Short?

Before we explain how to do multiple time frame analysis, we feel that it's necessary to point out why you should actually flip through the different time frames.

After all, isn't it hard enough analyzing just one chart?

You've got a billion indicators on, you've gotta read up on economic news, you've got basketball practice, a Call of Duty session, a hot date at McDonalds...

Well, let's play a game called "Long or Short" to show why you should be paying attention and putting in the extra effort to look at different time frames.

The rules of the game are easy. You look at a chart and you decide whether to go long or short. Easy, right? Okay, ready?

Let's take a look at the 10 minute chart of GBP/USD on July 1, 2010 (7/01/2010) at 8:00 am GMT. We've got the 100 simple moving average on, which appears to be holding as resistance.

With price testing the resistance and forming a doji, it seems like a good time to short right?

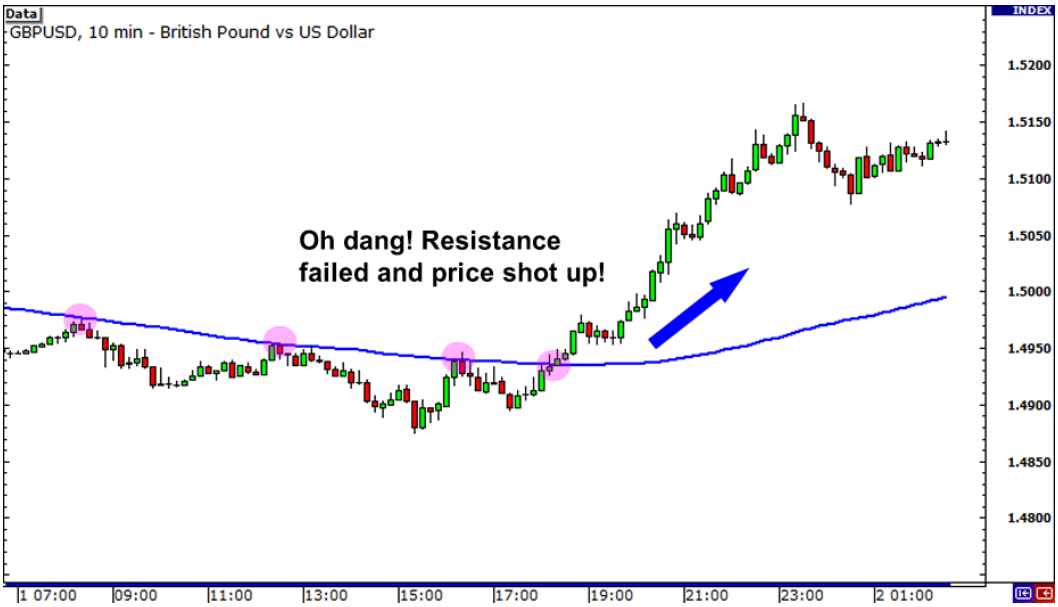
We'll take that as a yes.



But dang, look what happens next!

The pair closed above resistance and rose another 200 pips!

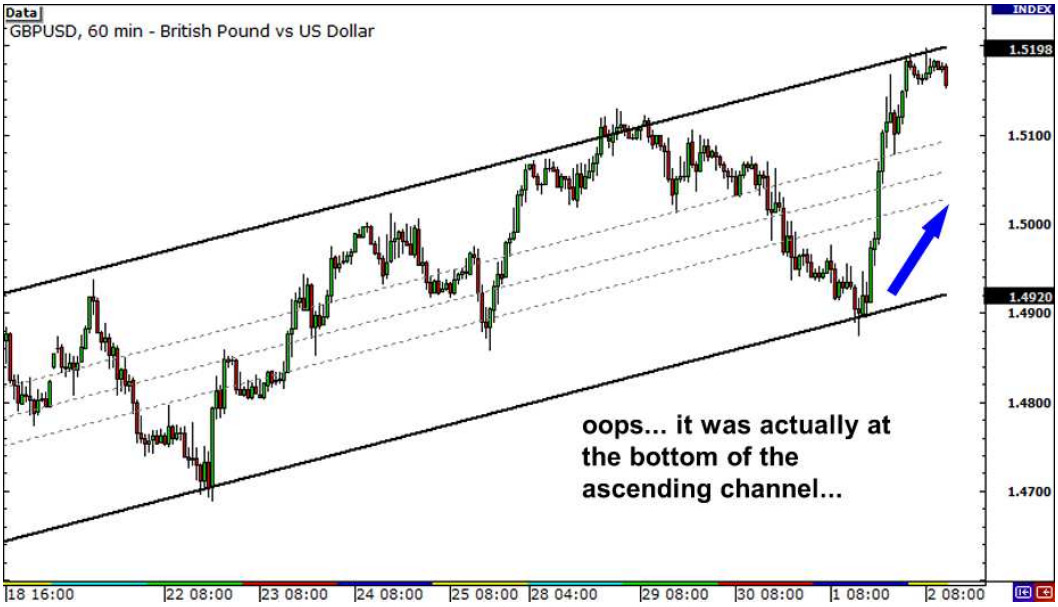
Ouch! Oh well, too bad!



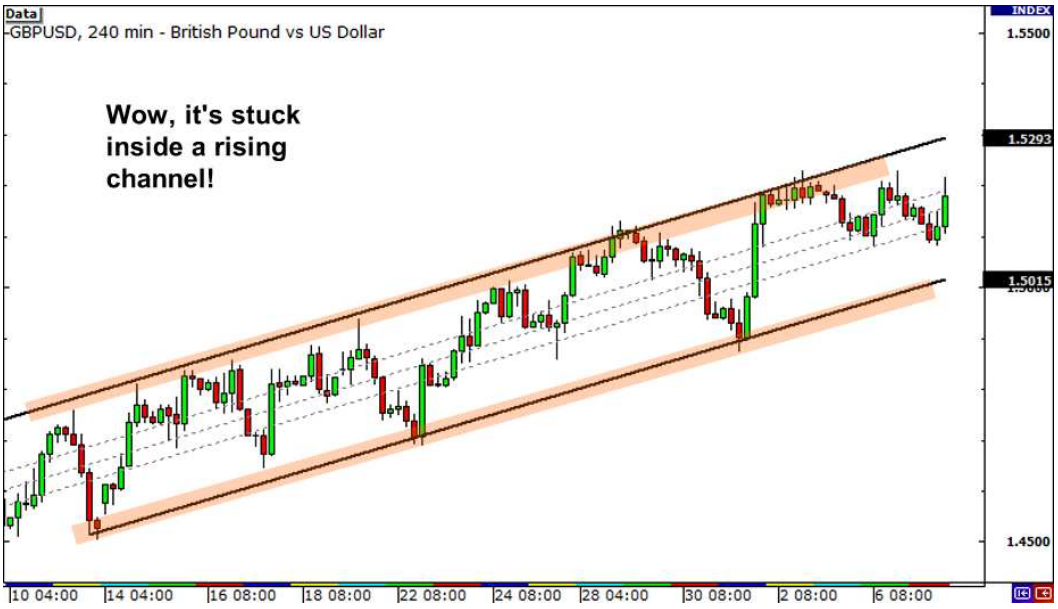
What the hell happened? Hmm, let's hop on to the 1-hour chart to see what happened...

If you had been looking at the one hour chart, you would have noticed that the pair was actually at the bottom of the ascending channel.

What's more, a doji had formed right smack on the support line! A clear buy signal!



The ascending channel would have been even clearer on the 4-hour chart.



If you had looked at this chart first, would you still have been so quick to go long when you were trading on the 10-minute chart?

All of the charts were showing the same date and time. They were just different time frames.

Do you see now the importance of looking at multiple time frames?

We used to just trade off the 15-minute charts and that was it.

We could never understand why when everything looked good the market would suddenly stall or reverse. It never crossed our minds to take a look at a larger time frame to see what was happening.

When the market did stall or reverse on the 15-minute chart, it was often because it had hit support or resistance on a larger time frame.

It took a couple hundred negative pips to learn that the larger the time frame, the more likely an important support or resistance levels would hold.

Trading using multiple time frames has probably kept us out of more losing trades than any other one thing alone. It will allow you to stay in a trade longer because you're able to identify where you are relative to the big picture.

Most beginners look at only one time frame. They grab a single time frame, apply their indicators and ignore other time frames.

The problem is that a new trend, coming from another time frame, often hurts traders who don't look at the big picture.

Time Frame Mashup



No, we aren't about to break out into song like the Glee cast.

Here at BabyPips.com, we've got our version of a mash-up, which we like to call the "Time Frame Mash-up".

This is where multiple or inter-time frame analysis comes in to play.

This is where we'll teach you how to not only lock in on your preferred trading time frame, but zoom in and out of charts so that you can knock a winner out of the park.

You ready? You sure you can hack this? You've basically got a semester left of BabyPips.com High School of Pipsology?

You don't wanna quit now do you?

Didn't think so!

First of all, take a broad look at what's happening.

Don't try to get your face closer to the market, but push yourself further away.

You have to remember, a trend on a longer time frame has had more time to develop, which means that it will take a bigger market move for the pair to change course. Also, support and resistance levels are more significant on longer time frames.

Start off by selecting your preferred time frame and then go up to the next higher time frame.

There you can make a strategic decision to go long or short based on whether the market is ranging or trending. You would then return to your preferred time frame (or even lower!) to make tactical decisions about where to enter and exit (place stop and profit target).

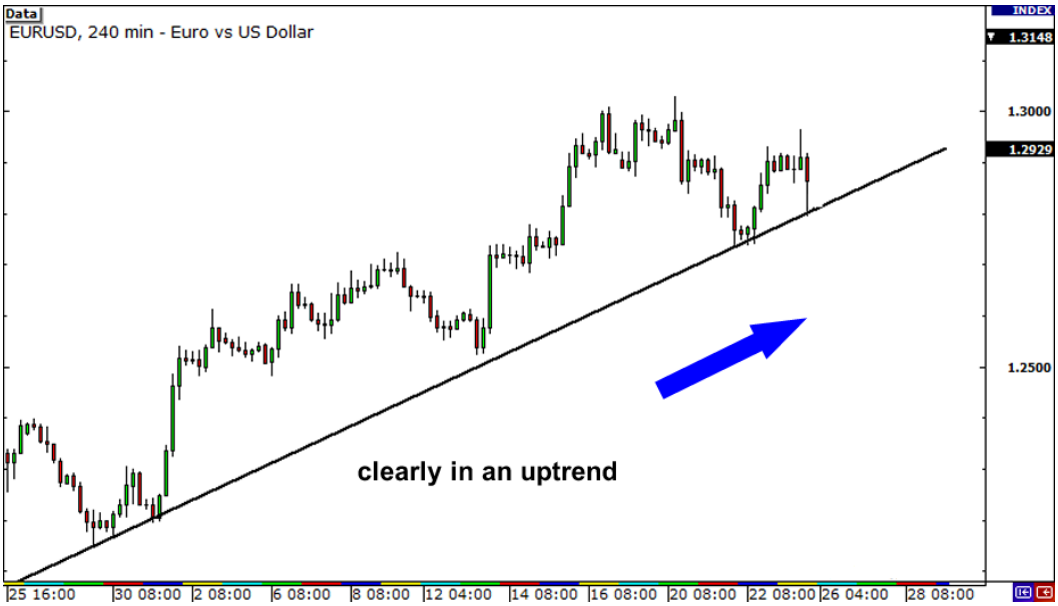
Just so you know, this is probably one of the best uses of multi time frame analysis - you can zoom in to help you find better entry and exit points. By adding the dimension of time to your analysis, you can obtain an edge over the other tunnel vision traders who trade off on only one time frame.

Did you get all of that? Well, if you didn't, no worries - we're gonna go through an example now to help make things a little clearer.

Let's say that Cinderella, who gets bored all day cleaning up after her evil step sisters, decides that she wants to trade.

After some demo trading, she realizes that she likes trading the EUR/USD pair the most, and feels most comfortable looking at the 1-hour chart. She thinks that the 15-minute charts are too fast while the 4-hour take too long - after all, she needs her beauty sleep.

The first thing that Cinderella does is move up to check out the 4-hour chart of EUR/USD. This will help her determine the overall trend.



She sees that the pair is clearly in an uptrend.

This signals to Cinderella that she should ONLY be looking for BUY signals. After all, the trend is her friend, right? She doesn't want to get caught in the wrong direction and lose her slipper.

Now, she zooms back to her preferred time frame, the 1-hour, to help her spot an entry point. She also decides to pop on the stochastic indicator.



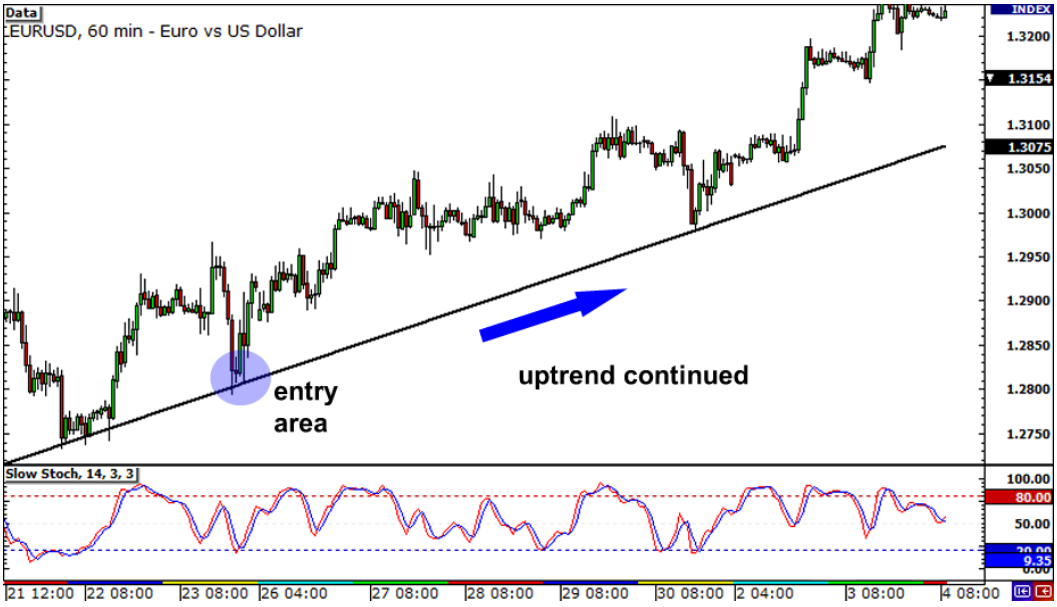
Once she goes back down to the 1-hour chart, Cinderella sees that a doji candlestick has formed and the stochastic has just crossed over out of oversold conditions!

But Cinderella still isn't quite sure - she wants to make sure she has a really good entry point, so she scales down to the 15-minute chart to help her find an even better entry and to give her more confirmation.



So now Cinderella is locking her eyes in on the 15-minute chart, and she sees that the trend line seems to be holding pretty strongly. Not only that, but stochastic are showing oversold conditions on the 15-minute time frame as well!

She figures that this could be a good time to enter and buy. Let's see what happens next.



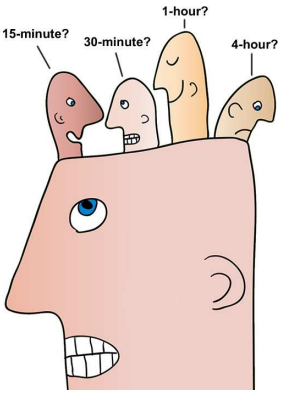
As it turns out, the uptrend continues, and EUR/USD continues to rise up the charts.

Cinderella would have entered just above 1.2800 and if she had kept the trade open for a couple of weeks, she would have made 400 pips! She could have bought another pair of glass slippers!

There is obviously a limit to how many time frames you can study. You don't want a screen full of charts telling you different things.

Use at least two, but not more than three time frames because adding more will just confuse the geewillikers out of you and you'll suffer from analysis paralysis, then proceed to go crazy.

Time Frame Combinations



Here at the BabyPips.com School of Pipsology, we like using three time frames. We feel that this gives us the most flexibility, as we can decipher the long, medium and short term trends.

The largest time frame we consider our main trend - this shows us the big picture of the pair we wanna trade.

The next time frame down is what we normally look at, and it signals to us the medium term buy or selling bias.

The smallest time frame shows the short term trend and helps us find really good entry and exit points.

You can use any time frame you like as long as there is enough time difference between them to see a difference in their movement.

You might use:

- 1-minute, 5-minute, and 30-minute
- 5-minute, 30-minute, and 4-hour
- 15-minute, 1-hour, and 4-hour
- 1-hour, 4-hour, and daily
- 4-hour, daily, and weekly and so on.

When you're trying to decide how much time in between charts, just make sure there is enough difference for the smaller time frame to move back and forth without every move reflecting in the larger time frame.

If the time frames are too close, you won't be able to tell the difference, which would be pretty useless.

Summary: Multiple Time Frame Analysis

So now you're done! Now you can add multiple time frame analysis to your trading tool box! Yeah mannnnn!

Here are a few tips you should remember:

- You have to decide what the correct time frame is for YOU. This comes from trying different time frames out through different market environments, recording your results, and analyzing those results to find what works for you.
- Once you've found your preferred time frame, go up to the next higher time frame. Then make a strategic decision to go long or short based on the direction of the trend. You would then return to your preferred time frame (or lower) to make tactical decisions about where to enter and exit (place stop and profit target).
- Adding the dimension of time to your analysis gives you an edge over the other tunnel vision traders who only trade off on only one time frame.
- Make it a habit to look at multiple time frames when trading.
- Make sure you practice! You don't wanna get caught up in the heat of trading not knowing where the time frame button is! Make sure you know how to shift quickly between them. Heck, you should even practice having chart containing multiple time frames up at the same time!
- Choose a set of time frames that you are going to watch, and only concentrate on those time frames. Learn all you can about how the market works during those time frames.
- Don't look at too many time frames, you'll be overloaded with too much information and your brain will explode. And you'll end up with a messy desk since there will be blood splattered everywhere. Stick to two or three time frames. Any more than that is overkill.
- We can't repeat this enough: Get a bird's eye view. Using multiple time frames resolves contradictions between indicators and time frames. Always begin your market analysis by stepping back from the markets and looking at the big picture.

Undergraduate

What is Market Sentiment

How's Mr. Market Feeling?

Every trader will always have an opinion about the market.

"It's a bear market, everything is going to hell!"

"Things are looking bright. I'm pretty bullish on the markets right now."





Each and every trader will have their own personal explanation as to why the market is moving a certain way.

When trading, traders express this view in whatever trade he takes. But sometimes, no matter how convinced a trader is that the markets will move in a particular direction, and no matter how pretty all the trend lines line up, the trader may still end up losing.

A trader must realize that the overall market is a combination of all the views, ideas and opinions of all the participants in the market. That's right... EVERYONE.

This combined feeling that market participants have is what we call **market sentiment**.

It is the dominating emotion or idea that the majority of the market feels best explains the current direction of the market.

How to Develop a Sentiment-Based Approach

As a trader, it is your job to gauge what the market is feeling. Are the indicators pointing towards bullish conditions? Are traders bearish on the economy? We can't tell the market what we think it should do. But what we can do is react in response to what is happening in the markets.

Note that using the market sentiment approach doesn't give a precise entry and exit for each trade. But don't despair! Having a sentiment-based approach can help you decide whether you should go with the flow or not. Of course, you can always combine market sentiment analysis with technical and fundamental analysis to come up with better trade ideas.

In stocks and options, traders can look at volume traded as an indicator of sentiment. If a stock price has been rising, but volume is declining, it may signal that the market is overbought. Or if a declining stock suddenly reversed on high volume, it means the market sentiment may have changed from bearish to bullish.

Unfortunately, since the foreign exchange market is traded over-the-counter, it doesn't have a centralized market. This means that the volume of each currency traded cannot be easily measured.



GASP!

OH NOOOO!!!!
Without any tools to measure volume, how can a trader measure market sentiment?!
This is where the **Commitment of Traders** report comes in!

Commitment of Traders Report

The COT Report: What, Where, When, Why, and How

The Commodity Futures Trading Commission, or CFTC, publishes the Commitment of Traders report (COT) every Friday, around 2:30 pm EST.

Because the COT measures the net long and short positions taken by speculative traders and commercial traders, it is a great resource to gauge how heavily these market players are positioned in the market.



Later on, we'll let you meet these market players. These are the hedgers, large speculators, and retail traders. Just like players in a team sport, each group has its unique characteristics and roles. By watching the behavior of these players, you'll be able to foresee incoming changes in market sentiment.

You're probably asking yourself, "Why the heck do I need to use data from the FX futures market?"

"Doesn't the spot FX market have a report that measures how currency traders are positioned?"

"I'm a spot FX trader! Activity in the futures market doesn't involve me."

Remember, since spot FX is traded over-the-counter (OTC), transactions do not pass through a centralized exchange like the Chicago Mercantile Exchange.

So what's the closest thing we can get our hands on to see the state of the market and how the big players are moving their money?

Yep, you got it...

The Commitment of Traders report from the futures market.

Before going into using the Commitment of Traders report in your trading strategy, you have to first know WHERE to go to get the COT report and HOW to read it.

3 Simple Steps to Access the COT Report

Step 1:

Open up the address below in your web browser.
(http://www.cftc.gov/marketreports/commitmentsoftraders/index.htm)



Step 2:

Once the page has loaded, scroll down a couple of pages to the "**Current Legacy Report**" and click on "**Short Format**" under "**Futures Only**" on the "**Chicago Mercantile Exchange**" row to access the most recent COT report.

	Futures Only		Futures-and-Options-Combined	
Chicago Board of Trade	Long Format	Short Format	Long Format	Short Format
Chicago Mercantile Exchange	Long Format	Short Format	Long Format	Short Format
Chicago Board Options Exchange	Long Format	Short Format	Long Format	Short Format
Chicago Climate Futures Exchange	Long Format	Short Format	Long Format	Short Format
Kansas City Board of Trade	Long Format	Short Format	Long Format	Short Format

Step 3:

It may seem a little intimidating at first because it looks like a big giant gobbled-up block of text but with a little bit of effort, you can find exactly what you're looking for. Just press CTRL+F (or whatever the find function is of your browser) and type in the currency you want to find.

To find the British Pound Sterling, or GBP, for example, just search up "Pound Sterling" and you'll be taken directly to a section that looks something like this:

```
BRITISH POUND STERLING - CHICAGO MERCANTILE EXCHANGE                Code-096742
FUTURES ONLY POSITIONS AS OF 03/16/10                              |
--------------------------------------------------------------------| NONREPORTABLE
      NON-COMMERCIAL       |   COMMERCIAL    |      TOTAL          |   POSITIONS
-------------------------|-----------------|-----------------|-----------------
  LONG   | SHORT  |SPREADS |  LONG  | SHORT  |  LONG  | SHORT  |  LONG  | SHORT
-------------------------------------------------------------------------------
(CONTRACTS OF GBP 62,500)                                OPEN INTEREST:      121,551
COMMITMENTS
  11,731   75,718      158   94,765   14,211  106,654   90,087   14,897   31,464

CHANGES FROM 03/09/10 (CHANGE IN OPEN INTEREST:    -27,011)
   1,314    1,828   -1,315  -24,446  -24,496  -24,447  -23,983   -2,564   -3,028

PERCENT OF OPEN INTEREST FOR EACH CATEGORY OF TRADERS
     9.7     62.3      0.1     78.0     11.7     87.7     74.1     12.3     25.9

NUMBER OF TRADERS IN EACH CATEGORY (TOTAL TRADERS:       81)
      12       41        3       13       18       27       60
```

Yowza! What the heck is this?! Don't worry. We'll explain each category below.

- **Commercial:** These are the big businesses that use currency futures to hedge and protect themselves from too much exchange rate fluctuation.
- **Non-Commercial**: This is a mixture of individual traders, hedge funds, and financial institutions. For the most part, these are traders who looking to trade for speculative gains. In other words, these are traders just like you who are in it for the Benjamins!
- **Long:** That's the number of long contracts reported to the CFTC.

- **Short:** That's the number of short contracts reported to the CFTC.

- **Open interest**: This column represents the number of contracts out there that have not been exercised or delivered.
- **Number of traders:** This is the total number of traders who are required to report positions to the CFTC.
- **Reportable positions:** the number of options and futures positions that are required to be reported according to CFTC regulations.
- **Non-reportable positions**: open interest positions of traders that do not meet the reportable requirements of the CFTC like retail traders.

If you want to access all available historical data, you can view it here.

You can see a lot of things in the report but you don't have to memorize all of it.

As a budding trader, you'll only be focusing on answering the basic question:

"Wat da dilly on da market yo?!"

Translation: "What's the market feeling this week?"

Understanding the Three Groups

In order to understand the futures market, first you need to know the people making the shots and those who are warming up the bench. These players could be categorized into three basic groups:

1. Commercial traders (Hedgers)
2. Non-commercial traders (Large Speculators)
3. Retail traders (Small Speculators)

Don't Skip the Commercial - The Hedgers

Hedgers or commercial traders are those who want to protect themselves against unexpected price movements. Agricultural producers or farmers who want to hedge (minimize) their risk in changing commodity prices are part of this group.

Banks or corporations who are looking to protect themselves against sudden price changes in currencies or other assets are also considered commercial traders.

A key characteristic of hedgers is that they are ***most bullish at market bottoms*** and ***most bearish at market tops***.

What the hedgehog does this mean?



Here's a real life example to illustrate:

There is a virus outbreak in the U.S. that turns people into zombies. Zombies run amok doing malicious things like grabbing strangers' iPhones to download fart apps.

It's total mayhem as people become disoriented and helpless without their beloved iPhones. This must be stopped now before the nation crumbles into oblivion!

Guns and bullets apparently don't work on the zombies. The only way to exterminate them is by chopping their heads off.

Apple sees a "market need" and decides to build a private Samurai army to protect vulnerable iPhone users.

It needs to import samurai swords from Japan. Steve Jobs contacts a Japanese samurai swordsmith who demands to be paid in Japanese yen when he finishes the swords after three months.

Apple also knows that, if the USD/JPY falls, it will end up paying more yen for the swords.

In order to protect itself, or rather, hedge against currency risk, the firm buys JPY futures.

If USD/JPY falls after three months, the firm's gain on the futures contract would offset the increased cost on its transaction with the Japanese sword smith.

On the other hand, if USD/JPY rises after three months, the firm's loss on the futures contract would be offset by the decrease in cost of its payment for the samurai swords.

In It to Win It - The Large Speculators

In contrast to hedgers, who are not interested in making profits from trading activities, speculators are in it for the money and have no interest in owning the underlying asset!

Many speculators are known as hardcore trend followers since they buy when the market is on an uptrend and sell when the market is on a downtrend. They keep adding to their position until the price movement reverses.

Large speculators are also big players in the futures market since they hold huge accounts.

As a result, their trading activities can cause the market to move dramatically. They usually follow moving averages and hold their positions until the trend changes.

Cannon fodders - The Small Speculators

Small speculators, on the other hand, own smaller retail accounts. These comprise of hedge funds and individual traders.

They are known to be anti-trend and are usually on the wrong side of the market. Because of that, they are typically less successful than hedgers and commercial traders.

However, when they do follow the trend, they tend to be highly concentrated at market tops or bottoms.

The COT Trading Strategy

Since the COT comes out weekly, its usefulness as a market sentiment indicator would be more suitable for longer-term trades.

The question you may be asking now is this:

How the heck do you turn all that "big giant gobbled-up block of text" into a sentiment-based indicator that will help you grab some pips?!

One way to use the COT report in your trading is to find **extreme net long or net short positions**.

Finding these positions may signal that a market reversal is just around the corner because if everyone is long a currency, who is left to buy?

No one.

And if everyone is short a currency, who is left to sell?

What's that?

Pretty quiet...

Yeah, that's right. NO ONE.

One analogy to keep in mind is to imagine driving down a road and hitting a dead end. What happens if you hit that dead end? You can't keep going since there's no more road ahead. The only thing to do is to turn back.

Let's take a look at this chart of the EUR/USD from **TimingCharts**:



On the top half, we've got the price action of EUR/USD going on. At the same time, on the bottom half, we've got data on the long and short positions of EUR futures, divided into three categories:

- Commercial traders (blue)
- Large Non-commercial (green)
- Small non-commercial (red)

Ignore the commercial positions for now, since those are mainly for hedging while small retail traders aren't relevant.

Let's take a look at what happened mid-way through 2008. As you can see, EUR/USD made a steady decline from July to September. As the value of the net short positions of non-commercial traders (the green line) dropped, so did EUR/USD. In the middle of September, net short positions hit an extreme of 45,650. Soon after, investors started to buy back EUR futures. Meanwhile, EUR/USD rose sharply from about 1.2400 to a high near 1.4700!

Over the next year, the net value of EUR futures position gradually turned positive. As expected, EUR/USD eventually followed suit, even hitting a new high around 1.5100. In early October 2009, EUR futures net long positions hit an extreme of 51,000 before reversing. Shortly after, EUR/USD began to decline as well.

Holy Guacamole! Just by using the COT as an indicator, you could have caught two crazy moves from October 2008 to January 2009 and November 2009 to March 2010.

The first was in mid-September 2009. If you had seen that speculative traders' short positions were at extreme levels, you could have bought EUR/USD at around 1.2300. This would have resulted in almost a 2,000-pip gain in a matter of a few months!

Now, if you had also seen that net long positions were at an extreme in November 2009, you would have had sold EUR/USD and you could have grabbed about 1,500 pips!

With those two moves, using just the COT report as a market sentiment reversal indicator, you could have grabbed a total of 3,500 pips. Pretty nifty, eh?

Picking Tops and Bottoms

As you would've guessed, ideal places to go long and short are those times when sentiment is at an *extreme*.

If you noticed from the previous example, the speculators (green line) and commercials (blue line) gave opposite signals. While hedgers buy when the market is bottoming, speculators sell as the price moves down.

Here's that chart again:



Hedgers are bearish when the market moves to the top while speculators are bullish when the price is climbing.

As a result, **speculative positioning indicates trend direction** while **commercial positioning could signal reversals**.

If hedgers keep increasing their long positions while speculators increase their short positions, a market bottom could be in sight.

If hedgers keep adding more short positions while speculators keep adding more long positions, a market top could occur.

Of course, it's difficult to determine the exact point where a sentiment extreme will occur so it might be best to do nothing until signs of an actual reversal are seen.

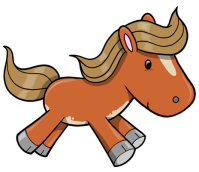
We could say that speculators, because they follow the trend, catch most of the move BUT are wrong on turning points.

Commercial traders, on the other hand, miss most of the trend EXCEPT when price reverses.

Until a sentiment extreme occurs, it would be best to go with the speculators.

The basic rule is this: every market top or bottom is accompanied by a sentiment extreme, but not every sentiment extreme results in a market top or bottom.

Your Very Own COT Indicator



Having your very own COT indicator is like having your own pony.

Using the COT report can be quite useful as a tool in spotting potential reversals in the market.

There's one problem though, we cannot simply look at the absolute figures printed on the COT report and say, "Aha, it looks like the market has hit an extreme... I will short and buy myself 10,000,000 pairs of socks."

Determining extremes can be difficult because the net long and short positions are not all relevant. What may have been an extreme level five years ago may no longer be an extreme level this year. How do you deal with this problem?

What you want to do is create an index that will help you gauge whether the markets are at extreme levels. Below is a step-by-step process on how to create this index.

1. Decide how long of a period we want to cover. The more values we input into the index, the less sentiment extreme signals we will receive, but the more reliable it will be. Having less input values will result in more signals, although it might lead to more false positives.
2. Calculate the difference between the positions of large speculators and commercial traders for each week.

   The formula for calculating this difference is:

   Difference = Net position of Large Speculators - Net position of Commercials

   Take note that if large speculators are extremely long, this would imply that commercial traders are extremely short. This would result in a positive figure.

   On the other hand, if large speculators are extremely short, that would mean that commercial traders are extremely long and this would result in a negative figure.

3. Rank these results in ascending order, from most negative to most positive.
4. Assign a value of 100 to the largest number and 0 to the smallest figure.

And now we have a COT indicator! This is very similar to the RSI and stochastic indicators that we've discussed in earlier lessons.
Once we have assigned values to each of the calculated differences, we should be alerted whenever new data inputted into the index shows an extreme - 0 or 100. This would indicate that the difference between the positions of the two groups is largest, and that a reversal may be imminent.

Remember, we are interested in knowing whether the trend is going to continue or if it is going to end. If the COT report reveals that the markets are at extreme levels, it would help pinpoint those tops and bottoms that we all love so much.

Getting Down and Dirty with the Numbers

Now that we know how to determine sentiment extremes, what's next? Recall that not every sentiment extreme results in a market top or bottom so we'll need a more accurate indicator. Calculating the percentage of speculative positions that are long or short would be a better gauge to see whether the market is topping or bottoming out.

The equation to calculate for the %-long and %-short is indicated below:

$$\%\ \text{long} = \frac{\#\ \text{of long contracts}}{\#\ \text{of long contracts} + \#\ \text{of short contracts}}$$

$$\%\ \text{short} = \frac{\#\ \text{of short contracts}}{\#\ \text{of long contracts} + \#\ \text{of short contracts}}$$

To illustrate this better, let's go back a few years and see what happened with Canadian dollar futures.

Going through the COT reports released on the week ending August 22, 2008, speculators were net short 28,085 contracts. On March 20, 2009, they were net short 23,950 contracts. From this information alone, you would say that there is a higher probability of a market bottom in August since there were more speculators that were short in that period.

But hold on a minute there... You didn't think it would be THAT easy right?



A closer look would show that 66,726 contracts were short while 38,641 contracts were long. Out of all the speculative positions in **April** (66,726 / (38,641 + 66,726)), **63.3%** were short positions.

On the other hand, there were just 5,203 long contracts and 25,875 short contracts in **March**. This means that (25,875 / (5,203 + 25,875)) **83.3%** of the speculative positions were short positions during that period.

What does this mean? There is a higher chance that a bottom will occur when 83.3% of all speculative positions are short as opposed to just 63.3%.

As you can see on the chart below, the bottom in fact did not occur around August 2008, when the Canadian dollar was worth roughly around 94 U.S. cents. The Canadian dollar continued to fall over the next few months. By the time March came around and the %-short ratio hit 83.3%, the Canadian dollar had hit a bottom around 77 U.S. cents. Then what happened? It started to steadily rise! A market bottom? Yep, you got it.

Summary: Market Sentiment

Did those thousand-pip moves excite you?

Before we start betting the farm based on our analysis of the COT report, remember that those were just specific cases of when the COT report signalled a perfect market reversal.

The best thing to do would be to back test and look at reasons why a reversal took place.

Was the economy booming?

Or was it in the middle of a recession?

Remember, the COT report measures the sentiment of traders during a specific period of time. Like every other tool in your toolbox, using the COT report as an indicator does not always correlate to market reversals. So take the time to study this report and get your own feel of what works and what doesn't.

Also, before we bring this lesson to an end, always keep in mind that market prices aren't driven by solely COT reports, stochastic, Fibonacci levels, etc.

The markets are driven by the millions of people reacting to economic analysis, fundamental reports, politics, Godzilla attacks, UFO sightings, Lady Gaga concerts - life in general! It is how you use these tools that will help you be prepared to what lies ahead.

In conclusion...

- As traders, it is our job to gauge what the market is feeling.
- One way to gauge market sentiment extremes is through the Commitment of Traders Report.
- By understanding the activities of the three groups of traders (commercial traders, non-commercial, retail traders), we can find ourselves in better positions to fish for tops and bottoms.
- Remember, every market top or bottom is accompanied by a sentiment extreme, but not every sentiment extreme results in a market top or bottom.

Importance of News



It's not enough to only know technical analysis when you trade. It's just as important to know what makes the market move.

Just like in the great Star Wars world, behind the trend lines, double tops, and head and shoulder patterns, there is a fundamental force behind these movements. This force is called the **news**!

To understand the importance of the news, imagine this scenario (purely fictional of course!)

Let's say, on your nightly news, there is a report that the biggest software company that you have stock with just filed bankruptcy.

What's the first thing you would do? How would your perception of this company change? How do you think other people's perceptions of this company would change?

The obvious reaction would be that you would immediately sell off your shares. In fact, this is probably what just about everyone else who had any stake in that company would do.

The fact is that news affects the way we perceive and act on our trading decisions. It's no different when it comes to trading currencies.

There is, however, a distinct difference with how news is handled in the stock market and the forex market.

Let's go back to our example above and imagine that you heard that same report of the big software company filing bankruptcy, but let's say you heard the report a day before it was actually announced in the news.



Naturally you would sell off all your shares, and as a result of you hearing the news a day earlier, you would make (save) more money than everyone else who heard it on their nightly news.

Sounds good for you right? Unfortunately this little trick is called **INSIDER TRADING**, and it would have you thrown in jail.

Martha Stewart did it and now she has a nice mug-shot to go along with her magazine covers.

In the stock market, when you hear news before everyone else it is illegal. In the forex market, it's called ***FAIR GAME***!

The earlier you hear or see the news, the better it is for your trading, and there is absolutely no penalty for it!

Add on some technology and the power of instant communication, and what you have is the latest and greatest (or not so greatest) news at the tip of your fingers.

This is great... Uhmmm... "news" for retail traders because it allows U.S. to react fairly quickly to the market's speculations.

Big traders, small traders, husky traders, or skinny traders all have to depend on the same news to make the market move because if there wasn't any news, the market would hardly move at all!

The news is important to the Forex market because it's the news that makes it move. Regardless of the technicals, news is the fuel that keeps the market going!

Why Trade the News

The simple answer to that question is "To make more money!"

But in all seriousness, trading the news gives us another opportunity to trade the forex market. As we learned in the previous section, news is a very important part to the market because it's what makes it move!

When news comes out, especially important news that everyone is watching, you can expect to see some major movement. Your goal as a trader is to get on the right side of the move, but the fact that you know the market will indeed move somewhere makes it an opportunity definitely worth looking at.

Dangers of trading the news

As with any trading strategy, there are always possible dangers that you should be aware of.

Here are some of those dangers:

Because the market is very volatile during important news events, **many dealers widen the spread during these times**. This increases trading costs and could hurt your bottom line.

You could also get "locked out" which means that your trade could be executed at the right time but may not show up in your trading station for a few minutes. Obviously this is bad for you because you won't be able to make any adjustments if the trade moves against you!

Imagine thinking you didn't get triggered, so you try to enter at market... then you realize that your original ordered got triggered! You'd be risking twice as much now!



You could also experience **slippage**. Slippage occurs when you wish to enter the market at a certain price, but due to the extreme volatility during these events, you actually get filled at a far different price.

Big market moves made by news events often don't move in one direction. Often times the market may start off flying in one direction, only to be whipsawed back in the other direction. Trying to find the right direction can sometimes be a headache!

Profitable as it may be, trading the news isn't as easy as beating Pipcrawler on Call of Duty. It will take tons of practice, practice and you guessed it... more practice! Most importantly, you must **ALWAYS** have a plan in place. In the following lessons, we'll give you some tips on how to trade news reports.

Which News Reports are Trade-Worthy?

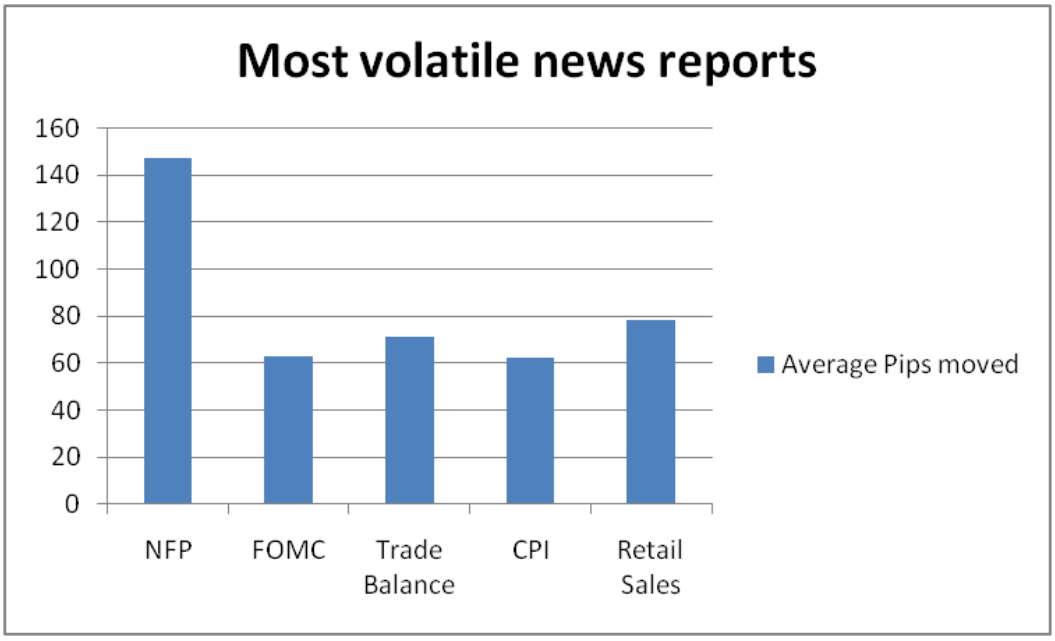
Before we even look at strategies for trading news events, we have to look at which news events are even worth trading.

Remember that we are trading the news because of its ability to increase volatility in the short term, so naturally we would like to only trade news that has the best market moving potential.

While the markets react to most economic news from various countries, the biggest movers and most watched news comes from the U.S.

The reason is that the U.S. has the largest economy in the world and the U.S. Dollar is the world's reserve currency. This means that the U.S. Dollar is a participant in about 90% of all Forex transactions, which makes U.S. news and data important to watch.

With that said, let's take a look at some of the most volatile news for the U.S.



In addition to inflation reports and central bank talks, you should also pay attention to geo-political news such as war, natural disasters, political unrest, and elections. Although these may not have as big an impact as the other news, it's still worth paying attention to them.

Also, keep an eye on moves in the stock market. There are times where sentiment in the equity markets will be the precursor to major moves in the forex market.

Now that we know which news events make the most moves, our next step is to determine which currency pairs are worth trading.

Because news can bring increased volatility in the forex market (and more trading opportunities), it is important that we trade currencies that are liquid. Liquid currency pairs give us a reassurance that our orders will be executed smoothly and without any "hiccups".

1. EUR/USD
2. GBP/USD
3. USD/JPY
4. USD/CHF
5. USD/CAD
6. AUD/USD

Did you notice anything here?

That's right! These are all major currency pairs!

Remember, because they have the most liquidity, majors pairs usually have the tightest spreads. Since spreads widen when news reports come out, it makes sense to stick with those pairs that have the tightest spreads to begin with.

Now that we know which news events and currency pairs to trade, let's take a look at some approaches to trading the news.

Directional Bias vs. Non-Directional Bias

There are two main ways to trade the news:

a) Having a ***directional bias***
b) Having a ***non-directional bias***

Directional Bias

Having directional bias means that you expect the market to move a certain direction once the news report is released. When looking for a trade opportunity in a certain direction, it is good to know what it is about news reports that cause the market to move.

Consensus vs. Actual

Several days or even weeks before a news report comes out, there are analysts that will come up with some kind of forecast on what numbers will be released. As we talked about in a previous lesson, this number will be different among various analysts, but in general there will be a common number that a majority of them agree on. This number is called a **consensus**.

When a news report is released, the number that is given is called the **actual** number.

"Buy the rumors, sell on the news"

This is a common phrase used in the forex market because often times it seems that when a news report is released, the movement doesn't match what the report would lead you to believe.

For example, let's say that the U.S. unemployment rate is expected to increase. Imagine that last month the unemployment rate was at 8.8% and the consensus for this upcoming report is 9.0%.

With a consensus at 9.0%, it means that all the big market players are anticipating a weaker U.S. economy, and as a result, a weaker Dollar.

So with this anticipation, big market players aren't going to wait until the report is actually released to start acting on taking a position. They will go ahead and start selling off their dollars for other currencies before the actual number is released.

Now let's say that the actual unemployment rate is released and as expected, it reports 9.0%.

As a retail trader, you see this and think "Okay, this is bad news for the U.S. It's time to short the dollar!"

However, when you go to your trading platform to start selling the dollar, you see that the markets aren't exactly moving in the direction you thought it would. This is because the big players have already adjusted their positions way before the news report even came out and may now be taking profits after the run up to the news event.

Now let's revisit this example, but this time, imagine that the actual report released an unemployment rate of 8.0%. The market players thought the unemployment rate would rise to 9.0% because of the consensus, but instead the report showed that the rate actually decreased, showing strength for the dollar.

What you would see on your charts would be a huge dollar rally across the board because the big market players didn't expect this to happen. Now that the report is released and it says something totally different from what they had anticipated, they are all trying to adjust their positions as fast as possible.

This would also happen if the actual report released an unemployment rate of 10.0%. The only difference would be that instead of the dollar rallying, it would drop like a rock! Since the market consensus was 9.0% but the actual report showed a bigger 10.0% unemployment rate, the big players would sell off more of their dollars because the U.S. looks a lot weaker now than when the forecasts were first released.

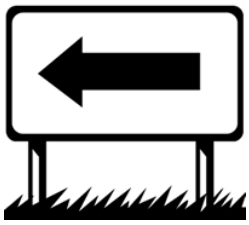
Keeping track of the market consensus and the actual numbers, you can better gauge which news reports will actually cause the market to move and in what direction.

Non-directional bias

A more common news trading strategy is the non-directional bias approach. This method disregards a directional bias and simply plays on the fact that a big news report will create a big move. It doesn't matter which way it moves... We just want to be there when it does!

What this means is that once the market moves in either direction, you have a plan in place to enter that trade. You don't have any bias as to whether price will go up or down, hence the name *non-directional bias*.

Trading with a Directional Bias



Let's go back to our example of the U.S. unemployment rate report. Earlier, we gave examples of what could happen if the report came in light with expectations, or slightly better. Let's say there was a surprising drop. What effect could this have on the dollar? One thing that could happen is that the dollar falls. What??? Isn't the dollar supposed to rise if the unemployment rate is dropping?

There could be a couple reasons why the dollar could still fall even though there are more people with jobs.

The first reason could be that the long-term and overall trend of the U.S. economy is still in a downward spiral. Remember that there are several fundamental factors that play into an economy's strength or weakness. Although the unemployment rate dropped, it might not be a big enough catalyst for the big traders to start changing their perception of the dollar.

The second reason could be the reason for the unemployment rate drop. Perhaps it's right after Thanksgiving during the holiday rush. During this time, many companies normally hire seasonal employees to keep up with the influx of Christmas shoppers. This increase in jobs may cause a short term drop in the unemployment rate, but it's not at all indicative of the long term outlook on the U.S. economy.

A better way to get a more accurate measure of the unemployment situation would be to look at the number from last year and compare it to this year. This would allow you to see if the job market actually improved or not.

The important thing to remember is to always take a step back and look at the overall picture before making any quick decisions.

Now that you have that information in your head, it's time to see how we can trade the news with a directional bias.

Let's stick with our unemployment rate example to keep it simple. The first thing you would want to do before the report comes out is take a look at the trend of the unemployment rate to see if it has been increasing or decreasing. By looking at what has been happening in the past, you can prepare yourself for what might happen in the future.

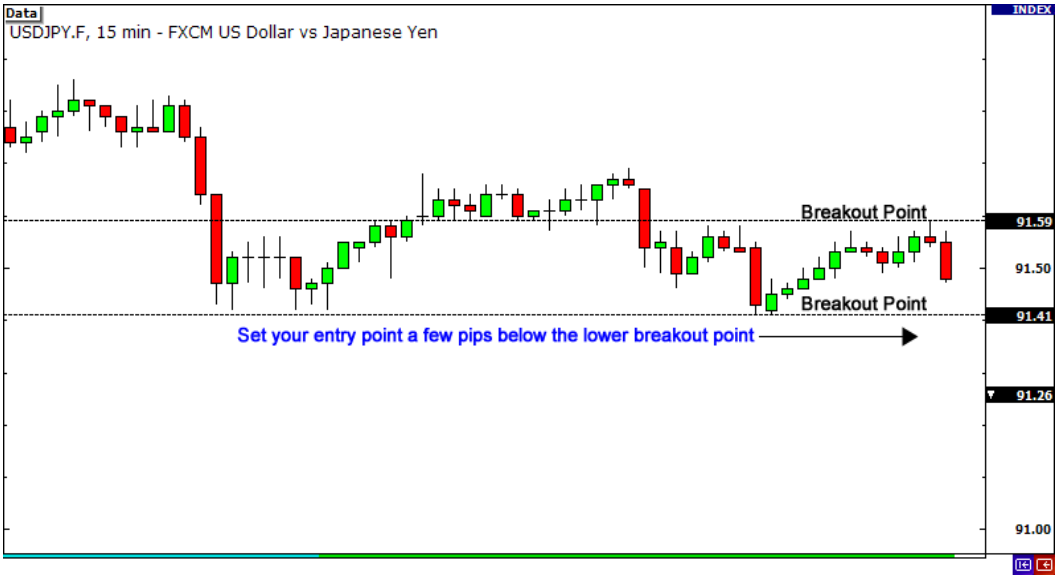
Imagine that the unemployment rate has been steadily increasing. Six months ago it was at 1% and last month it topped out at 3%. You could now say with some confidence that jobs are decreasing and that there is a good possibility the unemployment rate will continue to rise.

Since you are expecting the unemployment rate to rise, you can now start preparing to go short on the dollar. Particularly, you feel like you could short USD/JPY.

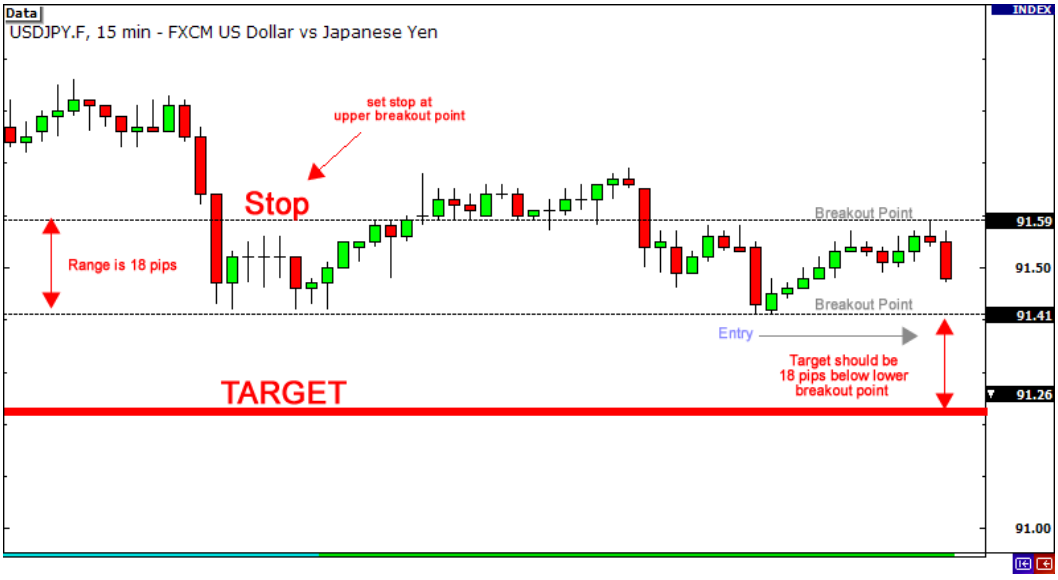
Just before the unemployment rate is about to be announced, you could look at the price movement of USD/JPY at least 20 minutes prior and find the range of movement. Take note of the high and low that is made. This will become your **breakout points**.

*Note: The smaller the range the larger tendency there is for a volatile move.

Since you have a bearish outlook on the dollar, you would pay particular attention to the lower breakout point of that range. You are expecting the dollar to drop so a reasonable strategy would be to set an entry point a few pips below that level.

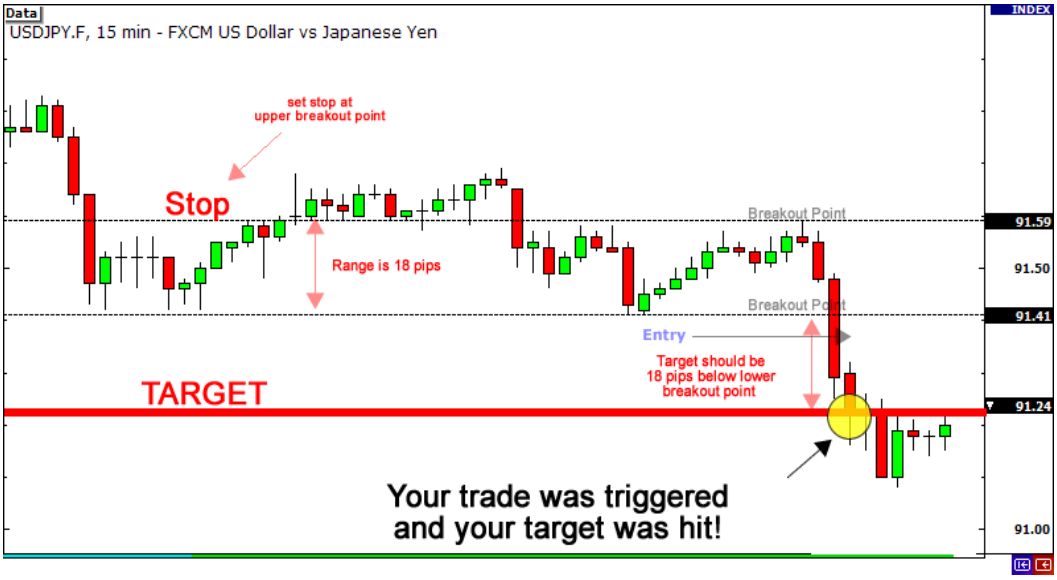


You could then set a stop just at the upper breakout point and set your limit for the same amount of pips as the breakout point range.



One of two things could happen at this point. If the unemployment rate drops then the dollar could rise. This would cause USD/JPY to rise and your trade would most likely not trigger. No harm no foul! Or if the news is as you expected and the unemployment rate rises, the dollar could drop (assuming the entire fundamental outlook on the dollar is already bearish).

This is good for you because you already set up a trade that was bearish on the dollar and now all you have to do is watch your trade unfold.



Later on, you see that your target gets hit. You just grabbed yourself a handful of pips! Booyeah!

The key to having a directional bias is that you must truly understand the concepts behind the news report that you plan to trade. If you don't understand what effect it can have on particular currencies, then you might get caught up in some bad setups. Luckily for you, we've got Pip Diddy and Forex Gump to help explain what effect each report can have on the forex market.

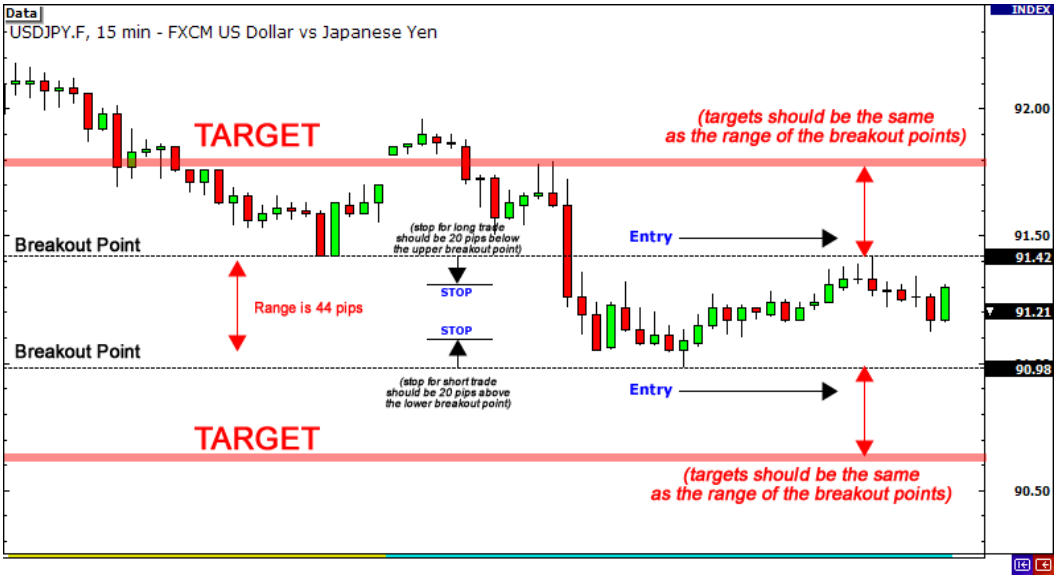
Letting the Market Decide Which Direction to Take



The first thing to consider is which news reports to trade. Earlier in this lesson we discussed the biggest moving news reports. Ideally you would want to only trade those reports because there is a high probability the market will make a big move after their release.

The next thing you should do is take a look at the range at least 20 minutes before the actual news release. The high of that range will be your upper breakout point, and the low of that range will be your lower breakout point. Note that the smaller the range is the more likely it is you will see a big move from the news report.

The breakout points will be your entry levels. This is where you want to set your orders. Your stops should be placed approximately 20 pips below and above the breakout points, and your initial targets should be about the same as the range of the breakout levels. This is known as a **straddle trade** - you are looking to play both sides of the trades, whichever trade it moves.



Now that you're prepared to enter the market in either direction, all you have to do is wait for the news to come out. Sometimes you may get triggered in one direction only to find that you get stopped out because the price quickly reverses in the other direction. However, your other entry will get triggered and if that trade wins, you should recoup your initial losses and come out with a small profit.

A best case scenario would be that only one of your trades gets triggered and the price continues to move in your favor so that you don't incur any losses. Either way, if done correctly you should still end up positive for the day.

One thing that makes a non-directional bias approach attractive is that it eliminates any emotions - you just want to profit when the move happens. This allows you take advantage of more trading opportunities, because you will be triggered either way.

There are many more strategies for trading the news, but the concepts mentioned in this lesson should always be part of your routine whenever you are working out an approach to taking advantage of news report movements.

Summary: Trading the News

There you have it! Now you know how to trade the news! Just keep these things in mind when trading:

- When you have a directional bias, you are expecting price to move a certain direction, and you've got your orders in already.
- It is always good to understand the underlying reasons why the market moves in a certain direction when news is released.
- When you have a non-directional bias, you don't care which way price heads. You just want to get triggered.
- Setups for the non-directional bias are also called **straddle trades**.

That's pretty much it...

Is it really that easy???

HECK NO!!!

You'll have to practice and trade many different reports before you get a feel of which news reports will make the market move, how much of a surprise is needed for the market to move, and which reports to avoid trading.

Like in any other trading method, your success depends on your preparation.

This will take time and practice. Do your homework and study the economic indicators to understand why they are important.

Remember, nothing worth having comes easy, so stick with it and you'll find that trading news report will be very rewarding once you get the hang of it!

What is Carry Trade?

Did you know there is a trading system that can make money if price stayed exactly the same for long periods of time?

Well there is and it's one the most popular ways of making money by many of the biggest and baddest money manager mamajamas in the financial universe!

It's called the "Carry Trade".



A carry trade involves borrowing or selling a financial instrument with a low interest rate, then using it to purchase a financial instrument with a higher interest rate.

While you are paying the low interest rate on the financial instrument you borrowed/sold, you are collecting higher interest on the financial instrument you purchased. Thus your profit is the money you collect from the interest rate differential.

For example:

Let's say you go to a bank and borrow $10,000. Their lending fee is 1% of the $10,000 every year.

With that borrowed money, you turn around and purchase a $10,000 bond that pays 5% a year.

What's your profit?

Anyone?

You got it! It's 4% a year! The difference between interest rates!

By now you're probably thinking, "That doesn't sound as exciting or profitable as catching swings in the market."

However, when you apply it to the spot forex market, with its higher leverage and daily interest payments, sitting back and watching your account grow daily can get pretty sexy.

To give you an idea, a 3% interest rate differential becomes 60% annual interest a year on an account that is 20 times leveraged!

In this section, we will discuss how carry trades work, when they will work, and when they will NOT work.

We will also tackle risk aversion (WTH is that?!? Don't worry, like we said, we'll be talking more about it later).

How Do Carry Trades Work for Forex?

In the forex market, currencies are traded in pairs (for example, if you buy USD/CHF, you are actually buying the U.S. dollar and selling Swiss francs at the same time). Just like the example in the previous, you pay interest on the currency position you sell, and collect interest on the currency position you buy.

What makes the carry trade special in the spot forex market is that interest payments happen every trading day based on your position. Technically, all positions are closed at the end of the day in the spot forex market. You just don't see it happen if you hold a position to the next day.

Brokers close and reopen your position, and then they debit/credit you the overnight interest rate difference between the two currencies. This is the cost of "carrying" (also known as "rolling over") a position to the next day.

The amount of leverage available from forex brokers has made the carry trade very popular in the spot forex market. Most forex trading is margin based, meaning you only have to put up a small amount of the position and you broker will put up the rest. Many brokers ask as little as 1% to 2% of a position. What a deal, eh?

Let's take a look at a **generic** example to show how awesome this can be.

For this example we'll take a look at Joe the Newbie Forex Trader.

It's Joe's birthday and his grandparents, being the sweet and generous people they are, give him $10,000. Schweeeet!

Instead of going out and blowing his birthday present on video games and posters of bubble gum pop stars, he decides to save it for a rainy day. Joe goes to the local bank to open up a savings account and the bank manager tells him, "Joe, your savings account will pay 1% a year on your account balance. Isn't that fantastic?"

Joe pauses and thinks to himself, "At 1%, my $10,000 will earn me $100 in a year."

"Man, that sucks!"

Joe, being the smart guy he is, has been studying BabyPips.com School of Pipsology and knows of a better way to invest his money.

So, Joe kindly responds to the bank manager, "Thank you sir, but I think I'll invest my money somewhere else."

Joe has been demo trading several systems (including the carry trade) for over a year, so he has a pretty good understanding of how forex trading works. He opens up a real account, deposits his $10,000 birthday gift, and puts his plan into action.

Joe finds a currency pair whose interest rate differential is +5% a year and he purchases $100,000 worth of that pair. Since his broker only requires a 1% deposit of the position, they hold $1,000 in margin (100:1 leverage). So, Joe now controls $100,000 worth of a currency pair that is receiving 5% a year in interest.

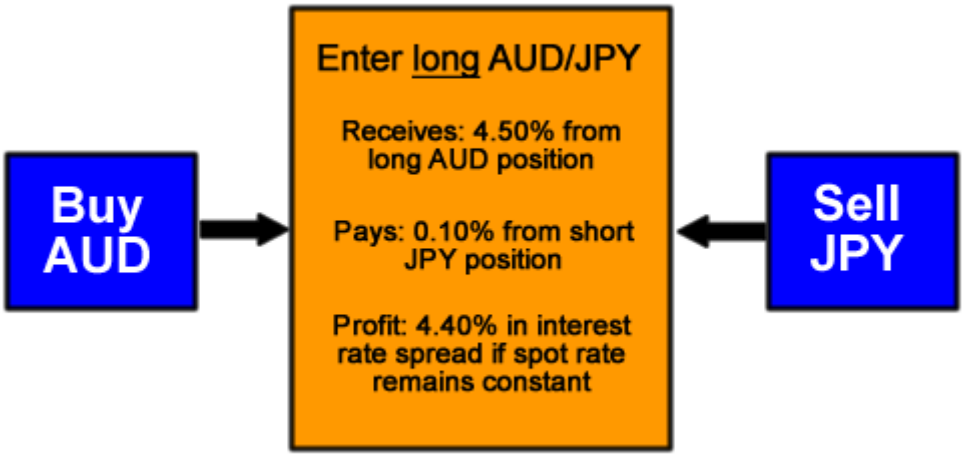
What will happen to Joe's account if he does nothing for a year?

Well, here are 3 possibilities. Let's take a look at each one:

1. **Currency position loses value.** The currency pair Joe buys drops like a rock in value. If the loss brings the account down to the amount set aside for margin, then the position is closed and all that's left in the account is the margin - $1000.
2. **The pair ends up at the same exchange rate at the end of the year.** In this case, Joe did not gain or lose any value on his position, but he collected 5% interest on the $100,000 position. That means on interest alone, Joe made $5,000 off of his $10,000 account. That's a 50% gain! Sweet!
3. **Currency position gains value.** Joe's pair shoots up like a rocket! So, not only does Joe collect at least $5000 in interest on his position, but he also takes home any gains! That would be a nice present to himself for his next birthday!

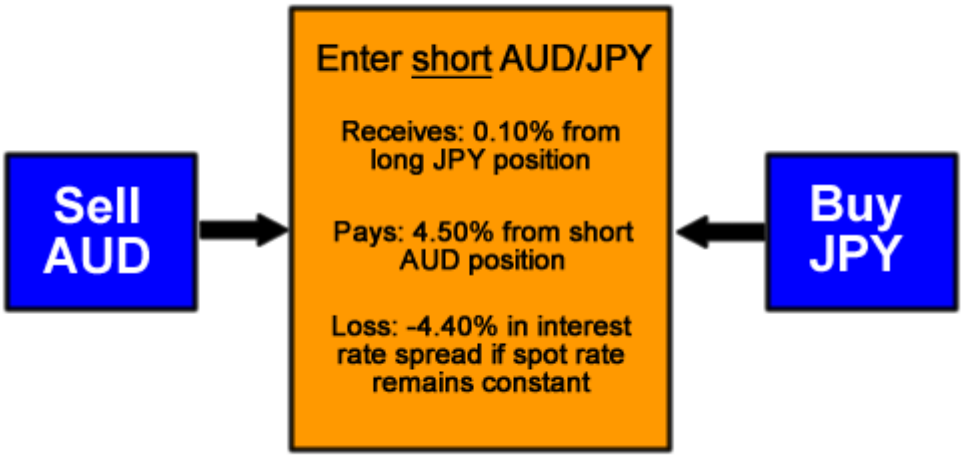
Because of 100:1 leverage, Joe has the potential to earn around 50% a year from his initial $10,000.

Here is an example of a currency pair that offers a 4.40% differential rate based on interest rates as of September 2010:



If you **buy** AUD/JPY and held it for a year, you earn a "positive carry" of 4.40%.

Of course, if you **sell** AUD/JPY, it works the opposite way:



If you sold AUD/JPY and held it for a year, you would earn a "negative carry" of 4.40%.

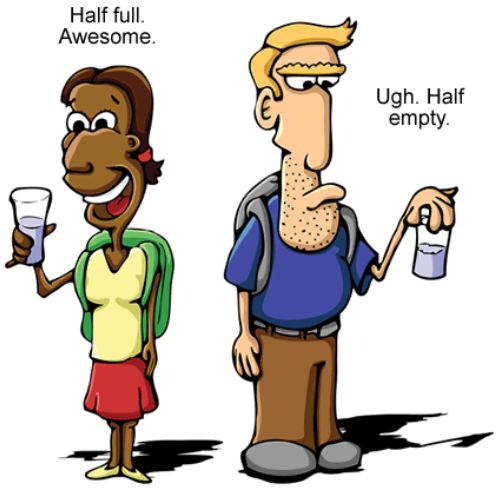
Again, this is a generic example of how the carry trade works.

Any questions on the concept? No? We knew you could catch on quick!

Now it's time to move on to the most important part of this lesson: Carry Trade Risk.

To Carry or Not to Carry

When Do Carry Trades Work?



Carry trades work best when investors ***feel*** risky and **optimistic** enough to buy high-yielding currencies and sell lower yielding currencies.

It's kinda like an optimist who sees the glass half full. While the current situation might not be ideal, he is hopeful that things will get better. The same goes for carry trade. Economic conditions may not be good, but the outlook of the buying currency does need to be positive.

If the outlook of a country's economy looks as good as Angelina Jolie, then chances are that that country's central bank will have to raise interest rates in order to control inflation.

This is good for carry trade because a higher interest rate means a bigger interest rate differential.

On the other hand, if a country's economic prospects aren't looking too good, then nobody will be prepared to take on the currency if they think the central bank will have to lower interest rates to help their economy.

To put it simply, carry trades work best when investors have ***low risk aversion***.

Carry trades do not work well when risk aversion is high (i.e. selling higher-yielding currencies and buying back lower-yielding currencies). When risk aversion is high, investors are less likely to take risky ventures.

Let's put this into perspective.

Let's say economic conditions are tough, and the country is currently undergoing a recession. What do you think your next door neighbor would do with his money?

Your neighbor would probably choose a low-paying yet safe investment than put it somewhere else. It doesn't matter if the return is low as long as the investment is a "sure thing."

This makes sense because this allows your neighbor to have a fall back plan in the event that things go bad, e.g. he loses his job. In forex jargon, your neighbor is said to have a high level of ***risk aversion***.

The psychology of big investors isn't that much different from your next door neighbor. When economic conditions are uncertain, investors tend to put their investments in safe haven currencies that offer low interest rates like the U.S. dollar and the Japanese yen.

This is the polar opposite of carry trade. This inflow of capital towards safe assets causes currencies with low interest to appreciate against those with high interest.

Carry Trade Criteria and Risk

Carry Trade Criteria

It's pretty simple to find a suitable pair to do a carry trade. Look for two things:

1. Find a high interest differential.
2. Find a pair that has been stable or in an uptrend in favor of the higher-yielding currency. This gives you the ability to stay in the trade **AS LONG AS POSSIBLE** and profit off the interest rate differential.

Pretty simple, huh? Let's take a real life example of the carry trade in action:



This is a weekly chart of AUD/JPY. Up until recently, the Bank of Japan has maintained a "Zero Interest Rate Policy" (as of September 2010, the interest rate stands at 0.10%).

With the Reserve Bank of Australia touting one of the higher interest rates among the major currencies (currently at 4.50% as of this writing), many traders have flocked to this pair (one of the factors creating a nice little uptrend in the pair).

From the start of 2009 to early 2010, this pair moved from a price of 55.50 to 88.00 - that's 3,250 pips!

If you couple that with interest payments from the interest rate differential of the two currencies, this pair has been a nice long term play for many investors and traders able to weather the volatile up and down movements of the currency market.

Of course, economic and political factors are changing the world daily. Interest rates and interest rate differentials between currencies may change as well, bringing popular carry trades (such as the yen carry trade) out of favor with investors.

Carry Trade Risk

Because you are a very smart trader, you already know what the first question you should ask before entering a trade is right?

"What is my risk?"

Correct! Before entering a trade you must **ALWAYS** assess your max risk and whether or not it is acceptable according to your risk management rules.

In the example at the start of the lesson with Joe the Newbie Forex Trader, his maximum risk would have been $9000. His position would be automatically closed out once his losses hit $9000.

Eh?

That doesn't sound very good, does it?

Remember, this is the worst possible scenario and Joe is a newbie, so he hasn't fully appreciated the value of stop losses.

When doing a carry trade, you can still limit your losses like a regular directional trade.

For instance, if Joe decided that he wanted to limit his risk to $1000, he could set a stop order to close his position at whatever the price level would be for that $1000 loss. He would still keep any interest payments he received while holding onto the position.

Summary: Carry Trade

While you are paying the low interest rate on the financial instrument you borrowed/sold, you are collecting higher interest on the financial instrument you purchased. Your profit is the money you collect from the interest rate differential.

This is another way to make money in the forex market without having to buy low and sell high, which can be pretty tough to do day after day.

Carry trades work best when investors ***feel*** like taking on risk. Current economic conditions need not be good, but the outlook does need to be positive.

If a country's economic prospects aren't looking too good, then nobody will be prepared to take on the risk. To put it simply, carry trades work best when investors have ***low risk aversion***.

Carry trades do not work well when risk aversion is high.

When risk aversion is high, investors are less likely to buy higher-yielding currencies or likely to reduce their positions in higher-yielding currencies.

When economic conditions are uncertain, investors tend to put their investments in safe haven currencies, which tend to offer low interest rates like the U.S. dollar and the Japanese yen.

It's pretty simple to find a suitable pair to do a carry trade. Look for two things:

1. Find a high interest differential.
2. Find a pair that has been stable or in an uptrend in favor of the higher-yielding currency. This gives you the ability to stay in the trade **AS LONG AS POSSIBLE** and profit off the interest rate differential.

Always remember that economic and political factors are changing the world daily. Interest rates and interest rate differentials between currencies may change as well, bringing popular carry trades (such as the yen carry trade) out of favor with investors. So, when doing a carry trade, you should still limit your losses like a regular directional trade.

When properly applied, the carry trade can add significant income to your account, along with your directional trading strategies.

What is the Dollar Index?

If you've traded stocks, you're probably familiar with all the indices available such as the Dow Jones Industrial Average (DJIA), NASDAQ Composite Index, Russell 2000, S&P 500, Wilshire 5000, and the Nimbus 2001. Oh wait, that last one is actually Harry Potter's broomstick.

Well if U.S. stocks have an index, the U.S. dollar can't be outdone. For currency traders, we have the U.S. Dollar Index (USDX).

The U.S. Dollar Index consists of a geometric weighted average of a basket of foreign currencies against the dollar.

Say whutttt!?! Okay before you fall asleep after that super geeky definition, let's break it down.

It's very similar to how the stock indices work in that it provides a general indication of the value of a basket of securities. Of course, the "securities" we're talking about here are other major world currencies.

The Basket

The U.S. Dollar Index consists of six foreign currencies. They are the:

- Euro (EUR)
- Yen (JPY)
- Pound (GBP)

- Canadian dollar (CAD)
- Krona (SEK)
- Franc (CHF)

Here's a trick question. If the index is made up of 6 currencies, how many countries are included?

If you answered "6", you're wrong.

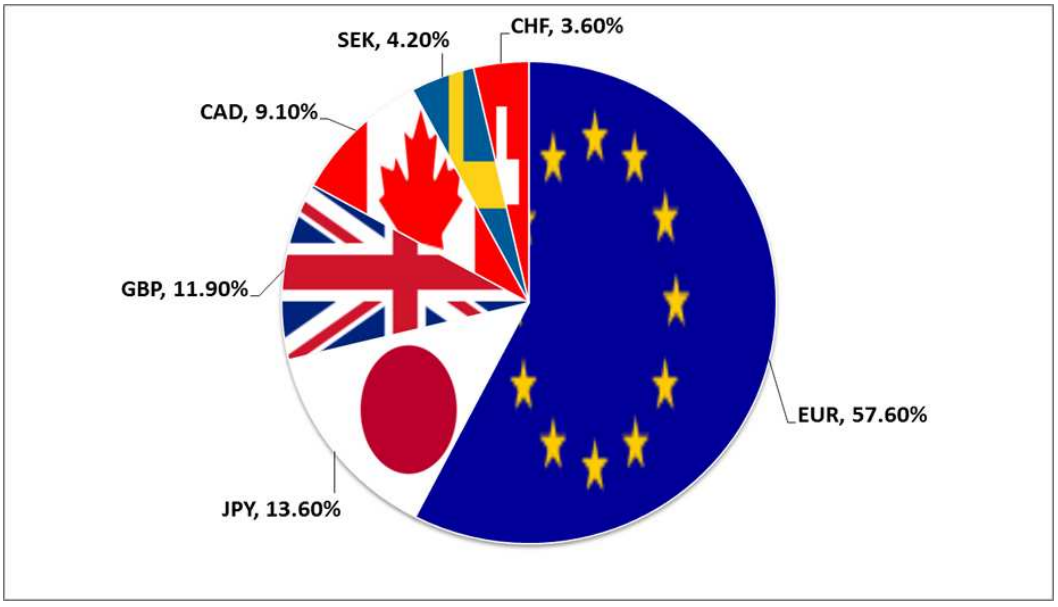
If you answered "21", you're a genius!

There are 21 countries total, because there are 16 members of the European Union that have adopted the euro as their sole currency, plus the other five countries (Japan, Great Britain, Canada, Sweden, and Switzerland) and their accompanying currencies.

It's obvious that 21 countries make up a small portion of the world but many other currencies follow the U.S. Dollar index very closely. This makes the USDX a pretty good tool for measuring the U.S. dollar's global strength.

USDX Components

Now that we know what the basket of currencies is composed of, let's get back to that *"geometric weighted average"* part. Because not every country is the same size, it's only fair that each is given appropriate weights when calculating the U.S. dollar index. Check out the current weights:



With its 16 countries, euros make up a big chunk of the U.S. Dollar Index. The next highest is the Japanese yen, which would make sense since Japan has one of the biggest economy in the world. The other four make up less than 30 percent of the USDX.

Here's something interesting: When the euro falls, which way does the U.S Dollar Index move?

The euro makes up such a huge portion of the U.S. Dollar Index, we might as well call this index the "Anti-Euro Index". Because the USDX is so heavily influenced by the euro, people have looked for a more "balanced" dollar index. More on that later though. First, let's go to the charts!

How to Read the Dollar Index

Just like any currency pair, the USDX even has its own chart. Holler at the U.S. Dollar Index:



First, notice that the index is calculated 24 hours a day, five days a week. Also, the USDX measures the dollar's general value relative to a base of 100.000. Huh?!?

Okay. For example, the current reading says 86.212. This means that the dollar has fallen 13.79% since the start of the index. (86.212 - 100.000).

If the reading was 120.650, it means the dollar's value has risen 20.65% since the start of the index. (120.650 - 100.00)

The start of the index is March 1973. This is when the world's biggest nations met in Washington D.C. and all agreed to allow their currencies to float freely against each. The start of the index is also known as the "base period".

The U.S. Dollar Index Formula

This is strictly for the grown and geeky. Here is the formula to calculating USDX:

USDX = 50.14348112 × EUR/USD^(-0.576) × USD/JPY^(0.136) × GBP/USD^(-0.119) × USD/CAD^(0.091) × USD/SEK^(0.042) × USD/CHF^(0.036)

Got that? Good! Now you can get a wedgie from the school bully.

Trade-Weighted Dollar Index

There is also another kind of dollar index used by the Federal Reserve. It is called the *"trade-weighted U.S. dollar index"*.

The Fed wanted to create an index that could more accurately reflect the dollar's value against foreign currencies based on how competitive U.S. goods are compared to goods from other countries. It was formed in 1998 in order to keep up-to-date with U.S. trade.

Currencies and Weights

Here is the current weighting (in percentage) of the index:

Country	Weight(%)
Euro zone	17.66
China	17.33
Canada	15.22
Mexico	9.72
Japan	8.71
United Kingdom	4.32
Korea	3.50
Taiwan	2.37
Singapore	2.02
Brazil	1.95
Malaysia	1.87
Hong Kong	1.75
India	1.61
Switzerland	1.42
Thailand	1.40
Australia	1.20
Russia	1.17
Israel	1.12
Sweden	1.00
Indonesia	0.92
Saudi Arabia	0.82
Chile	0.82
Philippines	0.65
Colombia	0.50
Argentina	0.48
Venezuela	0.47
Total	100

**Weights as of May 2009*

The main difference between the USDX and the trade-weighted dollar index is the basket of currencies used and their relative weights.

The trade weighted index includes countries from all over the world, including some developing countries. Given how global trade is developing, this index is probably a better reflection of the dollar's value across the globe.

The weights are based on annual trade data.

Weights for the broad index can be found at http://www.federalreserve.gov/releases/H10/Weights.

If you'd like to see historical data, check out http://www.federalreserve.gov/releases/h10/Summary/.

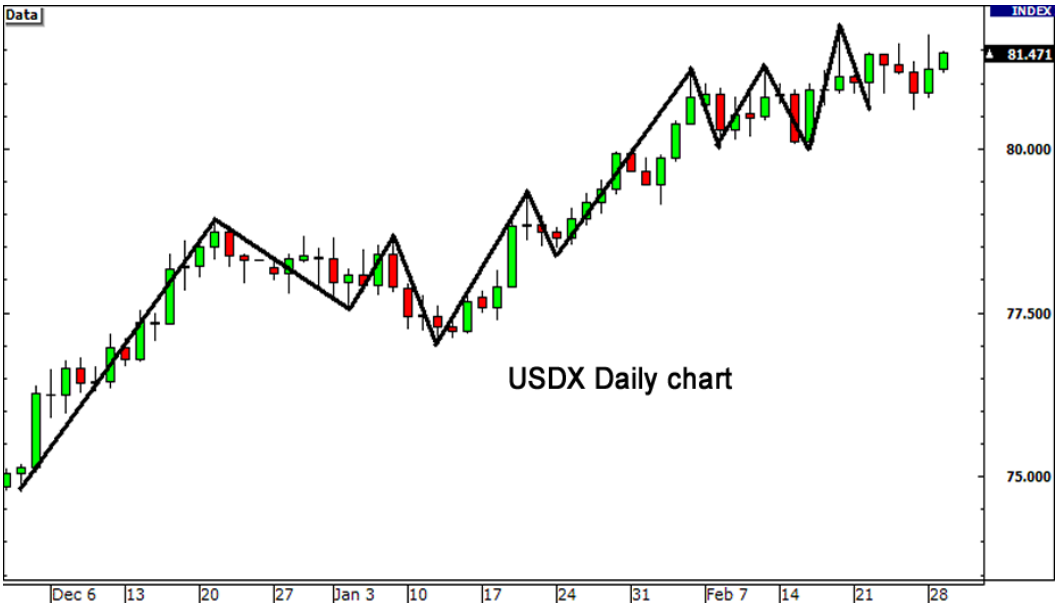
Using the USDX for Forex

I bet you're wondering, "How do I use this thing in my trading arsenal?" Well, hold your trigger finger and you'll soon find out! We all know that most of the widely traded currency pairs include the U.S. dollar. If you don't know, some that include the U.S. dollar are EUR/USD, GBP/USD, USD/CHF, USD/JPY, and USD/CAD.

What does this mean? If you trade any of these pairs, the USDX can be the next best thing to sliced bread (or hamburger on a bun... or chocolate ice cream).

If you don't, the USDX will still give you an idea of the relative strength of the U.S. dollar around the world. In fact, when the market outlook for the U.S. dollar is unclear, more often times than not, the USDX provides a better picture.

In the wide world of forex, the USDX can be used as an indicator of the U.S. dollar's strength. Because the USDX is comprised of more than 50% by the euro zone, EUR/USD is quite inversely related. Check it:



Next, take a look at a chart of EUR/USD.



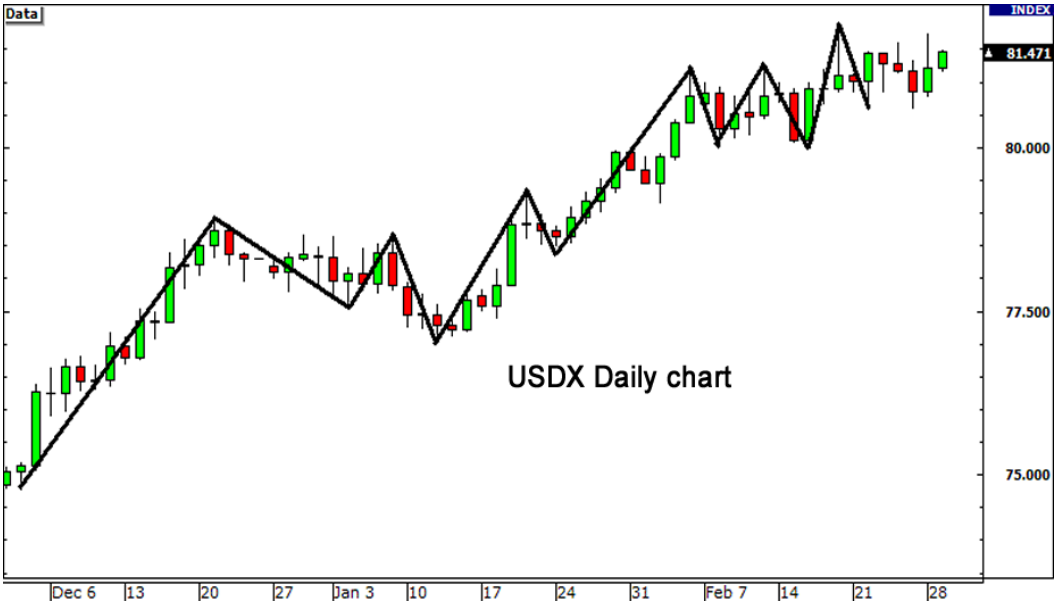
It's like a mirror image! If one goes up, the other most likely goes down. Will you look at that? It seems like the trend lines almost inversely match up perfectly. This could be a big help to those big on trading EUR/USD.

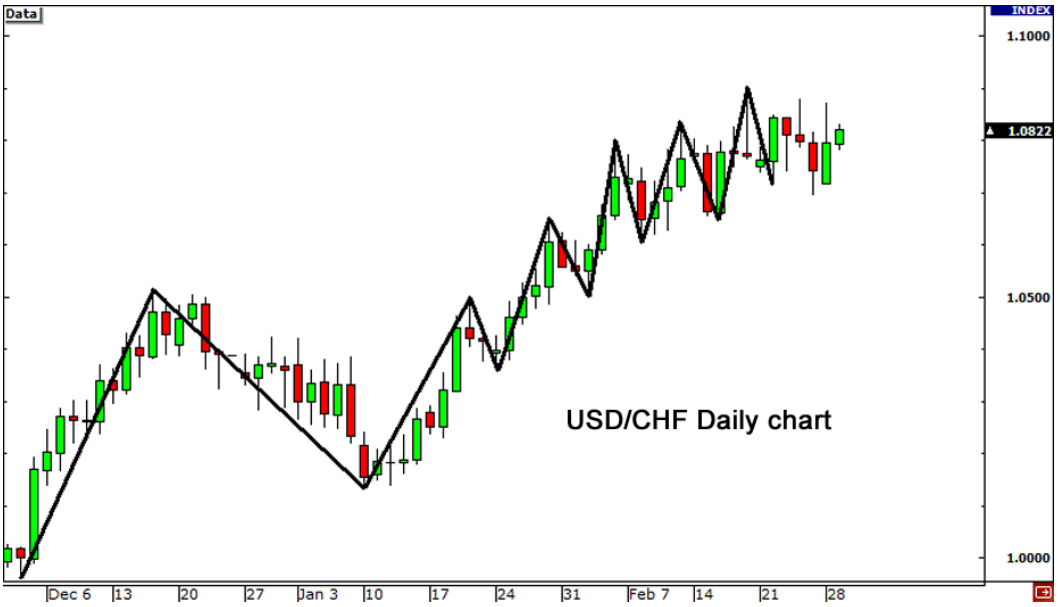
If the USDX makes significant movements, you can almost surely expect currency traders to react to the movement accordingly. Both the USDX and spot currency traders react to each other. Breakouts in spot USD pairs will almost certainly move the USDX in similar breakout fashion.

To sum it all up, currency traders use the USDX as a key indicator for the direction of the USD.

Always keep in mind the position of the USD in the pair you are trading.

For example, if the USDX is strengthening and rising, and you are trading EUR/USD, a strong USD will show a downtrend on the EUR/USD chart. If you are trading a pair in which the USD is the based currency, such as the USD/CHF, a rise in the USDX will most likely show a rise in USD/CHF charts like the one shown below.





Here are two little tips you should always remember:

If USD is the base currency (USD/XXX), then the USDX and the currency pair should move the same direction.

If USD is the quote currency (XXX/USD), then the USDX and the currency pair should move in opposite directions.

The Dollar Smile Theory

Ever wonder why the dollar strengthens both in times of tough luck and when the economy is booming like a Jay-Z remix? Well, so does everybody else. In fact, this really smart dude over at Morgan Stanley came up with a theory to explain this phenomenon.

Stephen Jen, a former currency strategist and economist, came up with a theory and named it

the "Dollar Smile Theory." His theory depicts three main scenarios directing the behavior of the U.S. dollar. Here's a simple illustration:





Scenario 1: Dollar appreciates due to risk aversion. The first part of the smile shows the U.S. dollar benefiting from risk aversion, which causes investors to flee to "safe-haven" currencies like the dollar and the yen. Since investors think that the global economic situation is shaky, they are hesitant to pursue risky assets and would rather buy up the less risky U.S. dollar regardless of the condition of the U.S. economy.



Scenario 2: Dollar drops to new low. The bottom part of the smile reflects the lackluster performance of the Greenback as the U.S. economy grapples with weak fundamentals.

The possibility of interest rate cuts also weighs the U.S. dollar down.

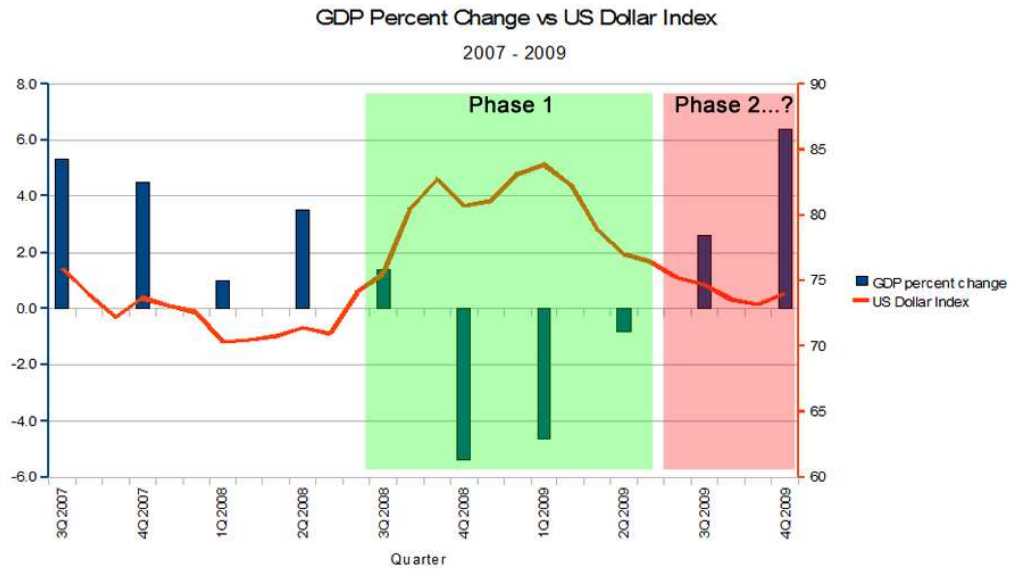
This leads to the market shying away from the dollar. The motto for USD becomes "Sell! Sell! Sell!"



Scenario 3: Dollar appreciates due to economic growth. Lastly, a smile begins to form as the U.S. economy sees the light at the end of the tunnel. As optimism picks up and signs of economic recovery appear, sentiment towards the dollar begins to pick up. In other words, the greenback begins to appreciate as the U.S. economy enjoys stronger GDP growth and expectations of interest rate hikes increase.

This theory appears to have been in play when the 2007 financial crisis began. Remember when the dollar got a huge boost at the peak of the global recession? That's phase 1.

When the market eventually bottomed out in March 2009, investors suddenly switched back to the higher yielding currencies, making the dollar the winner of the "Worst Currency" award for 2009.



So will the Dollar Smile Theory hold true?

Only time will tell.

In any case, this is an important theory to keep in mind. Remember, all economies are cyclical.

The key part is determining which part of the cycle the economy is in.

As Gold as it Gets



Before we detail the relationship between the com-dolls and gold, let's first note that the U.S. dollar and gold don't quite mesh very well.

Usually, when the dollar moves up, the gold falls and vice-versa.

The traditional logic here is that during times of economic unrest, investors tend to dump the greenback in favor of gold.

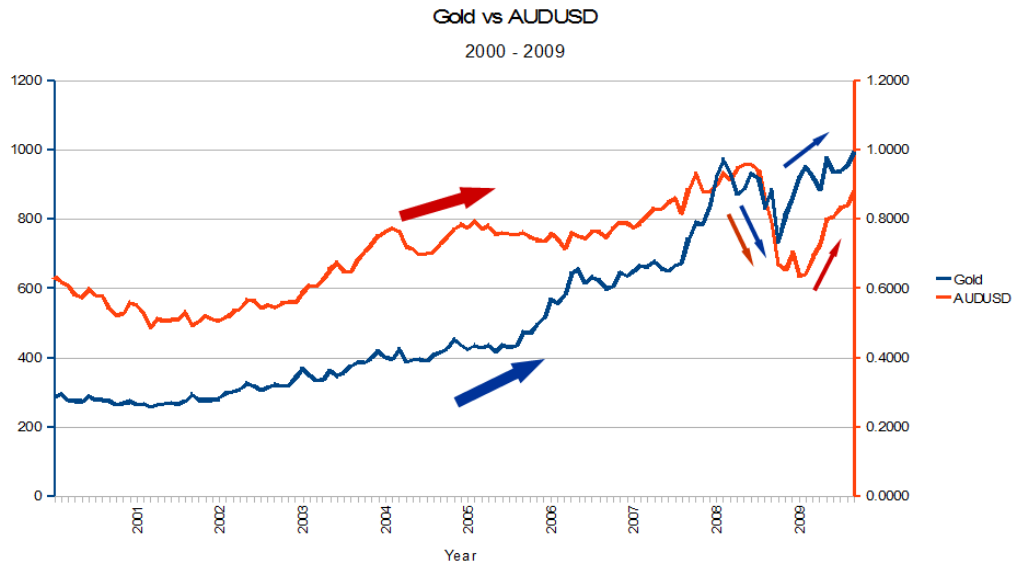
Unlike other assets, gold maintains its intrinsic value or rather, it's natural shine!

Nowadays, the inverse relationship between the Greenback and gold still remains although the dynamics behind it have somewhat changed.

Because of the dollar's safe haven appeal, whenever there is economic trouble in the U.S. or across the globe, investors more often than not run back to the Greenback.

The reverse happens when there are signs of growth.

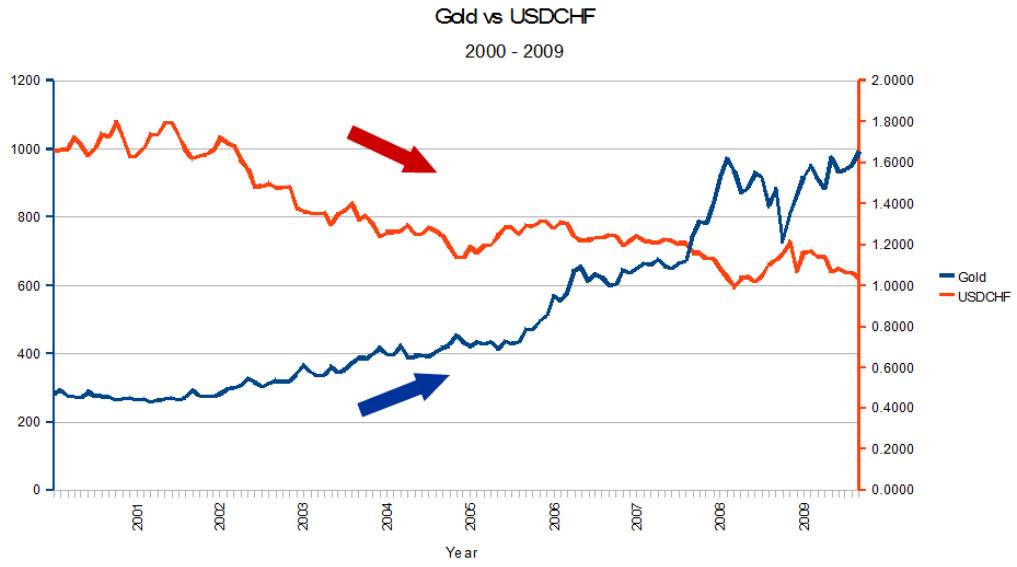
Take a look at this awesome chart:



Currently, Australia is the third biggest gold-digger... we mean, gold producer in the world, sailing out about $5 billion worth of the yellow treasure every year!

Historically, AUD/USD has had a whopping 80% correlation to the price of gold!

Not convinced? Here's another one:



Across the seven seas, Switzerland's currency, the Swiss franc, also has a strong link with gold. Using the dollar as base currency, the USD/CHF usually climbs when the price of gold slides.

Conversely, the pair dips when the price of gold goes up. Unlike the Australian dollar, the reason why the Swiss franc moves along with gold is because more than 25% of Switzerland's money is backed by gold reserves.

Isn't that awesome?

The relationship between gold and major currencies is just ONE of the many that we will tackle. Keep reading!

Black Crack



Now, let me talk about the other kind of gold... the black one.

As you may know, crude oil is often referred to as the "black gold" or as we here at BabyPips.com like to call it, "black crack."

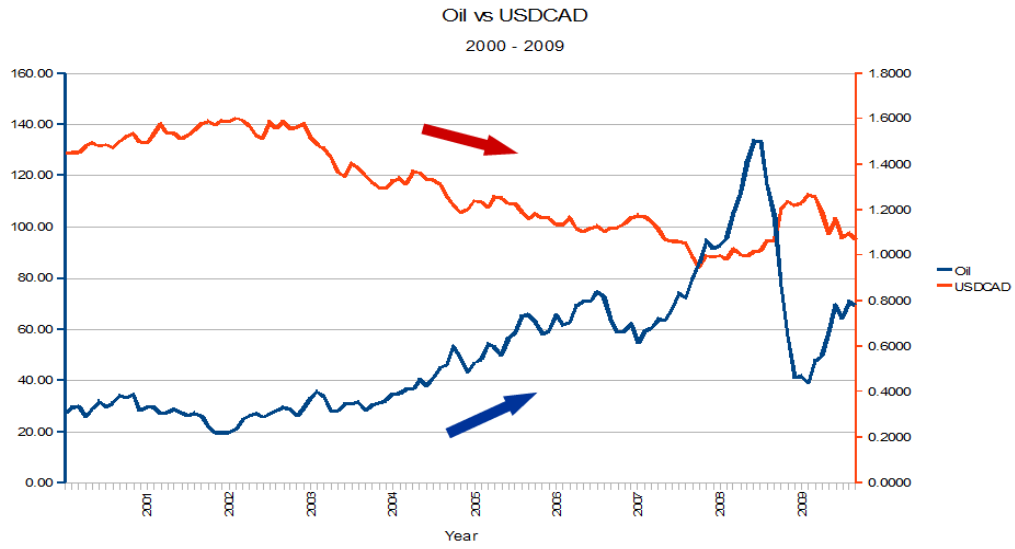
One can live without gold, but if you're a crack addict, you can't live without crack.

Oil is the drug that runs through the veins of the global economy as it is a major source of energy.

Canada, one of the top oil producers in the world, exports around 2 million barrels of oil a day to the United States. This makes it the largest supplier of oil to the U.S.!

This means that Canada is United States' main black crack dealer!

Because of the volume involved, it creates a huge amount of demand for Canadian dollars.



Whenever oil prices rise, it normally leads to some decline in USD/CAD.

Also, take note that Canada's economy is dependent on exports, with about 85% of its exports going to its big brother down south, the U.S. Because of this, USD/CAD can be greatly affected by how U.S. consumers react to changes in oil prices.

If U.S. demand rises, manufacturers will need to order more oil to keep up with demand. This can lead to a rise in oil prices, which might lead to a fall in USD/CAD.

If U.S. demand falls, manufacturers may decided to chill out since they don't need to make more goods. Demand in oil might fall, which could hurt demand for the CAD.

So, the next time you gas up your car and see that oil prices are rising, you can use this information to your advantage! It may be a clue for you to go short on USD/CAD!

Some forex brokers allow you to trade gold, oil, and other commodities. There, you can readily pull up their charts using their platforms. You can also monitor the prices of gold at http://www.timingcharts.com and http://www.kitco.com. You can likewise check the prices of oil, gold, and other metals using this link: http://www.cx-portal.com/wti/oil_en.html.

The 411 on Bonds

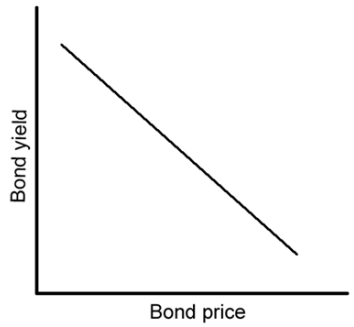
A bond is an "IOU" issued by an entity when it needs to borrow money. These entities, such as governments, municipalities, or multinational companies, need a lot of funds in order to operate so they often need to borrow from banks or individuals like you. When you own a government bond, in effect, the government has borrowed money from you.

You might be wondering, "Isn't that the same as owning stocks?"

One major difference is that bonds typically have a defined term to maturity, wherein the owner gets paid back the money he loaned, known as the **principal**, at a predetermined set date. Also, when an investor purchases a bond from a company, he gets paid at a specified rate of return, also known as the **bond yield**, at certain time intervals. These periodical interest payments are commonly known as **coupon payments**.

Bond yield refers to the rate of return or interest paid to the bondholder while the bond price is the amount of money the bondholder pays for the bond.

Now, bond prices and bond yields are inversely correlated. When bond prices rise, bond yields fall and vice-versa. Here's a simple illustration to help you remember:



Wait a minute... What does this have to do with the currency market?!

Always keep in mind that inter-market relationships govern currency price action.

In this case, bond yields actually serve as an excellent indicator of the strength of the stock market. In particular, U.S. bond yields gauge the performance of the U.S. stock market, thereby reflecting the demand for the U.S. dollar.

Let's look at one scenario: Demand for bonds usually increases when investors are concerned about the safety of their stock investments. This flight to safety drives bond prices higher and, by virtue of their inverse relationship, pushes bond yields down.

As more and more investors move away from stocks and other high-risk investments, increased demand for "less-risky instruments" such as U.S. bonds and the safe-haven U.S. dollar pushes their prices higher.

Another reason to be aware of government bond yields is that they act as indicator of the overall direction of the country's interest rates and expectations.

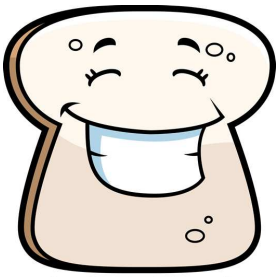
For example, in the U.S., you would focus on the 10-year Treasury note. A rising yield is dollar bullish. A falling yield is dollar bearish.

It's important to know the underlying dynamic on why a bond's yield is rising or falling. It can be based on interest rate expectations or it can be based on market uncertainty and a "flight to safety" to less-risky bonds.

After understanding how rising bond yields usually cause a nation's currency to appreciate, you're probably itching to find out how this can be applied to forex trading. Patience, young padawan!

Recall that one of our goals in currency trading (aside from catching plenty of pips!), is to pair up a strong currency with a weak one by first comparing their respective economies. How can we use their bond yields to do that?

Bond Spreads

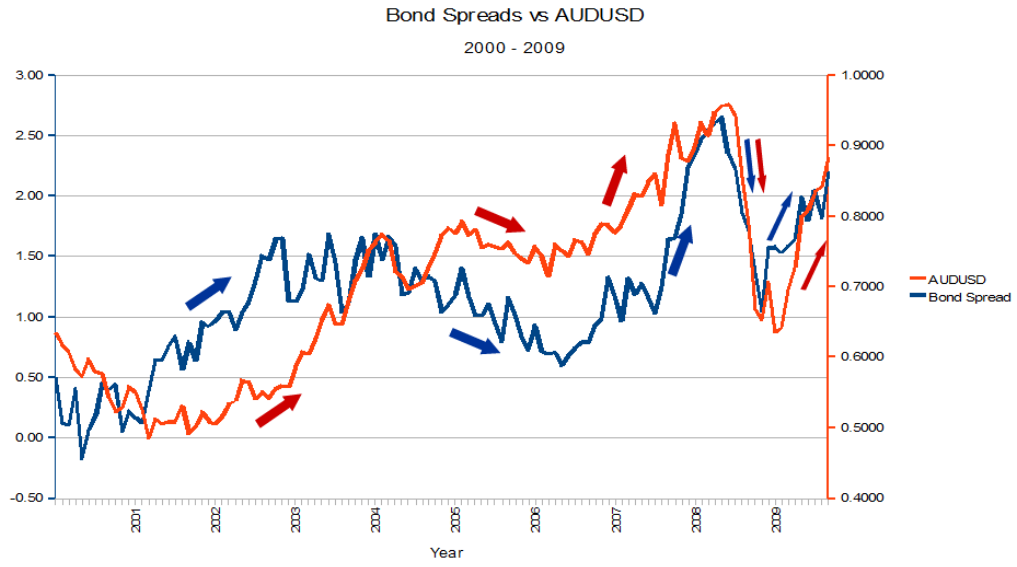


The bond spread represents the difference between two countries' bond yields.

These differences give rise to carry trade, which we discussed in a previous lesson.

By monitoring bond spreads and expectations for interest rate changes, you will have idea where currency pairs are headed.

Here's what we mean:



As the bond spread between two economies widens, the currency of the country with the higher bond yield appreciates against the other currency of the country with the lower bond yield.

You can observe this phenomenon by looking at the graph of AUD/USD price action and the bond spread between Australian and U.S. 10-year government bonds from 2000 to 2009.

Notice that when the bond spread rose from 0.50% to 1.00% from 2002 to 2004, AUD/USD rose almost 50%, rising from .5000 to 0.7000.

The same happened in 2007, when the bond differential rose from 1.00% to 2.50%, AUD/USD rose from .7000 to just above .9000. That's 2000 pips!

Once the recession of 2008 came along and all the major central banks started to cut their interest rates, AUD/USD plunged from the .9000 handle back down to 0.7000.

So what happened here?

One factor that is probably in play here is that traders are taking advantage of carry trades.

When bond spreads were rising between the Aussie bonds and U.S. Treasuries, traders load up on their long AUD/USD positions.

Why?

To take advantage of carry trade!

However, once the Reserve Bank of Australia started cutting rates and bond spreads began to tighten, traders reacted by unwinding their long AUD/USD positions, as they were no longer as profitable.

Bond Markets, Fixed Income Securities, and the Forex Market

A quick recap: So far, we've discussed how differences in rates of return can serve as an indicator of currency price movement.

As the bond spread or interest rate differential between two economies increases, the currency with the higher bond yield or interest rate generally appreciates against the other.

Much like bonds, fixed income securities are investments that offer a fixed payment at regular time intervals. Economies that offer higher returns on their fixed income securities should attract more investments, right?

This would then make their local currency more attractive than those of other economies offering lower returns on their fixed income market.

For instance, let's consider gilts and Euribors (we're talking about U.K. bonds and European securities here!).

If Euribors are offering a lower rate of return compared to gilts, investors would be discouraged from putting their money in euro zone's fixed income market and would rather place their money in higher-yielding assets. Because of that, the EUR could weaken against other currencies, particularly the GBP.

This phenomenon applies to virtually any fixed income market and for any currency.

You can compare the yields on the fixed income securities of Brazil to the fixed income market of Russia and use the differentials to predict the behavior of the real and the ruble.

Or you can look at the fixed income yields of Irish securities in comparison to those in Korea... Well, you get the picture.

If you want to try your hand at these correlations, data on government and corporate bonds can be found on these two websites:

- Bloomberg
- BondsOnline

You can also check out the government website of a particular country to find out the current bond yields. Those are pretty accurate. They are the government. You can trust them.

In fact, most countries offer bonds but you might want to stick to those whose currencies are part of the majors.

Here are some of the popular bonds from around the globe and their cool nicknames:

Economy	Bonds Offered
United States	U.S. Treasury bonds, Yankee bonds
United Kingdom	Gilts, Bulldog bonds
Japan	Japanese bonds, Samurai bonds
Euro zone	Euro zone bonds, Euribors
Germany	Bunds
Switzerland	Swiss bonds
Canada	Canadian Bonds
Australia	Australian Bonds, kangaroo bonds, Matilda bonds
New Zealand	New Zealand bonds, Kiwi bonds
Spain	Matador bonds

Some countries also offer bonds with varying terms to maturity so just make sure you are comparing bonds with the same term to maturity (such as 5-year gilts to 5-year Euribors), otherwise your analysis would be off.

And we wouldn't want that, would we?

Forex, Global Equity Markets, and You

Did you know that equity markets can also be used to help gauge currency movement? In a way, you can use the equity indices as some kind of a forex crystal ball.

Based on what you see on the television, what you hear on the radio, and what you read in the newspaper, it seems that the stock (equity) market is the most closely covered financial market. It's definitely exciting to trade since you can buy the companies that make the products you can't live without.



One thing to remember is that in order to purchase stocks from a particular country, you must first have the local currency.

To invest in stocks in the Japan, a European investor must first exchange his euros (EUR) into Japanese yen (JPY). This increased demand for JPY causes the value of the JPY to appreciate. On the other hand, selling euros increases its supply, which drives the euro's value lower.

When the outlook for a certain stock market is looking good, international money flows in. On the other hand, when the stock market is struggling, international investors take their money out and look for a better place to park their funds.

Even though you may not trade stocks, as a forex trader, you should still pay attention to the stock markets in major countries.

If the stock market in one country starts performing better than the stock market in another country, you should be aware that money will probably be moving from the country with the weaker stock market to the country with the stronger stock market.

This could lead to a rise in value of the currency for the country with the stronger stock market, while the value of the currency could depreciate for the country with the weaker stock market. The general idea is: strong stock market, strong currency; weak stock market, weak currency.

If you bought the currency from the country with the stronger stock market and sold the currency from the country with the weaker stock market, you can potentially make some nice dough.

Not too familiar with the major global equity indices? It's your lucky day! Here they are!

Stock Index	Description
Dow 	The Dow Jones Industrial Average (or Dow for short), is considered to be one of the premier stock indexes in the U.S. It measures how well the top 30 publicly owned companies are trading. Despite the name, barely any of the companies have anything to do with industrial production and are instead representative of some of the biggest companies in America. It is closely watched by investors around the world and is highly indicative of market sentiment, thus making it sensitive to both local and foreign economic and political events. The companies that are part of the Dow are so large that you probably deal with at least one of them every day. Imagine life without AT&T, McDonalds, Pfizer or Intel? Yes - these companies are all listed in the Dow!
S&P500 	The Standard & Poor 500, more commonly known as the S&P 500, is a weighted index of the stock prices of the 500 largest American companies. It is considered a bellwether for the American economy and is used to predict its direction. After the Dow Jones Industrial Average, it is the most traded index in the U.S. Some mutual funds, exchange-traded funds, and other funds such as pension funds, are designed to track the performance of the S&P 500 index. Hundreds of billions of U.S. dollars have been invested in this fashion.

NASDAQ



NASDAQ stands for National Association of Securities Dealers Automated Quotations.

It refers to the largest electronic screen-based equity securities trading market in the U.S., comprising of approximately 3,700 companies and corporations. It also boasts of having the largest trading volume among the world's stock markets.

Nikkei



The Nikkei, similar to the Dow Jones Industrial Average, is the most widely quoted average of the Japanese stock market. It is a price-weighted average of the top 225 companies and is supposed to be reflective of the overall market.

The Nikkei includes companies like Toyota, Japan Airlines, and Fuji film.

Dax



The DAX is short for the Deutscher Aktien Index (you're probably better off remembering just DAX). It is the stock market index in Germany that consists of the top 30 blue chip companies that are traded on the Frankfurt Stock Exchange.

With Germany being the largest economy in the euro zone, the DAX is normally the most closely watched index within the whole euro zone. Some companies that are part of the DAX are Adidas, BMW, and Deutsche Bank.

DJ EURO STOXX 50



The Dow Jones Euro Stoxx 50 index is the euro zone's leading blue-chip index. It comprises over 50 top-sector stocks from 12 euro zone countries.

It was created by Stoxx Ltd., which is a joint venture of Deutsche Boerse AG, Dow Jones & Company and SIX Swiss Exchange.

FTSE



The FTSE (pronounced "footsie") index tracks the performance of the most highly capitalized UK companies listed on the London Stock Exchange.

There are several versions of this index, such as the FTSE 100 or FTSE 250, depending on the number of companies included in the index.

Hang Seng



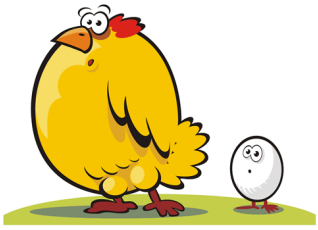
The Hang Seng index is a stock market index in Hong Kong. By recording and monitoring the daily price changes of the stocks included in the index, it tracks the overall performance of the Hong Kong stock market.

This index is currently compiled by the HSI Services Limited, which is a subsidiary of Hang Seng Bank.

The Relationship Between Stocks and Forex

One issue with using global equity markets to make forex trading decisions is figuring out which leads which.

It's like answering that age old question, "Which came first, the chicken or the egg?" or "Who's yo daddy?!"



Are the equity markets calling the shots? Or is it the forex market that wears the pants in the relationship?

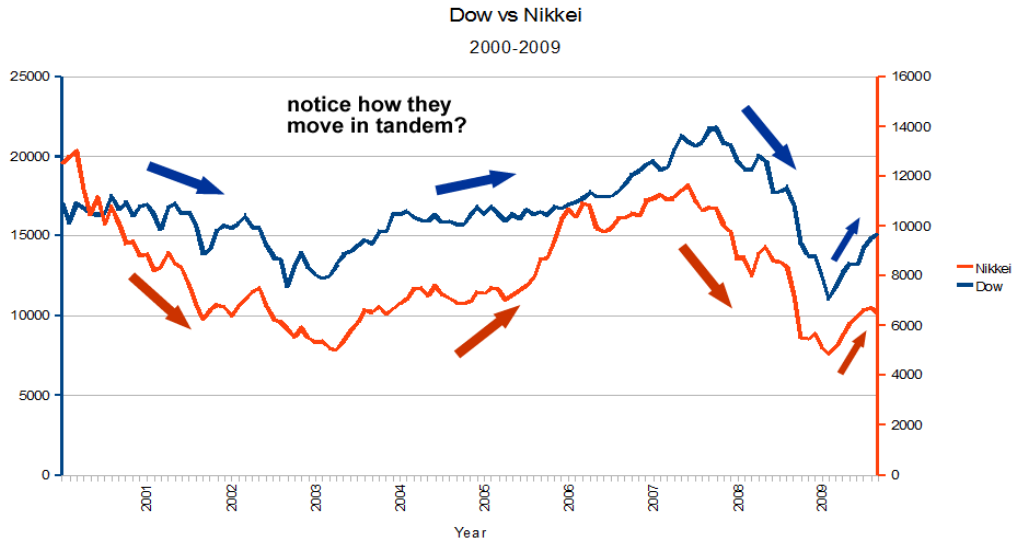
The basic idea is that, when a domestic equity market rises, confidence in that specific country grows as well, leading to an inflow of funds from foreign investors. This tends to create a demand for the domestic currency, causing it to rally versus other foreign currencies.

On the flip side, when a domestic equity market performs terribly, confidence falters, causing investors to convert their invested funds back into their own local currencies.

For the past couple of years, however, this principle holds contrary for the U.S. and Japan.

Any upbeat economic figures in the U.S. and Japan more often than not weigh down on their respective currencies, the dollar and yen.

First, let's take a look at the correlation between the Dow Jones Industrial Average and the to see how stock markets all over the globe perform relative to each other.



Since the turn of the century, the Dow Jones Industrial Average and the Nikkei 225, the Japanese stock index, have been moving together like lovers on Valentine's Day, falling and rising at the same time. Also notice that sometimes one index leads, rallying or dropping first before being followed by the other index. You could say that stock markets in the world generally move in the same direction.

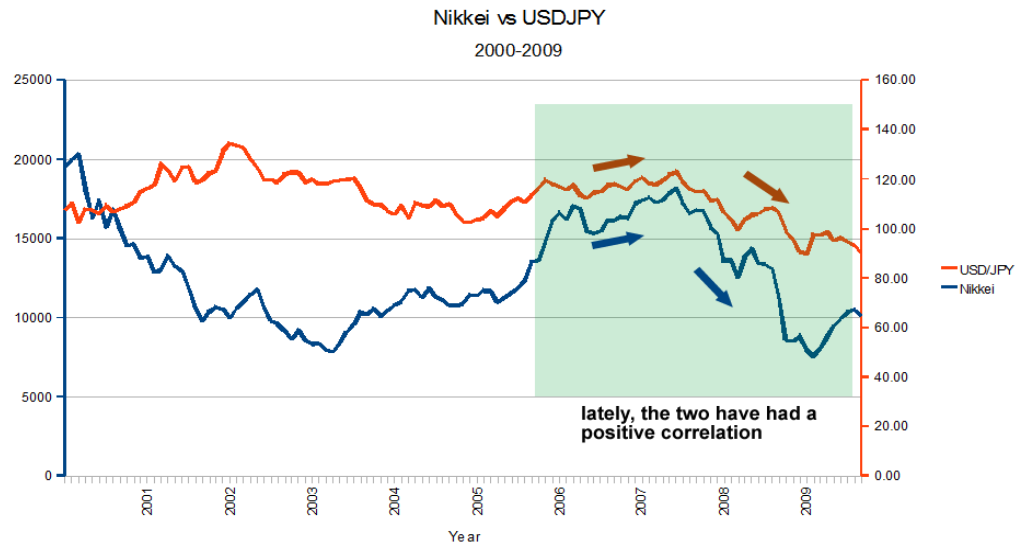
Correlations Between Stocks and Currencies

Nikkei and USD/JPY

Before the global economic recession that started in 2007, when most economies suffered consecutive quarters of negative GDP growth, the Nikkei and the USD/JPY were inversely correlated.

Investors believed that the performance of the Japanese stock market reflected the status of the country, so a rally in the Nikkei led to a strengthening of the yen.

The opposite also held true. Whenever the Nikkei would drop, USD/JPY would rise as well.



When the financial crisis hit, however, the relationships just went crazy like Lindsay Lohan.

The Nikkei and USD/JPY, which used to move oppositely, now move in the same direction.

Amazing isn't it?

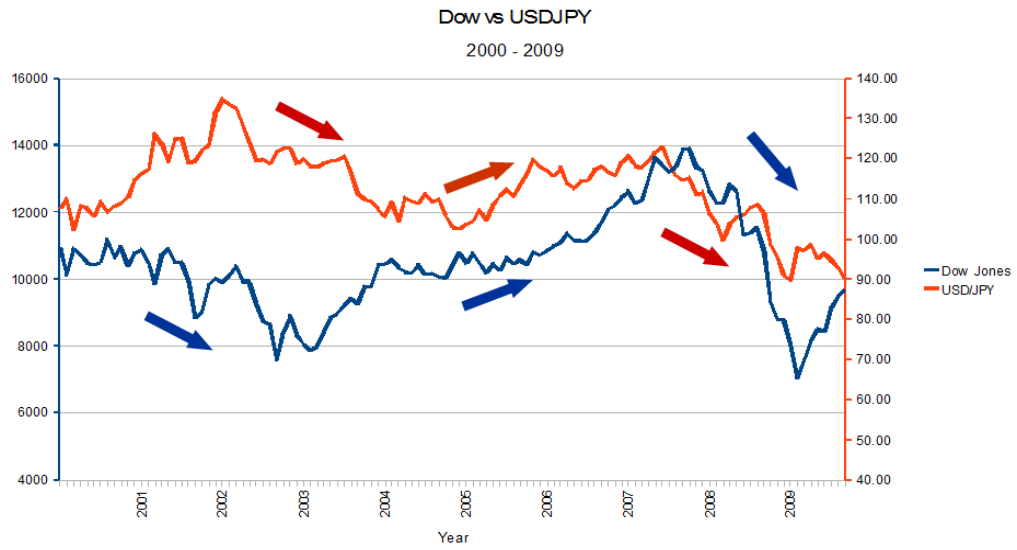
Who would've thought that stocks would have something to do with the foreign exchange market?

Well, we did, and now you know too!

Correlation Between USD/JPY and Dow

Let's take a look at the correlation between the USD/JPY and the Dow. Based on what you read earlier, you might assume that the USD/JPY and Dow would be highly correlated.

However, a look at the chart below would tell you that it isn't quite the case. While the correlation is positive, it isn't as strong.



Take a look at the Dow (blue line).

It peaked at 14,000 late in 2007 before dropping like a hot potato in 2008. At the same time, USD/JPY (orange line) also fell, but not as sharply as the Dow.

This could serve as a reminder that we should always take into account fundamentals, technicals, and market sentiment, so always read up!

Don't take correlations for granted because they aren't a sure fire thing!

EUR/JPY: Your Very Own Barometer of Risk



As we said earlier, in order for someone to invest in a particular stock market, one would need the local currency in order to purchase stocks.

You can imagine what the effect of stock markets like the DAX (that's the German stock market), have on currencies.

In theory, whenever the DAX rises, we can probably expect the euro to rise as well, as investors need to get a hand on some euros.

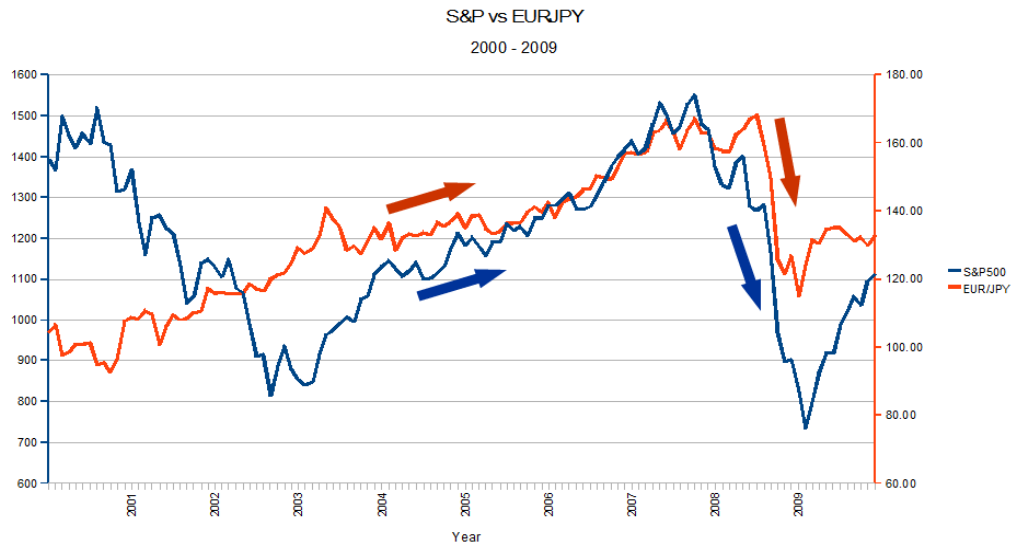
While the correlation is imperfect, statistics show that it still holds pretty accurately.

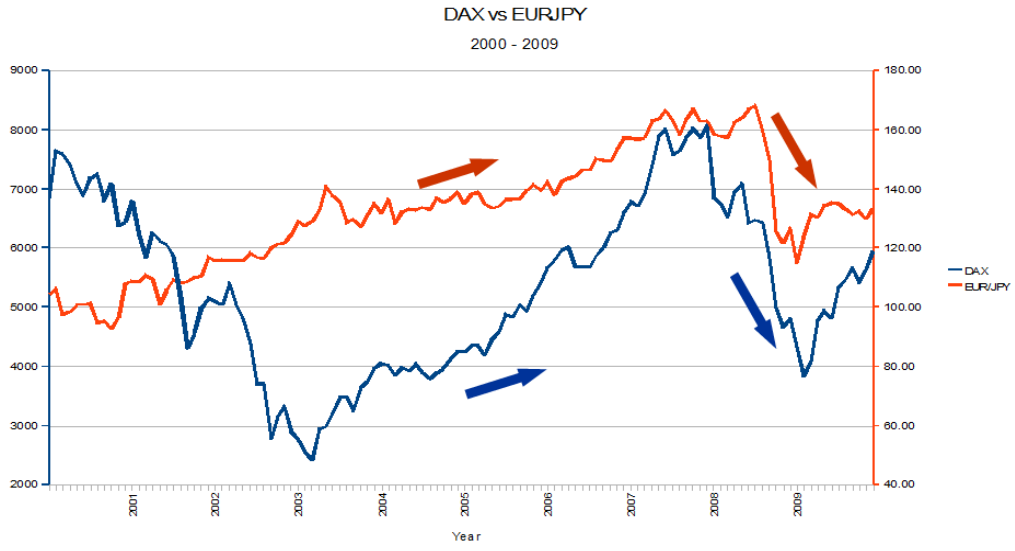
We here at BabyPips.com did a little research of our own and found out that EUR/JPY seems to be highly correlated with stock markets across the globe. You should know that the yen, along with the U.S. dollar, are considered to be safe havens amongst the major currencies.

Whenever confidence in the global economy is down and traders are fearful, we typically see traders take their money out of the stock markets, which leads to a drop in the values of the DAX and S&P500.

With money flowing out of these markets, we usually see EUR/JPY fall as traders run for cover. On the flip side, when the sun is bright and risk appetite is rampant, investors pour their money into stock markets, which in turns leads to a rise in the EUR/JPY.

Take a look at charts below to see the correlation between the EUR/JPY and the DAX and S&P500.





The correlation seems to have held well this past decade, as EUR/JPY and both indexes rose steadily together, until 2008, when we were hit with the financial crisis. In late 2007, EUR/JPY had hit its peak, and so did the stock indexes.

If you want to see the raw data for yourself, check out Yahoo! Finance

This a great place to start digging and doing your own research.

The site offers historical price data for almost all currency pairs and equity markets.

You can compare historical prices and come up with your own barometers of risk.

Intermarket Analysis Cheat Sheet

That's a lot of inter-market correlations to remember so let's do a quick recap. The price action of currencies is often driven by their relationship with commodities, bonds, and stock indices.

(see next page)

Here's a neat one-page cheat sheet for you to bookmark and make it easy for you!

If	Then	Why
Gold 	**USD** 	During times of economic unrest, investors tend to dump the dollar in favor of gold. Unlike other assets, gold maintains its intrinsic value.
Gold 	**AUD/USD** 	Australia is the third biggest gold producer in the world, sailing out about $5 billion worth a year.
Gold 	**NZD/USD** 	New Zealand (rank 25) is also a large producer of gold.
Gold 	**USD/CHF** 	25% of Switzerland's reserves are backed by gold. As gold prices goes up, the pair moves down (CHF is bought).
Gold 	**USD/CAD** 	Canada is the 5th largest producer of gold in the world. As gold price goes up, the pair tends to move down (CAD is bought).



Canada is one of the top oil producers in the world. It exports around 2 million barrels of oil a day to the U.S. As oil prices goes up, the pair moves down.



Since both gold and euro are considered "anti-dollars," if the price of gold goes up, EUR/USD may go up as well.



An economy that offer higher returns on its bonds attract more investments. This makes its local currency more attractive than that of another economy offering lower returns on its bonds.



The performance of the U.S. economy is closely tied with Japan.



Investors consider the yen as a safe-haven and tend to seek it during periods of economic distress.