

ANNA COULLING

FOREX **FOR**

BEGINNERS

**WHAT YOU NEED
TO KNOW TO *GET STARTED***

AND EVERYTHING IN BETWEEN!

Forex For Beginners

What you need to know to get started.....

And everything in between!

By Anna Coulling

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Forex For Beginners

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Who This Book Is For?

If you are new to the world of forex (foreign exchange) trading, and keen to learn more, then this book is for you. It has been written with one objective in mind. To explain in a simple, clear and logical way, everything you need to understand, in order to get started.

The book assumes you have little or no knowledge of how the forex market works, or the principles and methodology that you need to follow in order to make money **consistently**. And consistency is the key here. Because if you can be consistent as a trader, then the money will follow.

Forex For Beginners, covers all you need to know. Everything is explained in simple and clear terms, with hundreds of examples and charts to help you learn quickly. Not only will you discover how to trade, but also how to get going quickly with your new found knowledge, using the most popular FREE trading platform in the world, MT4.

In short, this book is what you need, and takes you by the hand, step by step, from complete novice to placing your first trade.

What This Book Covers?

Forex For Beginners is a straightforward guide to getting started in the extraordinary world of forex trading.

The book describes how and why we have a forex market, how it operates, as well as the mechanics of placing trades. Different analytical approaches are also included, along with understanding the importance of volume and price. From there, the book moves on to explain the concepts of margin and leverage, trading plans, risk, position sizing and money management. The book then pulls it all

together in order to help you get started, and in the final section describes key elements of the MT4 platform, as well as how to place and manage trades.

Throughout, there are many images, with simple explanations, to help you learn quickly. If you want a book that takes you from novice, to placing your first trade, (with everything in between), then this is the book for you.

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Foreward

An introduction to the book, which explains who I am, why I wrote this book, and what I hope you will gain from reading it. Forex For Beginners is just that. I have made no assumptions about your knowledge of trading, or the forex world. I remember what it was like when I first started trading. People make assumptions when teaching or writing, and from there comes confusion. This is not to say this is a basic book - it is not. There are some complex ideas and principles included, but I hope explained in a simple, clear and concise way. It defines what I believe is the correct way to approach this market. Some may disagree, but my views are based on many years of experience. It is this experience that I would like you to benefit from as you begin your own successful trading journey.

Chapter One : An Introduction To The Forex Market

If you are new to the world of trading currencies, then the forex market can seem a daunting place. In this chapter, I explain how the market works, why we have this market, who are the market participants, and how you can join in and profit by trading currencies. This lays the foundations and explains some basic concepts.

Chapter Two : The Principle Currencies Explained

Here we start to dig down into the most popular currencies, as I explain their personalities, their characteristics, and some of the factors which drive these major currencies. These are the currencies that will form the basis of your forex trading career.

Chapter Three : The Currency Quote

Currency quotes can be extremely confusing for new traders, even more so since the introduction of the fifth decimal place. In this chapter I explain every aspect of currency quotes, from the spread, the bid and ask to the reasons why currency pairs are quoted differently to all the others. In addition, I also explain the significance of the spread in relation to your approach to the market.

Chapter Four : Forces That Drive The Foreign Exchange Markets

Here I introduce the principle forces that drive this market. Some of these are

market driven, and others are anything but! The forex market is one of the most manipulated, and it pays to know who is doing what, when, how and why!

[Chapter Five : Trading Approaches](#)

Most forex traders only ever consider two approaches to the market, technical and fundamental. I use three, and here I explain how and why. Relational analysis completes the picture and gives you a three dimensional view of the market which few traders ever consider!

[Chapter Six : The Power Of Volume Price Analysis \(VPA\)](#)

This approach to trading has formed the cornerstone of my own trading career, since I first started. I have used it in every market I have traded, and I hope that in introducing you to the concepts here, you will embrace it too. It is powerful, logical and once learnt, is never forgotten. When used in conjunction with the MT4 platform, it provides forex traders with a unique approach, and a technique to truly read the market and price action, **before** it happens. And in case you want to learn more, I have written a complete book on the subject, but let's start here first!

[Chapter Seven : The Mechanics Of Trading](#)

This may sound like a chapter to skip perhaps - but don't! I could have called this chapter The Mathematics Of Trading. Here I explain all the underlying maths of the trading account in terms of leverage and margin, and more importantly position sizing and risk management - something rarely explained to new traders. You may need to read this chapter two or three times. I make no apology for this. It is the one area that most forex traders fail to understand. Remember, the devil is in the detail. Understand the detail, and the rest will fall into place.

[Chapter Eight : Risk And Money Management](#)

This is the easy part of risk. The financial part. Here I explain how to quantify and manage the risk on every trade. If you could distill the essence of successful forex traders, much of that success could be traced back here. I explain in detail the rules you need to follow in order to manage the financial risk correctly.

[Chapter Nine : Your Trading Plan](#)

If having a trading plan with rules was all you needed to succeed, then the world would be full of successful traders. It isn't. Many books will tell you that your

trading plan should have entry and exit rules, set up rules and all sorts of other 'mechanical rules' to follow. Not here I'm afraid. There are one or two rules that you **must** have, but these are for your money management. Everything else is discretionary!

Chapter Ten : The Psychology Of Trading

The markets are driven by fear and greed, and in many ways trading is in fact a mind game. It is not about making or losing money, but in managing your mind. Manage your mind better than others around you, and you will succeed. In this chapter I explain how the mind works in the way it does, and from there I introduce some simple concepts which will help you to manage your emotions as you begin trading.

Chapter Eleven : Choosing Your Broker

Few forex traders ever understand what the broker does, or why, and then complain when things go wrong. In this chapter I explain the various category of broker, the good the bad and the ugly, and the questions you should ask, before you open your account. It is a minefield, and with even large brokers going bust, it pays to do your homework.

Chapter Twelve : Choosing Your Currency Pairs

In an earlier chapter, we looked at the individual currencies and their characteristics. Here I explain the currency pairs, how they behave, and the importance of the cross currency pairs as alternatives to the once traditional major currency pairs. I also introduce the concept of the currency matrix, which will help you to identify the **true** strength or weakness of a currency.

Chapter Thirteen : Let's Get Started

A long chapter. This is where we put it all together with some real trades, which I have written up in real time and included in this chapter. It's all here as I walk you through every step from the initial analysis, to closing the position, and everything in between. This will give you a real sense of the complete process from start to finish, from the initial analysis, to getting in, staying in, and getting out! In this chapter you will also discover the power of trading using multiple charts in multiple timeframes, which can also be applied to a currency strength indicator.

Chapter Fourteen : Getting Started With The MT4 Trading

[Platform](#)

Now that you are ready to go, you need a trading platform, and what better choice is there for a novice than the MT4 MetaTrader platform. This is the world's number one platform for forex traders, and one I use myself. It could be summed up in one word - simplicity! It is also *free* to use and widely available from most forex brokers. Moreover, if you decide to change brokers, you have no new platform to learn. Here I explain the principle features, how to open, manage and close positions, personalize your trading platform and charts, and much more.

[Free Trading Resources](#)

Here you will find a list of some of the best free sites for forex traders, as well as acknowledgements to those people and companies who have kindly allowed me to use images or content from their site.

[Glossary](#)

A list of some of the more common terms and trader slang used in the forex trading world.

Testimonials

Dear Anna,

I want to thank you so much for providing retail traders with a wonderfully written, fun to read, and very smart book ! I just finished your “A Complete Guide to Volume Price Analysis” and found it thoroughly enjoyable, and very, very informative. I had been introduced to some of these concepts before (“volume spread analysis”) but have to tell you that your style and approach is a lot easier to comprehend, and a lot easier to actually put into practice.

JK

Dear Ms Coulling,

I found your book on Amazon by chance, after having typed in Trading using Volume Price Analysis. Got the book this week, and I am already half way through it. Your exposition of the volume behavior in the market and how different price bars relate to volume is fantastic. It truly is an eye opener. I have been interested in the Wyckoff approach for a while, but have not found something as clear as your book. Thanks for writing such a great book.

SG

Hi Anna,

Made up my mind.. I want to learn “forex trading” – after many months searching online you’re the only authentic person I come across!! Can you help me??

Regards,

Ali

Hello Anna,

Just found your site and am starting to dig in – seems like an endless source of knowledge – thank you for your effort to put it up. I am new to forex – still study the bits. My tendency is for buff trading-price action. Question is: how do you identify the psychology of the market?

Hello Ms Anna....!

I am very much impressed with your articles and your success story in the FX world. I am a beginner...You may also call me a newbie..as I only know the operation of the MT4 - platform...none of others...Since, it is my beginning...I will try all my best to learn, as much as I can, from anywhere in the world...Kind regards, - MBZ

Hi Anna

That was really a nice and wonderful update of the market. I really enjoy it and wish the best in your trading. But I still continue to ask to be shown how to get the USD index install in my system. And are you still trading the forex fixed odd. Which broker do you use for that.

Thanks for your time.

Kevin

Hi Anna,

Love your Covered Call website. Lucid and wise. I'm now a believer.....

Regards

Gordon

Hi Anna,

Your site(s) are absolutely brilliant! Really informative and well written.....

Kind regards.

Rich

Hello Anna

I am enjoying your many websites and wish that I had found you a long time ago. I appreciate your writing style and content. Please include me on the list for your book. How often do you publish your newsletter?

Best wishes

James

Hi Anna

you are a daisy amongst weeds !!

thank you for your reply – I think I will stick to initial path for a while yet since travelled so far down this route.....thanks again

Anna

Hi Anna,

your site is excellent – I wish I had found you sooner!! thank you for sharing such valuable information – it really is priceless, well written and comprehensive – I too am interested in your book. Ann

Hi Anna

Very useful thoughts as usual, thank you – I presume the hammer candle is a “reversal” indicator – i.e. you could have the reverse situation after a period of increasing prices?

Regards

Alex

How I use the CFTC cot data - I've been a follower of Anna Coulling for a while now. I suggest you check out this video. She's worth bookmarking in my opinion. [...]

One of my favourite analysts whom I frequently check for her across the Pond perspective is Anna Coulling and her thoughts today are worth reading: Gold Forming Strong Pennant on Daily Chart.

Hi Anna,

Great to meet you at the traders expo . I will keep an eye on your web site.

Hi Anna,

I have followed your website and Facebook page for a while now and I find your work really helpful – thanks!

I see gold has now broken through the triple top resistance of \$1,425 – so I've bought GLD LEAPS and Gold June 2011 futures today – but now I see your comment about buying on strength – have I jumped the gun and bought too early do you think?

Regards

Alex

Foreward

[At age 106] People are always worried about the economy and the world, especially since the financial crisis of 2008 and Europe's sovereign debt crisis in 2011. I feel that people should learn to be optimistic because life goes on, and sometimes favorable surprises come out of the blue, whether due to new policies or scientific breakthroughs

Irving Kahn

We all dream of financial freedom. Of giving up our job. Perhaps it is a job we hate, and yet one we have to do in order to support our family. But what if we could provide a better life for our family, as well as for ourselves? More time together and a better quality of life. This is the dream for many people, and there is absolutely nothing wrong with this dream. It is a laudable ambition, and one that I wholeheartedly endorse.

There are many ways to fulfill this dream, and achieving it through trading in the foreign exchange markets is just one. However, as its popularity has risen, so have the number of opportunistic marketers, keen to make a fast buck, using every marketing trick to part ever hopeful novice traders from their money. They will stop at nothing. I'm sure you have come across them already. Wild promises of untold riches, easy money, and a lavish lifestyle can all be yours, for just a few minutes work a week. All you have to do is grab the opportunity, sit back, and all your dreams will be fulfilled.

Unfortunately this has led to the foreign exchange market having a very tarnished reputation, and continues to do so. It is getting better, but only slowly, as the market gradually starts to mature, and these schemes and wild claims are seen as nothing more than scams. Which in short is what they are. They are there for one reason and one reason only. To make money for the marketer, and not you. The majority of these people do not trade, and never have. They have little or no knowledge of the market, have never written a word of market analysis, and are all peddling worthless rubbish which will not only leave you poorer, but with nothing of value whatsoever.

This in itself is immensely sad, as dreams are shattered, and hopes are crushed, because in life it is hope that keeps us going. Once hope is gone, there is nothing left.

Depressing isn't it? And, as if this wasn't enough, these practices extend well beyond the internet marketing scams, and into the brokers, where sharp practice and simple price manipulation are commonplace. Again, this is changing, through a combination of trader education, a maturing market, and a tightening of the rules by the various regulatory authorities.

So, what's the answer?

First I hope that in some ways this book, in a very small way, helps to redress the balance. If your hopes and dreams have been dented - take heart. Help is at hand because this book is the antithesis of this overblown marketing hype. It is as far removed as it is possible to be from this view. Second, it is priced at an extremely low price, as I want you to learn, and learn correctly. To put in place those first stepping stones on your road to becoming a forex trader.

Finally, if you have had your hopes dashed I would like this book to help rebuild that hope, and to get you back on track - in the right way.

However, let me make one thing clear from the start, before you read on.

The foreign exchange market is complex, and trading is not easy. This book should be one of many that you read, as your knowledge builds and grows. Education and learning never stops.

Unfortunately, the forex market is promoted as one that is 'easy'. Easy to get started, easy to trade, and finally easy to make money.

The first is certainly true. You can get started as a trader, quite literally in minutes. All you need is a credit card, and one of the many online brokers will then be happy to open an account, and off you go. The market is open twenty four hours a day, so wherever you are in the world you will always be able to access this market, whenever you choose. It is always there, night and day.

The second is also true. It is very easy to trade. After all, the only decision you have to make is very simple. Is the price going to go up or down. In other words, it is like the simple pack of cards, and all you are being asked to do, is to guess whether the next card is higher or lower than the last.

The third and last statement is most certainly not true. It is not easy to make money. In fact, it is extremely hard, and anyone who tells you otherwise can be assumed to be one of the marketers I referred to earlier. However, whilst it is hard, it is not impossible, provided you have the right education and are prepared to study, learn and practice. **Forex For Beginners** is your first step.

The purpose of this book is to teach you, what I believe, are the essential building blocks to longer term trading success in the forex markets. After all, if you were learning any other skill, whether as a hobby or as a profession, you would start by understanding the basics, and then build on that knowledge, using more sophisticated techniques. This is the approach here. This is a book designed primarily for the novice. Someone who knows very little, or perhaps

nothing, about forex trading, but is keen to learn from someone who has traded for many years and is happy to pass on that experience.

This book covers all the basics and much more, in what I hope is a simple and clear way. As you will see once you start to read, I have firm beliefs in what you need to know and understand in order to become a successful forex trader. I also believe anyone can succeed, provided they take the right approach to the market. This book will provide you with the solid foundations, to move forward, as your knowledge and experience grows.

I have written it in what I hope is a logical way, with each chapter building on the last until at the end of the book we put it all together. It is a journey, a journey of discovery, where everything is explained and puts into context the decisions and processes that you will need to understand, before you press that all important buy or sell button.

If you are familiar with any of my other books, you will already know that volume price analysis lies at the core of my trading methodology. To me, this approach just makes sense. It is what I fervently believe will help you to succeed as a forex trader, and to fulfill your hopes of a more secure financial future for you and your family. It is the one I have used for many years, and across all markets. And you will discover why as we get started. It is also perfectly suited to the MT4 trading platform - the world's most popular trading platform, which also has the added bonus of being *free*!

At this point, many of you may be wondering who I am, and why you should believe anything in this book. Here is a little about me, and details of some places where you can check out my references.

Who Am I?

I began my own trading career back in the early 1990's, before the days of the internet, and started trading index futures using price and volume. In those days there were no online brokers, and all the data came in via a satellite feed. Orders were placed by phone with the broker, and then executed and filled on the floor of the exchange. It was very stressful, not least because of the time delay in getting filled, or when the data feed broke down, which happened regularly!

Since those heady days, I have traded virtually every market and every instrument, and indeed came to the forex market last of all.

This trading experience has given me the grounding I needed to succeed, which

is what I want to share with you in this book.

My trading philosophy is, in essence, very simple and akin to the ubiquitous KISS, except my version is Keeping it Super Simple!

I've also found over the years, that the best results come from having an approach that is uncomplicated, not least because the markets are complex enough. Trading may not be easy, but it is straightforward.

My trading techniques are based on chart analysis, backed by my view of the broader fundamentals and related market sentiment, which provide the framework against which the markets move each and every day. It is I who make the decision to trade - no one else.

As I say in my webinars and live trading rooms, there are only two risks in trading. The first is the financial risk, and the second is the risk of the trade itself. Nothing else.

The first is easy to quantify and manage. This is pure and simple money management, which I cover in detail for you. The second, the risk of the trade itself, is much more difficult to assess. This is what we need to quantify every time we open a new position or consider taking a position in the market. What is the risk on the trade? What is the probability of success? Am I taking on too much risk and how do I measure that risk?

In a nutshell, this is what I want to share with you in this book. I want to arm you with the knowledge, skills and tools so that you too can become a confident, consistent and profitable trader. Like me, you too will be able to make your own discretionary trading decisions based on your analysis of the price and market activity, coupled with the underlying fundamental and relational picture.

This is the approach I also use in my market analysis which is taken by a number of leading financial internet sites and magazines. At present I am an expert contributor to FXStreet, one of the world's leading forex portals. Here you will find my weekly forecasts as well as market analysis on gold, silver, oil and the indices. <http://www.fxstreet.com/technical/currencies-forecast/>

I also host the London MeetUp group on behalf of FXstreet, so if you are in London at any time, I would be delighted to meet you in person. The group meets monthly and you can find further details here - www.meetup.com/London-Forex-Group-MeetUp-FXstreet/

I write daily market analysis and commentary on my personal site, www.annacoulling.com. Here you will also see that, over the years, I have been invited to speak by the CME and Working Money and, in addition, I contribute articles to a variety of publications including Your Trading Edge.

I have published over 50 web sites, all of which have free content on a variety of trading and investing topics. I have a dedicated forex Facebook page which you can find at www.facebook.com/learnforextrading and a strong following on Twitter at www.twitter.com/annacoull.

I also provide regular market analysis and content for Investing.com, Bullbearings, SeekingAlpha and Forexspace.

Alternatively, you can simply Google my name!

Let's get started, and begin our forex trading journey together.

Anna

Chapter One

An Introduction To The Forex Market

Remember, it [the market] is designed to fool most of the people most of the time
Jesse Livermore (1877-1940)

Of all the financial markets, the forex market is perhaps the least well understood, and yet it impacts us all every single day of our lives, in a myriad of different ways. Whatever we buy or sell, no matter how small or incidental, will in some way have been influenced by what we call the forex market, or more accurately foreign exchange.

Perhaps the simplest and most visual example is when we travel abroad. The first thing we do, either at the airport or before, is to change some of our own currency to that of the country where we are traveling. If we are in Europe and traveling to another European country, then this is less of a problem since the introduction of the so called 'single currency', the euro. A German traveling to Italy has no such worries, since both countries use the same currency. But once he or she travels to the UK or the USA for example, then euros need to be exchanged for US dollars.

This is the principle of the foreign exchange markets, and the small electronic boards that you see at international airports, are simply visual reminders that currency exchange rates affect us all. Whether we are traveling, buying products from overseas, using base commodities such as oil and petrol, or consuming imported foodstuffs, all are subject to, and influenced by, foreign exchange rates between countries around the world.

Every country in the world has its own currency. It is the quoted exchange rate of one country's currency against another, which is the simple principle on which the forex market is built.

Now, I make no apology by starting with the basics, as these are the building blocks of your knowledge, so let me begin by answering the five most asked questions in forex trading which are as follows:

- What is forex trading?
- Why do we have a forex market?
- Who are the the main participants?
- How are prices derived?
- Where do I fit in?

What Is Forex Trading?

Forex trading is short for foreign exchange trading and, represents the market in which one country's currency is quoted against that of another. It therefore provides the basis for anyone in the world, from governments, companies and private individuals to agree a rate of exchange between one currency and another. Without these market rates being quoted, parties wanting to exchange their currency, would be forced to agree a rate for each transaction on an individual basis. In other words, there would be no agreed standard by which to set these rates.

An interesting feature of the forex market is that it has no centralized exchange, such as in stocks or futures. As a result all trading is conducted over the counter (OTC), which simply means that it is not conducted in a regulated environment, and indeed is often referred to as 'off exchange' trading. The forex market allows businesses, investors and traders to take advantage of the change in currency rates by taking a view as to the likely future direction of one currency, relative to another. As a result all currency rates are quoted in pairs, with one country quoted against another.

To answer the question, what is forex trading? It is a financial market, like a stock market for example, where you as a trader take a view on the future direction of the price. In the forex market, you are simply taking a view on exchange rate movements between two currencies, rather than stocks.

Just like any other market, if you are right then you make money, and if you are wrong then you lose money.

Why Do We Have A Forex Market?

The primary purpose of the forex market is to provide an easy and straightforward way for companies to conduct international trade, allowing businesses, banks, governments and countries, to convert from one currency to another easily and quickly. It is one of the largest financial markets in the world,

and every day turns over in excess of 5 trillion US dollars, dwarfed only by the bond markets.

If, for example, a US based company is importing goods from the UK, they can then pay for those goods in the currency of the exporter, in this case the British Pound, and the forex market would provide the relevant exchange rate on the day of the transaction. Alternatively, the company may decide to fix the future rate in advance by buying the exchange rate on a forward contract, in order to avoid any currency fluctuations on the order. In effect this 'fixes' the exchange rate.

This, of course, can help to fix the price for the goods, but equally, the company may also lose out on potential savings should the currency rate move in their favor. This is a judgement that each company makes when dealing in the forex market, whether to fix a rate in the future, or to exchange at the current prevailing rates, with advantages and disadvantages for both approaches. The modern exchange rate system of today was created in the 1970's when countries gradually moved to free floating exchange rates, from the previous fixed rate system. Under the fixed rates system, exchange rates were pegged using an artificial system known as Bretton Woods.

Over the last century there have been many attempts to 'anchor' currency exchange rates for many reasons, not least to try to help countries have a rate which is 'fixed' against some other tangible asset. The Bretton Woods agreement, and the Marshall plan of the 1950's before it, were attempts to 'fix' exchange rates globally, using gold as the standard. In simple terms a price would be agreed for gold, against which any currency exchange rates would then be quoted accordingly.

All of these attempts ultimately failed, and following the collapse of the Bretton Woods agreement in the early 1970's, the US dollar was established as the 'de facto' global reserve currency, and is now referred to as the currency of 'first reserve'. It is the most widely held currency (after the home currency), by banks around the world. As you would expect, it is considered to be an extremely 'safe currency', as it is the currency of the largest economy in the world, and backed by the US Federal Reserve.

The gold standard was an attempt to peg currencies to gold, using an artificial model based on the price of gold, set at a fixed price per ounce within the agreement. All of these agreements, and many others, have all failed, and the

demise of the Bretton Woods agreement, really ushered in the free floating currency model, which has been more or less adopted across the globe.

In the forex markets today, most exchange rates are left to 'float free', with market forces then pushing these rates higher and lower. Some countries do still peg their currencies, most notably to the US dollar, but for the purposes of this book, and the countries and currencies we are going to concentrate on here, these exchange rates are all considered to be free floating.

Who Are The Main Participants?

In simple terms there are five broad groups of players in the forex market, each of whom has very different trading objectives and strategies. It is important to understand their role in order to gain a deeper understanding of what drives prices, and why the forex markets react to the stream of daily news and analysis. The major groups are as follows, and we will look at each of these in turn in detail:

- Market makers
- Multinationals
- Speculators
- Central banks
- Retail traders

If we start with the market makers, in contrast to all the other participants in the forex market, these are the only 'non customers' and are there in order to provide a service to their paying clients. In general, these are the major retail banks, with the big three of Deutsche Bank (20%), UBS (12%), and Citigroup (11%) continuing to dominate the market. Between them they account for almost 45% of turnover on a daily basis.

These international banks are the only organizations large enough to manage the multi billion dollar transactions involved in the corporate world, and in effect create the market prices which are quoted on a daily basis. Now, whilst it is true to say that the above statement is generally correct, in the last few years we have seen the market makers move away from their traditional role, and diversify into proprietary trading themselves, as well as trading on behalf of their clients, along with offering retail brokerage accounts to the small trader and speculator.

This blurring of once traditional roles in the market is likely to continue, as the profits to be made from trading in forex continues to increase exponentially, an opportunity that these large banks can no longer ignore. Of the three banks above, Deutsche Bank is the only one (to date) who has entered the retail market. However, they subsequently withdrew in 2011, having failed to attract enough customers in an increasingly competitive market. But, do not be surprised to see one of the other market markers come in at the retail level in future. They simply will not be able to resist!

Until relatively recently, the forex market was almost a backwater for many banks, who simply offered this as a 'minor service' to some of their larger clients. In the last ten years, this has changed dramatically, as the forex market moved into the mainstream of the trading arena, with mass market appeal and consequently large profits to be made by the banks themselves.

Next we have large corporate companies who are the bread and butter of the forex world. In many ways this group are seen as the most logical players, requiring currency exchange for 'real' business purposes, such as paying for imports and receiving payments for exports, hedging future prices for large consumable items, and finally for major mergers and acquisitions. A well run finance department can save a large blue chip company millions of pounds or dollars a year, simply by ensuring that purchases and payments are either fixed, or made at optimum times to maximize potential savings or additional profits, through the simple mechanism of an exchange rate. These are magnified as a result of the volume involved.

As a general rule, corporates are relatively conservative in their buying and selling decisions. They rarely speculate in exchange rates, preferring to fix rates and hence fix their costs or profits, rather than speculate on future exchange rates and run the risk of increased costs, foregoing (generally) the chance of increased profits.

The third major group of forex participants are the speculators, and in many ways these are the most interesting, and come in many shapes and sizes. Their primary aim is to make a profit from their analysis of the market, and they have no interest in acquiring real holdings of the currency, but simply 'bet' on which way the market is likely to move in the future. The biggest players in this group include proprietary traders (banks trading their own money), hedge funds, commodity trading advisors (CTA's) and currency overlay managers.

These trading groups are high risk traders, trading large volumes, and are happy to take on excessive leverage in order to make huge profits. Equally however, they are also subject to large losses, and it is this group that is responsible for the majority of intraday moves in the forex markets.

The fourth group are the central banks of the world who are responsible for managing the economy, with each National Bank responsible for its own currency. In general, central banks do not like to see their currency being used for speculative purposes, and as a result are not averse to stepping into the market in order to manipulate their own currency to reduce harmful volatility, which in turn could damage the reputation or economic stability of the country as a result.

The Bank of Japan, for example, frequently intervenes in this way, particularly where any strength in the Japanese Yen is likely to damage Japanese exports, which in turn makes them more expensive to overseas buyers. The Swiss National Bank is another. The role of the central bank is to manage monetary policy to ensure economic stability and to remove volatile currency fluctuations wherever possible, which is easier said than done for some countries.

Finally we come to the last group of traders in the forex market, which is **us - you and me**, and we could equally be classified as small speculators, as we have no interest in holding the currency we are buying or selling. We are simply looking to make a profit from our analysis of the market. Unfortunately, we come at the bottom of this list and are also the smallest, and generally provide a constant new supply of funds to the bigger market players.

If this sounds a little depressing, please don't worry. This book will level the playing field for you, and by the time you have finished reading, will have nothing to fear from these 200 lb. gorillas! (I like gorillas but not these ones!)

How Are Prices Derived?

The prices we see quoted on our screens every day come from one principle source, but arrive in front of us in very different ways. In simple terms, it is the major retail banks outlined above who effectively set the central exchange rates, by virtue of their interbank trading, and this is often referred to as the interbank liquidity pool. This group of banks, therefore, act as the central exchange for the forex market, and whilst they are regulated as a bank, they are unregulated as far as the provision of currency rates is concerned, and are able to influence market prices to suit their own investment and trading needs.

Indeed, the nirvana for any bank is to earn income from what is called 'off balance sheet', and this is where the forex market delivers in abundance, with millions in profit every day. All that is required is for the bank to set up a forex dealing desk, along with a proprietary trading group, and fairly soon the money starts rolling into its coffers!

The interbank liquidity pool is the starting point for the market, and from here the rates are then delivered via a number of live feeds through a variety of channels. The most expensive live feeds come from three major providers, namely www.currenex.com, EBS and www.fxall.com, and represent the professional end of the market. These feeds are generally way beyond the budget and pocket of the small retail trader, costing thousands of dollars a month. I have never subscribed, nor indeed have I ever felt the need to subscribe. I have managed perfectly well using simple feeds (both free and paid) and happily made money, and so will you!

However, if you do trade using one of these, you will effectively be trading at the 'central exchange' along with the major banks. Here you will be receiving the latest quotes, the tightest spreads and access to the deepest pool of liquidity, as well as the ability to see the depth of the market at any time - the equivalent of level 2 and level 3 data feeds in equity markets.

Whilst it is possible for individual traders to subscribe to these feeds directly, it is much more likely that you will become a client of a broker who is using one of these feeds to provide live prices to their own platform, and this is the price you are likely to see quoted on your trading screen. However, it is important to note that as the broker is now 'making a market', the price quoted by one broker may be very different from that quoted by another, as each is able to present the price they wish at any time.

In addition, the price they quote may be very different from that being quoted in the interbank market. Many of these brokers are in fact trading against you, and along with market manipulation, lagging prices, and outright malpractice, represents one of the many challenges we face as forex traders every day. Some smaller brokers may not even be able to afford to subscribe to these feeds directly, or have sufficient funds to establish their own platform and to meet the minimum capital requirements under the various regulatory rules.

These brokers are known as 'white label' for the larger brokerage companies, in effect adding a further layer to the prices quoted, with all that this entails,

removing you as the trader still further from the real price action in the interbank pool.

The interbank liquidity pool is dominated by the following major banks, who between them control around 80% of the forex market:

- Deutsche Bank - 20 % forex market share
- UBS - 12% forex market share
- Citigroup - 11% forex market share
- Barclay's Capital - 7% forex market share
- RBS - 7% forex market share
- Goldman Sachs - 5% forex market share
- HSBC - 5% forex market share
- Bank of America - 4% forex market share
- JP Morgan Chase - 4% forex market share
- Merrill Lynch - 4% forex market share

The easiest way to understand how prices are quoted between the various entities in the market is to think of these banks as wholesalers. In every other business we have wholesalers and then we have retailers. A wholesaler is generally a company that buys in volume and therefore gets the best price. The goods or services are then broken up into smaller order sizes, and bought at a higher price by the retailer, who then sells the product in single quantities to the end user - you and me in other words. This is the way most markets operate, with the wholesaler making a profit in selling to the retailer at a higher price, and the retailer then selling to the consumer at a higher price still, once again making a profit on the sale. The forex market works in much the same way.

Prices from the Interbank pool follow the same principles. This group of ten major banks effectively sets the wholesale rates for the rest of the market, with every 'retailer and distributor' (large or small broker) in the chain quoting a rate, which then allows them to make a profit.

This, in basic terms, is how prices arrive on the screen, but I will cover this in much more detail when we look at the different types of brokers, and how they manipulate the prices quoted on your screen.

Now if the last sentence might surprise you, it is a fact of life, and indeed the

forex market is the most manipulated of all the financial markets, and it's not hard to see why. There is simply too much money to be made. Whilst there are many types of manipulation, the one that is perhaps the worst is that by the Interbank market makers themselves, and before we all cry 'not fair', if we were in their position we would do the same!

Here is a group of ten banks who effectively control a market of several trillion dollars a day, and which has no central exchange. It would be unreasonable to think otherwise. And this is what they do, day in and day out, generally using the stream of economic news and comment from around the world to push the market back and forth, triggering stop losses and forcing traders into weak positions. That's the bad news. The good news is that with the MT4 platform, and indeed others, we have the perfect weapon to fight back, and it's called volume.

Volume reveals activity, and provided you understand the volume price relationship and how to interpret what this is telling you, then you can literally see the market makers at work. Now you might ask, how does this help?

Well first, if we see a price move where the market makers are not joining in, then we stay out. If we see a move where they are joining in, then so do we. It really is that simple, and it's all revealed for you in the volume price relationship. What I call Volume Price Analysis, or VPA for short. After all, the market makers can manipulate the prices as much as they like, but the one activity they cannot hide is volume, which is why this technique is so powerful. In addition, both volume and price are what we call leading indicators.

In other words they are at the leading edge of the market, so a double whammy if you like. If all this sounds a little overwhelming, please don't worry. I will show you how in a later chapter, and if you are keen to learn more, I have written a complete book on the subject, not surprisingly called '[A Complete Guide To Volume Price Analysis](#)' - not very original I know! It is one of my passions, and I hope will become one of yours too.

Where Do I Fit In?

As I said before, as small retail forex traders we are at the bottom of the heap, and are generally considered by the rest of the market as 'fair game' both by the institutional banks and market makers, as well as by our own brokers! The forex market is a voracious beast, which requires fresh money every day. With such huge sums being made, it is no surprise that it often attracts the worst kind of

business practice and outright profiteering, which can leave new traders disillusioned and substantially less well off than when they started. This was one reason I wrote this book. To help to level up the trading playing field.

The market makers have had it too easy for too long, and now, as retail traders we have the tools to fight back. The tools we have are free and part of the MT4 platform, which is also free. Learn how to use them and you will be amazed at what they reveal. No longer can the market makers hide their activities, and once you have read this book, you will be able to see them at work, just as I do on my screen.

Finally, just to wrap up this introductory chapter, let me round off by explaining some of the other basic concepts, before moving on in the next chapter to look at currency pairs and how they are quoted.

Who Am I Trading Against?

Although we are perhaps getting a little ahead of ourselves in asking and answering the above question at this stage, you might well be wondering, how and where do we trade. Is it simple, complex and who offers these prices for us to see? And the answer is the retail forex broker. Twenty years ago, trading in the foreign exchange markets would have been extremely difficult, if not impossible, but the internet has changed all that. Now you can find hundreds of brokers, all offering a very popular platform known as MT4 (MetaTrader 4) which is free, who will open an account for you and have you trading in minutes. I hope that answers that particular question, which then leads on logically, to who am I trading against?

And indeed this is a question which even seasoned forex traders have difficulty answering, and is often one that new traders don't like to ask. Let me answer it here for you, and the answer also introduces a further aspect. Trading in currencies can be done in many different ways, using different instruments. After all, when we travel, we are simply changing our currency from that of one country to another. It just so happens that we do this at the airport and use physical cash. But the process is the same - we are still changing currency.

Let me take the second part first.

As you might expect there are several ways to trade in the forex market, but the two most popular are using what we call the spot market and the futures market. There are others, but these are the two principle ones, and the one we are going

to focus on for the remainder of this book is the spot market.

You can think of the spot market as a cash market if you like, and it's called the spot market as prices are settled on the spot. In other words, there and then. Think of this in just the same way as you might buy a stock or share. Here you are buying and selling your stocks or shares with real cash and as soon as you buy or sell, the order is completed. It's the same with the spot forex market, which you can think of in this way. There are some nuances to this simple statement, which I explain later in the book when we look at how transactions are 'settled' after the order is complete, but in terms of the price, it's effectively fixed 'on the spot'.

The futures market on the other hand is very different, and here you are buying and selling a 'defined contract', which has a settlement date in the future. The futures market is also very different in another respect. It has a central exchange, and all the buying and selling is executed through the exchange in the same way as when you buy or sell stocks and shares.

To answer our first question then. Who am I trading against? In the spot forex market, we are often trading against our broker (although not always as you will see later), and in the futures market we are trading against someone who has taken an opposite position in the market. In the futures market, if I have bought, then I am matched with someone who has sold, and vice versa. In other words, if I win, then he or she loses, and conversely if I lose then he or she wins. The futures exchange sits in the middle and manages all this trading on our behalf, and everything is transparent.

In the spot market this is very different, and here we are often trading against our broker, or they are trading against us! This leads to the next question which is whether this raises a conflict of interest, and the answer is - it depends on your broker. This is why it is so important to ask the right questions, and also to understand the different types of brokers in the market. Some will be trading against you directly, whilst others will pass your orders through electronically with no dealer intervention. A key difference and one I will explain in the section where we look at the various types of brokers and how they work.

But for now, and for the remainder of this book, we will be focusing solely on the spot forex market, and using charts and examples from the MT4 platform.

Forex Market Hours

One of the many beauties of trading the forex market is that it is one that is open twenty four hours a day, and almost six days a week. This means that even if you have a full time job, or are in a different part of the world, the market is ***always open***.

It rarely if ever closes, and unlike many of the physical stock exchanges, or futures exchanges, never closes on public holidays, with virtually the only days being Christmas Day and New Year's Day. The remainder of the year the market is open.

For traders in the Northern Hemisphere, the forex market opens on a Sunday evening and finally closes late on Friday night, before reopening on Sunday evening once again, as a new trading week starts afresh.

This is all shown in Fig 1.10. Here you can see the cycle that the forex market takes, as first one major trading centre opens, before moving on to the next, with the first then closing. If we move from right to left, the first market to open is New Zealand, followed shortly after by Sydney, which opens at 10.00 pm GMT. These are joined two hours later by the first major Asian centre Tokyo, along with Hong Kong. The markets then trade together until 7am GMT when the European forex market opens, with London following an hour later, and consequent deep liquidity as a result. The Asian markets close, leaving the UK and European markets to trade together until the open of the New York market at 1pm GMT.



Fig 1.10 Forex market hours 24 hour cycle

At this stage we have three major markets trading once again for a two hour period, before Europe closes at 3pm GMT followed by the UK at 4pm GMT, leaving the US market to trade on until the NY close at 9pm GMT, with the West Coast closing between 9 and 11 GMT, before the cycle repeats itself once again with the Sydney open.

At this point let me try to put this into some sort of context for you. Many forex traders mistakenly believe that the currencies that are traded most heavily remain the same, whatever the time of day or night. In other words, a currency that is traded heavily in the London session, is also traded heavily in the Tokyo session. However, nothing could be further from the truth. This is a key point as we move deeper into the book, and in particular as you start to consider your own approach to the market, which will be heavily influenced both by the time you have available, but also where you are in the world. I am privileged to live in a timezone which makes it very easy for me to trade in the markets when they are at their most active, and in those currencies which are heavily traded. You will often hear this referred to as 'deep liquidity' and in fact I used this term above. All this means is a market which is very active, and you can think of this in

terms of - yes you have guessed it - volume! Volume is activity and activity is volume.

You may not be so fortunate, and you may also have work and family commitments which restrict your trading time further. The choice of which currencies to trade, and over what timeframes, then becomes an important consideration. This decision has to fit into your work/life balance, as well as allowing you access to those currencies and currency pairs when they are at their most heavily traded.

Let me explain.

In Fig 1.11 and Fig 1.12 you will see two pie charts for various currency pairs, and for two distinct times during the 24 hour session. The first is for the Tokyo session, and the second is for the London session. Each pie chart shows the percentage of trading in a variety of currency pairs, and just to explain what each is, ahead of the next chapter, the JPY is the Japanese yen, the USD is the US dollar, the EUR is the euro and the GBP is the British pound.

Let's take a look at each chart in turn.

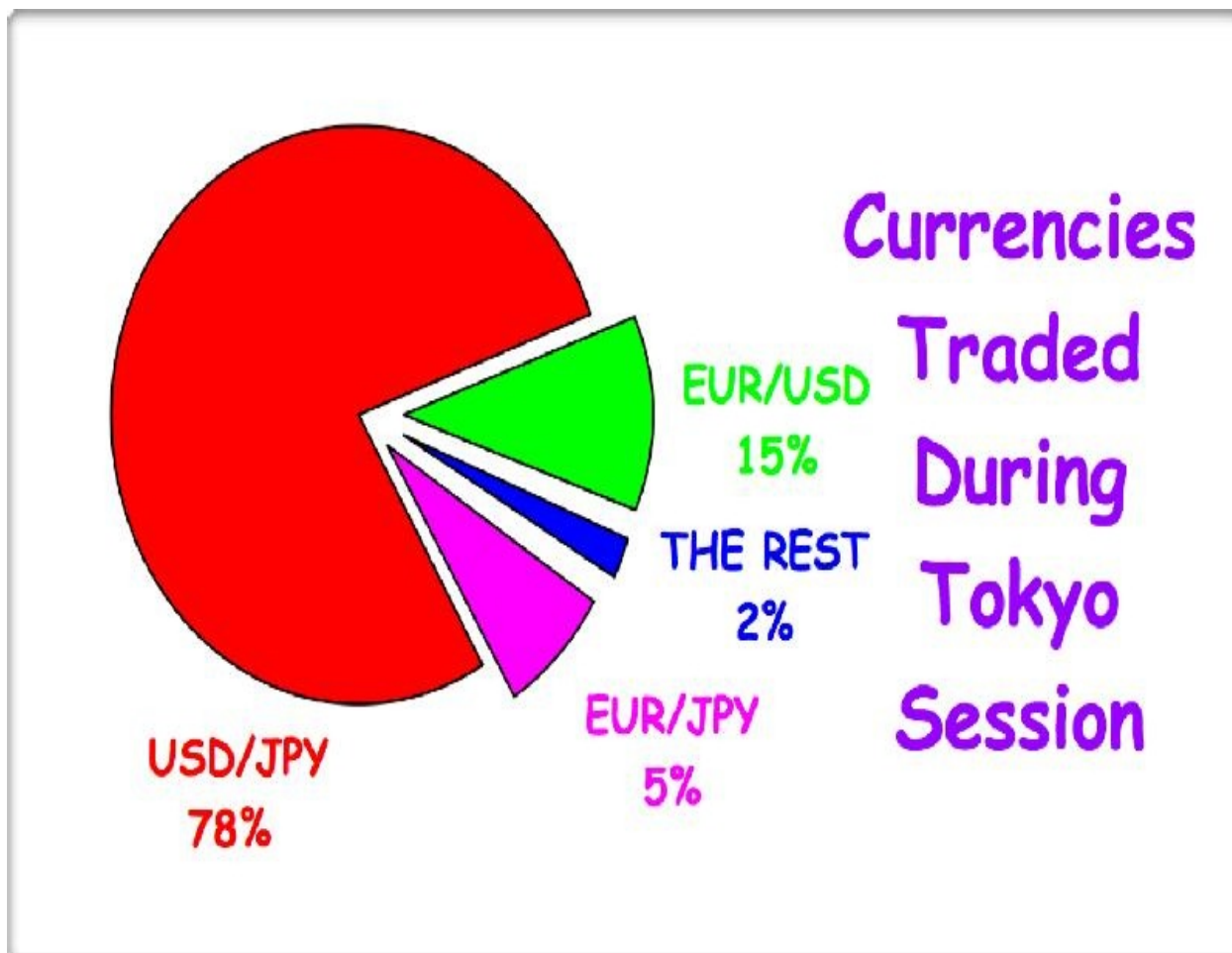


Fig 1.11 - Currencies traded during the Tokyo session

We can see instantly from the pie chart, that the red slice dominates this trading session, with the US dollar and the Japanese yen responsible for 78% of the volumes traded in the session. If we add in the pink slice and the green slice, then between the yen (JPY), the US dollar (USD) and the euro (EUR), these three currencies account for 98% of the trading activity. This is a staggering percentage with the session dominated by trading in the Japanese yen. The message here is clear and simple. If you are trading in the overnight session in Asia and the Far East, then your focus will be primarily on the Japanese yen, either against the US dollar or the euro, since these are the most heavily traded in this session.

This is no great surprise, since over 40% of forex trading volumes in the retail sector (you and me in other words) are from Japanese speculative traders, whose primary focus is on one currency - their own! Now let's take a look at what happens as we move around the globe to the London session.

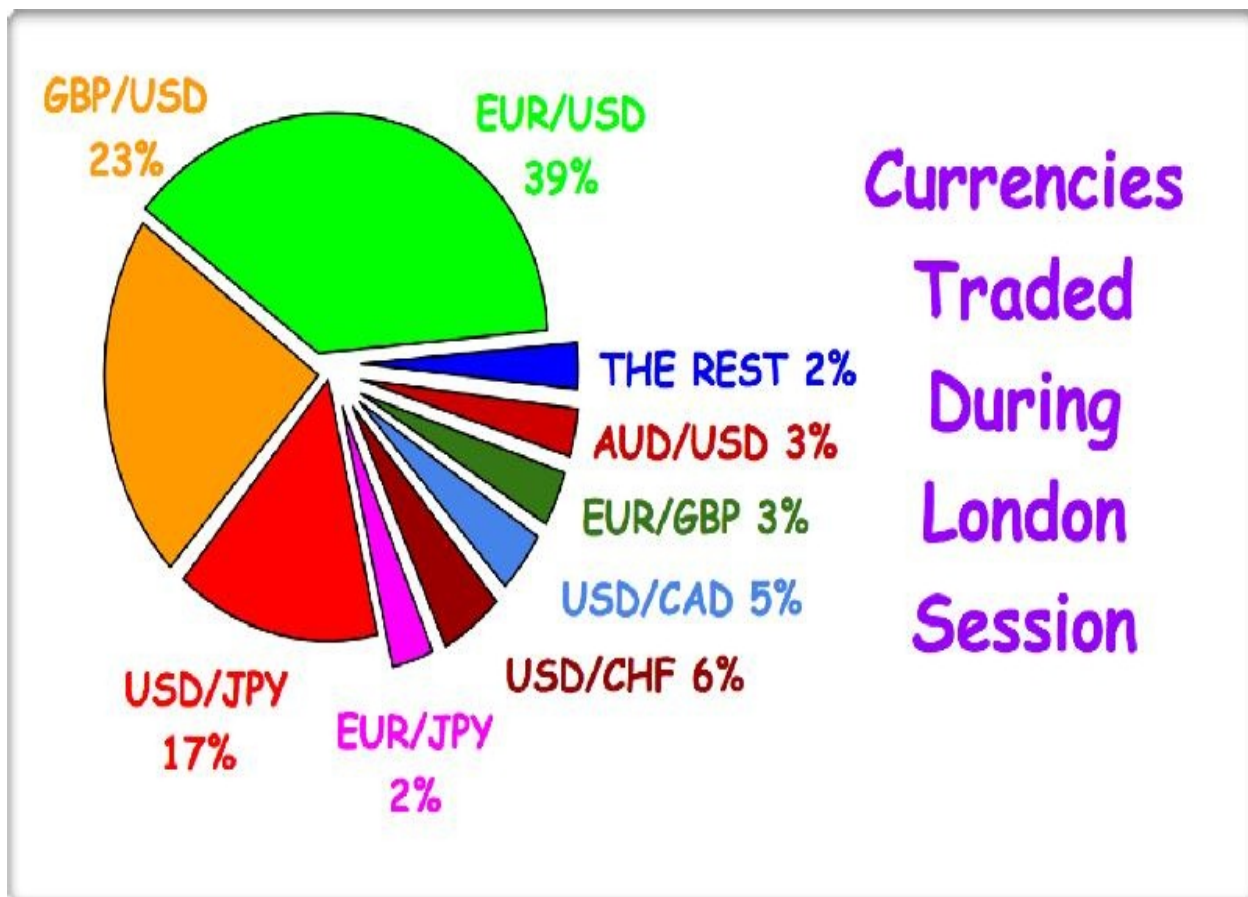


Fig 1.12 - Currencies traded during the London session

What a difference! In the space of a few hours, with the focus of the market moving from Tokyo to London, interest in the Japanese yen (JPY) has fallen dramatically, with the red part of the pie chart dropping to just 17%! The green area on the other hand has risen dramatically to almost 40% and has now been joined by the British pound in orange (GBP).

This is one of the ironies and paradoxes of the foreign exchange market. It is both vast and global, and yet in some ways very parochial as you can see from these charts. As each session moves on, the focus then also moves from one local currency to another. In Tokyo, attention is on the Japanese yen, as we move to Europe and London this focus falls away and moves to the euro and the pound, and as the market shifts to the US, then the focus shifts also, more towards the US dollar.

The constant change in focus then translates into the trading volumes and price action for each currency or currency pair, and herein lies the problem. Some traders, and you may be one of them, are not fortunate to live in a timezone

which fits into this 24 hour world. After all, we have to sleep, eat and may also have work commitments, which make it difficult to trade in those currencies and markets when they are at their most active. This is one of the many issues I cover later in the book when we start to think about building your trading plan, but this is a key point. The focus of the forex market is constantly changing, depending on where it is in the world.

Whilst it is certainly a 24 hour market, it is not one that remains constant. Trading volumes in the various currencies change dramatically as the market moves around the world, and therefore in your trading plan, you must consider this too. But don't worry, we explore this in more detail later, and there are many ways to overcome this issue - it's simply a question of adapting your approach and strategy to suit your lifestyle, your commitments, and your timezone.

This then is the forex market. A global market that is available twenty four hours a day, wherever you are in the world. The opportunities are there, provided you have a guide and mentor to help you succeed. This is what the book is about. To help you avoid all the pitfalls, and to hold your hand as we go step by step, deeper into the forex market.

In the next chapter we are going to start by looking at the main currencies, how they are quoted, and the characteristics of each, as we begin our trading journey together.

Chapter Two

The Principal Currencies Explained

*There is only one side of the market, and it is not the bull side or the bear side,
but the right side*

Jesse Livermore (1877-1940)

With almost 200 countries and independent states in the world, each with their own currency, deciding on which currencies to trade and when, can be a daunting task. In fact, the problem is far worse than this, since in forex trading, each currency is then quoted against another, resulting in literally thousands of currency pairs covering all the possible combinations.

But don't worry. Help is at hand, and in this chapter we are going to focus on those currencies and currency pairs, which are the bedrock of the forex market.

Now at this point, I feel it is both appropriate and relevant to explain how the forex market has changed over the last few years. The catalyst for this was the financial turmoil, triggered in 2007 by the sub prime mortgage crisis which sent world economies into a steep decline, and ultimately deep recession. Banks such as Lehman Brothers and Bear Sterns collapsed, as the true extent of the crisis unfolded. In Europe, the situation was so severe that several countries came close to bankruptcy, only saved by the intervention of the European Central Bank.

What effect has all this had on the currency markets?

The simple answer is dramatic. This is not the book where I propose to cover this in detail. I have written other books on this subject, but I wanted to touch on it here, and the main drivers of change have been the central banks of the United States, Europe, Japan and other major economies around the world. What each of these has done in different ways, is to distort the currency markets, by effectively printing money using a process referred to as quantitative easing. You can think of this as increasing the amount of currency in the market, which helps to drive some much needed inflation into ailing economies. It is a blunt instrument at best, with indeterminate results.

Secondly, the banks have been forced to lower interest rates to low, or ultra low levels, in an attempt to stimulate growth in otherwise stagnant economies. This has led to what has been dubbed the 'race to the bottom'. In other words, each country's central bank deliberately attempting to maintain a low interest rate, which in turn helps to protect its export market. This is particularly true of major exporters such as the US, Japan and China. This sequence of events has distorted what was once a system of 'free floating' exchange rates, and is a feature which is set to continue for years to come. It is a fact of life, and one we have to live with as traders.

There is nothing we can do about the situation, except to recognize the fact that the foreign exchange markets have been drastically distorted by the events of the last few years. They will return to 'normal' within the next five to ten years, as the effects of the financial crisis start to wane, but for the time being, this is the situation, and one that we have to accept. If you were starting your trading journey in the forex market ten years ago, then life would have been very different. I am not suggesting that it was ever easy, far from it, but the word I would use here would be 'predictable'.

The financial crisis has removed that 'predictability' from the currency market in many different ways, and not least in the various attempts by central banks to both protect, and stimulate their own economies. This is what I meant in the last chapter, when I referred to the paradox of the forex market. On the one hand it is global, and yet on another it is **very** local. Central banks will do anything and everything in their power to protect their own economy **first**. It is very much a case of 'I'm all right Jack'. We see this every day, and interest rates and quantitative easing are all part of this distortion. Add in the politics of Europe and the major economies of the world, and it becomes a witch's brew. Even the fundamental news has lost that predictable element.

And it's not just in the currency markets themselves that these changes are having an effect. The bond markets have been the vehicle used by the central banks for currency creation, as they buy bonds in ever increasing quantities. At some point this will cease, but as this is 'new territory' for the central banks, no one knows what the long term effects will be, once these programs are tapered and cease. Least of all the banks themselves. All of this will play out in the next few years in the currency markets, and as forex traders, we have to be aware of these forces. The 'predictability aspect' of trading in currencies has gone. It will return, but not for many years, which is why volume becomes a key tool in our trading armory. It is one of the few indicators, which when combined with price,

truly reveals what is happening as a currency moves higher or lower. Volume and price reveal the truth behind the move, which is why it is so powerful, and perhaps even more relevant today than ever before.

The above comments are not designed to frighten or worry you, they are simply a statement of fact. Things have changed and I would be doing you a huge disservice if I did not make this clear from the start. It's something to be aware of, and accept, and as you will see later, these changes have also led to changes in the focus on which currency pairs to trade.

Let's get started then, as I explain each currency, why it is important, and the associated currency pairs that we will consider for the remainder of this book.

The US Dollar

The US dollar is the number one currency in every respect. The US economy is the largest in the world, and although set to be overtaken by China in the next decade, remains the most important at present. The US dollar is referred to as the currency of 'First Reserve', simply because every bank around the world will have the largest percentage of their foreign exchange reserves held in US dollars. And the reason for this is simple. The US dollar is seen as safe. The dollar underpins the largest economy in the world, is backed by the US Federal Reserve, and since the demise of the Bretton Woods gold standard, has been adopted as the currency of first reserve. In addition, the US dollar lies at the heart of the largest debt market in US bonds. Finally, all commodities are also priced in US dollars, including both oil and gold.

As a result, the US dollar is classified as a 'safe haven' currency. In other words, when everyone is frightened and worried, then the US dollar is seen as a 'safe' place to put your money, and as a result investors and speculators will run for cover to the US bond market. Money flow and risk go hand in hand and work on the fulcrum of fear and greed, or risk and return, if you like. If you are greedy and prepared to take on more risk, then you are rewarded with higher returns. If you are frightened and want a lower risk investment, then the returns will be lower.

The US dollar is therefore the ultimate barometer of risk. It is the fulcrum on which the currency markets balance, and indeed in many ways, all you need to do to succeed as a forex trader, is to have a clear view of the US dollar. If the US dollar is going up, then other currencies will be going down, and vice versa. It really is that simple.

Indeed, the importance of the US dollar is further reinforced with one chart that reveals strength and weakness against several of the major currencies (which we're going to look at next), and that's called the US dollar index.

This is one of the single most important charts to watch, whatever the time frame you are trading, or whether you are an investor, or a pure speculator. This one chart will tell you whether the US dollar is rising or falling against those currencies around the world which are quoted against the dollar.

The dollar index is the starting point for every forex trader, every day, and should be yours too. Understand where the US dollar is in relation to the other major currencies, and you then have a 'framework' against which to trade. The US dollar sets the landscape for the forex market, and the US dollar index chart displays this for you quickly and easily.

There are several versions of the US dollar index which display US dollar strength and weakness, using a different 'basket' of currencies. The oldest of these is the USDX, which was originally introduced in 1973, following the collapse of the gold standard, and has been the 'industry standard' ever since. The US dollar is measured against six other currencies which are all weighted. The euro has the greatest weighting at almost 58%, with the Japanese yen next at almost 14%, with the British pound, Canadian dollar, Swedish Krona and Swiss franc making up the remainder.

Whilst this index has been widely used, and is freely available on the internet, in my humble opinion, it has several fundamental flaws.

First, the weighting of the currencies is very heavily skewed to Europe, with the euro and the pound accounting for over 70%. Not only is this not very representative, it no longer represents the 'real world'. In the 1970's this may have been the case with the index changing in the late 1990's as the euro was launched. However, in today's world, the currency landscape has changed dramatically, and the euro may even disappear in the longer term should the European project ultimately fail.

Second, the weighting for currencies such as the Japanese yen no longer represent the importance of this major currency.

Third, the Australian dollar does not even appear in this basket of currencies. As one of the strongest commodity currencies, it is odd to think that an index for the US dollar has no representation of the commodity markets, given that

commodities are priced in US dollars and therefore have a strong correlation with this sector.

Nevertheless, this index remains very popular, and below is an example from the [Investing.com](https://www.investing.com) site which you can find by clicking on the link.

This is shown in Fig 2.10.



Fig 2.10 - US dollar index daily chart

However, I believe there is a better and more representative dollar index, which has only recently been launched, and this was a joint venture between FXCM, one of the world's largest FX brokers, and the Dow Jones organization.

This index takes a very simple approach and uses four currencies, the euro, the British pound, the Japanese yen and the Australian dollar, and gives them an equal weighting, so that each has a 25% weighting against the US dollar. Below is an example using the daily chart again. The symbol for this index is USDOLLAR and you can find further details on this index here:

<http://www.djindexes.com/fxcm/>

It is widely available free in both Yahoo finance and also Google finance, so you do not need any special trading account. The example here is from my NinjaTrader trading account.



Fig 2.11- US dollar index daily chart: USDOLLAR

The scale of both charts is different, with the 'original' USD index typically moving between 70 to the downside and 100 to the upside, whilst the DJ FXCM index is based on a mini lot of 10,000. The underlying principle however is the same. To show US dollar strength or weakness against the other currencies in the market. It is just two different ways of presenting the same thing. My personal belief is that the DJ FXCM is more truly representative of the currency market, and whilst simpler to understand, is more realistic in it's presentation of the US

dollar and the underlying relationships in the market.

The Euro

Next in terms of importance comes the euro, a political currency in every sense of the word.

The euro is the single currency of most of Europe, although not all, and was introduced initially to the financial system in 1999, with coins and notes in circulation from 2002. It was introduced by the politicians, superficially to create a ‘unified’ Europe, which in theory would then be capable of challenging the major industrial powers of the US and China in world trade. This was how it was proposed to the European public. History of course tells a very different story, with monetary unions of this kind, always ultimately failing, since there can be no monetary union, without political union, and for Europe, this will never happen. Longer term, history suggests that the euro is doomed.

Since the crisis of 2007, the euro has staggered and lurched from one crisis to another, but as the years have gone by, the markets have become increasingly inured to the weekly diet of crisis and recovery. The PIGS were first, with Portugal, Ireland, Greece and Spain all threatening to default, with the prospect of being forced out of the ‘euro project’. The most recent casualty has been Cyprus, with banks forced to close to prevent a run on capital reserves.

The euro has only survived thanks to support from the ECB, which now stands as the lender of last resort, coupled with support from Germany, the single most powerful economy in Europe. Without these twin pillars the euro would collapse, with the most revealing comment coming from Mario Draghi, the President of the European Central Bank who in 2012, said:

“Within our mandate, the ECB is ready to do whatever it takes to preserve the euro,” he said, adding: “believe me, it will be enough.”

These are not the words of someone who is about to see the euro project fail, which is why I said at the start that the euro is a political currency in every sense of the word. The politicians in Brussels and the ECB, the central bank, simply will not, and cannot allow the euro to fail. There are too many egos at stake, and too many politicians have staked their futures on it. Failure is not an option. At least, not just yet. But how does this impact the euro and its price characteristics?

In two ways.

First, given all the problems to date, it is seen as a high risk currency, and the opposite of the US dollar in this respect.

Second, it is heavily influenced by political rhetoric of every kind, from the central bank to politicians, and can therefore behave in some very strange ways. As a forex trader we always have to remember that the statements made by politicians and from the ECB are made with one simple objective in mind - to keep the euro afloat.

Third, and somewhat ironically given the above checkered history, it is the second most widely held currency by banks around the world. The euro is constantly touted as a possible replacement to the US dollar as the currency of first reserve, generally by those dissatisfied with the current US economic policy of sustaining an artificially weak currency. The euro is the largest constituent of the basket of currencies against which the US dollar is quoted for the dollar index, at almost 58% which is odd when you think about it. And remember in chapter one, the dominance of the yen during the Asian trading session, with the euro almost nowhere to be seen! Which is one of many reasons why I have a problem with the 'old style' dollar index. I just don't think it is representative of true market conditions any longer.

The Japanese Yen

The Japanese yen is a currency heavily influenced by several factors, some overt and some covert, which make it one of the most volatile and difficult currencies to trade. It has a characteristic and personality all of its own, and is very different to the first two currencies we have considered here. The reasons for this can be traced back to the financial crisis that engulfed Japan and its economy in the late 1980's, once again one that was caused and created by an economic bubble based on cheap credit. The bubble finally burst in 1990, with the subsequent collapse of several banks, housing repossessions and an economy that hit the buffers overnight.

At the time, the Japanese were still regarded as an economic miracle, having recovered from the Second World War to transform themselves into one of the leading exporting nations in the world. The central bank, the Bank of Japan was forced to act, and with the country mired in recession, had no choice but to reduce interest rates to zero and just above, in an attempt to stimulate growth in the country. This has remained a feature of Japan and its economy ever since, with interest rates remaining at these ultra low levels. In addition, as a major exporter and the third largest in the world (only recently surpassed by China),

Japan's central bank has always taken a protectionist stance to ensure that the currency remains weak, in order to protect the lifeblood of the country - its export market.

As a result of the above, the Japanese yen has several interesting characteristics.

First, just like the US dollar, it is considered by the market to be a safe haven currency. When investors and speculators are fearful, then the Japanese yen is bought, and equally when these groups are happy to take on more risk, then the yen is sold. And the reason for this is what is known as the carry trade. In simple terms this is a strategy that takes advantage of the differential interest rates between two currencies, one with a low interest rate and the other with a high interest rate.

Owing to its economic history, the Japanese yen duly became the 'de facto' standard for the low yielding currency, and therefore sold when investors and speculators were in search of higher yielding currencies. Equally, when markets were fearful, then the Japanese yen would be bought and the high yielding currency sold, resulting in the consequent ebb and flow of buying and selling in the yen as risk appetite reversed. As a result, the yen is seen as a safe haven currency.

Second, as I mentioned earlier, the Bank of Japan is one of the most interventionist in the world, and will step into the currency markets at any time, should it feel that its export markets are under threat from a strong yen. Whilst the BOJ is independent from the government, it is nevertheless, heavily influenced by them, and both parties have only one objective - to protect their export markets at all costs.

Third, the Japanese have some curious exporting traditions in terms of their currency, and unlike every other major exporter around the world, their goods are invoiced in the currency of the import nation. For example, when the USA is importing cars from Japan, the invoice will be in US dollars and paid for in US dollars, and not Japanese yen. This net inflow of foreign currency reserves then has to be converted back to yen, selling US dollars and buying yen. The Japanese are creatures of habit and this is generally done for accounting purposes at the end of September and the end of March, resulting in some curious, but predictable behavior in the currency.

Finally, Japan is heavily dependent on imports of commodities as it has few natural resources of its own, so currency movements in the yen are often

influenced by, and reflected in, certain commodities such as oil.

The British Pound

The British pound, or Sterling, as it sometimes referred to, is the black sheep of Europe. The British government was wise enough to retain its home currency, and despite protestations from many in Europe, remains on the inside politically, and on the outside monetarily, which upsets many in Europe as you might expect!

The pound can best be characterized as steady. It is not volatile, has no particularly strong influences, and in many ways reflects the British personality - measured and controlled with occasional bouts of excitement. It is rather like Big Ben - old father time, safe and dependable, and for new currency traders is a great place to start. Unlike the Euro, it has no political influences, is managed by the Bank of England, and with London still considered as the financial centre of the world, is therefore viewed as 'safe'. Of all the currencies, it is the pound which perhaps has been the least affected by the financial crisis of the last few years.

Whilst the UK central bank, the Bank of England followed the US authorities with their own brand of quantitative easing, the extent and depth has been modest in comparison. As a result, the pound has retained a modicum of 'predictability' sadly lacking in many other currencies. The pound is also relatively free from political influences, and therefore reacts to fundamental news, in a more predictable way - that word again. If the data is good for the pound, then it is likely to be reflected in the currency which should strengthen. Conversely, bad news should see the pound weaken. In these uncertain times, the pound is certainly one currency that tends to more truly reflect the underlying fundamental picture, than many of its neighbors.

The Australian Dollar

The next three currencies all have one thing in common - commodities.

The first of these is Australia, a country rich in natural resources, and whose export markets depend on demand for basic commodities, such as iron ore, coal and of course gold. Mining lies at the heart of the economy. Iron ore and gold account for almost 30% of exports, with coal accounting for a further 18%, and it probably comes as no surprise that the Australian dollar has a strong relationship with the price of gold. When gold falls in price, then the Australian

dollar tends to fall along with it, and rise when the price of gold is rising, so a direct and positive relationship.

Being dependent on commodity exports, and with China as its largest trading partner, the Australian dollar is particularly sensitive to any economic data from this country. The Australian economy has weathered the financial storm of the last few years better than most, with interest rates remaining higher (relatively speaking) throughout, and as a result, the currency has been one of those favored as the high yielding currency in the carry trade. In addition, and slightly at odds with this statement, the currency has also been seen increasingly as another 'safe haven' due to the way the economy has been managed through the crisis, and not just survived, but prospered as well.

The Canadian Dollar

Just like the Australian dollar, the Canadian dollar, often referred to as the Loonie, is the second of our commodity based currencies, but this time the commodity in question is black gold, or oil. To put this into context, which is often a surprise to many forex traders, Canada has the third largest oil reserves of any country in the world after Saudi Arabia and Venezuela. The most significant deposits are those in the Alberta Sands in Northern Alberta, dwarfing those of more traditional oil producers in the Gulf states.

Whilst this is good news for Canada and its commodities driven export market, what is less good news is that over 80% of exports are absorbed by its nearest neighbor, the USA. As the saying goes, when the US economy sneezes, Canada catches a cold. Nevertheless, despite this, Canada, just like Australia, is another country that has weathered the financial storm well, and escaped relatively unscathed.

As you would expect with a country dominated by commodities and oil, the Canadian dollar has a close relationship with the oil market, and any fall in the price of oil is likely to be reflected in the currency which may weaken as a result. Conversely, if the price of oil is rising, then the Canadian dollar is likely to strengthen along with it. Any economic data relating to oil will also affect the currency, and the one we watch here are the weekly oil statistics, which report whether oil inventories have been increasing or decreasing. In other words, a snapshot of the supply and demand relationship for crude oil.

The New Zealand Dollar

This is the third of our commodity currencies, the New Zealand dollar, and once again a country that has weathered the financial storm of the last few years, well.

Whilst New Zealand is also rich in natural base commodities, it is soft commodities which dominate its export markets, with milk powder, butter and cheese the main constituents.

However, there is one aspect of New Zealand's economy which dictates the behavior of the currency in the markets, and that's interest rates. Prior to the start of the financial crisis, interest rates were 8.25 %, making the currency the number one target for the carry trade, causing two major problems for the central bank. First, a strong currency, which undermined the export market, and secondly an extremely volatile currency, caused by the constant speculation, a feature of all high yielding currencies on this side of the carry trade. Since 2009, interest rates have fallen and are currently at 2.5%, with a consequent drop in the use of this currency for this strategy, sending currency speculators hunting for higher yields elsewhere. Nevertheless, once the current crisis is over, the New Zealand dollar will return to this once traditional role, as soon as interest rates begin to rise again.

The Swiss Franc

The Swiss franc can be summed up in one word. Safety. Switzerland is seen as a safe country, with a safe and secure banking system, underpinned by massive gold reserves. It is a country with an extremely high standard of living and is outside the EU, yet geographically in Europe. It also has a central bank which makes no effort to conceal any intervention into the currency markets, and just like the Bank of Japan, does this frequently and often as the need arises.

This has certainly been the case in the last few years with the Swiss franc increasingly seen as safe haven in these troubled times, forcing the central bank to step in on several occasions, all of which failed to prevent further buying of the currency.

The currency is also heavily influenced by the price of gold. Firstly, because gold itself is seen as a safe haven asset in its own right, but also because the Swiss banking system is underpinned by the world's fifth largest holding of the precious metal at just over 1100 tonnes. The gold is held in reserves to ensure the stability of the Swiss franc, with the currency reflecting changes in the price of gold as a result.

The strength of feeling by the Swiss towards their currency and gold in particular can be seen from the recent referendum which has been called to help prevent the Swiss National Bank selling off more of its gold reserves, something it has been doing quietly over the last few years. Within the referendum there is a clause to force the bank to retain a minimum of 20% of its reserves in gold. The result of any referendum is likely to result in some volatile price action in the Swiss franc, particularly if the vote goes against the Swiss people.

These then are the primary currencies that we are going to focus on in the remainder of this book. There are, of course, many other currencies around the world, sometimes referred to as exotic currencies. There is nothing wrong with trading these once you have some experience. However, whilst exotic currencies can offer better and faster returns, they are not without their problems, and volatility and lack of liquidity being just two. I have written other books where I explain these currencies and the opportunities, but this book is intended as a guide for new traders, and therefore the currencies I have outlined above are those that are considered to be both widely traded, and relatively cheap to trade.

In the next chapter we are going to look at the mechanics of how these currencies are quoted in the forex market, and the principles of how we make money from trading them.

Chapter Three

The Currency Quote

Money is the sixth sense that makes it possible to enjoy the other five

Richard Ney (1916 - 2004)

In the last chapter, I introduced you to the principle currencies that I believe you should be trading initially as a novice forex trader, and one of the questions you may be asking right now, is simply this - is that it? Just seven currencies. It doesn't seem very many. Which is absolutely true. However, what we are going to cover here is how these currencies are then quoted in order to allow us to trade in them, and the associated quoting conventions. This will help you to understand what you will be looking at shortly, once we move to consider the price charts in more detail.

As I said in the previous chapter, there are hundreds of currencies around the world, but these are the ones most widely traded and therefore the ones to start with, as you begin your journey as a forex trader.

The Currency See-Saw

Imagine for a moment that you are American. You walk into your local bank, approach the teller, and from your pocket produce a \$100 bill. You then ask the teller if you could buy some dollars. The teller would give you some strange looks. It's simply not possible to trade a currency in that way. It simply doesn't work. After all, as an American you are paid in US dollars and your bank account is in dollars, you cannot 'buy' more dollars, using dollars.

In order to overcome this problem the foreign exchange market pairs currencies together in... well pairs! You can think of this like a child's see-saw. On one side is one currency, and on the other is a different currency. And just as on the see-saw, as one rises, the other falls, and as this falls then the other rises. They are always in balance around the fulcrum of the see-saw, rising and falling every second of every day. The fulcrum point is the exchange rate being quoted at that precise time. No more, and no less.

In the previous chapter we looked at eight currencies, and you may have thought

to yourself - how dull. We only have seven currencies to choose from when we are trading. In fact, in creating currency pairs, we now suddenly have 28 trading opportunities in the forex market. A much wider selection. Let's break these down into two groups, which we refer to as the major currency pairs, and the cross currency pairs.

Major Currency Pairs

There are generally considered to be seven major currency pairs, and are those currencies which are quoted against the US dollar:

- EUR/USD
- USD/JPY
- GBP/USD
- AUD/USD
- USD/CAD
- NZD/USD
- USD/CHF

All currencies when quoted in the forex market are denoted using the three letter acronym as follows:

- USD - US dollar
- EUR - Euro
- JPY - Japanese Yen
- GBP - British pound
- AUD - Australian dollar
- CAD - Canadian dollar
- NZD - New Zealand dollar
- CHF - Swiss Franc

Cross Currency Pairs

The cross currency pairs are all those pairs which are not quoted against the US dollar. In other words, these are all the other pairs which go to make up our 28 currencies in total, and these are as follows:

Euro cross currency pairs

- EUR/JPY
- EUR/GBP
- EUR/AUD
- EUR/CAD
- EUR/NZD
- EUR/CHF

Yen cross currency pairs

- EUR/JPY
- GBP/JPY
- AUD/JPY
- CAD/JPY
- NZD/JPY
- CHF/JPY

Pound cross currency pairs

- EUR/GBP
- GBP/JPY
- GBP/AUD
- GBP/CAD
- GBP/NZD
- GBP/CHF

Australian dollar cross currency pairs

- EUR/AUD
- AUD/JPY
- GBP/AUD
- AUD/CAD
- AUD/NZD
- AUD/CHF

Canadian dollar cross currency pairs

- EUR/CAD

- CAD/JPY
- GBP/CAD
- AUD/CAD
- NZD/CAD
- CAD/CHF

New Zealand dollar cross currency pairs

- EUR/NZD
- NZD/JPY
- GBP/NZD
- AUD/NZD
- NZD/CAD
- NZD/CHF

Swiss franc cross currency pairs

- EUR/CHF
- CHF/JPY
- GBP/CHF
- AUD/CHF
- CAD/CHF
- NZD/CHF

Currency Notation

As you can see from all the above currency pairs that we now have, there seems to be no logic to the way these are quoted, and this can be confusing for new traders. The quoting convention has really evolved over time, and what we have now, is an historic system, where the first currency quoted was considered to be the stronger of the two, and the second was considered to be the weaker.

As an example, in the case of the GBP/USD, the UK pound was considered to be a stronger currency than the US dollar - ironic really!

The first currency quoted is referred to as the **base** currency, so in our example above this would be the British pound, and the second currency is referred to as the **counter** currency, in this case the US dollar.

The currency quotations I have listed here are the standard notations that you will come across when trading in the spot forex market. However, if and when you do move to the futures market, you will find that these change. In the world of futures, all currencies are quoted against the US dollar which is the counter currency. As such, you will find that some of the popular major currency pairs will be shown reversed. In other words, in the spot market the USD/CAD is quoted in this way, but in the futures market it is quoted as the CAD/USD. Forex traders who move from the spot market to the futures market are often confused, and we do have to be careful. It's very easy to buy or sell the wrong currency.

A buy order on the USD/CAD in the spot market is **very** different to a buy order on the CAD/USD in the futures market, so please be careful. It's an easy mistake to make and applies to all major currency pairs and others, so the USD/JPY will appear as the JPY/USD in the futures market. You have been warned!

Currency Quotes

Now we come to the whole business of how currency pairs are quoted in the market and what this all means.

Let's start with a simple example from the MT4 trading platform which will make it much easier to explain.

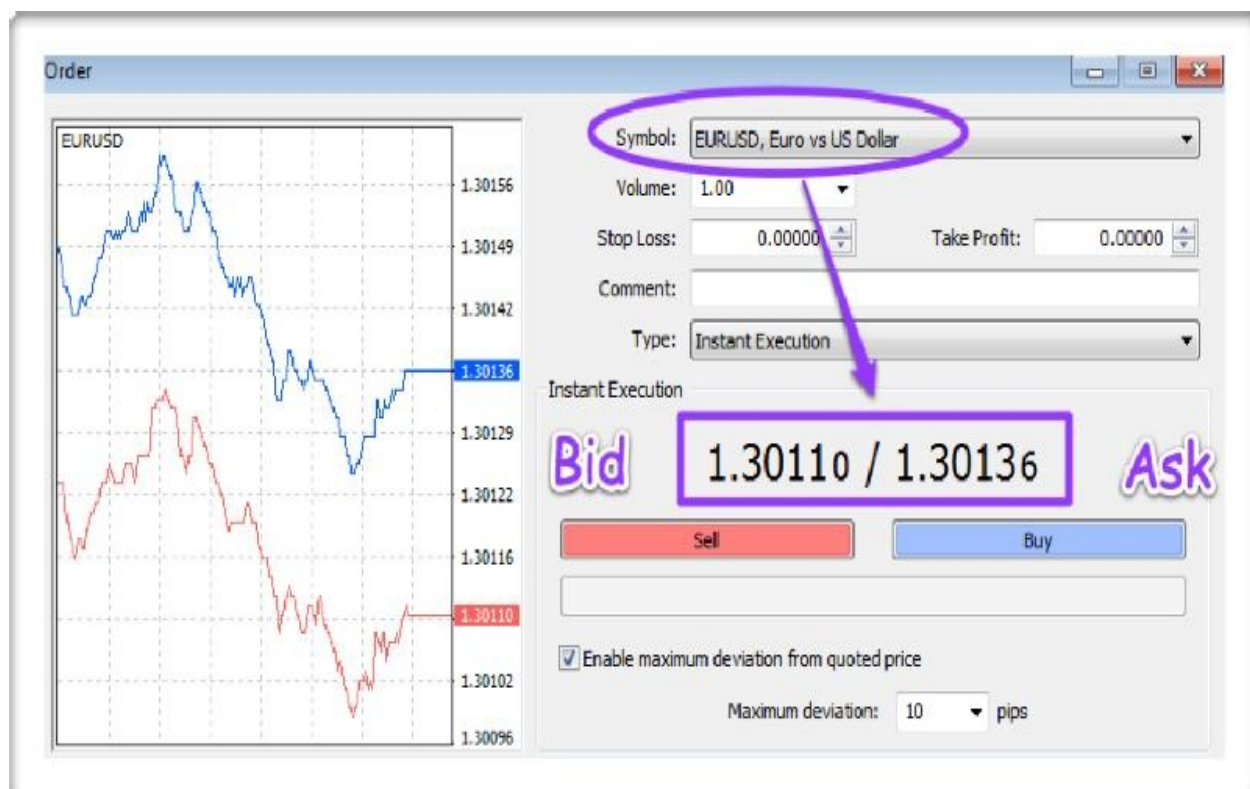


Fig 3.10 - Quotation window on MT4 for EUR/USD

In this example we are looking at a quote for the EUR/USD which I have circled at the top of the image. In Fig 3.10 you can see that we have two numbers quoted here, 1.30110/1.30136 - what do these numbers mean? Let me explain.

Until recently currency pairs were quoted to four decimal places, in other words, 1.3000 or 0.5690, where the last digit was the most significant for us as forex traders (and I'll explain why in a moment). However, in the last year, the quoting conventions have changed, and currencies are now quoted to five decimal places, as we can see here. We have one number which is 1.3011(0) and the second which is 1.3013(6), and I have added the fifth decimal place in brackets.

Whilst **most** of the major currency pairs follow this new convention, there is one that is only quoted to three decimal places, and that's currency pairs with the Japanese Yen, where the second decimal place is the most significant.

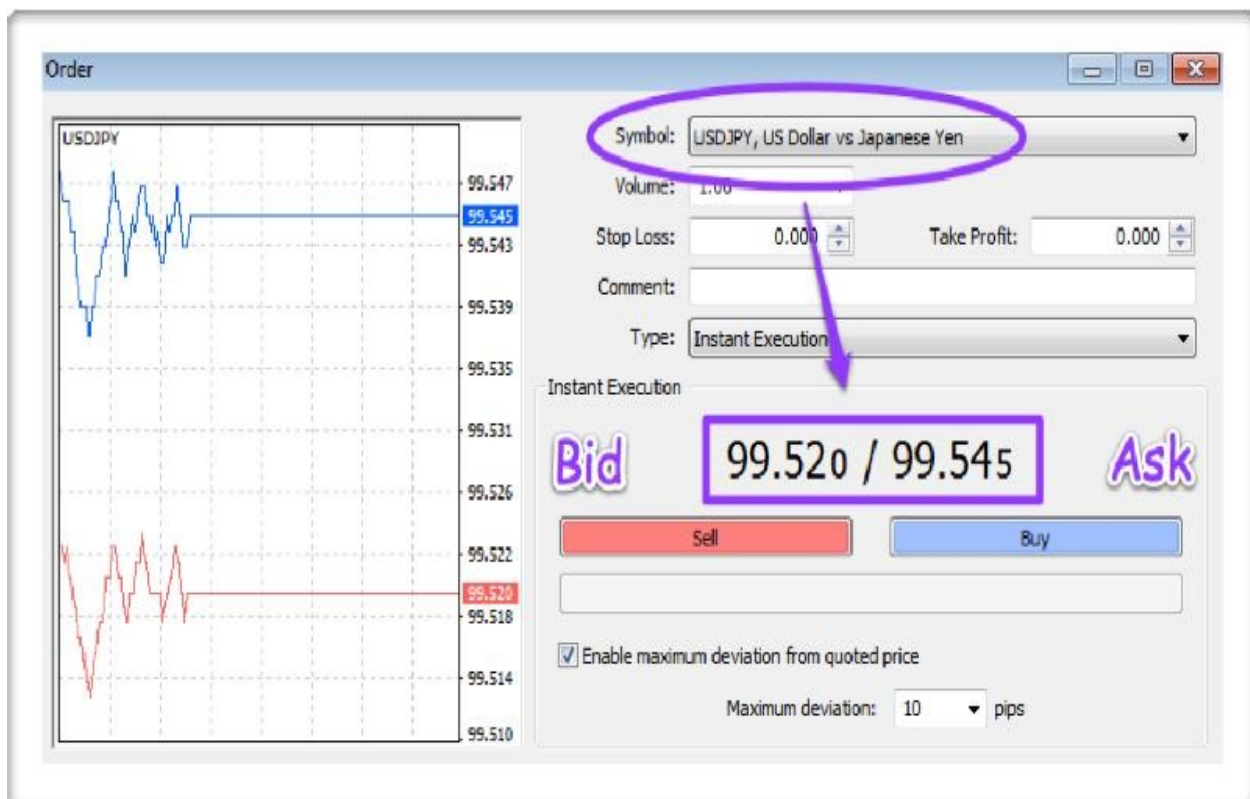


Fig 3.11 - Quotation window on MT4 for USD/JPY

If we start with the EUR/USD example, as I said, the old style of quotation was to four decimal places, and the fourth decimal place was the most significant and denoted as what we call a 'pip' or 1/10,000 of a movement in the exchange rate.

For instance, if a rate was quoted as 1.3000 and then some time later as 1.3005, then the exchange rate has changed by 5 pips having moved from 0 to 5. Equally if the exchange rate had moved from 1.3000 to 1.3020, then this has moved by 20 pips, and finally the last example, if the rate has moved from 1.3000 to 1.3100, then the rate has changed by 100 pips.

Don't worry at this stage how this is converted into profit or loss when we are trading, as I cover this in a later chapter, once we get to the mechanics of trading. For now, I am just trying to explain the basic mechanics of currency quotations.

In order to try to differentiate themselves, and to attract new customers, the forex brokers decided that it would be a good marketing ploy to quote currencies to five decimal places. I have to say I find this very irritating and confusing, but this is what we are stuck with!

If we go back to our first example above, the rate will now be quoted as 1.30000 and moving to 1.30050 - this is still a 5 pip move, but looks very different. In other words, currency quotations in the major currency pairs (and in many others, excluding the Yen pairs) are now quoted in 1/10 of a pip. So for example, if the quote above was 1.30054 then this would equate to 5 full pips and 4/10 of one pip, or 5.4 of a pip!

To summarize - the number that is the most important in the forex market in terms of quotations is the ***fourth decimal place***, not the fifth, which to be honest you can ignore. It is a fractional pip quotation. It moves so fast anyway, that as far as I am concerned it is irrelevant. Unfortunately most brokers seem to have adopted this convention in their feeds, and the MT4 platform does not provide an option to reduce this back to four, at the time of writing, but hopefully this may change in the future. Your broker may offer this and it is worth asking.

For now, just remember. It is the fourth decimal place which is our ***pip*** which represents 1/10,000 of a movement in the market.

As I mentioned above, the same principle applies to the USD/JPY, but in this case, the old convention was two decimal places, whilst the new convention is three decimal places. Let's take the example from Fig 3.11.

Here we have two numbers quoted, 99.520 and 99.545 and for Yen based pairs, the old convention was two, so in this example, if the pair had moved from 99.52 to 99.54, then this would be 2 pips. The difference here is that 1 pip is equivalent to 1/100 of a movement in the exchange rate, whereas with the EUR/USD 1 pip

was equivalent to a movement of 1/10,000. I'll explain why in a minute.

Just as with the fifth decimal place for the EUR/USD, the USD/JPY here is quoted to three decimal places, so in our Yen example, the third number once again represents a tenth of a pip 1/10 as before. In the case of a Japanese yen pair, if we moved from 99.550 to 99.595, we have moved 4.5 pips or four and a half pips - from 55 to 59 is four pips, and then the third decimal place is our half pip.

When trading yen pairs we only concentrate on the second decimal place which is our pip value, so a move from 99.55 to 99.85 is 30 pips, and from 99.55 to 100.25 is a move of 70 pips. I hope that makes sense!

The next logical question from the above is why do most currencies quote to four decimal places (and five now) and the Yen based pairs (and other exotic currencies) only quote to two (and now three)? And the answer is simply this. Currency exchange rates between most countries are relatively close, and generally in single figures. The US dollar against the Canadian dollar for example is often around 1, so when changing currency from one to the other, they are very close in terms of exchange rates. In order to offer meaningful moves in the markets and allow traders and speculators to profit accordingly, these currency pairs are quoted to four and five decimal places. Imagine if the USD/CAD were quoted to two decimal places, as 1.01 and 1.02, this would represent a huge move in the exchange rate, and have little value other than for very long term trading. After all, a move from 1.00 to 1.01 would be 100 pips, and a long wait for a scalping trader! Hence, these currency pairs are quoted to four (and now five) decimal places.

The Japanese yen on the other hand is very different.

Whilst the US dollar and the Canadian dollar are very close in exchange rate terms, the Japanese yen is not, and often trades around 100 or more to one US dollar. Here we would have the reverse problem if the pair were quoted to four (or five) decimal places. In this case if the USD/JPY were quoted as 100.0000 then the fourth decimal place in this example would be equivalent to 1/100 of a pip, a tiny amount, and a price which would then be moving at an absurd speed. This would be impossible to trade!

If it helps to understand, think of it like this.

Most currencies have a value equivalent to a paper banknote. The yen is closer

to a coin. That's the difference.

Finally, and just to round off. The pip is our principle trading unit, and you can think of it just like a point. A stock index moves in points, as do many other instruments. For us, a pip is our trading unit. For the major currency pairs it's either the fourth decimal point, or the second for yen pairs. And in a later chapter I'll explain how this basic trading unit then converts into our profit or loss on each trade.

The Bid, Ask And Spread

In every currency quote, there are always two figures quoted. The first one on the left hand side is called the **bid**, and the second on the right hand side is called the **ask**. The difference between the two is called the **spread**.

The bid, the lower of the two prices is the one at which you can sell the base currency. If we go back to our EUR/USD example in Fig 3.10, the bid price is 1.30110 and is the price we would get if we sold the euro against the US dollar. In other words the bid price, is the price at which the market will **buy**.

On the other side we have the ask price, and this is the price at which the market will **sell** to you which of course is higher. Why? Well the forex broker has to make a profit and their profit is generally, (although not always) in the spread, which is the difference between the two prices. In this case the spread is the difference between 1.30110 and 1.30136 or 2.6 pips.

What does this mean? As a matter of fact, several things.

First, the spread that is quoted will vary from broker to broker and also throughout the trading day. It is **not** fixed and will change according to market conditions. If the market is volatile and moving quickly then the spread will widen, possibly to several pips or more, and then gradually move closer again once the volatility has passed. The reason for this is that your broker has to cover all his or her customers positions, and in a fast moving market the risks are much higher. Some brokers do offer fixed spreads in all markets, and while this may seem attractive when other brokers are widening their spreads during a news release, there are always pros and cons. After all, major news releases are relatively infrequent during the day, and for the rest of the period, a fixed spread broker is likely to be less competitive than a variable spread broker. As always, it is swings and roundabouts, and there is no such thing as a free lunch. But I digress!

The spreads are also widened during volatile trading sessions for a very different reason, and that's to stop you taking advantage of a fast moving market. Many brokers actively discourage scalping trading (taking short term trades for a handful of pips) during these periods when markets are fast moving, and one of the ways brokers do this is to widen the spread to such an extent it is impossible to get into a strong position. You will hear this promoted as a trading strategy, often referred to as 'trading the news'. It does not work I'm afraid. You are welcome to try. It sounds good in theory, but in practice fails with the broker making sure for good measure!

Which leads me to the second point. Whenever we open a new trading position, we automatically start with a small loss. This reflects the fact we have entered at one price, and now have to wait for the spread to be absorbed by any market move, before we can move into profit in due course.

Imagine this as though we are starting a race, but giving everyone else a 2.6 pip start, taking our earlier example from Fig 3.10. Before we can catch up and move into profit, we have to recover the spread first. It's the cost of the trade if you like, and is the profit for the broker that has to be recovered. Imagine trading stocks. Here you pay a commission when you buy or sell. This is just the same. In the forex market the commission just happens to be in the spread with most brokers. There are some, where you pay a commission instead, just as in buying and selling stocks, and I explain this in the chapter on the types of brokers. In return, you get a tighter spread quoted. But again, it's swings and roundabouts.

Finally, spreads reflect the liquidity of the currency pair, and by liquidity I mean how heavily the pair is traded, which is why as novice traders, the best pairs to start with are the major currency pairs. First they are heavily traded throughout the trading session, with the EUR/USD the most widely traded of all, particularly through the European and US sessions. This will be reflected in the spread which will generally be quoted at somewhere between 1 and 2 pips. Other major currency pairs will have slightly wider spreads, generally averaging somewhere between 2 and 3 pips. However, move into the cross currency pairs, or exotic currency pairs, and the spreads will jump much higher, so 6, 7, 8 pips or more and into double figures. Everything of course is relative.

If you are trading over days and weeks, then a few pips here or there on a spread are irrelevant. However, if you are looking to take a few pips from the forex market as a scalping trader, then the spread becomes significant, and a significant percentage of any gains or losses. Consider this for a moment.

Suppose you are trying to take just five pips from a price move, but the spread on the pair is 2.5 pips. That's equivalent to 33% of the total move, and to put this into context, is the same as giving someone a 33m start in a 100m race. The chances are you would lose, and lose easily! This is one of the many reasons that it is so difficult to be consistent using this approach, as the maths is heavily weighted against you. Move to something a little longer term where perhaps we are looking for 20 or 30 pips, and the spread becomes far less significant, and is then simply the 'cost of trading'.

The other point about the spread is this - those currency pairs with tighter spreads will also signal a pair which will move continuously and smoothly throughout the day, simply because there are so many buyers and sellers in the market. This will be reflected in the price chart, which we will cover in a later chapter. Exotic currency pairs will stop and pause, sometimes for minutes or longer, before jumping in price one way or the other. This is simply because there are insufficient trading volumes to move the market in a continuous way. As a result, the market stops and pauses before moving on, making these pairs very difficult to trade on an intra day basis.

What we are looking for when we start trading is those pairs which move smoothly, and this is always the case with the major currencies, and most of the cross currency pairs. There will be periods of volatility, but never periods where the market just stops. Where you will see this however, is in the futures market, particularly on some of the less liquid contracts which are relatively new. For example, a micro futures contract on the EUR/USD will not move smoothly, even though it is derived from a major currency pair. It is simply that the volume of trades in this contract is relatively low at present, and this will be reflected in the associated price action.

Having covered the basics of how foreign exchange rates are quoted and what they mean, in the next chapter we're going to look at some of the forces which drive the forex markets, and are then reflected in the constant ebb and flow of these rates.

Chapter Four

Forces That Drive The Foreign Exchange Markets

Buy when the insiders buy
Christopher Browne (1946 - 2009)

Boil any financial market down to its basic components, and you will find that there are only two forces which drive price action, day in day out. Fear and greed in equal measure. These two emotions manifest themselves in the simple mechanism of risk and return. The higher the return, then the greater the risk. The lower the return, the lower the risk.

This is what creates the constant flow of money, into one asset and out of another. It is why the US dollar and the Japanese yen see money flow into the currency when the markets are nervous, and out again, when speculators and investors are prepared to take on more risk.

The question now is, do the forex markets work on this simple principle? And the answer is both yes, and no. You see the forex markets are unique. They sit at the heart of all the other major markets, and it may sound a rather obvious statement to make, but the forex market is about money. It is where money flows when assets in other markets such as stocks, bonds and equities are being bought and sold and converted into cash. It is also the market that underpins economies and whose currencies are held in reserves by the central banks around the world. It is the market where governments and banks try to control and manage their economies. Finally, it is also one of the most manipulated markets on a variety of levels, simply because there is so much money to be made. So, let's start there, and then move on to the central banks and finally take a brief look at economic data, which will then take us neatly into the next chapter.

Market Makers

As I explained in the introduction, the forex market is effectively managed and controlled by a handful of extremely powerful and increasingly profitable banks. There is no central exchange as with other markets, and as a result, this cartel of banks effectively runs the market. They are the source of the wholesale pricing which is then distributed through a spider's web of brokers, dealers, resellers, and finally out to us as traders at the end of the line. They are 'making a market' which is why they are referred to as market makers.

Regulation of course does apply, but not at this level. The banks themselves are regulated to make sure that their banking practices are fair and ethical, and that

they are holding sufficient reserves, but other than that, regulation of the forex market does not exist in this context.

Now the question you may be asking at this stage is, how do they do this and why is it not self evident to everyone?

To answer the first part of the question, they do this using the media, and indeed whilst writing this chapter we had a perfect example yesterday. The Twitter account of the news service Associated Press was hacked and a tweet released suggesting there had been two explosions at the White House, and that the President had been injured. The forex markets reacted suddenly and violently, with immediate flows into the Japanese yen and the US dollar. As soon as this news was in the public domain the market makers would have reacted quickly, moving prices fast and with three objectives in mind.

- Frighten traders into closing existing positions
- Take traders out of the market by triggering stop orders
- Trap new traders into weak positions on the wrong side of the market

A move such as this would have netted these banks 100's of millions of dollars, pounds or whichever currency you prefer to choose!

But don't worry if all this sounds a little complicated. You don't need to understand why or how they do this, just simply that they do. The market makers will use every piece of news, no matter how small to move the market around to suit their own objectives. In this case, it was a very short and sudden move, and the move out of both the yen and the US dollar was just as fast and volatile as the move in, once it was confirmed that the news had all been a hoax, and prompted by hackers.

We will look at the news in a little more detail at the end of this chapter, as we start to explore what we call the fundamental approach to trading. But the forex markets, just like all financial markets, are bombarded with news and comment throughout the day, from politicians, central banks, and government officials along with all the economic data which is released every day, coupled with natural disasters and world events. When you think about this logically it is really very simple, and given the same circumstances you would do the same.

At this stage let me say two things.

If you are starting to worry and perhaps think that forex trading is not for you, stop worrying now. And second, the reason that I am explaining this here, is that I believe that it is an aspect of the forex markets that you need to be aware of, before you start trading. Many traders start trading currencies with very little idea of who they are trading against, or how manipulated the market is, by various groups. The market makers are one group. The central banks are another, and the finally there are the forex brokers. All have their own agendas, and all manipulate the markets in different ways. Whilst the market makers are perhaps the most pervasive, ironically they are the easiest to see, as we have one powerful tool in our armory with the MT4 platform, and that's volume. And better still, just like the platform itself, it's free.

Whilst the market makers can manipulate prices and move market prices as news in the media ebbs and flows, there is one activity that they cannot hide which is volume. You can think of volume as activity, it is much the same. If we see strong volume (activity) in a price move higher or lower, then we know that the move is genuine. In other words, the market makers are joining the move themselves, which is our signal to enter the market. It really is this straightforward, and when we look at volume and price together, this reveals not only the strength of any move higher or lower, but also shows when and where the market makers are buying or selling themselves. This is the power of VPA or volume price analysis, which I explain later - so there is no need to be alarmed by the market makers or their activities. They are there, and manipulate the markets to meet their own objectives, but we can see them at work very clearly through the prism of volume and price.

Let me give you a very simple example from everyday life of the power of volume and price. Consider an auction on Ebay.

An item is posted for sale, and immediately attracts buyers, pushing the price higher, more bidders join the auction, and as more bids are received the item moves higher very quickly, and finally sells at a very high price. This is a genuine move higher, since the price action has been pushed higher by the volume of bidding. This is the simple principle of price and volume. The volume has validated the price move higher.

But take another example, this time from a more traditional auction, where the auctioneer is selling a piece which is of poor quality, and with few bidders in the room. The auction starts and there are no bids for the item. In an attempt to spark some interest, the auctioneer pretends to take some bids (this is called taking

bids ‘off the wall’) which are simply fake. This attracts a few bids and the price moves higher slowly, and finally the auction ends. In this case the price has moved higher, but on very low volume. Is the price move higher genuine? **No**, simply because there was no activity (volume) as the price moved higher. In other words, this was a fake move by the auctioneer. This is the simple principle that reveals the activities of the market makers. Therefore, don’t worry. In reading this book, and in another I have written called [A Complete Guide To Volume Price Analysis](#), you will have the tools to combat this aspect of market manipulation. I have also written a complete chapter in this book, to explain the basics and help you to get started, so even less to worry about!

Central Banks

If the market makers can be considered as the ‘micro’ manipulators working at the pip level and above, the central banks are at the other end of the scale, at the macro level. They are the ‘big picture’ market manipulators, and as such operate in a number of ways.

The mandate for most central banks around the world is very simple. It is to create a stable economic environment which encourages growth, creates prosperity for the people of the country, and where inflation is kept low. All of this is generally achieved with one simple mechanism - interest rates. As well as being responsible for monetary policy, central banks are, of course, responsible for the currency of the country in every respect.

Whilst most central banks are considered to be independent of their government, it would be naive to think that they are not fully aware of the views, ideals and policies of each administration as they come and go, and also of the effect that monetary policy may have within the framework of government policy. Most governors and presidents of the central bank are ‘called to account’ by their lords and masters, the government, generally on a regular basis through monthly meetings and public hearings.

The game changer in terms of the role of central banks, and certainly for those currencies mentioned in the previous chapter, was the financial crisis which enveloped the world in 2007/2008. Up to this point, one of the primary forces to drive the foreign exchange markets was interest rates, for one simple reason. Return on investment. If assets in one currency are offering a better return on investments than assets in another currency, then investors and speculators would seek out the higher yielding currency, either in terms of the currency itself, or to invest in assets denominated in that currency such as bonds and

equities.

It was the interest rate differential that was the number one focus, and when interest rate changes were announced by the central bank, the markets paid attention and moved as a result. And this is what I was referring to in my introduction when I described this 'loss of predictability'. Interest rate differentials, which were once considered the 'arbiter' of exchange rates, no longer apply. The rule book has been thrown out of the window, and the 'old rules' no longer apply.

Since the financial crisis, interest rates around the world have fallen sharply, as central banks desperately tried to stimulate their economies. These have fallen to such an extent that interest rate differentials are now almost completely eroded. The US at 0.25% is now on a par with Japan at 0.1%, with the UK at 0.5% and Europe at 0.75%. Canada is at 1%, New Zealand at 2.5% and Australia at 3%. Switzerland languishes at 0%. As a result, investors and speculators around the world have been searching out currencies with higher yielding interest rates in the Far East, Latin America and India.

No doubt in the future, interest rate differentials will return and become the primary force they once were, but not for many years, as the financial crisis has also led to a global economic collapse, plunging most economies deep into recession. The problem for the central banks, and particularly for those with strong export markets, has been to ensure that these markets were protected, by keeping interest rates low for as long as possible, which they have all continued to do, either covertly or overtly. Whilst rising interest rates generally signal growth and a strong economy, they also attract inflows of money, hunting out the higher yields I mentioned above. It is a double edged sword for many central banks around the world, and one they have to manage carefully, which many of them do, by direct intervention. The Bank of Japan and Swiss National Bank are classic examples, but other central banks also intervene directly when the home currency becomes too strong, and begins to threaten its competitiveness in world markets.

The simple message that has become very clear over the last few years is this. Each central bank in every country is now only interested in one thing - preservation of its economy and protection of its markets. Until the current crises ends, interest rates will continue to remain relatively insignificant - but they will return to their dominant position in due course.

Next, and as the counterbalance to the above, many central banks embarked on various programs of ‘quantitative easing’ or QE for short. All this means in simple terms is printing money, or adding money into the system if you like, and they do this by buying bonds. However, you don’t need to understand **how** they do this, just that they do! What is happening here is that a central bank is simply increasing the amount of money in circulation, which should in theory weaken the currency, since there is more of it in circulation! But has this happened so far? The short answer is yes, and no. The US dollar did indeed weaken when the first program was introduced, but has since recovered. The Japanese have been trying this approach for years, with little success, and only recently have they made some progress following a change in government. The Swiss have tried and each time the exercise was a failure.

All of this is played out in the currency markets which increasingly have become a battleground for these leviathans of the major economies. The term currency wars is appropriate, and has become the norm and the backdrop for forex trading. At this point you may be wondering why I am explaining all this in a book entitled ‘Forex For Beginners’ and the answer is this. I believe it is important that you have an understanding of the big picture. Many traders come to this market with little or no knowledge of the forces that drive it. I believe that to succeed, you need, at the very least, to have some idea of the many and varied forces which play out in the world of foreign exchange.

To combat the market makers we have an answer, and it’s called VPA. The central banks, on the other hand, are a law unto themselves and are becoming an increasingly dominant force in their own right. A decade or so ago, it was their monetary policy and interest rate decisions that were the focus. Now for us as forex traders, it is the extent to which a central bank is likely to intervene, coupled with programs to maintain low interest rates and a weak currency to boot. In other words, decisions designed to keep their political lords and masters happy.

Finally, of course, central banks not only ‘manage’ free floating currencies such as those outlined in the last chapter, either overtly or covertly, but also in those currencies which are pegged, often to the US dollar. These types of arrangements range from fixed pegs, where the currency is managed in a range, or informal ‘dirty float’ regimes and others, where the currency is allowed to float free and with no public statement on when or where intervention is likely to occur. Each central bank takes its own very different approach.

Some are straightforward, and what you see is what you get. Examples here would be Australia, Canada, and New Zealand whilst others are highly political, such as the ECB in Europe. The Bank of Japan and Swiss National Bank are openly interventionist and protectionist. Away from the major currency pairs, some central banks are happy to see strength in their currency, such as the Bank of Mexico which is seen as non interventionist, whilst Brazil's central bank is perceived as the complete opposite.

Therefore, in summary.

First, be aware that the framework of the forex market is very different for the reasons I have outlined above. The old forces which once drove the markets have changed dramatically in the last few years. Normal service will be resumed, but not for some years - at least 5 or more in my opinion, with economies unlikely to recover much before 2015. At that point we may start to see interest rates becoming the focus once again, but until then, the above conditions will prevail for the foreseeable future.

Which leads me neatly into the final group of forces which drive the markets, and these are back to the micro level, and here it's the economies and economic data.

Economic Data And News

I am going to cover this in more detail in the next chapter, but one of the primary drivers of the foreign exchange markets is economic data, which we refer to as fundamental news or fundamental indicators. Essentially all this means is that every day, there is a stream of economic data which is released by a variety of organizations, governments, and central banks themselves, which highlights some aspect of economic activity in the country. In addition to these economic releases, there are financial and political statements, once again from a variety of sources, all of which influence the market to a great or lesser extent. A statement from the governor of the bank will have some weight, and the forex markets will pay attention. Equally an economic release from China will have a huge impact, particularly if it is one which signals economic growth, or possibly an economy that is slowing down.

These releases appear daily, and for virtually every country around the world. Generally they are signaled well in advance and will appear in the economic calendars which are freely available online. The economic calendar I have used for many years is <http://www.forexfactory.com>, as shown in Fig 4.10:

10:36am	Currency	Impact		Detail	Actual	Forecast	Previous	Graph
2:00am	CHF		Trade Balance		2.49B	2.32B	1.86B 	
4:00am	GBP		MPC Member Bean Speaks					
4:30am	GBP		Public Sector Net Borrowing		9.4B	10.4B	10.8B 	
8:30am	CAD		Core Retail Sales m/m		0.4%	0.2%	0.8% 	
	CAD		Retail Sales m/m		0.2%	0.3%	0.5% 	
	USD		Non-Farm Employment Change		148K	182K	193K 	
	USD		Unemployment Rate		7.2%	7.3%	7.3%	
	USD		Average Hourly Earnings m/m		0.1%	0.2%	0.3% 	
9:00am	USD		TIC Long-Term Purchases		-8.9B	30.9B	31.0B 	

Fig 4.10 - Forex factory economic calendar

Each release is ranked in order of importance. A release with a red flag is expected to have the greatest impact, one with an orange flag, medium impact and finally one shown with a yellow flag likely to have a low impact. These are all listed and ranked on the left hand side, and in date and release time order.

Moving to the right hand side of the page, for each release, there is an actual, a forecast and a previous. This tells us very quickly what the number was last time, and what the market is expecting this time in the forecast. Finally, on the extreme right of the screen, if you click on the icon, this opens a new window to display an historic chart of the release, generally over a year or longer. This helps to 'frame' the release in terms of what has gone before. The markets will rarely if ever reverse a longer term trend simply on one number. They may react to the number in the short term, for example if the longer term trend for a particular release is down, and the market moves higher on the news, this is only likely to be a temporary move, before the dominant longer term trend is re-established.

In the centre, between the release and the details on the right, there is a column labelled detail, with a small 'folder' icon. This is extremely useful and gives more information on the release, along with links to any associated sites where the release is posted once it has been released. These can also give helpful guidance and tips as to likely market direction, but please treat these with

caution! As I have explained above, the markets are very different at the moment, and far from what could be considered 'normal'.

Markets in general do not like surprises, and the forex market is no different. The key here is how the number that is released is seen against the forecast that the market is expecting. Indeed this is why the monthly interest rate announcements, which are part of the economic calendar, have little or no impact, Market participants know that interest rates are likely to remain low for some time to come, so there are no surprises in store. It is the surprise element that makes market jump, and this can be either a number which is well above the forecast, or well below. An unexpected or extreme number will always come as a surprise.

Finally, one other key point concerning economic data. New traders are often surprised when a market rises on 'bad news' and falls on 'good news'. Why does this happen? It happens because everything is relative! If the market was expecting bad news, but perhaps the news wasn't quite as bad as expected, then this is considered 'good news'. Equally, if the market was expecting good news, and the news wasn't quite as good as expected, then this is 'bad news'.

When we move to considering trading strategies, the fundamental news becomes a key point and one you will have to consider carefully. These releases are a fact of life, and one of the primary forces which shape and drive the foreign exchange markets, which is then reflected on our price charts. They cannot be ignored and have to be factored into any trading strategy, and the issue is always this? Do we take a trade before the release, or wait until after? Much will depend on your approach to the market, and in particular the time frame you are trading, but I will be covering this in more detail, later in the book.

Meanwhile, I hope the above has given you a brief introduction to some of the major forces and influences that shape the foreign exchange markets on a daily basis. They are a complex mix of manipulation, coupled with the more 'transparent' daily news flow of statements and economic data, which are part and parcel of trading.

In the next chapter we are going to consider the various approaches to trading, and more particularly the one I recommend and why!

Chapter Five

Trading Approaches

If past history was all there was to the game, the richest people would be librarians

Warren Buffet (1930 -)

As long as there are traders and financial markets, there is one thing you can be sure of - that traders will disagree on the most effective way to trade, and on which approach will ultimately yield the best return. This is a fact of life, and in many ways reflects the way the markets work. After all, if we all had the same opinion, there would be no market, since everyone would trade in the same direction!

The question now is, what are the various approaches, and which of these do I follow? And the corollary is, which approach do I recommend. As you can imagine there are as many approaches as traders, but in this book you will discover what I have found works for me, and I hope it will work for you too. My approach or method is based on simple common sense and logic, and underpinned by an analysis of price and volume. Moreover, the indicators I use in my own trading, are not there to give me buy or sell signals because no software can do this for you. What the indicators are there for is to display information that would be difficult to replicate in the same time manually. In other words - speed. It is my underlying methodology and analysis of the price and volume which is used for my entry and exits, not the indicators.

At this point, most books will suggest that there are only two approaches you can take to trading, known as technical and fundamental. To this I add a third, which I call relational. This then combines all three into one unified approach to the forex market. But let me explain.

Fundamental Analysis

In the previous chapter we looked briefly at the economic data that is released to the market every day from around the world. These releases are also referred to as fundamental indicators, and in a nutshell are designed to provide central

banks, governments, investors and traders with a view of the economy. A snapshot, if you like, of whether an economy is expanding, contracting, or simply flat, and its prospects for the future. These fundamental indicators cover every aspect of the economy, from jobs, to housing, unemployment, interest rates, exports, imports, consumer spending, manufacturing, commodities and prices. In short, anything and everything which can, and will affect the future economy. Some of this data is then used by the central banks in managing and implementing future monetary policy.

A fundamental trading approach is premised on the belief that foreign exchange markets, and indeed all markets, are driven by the economy and the economic data that is released daily. Fundamental traders do not believe that any other factors play a part, and trade simply based on an economic approach, and an interpretation of the data which is released. This belief could best be described as a 'scientific approach'.

Technical Analysis

A technical trader, on the other hand, has a very different view, and I would also suggest that technical traders are in the majority.

A technical trading approach is premised on the belief that every aspect of market sentiment, the buying, the selling, the fear and the greed, is all encapsulated and captured on one simple price chart. In other words, the fundamental aspect has already been factored into the price chart, along with the views of every speculator and investor around the world. Unlike the fundamental approach, technical trading or analysis is more of an art than a science. It is the antithesis of the fundamental approach, and needless to say, fundamental and technical traders will always argue that their approach is right, and the other is wrong!

Relational Analysis

A third approach to trading and the markets is what I call relational. It is an approach that few traders even stumble across, and fewer still ever use. In simple terms, as the name suggests, relational analysis considers the associated price action in related markets to provide a 'triangulation' point on the forex market. And if you think about this logically, this makes sense. After all, no market, least of all the forex market, trades in isolation. How could it as every market is connected to every other market, and as money flows out of one, it then moves into another. As I have already touched on earlier, every decision in every

financial market is about risk and return, with investors and speculators searching out higher risk when greed is the primary driver, and lower risk when fear is the dominant emotion. This constant ebb and flow is seen in every market including the forex market, and simultaneously reflected in related markets. This is the principle of relational analysis.

So, what approach do I recommend and suggest you adopt too?

As a matter of fact I use all three elements. Each element on its own is strong, but when all three are combined, we are given a three dimensional view of the market. The analogy I use is that of a rope. On their own, each strand of analysis has its own strength, but combine them together and each validates the other, giving us valuable insights and perspectives. In other words the sum of the whole is greater than the sum of the parts.

In this book, designed for novice traders all I want to do is simply introduce some basic concepts. But if, after reading this book you would like to discover more, I have written [A Three Dimensional Approach To Forex Trading](#), which explains the principles I am about to cover in much greater detail.

Let's get started with the first element of our three dimensional approach, which is fundamental analysis.

Step 1 - The Fundamental Approach

The first thing to establish straight away, is that you **do not** have to be an economist to understand the fundamental news releases. Second, you will very quickly learn to recognize those items of economic data which are important, and those which are less so. Third the significance of any data will also depend on the country releasing the data, (major economies will have a greater impact). Finally, the constant round of economic releases have a cycle all of their own, so let me begin by explaining what I mean by cycles, and in a way we have already touched on this.

Had I been writing this book ten years ago, then the number one release for every country, every month, would have been the interest rate decision, and any associated statement from the central bank. This would then have set the tone for the currency and associated currency pairs, setting trends in place based on the prospects of rising or falling interest rates.

This has all changed, and although interest rates are still shown as a red flag release, the **only** element that the markets will watch and take note of, is the

accompanying statement, and not the rate decision itself. The reason for this is simple. It is how the bank communicates with the market, and more importantly likes to test the market's response to any proposed changes, which it does using these statements.

Interest rates are now ranked well down the list at the moment, and this is what I mean by the cyclical nature of the economic releases. At present, most economies are in recession, and unlikely to recover for some time, so the question is, which releases are important and why? This is really no more than applying a little common sense to the data, which is generally classified in one of three ways, namely leading, lagging or coincident. In other words, a leading indicator will signal a change coming before it happens, a lagging indicator after it has happened, and a coincident one, at the same time!

Therefore, let's try to break the economy down into its core components. What elements are the most important and which influence whether an economy is expanding, contracting or just stagnating? And in essence there are just three.

- Employment
- Consumer spending
- Business

Let's take each of these in turn.

It may sound simplistic, but if unemployment is rising and the number of new jobs being created is falling, then this is not a good sign for any economy! If unemployment is falling, and new jobs created is rising, then this is generally good news and signals a strong economy, provided this is part of a longer term trend. Jobs and job creation lie at the heart of economic activity, and from which everything else flows. After all, if people feel secure in their jobs, then consumer confidence grows, followed by demand for goods, products and services, which in turn creates further jobs and further growth. As a result, any employment related data is a high priority indicator as the ripples flow out, and are then reflected in the broader economy.

These releases carry even greater significance in the current economic cycle, since it is the employment figures and the number of new jobs created each month, which will then send clear signals of a possible recovery in the economy. But, the key point is that any release must be viewed in the context of the trend

over the longer term. One 'positive' release may simply be a seasonal variation, which is why the trend is so important.

Next is consumer spending.

If consumers are reluctant to spend, then nothing moves, which is precisely what is happening to many economies at the time of writing this book. Confidence is low, job security is non-existent, and without spending, no new jobs are created, businesses struggle or collapse and no longer invest in equipment or staff. Everyone is frightened, and with uncertainty comes fear - a fear of spending, of investing, and of taking any risks. To date central banks have done all they can to stimulate demand by keeping interest rates low, but until confidence returns, nothing much is likely to change. Consumer spending is reported in several different ways, but one of the simplest is in the retail sales figures.

The housing market is also another key measure of consumer confidence, and whose influence extends out into every area of the economy from financial services, to household goods, furniture, electrical goods and furnishings, and on into the retail sector. Low interest rates should signal demand for houses, demand for mortgages and a rising market signaling growing confidence in the economy. When house prices are rising, everyone feels more secure and spend accordingly. Purchasing moves from the essentials of every day life, to discretionary spending on the non-essentials.

Finally, we come to the business sector, which in reality is simply a reflection of consumer sentiment and employment. If consumers are spending, then this ripples through into every business sector, whether in terms of manufacturing, the services sector or in imported goods. Consumer spending creates the jobs which are demanded by business to provide the products and services, which then spills over into the housing market, and luxury goods along with discretionary purchases.

And now you wonder why you ever thought it was difficult to be an economist! It really is just common sense when you start to think about it in every day terms.

Most economic releases will fall into one of the three broad categories above, but there is another. These are the figures which encapsulate all this activity in economic numbers, and which then paint the 'macro' picture for the country.

These are the releases that perhaps you have heard mentioned in the media from

time to time, such as GDP, and CPI. They simply describe the economic outlook for the country as a whole, or some aspect of the economy, such as inflation. As you might expect, these generally lag the economy as the data is normally collected over an extended period, often over three months or more, and is then collated and presented one month later. But this is all 'big picture', and the best place to start learning is once again at forex factory, by clicking on the folder icon, which will give you a short overview.

In simple terms, the big numbers to watch are those that give clues as to the growth in the economy, so GDP is always a very important number. Another is the Trade Balance, which reports the balance between imports and exports. For a country such as Japan, they will always have a trade surplus, in other words, they export more than they import, and this will be the case for many major exporting nations such as those in the Far East. Countries with a trade surplus will generally have a strong currency, as overseas buyers of their products have to convert their own currency to buy these products.

Inflation data is one that all markets watch carefully, since this can signal many things. Inflation can be both a good and a bad thing! Too much, and economies spiral out of control. Too little, and they stagnate, which is the case at the moment.

In a strong and expanding economy, inflation will generally be rising gradually in a controlled way, and as inflation increases, then the central banks will start to consider raising interest rates to keep inflation under control. As inflation rises, so does the prospect of an interest rate rise which will increase the interest rate differential between currencies, as well as attract investors and speculators searching out higher yields and better returns on their money.

The problem for most central banks is that inflation, as with GDP is a lagging indicator and just like the oil tanker, controlling it with any accuracy is very difficult. This is why economies around the world lurch from boom to bust and back again. The only effective measure that any central bank has is interest rates, which are a very blunt instrument with which to control an economy. And the reason, is that by the time any changes have filtered through into, say the housing sector and the broader economy, it is generally too late!

When the captain of an oil tanker stops his engines, the vessel will continue on quite happily for several miles under its own momentum. The economy is just the same. By the time the bank takes action, the economy is normally expanding

too fast on a credit bubble, which subsequently bursts in the grand style as happened in 2007/2008.

In summary, whilst you may feel a little overwhelmed when you first start to look at an economic calendar, if you can break the releases listed down into these simple groups, this should help to make them more meaningful. Remember, that most of these numbers are common sense, and you truly do not need to be an economist to make sense of them. I am not, and I manage quite happily, and so will you. Simply follow the red flags to start with, and read the detail on the release which will help you to understand them, and if you do want to discover more, there is always my book!

Finally, on the fundamental approach to trading, I just want to cover one other aspect which is this. Whilst GDP, for example, is reported in much the same format for every country, its impact on the market will be very different, depending on which country is being reported. A GDP release from one of the top six economies of the world, such as the US, China or Japan, will have a dramatic effect, not just on the home currency, but also across the markets in general. China is a classic example along with several other major exporters from the Far East and Asia.

China's growth has been dramatic and continues to remain so, with a booming export driven economy, and China's demand for basic materials and commodities also increasing. Therefore, it is not difficult to imagine the impact on the markets of a GDP number which comes in worse than expected. The markets in general will panic as traders and investors begin to question whether the Chinese economy is slowing down, and if so, will it trigger recession or recessionary fears around the globe. This is the message such a number sends to the market. The same is true of the US, or Japan, or indeed any other major exporter.

Ironically, a few short years ago, we would have been hard pressed even to find Chinese data reported. Now it is the norm and routine. Other countries will follow, so expect to see data from Latin America, Africa, India and South East Asian economies increasingly reported. Do not make the mistake that if you are trading in a major currency pair, that these releases will not affect the currency you are trading. They will, and dramatically. For example a poor GDP number for China would not only be extremely bad news for the Australian dollar, but would also impact every other market namely bonds, equities and commodities.

Step 2 - The Technical Approach

A technical approach to trading is very different from the ‘academic’ approach outlined above. Fundamental analysis gives us the economic numbers which drive economies and shape economic policy set by the central banks. Technical analysis, then ‘frames’ all this opinion and sentiment on a simple price chart for us, to which we then apply several analytical techniques to reveal where the market is likely to be heading in the future. Technical analysis, is therefore much more of an art than a science, and if you wanted to create a picture in your mind, the see-saw is a good analogy. The fundamentals sit at one end, the technicals sit at the other, and the relational is the central fulcrum around which the markets move.

As you may know, there are hundreds if not thousands of books which have been written on the various aspects and approaches to reading price charts. Indeed I have written my own. However, what I would like to do here is to explain some of the basic principles which I use every day, and this will then lead nicely into the next chapter on volume price analysis, which is the cornerstone of my own approach to trading forex, and every other market.

Let me start with price action and how it is represented, and I’ll get straight to the point here - I only use Japanese candlesticks for all my trading, as I find them powerful, descriptive and clear, particularly when used in conjunction with volume. If you have never seen a price chart before, or indeed the term candlestick may be new to you, let me explain with a simple chart.

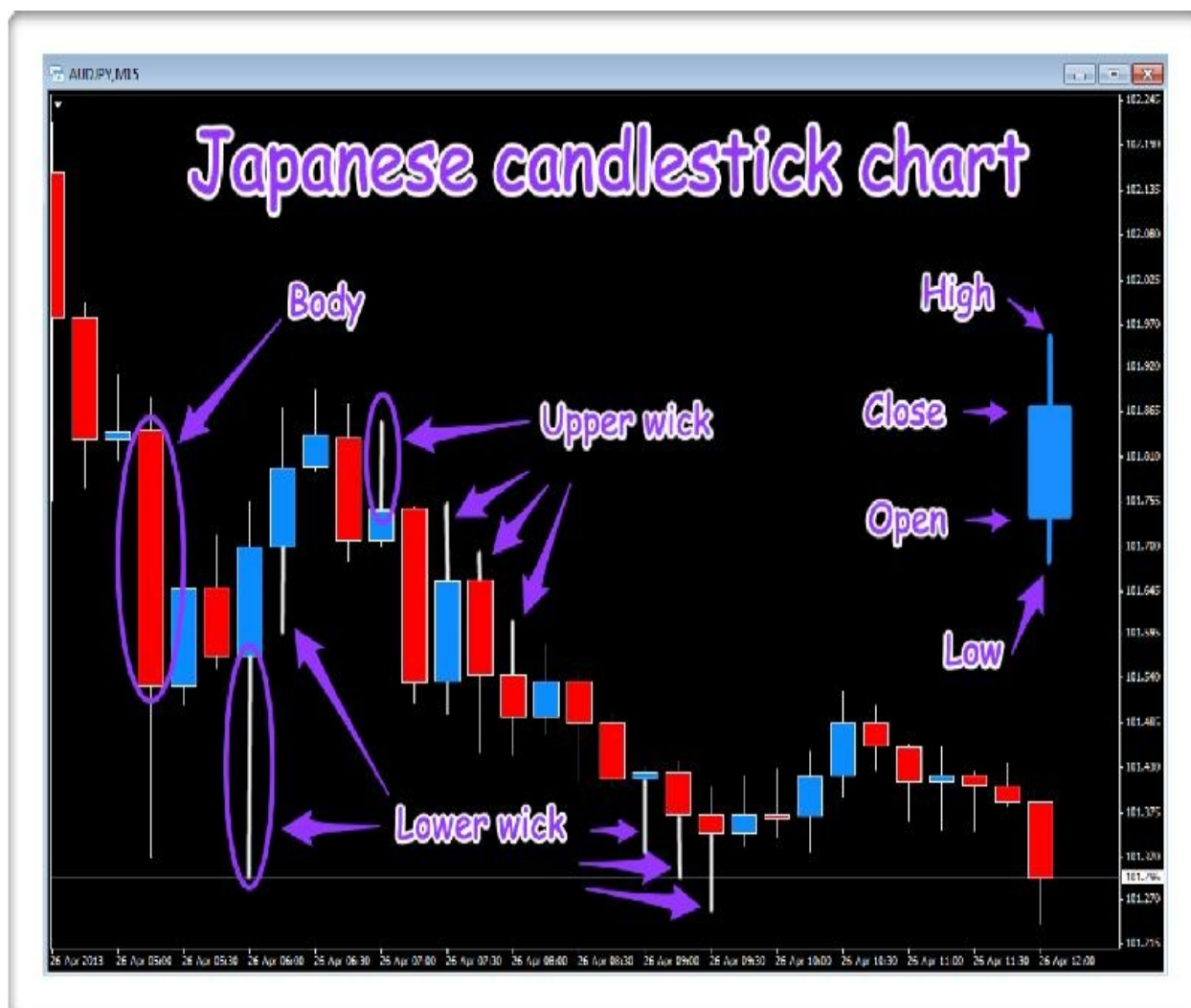


Fig 5.10 - Japanese candlestick chart

There are many ways to present the price action on a chart, but in my humble opinion this is the best, and the one I have used for over 16 years. It works, and is the one you will find in virtually every trading room around the world. The bars are referred to as candles or candlesticks, simply because they resemble a candle, and indeed we call the tails at the top and bottom, wicks. Therefore, for the remainder of this book I will refer to them as candles (except when I forget, and call them candlesticks!)

Each candle reports four prices during the session, whether this is a 1 minute chart or a 1 day chart. These are the Open, the High, the Low and the Close, and you can see these in the little diagram to the right of the chart, which I hope helps to explain. Now, of course price goes up and down during any trading period, and in the example here, I have used an 'up' candle, which is shown in

blue, on the right. So how is the candle created?

Simply as follows: the price opened, and then at some point in the session, touched a low, before moving higher to touch a high, finally closing below the high of the session. In this case, the close is above the open, in other words the price action was higher in this session, and an 'up' candle was duly created. We also know that the low of the session was below the open, and the high of the session was above the close. It is this action which gives rise to the so called 'wicks', the thin narrow lines, which appear above and below the candle. I've shown several of these on the actual chart and as you can see, we have an **upper wick** when it appears above the candle and a **lower wick** when it appears below. The solid centre of the candle, is referred to as the **body**.

The body of the candle is painted either blue or red (or whatever color you like - this is my preferred, but you can choose your own colors), which then denotes whether the candle closed higher or lower in the trading session, which is one of the many beauties of candles. You have an instant visual picture of the price action. Sometimes, the open and close are identical, in which case there is no body at all, but just a line. This is a particular type of candle which I will explain shortly, and is one with either no, or a very small body. We have one or two in this chart as you can see, where the body of the candle is very small.

There are many different types of candles, and candle patterns, that we see every day on our charts, but what I would like to do here is to introduce you to the most powerful candles that we look for all the time, and I'll explain why as we go along. In simple terms, these are the candles, which when validated with volume, give us terrific signals of potential turning points and reversals in trend. In other words, they are an early warning signal that the market is about to turn, and we should **pay attention!**

To be honest, if you simply spent your trading career just studying these candles, and trading accordingly, you would be successful - that's how powerful they are, based on price action alone. Imagine how much more powerful they become once we add volume into the equation. The candles that I am going to explain here for you are based on over 16 years experience.

They are not based on hypothesis, but are the candles which have netted me more money than all the others put together, so are deserving of close attention. And if you take nothing else away from this book, please study and understand these candles for yourself. They are so powerful and work in all timeframes.

Let's start with the the hammer candle.



Fig 5.11 - The hammer candle

The hammer really describes the price action for this candle perfectly. It is hammering out a bottom, which is why it is called the hammer. Let's explore the price action here in a little more detail and examine why this candle, and the others are so powerful.

This is the GBP/USD on the M15 chart (15 minute) and, as we can see, the pair has been moving lower in a series of steps. Finally on our chart we see the hammer formed, and immediately this grabs our attention. There are no hard and fast rules when it comes to the precise formation, as this is an art not a science. But the body of the candle should be small, and the lower wick should be long, and as a rule of thumb at least three times the length of the body. The body of the candle can be either red or blue, either is fine, and of course, on occasion, there

will be no body. A perfect hammer if you like, with an identical opening and closing price.

But what has actually happened over the 15 minutes here in terms of the price action, and why is this candle so powerful?

The market has been moving lower, so we know that in general the UK pound is being sold and the US dollar is being bought. The price on this candle then opens, with selling of the pound continuing. However, at some point during this period, buyers come into the market, buying the UK pound and selling the US dollar. Ultimately, the sellers of the british pound are overwhelmed by the buyers of the US dollar, who stop the price moving lower, and start to take the pair back higher, to close somewhere near the opening price. You can think of this as a tug of war with two teams, which is essentially all the market is - the buyers and the sellers, the bulls and the bears battling for supremacy in every candle.

In this case, imagine we have two teams and a tug of war rope, with a white flag attached at the centre of the rope. Both teams then take the strain as the candle opens, but the sellers are much stronger and pull the rope further and further to their side of the line. The buyers are losing the tug of war at this stage, but then urged on by encouragement from their coach, they find some reserves of energy. Slowly but surely they begin to drag the rope back, until finally the match ends with the white flag back in the centre, where it first started.

The significance of the hammer candle is this. It is sending a clear and unequivocal signal that the sellers have been overwhelmed and that buyers have started to take control. It is therefore the first signal of a potential reversal in the trend. However, please note the word potential. All we know at this stage is that we are paying attention, and now need to validate this price action which will then give us some clues as to how far any potential reversal is likely to travel. And to do that we use..... volume of course! Which I introduce in the next chapter. But for now, just remember, the hammer is one of the most powerful candle signals. It is sending its own signal, purely based on the price action, that the selling has been absorbed and the buyers are moving in, possibly to take the market back higher, which is exactly what happened here.

Now let us look at its celestial twin! - the shooting star candle.



Fig 5.12 - The shooting star candle

The shooting star in Fig 5.12, is the mirror image of the hammer candle, and occurs at the top of a trend higher. Once again we are on the 15 minute chart, this time for the EUR/JPY. The pair has been moving higher in this time frame, where the market has been buying euros and selling the Japanese yen. Then we see the shooting star candle form, giving us a loud and clear signal that the market may be tiring, only this time with the buyers being overwhelmed by the sellers. This is the reverse of what happened with the hammer candle.

It is the same price action as with the hammer candle, but in reverse as it is the sellers who are coming into the market, and forcing the price lower. This time in our tug of war, the buyers win the first half of the battle, but the sellers then drag the rope back to the mid point as the candle closes.

Once again the same 'rules' apply, and the example here is perfect. In this case

we have a nice deep upper wick standing like a flag pole on the top of a mountain, with a very narrow spread body below. The upper wick should be at least three times the depth of the body, and can be either red or blue. It makes no difference. I should have mentioned it earlier, (apologies) so will mention it here!

You can see that the shooting star has a small lower wick in this example. This is fine and nothing to worry about, and in the hammer candle, the reverse would also be true with a small upper wick, also being perfectly acceptable. I cannot give you hard and fast rules here, but the smaller the better, and certainly no more than shown in this example.

Once again, as with the hammer candle, we then validate the candle using volume, but this candle on its own is sending a clear signal of a potential reversal, this time from bullish to bearish (buying to selling). All we have to do is use volume price analysis to confirm the weakness and to assess the likely extent of the trend lower. As you can see in Fig 5.12, a nice position developed shortly after.

But now - a word of caution. Markets rarely turn on a dime. They take time to reverse, and in this example we had to wait for two more candles to form before the pair rolled over. This is a feature of market behavior that you have to understand. The market is like an oil tanker. When the captain stops the engines, the vessel will continue to move on for several miles. Therefore, don't jump in too early. Wait and be patient. These are warning signals of a potential reversal which we then validate with volume, before taking any trading decision.

The hammer and the shooting star are the two most powerful candles that you will see on your price charts. They are the first sign of a change, a reversal from bearish to bullish or from bullish to bearish. They stand alone as the most powerful and descriptive candles that you can use in your technical approach to trading. As I said earlier, these two candles have made me more money than any other, and they will do the same for you as well. I cannot stress this too strongly. Furthermore, if these were the **only** candles you waited for in all time frames, this alone would put you on the road to success.

Now let's take a look at three other candles, starting with the doji candle.



Fig 5.13 - The long legged doji candle

The doji candle is a powerful signal of market indecision, and the simplest way to imagine the price action here, is to go back to our tug of war analogy.

First the buyers pull the rope well over the gain line, then the sellers pull it back again, then the buyers start winning again and pull the rope back, before the sellers find some renewed energy once more and haul the buyers back again. The tug of war ends with the rope firmly back in the middle ground with no clear winner.

This is exactly what is happening in this price candle. There is no clear winner and the buyers and sellers are canceling one another out. In other words, the market is lacking direction and this is classically seen following a news release, with an initial surge in one direction, followed by an equal surge in the opposite direction, before the market closes, close to the opening price.

On any price chart you will find hundreds of such candles, as markets are always pausing, but the key one to watch for, which is far more powerful is the so called 'long legged doji' candle. As you can see from Fig 5.13, the upper and lower wick are extremely long in comparison to the body, which is very small. The candle resembles a flying insect called a daddy long legs, which is extremely delicate with a small body and very long thin legs. The power of the signal comes from the length of the upper and lower wicks, which are sending a clear signal that despite the price volatility, which is reflected in the length of the wicks, the market is lacking direction at this price point. The example is from a four hour chart for the USD/CAD.

There are several things to consider with the long legged doji candle.

First, unlike our previous candles which are specific to points in a trend, the long legged doji candle can appear at the bottom of a bearish trend, or the top of a bullish trend. The signal it is sending is one of indecision and potential weakness. After all, if the trend were strong, then this volatility would have helped the pair continue in the direction of the original trend. It's therefore an early warning of a **possible** change, in other words a market that has become tired.

Next, on its own it is a powerful signal, but this power is increased when it validates either a hammer candle or a shooting star candle. If, for example we see a shooting star, followed by a long legged doji candle shortly after, then this is confirming the shooting star, and sending an even stronger signal that the market is indeed weak at this level. Equally, in a down trend, if we see a hammer candle, followed by a long legged doji candle, then this adds further validation to the hammer candle, and again is a strong signal of a potential reversal at this level.

Both of these candles would also be validated using volume price analysis, and several other techniques which I will explain later in the book.

The candle itself can have either a red body, or a blue body, it makes no difference, but the body itself must be very narrow, the legs should be four to five times as long as the body, and where possible the body should be at the mid point along the length of the legs. In other words as evenly balanced as possible, since this then reflects the fact that the battle between the sellers and the buyers has ended in a draw. The legs themselves should be as equal in length as possible, giving a nice symmetrical appearance to the candle.

Finally, just to answer one question that you may be asking, ‘does it matter how soon after the hammer or the shooting star, that the long legged doji appears?’, and the answer is no. Sometimes this candle will appear immediately after, and at other times it may be several candles later. It does depend on the forces driving the market at that time. For example, a shooting star may appear, well ahead of a major piece of economic news, which then triggers the long legged doji. There are no hard and fast rules here. And indeed, no doji candle may appear at all. But when it does, look back to the previous candles to see if it is confirming an earlier signal. There is no guarantee that the market will reverse, it is simply sending a signal of indecision, nothing more nothing less. Volume will then validate the price action, along with our other techniques which come later.

The last two candles are in fact candle patterns. In other words two candles together, and these are called the tweezer top and the tweezer bottom candles, and let me start with the tweezer top.



Fig 5.14 - The tweezer top candle

The tweezer top candle pattern in Fig 5.14, is created when two candles close with deep upper wicks, and where the high of each pulls back from the same price point. In doing so, this then creates the 'effect' of a pair of tweezers. Hence the name.

However, first things first. Whilst the hammer, shooting star and doji candles are appropriate for all time frames, and indeed all markets (not just spot forex), the tweezer top and tweezer bottom are very different. They are scalping patterns **only**, and for the forex market only. In other words, they should only be used on very fast timeframes such as the 1 minute or 5 minute charts, and no slower. Their power is in signaling short term weakness as they signal two subsequent 'failures' at the same price level. Fig 5.14 is from a 1 minute chart of the EUR/USD. In this case the market has risen, touched a high, and closed well off the high. The EUR/USD has then tested this level again, and failed at the same price point for a second time, closing much lower this time. This is now a clear signal of 'short term' weakness, and it is at this point we would be looking for validation with volume price analysis.

It is a classic intra day scalping pattern, and in many ways the word tweezer defines the pattern. The tweezer is a delicate instrument, and this is a delicate pattern. It is not a pattern of major reversals in trend, but simply signaling a short term change, and the opportunity to be in and out very fast! The power of the pattern comes from the depth of the upper wicks. As you can see here, the market has tried to move higher, but has been forced lower, and then tried again, and this is similar in many ways to the price action of the shooting star. The buyers are in control and push the price higher, but then the sellers move in, and force the market lower. The next candle opens, tries to rise again, but the buyers are once again overwhelmed, as the price is forced back down, and on this occasion ending with a red candle.

The body should be wide, but there are no hard and fast rules regarding the ratio of the body to the upper wick, other than both wicks should be tall. The idea here is that the market has moved up firmly in the time frame, and then 'topped out', before pulling back. This has then been repeated creating the tweezer top, with the body of the candle suggesting some momentum in the price moves.

Now let's look at the tweezer bottom, which is the mirror image in a move lower.



Fig 5.15 - The tweezer bottom candle

In Fig 5.15 we have an example of a tweezer bottom from the 1 minute USD/CHF chart. Here the market has been moving lower and we then see two candles appear, both with deep lower wicks and both testing the same price point. A mirror image of the tweezer top, with the classic tweezer shape created by the deep lower wicks. Again, this is a short term signal **only** and for scalping traders **only**.

In this case we also saw a further test of this price level, two candles later, so a further confirmation of the bearish move running out of steam, and a possible reversal higher, which duly occurred. But note the time that this reversal lasted - just a few minutes, and this is how to use these particular candle patterns. I have included them here as many traders in the spot forex market are quite literally, scalping for pips, and the tweezer top and the tweezer bottom patterns are excellent signals to use.

Speaking of signals, as you will see shortly, my approach to trading has always relied on volume and price analysis, as providing the core principle on which my methodology has been built, and I hope that it will become yours too. However, I cannot ignore the fact that many traders, myself included over the years, have tried some of the many technical indicators, which are freely available with most trading platforms. There is nothing wrong with using some of these indicators, provided they underpin some other methodology, and are not there to give you buy or sell signals. The rational here is simple. If they offer you some insights into market behavior and price action, which would otherwise be difficult or tedious to do manually, then they have some value. What they should **not** be used for, in my opinion, is to give you buy and sell signals. There are only two indicators that will do this for you consistently and they are price and volume, which are both leading indicators. And in using price and volume for our analysis, it is we who make the decisions based on our analysis, and not any software. As you will see, volume price analysis is an art, not a science, and never will be, and as such it is for you to draw your own conclusions on any analysis, not a computer driven program.

As I said earlier, I have used a few of these indicators myself, so feel I can offer an insight from a trading perspective. The others, I will leave to you to explore and try for yourself. You may find them useful or not, but my advice is never to use them in isolation or as buy or sell signals, but simply to support your analysis using other techniques.

Of those that I have used in the past, simple moving averages are perhaps the most common, as they help to provide a view of the trend. As the name suggests, these are simply 'moving averages' - in other words, the average of the closing price considered over a certain number of candles, which then moves forward after each candle is built. For a ten period simple moving average, the indicator looks at the closing price of the last ten candles, sums these together, and then divides this by ten, to arrive at the average price.

There are two in particular that I should mention, and these are the 100 and 200 period, and in particular when used on the longer term charts. You will also find these referred to in the financial media and on TV, as they have developed an 'iconic' status in the trading world, largely because they are used on most trading floors, and are therefore often 'self fulfilling prophecies'. When touched, they frequently trigger reversals in the longer term trend, particularly on daily and weekly charts. This is where markets have been in long term up, or down trends. If they touch these averages and then reverse this is seen as a strong signal -

equally if the market breaches them, then this is seen as further strength in the move. Also when one crosses the other, this again is seen as significant.

On an intraday basis, price action that moves too far away from a simple moving average will tend to move back towards it in due course. For example, a sudden move higher, and away from the moving average below, will tend to see the price action reverse back to touch the moving average as it 'catches up' with the price action. Some of the more popular moving average periods are 8, 9, 10, 14, 26 and 40, but there are many others. It's simply a question of personal choice. There are also several variants of the simple moving average (SMA) with exponential moving averages one of the more popular.

One of the other indicators, introduced to me very early in my trading journey, were Bollinger bands. However, I have to be honest and say that having tried them for several weeks, I personally found them of little use. However, I know many traders use them and you will have to try them for yourself and make your own judgment.

The same is true of Fibonacci levels and Gann angles. Many traders are convinced of their use in trading decisions, and of the two, Fibonacci levels are probably the more popular with forex traders.

Finally, there are a whole host of other indicators which I have never used such as MACD, Stochastics, and many, many more. I have never used them myself, and would never suggest they have no value. It's simply that my own trading method has been based on volume and price, and I hope that in reading this and my other trading books, I can convince you that this is ultimately the best approach. The good news is that most of these indicators are free, and virtually every MT4 platform will have them.

Step 3 - The Relational Approach

The third element of my three dimensional approach to trading is to use relational analysis, which may be a new term, but does describe this analytical technique. In other words, relational analysis helps us to gain further insights into movements in the currency markets, which are signaled by movements in related markets. Furthermore, this can be broken down into two distinct relationships. Those within the forex market itself, and those in other markets.

When you actually consider why money flows from A to B, and why a currency moves higher or lower, all this boils down to in very simple terms is changes in

risk appetite and market sentiment. In other words, investors and speculators seeking out high risk returns when they are greedy, and lower risk returns when they are fearful, so called safe havens for their money. This constant too and fro in money is reflected in every currency, and in every other market. Let me just introduce some simple examples here to wrap up this chapter, and then we can move on to consider volume price analysis in more detail.

Once again, this is a large subject and what I want to do here in this introductory book, is to explain the broad principles, and then as your knowledge and experience grows, to build on this subject as your trading skills develop. The best place to start I think is with some simple examples to introduce the basic concepts, and which then sets the framework for your forex trading.

Let's start with some of the 'internal' relationships between currencies in the forex market itself, before moving on to consider some of the external relationships between currencies and other capital markets.

However, before we start, there is a key point to remember. These relationships can and do break down from time to time, for a variety of reasons. In other words, do not think that once a relationship (or correlation) is in place, it can be guaranteed for ever. It will almost certainly break down at some point for many different reasons, and then perhaps re-connect later. This happens all the time and is a fact of trading life. After all, the influences which drive money flow from one market to another are forever changing. We only have to look at the US dollar as an example and the current interest rate regime. Who would have thought, a few years ago, that the US dollar would compete with the Japanese yen as the funding currency in the carry trade. And yet, here it is.

As with technical analysis, relational analysis is more art than science. These relationships are generally based on changes in risk sentiment in the medium to longer term, so it's therefore no surprise that they can and do change over time.

Let me start by introducing the concept of correlation, which is very simple, and whilst it is a mathematical term, the principle is very straightforward. There are two types of correlation. Positive and negative. Two data sets which correlate positively move in the same direction. If we take the markets as an example, as one rises, so does the other. Equally, when one falls then the other also falls. We can then say that these two markets correlate positively. In other words, they move together, up or down.

The opposite of this is negative correlation. In this case, as one moves higher

then the other falls, rather like a see-saw. This is called negative correlation. Correlation is measured mathematically on a scale of 0 to 1, and 0 to -1. If two markets correlate perfectly and positively, which rarely if ever happens, then this would be +1. If they correlated perfectly, and negatively then this would be -1. In the financial markets there are never perfect correlations, and this is also true in the forex world.

In order for a correlation to be considered 'valid', and this is only my own definition, I normally look for anything above 0.8 or -0.8. Below these figures then any correlation is likely to be less reliable, whilst above is confirming the strength of the relationship.

As you might expect, with the forex market being US dollar centric, then US dollar strength is usually reflected in weakness in the opposite currency, but as you will see when we look at the characteristics of currency pairs this is not always the case. Before the onset of the financial crisis, one of the positive correlations that was extremely strong in the major currency pairs was that between the EUR/USD and the GBP/USD, which was a positive one, so any weakness in the USD would see strength in both the euro and the British pound. This is a good example of a relationship that was once extremely reliable, but has since broken down, owing to the problems in Europe and the Eurozone. The relationship does re-connect from time to time, but is far from reliable at present.

However, one that does work and works consistently is that between the EUR/USD and the USD/CHF. This is an inverse relationship, so as one pair falls the other rises, and vice versa. There is an excellent site where you can check out the latest correlations from an intra day to daily basis. This used to be called www.mataf.net, but they have recently been acquired by another company, and can now be found at www.forexticket.co.uk.

However, one final point, and a slight digression here, but I feel it is appropriate. Many novice forex traders become very excited when they come across the correlation between the EUR/USD and the USD/CHF, thinking they have found the perfect 'hedge' (a hedge simply means that we have offset our risk in some way by using another market or instrument). This is simply not the case, and let me explain why, and in doing so will also help you to understand how exchange rates in cross currency pairs are calculated.

Let's take the EUR/USD and USD/CHF pairs as our example. We know that as one falls the other rises, and vice versa, and to keep things simple, assume we

are trading in a unit of one.

If we buy one EUR/USD we have bought one euro and sold one dollar. If we then buy one USD/CHF, we have then bought one dollar and sold one Swiss franc. What is the net result? Well it looks something like this:

- + 1 Euro
- - 1 US dollar
- + 1 US dollar
- - 1 Swiss franc

In selling one US dollar and then buying one US dollar, these transactions cancel one another out, and we are left with + one Euro and - 1 Swiss Franc. In other words, we have bought one EUR/CHF, as the action of first buying, and then selling, the US dollar, cancels itself out. You can think of currency pairs as fractions if you like with a numerator and a denominator, just like $1/2$ or $1/4$. In other words, the USD below the line can be cancelled out by our USD above the line, to leave the EUR/CHF.

In buying the EUR/USD and the USD/CHF, we have not created a hedge at all, but have simply bought the EUR/CHF.

You can check this for yourself. For example, if you want to arrive at the exchange rate for the GBP/JPY, then simply multiply the exchange rates for the GBP/USD and the USD/JPY. This will give you the cross currency rate for the GBP/JPY and just to prove it, here it is at today's rates!

GBP/JPY - current quote 151.733 - 151.816

And here are the currency quotes for the GBP/USD and the USD/JPY:

- GBP/USD - current quote 1.5473 - 1.5478
- USD/JPY - current quote 98.048 - 98.096

If we then multiply one by the other we get:

- $\text{GBP/JPY} = 1.5473 \times 98.048 = 151.71$
- $\text{GBP/JPY} = 1.5478 \times 98.096 = 151.83$

There will always be a slight difference of a pip or two, but this is the general principle. Try it for yourself.

Just to recap. First, relationships/correlations do exist in the forex markets internally, and the EUR/USD to USD/CHF is a classic, and one we can use to advantage in volume price analysis. Second, that if you are trading in several pairs, make sure you understand these relationships, as you could end up trading in pairs which are correlating positively or negatively, thereby indirectly trading a third pair!

Moving outside the forex market and into the other capital markets of bonds, equities and commodities, here our starting point is once again the US dollar. Remember the forex market revolves around the US dollar which is why, (and I'm sure you remember why) the USD index is so important.

At this point I just want to focus on a couple of relationships, and the first to consider in broad terms is that between the US dollar and commodities. With all the principle commodities priced in US dollars there is, as you might expect, a general relationship between the US dollar and commodities. Just as with the US dollar index, there is also a commodities index which provides a broad measure of commodity prices in general. This is the CRB index, and is based on a basket of the primary commodities.

In Fig 5.16, you can see that we have plotted the chart for the USD index above, with the CRB index below, using a weekly chart.



Fig 5.16 - USD index vs CRB index

As you can see, one thing is instantly clear, that in general terms, as the US dollar index falls, then the CRB index rises, and vice versa. In other words, the US dollar and commodity prices are closely linked, which often comes as a surprise to many forex traders. This is one of many key relationships that exist between the markets, and is shown here on a weekly chart. In this example I have used the ETF equivalent for the CRB index, namely the QCRB. Just to reinforce the point, in Fig 5.17 is the US dollar index again, but this time against gold, the ultimate safe haven, which is one of many constituents of the commodity index. Once again this is based on a weekly timeframe. For gold I have taken another very popular ETF (exchange traded fund), this time the GLD, which is backed by the physical asset.



Fig 5.17 - US dollar index vs gold

Finally, just to round off this introduction to relational analysis, let's take a look at a connection between a currency pair and equity markets, and here we have the AUD/JPY and one of the principal US indices for equity markets, the DOW 30 (shown using the E-mini futures derivative).



Fig 5.18 - AUD/JPY vs Dow 30

In this case, the relationship works in a direct way. As one rises then the other rises in lock step, and as one falls, so does the other. Many forex traders find this strange. After all, here we have a currency pair which is rising and falling in line with a stock index. However, if you remember back to something I mentioned earlier, markets are all about money flow and risk, and this is a classic example.

Here, we have a currency pair which is a gauge of risk sentiment, because of the currencies involved. If equity markets are rising, and they are considered to be risk assets, then the Aussie dollar will also rise against the Japanese yen as this pair is a balance between a risk currency, and a safe haven currency. In other words, money is flowing into a risk currency and mirrored in a related risk market. This is the basis of relational analysis and the above are just some simple examples to explain this concept in more detail. As I said earlier, it is a

big subject and relationships exist across all the four capital markets. Ultimately, money is money, and financial markets, whatever the instrument, are simply an expression of risk sentiment - no more and no less.

When traders, investors and speculators are happy to take on more risk, then risk assets and currencies will be bought and safe haven assets sold. Conversely, when fear is the primary driver, then safe haven assets will be in demand, with risk assets being sold. All we have to do as traders is to understand which are which, and then use relational analysis to cross check. Markets do not operate in a vacuum, and the forex market is the axis around which all others spin. It is the central hub of world economies, and the ultimate manifestation of risk.

However, I must make one thing very clear before moving on. Relational analysis is one aspect that you can 'bolt on' to your knowledge as you build your trading experience. It is the next logical level in your learning path if you like. You will be able to trade perfectly happily using the other techniques and tools I teach in the rest of the book. What relational analysis gives you, is that extra dimension, that 3D view, an all round view if you like. It will clarify and explain market behavior, and give you a depth of understanding that few forex traders ever achieve.

That concludes this chapter on the various trading approaches. I hope that you can begin to see that to succeed as a forex trader, you need to understand all three, the fundamental, the technical and the relational. Together they make a complete picture.

In the next chapter we are going to study just one approach in detail, which I hope will form the cornerstone of your forex trading success, and that's the volume price relationship. What I call volume price analysis, or VPA for short.

Chapter Six

The Power Of Volume Price Analysis (VPA)

Where there is panic, there is also opportunity

John Neff (1931 -)

As long as there are markets to be traded, traders around the world will continue to devise new and innovative ways to forecast price behavior. Why? Because, in simple terms, this is all trading is about. To try to interpret, using a variety of techniques and indicators, where the market is going next. If we can predict this with any degree of confidence, then the rest is plain sailing. And in this chapter, my purpose is this - to explain the power of volume price analysis. To explain what it is, why it works, and how you can harness its power in your own trading. And by the end of the chapter, I hope you will be convinced of its effectiveness. It is the approach I have used for over 16 years, and which I continue to use in my own trading, every day, and in all my online trading rooms.

Using VPA will, not only give you the power to read the market, but also to profit accordingly. As the quote above says 'where there is panic, there is also opportunity'. Volume price analysis will give you the tools and techniques to profit from each and every opportunity.

Volume Price Analysis - VPA

Before we start let me just say that if you think using volume and price as a trading method is a new concept, think again. This was the approach used by some of the greatest traders of the past. Traders such as Charles Dow, Jesse Livermore, Richard Wyckoff and Richard Ney. Between them, these iconic traders span over a century of trading history, and they all built huge trading fortunes using one simple principle - what they referred to as tape reading, and what we would call volume and price analysis. For them, the ticker tape conveyed all the information they needed in terms of the price quoted, and the number of shares bought or sold. In other words, price and volume.

From these two simple pieces of information they were then able to construct their charts and build a picture of the stock or the commodity they were trading.

Traders such as Jesse Livermore traded directly from the tape itself. No computers, no electronic prices, and no electronic charts. It was a manual process from start to finish with hand drawn charts, and an intuitive grasp of price behavior based on years of experience of watching the tape.

For us, life is much easier. We have our electronic MT4 platform which delivers prices and the associated volume instantaneously. All we have to do is interpret the relationship, and act accordingly.

Let me start with an analogy, which although not perfect, will I hope explain some of the principles of volume price analysis, and the power that the simple logic of this relationship conveys to us as traders. Imagine it is the week before Christmas, and you are the manager of a large department store in the middle of town. In the run up to Christmas, sales have been very disappointing, and you decide that something needs to be done. Your solution is to have a sale as soon as the holiday is over.

In order to ensure its success, you choose which products will be in the sale, and the discounts. Then you launch a big advertising campaign to let everyone know that the day after Christmas you are holding a huge sale, and that many items will be available at big discounts. What happens next?

Overnight, queues of eager shoppers begin lining the pavement, keen to be first through the door when your store opens in the morning, so as not to miss out on these great bargains. Finally it's time to open the doors, and the shoppers flood in, snapping up the bargains and buying everything in sight. Very soon some items are sold out as the buying frenzy continues, until finally you close at the end of the day. Using the simple mechanism of a sale, you have been able to boost sales dramatically, simply by lowering prices substantially and attracting customers as a result.

This simple analogy is from the 'real world'. It happens in every retail market, from the smallest market stall, to the largest superstore. It is the direct relationship that exists between price and volume, and which is often explained by economists as the 'price elasticity' curve. In our language it means this - lower the price of an item and you attract more buyers, raise the price, and you attract fewer buyers. Now at this point, I want to make one thing crystal clear. This is an imperfect analogy from a trading perspective, but I have used it here to explain the principle of the link between volume, which in this case was our buyers, and the price of the goods being sold, the price.

Now let's take another example from the world of retail, but this time something very different. Imagine you have designed and built a limited edition exclusive car, which is being launched in a few months time. You are happy to take advance orders for the car, which is highly desirable, but you are only manufacturing a limited number of these cars. What happens? As the launch date approaches, those people who have pre-ordered their cars, are now selling them at higher and higher prices, ahead of the launch date. In other words, those people desperate to own one of these cars are forcing the price higher. Again whilst not a perfect example, I hope that once again you can begin to see the relationship that exists between 'volume' and 'price'. In our first example, prices were falling and volumes were rising, whilst in the second case, prices were rising with rising volume.

The two examples above, highlight one of the **key** principles which underpin the entire volume price relationship which put simply is this. If we think of effort as volume, for a market to rise, takes just as much effort as for a market to fall. The reason many traders struggle with this concept is that we are all used to gravity, and this is fine when using a simple analogy such as driving up a hill. Here we have to apply more pressure to the accelerator in order for the car to overcome gravity. In other words, we are increasing the effort in order to move uphill. This is a simple concept to understand and can equally be applied to the market. It takes effort for the market to move higher.

However, when we try to apply the same analogy to a market that is falling, the car example simply does not work, since gravity takes over! In the markets it is very different, since it takes **just** as much effort (or volume) for the price to fall, as it does for the price to rise.

All of this is encapsulated for us in one of the three principle rules of Richard Wyckoff, one of the founding fathers of tape reading and volume price analysis. This states that:

..“simply stated, if there is an effort, the result must be in proportion to that effort and can not be separated from it. If it is not, it is an indication of other principles in action. Think of effort as the volume on a move, and the result is the corresponding price action. These two should be in harmony. If you have a lot of volume, you should see a lot of move, if you don't...why? What is happening? This is where we become the detective, use our tools, evaluate that price action (result), with the corresponding volume (effort), and make some deductions based on the balance of probabilities”.

This is the law of effort and result, and is the bedrock on which volume price analysis, or what I refer to as VPA is built. But what does this law mean? Well in simple terms, if the market is going higher, then we should see this reflected in increased volume. If the market is moving lower, then this should also be reflected in increasing volume.

In other words, the price is validated by volume. If the price is moving higher supported by strong volume, then we know it is a genuine move higher. If the market is moving lower, again on strong volume, then once again, we know this is a genuine move lower. Without volume, we would not be able to validate price, and this is the power that volume price analysis delivers.

On its own, a price chart is just that - a price chart. We may see the market moving higher or lower, but is this a genuine move? We have no idea. Equally, if we remove price, and simply look at volume. On its own, does volume reveal anything? After all, if I told you that in the stock market there had been 500,000 shares sold today, would this reveal anything about the stock? And the answer is no, even if I told you that the day before, only 250,000 shares had been traded.

Volume on its own is just that. It could be the number of shoppers in our store earlier. It is just a number. Equally price, is just the latest price, and tells us little, other than where price has been in the past, but not where it may be going in the future, which is what we need to know. However, combine volume with price using VPA, and we have an explosive combination giving us the power to forecast future price action with confidence. But how do we do this?

You will be pleased to know that in applying VPA to a chart, we are only searching for two things. Either agreement, or disagreement between the two. Confirmation of the price action by the volume, or a signal of an anomaly.

If volume is in agreement with the price, then this is a valid move, and we know it is genuine. Conversely, if there is disagreement, or an anomaly between the price and volume, then this is not a valid move, or it is sending us a clear warning signal of a potential change in trend. From this simple principle everything else in VPA then flows. Using this approach we can then forecast with confidence, turning points, reversals in trend, strength and weakness, and when combined with Japanese candlesticks, we have the ultimate toolset and methodology for forecasting and confirming future market direction. And perhaps more importantly, we know what the market makers (the big operators or insiders) are **really** doing!

And the good news is that both price and volume are *free* on the MT4 platform. The Japanese candlestick is the visual representation of price which brings the technique of volume price analysis together on our charts, giving us the tools to truly forecast where the market is going next. And the reason is simple.

Volume and price are both considered to be leading indicators. In other words, they lead the market. Every other indicator that has been developed over the years lags the market in some way. Volume and price do not. They are at the leading edge, and in using their combined power in VPA, they deliver the ultimate methodology for answering the question we all ask ourselves each time we trade which is - 'where is the market going next'?

It is volume which is the fuel that drives the market, both up and down. If there is no fuel then the market will not move, and if it does, then this is a trap, set by the forex market makers, of which more shortly! All you need to remember is that when we combine volume and price, we can see how much 'fuel' is being applied to the move. If there is a great deal of volume, then the move or trend will develop further. If there is none, or only a little, then equally the market will not move far. These are examples of the price and volume relationship being in agreement. However, as I mentioned earlier, when the volume and price relationship disagree, then this is when the warning bells really start to ring. This is VPA sending a strong signal of potential changes in trend, allowing us to prepare, and get ready to enter or exit the market.

This 'disagreement' may be as a result of weakness in the market, *or*, the market makers trapping us into a weak position, and this is where we use our VPA techniques to identify their activities, which I mentioned in the opening chapter. Volume is something they simply cannot hide. They can hide many of their other activities, but volume reveals the truth of the price action, and when the market makers are manipulating the price action to trap you on the wrong side of the market, then volume will tell you this instantly. And when combined with price using VPA, you will have the ultimate tools to see this in action on every chart, from one minute to one month. It is there for all to see. All you have to do is to interpret the volume and price relationship and understand the clear signals it is sending. This is what you will discover in the remainder of the chapter, and more fully in '[A Complete Guide To Volume Price Analysis](#)'

At this point, you may be thinking, 'well this is all very well, but I have been told that there is no volume in the spot forex market', and to a point you would be right. After all, there is no central exchange in the spot forex market, and

therefore no recorded volume of trading activity. However, even if there were, what would the exchange report? The actual currency amounts being bought and sold, the number of transactions, or some other measure? How do we handle this problem, and more importantly how does our MT4 platform deal with this issue?

Fortunately, in the spot forex market we have something called tick data. In simple terms a tick is counted each time there is a change in price. When the currency pair on the chart registers a change in the price, then this is registered as a tick. In the currency market, the smallest price movement used to be a pip, but as we saw in an earlier chapter, pairs are now quoted in tenths of a pip. These changes in price are then represented as vertical 'volume' bars at the bottom of the chart, and the question is whether this is a valid 'representation' of volume?

However, let's think about this logically, and perhaps with an extreme example. Suppose we are trading in the GBP/USD, and the price changes twice in an hour. Would you say this is a market with a great deal of activity? No, of course not. This would make trading a very dull business, and no one would ever make any money!

But suppose we are trading the GBP/USD again, and the price changes 100 times in 10 seconds. Would you say this is a market with a great deal of activity now? Yes, of course you would.

Why?

Because activity, (or the lack of activity) is the same as volume, in my opinion. After all, if we go back to our analogy earlier with the department store, all you would need to check is the cash register to see the activity or volume of sales on the day. You would not need to physically be in the store, to see the shoppers coming and going. The cash register 'activity' would reveal everything. If there were many sales made, then this is activity and would only have been achieved with a high volume of shoppers. Equally, if the cash register only revealed a few sales made on the day, then this is low activity, which equates to a low volume of shoppers in the store. To me, activity and volume are one and the same!!

It's the same with the tick and the currency pair. Consider this example. Take a one minute chart and on one candle we have 100 changes in price recorded, but then some time later with a similar candle there are only 20 changes in price recorded. We can infer from the **ACTIVITY = VOLUME** relationship, that in the first example the volume was high, and in the second example the volume was low. It really is that simple! Tick activity is volume, and this is what we use

on the MT4 platform.

Over the years there have been many studies to equate activity to volume, and how truly this relationship represents what is actually happening. It has been shown, time and time again, that tick activity is between 85% and 90% representative of the true balance of buying and selling in the market. However, let me be provocative for a moment. Even if it were less accurate than this, do we care? And the answer is no, because with volume, we are comparing volume bars, one with another. Is this one higher or lower than what has gone before. In other words, provided we are using the same platform, even if the data is less than perfect, provided we are simply comparing one volume bar with another on the same platform, then does it really matter if we have less than 100% of the volume/activity information, and to me, it doesn't.

A further question you may have about tick activity or volume is this. Does it vary from MT4 broker to broker? And the answer is, yes it does, a little. But again, provided you are simply using one MT4 platform, and comparing the volume bars on one chart then again, this is not significant.

So, let's get started and begin with some simple examples which I hope will start to paint a picture for you of the power of VPA.



Fig 6.10 - AUD/JPY 15 minute chart

Here in Fig 6.10 we have our first chart, and as you can see, we have our candlesticks displaying the price action, with an up candle in blue and a down candle in red. When the price closed higher over the 15 minutes then the chart paints this blue, and conversely when it closes lower over the period, then the body of the candle is painted red.

Now, the same applies to the volume indicator which is shown below, and simply reflects whether the candle associated with the volume bar is an up candle or a down candle. This is not critical, and indeed some traders prefer to have the volume bars all the same color. If this is the first time that you have ever seen volume on a chart, one thing is instantly apparent, namely the variation in the height of the volume bars. This is the essence of analyzing volume! In our VPA analysis, all we are doing is comparing the heights of the various volume bars, against one another to see whether they are very high, high, average, below average or low. From there, we then move to compare the volume bar with the

associated price action, and draw any relevant conclusions from this analysis.

This is one of the many beauties of volume price analysis or VPA. As humans, we have an inbuilt ability to judge differences very quickly and then process this information fast, often in milliseconds. A quick glance at the above chart, and your eye will instantly be drawn to those extremes - the volume bars that stand out, either because they are high or low. These are the ones we are always looking for, as this is where we start to uncover the secrets of what is going on inside the market, once we compare this with the associated price action.

The yellow dotted line that you can see in this example is simply a little guide to help define what can be considered, 'above average', 'average' or 'below average' and this will vary from trading session to trading session. After all, the average volumes in a very busy trading session, when the European, and London markets are open, will be much higher than in an overnight session in Asia, where the trading volumes and activity will be much lower. This is something we always have to bear in mind when considering volume. But again, all volume is relative, so whilst a high volume bar in the Asian session may be 500 ticks for example, in the London session, this might be below average. The point is this. It is all relative, as we are always comparing one bar with another. The only time this will become apparent is when looking at an intra day chart that covers different sessions, in which case you will then see this reflected in the volume and clearly visible.

Returning to Fig 6.10, and the two candles I would like to focus on here, are those in the middle of the chart labelled 'Candle 1' and 'Candle 2', and the associated volume. If we take Candle 1 first, what do we have here?

Candle one was a wide spread down candle which closed with a nice wide body and painted red. Clearly over this period of 15 minutes the market was bearish on this pair, with the Aussie dollar being sold and the Japanese yen being bought. Moving to the associated volume, we can see the volume bar is very tall, and almost double the 'average' and well above our yellow dotted line. The question we now ask ourselves is very straightforward. Is this what we should expect? And in this very simple example the answer is, yes. A 'big' change in price has been matched with a 'big' volume bar. In other words, the price action has been validated by the volume. Price and volume are in agreement here. The second reason I chose this example is to make the point, which I stressed earlier in the chapter, is that volume (effort or activity) is required for a market to move lower as well as higher. And I hope this clarifies this for you.

Moving to Candle 2 and the volume bar. As we can see here, the volume bar is exactly the same as for Candle 1 in every respect. In fact, it is identical, and therefore we should expect to see a wide candle on our price chart. This is most certainly not the case. What has happened? After all, if the price action on Candle 1 ended with a wide body, why has Candle 2 ended with a narrow body and a deep lower wick. Is the volume and price relationship in agreement here? And judging from the previous candle it would appear the answer is no. If the volume bars are identical, then we should expect to see an identical candle also, which is clearly not the case. The alarm bells are now ringing, as we have a disagreement in the volume price relationship which requires further analysis.

Therefore, what has happened here? Let's think about this logically.

The market has opened from the previous candle, moved a little higher, and then fallen, before recovering to close just below the open, and ending with a narrow spread body and a deep wick to the underside of the candle. Do you recognize this candle? It's a hammer candle. During this 15 minute period, the AUD/JPY pair had been moving lower, but then started to move higher. How is this possible? And the only conclusion we can draw is that at some point in this session, the sellers were overwhelmed by the buyers. Buyers have come into the market and stopped the sellers moving the pair lower, and you can compare this in some respect to our department store example. The store puts on a sale, reducing its prices, and in come the buyers, spotting a bargain! After the sale, the department store puts its prices back up again. Another analogy which might help you to put this into perspective is the old fashioned tug of war.

Remember the analogy of the hammer candle as a tug of war between the sellers and the buyers, the bears and the bulls. The two teams of eight take the strain on the rope and the white marker in the middle of the rope defines the mid-point. The referee blows his whistle and the two teams start to pull. Using Candle 2 as the example, the sellers take control initially, and urged on by their coach pull the white marker further and further away from the mid-point, and look as though they are about to win the contest. Suddenly, the buyers find reserves of energy, and slowly but surely begin to pull the rope back towards the middle again. The sellers are tiring and the buyers find further strength, pulling harder and harder on the rope as the sellers lose their grip. Finally, the referee blows the whistle and the tug of war ends with the the sellers, just winning on this occasion. This in simple terms is what is happening here.

We know from our earlier examination of the hammer candle, that in itself the

candle is suggesting a change in price, as the buyers come into the market. However, based purely on the price action, we have no idea how strong this change in sentiment might be. But suddenly with volume, we can see instantly that this is a major reversal. Why? Because the volume is extremely high, and VPA is therefore sending us two clear signals. First, based on price which is signaling a possible change in trend, and second with volume that this is potentially a significant change. After all, if this were not the case, then the volume would be low. Clearly the volume of buying here has been high, it must have been, simply to absorb the high selling volumes, and it must be buying volume as the price has recovered from the low of the session to close back near the open.

This is the analysis we execute on each and every candle and associated volume bar, and in this simple example, I hope I have managed to convey to you the power of volume price analysis. On their own, each is a leading indicator. Price reveals where the market is now, and volume reveals the activity now. On their own, they are simply that - measures of where we are now, but combine them together using VPA, and suddenly we have an immensely powerful, predictive technique which reveals, not only changes in market direction, but also the extent and validity of the change.

We know the hammer candle on its own could simply be the market makers manipulating the price for their own ends. In this example this is not the case. We know this is a genuine move, as the volume is extremely high, so clearly the market makers are joining in. This is what volume also reveals. It reveals the activity of the market makers. If the price action is genuine then it will be seen in the associated volume. If it is false, and a trap set by the market makers, then we will see this in the associated volume. Activity cannot be hidden. It is there for you to see on your charts. All you need to do is to understand VPA and apply your analysis accordingly.

In the above example, the pair moved sideways for a period, before finally moving higher, and as always we have to remember that the market is like an oil tanker. It often takes time for any change in trend to develop, so do not be surprised if this does not happen immediately. This was one of the lessons that I had to learn myself when I first started studying and using VPA. In our first example, Candle 2 was our early warning signal. Our VPA analysis is telling us very clearly to ***'pay attention'***, and from there we continue to read the market over the next few candles, and prepare to take a position in due course.

Now let's look at a second example in Fig 6.11.

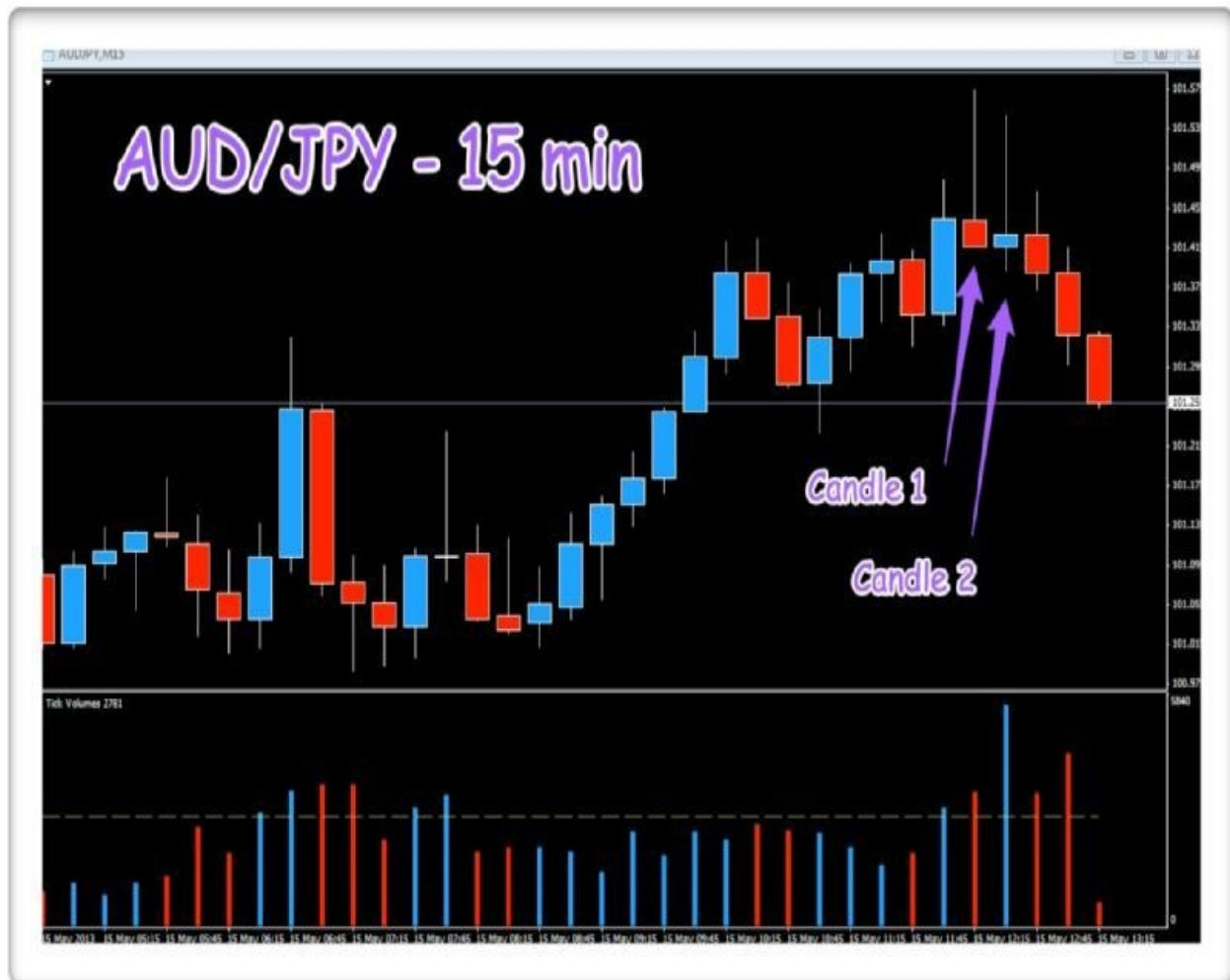


Fig 6.11 - AUD/JPY 15 minute chart

As you can see this is the same pair once again, and in fact the same chart, as the next examples came in some hours later. You can see our earlier example on the left hand side of the chart, and there are several issues I want to explain here.

Beginning with our example here, and once again the two candles to concentrate on are shown as, 'Candle 1' and 'Candle 2', and of course you should recognize these instantly as two shooting star candles. We already know from the price action alone, that a shooting star candle is a potential sign of weakness in the market, since here we have the exact opposite of the hammer candle. If we go back to our tug of war example, in the case of the shooting star it is the bulls (the buyers), who are initially in control at this point, before the sellers (the bears) come into the market at this level. The buyers have pulled the rope well away from the mid point, before the sellers have found some strength and slowly but

surely pull the rope back towards the mid point once again. This is the price action in the shooting star candle. At this point, we are already paying attention, just from the price action alone.

Then we check our volume on Candle 1. It is well above average, so the market is weak at this level, and it is genuine weakness as signaled by the volume. The market makers are selling here! The alarm signal has been sounded! Because if this volume had been buying volume, then the market would have closed with a wide spread up candle. It didn't. The pair closed with a shooting star candle. Clearly the market is showing weakness at this level.

Then we get a repeat performance. A second shooting star, but look at the volume, it is ultra high. If this had been buying volume, the market would have moved higher with a wide spread up candle. It hasn't. It's closed marginally higher, but with a deep upper wick, and a further sign of weakness. More selling has appeared, overwhelming the buyers once again. Even more significant, the volume on candle two is huge, and is standing like a telegraph pole above all the others. This is a massive signal, and clearly sending a message that the market is now very weak and preparing for a potential reversal. The market makers are selling at this level and so should we, so we join them and take a short position! (A 'short' position is when we sell the currency pair - conversely a 'long' position is when we buy. We sell, or go short when we think the market is going to fall, and buy or go long when we think the market is going to rise.) This is the power of VPA once again.

The logic and power of our VPA analysis is inescapable.

The currency pair has risen when initial weakness appeared on Candle 1. The volume tells us that the market makers have also seen this weakness and are selling. We are ready and waiting. Candle 2 then forms, and if we weren't paying attention before, we should be now! The market makers are now selling heavily into a weak market. How do we know? Volume. How do we know the market is weak? Well two reasons.

First the price action is telling us so with the shooting star candle, and second, if the volume had been buying volume, then the market would have closed higher with a wide spread up candle. The volume associated with this candle must therefore be selling volume. The market makers are preparing for a fall in the pair, and as you can see, on this occasion the market moves lower almost immediately.

This example also raises a couple of other points which I think are relevant at this stage of our VPA journey. The first is this.

When we see two (or more) of our primary candles, one after the other, then this is giving us an even stronger signal of a reversal. A shooting star or a hammer candle on their own is good news, and we start to pay attention, but if we see a second, or even a third in the same price region, this confirms the strength or weakness exponentially. The candles do not have to follow one another immediately, but if we see weakness appearing, later confirmed by further weakness, as the market prepares to reverse, this is sending an even stronger signal. In other words, the weakness has been validated if you like with further weakness.

The other point I want to make here, which I referred to earlier, is the concept of the 'relative' nature of volume when we are studying a chart. In Fig 6.10, the volumes associated with Candles 1 and 2, were very high as the market unfolded at the time. However, as you can clearly see from Fig 6.11, with the market moving on, and our 'telegraph pole' of volume on Candle 2, the volume here is even higher, forcing the other candles that have preceded it, lower, as volume is always relative. Indeed, it could be the case that an even higher volume bar might appear later, and this is in fact what happens. Four candles after the appearance of our two shooting star candles, with the market moving nicely lower and a very solid profit from the position, we were then presented with a hammer candle, with volume which beat the previous high, and here it is in Fig 6.12.

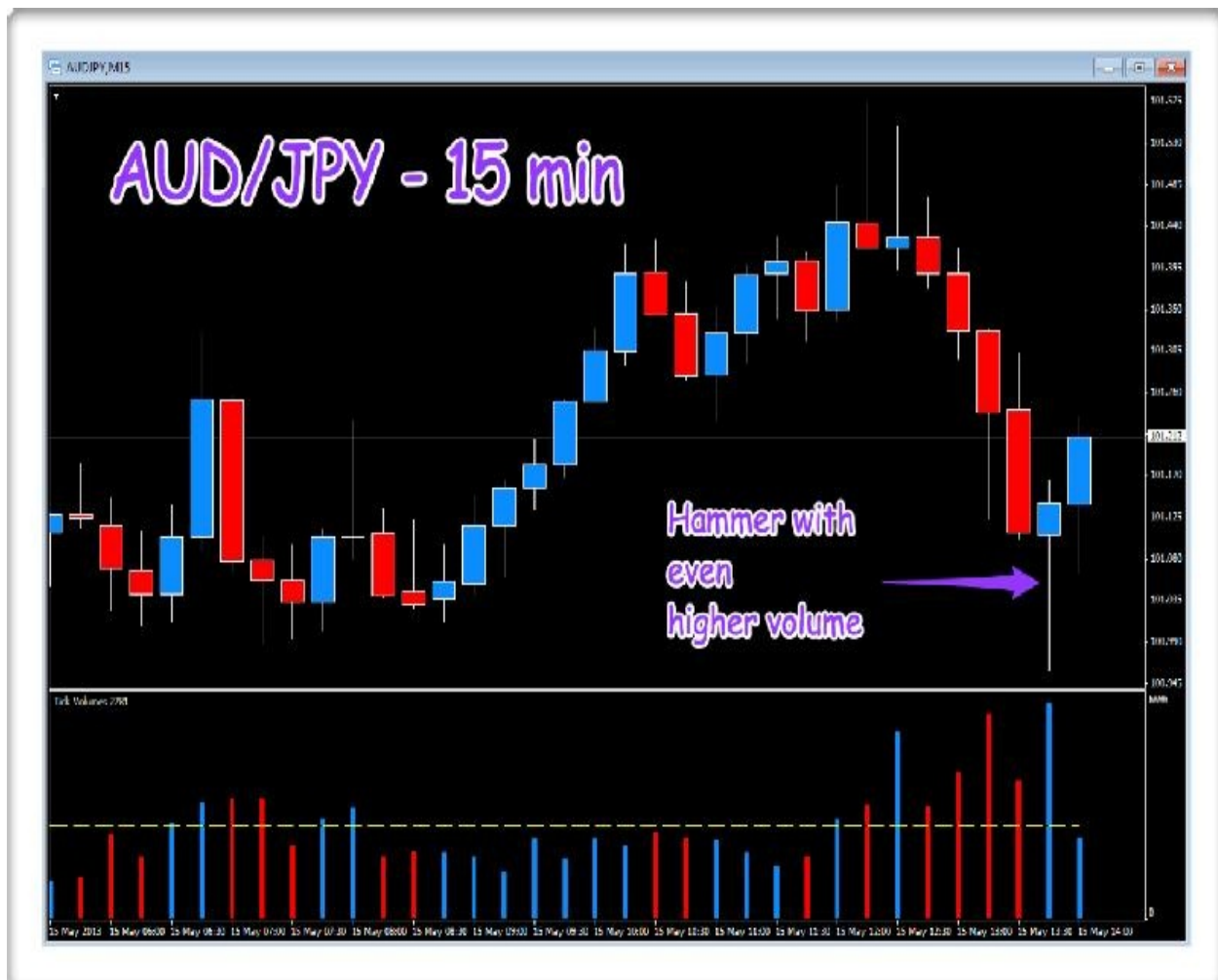


Fig 6.12 - AUD/JPY 15 minute chart

As you can see we had, what I call, a nice 'price waterfall' which lasted for an hour, before the hammer candle arrived, with extreme volume. The volume is above that of our earlier bars, and also above those candles associated with the move lower. In addition, and the point I really wanted to make, was that the volume of our first two candles in Fig 6.10, has now been reduced in proportion. Does this matter? The answer is no, as everything is relative, and at the time the volume would have been well above average. However, we always need to bear this in mind. Volume is always relative, and in moving from one session to another, a high volume bar in one session, may only be average in another.

The reason that the volumes have increased significantly, is simply that during the writing of this section of the book the markets moved from the London open to incorporate the US markets, reflecting increased activity. Finally just to round off this point, as you start to study these charts on a daily basis, and in different

timeframes, you will, very quickly, develop your own view of what is ultra high, high, average or low volume, and this is where the MT4 platform steps in to help.

On the left hand side of the volume indicator the tick count appears live in real time, and this changes from timeframe to timeframe. In addition this information is also shown on the scale on the right hand side of the indicator, so both of these will give you a perspective on the associated volume.

Having considered one or two individual candles, I now want to look at a series of candles as they build into the complete picture of VPA on a chart. Fig 6.13 has several interesting points, and is from a 5 minute chart of the GBP/USD.

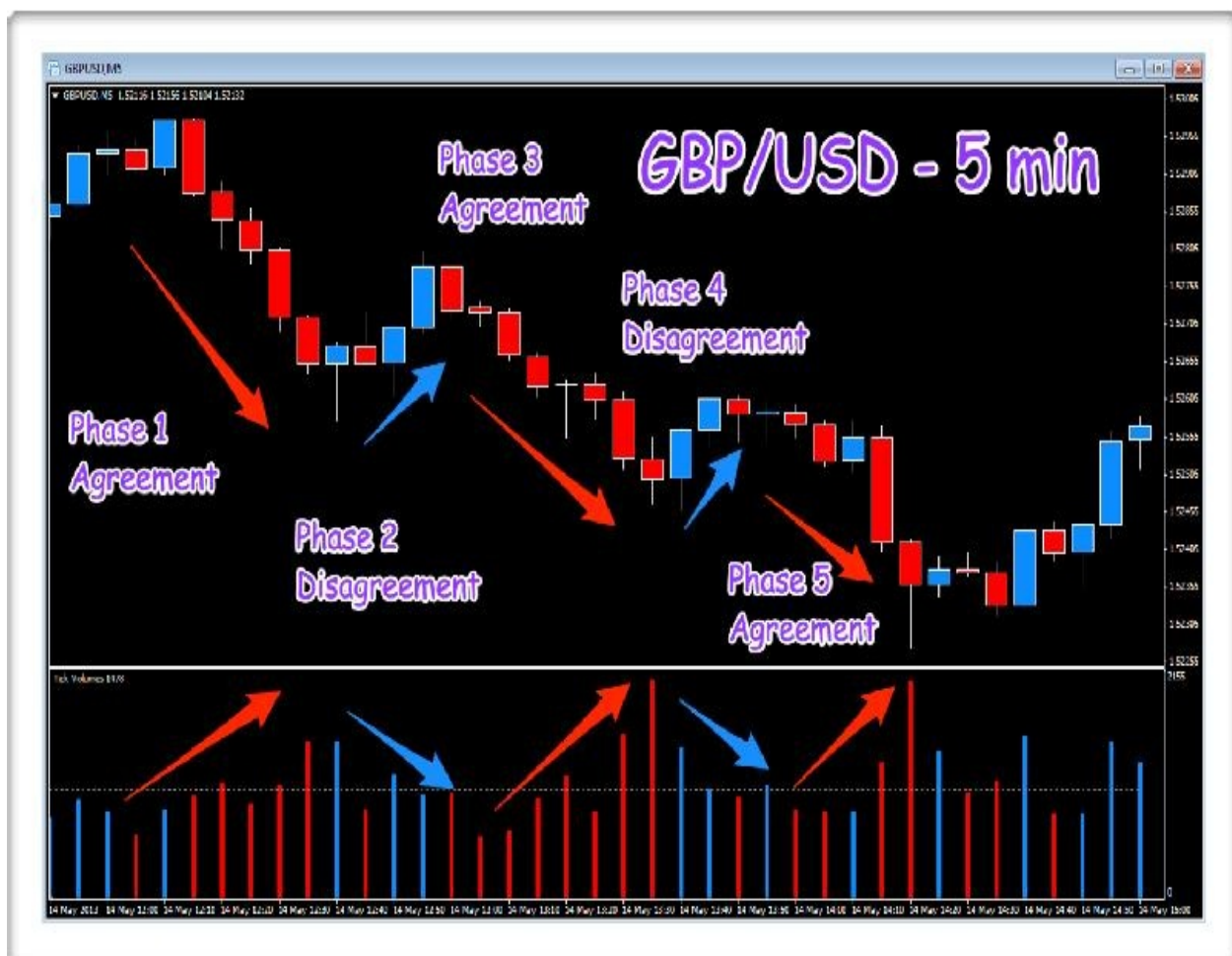


Fig 6.13 - GBP/USD 5 minute chart

As you can see we have five 'phases' of price action, and this example highlights the importance of volume and price action when we are considering the relationship over a series of candles as the price action builds. Let's start with a

market that is rising, as this is probably the easiest to understand. If the market is moving higher, candle by candle, then this should be accompanied by rising volume for the move to have any momentum. In other words, rising prices and rising volume. If the market is rising on falling volume, then this is an anomaly.

Remember, that volume is the fuel of the market, and if there is little or no fuel in the tank, then the market is not going to move far. To use another analogy, it's similar to the way you feel in the evening after a hard day at work - lacking energy and rather tired. This describes a market that is attempting to rise on falling volume. It is sending you a clear signal of weakness. If the market is moving higher on rising and strong volume, then the market makers would also be joining the move, but since the volume is falling, then clearly they have withdrawn. A potential trap is being laid for the unwary trader! A market moving higher on falling volume is not going very far.

The same applies equally to a falling market. If the market is falling on falling volume, then it is not going very far either. Remember, it takes effort to fall as well as rise. A market that is falling on rising volume has momentum. For a market to fall far and fast, we expect to see volumes rising as the market falls. If volumes are falling in lockstep with the price action, then the market makers are not involved in the price action, they are not selling, and it is a trap move, or it is a market that is simply tired.

Let's take a closer look at the price and volume in Fig 6.13 and the five phases of VPA action.

In phase 1, the pair has fallen for five consecutive candles, with a variety of spreads, but the volume is generally rising in agreement.

Volume is validating the price and confirming that this is a genuine move lower. The market then pauses in phase 2, and attempts to rally, but the rally is weak. Why? Because the rising candles are associated with falling volume, which is therefore in disagreement with the price action. What signal is this sending to us? Well first, that we have an anomaly, rising prices and falling volumes, and second, given this fact, this is likely to be a simple short term reversal higher in an otherwise longer term trend lower. After all, if the rally higher were to have momentum then we should expect to see rising volume, and not falling volume.

At this point, let me introduce another of the powerful features of VPA which, whilst self evident perhaps, is still worth making here. Suppose we have taken a short position in the market (we have sold), at the start of the price waterfall

lower, and are now watching the market recover slightly. How can VPA help here? The answer is straightforward. VPA gives us the confidence to hold our position and not to panic or close out and take our profits 'off the table' (in other words to close our position). VPA helps to overcome those emotional trading decisions we all suffer from time to time, and allows you to become a trader in control of your emotions.

Holding the trend to maximize your profits is key, and one of the issues we will be considering in the section on money management and risk. This is the power of volume price analysis, because if your analysis is clearly telling you that the reversal is not likely to move far against you, then why panic. You have applied simple logic to the chart using VPA and with falling volumes and rising prices you do not expect phase 2 to last for long. And as we can see shortly after, the downwards trend resumes in phase 3. This is how markets move all the time. They never, ever, move in a straight line, but constantly move higher and lower in a series of steps, of which this is a simple example.

In phase 3, once again we have agreement between the price and the volume, with prices falling and volume rising. The volume is confirming that this is a genuine move, with the market makers selling into the move lower.

We then move into phase 4. Is this a genuine reversal, or a second pullback in the longer term bearish trend? And once again volume gives us the answer. This is yet another minor reversal, as the rally higher is accompanied by falling volume, once again a clear signal that the market makers are not involved in this move. Some traders will have either closed existing positions, or taken new long positions, thinking the market has now reached the bottom. It hasn't! Our volume price analysis is clearly telling us this is not the case, and we move lower still, and into phase 5.

At this stage the volume price relationship is once again back in agreement, as the market moves lower with rising volumes. Finally on the right of the chart we move into a consolidation phase, which I am going to explain shortly.

This is the power of volume price analysis. Not only does it tell you where the market is going next, getting you into strong positions, it also reveals the extent of any pullback or reversal, thereby helping to keep you in. Finally, as you will see in a moment, it also tells you when to get out! Using two simple indicators gives you all this and more, through the power of simple logic and common sense. What more could we want as traders, which is why I have been a devotee

of using volume and price for over 16 years. I hope that in this short introduction I have convinced you too, but you can discover more by reading my book, '[A Complete Guide To Volume Price Analysis](#)', which expands on this introduction to the topic. However, I hope that this has at least provided you with enough of a flavor to want to learn more. I do cover this in more detail in the chapter, Putting It All Together, where we work through some complete examples, so don't worry. There is more to come later in the book!

Before we move away from volume price analysis, there is one other concept that I would like to introduce at this point, and is another of the trading cornerstones, not only of the VPA methodology, but of technical analysis in general. And this is known as support and resistance. Let me explain.

Support & Resistance

Markets generally move in one of three ways, either up, down or sideways, and of these three it is the last where they spend most of their time. Many forex traders are mistakenly told that the currency markets are strongly trending markets. Whilst this may have been true several years ago, this is certainly not the case now, for many reasons. Partly, it is as a result of the financial crisis of 2007 and the associated ramifications globally, and partly also as a result of changes in the way currency markets are now increasingly manipulated by a variety of forces.

As a direct consequence, any currency pair will tend to spend around 70% of the time moving sideways in a narrow trading range, and 30% of the remaining time trending in one direction or another. This of course occurs in all timeframes, so on a 5 minute chart for example, an extended period of sideways price action might last a few hours, whilst on an hourly chart, this might last for a few days. Many forex traders become frustrated, assuming incorrectly, that a currency pair which is moving sideways is a trading opportunity lost. Nothing could be further from the truth. It is in fact a trading opportunity in waiting. Let me explain why with a simple example in Fig 6.14.

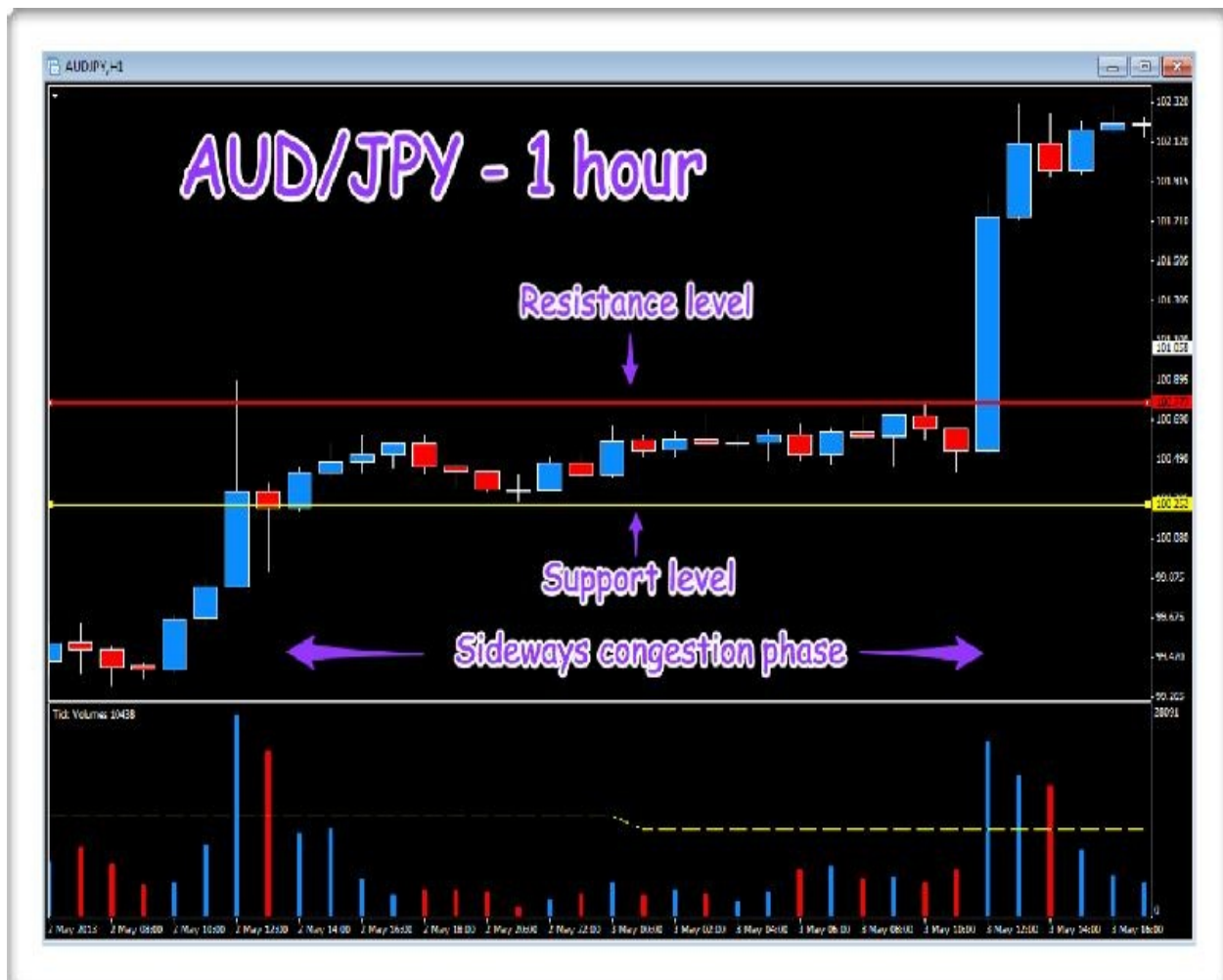


Fig 6.14 - AUD/JPY 1 hour chart

As you can see, we are looking at an hourly chart here for the AUD/JPY, covering a period of approximately two days in total. As I said earlier, congestion phases can last for extended periods!

Let's take a look at this chart, which is an excellent example to explain the principles of price behavior in these congestion phases, and why they are so important. If we start at the left hand side of the chart, the pair were mildly bearish, moving gradually lower, but note the volume, it is falling, so we know that this phase is unlikely to last long. We then see a series of three 'up candles', with increasing volume, but on the third candle in the sequence, there is a deep upper wick, suggesting weakness. After all, if the market were strong, with this level of volume, then the close should have been somewhere near the high of the session. It is not, and has closed at the mid-point, so clearly there is selling now coming onto the market. The following candle ends marginally lower, but with a wick to the downside, suggesting buying support at this point, and signaling that

this is probably a minor reversal in the longer term bullish trend.

The pair then continue higher for the next four candles, but note the price action. The price spreads are narrowing, suggesting a market that is running out of energy, and indeed this is confirmed by the volume which is falling, not rising, as the spreads narrow. The volume is in agreement with the price action, in other words narrow price spreads, with average to low volume. But the volume is falling away in the move higher, so clearly the market is weak, and unlikely to continue higher, just yet. At this point we then start to move into our congestion phase, and note the volumes throughout - they are extremely low. Buying and selling activity has died away completely as the pair wait for a catalyst to bring it back to life. The volumes are now simply reflecting the price spreads, with low volume associated with narrow spreads, which is as we expect. Remember, this is in agreement. A narrow spread candle should have low volume. High volume would be an anomaly, and an alarm signal.

As the market moves in this congestion phases, it creates two price levels on the chart. One above, which we call resistance, and is shown by the red line, and the other we call support, which is shown by the yellow line. However, there are several questions here, not least, is why we call then support and resistance, and why congestion phases are so important. Therefore let me try to explain.

The reason any congestion phase is important on any chart, whatever the time frame, is simply that this is where trends are spawned and then develop, before finally breaking out into the next phase of price action. The next phase of price action may be a continuation of the current trend, or a reversal to a new trend and a consequent change in direction. It doesn't matter. You can think of a congestion phase as the source of a great river, where salmon return year after year to breed and spawn. Once they are large enough they then return to the sea to start their long journey around the world. This is why I always refer to these congestion phases in terms of salmon and their spawning grounds, as I believe this makes the point using a real world analogy. When the market is moving sideways, it is waiting, building its strength, and preparing to launch the next phase of the price action, and the next trend.

This is why these phases of price action are so important. We know that the market is going to breakout from this price region, it is just a question of when, not if. As forex traders, all we have to do is to wait and be patient, which is often the hardest part. When we see a market in price congestion, as in Fig 6.14, this is good news. Now all we need to do is wait for the signal of a breakout, which

will, of course, be instantly apparent from our volume price analysis.

In creating these 'channels' of price action, the two lines of support and resistance are also created, and again we need to understand why these are so important, and here the clue is in the name we give to these price levels, 'support and resistance'.

In the above example, the pair has been moving higher, before entering our congestion phase, so any attempt to move higher at this stage of the price action, is considered resistance. In other words the market is 'resistant' to any move higher at this point. Equally, any move lower in the congestion phase is finding 'support', in other words the price action at this level is finding a 'platform' which is helping it to bounce back higher again. The two levels are rather like the first electronic games of ping pong, with two paddles on the screen, one left and one right, and the ping pong being bounced back and forth by the two players.

Finally of course, the catalyst arrives, which I think in this case from memory was an item of fundamental news, which drove the pair higher, breaking out from this extended phase of price congestion with the wide spread up candle on the right hand side of the screen. Our first question at this stage is simply, 'is this a valid breakout ?' And the answer here is a resounding 'yes'.

Why?

Because the associated volume is ultra high and in agreement with the price action, so a valid breakout is in progress. The market has 'broken out' from the congestion phase, and the 'new' trend is underway, only in this case it is simply a continuation of the current longer term bullish trend. The currency pair has risen, paused into the congestion phase, and then with the catalyst of fundamental news, has broken out into the next leg up. But for how much longer? Well as you can see the volume is starting to fall away, as we move higher, so perhaps another phase of congestion is in prospect. We would now be watching and waiting.

There are several points which are key from the above and these are as follows:

- When a market breaks out from congestion, what was resistance becomes support, and what was support becomes resistance
- Any breakout from congestion is a great trading opportunity, provided it is

confirmed by VPA

- Support and resistance create natural barriers for placing stop loss orders
- Support and resistance levels are **not** solid bars, but are more like rubber bands, and as always with technical analysis, this is an art and not a science!

Let's take these one at a time.

The analogy that I always use to explain the concept of how resistance becomes support, and conversely how support becomes resistance, is to use a house as an example. Imagine that you are standing in front of a house which has two or three floors, and the front wall has been removed completely. What would you see?

If you have ever seen a toy doll's house, then it would look much the same, with a cross section of each floor and ceiling now exposed. Imagine now you are standing on the ground floor, and want to move up to the first floor. Above you is the ceiling, and if you cut a hole in the ceiling, and then climbed through, you would now be standing on the first floor. But what was the ceiling when you were on the ground floor, has now become the floor on the first floor. If you repeated this exercise and cut a hole in the first floor ceiling, and then climbed through to the second floor, once again what was the ceiling at the first floor level, has now become the floor at the second level where you are now standing.

This concept is very familiar to us, and rarely one we ever think of when we are in a building with several floors, but as we climb the stairs, what was the ceiling below is now the floor above. Equally, when we go downstairs, what was the floor above, has now become the ceiling from below! This is the principle of support and resistance which is at work on our price charts, and which is so important once the ceilings and floors (price levels) are breached.

Returning to our example in Fig 6.14, whilst the market was in its congestion phase, the red line was the resistance level, and the yellow line was the support level. However, as soon as the market broke out through the resistance level, the yellow line, immediately becomes a potential support level. In other words, going back to our house analogy, the market has moved upstairs to the first floor and the price resistance ceiling, has now become the price support floor for a further move higher. In other words, this area of price resistance, which has now become support, is acting as a springboard, a platform if you like, to help the market move higher.

The reverse is also true. Had the market broken to the downside on this occasion, then the floor of support, the yellow line, would then have become a resistance area. In other words the floor has now become the ceiling as we move downstairs. It is these areas of dense price action which create the 'natural' areas of price support and resistance. These then come into play, either immediately as the market breaks away, or later when the market returns to these areas in the future.

Which leads us to the second point. When a market breaks away from one of these areas of price congestion, we know that this is an excellent trading opportunity, provided it has been validated with volume. Why?

Because these are the regions where trends are born and created. They are the regions where the market is pausing, waiting and preparing, building up strength or waiting for a catalyst, often an item of fundamental news. This is why they are so important. They are the launch pad for future price action. Not only do they offer excellent trading opportunities, but also provide the added protection of a natural price barrier above or below, which leads me on to the next point.

These price levels are defined by the market. They are not our levels, but the market's levels, and so as the market moves away from these regions, we have some natural barriers of price protection in place. In our example in Fig 6.14, the AUD/JPY broke higher, and on this occasion moved firmly higher on strong volume. However, what you will often see is the market move away, and then reverse back to test the 'new support' level (the old resistance level), before bouncing off, and moving away again. This is why these price regions are so important as they help define how and where to place any stop loss orders, to protect our position in the market. I will be explaining this type of order later in the book, but for now, just recognize the importance of these regions. They define the areas at which we can place our money management orders, and in this example we would place these somewhere below the yellow line. In other words, the market has set this price level for us, by the associated price action.

And finally to the last point.

Having read the above description, where we have talked about floors and ceilings, which are solid structures, the last thing I want you to think is that support and resistance levels on a chart are just the same in that sense. They are not, and you should think of them more as rubber bands. They have some 'give' in them, both when applied to any price action and also in any subsequent price

action when the market breaks away. This is why you always have to be careful and wait for a clear break, and not simply the point at which the price action has just cleared either above or below one of the areas.

There are really two points here in one. The first is this. When drawing these levels on a chart, or applying the line to connect these points together, we do have to allow ourselves a degree of ‘poetic license’. In other words, technical analysis is an art and not a science, so joining up price points precisely is not what is required. What we are looking for is the general price levels only, not three or more precise points. A ‘best fit’ approach to placing the lines is fine, and don’t worry if some of the historic price action is slightly above or below the line. That’s the first point.

The second which follows on, is that we have to wait for a clear break from the price congestion, before entering the market. Here it is generally a case of waiting for the first candle to complete, in whatever your timeframe, and then make a judgment based on the price action and associated volume.

In Fig 6.14, the currency pair has broken firmly higher, and once the candle has completed, we can then assess the associated volume. Here we have a strong move higher, the price action is now well clear of the congestion, and we have excellent volume, so it is a valid move higher.

This is the analysis that we carry out every time we see a congestion phase and subsequent breakout. The first point is how far the market has moved away, and the second is the associated volume. If the close of the breakout candle is well above (or below) the associated resistance or support levels, and we have good supporting volume validating the price action, then it’s time to make our move!

If you are a novice trader I would urge you to embrace this approach. I consider myself to have been immensely fortunate in my own trading career, having been introduced to volume and price analysis from the beginning. To me, it just made sense, and has done so ever since. It is a method I use in all the markets I trade, not just spot forex, but in futures and stocks. It is, I believe, the right approach, the only method that applies common sense and logic to the analysis, using two leading indicators. It will take you a little time to learn to become confident and proficient, but like riding a bicycle, once learnt it is never forgotten.

I hope this chapter has helped you gain some insight into the methodology of trading using VPA, and also convinced you of its merits and power! As I mentioned at the start, if you would like to learn more, please study my volume

book, which explains some of the more advanced concepts, and builds on what we have covered here.

In the next chapter I want to move on to explain the mechanics of the trading process, how we make money, and how the trading process works.

Chapter Seven

The Mechanics Of Trading

We simply attempt to be fearful when others are greedy, and to be greedy only when others are fearful

Warren Buffett (1877 -)

In this chapter I am going to walk you through all the various aspects of forex trading, that even those people who have been trading for some time, don't really understand. By the end you will have a complete and thorough understanding, from the different types of orders, contract sizes, leverage, margin, and rollover, and how this all translates into making money from the associated pip values of each currency. Let's get started with some of the basics.

Trading Both Sides Of The Market

One of the concepts that many new traders struggle with when they first start, is the issue of trading both sides of the market. In other words, making money when the market goes up, and also when it goes down. I can assure you when I first started, I couldn't understand this concept. After all, we are all familiar with the principle of buying something at one price, which then increases in value, and we then sell at a higher price for a profit. This is generally what happens in the world of business! Many of us come into the trading world with some knowledge of stocks and shares, and here again, we are all familiar with buying a stock at a low price, and then waiting for the price to go up, before selling at a profit.

However, in trading, we can also make money when the market falls, and this is what I mean by trading both sides of the market, and I'll explain why it is so important in a minute. In this case, we are selling something we do not own, which we then buy back at a lower price, and make a profit. Yes, it is a strange concept when you think about it, but this is what we are in fact doing. If we think that a currency pair is going to fall in price, then we sell it, and when we believe it is about to move higher again, then we buy it back. If you think about this logically, then this is simply the reverse process of what we are doing when buying and then selling. When a currency pair is moving higher we buy first, and

then sell to close the position. When a currency pair is moving lower, we sell first and then buy to close this position. Exactly the same process, but simply in reverse!

When we buy it's called a **long** position, and when we sell it's called a **short** position.

Now, why is it important to trade both 'sides' of the market, the long side and the short side?

Well first, and perhaps most obviously this allows you to take advantage of price moves in either direction. After all, if you only traded in one direction all the time, this would be very limiting, and really reduce your trading 'horizon' dramatically. In other words, you would rule out 50% of the price action. However, there is a more subtle and far more dangerous aspect to taking a one sided view of the market, and it is this. If you only ever trade in one direction, then you will always be looking for market opportunities in this direction, and none other. In other words, your mind will be influenced by what you want to see, and not necessarily by what is happening in front of you, on your screen. Your mind will start to play tricks on you, and tell you that a market is going in the direction you want to trade. This is fatal, and you are in effect trading 'with an opinion' as you want to see the currency pair move in your 'preferred' direction.

Now there is also another reason that you must learn to trade both sides of the market, and it is this. All markets go up in stairs, and down in escalators. In other words, up relatively slowly, but down very quickly, and the forex market is no exception. You will make money far more quickly in a falling market, than in a rising one. Equally, if you are on the wrong side of the market when it falls, then losses can mount up fast too, something we will cover later in the chapter.

The first point is this - you must learn to trade on both sides of the market, without an opinion. If you see a currency pair rising, and you have done your analysis, then you buy to enter a long position. If you see a currency pair falling, and your analysis confirms a good low risk trading opportunity, then you enter the market with a sell order to open a short position. It's important to develop this approach so you do not have a bias, one way or the other. Simply take a long or short position with equal confidence, and based on your analysis of the market. I cannot stress how important this is, and indeed you may find that once you begin trading, that you do develop a bias to one side or the other. This is

easy to check on your trading statement. If so, be careful! This can be dangerous as you will begin to see trading opportunities in your 'direction of bias', so do watch out for this as you begin your trading journey. Finally, and just to use the correct terminology, when you speak to your broker, when you have a 'live trade' in the market, it is called a 'position' in the market. Your broker will then understand what you mean! Now let's move on to look at two of the most misunderstood terms, leverage and margin.

Leverage & Margin

These are two of the most misused and misunderstood terms in trading, and yet there are thousands of forex traders happily trading, who have little or no grasp of these basic terms, or what they actually mean. And the first point to clarify is that leverage and margin are very different, and as such represent very different things.

They are not the same, nor are they interchangeable terms. So what is leverage, and what is margin, and why is it so important to understand the basic concepts of these two key financial terms?

Let me start with a simple example.

Suppose you have gone to the casino with some friends, and you have a hundred dollars in your pocket for the evening. You begin to bet on the roulette wheel.

Unfortunately you are out of luck, and after a few minutes you have lost all of your money. At this point you ask one of your friends to lend you another one hundred dollars, so that you can carry on playing. Sadly your run of bad luck continues, and you lose this as well. At that point you decide to quit and leave the table.

What have you lost, and how much do you owe?

Well in simple terms, you have lost your own one hundred dollars, the borrowed one hundred dollars, and you also owe your friend one hundred dollars. In other words, 200% of your original starting capital.

In effect what you were doing when gambling with the second one hundred dollars, was betting using borrowed money, and in essence this is what leverage is all about. It is a loan given to you by your broker in order to allow you to magnify your trading profits.

However, what many traders neglect to appreciate is that this will also magnify your trading losses as well. Now leverage is used in all walks of life, and indeed you can think of a mortgage to buy your house as leverage. If you look for a definition of leverage, you may come across the following which really explains what it is:

“leverage is the use of credit or borrowed funds, to improve one’s speculative capacity and increase the rate of return from an investment, as in buying securities on margin”

Now if we take the first part of this statement and then look at margin in a minute, we can think of leverage in many different ways. One of my favourite analogies is to use property. A property speculator uses mortgages to increase leverage, to buy more properties to add to his or her portfolio.

Without the lender, all they would be able to afford would be the outright cash purchase of the asset with their own money, so we use lenders to ‘leverage returns’ on our houses, whether for personal use, or as a landlord. This is all well and good when property prices are rising fast, and one of the favourite strategies of property speculators was to constantly refinance as the capital values increased, releasing equity from the portfolio to buy more properties. The banks and finance companies were happy to oblige, until global economies collapsed with the consequent meltdown in property values, and subsequent repossessions!

Now before moving on, let me just finish our property example, which will then put the whole issue into context for you. It will also help you to understand what leverage is, and how dangerous it can be. It has a huge benefit of course, but is a double edged sword which is why I have taken some time with this example to make the point.

Suppose we take a typical property here in the UK, and imagine we are buying a small house for our portfolio. Most lenders require a deposit (on average), somewhere in the region of 20%, in return for providing the balance of 80%. What this means, in effect is that the bank is offering leverage of one hundred divided by twenty ($100/20$) or 5 to 1.

In this case, and in order to keep the numbers simple, if we have £20,000 as a deposit we could then afford to buy a house at £100,000. The formula for leverage is very straightforward and is simply the property value divided by the deposit amount. In this case it’s one hundred, divided by twenty, which is five.

Now let's equate this to the forex market, and the first thing you will see when looking at all the hundreds of forex brokers, is that they all offer different leverage levels on their accounts. These are expressed as a ratio, just as in our simple example above. The minimum leverage offered by most forex brokers is fifty to one, followed by one hundred to one and even as high as four hundred to one!

If we just think about this for a minute in the context of our property example above, and use four hundred to one. This means that a mortgage lender could offer us a loan of £8,000,000 (eight million pounds sterling !!) against a £20,000 deposit.

Can you imagine any lender in their right mind offering this sort of leverage - unthinkable. And yet until recently this was what was being offered by many forex brokers to their novice clients. In the context of property you wouldn't even consider such an offer as you would only survive for one month, before the first mortgage payment was due, followed by a swift repossession and bankruptcy. Fortunately, in the last few years the various regulatory authorities have started to curb the worst excesses of some brokers in the forex market, led by the CFTC in the US.

This has forced many of them offshore as a result, and thankfully the days of bucket shop operators with absurd leverages are coming to an end. I will cover this in more detail once we start looking at the various types of forex brokers and the questions that you need to ask before opening an account. It took the CFTC and NFA years to act, but they have tightened the regulations for US brokers considerably since the early days, with leverage now capped at 50:1. However, as I mentioned earlier, this has simply forced many brokers offshore, into overseas jurisdictions, and avoiding these regulations as a result. Further legislation is now in the pipeline to cut leverage to a maximum of 10:1, and to force brokers to register by law with the appropriate authorities.

I hope that the above simple example has not only explained what leverage is, but also how dangerous it can be when you fail to understand the underlying concepts and risks. We are going to take a look at some examples in the forex market in a moment, and of course why we have leverage in the first place, but hopefully you now have a clear understanding of what leverage is.

The other side of the equation is margin. In a way we have already covered this, as margin is in effect your deposit or the amount of money that you have to place

with your lender or broker. It is your sign of good faith that you have sufficient funds. It is the entry ticket to the market, and once your margin or deposit is safely with your lender or broker, then they will release the funds, or advance the loan, as their sign of good faith. In broker terms this is generally referred to universally as 'initial margin', which is your deposit.

To summarise. Leverage is the loan element of the contract, and is the money advanced by the broker or lender, whilst margin is the money you put into the asset or account and represents the cost of entry. However this is not the end of the story as you will see.

The next question is why do we have to have leverage in the first place, and this is partly answered by our property example which we looked at earlier. Without it, property prices would be substantially lower, as no-one would be able to afford more than they could afford in cash. Secondly, the lenders would not make any money, as they would have no loans on which to charge interest.

In order to put this all into context in terms of trading forex, let's look at a simple example using no leverage, and then the same example using leverage of 100/1, and see what happens as a result.

If we take the USD/JPY as an example, and at today's exchange rate the pair are trading at 102.50, which means that for every one US dollar we would be able to buy 102.50 Japanese yen.

Now suppose we have placed \$1,000 of margin (our deposit) in our account which has a leverage of 100:1.

For our first trade we are going to use no leverage. Effectively we are trading at a ratio of 1:1 with no borrowed funds. In other words we are just using our own cash.

In our forex trading account we have our \$1,000, so we can buy a thousand times 102.50, or 102,500 Japanese yen. Here we are selling the US dollar and buying the Japanese yen. A short position in other words. Suppose the currency pair moves to an exchange rate of 102.00, how many US dollars can we now get for our yen ?

In order to arrive at the answer we simply divide 102,500 (the amount we started with in yen) by the new exchange rate which is now 102, which gives us \$1,004.90. In other words our initial \$1,000 has now become \$1,004.90, and we have made a profit, (if we closed the position at this exchange rate) of \$1,004.90

- \$1,000.00, or \$4.90.

Not terribly exciting, when we consider that this currency pair might move this amount in one day's trading, and probably more, and therefore unlikely to yield any substantial profits for anyone using a 1:1 leverage. Now if we had \$10,000 in our account, this would make things a little more interesting, and we would have made \$49.00 (10 times). Equally with \$100,000 in our account, this would then be \$490 (100 times), which starts to become more interesting.

And this in essence, is where the broker steps in with leverage, since not many of us have \$100,000 sitting around doing nothing, but if we did, we could happily trade this way with our own money, effectively leveraging ourselves if you like.

Now let's take another example, but this time using our leverage of 100:1 with the forex broker, and in this case (and I have already given the game away above), the outcome is more interesting!

With our leverage from our margin of \$1,000, we can now buy 100,000 x 102.50 yen or 10,250,000.00 yen . Consequently, when we close the trade at the new exchange rate of 102.00, this then becomes $10,250,000.00 / 102 = \$100,490.20$ leaving a profit of $\$100,490.20 - \$100,000 = \$490.20$.

This is the power of leverage. The corollary is that this could equally have been a loss of \$490.20 for a relatively small move in the market. Now the other attraction of leverage is in the returns it generates, in percentage terms. After all, we have just generated \$490 using only \$1,000 of our own money, a staggering return on investment of 49% per cent over the miserly 0.49% using our own money and with no leverage. Once again, demonstrating the power of leverage.

The question you might reasonably ask at this stage is what is an acceptable level of leverage for your account. Here I can only give you my advice, which is backed up by the views of professional traders, who limit their leverages to somewhere between 5:1 and 10:1. And in some ways this is confirmed by the new rules now in prospect for US forex brokers, with the regulatory authorities now looking to cap leverage at a maximum of 10:1. This often comes as a complete surprise to many forex retail traders, and only goes to show how dangerous leverage can be if you don't understand how it works, and the advantages and disadvantages of using it. Just remember the example with our house - would you really consider buying an £8m house, with just £20,000.

My own view, for what it's worth, is that as a novice trader the maximum leverage you should consider is 50:1 and certainly no more, and less if possible. The CFTC in America has increasingly tightened the legislation for brokers in this area. Over the next few years we are likely to see leverages falling dramatically, as the bucket shop brokers are cleared out and a more orderly and professional market is created.

Just to put this into context for you, the leverage offered on equities is never more than two to one, so just remember this when you are looking at the various broker offerings. We'll come back to this issue once we start to look at the broker types in more detail, later in the book.

Now that we understand a little about leverage and margin, in the remainder of the chapter I'm going to explain some of the other financial terms you're going to come across in your trading account, as well as explain how currency pairs are quoted and settled, how profits and losses are calculated, and also explain about rollovers and interest rates.

And before we start on the next section, a word about broker terminology and the terms of the account. Whilst some brokers use the same terms to explain aspects of the account, others will differ. There is no standard terminology, so the terms used may differ from account to account. The only one that is generally common is initial margin which we looked at earlier.

Second, the terms of each broker account will be different and this I'm afraid means that you have to read the small print or contact them by phone or live chat and ask. Don't be afraid to ask and get them to explain until you are absolutely clear as to how they operate, in terms of their rules and procedures.

My job here is to give you as much broad information as I can so that at least you understand the principles, and therefore also know the questions to ask and to phrase them in broker terminology.

Open Positions & Contracts

We began this chapter looking at leverage and margin. In this section, we are going to explore how forex contracts are priced and executed, first by considering some of the broad concepts, and then move on to some simple examples which I hope will show you how it all works.

As soon as you open a position on a currency pair, four things happen simultaneously.

First, you have used some of your initial margin to support this position, so the amount of your initial margin remaining has fallen.

Second, your broker has loaned you some money to fund the position.

Third, the position is now moving between profit and loss second by second

Finally, whilst your balance has remained unchanged, your overall equity position has changed, and before moving on let me just explain the difference between balance and equity as they are not the same thing. The balance in the account is the physical cash balance, so just like a bank statement it reflects how much cash you have in the account at the time.

When you first open your account, and deposit say \$1,000, then your balance will say \$1,000.

Equity on the other hand reflects the live position of your account at any one time. Taking the same example, if we had an open position in the market which was \$200 in profit, then you're equity would be \$1,200. This would change second by second, and I'll explain this in a moment.

Next, let's look at this from the broker's perspective. All brokers are in business to make a profit, and therefore profits have to be protected at all times, particularly in the volatile world of forex trading. How do they do this?

Well, whilst they are happy to lend you money against your initial margin, they will only do this up to a point, as they have no intention whatsoever of subsidising any losses you may make with their money. In order to avoid this potential situation arising, every forex brokerage account has a trigger which sets the alarm bells ringing, and the mechanism used is called maintenance margin.

We're going to do a very simple example shortly, but before we do, let me just try to explain some of the broad concepts to lay the foundations for you.

First, as soon as you open a trading position then you have an unrealised P & L (profit and loss) on the account, which will change in real time, second by second, and this is unrealised.

In other words you haven't closed out the position or positions to take a profit or a loss, which will then be reflected in your account in both the balance and the equity.

If you have no open positions, then your balance and equity will be the same. In

other words, the cash in the account. If you do have open positions, then the balance will reflect the cash amount in the account before you opened these positions, whilst the equity will reflect the balance plus any unrealised profits or losses.

In our example above, if we have a \$200 profit in an open position the balance would read \$1,000 and the equity would read \$1,200, and if the position were closed at this point, then both the equity and the balance would be the same at \$1,200.

Now, maintenance margin, as the name implies, is the margin that your broker requires to be in the account at all times in order for you to continue trading. If it falls to or below this level, then any positions you have open in the account will be closed in order to protect you, and more importantly your broker. Maintenance margin is also often referred to as variation margin, but essentially these are one and the same. Once again, this changes second by second, as soon as you have an open position in the market.

Finally, before we look at a simple example, let me just introduce two more terms here, which will make the example more realistic, and these are 'useable margin', and 'used margin' which work in a close relationship with our initial margin.

Let's assume once again that we have opened our account with our \$1,000 and we have no open positions, so our useable margin is \$1,000 as we haven't used any of this yet to support a market position, and the used margin is 0, since we haven't used any to open any positions.

However, as soon as we open a position then the useable margin will fall and the used margin will rise by the same amount. If we had used \$100 in margin to support a position, then our usable margin would be \$900, and our used margin would be \$100.

Now let's look at a very simple example and we're going to ignore commissions and spreads as it's an unnecessary complication. We now have our four principle terms within our trading account, namely, balance, equity, useable margin and used margin.

The key relationship that your broker will be monitoring second by second, and so should you, is that between equity and used margin, and this is what creates the trigger for your broker, when the alarm bells will start ringing. And the

trigger is this.

If the equity in your account is greater than the used margin, then your broker will be happy and your account is not in danger. If the equity in your account falls to, or below, the used margin, then this will trigger the alarm bell, and your broker will do one of two things. First, he or she will close out some or all of your positions to prevent any further loss. Second, they may or may not contact you for more funds, often known as a margin call, which simply means more cash is needed in the account - immediately. And if this is not received within the required time, which is normally hours, then your position or positions will be closed, in order to bring your equity level back above the used margin level once more.

In other words this is a very simple equation which is as follows:

$$\text{Useable margin} = \text{Equity} - \text{Used Margin}$$

For the broker this means that their money is never put at risk by your actions, and this in simple terms is really what margin is all about. It is your broker, 'locking away' portions of cash which are his protection in the event of things going wrong. Think of them as locked safes, where your broker has deposited some of your cash.

Let's take a simple example, and then we'll look at how the maintenance margin then fits in alongside, and once again, how this works will vary from broker to broker, so you will need to check this carefully. Let's go back to our well worn example, using our simple \$1,000 once more:

- Balance - \$1,000
- Equity - \$1,000
- Useable margin - \$1,000
- Used margin - \$0

We then open a small position which requires \$100 of margin. How does our account change?

- Balance - \$1,000
- Equity - \$1,000
- Useable margin - \$900

- Used margin - \$100

Some time later, we check our account and find that our position has deteriorated, and we are now looking at a potential loss of \$500. How does our account look now?

- Balance - \$1,000
- Equity - \$500
- Useable margin - \$400
- Used margin - \$100

Well, our balance is still the same at \$1,000 as we haven't closed the position yet. Our equity is now \$1,000 minus the potential loss of \$500, so this is \$500. Our usable margin is now \$900 minus \$500 so \$400 (which is from our simple equation above), and our used margin remains unchanged at \$100.

Now at this point our equity of \$500 is still greater than our used margin at \$100, so we have not reached our danger level yet in terms of the margin level required to continue trading with this position open. However, let's assume the situation gets worse. We check again, and now the position is \$900 in loss. What does the account look like now?

- Balance - \$1,000
- Equity - \$100
- Useable margin - \$100
- Used margin - \$100

Well, our balance is still \$1,000, our equity is now \$1,000 minus \$900 which is \$100. Our useable margin is now \$1,000 minus \$900 which is \$100, and our used margin is still \$100. However, our equity is now equal to our used margin at \$100 and the alarm bell will ring as we are about to break below the margin level required. Your broker will not allow this to happen as it means potentially that he could then be responsible for your losses, and his automated systems will trigger a margin call to you.

At this point, you either add further funds into the account, which will lift your balance and your equity, which in turn will then be higher than the used margin once more. Or your position will be closed by the broker, and your account will

then look like this:

- Balance - \$100
- Equity - \$100
- Useable margin - \$100
- Used margin - \$0

The balance is now \$100 as we have closed the position and taken the loss of - \$900 into our account. Our equity is now also \$100 as we have no open positions. The useable margin is now \$100 and the margin used is back to zero, as we have no open positions in our account.

My golden rule is this. If you ever receive a margin call then your trading is out of control, and you should stop immediately. It's as simple as that - sorry! You should never, ever receive a margin call if you are running your trading account correctly, which you will be, once you have finished reading this book!

I hope that the above examples have explained the various margin principles, but there is one other which we discussed earlier in the chapter, and that's maintenance margin, which can come into play at this point. In the last example, we assumed that the broker would issue a margin call at the precise point at which the equity was equal to the used margin, but this is not always the case. Some brokers will offer you the option to use a percentage of this 'used margin' to support further losses. You can think of this as though the broker has locked this money away for your own protection, but allows you to have some back 'if required', and this brings in the concept of 'maintenance margin' which may be below the 'used margin'.

Suppose for example, that your broker has a policy whereby their maintenance margin level is 50% of the used margin, then in this case you would have a further \$50 of margin to use to support the position. Here, you would receive a margin call at this lower level, when the position was a further \$50 in loss. If closed at this level, then your account would look like this:

- Balance - \$50
- Equity - \$50
- Useable margin - \$50
- Used margin - \$0

Every broker account will be different in terms of the words they use and the layout of the account. You may come across slightly different terms such as free margin, or available margin, as well as required margin and variation margin along with maintenance margin. However, the fundamental principle of how margin works remain the same.

It's important to realise that margin requirements can and do change from time to time, and also more importantly when holding positions overnight and also at weekends. In other words as risk increases. Again, you can think of this as a safety measure taken by your broker who is locking money away to protect himself. After all, unexpected events can happen at the weekend when the markets are closed, including natural disasters, shock economic events, and world events, all of which can impact the forex market. It is not surprising that your broker will allow for such events in the margin calculations. The same applies to positions held overnight.

But the key point is this. Provided you understand how the account is constructed in terms of the underlying margin requirements, you should never have to worry about approaching any of the trigger levels, provided you follow the rules and trading methods I explain here. I will be covering risk and money management later, so please don't worry. All you need is here, and I hope explained both simply and clearly.

I also hope that wasn't too confusing and you now understand the basic concepts of margin. It's so important. Please just take time to go over these examples again if you are a little confused. It is actually relatively simple once you can get your head round the idea of the broker not wanting to lose any money, which is really all it's about at the end of the day.

Pips To Cash

In this section we are going to look at how a currency exchange rate gets converted into cash, in other words, pips to cash, so some more maths I'm afraid!

If you remember earlier in the book I explained about pips and fractions of pips which are now becoming increasingly popular.

In order to keep our examples simple I am only going to use four decimal places, not five, so we'll just work in whole pips and not fractions for simplicity.

Let's start with real cash.

Imagine you have 100,000 euros in your bank account, and are thinking of buying a property in America. How many US dollars would you get if the exchange rate for the EUR/USD is 1.4000? The answer is \$140,000. A month later you are ready to go ahead with the purchase, and you still have your 100,000 euros in your bank, but the exchange rate has changed to 1.4500. Now for your 100,000 euros you will receive \$145,000, a gain of \$5,000. The maths here is very simple. The exchange rate has moved from 1.4000 to 1.4500, a total of five hundred pips, and our capital has increased by \$5,000. Each pip movement has increased our capital amount by \$5,000 divided by 500 which is \$10.

In other words, for every one pip move higher we have gained \$10. Had we only started with 10,000 euros in our account, then we would only have made \$500 (\$14,500 - \$14,000), in other words 1/10th. In this case each pip would have been worth 1 dollar or \$500 divided by 500 which is 1.

Finally, if we had started with 1,000 euros, then each pip move higher would have seen our capital increase by 0.1 of a dollar or 10 cents (\$1450 - \$1400). Here we would have made \$50 and \$50/500 is 1/10th.

Just to summarise this for you in bullet points:

- \$100,000 is equivalent to \$10 per pip
- \$10,000 is equivalent to \$1 per pip
- \$1,000 is equivalent to \$0.10 per pip

This in a nutshell is the principle on which the retail forex market works, and how currency exchange rates are converted into cash. In other words, the more currency you are trading, then the greater the value of the pip. The smaller the amount, then the smaller the value of the pip for that currency pair.

Contract Sizes

Let's now take these examples and convert them into what we actually trade, when speculating in the foreign exchange market.

In the spot forex world we are dealing with the simplest of all the currency contracts which are generally settled in two working days. Many forex traders fail to appreciate what it is exactly that is being bought or sold, and it is in fact a contract. Whenever we buy or sell currencies, we are in reality buying or selling

a contract to deliver or take delivery of the amount of currency we have bought or sold. In the currency futures world, the contract being bought or sold specifies the underlying amounts of the currency, the agreed price, and in addition, a delivery date for settlement of the contract. In the futures world, this may be weeks or even months in advance.

The spot forex market, is much more straightforward, and indeed as a trader in this market, all of the contract management is executed by your broker. So much so, that as I mentioned earlier, most spot forex traders, have little or no idea of what in fact is being bought and sold. The primary difference between these two market instruments is that the spot forex contract is settled, generally within a very short period, normally 2 days or less, whereas the equivalent futures contract may settle weeks or months later. In using the term settle, what we mean here is that the physical exchange of currencies actually takes place, so the contract is 'settled' or fulfilled if you like, and everyone then moves on.

I am going to explain all this in the next section when we look at something called rollover, but all we need to understand for now, is that these are very simple contracts, which simply specify the pair, the amount of currency involved in the exchange, and the price.

The term used to describe them is a 'lot', and using the EUR/USD example above:

- 100,000 euros against the dollar is called a **LOT**
- 10,000 euros against the dollar is called a **MINI LOT**
- 1,000 euros against the dollar is called a **MICRO LOT**

From some very simple maths above, you can then see that 10 micro lots are equivalent to **one** mini lot ($10 \times \$1000 = \$10,000$), and that 10 mini lots are equivalent to **one** full lot ($10 \times \$10,000 = \$100,000$).

Not all forex brokers offer all the different sizes of contracts so you will need to check with your particular broker. However, as most forex brokers are aiming at the small retail forex trader, then they tend to offer the mini lot as standard, with some now offering the micro lot on their learning platforms.

Personally I think this is an excellent development and my advice is very simple.

First there is nothing like using real money to learn, and with a micro account,

you are not going to do yourself a great deal of damage when you first start.

Second, you can always buy or sell more than one contract when you are ready, so even if you started with a micro lot account, as your experience grows, you would then simply increase the number of micro lots. For example, rather than trade in one micro lot at 10 cents per pip, you could buy or sell 5 micro lots, which would then increase the pip value to 50 cents per pip, or half a mini lot if you like, and on up until you were trading in 10 micro lots which is equal to one mini lot.

So, just to work backwards for a moment!

One micro lot is equivalent to ten cents per pip movement, and ten micro lots is equivalent to one mini lot, which is equivalent to one dollar per pip movement. Finally, ten mini lots is equivalent to one full lot which is equivalent to ten dollars per pip movement.

I hope that makes sense!

This is really the starting point for any trader in the spot forex market, and it's vital that you understand the potential profit or loss on any trade, before you open the position. Using simple maths, and knowing your lot size, this should now be very straightforward. When we buy or sell **one** mini lot on the EUR/USD pair, we know we are buying or selling in a 10,000 unit size, and therefore each pip movement will then equate to + or -, **one** dollar.

If we have our stop set 50 pips away from the market price, then we know our maximum loss is $50 \times \$1$ or \$50. This is on the EUR/USD currency pair.

Now the next issue concerns the counter currency, which is the currency in which the contract is settled. For any currency pair with the dollar as the counter currency, such as the EUR/USD or the GBP/USD, then this is settled in US dollars and the maths is easy, 10 dollars per pip on the full lot, 1 dollar per pip on the mini lot, and finally 10 cents per pip on the micro lot.

Moving to another pair, let's take a look at the USD/CHF and see how that works out in practice. In this case our pip value is denominated in Swiss francs as the counter currency, and once again we are going to take a mini lot, which is \$10,000 against the Swiss franc. What we have to do here is to convert a 1 pip move in the Swiss franc and convert this into US dollars.

How can we do this? Well let me try to come up with a simple explanation using

the mini lot again.

At the exchange rate of 1.2000, this means:

- $\$10,000 = 12,000 \text{ CHF}$

Or, putting this another way:

- Dividing both sides by 1.2000

Gives the following:

- $\$10,000/1.2 = 12,000/1.2 \text{ CHF}$

Which then gives us:

- $\$8,333.33 = 10,000 \text{ CHF}$

In other words, 10,000 Swiss franc is equivalent to \$8,333.33 US dollars, which in turn means that our 1 pip movement in the Swiss franc will be equivalent to:

- $\$8,333.33/10,000 = \0.8333

When trading in this currency pair, the pip movement on a mini lot will be \$0.833, slightly less than a full dollar, and this will change slightly as the exchange rate changes. If it helps, you can think of it this way. If the exchange rate is 1.0000 then the pip value is the same as for a EUR/USD or GBP/USD pair. When it moves above 1.0000 to 1.2000 as in our example, then the pip value will be less than a dollar, and when below a 1:1 exchange rate, then it will be higher.

The same principle applies to all other cross currency pairs, but of course is a little more complicated as we first have to convert from one currency to another, for the pip value, and then convert this into US dollars. Most forex brokers do this for you automatically as the account generally defaults to US dollars for both trading and reporting. Nevertheless, it helps to have some idea of the pip value for each. Let's take the EUR/GBP as an example.

If we take an exchange rate of 0.8546 for the EUR/GBP, then how do we calculate what a 1 pip move is for the pair. When you think about this logically, what we are really doing here is working out what the GBP to USD exchange rate is - no more, and no less! Why? Well it's very simple. Let me try to explain.

If you remember back to some early maths, perhaps in your high school or junior school, what we are dealing with here are simple fractions. When using simple fractions, we can apply simple rules of mathematics, multiply and divide fractions to arrive at the answer we want. What we want here is to arrive at the GBP/USD rate, since this is what we are trying to calculate which in turn will then tell us the pip value in US dollars for the EUR/GBP pair.

The first thing we want to do, is to have the GBP on the top and the EUR underneath, in other words invert the pair as follows:

- $\text{EUR/GBP} = 0.8546$
- $\text{GBP/EUR} = 1/0.8546 = 1.1701$

Next we take the EUR/USD exchange rate at say 1.2870

- $\text{EUR/USD} = 1.2870$

Now if we multiply them together, the EUR on the top, cancels out the EUR on the bottom, and we are left with our GBP/USD exchange rate as follows:

- $\text{GBP/EUR} \times \text{EUR/USD} = \text{GBP/USD}$
- $1.1701 \times 1.2870 = 1.5059$

Our GBP/USD exchange rate is 1.5059 which means that each pip movement will be \$1.50 for this pair. Whilst it is easy to check this simply by looking at the relevant exchange rate, the point is this. In trading a major such as the EUR/USD, the pip value for a standard mini lot is \$1. Move to a cross currency pair, and the pip value increases dramatically to \$1.50 cents per pip. A significant increase. You need to be very aware of this when calculating stop loss positions and your money management rules. After all, a 50 pip stop loss in the EUR/USD would be equivalent to \$50 on a mini lot contract, but on the EUR/GBP example, the same pip value would increase to \$75, a big increase. Knowing the dollar value of pips is very important once you move away from

the major currency pairs.

Let's take another example, and one which is more complicated, the EUR/CHF with a current exchange rate of 1.2560.

In this case we want to arrive at the exchange rate for the CHF/USD, but note how this is written - it is upside down. The exchange rate is normally expressed as the USD/CHF, but we want the inverse of this, in other words from Swiss francs to US dollars, and not the other way round. How do we go about calculating this?

Well, first, let's turn the EUR/CHF upside down like this:

- $\text{EUR/CHF} = 1.2560$
- $\text{CHF/EUR} = 0.7962$

Now we need to take the EUR/USD:

- $\text{EUR/USD} = 1.2858$

Finally, to arrive at our CHF/USD, we simply multiply these two together, with the EUR's top and bottom once again cancelling one another out:

- $\text{CHF/EUR} \times \text{EUR/USD} = 0.7962 \times 1.2858$
- $\text{CHF/USD} = 1.0237$

In this case, each pip value move for the EUR/CHF pair is \$1.02, for a mini lot contract. Not so dramatic as with our EUR/GBP example.

One of the odd currencies is the Japanese yen which only has two decimal places, and not four, so let's work that one out on the USD/JPY.

In this case the counter currency is the Japanese yen, and we need to convert this back to US dollars. The yen can be a little confusing for two reasons. First, we get some rather large numbers at times, and second it is always quoted to two decimal places and not four. To start, let's just do a simple cash example to get the picture.

Assume we have \$10,000 which we want to convert to Japanese yen, and the

current exchange rate is 100.00 - nice and easy!

In this case \$10,000 is equivalent to 1,000,000 yen, and if the exchange rate was then to move higher to 101.00, then this would be 1,010,000. With the exchange rate moving from 100.00 to 101.00, we have gained 10,000 yen. The move from 100.00 to 101.00 is a hundred pips, as we are only dealing in two decimal places this time. 10,000 yen is equivalent to one hundred pips and each pip is therefore one hundred yen ($100 \times 100 = 10,000$)

All we need to do, is to convert this back to US dollars to arrive at our dollar per pip rate. The maths here is simple! If the current exchange rate for the USD/JPY is 100.00, and each pip movement is 100 yen, then the pip value in US dollars is $100/100$ which is one US dollar. As the exchange rate moves beyond 100, then the pip value will start to fall below \$1, and conversely if the USD/JPY rate falls, then the value will rise above the \$1 level. All the maths here is once again based on a mini lot contract size.

I'll leave you to work these out for yourselves for the micro and full lot size contracts, but here's a clue - one is a tenth the size, and the other is ten times.

Now if your head is spinning at this point - don't worry. My purpose in explaining the maths behind pip values is to make one simple point. These values can and do vary enormously once you move away from the standard US dollar majors, and will have a big impact on your money management rules, which I cover later in the book.

As a general rule, MT4 brokerage accounts will normally default to US dollars anyway, so all the maths is done for you automatically. If you do want to check and confirm these for yourself, there are plenty of free online pip calculators available, and the chances are your broker will offer one as part of the tools package. If not, simply click on the link below, and this will give you an idea of how the calculator works. All you need to do is select your pair, enter the size of the position (10,000 etc), add the Ask price and select USD, and then click the calculate button.

<http://www.babypips.com/tools/forex-calculators/pipvalue.php>

Not so scary after all! But at least you now understand how these numbers are derived from the underlying currency relationships and exchange rates.

Now that I have explained how the contracts are priced and operate in practice, it's time to move on and give you a complete example of how your account

works with margin. Let's take the EUR/USD again and a mini contract of \$10,000, and we're going to trade one contract assuming the exchange rate is 1.4500. In addition, we are going to assume a leverage of 50:1. I didn't explain this in detail when we were looking at leverage and margin deliberately, as I wanted to cover it here, since it is more appropriate and will make more sense for you.

Our account leverage, can be looked at in two ways. First, for every dollar, our broker is going to lend us fifty dollars. In other words one to fifty, or converting to a percentage it's $1/50 \times 100$, which is 2%, or looked at another way, for every \$100 he lends us, we only have to use 2 US dollars of our own money.

Second, if we take the 2% figure, this means that for one mini lot of \$10,000, our broker will only require 2% of \$10,000 which is \$200 which then becomes our used margin. As the exchange rate changes, then this impacts the margin. A higher rate will increase the margin demand, and conversely a lower rate will decrease the margin demand.

That's it on the basics of how the profit and loss is both calculated and reported in a currency pair, and the conventions of contract size and specification. As I said earlier, all the conversions will be done for you within the account, so you won't have to worry. But you do need to know how much a pip is worth, how margins are calculated and reported within the account, contract sizes and of course leverage.

If you are new or a novice forex trader, then I would suggest starting with micro lots, then graduate to multiple micro lots and from there to mini lots, and take the same approach. Finally arriving at trading full size lots. Full size lots is not the place to start, and indeed if you only have a small amount of trading capital then you would probably not be able to cover the margin requirement anyway. On a full size EUR/USD lot, in a 100:1 leveraged account, and at an exchange rate of 1.4500, this would require \$1450 for just one contract. Not the place to start if you are a beginner. And remember, at 50:1 this would be double that amount.

Now let's move on to look at rollover and interest rates.

Rollover & Interest Rates

In this section we're going to consider rollover. This is where the world of money meets the world of interest rates, and you will be delighted to know that

all of what I am about to describe, happens automatically. In fact, if I didn't tell you about it here, you probably wouldn't even now it was happening. But, there is a reason for understanding how and why this happens and it's called profit and loss, and your overall P & L on your trading account. In addition, and even more importantly, there is a trading strategy that takes advantage of this mechanism, and that's the 'carry trade'.

Let's talk about rollover, what it is, why it happens and what actually happens within your account as a result. Rollover as the name implies, is when a contract rolls over into a new period, and in the futures market this happens regularly as traders move from one contract period to another, as each contract reaches expiry.

Naturally this comes at a price, but it allows a futures trader to continue to hold an existing position for a longer term, by simply rolling it over into the next monthly or quarterly cycle. It's just like renewing your gym membership for another quarter. You pay a renewal fee and your membership is updated for another period, but in the case of the financial markets there is an 'extra' price to pay.

Now in the spot forex market we have a very similar system. Here this happens daily at 5.00 pm Eastern Standard Time in New York. Suppose you have opened a position during the day, and it is still open when it reaches 5 pm in New York, then your broker will automatically 'roll this contract over' into the next day.

Your gym membership has just been renewed for a further twenty four hour period, and your forex broker will continue doing this until you tell him or her to stop - by closing the position!

The question you are probably asking is why does this happen and what impact does it have on your account. Let me try to explain.

In the spot forex market this is where currencies are bought and sold, and then settled with the currency then being moved from A to B, and in order to allow all this to happen in an orderly manner, settlement of any contract takes place within two working days. This allows the various parties to transfer the currency from one to another. In other words, everyone's obligations under the terms of the contract are met. The seller has delivered the agreed amount of currency to the buyer. There is one contract that settles in a day, and that's the USD/CAD, but for our purposes, let's just assume it's two days.

Assume it is Monday morning, and you have opened a position in the spot forex market. If this is then closed before 5 pm New York time, settlement of the contract would take place by Wednesday 5 pm EST. However, if you had left this position open, then at 5 pm EST it is rolled over, and immediately becomes a contract of Tuesday which has an associated settlement date of Thursday. Likewise, if you leave it open on Tuesday then it is rolled over into a Wednesday contract. But on Wednesday at 5 pm EST things change, and the settlement date is rolled to Monday, which means a three day rollover cost to allow for the weekend.

In simple terms this means the cost of rollover is three times as much. And so the cycle continues until the position is closed. Now at this point you might be saying, 'well this is very interesting, but if it is all happening automatically, why should I know or care?'

The answer is this. Each time a contract is rolled over to the next day, there is a cost involved to one party or another, and the position will either earn you interest, or you pay interest. This is because rollover is the point at which two things happen.

First, your position in the market is rolled over into the next day so that your contract remains open, and second the interest rate earned, or to be paid on the position, is calculated and either debited from your account, or credited to your account. And because forex is traded in pairs, every trade involves not only two different currencies, but also two different interest rates as well.

You can think of it as having two separate bank accounts in two countries, with different currencies in each. We are trading real money here after all!

If the interest rate on the currency you bought, is lower than the interest rate on the currency you sold, then you will have interest to pay, and is called a negative rollover. However, if the interest rate on the currency you bought, is higher than the interest rate on the currency you sold, then you will earn interest on the position. This is where the carry trade becomes a speculative trading strategy for many traders, who look for the maximum interest rate differential between two currencies, which then accrues every twenty four hours.

Let's look at how this works in practice, with a simple example, and remember that if you are keeping positions open over the weekend, then the rollover costs will be roughly three times those during a twenty four hour period.

I want to try to keep the maths as simple as possible here, and also bear in mind that interest rates are at historically low levels around the world, so the cost of the rollover in the last few years has been very low. But equally, any credits have also been poor and even the carry trade has only been able to achieve a maximum differential of around 4.5%, which is why many traders have sought out the exotic currencies for higher yields. This will change as inflation rises, along with interest rates and rollover costs, and they will not stay low for ever.

Here is a simple example with the EUR/USD using a mini lot with an exchange rate of 1.4500, and an interest rate of 1% for the euro, and 0.5% percent for the US dollar.

Suppose we have bought the contract, and are therefore long euros and short dollars, and just to make the maths simple, we are going to assume we hold this for 1 year! An absurd time, but it just helps to make the maths a little easier. I have also assumed for simplicity, that the exchange rate is the same at the start of the year as at the end of the year, and this will almost certainly not be the case! But this is just to show you how the interest rates work.

Our 10,000 euros over a year would earn us:

- $10,000 \times 1/100 = 100$ euros

On the other side of our position we have \$14,500 US dollars, which would be costing us:

- $14,500 \times 0.5/100 = \72.50

If we were to hold this contract for one year and roll it over day after day then at the end of the year we will have earned, 100 euros on the euro balance, and paid \$72.50 dollars on the dollar side of the position. Now if we convert the euro earnings back to dollars using the 1.4500 exchange rate, then this becomes \$145 on the euro side of the contract, which is in our favour.

In short, we have earned \$145 and in earning that interest, this has cost us \$72.50. So a net credit of $\$145 - \$72.50 = \$72.50$.

Here we bought the higher interest bearing currency, the euro and sold the lower yielding currency, the US dollar. This is over an entire year so converting this to a daily dollar rate, we simply divide by 365, and we get 0.20 or 20 cents per day.

Not a lot you might say, which is true in this case, and you probably wouldn't even notice it in your account, as this all happens automatically at 5 pm EST.

However just let me highlight some issues here for you. First, at the moment we are in a period of ultra low interest rates and therefore in this case, which I chose deliberately, the interest rate differential between these two currencies is very small at 0.5% and reflects the current situation. This is not going to last forever, and at some point soon rates will begin to rise. What happens if the economy in Europe begins to expand faster than that in the US?

Let's assume interest rates in Europe are now 4% and in the US are 1%, still using one mini lot and the same exchange rate.

In this case we would earn 400 euros on our base currency and be paying \$145 on our counter currency, and converting everything back to dollars, gives us a net gain in interest of:

- $\$580 - \$145 = \$435$

A total of \$435, which converts to a daily credit of \$1.20. This is great if we are long the contract, and the position is going in our favour, and herein lies the problem which many forex traders forget.

Earning interest on a position that you are holding for the longer term may sound very attractive, and in some cases it is - but there are always two sides. You may well be earning interest, but if the position is deep in loss, the fact that you have earned a few dollars will be neither here or there. The message here is clear and simple. Focus on the pair and the direction of the currency pair, and not on the underlying credit or debit on your account. Get the direction right and the profits will look after themselves. Too many forex traders focus on trading positions to take advantage of the credit on rollover, which is a big mistake. My purpose here has been to explain what it is, and why it happens, and simply to be aware of this which all occurs automatically in your account.

The carry trade is one specific strategy that harnesses this aspect of currency rates, and interest rates, but is generally based around the Yen currency and particularly with the Australian Dollar. There are many other high yielding currencies around the world such as the Mexican peso, and the Brazilian real to name just two, but these are extremely volatile and not for the novice trader. Of course, get it right and it's a double whammy of interest rate credits and profit on

the position. Get it wrong however, and the interest rate credit will become incidental!

Now in the above examples we only chose a mini lot. If we were trading a full size lot then we simply multiply by ten, and so in the last example we would be earning or paying \$12 a day on this contract.

Finally, do not expect your broker to charge you central bank rates, he won't, and what you will find is that the interest that you pay always seem higher than you expect, and interest that you earn always seems lower than you expect. Why?

Well, just like a bank your broker is going to make money from financing your trading, so the rates he charges will already have a profit or margin built in, so he will be making money on the spread as well as on interest rates quoted.

Your broker, may, if he's generous pay you a small amount of interest on the balance in your trading account, but generally they don't, and to be honest the rates are so low it really isn't worth worrying about at the moment. Rollover however can get expensive when the differential is high, which is why the carry trade is so popular.

In summary, that's how rollover and interest rate differentials can work both for you, and against you, but these calculations will be going on daily in your account and often unbeknown to the trader. Be aware of it however, particularly if you are trading in multiple lot sizes and holding positions over longer periods

Trading Capital

I now want to consider the single most important financial aspect of your trading business, and that's your trading capital. This is no different to the capital that you would invest in any other business. If you were starting a business from scratch, then you need some start up capital of your own. After all, even if you approach the bank for a loan, they would still expect you to have some initial capital to put into the business.

Trading is no different and your trading capital is your most valuable asset. Never forget it!

It must be jealously guarded and protected at all times. Lose your capital and your business goes bust, it's that simple. Now the \$6 million dollar question is how much trading capital do I need to get started?

Whilst this is an almost impossible question to answer I will try to give you my thoughts and suggestions, based on many years experience, which I hope will help to guide you in making this important decision. And in accumulating your trading capital there are two golden rules that you must adhere to at all times

The first rule is that this must be money you can afford to lose, and which does not affect your lifestyle, your family or your circumstances in any way whatsoever.

The second rule, which follows from the first, is that this money is never ever borrowed either from a bank, or from friends, family or acquaintances. Nor is it raised by releasing equity from a property or other assets, for the simple reason that this is then money which will affect your lifestyle if lost, and contravene rule one above!

Your trading capital should come from savings, or the sale of other assets, and is therefore money that you can afford to lose. It might be a painful experience if you did, but once lost your financial circumstances have not been affected. Nor do you owe anyone money you no longer have, or even worse, are paying interest on money that has been borrowed and then lost.

These are the golden rules. Yes it sounds very negative at this stage to be discussing this issue before we've even got to the section on making money, but this is trading. Focus on the risks, the downsides of each position, and the potential losses that could arise, and in doing so, the positive side of the business will then start to look after itself. It seems counterintuitive, but it is a fact. Think of it in these terms. If you were building a large liner, one of your primary concerns would be to ensure that there are enough lifeboats on board, should the worst happen. It probably never will, but covering that eventuality then allows you to focus on the positives of building the most beautiful and successful cruise liner in the world.

Novice traders when they start, focus on how much money they are going to make from a new position. Experienced traders focus on how much money they are prepared to lose on a position. A completely different perspective, but one where concentrating on the loss side of the equation, allows the profit to take care of itself.

Once again this is no different to starting a business in any other field. You concentrate on your business plan, the cash flow, the marketing and the product or service costs. In all your projections and financial forecasts, you always take a

worst case scenario, so that you know where your bottom line is - your threshold for the business. Provided you can do better than this, then the profits will look after themselves

Trading is no different. We only use money we can afford to lose and which is not borrowed in any way. This removes any additional pressure which would certainly come from using other people's money, or by using money that we simply cannot afford to lose.

The next question is how much, and let me talk here a little about percentages and try to explain how most forex traders view success and apparent failure, and how I view it!

Virtually every forex trader I know and have ever spoken to, concentrates on the cash return on each trade, and not on the percentage return. Why? Well it's largely as a result of the way the industry is marketed, so that the retail forex traders are brainwashed into thinking dollar amounts all the time. This is further reinforced by the retail broker platforms. These have been designed to flash live profits and losses second by second, to create the casino environment, carefully configured to ensure you 'over trade', whilst also subjecting you to the emotional stress of a P & L (profit and loss) which is constantly changing.

Let me put this into context for you in the real world, and first consider percentage returns on your trading capital. If you have ever spoken to a professional fund manager in equities, or one running a forex managed fund, it may surprise, or even shock you to know, that in equities, a fund manager is considered to be doing well when the fund returns between 10% and 15% per annum consistently.

A forex managed fund is slightly higher at an average of between 20% and 30% per annum. Now it is true to say, that in the last few years most forex managed funds have done better than this, with some achieving between 50% and even as high as 90%, but since the financial crisis and the increased market volatility, returns in most forex funds have fallen dramatically. Nevertheless, let's take a figure of 50% per annum, which is extremely high to achieve consistently year in year out and way above any return you could expect in the equity market, and try to relate this to our own simple forex trading account.

Suppose you've come to me for some help and advice to get you started as a forex trader, and you've managed to save \$1,000 as your starting capital. We open the account and I then tell you that each week we're going to look for one

trading opportunity of at least ten pips using a mini lot. \$10 per trade. Excited?

Probably not, and no doubt beginning to wonder if I had any idea what I was talking about! However you agree, and by the end of the year your account has risen from \$1,000 to \$1,520. In other words from an entire years trading you have generated \$520.

Are you ecstatic and delighted, or underwhelmed and depressed?

Well, you should be delighted. You've managed to out perform most top forex funds by generating a 52% return on your trading capital - an excellent performance. If you repeated this performance, then your balance would increase to over \$2,000 by the end of the following year.

This would place you in the top echelon, of fund managers. And herein lies the problem. \$1,000 in itself is not a large sum, but in % return, is an exceptional performance, which has been achieved with one trade per week of ten pips.

Everyone is brainwashed into thinking that the absurd returns quoted on the internet are real and the norm. They are fiction, not fact. As a result, when a novice trader starts, their first instinct is to attempt to replicate what they think are the returns, other traders are making. They are misled into believing these absurd figures. Believe me when I tell you virtually all are rubbish, as none of these people actually trade.

Percentages are what matters. The percentage returns in the forex market are certainly higher than in most other markets by some distance. Most forex funds are somewhere between 25% and 50% which is much closer to the truth. The problem that this illusion creates, is that new traders then try to replicate this, and duly break every rule on risk and money management in the process.

In order to help, let me try to give you some basic parameters which I hope will provide a frame of reference, and a perspective against which to gauge your own performance, based on your initial trading capital.

- If your initial investment is more than \$500 but less than \$5,000 dollars then you should start your forex trading using a micro lot account, but trading multiple contracts up to a maximum of nine. Start with one. You are then trading real money, and you will then learn quickly how to manage your emotions, and manage your positions and close out when necessary. From there, you can start to increase the number of contracts, and rather than

close out a complete position, simply take off one contract and leave the others in place. This is known as 'scaling out' of a position. An alternative approach is referred to as 'scaling in' where we add to the number of contracts, as the position moves into profit. This is my preferred approach as it is premised on the basis of a profitable position to start with, rather than scaling out, which assumes success from the start - a very different approach. Both of these are more advanced approaches, and ones which can be adopted and learnt as your trading skills develop. In other words, take some profit and bank it.

- From \$5,000 to \$50,000 we can start to look at trading in mini lots and multiples of mini lots up to a maximum of nine contracts. The same principles apply here. Again start with the smallest contract multiple of one, and build up slowly.
- Above \$50,000 we can now start to think about trading full lot contract sizes and multiple contracts.

I hope that gives you some idea of how to match your trading capital to the lot sizes. These are only guidelines to help you as you get started.

Just to continue on the theme of percentage returns, and why you should use then as your yardstick and not dollar amounts, it is simply this. If you have a \$500 account and from your consistent trading, you can turn this into a \$1,000 account over an extended period of time, (weeks or months), then this raises two fundamental points:

- First you are doing far far better than virtually every other forex trader
- Second, you have proved that you can be consistent in your results, and once you have achieved this goal, then the world is your oyster

Consistency is the key to success. If you can be consistent, then all you will need to do to make more and more money, is simply to follow your trading plan, but with larger contract sizes or multiple contracts, gradually increasing your position sizes and moving from micro lot, to mini lots and finally to full lot contracts.

At any stage in building your trading capital, you can always trade multiple lot sizes, even at the micro level, so if your trading capital falls somewhere between the figures I've outlined above, then you can simply gear up in multiples according to your money management rules which I explain shortly.

It really is this simple. Success is about consistency. If you can be consistent trading in micro lots, then you can be consistent in trading full lots. The reason is self evident. In achieving consistency, you have proved to yourself that you have the discipline to follow the rules in your trading plan, which again I explain later in the book. In other words, the money is irrelevant at this stage when you start. What you are looking for is consistency and percentage returns. If you can achieve this, then the money will flow into your account in ever increasing and larger flows. It has to, provided you follow what you have done before, and do not become over confident.

The key is to follow your rules and trade using patience and common sense.

If you only have a few hundred dollars to start with, don't worry. Start with micro lots, and concentrate on the percentage returns. They may not be spectacular in terms of the monetary value, but if you've made a 10%, 20%, or 30% return on your starting capital, over a period of two to three months let's say, then you've done really really well, and should feel rightly proud of your achievements!

In summary, ignore all the hype, and just remember, when collecting your trading capital together, always bear in mind my two golden rules. Once you have it and start trading, only concentrate on your percentage returns, and not on the dollar amounts as your performance yardstick. It is consistency that you are after as a new trader - nothing else. If you can be consistent over an extended period of a few months, then as I said earlier, the world is your oyster, and the money will flow. From there it's easy. Simply trade larger and larger positions to increase your trading capital quickly.

Anna's trading equation is this:

TRADING CONSISTENCY + % RETURNS = WEALTH

Please remember it at ALL times!!

Chapter Eight

Risk And Money Management

Being wrong – not taking the loss – that is what does the damage to the pocket book and to the soul

Jesse Livermore (1877 - 1940)

In every walk of life, whether in your personal or business life there is risk. Risk is everywhere. A new business has risk, a relationship has risk, travelling involves risk, as do most sports and hobbies. It is impossible to avoid risk completely, and to do so would lead to a very sterile world. What we all attempt to do, whether consciously or subconsciously is to judge that risk, and then decide for ourselves whether we wish to accept or reject the activity, based on our assessment.

Whilst we may never think of the risks associated with driving a car, we may be more aware of the risks when crossing the road. We judge financial risk in much the same way, whether lending a small sum of money to a friend, or investing in a start up business. We assess the risk and then make a decision accordingly.

Trading, by its very nature carries a high degree of risk, and as I always say in my forex trading rooms, there are only two risks in trading. The first is the financial risk which is easy to quantify and manage, and the second is the risk on the trade itself, which is much harder. In this chapter we are going to focus on the financial aspects of risk management. In other words, protecting your trading capital, which, as I said in the previous chapter, is your most precious asset.

The reason it is so precious is very simple. First, if you lose it, then you are out of the market and your account will be closed, probably by your broker! Second, and perhaps less obvious, each % that you lose, makes it harder to recover, and gradually what will happen is that your trading will become more akin to gambling, as you try to recover your losses. Let's look at the maths, with a simple example which I hope will make this point.

Suppose you have opened your trading account with a deposit of \$1,000 and in your first week of trading, you lose \$100. This is 10% of your trading capital,

and you now have \$900 remaining in your account.

- $\$100/\$1000 \times 100\% = 10\%$

The next question is this. How much, in percentage terms, do we have to regain, in order to return to our starting point of \$1,000? To find the answer, we simply take our remaining capital, which is now \$900, and calculate \$100 as a percentage of this figure.

- $\$100/\$900 \times 100\% = 11.11\%$

In other words, we have lost 10% of our starting capital, and in order to recover this amount and get back to 'square one', we have to make 11.1% on our remaining trading capital. This is how the maths works against us, and as the losses increase, then the harder it becomes to recover.

Imagine if the loss were 20%, then to recover, we would need a return of:

- $\$200/\$800 \times 100\% = 25\%$

Once again we have to recover more, in percentage terms against the remaining capital, than we have actually lost. And this is why the maths is always working against us, whenever we sustain a loss. This is why managing and keeping losses small, is the number one rule in money management, and I hope that the above examples prove why!

Just to reinforce the point, consider this - if you lost 50% of your trading capital in one trade, then you would have to make a 100% return on the balance remaining, just to return to your original amount. This is when trading becomes a bet - nothing more and nothing less. A 'double or quits' which is the last throw of the dice. You may be lucky and win, but the chances are you will lose and be out of the game, poorer and hopefully a little wiser!

The question that you might reasonably ask at this stage is, why all this focus on loss, when actually we are supposed to be making money? Let me explain, as this is one of the great ironies of trading, that many new traders struggle to grasp. So much is written about making money, that the prospect of making a loss is almost ignored, and yet managing losses is of far greater significance than making money! It sounds odd, doesn't it. And yet I can assure you that your

focus at all times, should be the opposite of what you might think. Each time you open a new position, the focus should be on how much we are 'prepared to risk' on the trade, in other words how much we are prepared to lose. This is the starting point. The profits will then look after themselves, and has much the same sentiment as the old saying:

'look after the pennies, and the pounds will look after themselves'

In the above, simply replace the word '**pennies**' with the word '**losses**', and the word '**pounds**' with the word '**profits**' and you have the perfect approach to money management.

This is the approach that you have to develop, and I hope from the above that you can understand why. If you focus on what you are prepared to risk and possibly lose, then the profits will look after themselves. Most new traders, and many experienced traders, do the exact opposite, and only concentrate on the profits. Like many things in trading, we have to view money management and risk from the other end of the telescope.

Staying with the theme of risk and loss, let me introduce another favourite maxim of mine which is this - you have to learn to lose before you can learn how to win. Why is this?

Whilst trading is many things, it is in essence a battle with yourself. It is a mind game, in which, as a trader, you are constantly struggling to manage your emotions as they are driven this way and that by the market. You have to learn how to manage your emotions, dealing with the emotional pressure of a potential loss, as well as the pressure of losing a potential profit. Both very different emotional responses. I will be covering this in more detail for you later in the book, but the point that I want to make here, is simply this. If you can learn how to lose, and manage that loss both emotionally and financially in a calm way, and move on, then you have mastered one of the most important lessons of all, namely the ability to view a loss as part of the business of trading. Trading is, after all, a business, and one like any other where we make and lose money.

In business, we sometimes make bad decisions, which result in a loss. We learn from the experience and move on, accepting that this is part and parcel of risk. Perhaps we invested in some new product or process, perhaps we invested our time into a new project within the business, which ultimately did not produce the results we expected, or hoped for. Whatever the reasons, as long as we can look back and say we gave it our best efforts, then we move on, with the benefit of

wisdom and experience. In trading, this is rarely the case. Many traders simply cannot accept a loss. A loss is seen as a personal failure, or a failure to read the market correctly. This emotion builds into anger and resentment and ultimately an urge to 'get even' with the market. Loss builds on loss, and emotions run out of control. In a short space of time, trading based on logic, common sense and rules is replaced with gambling.

If you cannot learn how to accept a loss and move on to the next opportunity in a cool and philosophical way, then trading may not be for you. It's not for everyone. This is the time to be honest with yourself, and is one of the many reasons that you should never trade with money that you cannot afford to lose. After all, losing money is one thing, losing someone else's (either a friend's or the bank's), is something very different.

This is what separates traders who struggle from those who succeed. Traders who make it, start by focusing on protecting their capital and deciding, in advance, how much they are prepared to risk, not how much they may make. And I hope I have made the point very clear.

Now let's move on to consider money management in detail. How much should you risk, and how do you convert this into position sizes in the market? And there are two elements here. The first is on a position by position basis, and the second is in your overall trading account.

If we start with a simple example, which I hope will make the point as forcefully as possible and we'll work in percentages as it's easier. Imagine you have just opened your forex trading account and have deposited some funds, it doesn't matter how much, and we're ready to trade. We see an opportunity and decide to risk 50% of our trading capital on the trade. It ends as a loss, and we now only have half of our capital left. We decide to try again and not surprisingly we lose again, and have no capital left and our trading account is closed. We have lost 100% of our capital in two trades, which I hope you agree is not very sensible.

The question then is how much should we risk on each trading position, and my rule of thumb here is very simple. My suggestion and advice is try not to risk more than 1% of your trading capital on any one trade. Why?

In simple terms, what this means is that you can be wrong 100 times before your trading capital has gone. In the above example you were wrong twice, before arriving at this position. Using this money management rule, you can be wrong 100 times consecutively. More importantly, each loss is small, and if you

remember back to the earlier examples, any loss has to be recovered by a larger % gain against the remaining capital. It is therefore imperative that any losses are kept as small as possible.

The next point is this. Trading success is not simply a question of being right more times than you are wrong. It is far more complex, and those traders who succeed and produce consistent results over an extended period, will do so by keeping their losses very small. The profits on those winning trades will then outweigh the small losses. Suppose for example, a trader had eight losing trades and two winning trades. Is this trader profitable?

It would be impossible to say. But let me give you two scenarios.

If the winning trades were \$500 each and the losing trades were \$50 each, then the answer would be yes. But take the monetary aspect away for a moment, and in this example I presented a trader who lost eight times out of ten. Your immediate assumption would be, that this was a trader who was losing and losing consistently. The opposite is in fact true. And this is what makes money management so important. If you allow one losing trade to become large, it will destroy that fine balance between profit and loss, which is not premised on the win/loss relationship at all, but on the monetary relationship between the winners and the losers.

Now having advised that 1% should be the maximum risk on each position, there is also an argument for increasing this figure, depending on the amount of your trading capital, and strangely this works inversely. In other words the smaller your account, then the larger the risk, but again this has to be capped and the guideline here is a maximum of 5%. The question is, why have two levels, is one not enough?

The reason for this is simple. If you have a small trading account, then the object of the trading exercise is to grow the account. In other words, capital growth. If you have a trading account with perhaps \$500 or \$1,000, then a 1% rule would equate to \$5 risk or \$10 risk per trade, which in turn would not offer a 'proportionate' risk/return ratio. However, increase this to 5% and we now have a risk of \$25 or \$50 per trading position, and provided we stick to this money management rule, then this gives us the opportunity to grow the account from a relatively small base. In other words, achieve capital growth.

As the account builds, then the risk percentages are gradually reduced sliding from the 5% maximum, back to the 1% maximum and reflecting the change

from capital growth, the starting position of our account, to income. In other words, once we have achieved capital growth, and the account has grown to \$5,000 or \$10,000, then trading percentages are reduced to the 1% rules for future trading and the account is protected.

Again, this sounds slightly counterintuitive, but with a modest account size, it is very difficult to grow the account without taking on more risk initially. In many ways this reflects the approach entrepreneurs take in business. As they first start, the risks are high, but as the business becomes established, the risks taken are lowered, as there is more to lose. It's all about judgement of risk. Losing a small amount of start up capital may be an acceptable risk for larger, longer term gains. Losing a large amount of capital is not an acceptable risk, and therefore the risk profile is reduced to a more acceptable level. I hope this makes sense!

Let's look at some simple examples, and how we convert these money management rules into positions in the market.

If we take a small account as an example, and suppose we have \$500 of trading capital deciding to use the 5% rule as our maximum loss. This equates to \$25 on each position in the market. Now we have to work backwards.

We know from examples earlier in the book, that a micro lot on the EUR/USD is equivalent to 10 cents per pip, a mini lot, to \$1 per pip, and a full lot to \$10 per pip. Clearly a full size lot is not appropriate since this would be equivalent to a 2.5 pip move in the market before any loss were triggered - not a practical proposition.

The mini lot makes more sense. Here we would have a 25 pip move before any loss, and equally a micro lot, would allow for a 250 pip move. The decision here would therefore be between a single mini lot, or a multiple number of micro lots. Both would be equally viable, but let's assume for simplicity, that we decide to opt for one mini lot.

Any order management rule would then be triggered if the market moved against us by 25 pips, so provided our stop loss order (which I will explain later in the book) is at, or less than this from the price we enter the market, then our money management rule will keep any loss to 5% of our trading capital, or less.

Alternatively, we could have entered a multiple number of micro lot contracts, at different levels, which would then have given us more flexibility in terms of managing and closing out positions as the market moved. However, provided the

combined amount of capital at risk did not exceed the 5% limit, then the money management rule remains intact.

There is one final element here which is this. The above examples assume that the capital at risk remains the same throughout the life of the trade, and this is often not the case, as profits are often 'locked in' as we will see shortly. The % risk capital is the maximum at the open of any new position which is then reduced as the trading position develops in the market, and again I will cover this later.

Finally, just to round off this chapter on risk and money management, there is one other aspect that you will need to consider as your experience and trading account grows, and that's the question of how much of your trading capital should be exposed to risk at any one time. My rule of thumb here is 10%. For example, if you have a modest trading account which is growing and perhaps has \$1,000, then the maximum amount of capital exposed at any one time should never be more than \$100, in other words, two trading positions using our 5% rule.

For larger trading accounts, such as \$10,000 and above, then the same rule applies and in this case would be \$1,000, and using a 1% rule, then ten trading positions would be the maximum. Now it is also important to remember, that these rules are your **maximum** levels of risk. When you open a new position, and you are able to take less risk, then that's great and to be welcomed. As you will see shortly, we use the market to help us decide where to place our stop loss order, so if we can take a position and risk less, then even better. The point is this. The rule is the maximum. If we can open a position with a lower financial risk, but with the same probability of success - then all well and good. Maximum is just that - the maximum. Aim for less if you can!

These then are the very simple money management rules which will keep your trading capital safe. Your trading capital is the lifeblood of your business and needs to be protected and guarded jealously at all times. You do have to accept risk. After all, without risk you cannot profit. As I have already said in this book - there are only two risks in trading. The risk on the trade itself, and the monetary risk. The first part is the most difficult, and comes from analysing all the information from a technical, fundamental and relational perspective and then making a decision based on the collective information. The second is comparatively straightforward, and is what we have covered in this chapter. Provided you follow the simple principles explained here, then your trading

capital will be protected and only exposed to quantifiable and manageable risk. In following these simple rules it will ensure your longer term survival in the market. And the longer you survive, then the greater your chances of longer term success.

Chapter Nine

Your Trading Plan

By risking 1%, I am indifferent to any individual trade. Keeping your risk small and constant is absolutely critical

Larry Hite (1956 -)

Of all the chapters in this book, this one is perhaps the most important, and also one of the most difficult to write. It is difficult to write for several reasons, not least because I have never met you, and may never do so, although I hope you will 'e-meet' me metaphorically in one of my trading rooms, or indeed at a seminar.

And the reason it is hard to write, is that as you will see from the title, this chapter is entitled 'Your Trading Plan'. It's not mine, or anyone else's but yours, and yours alone. It will be personal to you, your circumstances, your view of money, and your goals and objectives in entering the trading world. Over the years, your plan will alter, just as in other aspects of your life. As your knowledge grows, so your plan will change.

My purpose here therefore, is to try to provide you with 'food for thought', the basic ideas, principles and concepts, which you can then develop into your own unique and personal trading plan. After all, it would be very easy for me to give you a blueprint of a trading plan and leave it at that. However, this is not what this book is about. In everything I write, I am trying to help, educate and teach based on my years of trading experience. And just as with every other aspect of trading, there is a great deal of nonsense written about trading plans, generally from people who have never traded in their lives, and it shows. These are then my own thoughts, observations and ideas, which I hope will help you to understand why we need to have a plan, but where that plan stops and what I call 'discretionary trading' steps in, and in order to start the ball rolling, let me begin with a simple, extreme example to explain this statement.

You may already have come across the term 'black box system' which generally means a piece of software that mechanically produces the buy and sell orders. Your entry and exit signals if you like. In other words, you do nothing, other than

follow what the software is telling you to do. In addition, the system may also implement the money management rules that we looked at in the previous chapter. And that's about it. Now, ask yourself a question. If anyone, anywhere, was ever able to develop a 'black box' system that worked, and worked consistently, then such a system would rule the world for its inventor. No one else would survive against it.

That's the first point. In other words, no one has, and no one ever will develop a 'black box' system that works consistently to produce profits in all markets, and in all market conditions.

The next point is this - it may be very easy to produce a black box to signal an entry, but what about the exit, which is much harder? Can a black box system see the market, react to the fundamental news, react to relational markets, or consider the technical picture in multiple time frames. No. In closing a position in the market, most black box systems will simply reverse the initial entry rule which is why none of them work. No, let me correct what I said here - they can work for a time, but then fail, and this is no great surprise, since it is impossible for anyone to design a mechanical system which has the flexibility to adapt to different market conditions. Some of the systems may work if the market is trending, but then fail in sideways moving markets. Others may work when price congestion is dominating market behaviour, and then break down when the trend begins.

Many people have tried and failed, from 'learned institutions' to 'trading gurus'. All these systems have one thing in common, they all fail, and some in spectacular fashion.

So what can we learn from all this? And more importantly, what is the relevance to us as humble retail traders when considering the 'trading plan'? One thing I hope is clear from the above. A trading plan is many things, but one thing it is most certainly not is a set of mechanical rules, which you then follow on each and every trade. If it were, then we could call it a 'black box' trading plan, since this in essence is exactly what it is. A set of rules, that you follow blindly, irrespective of market conditions, and this is the problem. Most people who write about a trading plan will suggest that you write your rules, and then apply them to the market. Blindly. Sorry, this is complete rubbish, and in the rest of this chapter I'll explain why, and more importantly how to develop your trading plan so that it is meaningful, but protects your capital at all times.

Let's start with why we have a trading plan.

If you have read any of my other books on trading, then you will know that I love to use analogies to try to explain concepts in a simple and clear way, (that's the theory anyway!). The analogy that I believe works well here, is to think of a journey by car from A to B.

First we decide that we actually want to travel from A to B. Then we get in our car and start driving. Do we drive at the same speed all the way? No - we are constantly having to adjust our speed for a variety of reasons. The road conditions may vary, the weather may vary, the amount of traffic may vary. These are all variables which influence both our driving style, and speed. If the roads are dry, and empty, then we can drive fast, but if it is raining heavily and there is a great deal of traffic, then we are more cautious and drive slowly, and only speed up once conditions allow. We are driving in a discretionary way, because the prevailing conditions dictate that this is the most sensible way to drive.

When you think about it, what we are actually doing is assessing risk - no more, no less. If the roads are wet, and visibility is poor, then we drive more cautiously, in order to lower the risk of an accident. As road and weather conditions improve, then we feel comfortable in increasing our speed as we now judge that there is less risk in driving faster.

To extend this analogy further, for those of us lucky enough to have cruise control on our car, would we consider driving with this on all the time? The short answer is no, since at some point the weather or traffic conditions or both, would force us to go back to our discretionary driving, or if not, accept the fact that sooner or later we would crash.

It goes without saying that there are some 'rules of the road' which we never break, and these are always in force, such as which side of the road to drive on. We all drive on the right, or the left, depending on where we are in the world, and this, by and large, avoids chaos. Everything else we do on our journey is based on our assessment of conditions (other than stopping at traffic lights!)

To summarise.

We plan our journey from A to B. Our journey has two primary rules:

- Drive on the correct side of the road

- Stop at red traffic lights

Virtually every other decision is discretionary. I accept the above is not a perfect analogy, but to me it best describes the core principles of what I believe should be the foundations to a sensible and workable trading plan. If you have a trading plan which is a 'black box' set of rules, then you are on 'cruise control' and sooner or later you will crash, but as I hope I have explained, a methodology based on such an approach will ultimately fail.

There is no doubt that you do need to have a trading plan, but one that is realistic and workable. This is what we are going to cover next.

Let's start with the easy part - the two rules of driving (trading!)

- **Rule one** - Every position will have a stop loss
- **Rule two** - The maximum loss on any position to be x%

These are the **only** rules which apply to **every** trade. Every other decision you make as a trader should be discretionary, and based on market conditions. The remainder of your trading plan will be developed around you, your personality, time available to trade, experience, trading capital, and many other factors. Nothing else is written as a 'rule' which has to be obeyed come what may. **The only two rules which apply are those written in red above.** It is no coincidence that both of these apply to protecting your trading capital. As I tried to explain in the previous chapter, this overrides everything else. Your trading capital is like the 'crown jewels' and should be treated as such. These two rules are the foundations on which your own personal trading plan is then built. Let's get started on building your plan!

Your Trading Capital

First and foremost, the amount of trading capital that you have available does not dictate your strategy or approach to the market. Many books will suggest that if your trading approach is based on a longer term timeframe, then you will need a significant level of trading capital. This is simply not the case. You can trade long term with a very modest amount, and it is simply a question of trading the correct contract size dictated by your money management rule above.

As a rough rule of thumb, trading strategies break down into two broad approaches, long term and shorter term. Many books will reference three,

namely scalping, swing trading and trend trading, which could also be called, 'short', 'medium' and 'long term'. Long term can be anything from holding a position for days, weeks or even months, whilst a short term position, is anything from seconds, to minutes to hours, and medium is anywhere in between!! I have never been a great fan of these terms, so let's just stick to simple, short, medium and long for the rest of the book! The underlying philosophy and principles are as follows.

A longer term approach to trading is premised on the principle that in adopting this strategy, a trader is prepared to accept a larger loss, in return for a larger potential gain in the longer term. Here, a forex trader might be prepared to accept a 100 pip loss, in return for the potential of a 300 or 400 pip gain in the longer term. Now the quid pro quo is that in order to allow this size of gain to develop over time, the forex trader accepts that he or she has to allow the position to 'breathe', in other words, to allow for the up and down price action to be absorbed. To go back to the driving analogy for a moment, you can think of this as a shock absorber on your car, which absorbs all the bumps and potholes, making your journey much smoother. This is what we have to do in trading, and match this to our timeframe. We have to try to absorb those bumps and potholes, as the price action develops on the chart without breaking our shock absorbers! In fact, this is a very good name for the stop loss - it's a shock absorber - short and simple!

Let's take a look at some chart examples and the approach if you are a short term, medium or a longer term trader. In the following examples I have taken three different timeframes, 5 minute, 1 hour and 1 day, which 'very broadly' represent the three trading approaches. On each chart we've taken a section of the price action where the market is moving sideways in order to demonstrate the 'relative' nature of price action in the various time frames.



Fig 9.10 - EUR/USD 5 minute chart

If we start with the 5 minute chart, the two yellow lines denote a period of sideways price action, where the pair has moved up and down in a 10 pip range. All of the candles in this period are in fact much less than this, with the largest candle at just over 5 pips. What we can conclude from this, in very simple terms, is that on a 5 minute chart for this currency pair, the average pip range is likely to be between 5 to 7 pips. Now, this does assume that there are no major items of fundamental news, which will always play a part, and on a major release, the pair could move 50 to 70 pips in this timeframe. But my point here is this - in general market conditions, where no external factors are imminent, then the typical price range for a 5 minute candle will be in single figures.

Now let's move to an hourly chart for the same currency pair.



Fig 9.11 - EUR/USD 1 hour chart

Once again I have taken the same approach, with a phase of sideways price action shown between the two yellow lines. In this time frame the pair are moving in a 46 pip range, and the largest candle here is approximately half of this, and we can therefore assume that as a very 'rough rule of thumb' this pair will move 20 - 25 pips during an hour (assuming no major external factors).

Finally if we look at a daily chart for the EUR/USD as shown in Fig 9.12:

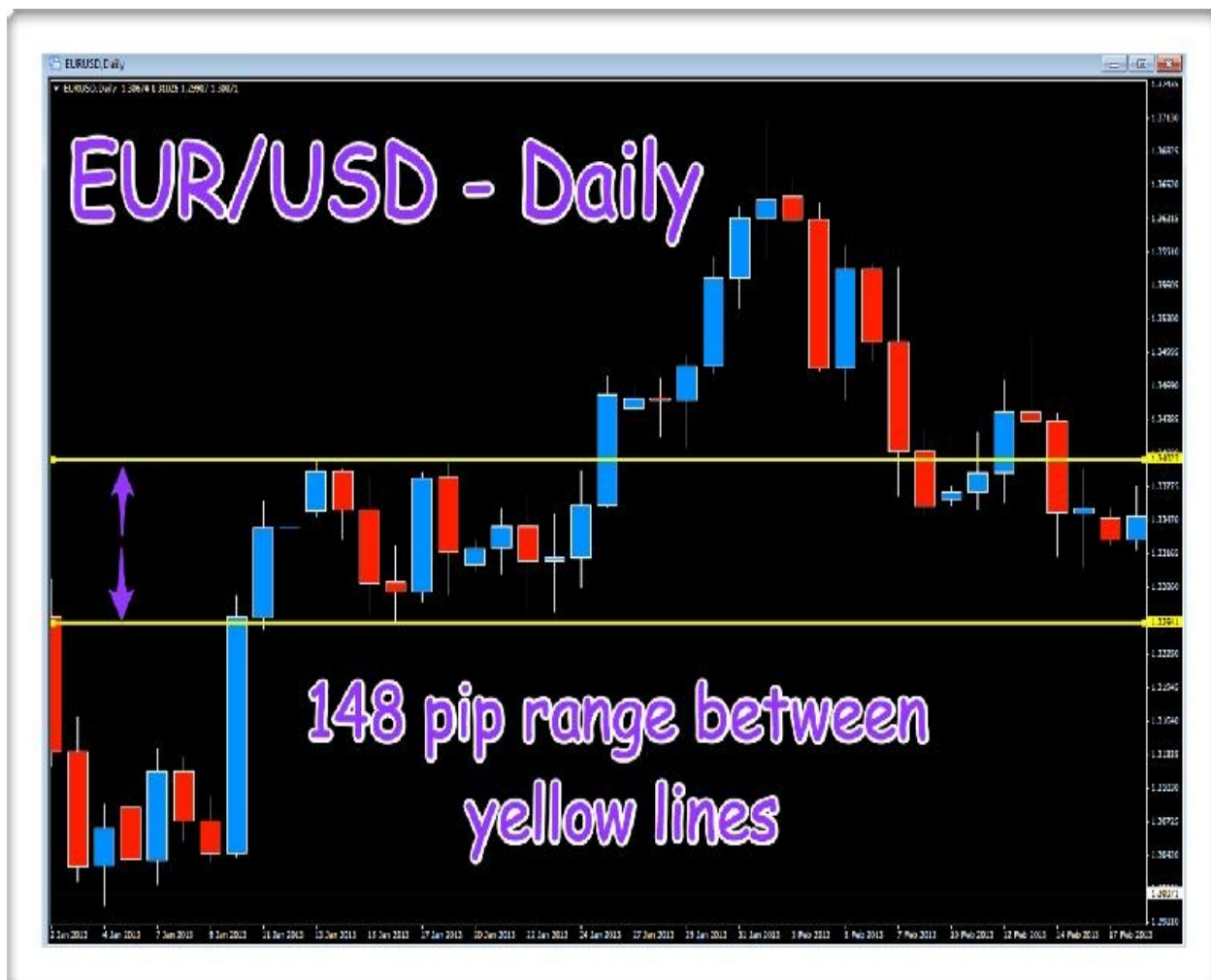


Fig 9.12 - EUR/USD daily chart

Once again, I have taken a period of sideways price action, and here you can see that the spread this time between the yellow lines is 148 pips. The widest candle here is approximately two thirds of this, so in very simple terms we can say that the average pip movement on a daily basis is around 100 pips.

The point I am trying to make here is this. As you begin to think about your approach to trading the market, the correlation between risk management and time frames is positive. In other words, the slower the time frame, then the greater the distance any stop loss needs to be from your entry position, and I hope that in the above examples I have shown you why.

In the first example, on the 5 minute chart, our average movement here was 5-7 pips, so any stop loss position would reflect this and it may be positioned to allow for perhaps 2 or 3 candles to move against you. Perhaps 20 pips would be the maximum here.

As a 'medium term' trader, using the hourly chart as our example, our 'average' candle was approximately 25 pips, and using the same maths as above, we would perhaps be looking to place our stop loss 50 or 75 pips away from the entry.

Finally, moving to the 'long term' approach, with an average candle of 100 pips, our stop loss would need to be somewhere between 200 and 300 pips away from our entry.

I hope that the above examples have explained the 'relative' nature of risk and money management, and how and why this changes depending on your approach to the market. This then leads us on to ask, and answer two fundamental questions which I introduced earlier in the book.

But here I want to explore them in more detail, now that you have an understanding of the relationship between time frames and position management, as you start to think about your trading plan. These two questions are as follows:

- If I only have a modest amount of trading capital, can I adopt any of these strategies or am I limited in my approach?
- How does the maths work in each case and is it different?

In order to answer the first question, we are going to take three examples, using our short, medium and long term approach, and using the same, small amount of trading capital in each example, of \$1,000.

To keep the maths simple for comparison purposes, we are going to use a 2% money management rule. The basic numbers are therefore as follows:

- Trading capital: \$1000
- Risk per trade: \$20
- Pip stop loss - 2 times average candle value

Short Term Trading Example

From our examples above, the average candle movement on a 5 minute chart, is between 5 and 7 pips, so let's take 10 pips. Our maximum loss that we are going to accept is therefor 2 x 10 or 20 pips.

Our money management rule states that our maximum financial loss is \$20.

The maths here is very simple. Our stop loss is going to be placed 20 pips away from our entry, and we are prepared to lose \$20, so if we divide the dollar amount by the number of pips, this will tell us the \$ per pip as follows:

- $\$20/20 = \1 per pip

In other words, to meet all our criteria in placing this position in the market we could use 1 mini lot contract at \$1 per pip.

We know from earlier chapters in the book that 1 mini lot is also equivalent to 10 micro lots, (1 micro lot = 10 cents per pip), and in this example this would be perfectly acceptable. All the rules remain fulfilled. This also opens up an alternative approach which is to use a smaller number of micro lot contracts, as the rules in your trading plan are always the maximum. This does not mean you have to use the maximum on each position, but simply defines the maximum allowable. There is nothing wrong with staying below the maximum, and using micro lots in this example does just that!

Suppose we only use 5 micro lot contracts in this example, so \$0.50 cents in other words, rather than \$1. What options do we have now? Well several in fact as follows:

- Increase the number of pips we are prepared to lose to 40 pips ($40 \times \$0.50 = \20)
- Keep the number of pips we are prepared to lose at 20 pips, which reduces our financial loss to 1% ($20 \times \$0.50 = \10)
- Enter with 5 micro lot contracts initially with a 20 pip stop loss, and then add a further 5 micro lot contracts once the position moves in our favor. This would then equate to the original maths of $10 \times \$0.10 \times 20 = \20

I hope from the above very simple example, you can begin to see that everything stems from the simple rules that underpin your trading plan. I am going to cover and explain stop loss management and positioning in due course, and as you will probably appreciate, this is an art and not a science. Nevertheless, the maths which underpins it is key, and I hope that in the example above, using a short term approach to the market, you can see that even when you have clearly defined your money management rules, you still have the flexibility within those

rules to be 'creative' in your trading approach. This is what we call, 'position sizing' which simply means adjusting your position to fit your money management rules. There is no mystique and it is really very simple, once you appreciate that it is a 'backwards process' of starting with a financial value, and then applying this to an equivalent in pips, so that your rules always remain intact.

Also, let me make the point again. Whatever rule you have as your % at risk, whether it is 1%, 2% or 5%, this is the **maximum**. It is not a target to be aimed for, but merely a level which must never be broken.

Medium Term Trading Example

If we take the same approach based on our hourly chart. And here let's assume 25 pips is the average, so our maximum loss is 2×25 or 50 pips.

Once again, we are going to use the 2% rule for our money management, which is our \$20 again, and as before we divide the pip value by our money value:

- $\$20/50 = \0.40 per pip (40 cents per pip)

Now our rule set is dictating the contract size for us, and we cannot trade using a mini lot unlike our first example. In this case we can only enter positions in this time frame using micro lots, if we are to maintain our rules. Here the maximum number of contracts is four micro lots.

Once again though we have some options. Suppose we halve the number of contracts again, reducing this to 2 - this opens up the following possible alternatives:

- Increase the number of pips we are prepared to lose to 100 pips ($100 \times \$0.20 = \20)
- Keep the number of pips we are prepared to lose at 50, which reduces our financial loss to 1% ($50 \times \$0.20 = \10)
- Enter with two micro lots initially and if the position moves in our direction then add the other two. This then equates to our original calculation of $4 \times \$0.10 \times 50 = \20

Again, several options here, but the key point is this. In moving to a slower

timeframe, and with the same amount of trading capital, we no longer have the option to trade using a mini lot, and are forced, by our rules, to use micro lots instead. If we did want to trade using a mini lot, then either our rules need to be changed, with an increase in percentage risk on our capital, or an increase in our trading capital.

Long Term Trading Example

Finally, let's move to our long term example where we are proposing to take a position in the market using the daily chart.

From our example earlier, if we take 100 pips as the average and a factor of two, then our stop loss value in pips is 100×2 or 200 pips.

Taking our 2% money management rule again, this equates to \$20 and if we then divide this by our number of pips, this gives the following:

- $\$20/200 = \0.10 per pip (10 cents per pip)

What are our options now? The short answer is none. We are now at the extreme of our money management rule, trading the smallest contract size, a micro lot, on the longest timeframe, and there is no room for maneuver, other than to reduce the number of pips in our stop loss position (which we could do).

However, what I hope this last example has proved, is that even with a modest amount of trading capital in your account, and with very conservative money management rules, it is perfectly feasible to take a longer term approach to trading, and still maintain that balance of risk and money management which is so crucial. It also goes to show, I hope, that within each approach, you have some additional flexibility in adjusting both the way any position is built in the market, as well as reducing your financial risk if you wish, provided your rules are never breached. The only example where this was not the case, was the last, where our rules dictated the absolute position we could take, no more no less.

How Do I Choose My Approach?

This is a big question to answer, and before I start trying to answer it, let me begin with some broad principles, which we can then consider in more detail.

- There is no right or wrong way to trade - it is your way

- Short term trading is more stressful than longer term
- Trading success as you start is about consistency, not money
- Your approach will be based on many factors, such as time available, personality, attitude to risk

First, there is no right or wrong way to trade in the forex market, despite what you may have been told or read elsewhere. I hope that in working through the above examples first, it has proved to you that even if you only have a modest amount to start with, every approach is feasible.

The choice is yours, and one of the major influencing factors may well be the time that you have available. One of the pieces of advice I always give to new traders, is never give up any full time job, and the trick is to find a way to combine your job and your trading, which is why I took so much time in explaining how you can trade the longer term timeframes, even with a small trading account. Trading longer term positions allows you to continue any full time employment, as you build up your trading experience. Longer term trading has many advantages and this is one of them - you do not need to sit in front of the screen, hour after hour. This is also why this approach is less stressful, since you are not exposing your emotions to the market, of which, more in the next chapter!

Let's take this in reverse order then, as I suspect that if you are relatively new to the world of forex trading, then this approach may be the place to start for several reasons:

- It allows you to continue to hold down a full time job, whilst you start to learn and build up your knowledge. This way, you can have two streams of income, one from your job, and one from trading
- It does not require you to be sitting in front of the screen for hours at a time
- It is the least stressful way to trade as you place your position and leave it to develop
- You can trade all the pairs as spreads are of less concern in the overall profit and loss figures
- By default you trade less, so your costs of trading are less (there is no such thing as a free lunch)
- It allows you to take advantage of the most active periods of market price action, wherever you are in the world

Let's look at these one by one, and in this approach we are primarily focused on the daily and weekly chart timeframes, with a four hour chart, the 'fastest timeframe'. Here we would be considering the four hour chart, basing our decision on the daily chart, and then considering the weekly chart for the longer term trend.

If you have a job - keep it! That's my advice. You may have started forex trading as your route out of the daily grind, which is fine, but be patient. If you jump too early, you will put too much pressure on yourself to succeed. There is enough pressure just trading. You don't need any more by having to trade in order to pay the bills, so ***don't do it***.

If you have read another of my books on Volume Price Analysis, you'll know that I began my own trading career many years ago in London, following a two week course. What I do remember very clearly though, is several students calling their employers towards the end of the course, and resigning. This was madness in my view, and something I have always advised new traders, never to do, however desperate you are to leave and trade full time. Look on the positive side and consider your job and your current employer as merely supporting you, while you learn a new skill.

A longer term approach means you do not need to sit in front of your screen. After all, you have a position in the market which is fully protected, and you should only need to check this once or perhaps twice a day at most. The problem for many traders is simply that when they sit in front of a screen, they feel they must trade, and something called 'over trading' then becomes a real problem. In other words, trading for the sake of trading. The reason for this is simple to understand when you begin to think about it. After all, trading is now your job, and if you are sitting in your 'office' in front of your screen, then your brain will be telling you that you need to trade - you should be 'doing something'. It is the hardest thing in the world to sit in front of a trading screen and do nothing. This is why the longer term approach, coupled with a job, works well. It saves you from this problem, since you are simply not there. You are at work, but learning nevertheless.

Now another issue is the cost of the trade, and despite what you have read, there is no such thing as a 'free lunch'. Whilst every MT4 broker will offer you 'free trading', the costs are already built into the spread. Those currency pairs which are the most heavily traded such as the majors, will have relatively tight spreads of a few pips. However, some of the less heavily traded pairs will have much

wider spreads, which make them almost impossible to trade on a short term scalping basis. After all, if the pair has an 8 pip spread, and you have a 15 or 20 pip stop loss, this is a massive percentage to be absorbing into a position. This is rather like running the 100m, but giving everyone else a 40m start.

On a long term strategy, this can be absorbed easily, since you are taking a longer term view and a stop loss of 200 pips plus. An 8 pip spread here is now very small in percentage terms.

As I have outlined above, you trade less by default, since you are out at work. This prevents you from falling into the 'over trading' trap.

Finally, one of the problems that many new forex traders face, is in accessing the markets when they are at their most active and liquid. For traders like myself who have the 'double luxury' of living in the Northern Hemisphere, as well as being able to be in front of a trading screen, this is easy. I have the best of everything. I can trade in the forex market at a sociable time, during the London open and into the US session, and I also get to sleep when the markets are relatively quiet in the Asian and overnight sessions.

For traders in other parts of the world this is not so easy. The London and US sessions may be in the middle of the night, and made even more difficult to access if you are out at work during your daytime hours and need to sleep - not unreasonable! This is where a longer term strategy can help, allowing you to take advantage of these active periods, as well as allowing you to lead a normal life as you start your own trading journey.

This is why I went to some lengths to explain that longer term trading is possible. I am not advocating it as the best way. It is one way which has many advantages, and particularly if you are just setting out on your own trading journey. It is one approach which you need to think about carefully, as it may be the one that helps you get started, with the least amount of risk.

Moving on to consider the medium term approach, the timeframes we would focus on here would be the 30 minute, the hour and the four hour charts, with perhaps the daily as our guide to the longer term trend. We may even move up to the 4 hour chart as our standard, with the 1 hour chart below, and the daily chart above.

Once again, this is an approach that can be tailored and adapted to suit work and family commitments. After all, two candles on a four hour chart are equivalent

to the working day, and once again allow you to take advantage of the most liquid trading times, even if these are at unsociable times or at night. Trading in these slower time frames is relatively stress free. The intra day volatile price movements are absorbed into these longer term candles, removing much of the emotional pressure which can be damaging when you are constantly sitting in front of the screen.

Finally, we have the third approach - the very short term scalping approach, which is probably the most widely adopted by forex traders around the world. This is fine if you do not have a full time job, and can dedicate the time needed to sit in front of a screen for long periods of time. However, there are several issues you need to consider carefully in taking this approach and these are as follows:

- Time - you do need to be able to commit the time to spend in front of your screen
- It is very hard to combine this approach with a full time job
- Intra day trading can be much more stressful as you are watching positions move up and down minute by minute
- You will be restricted to those currency pairs with narrow spreads as the maths simply does not work otherwise
- Your timezone may be far from perfect to allow you to take advantage of the most active markets during European, London and US sessions
- There are higher costs of trading, as you will be a more active trader
- The issue of 'over trading' becomes a real problem

There are many other issues which you will need to consider carefully, and perhaps even discuss with your family as you get started. Your trading approach has to fit in with many things, not least your work/life commitments and this is something that you will have to think about, and judge for yourself. As I said at the start, there is no right or wrong way to trade. The right approach is that one that suits you, your commitments, your lifestyle and your personality.

Technical Or Fundamental?

Having decided on the broad approach you are proposing to take, the next questions you might ask yourself in developing your plan, are as follows:

- Am I going to be a technical trader?
- Am I going to be a fundamental trader?
- Am I going to adopt both approaches and bolt in relational in due course?

Once again, there is no right or wrong answer. As we saw when I introduced these approaches earlier in the book, they have very different underlying philosophies. The central tenet for a technical trader is that the price chart is everything. Within each price candle are the views of every investor, trader and speculator around the world. The price chart is the fulcrum of risk and market sentiment which is displayed second by second before moving on to the next phase of price action, whether on a tick chart or a monthly chart. The price also contains all the news which is absorbed and then reflected on the chart. In other words, the price chart contains and displays all the information about the currency pair in a simple and visual way. Any trading decision is then based on the chart using a variety of technical tools and techniques.

The fundamental approach is entirely different in concept and approach. Here, trading decisions are based on the 'pure economics' of the market. The underlying philosophy of the fundamental trader is that currency strength and weakness is determined by the 'big picture' data which reflects imports and exports, interest rate differentials, inflation and deflation, economic cycles, employment, housing, retail sales, manufacturing, and a whole host of other numbers, which determine whether a currency is in demand or not. For a fundamental trader, the technical picture is irrelevant, and they will only consider the chart when ready to trade, and as the mechanism by which they open a position. They do not believe in support and resistance, candlesticks, candle patterns, volume, or indeed any other technical indicator. Their analysis of the market is purely based on the economic picture, both at the macro and micro level.

Technical and fundamental traders never agree. Both maintain that theirs is the right approach, and the other is wrong, and here is where I step in.

By all means investigate both as you will need to understand both, and my advice is simple. If both approaches have value, why restrict yourself to one or the other - use both! And in my case, I use a third which is the relational element that I introduced earlier in the book.

My own trading has been based on a technical approach, ever since I first started all those years ago. However, I am the first to admit that I pay great attention to

the fundamental aspects of broader economics, for many reasons, but for one in particular. Even if you decide ultimately that you are only going to trade using a technical approach, the fundamental news is always there. It dominates this market, and you only have to look at the economic calendar to appreciate why. Every day is full of economic releases, statements and news announcements from around the world, which will impact the price on release. Therefore, in a sense, you cannot avoid fundamental releases anyway, as one of the decisions you will have to factor into your trading plan is this. Do I trade ahead of the news, through the news, or wait until after the news has been released and the market has reacted accordingly?

In other words, the news is there whether we like it or not, and to simply ignore it would be foolish in the extreme. If this is the case, then even if you ultimately decide that your approach is purely technical, the fundamental will always have an impact, whether in the timing of your decision in opening any new position, or simply how it affects the price on the chart. You may decide, as many forex traders do, to ignore fundamental news completely, and simply consider the timing aspect. In other words, check the economic calendar on a daily basis, and note the times when the major releases are due. You can then simply avoid these completely, or manage positions closely during any release.

There are many free sites with good economic calendars which list all these for you and generally for weeks and months ahead. The site I use myself as you know is <http://www.forexfactory.com>, but there are others. The common theme with all these sites is that the news is ranked in terms of impact on the market. A red flag indicates an important item which will have a major impact, whilst orange and yellow releases have less significance. In addition you will also find a wealth of other information, including historical charts for the release, an explanation of the data, a forecast of the expected number, and links to any associated sites or statements.

If you do decide to pay closer attention to the economic news, then this is a big subject in itself, but worth the effort required to understand, what is, in every sense, the ‘big picture’.

In a short book, such as this, it is impossible to give you a detailed view of the fundamental approach, but let me try to build on some of the concepts I introduced in an earlier chapter, which I hope will at least lay the foundations for you. The approach that many novice forex traders take, which I believe is a common sense approach, is to start by learning the technical approach first, and

then to build on this knowledge adding in the fundamentals. Economics, after all, is a subject in its own right, and we are not studying to become an economist, just that we have sufficient knowledge to understand why the market has reacted in the way it has, or perhaps how it is likely to react in the future.

Therefore, let me try to give you some broad concepts here, which I hope will help, and the first point is as follows.

No single item of economic news, no matter how important, is likely to reverse a longer term trend on its own. It will have an impact short term, and the market may reverse sharply on an intra day basis, but looking at the longer term trend, this is unlikely to change, unless the number is reinforcing a longer term change in the data itself. Let me explain.

Most forex traders will be aware of the monthly release in the US, the Non Farm Payroll. This is a number which always moves the markets, whether the number comes in above, below or at the market's expectation.

Most forex traders will also simply look at the headline numbers in much the same way as the media, since this is a quick and easy way to absorb the information. However, as I mentioned earlier, when you start to look at an economic calendar, such as the one on the Forex Factory site, you will find an historic chart which details all the previous releases going back over the last 12 or 18 months.

If the chart shows a pattern, let's say of rising unemployment, and the number is positive, with a fall, this alone will not trigger a major change in the longer term trend. It may be the first signal, but on its own, it will not be enough to see any longer term trend reverse. My point is this - always check how an economic number fits into the trend of the longer term. If the number confirms the trend, then it will continue. If it is 'against' the trend, then the market may pause and reverse in the short term, but the longer term trend will remain in place, if and until this data is confirmed, either in subsequent months, or by other associated news.

The second broad principle is this.

Economic data from one country will impact all currencies, particularly for major economic powers such as the USA, Japan and China. China is a classic example and every economic calendar now carries releases, since the economy of China is now so dominant, that any changes here are likely to have an

immediate impact on global markets. Chinese data moves every market from equities to currencies, commodities and bonds, and perhaps even more so at present. With the markets generally very nervous following the financial collapse in 2007, any changes in Chinese data are seen as extremely significant, and are the 'hair trigger' on which markets focus at present. This will change over time, but is likely to remain a feature in the short term.

Third and last, and as I mentioned earlier in the book, economic data is cyclical in nature. In other words, at present, given the ultra low interest rate environment that exists in the world, these economic releases are far less significant, since this is a feature which is likely to remain in place for the next few years. This will change, but not just yet. As a result the markets tend to focus on those releases likely to signal expansion and growth for an economy.

This in turn will lead to changes in interest rates in due course, which in turn will then become significant once again. It is rather like the leader board in a game of golf, or the teams in a football league. Throughout the tournament or the year, teams or players will move up and down the rankings, sometimes they are at the top, and sometimes they move lower - it is the same with the 'groups' of economic data. The market focus will change, depending on where the global economy is in terms of expansion or contraction, and the associated inflationary pressures which will then be reflected in related markets.

Now you may be reading this and thinking this all sounds very complicated. After all, we are here to trade and not to be economists or market analysts, which is certainly true and is a very common feeling. There is a great deal to think about when you first start, and my advice here, is always the KISS principle - **Keep It Super Simple**.

With simplicity in mind, let me highlight what I believe are the first steps to take when thinking about developing your own approach to a trading plan. The plan is there to provide the foundations of your trading, and not the detail. I could even go one stage further and say that it is really there to define the money management aspects of your trading approach, and from which all else flows. After all, if this is not in place, then it is almost impossible to be precise in the other aspects of your plan.

Here then are the initial steps which you need to consider as you develop your trading plan:

Step One

Decide on the amount of your initial trading capital. This should be money you can afford to lose, and not be borrowed or loaned.

Step Two

Consider your family and financial commitments carefully and the time you may have available for trading. Think about the markets, the best times to trade and how this fits with your own personal work/life balance. If you have a job - keep it - your trading plan has to fit into your life, not the other way round. Look for the best fit, and adapt your trading approach accordingly.

Step Three

Which approach are you going to take? Purely technical, purely fundamental, or a mixture of both. Explore them both. Read and digest arguments from both sides, then make your own mind up. Relational comes later, much later, as your experience grows.

Step Four

Think about the advantages and disadvantages of various trading approaches. Your chosen approach may be dictated by your personal circumstances. If not, then consider the pros and cons of each, and in particular how each will suit you, your temperament and your personality. This is extremely important and needs careful thought and consideration. There is no right or wrong way to trade, just the way that suits you.

Step Five

Set yourself realistic, simple and achievable targets, which should be non-financial. Do not set monetary targets. Trading success is about two things primarily - consistency and money management. If you can be consistent over an extended period, then the money will flow. Being consistent is about the number of pips you make in a week or a month, not about how much money. Twenty pips a week may not sound very much, but at \$10 per pip it's \$200 and at \$100 per pip it's \$2,000 per week. Once you have a solid set of money management rules in place with your plan, then you are looking for consistency. From consistency comes money - it's just a question of increasing your contract size on each trade.

Step Six

Define your money management rule depending on the amount of trading

capital. The minimum is 1% and the maximum is 5%. The rule you set is the maximum - you do **not** have to use it on each position!

Step Seven

Based on your decision about your approach to the market, both in terms of timescales and technical, fundamental, or a combination, you now need to start thinking about how you are going to define an entry to the market. What is the trigger? How do you decide? What are the rules? Are there any rules or are you going to be a purely discretionary trader. All of these things you will need to consider and seek guidance. Again, there is no right or wrong answer here. There are many, many ways. You may decide that a piece of software is the correct way to start, or perhaps using one of the many technical indicators which are freely available?

I will give you my own view later in the book, as this is a huge topic in its own right. Many traders like to define hard and fast rules in their trading plan. In other words, I will do A if B happens. This could be very simple, or complex, but in essence it is a rule set that defines the entry. It will probably not surprise you to learn that this is not a route I advocate for many reasons, not least of which is that this is too prescribed. It verges on the mechanical, and the market is not a mechanical animal. If it were, then trading would be very easy.

If your entry is going to be discretionary, then that's fine, but within your plan you just need to try to define what the parameters are that signal an entry or what's often called a 'set up' for your new position. What you will probably discover is that your entry decision will be based on a combination of elements, perhaps, as in my case, volume, price action and a simple indicator.

Step Eight

Define your management and exit rules. This is another very grey area for novice traders, and I'm afraid one that non traders write about a great deal, and sadly write a great deal of nonsense. Again, I am going to cover this in much greater detail when we start putting everything together, and the reason I include it here is simple. You do need to say within your trading plan how you are going to manage any position, and what your exit is based on - if it is purely discretionary then that's fine and no problem at all.

Many trading books at this point will suggest a simple risk reward relationship and once that has been met then you exit. This sounds very simple in theory, but

that's where it stops - in theory! The practical is very different. After all, why should the market give you 20 pips if you are prepared to risk 10. Or 30 pips, or whatever target you have in mind. The market does not work this way and never will, which is why you have to be discretionary in your trading management and exit.

Let me explain with a simple example which combines the entry and the exit and uses the hammer candle, and the shooting star candle that we looked at in one of the early chapters.

Suppose your entry rule for a long position is a hammer candle and the associated exit rule is a shooting star. The opposite would be a shooting star for a short position as your entry trigger, and a hammer candle for your exit rule. A very simple rule set, which can then be applied to your trading timeframe which might be a 5 minute chart, an hourly chart or a daily chart. That is your rule.

Do you follow this rule blindly and without thought on each position? Well possibly, but I doubt it very much.

What happens when your entry rule, a hammer for example, is then followed on the next candle by a shooting star. Do you exit immediately? Probably not, and the reason, is simple. You have only just entered the position and your mindset is still in 'hope'. You are hoping for a profit and not yet prepared to consider exiting at a loss after such a short space of time, which is one of the reasons these types of rules simply don't work.

The corollary to this, is that you might say, well I will adjust the rule to say after X bars. In other words, if my exit candle appears within 1 or 2 candles from my entry, then I will ignore it under my rules. Very soon, your rules become discretionary, or very complicated!

Let me give you another example which is a common rule that traders apply when trading in a market that has a physical exchange with an open and close - stocks for example or an index future. The rule here is generally something along the lines of: 'never take a trade in the first ten minutes of the open'. This sounds very plausible. In other words, let the markets settle down before taking a position. But why 10 minutes, why not 9 or 11 or 15 minutes? And what happens when an opportunity appears after 9 minutes and your rule states that no position is to be taken before 10 minutes have elapsed. Do you wait? Do you take it? Is one minute important? This is what happens when you put these sorts of rules into a trading plan, which is why I have a problem with them, and I hope that

you can start to see why!

I'm going to cover this in more detail later in the book for you, but this is perhaps the one area that is the most difficult for new traders. The only rules which are set in stone are your money management rules. Everything else is discretionary, they have to be. Traders who have trading plans which have no leeway will fail ultimately. The plan may work for a while, but market conditions then change, and the old rules no longer apply. It is rather like opening a shop and saying that today I want to make X. Well you may want to, but what if the weather is bad, the road is being dug up, it's a Monday, or a shop close to you is having a sale? All these factors will play a part. Nothing stays the same day to day, and it's the same with the markets. Every day is different, every day there are different forces at work, and to think that a mechanical plan will work consistently is somewhat naive.

Your plan needs to reflect this and needs to be practical. If you are going to take your signals after a break out from congestion, then say so. If you are going to do this in conjunction with a technical indicator, then say so. What your plan will not say is precisely when you are going to act. Equally, if you are going to exit when the market moves into a congestion phase, then say so in your plan and you will then need to explain how that congestion is defined on your chart. At least you then have a basis, a framework around which to work, and not some hard and fast rule set which is unworkable, inflexible, and probably much too complicated.

Don't worry, if this doesn't make sense right now, it will by the end of the book, but remember, I will be teaching you what I believe is the correct approach - you may disagree! But I hope I can convince you.

Step Nine

Then choose your broker with care - there are many good ones out there, but quite a few bad ones. Make sure you carry out due diligence before sending off your hard earned trading capital. I explain all about the good, the bad and the ugly of the trading world later in the book, as well as the various types of brokers and the questions to ask.

Step Ten

Execute your first trade with the minimum contract size available. I do not believe that paper trading in a demo account teaches anything of value, other

than perhaps how to use the trading platform. In many cases the live and demo feeds are very different from one another, and any strategy you decide to test in a demo account simply will not work in a live account. Spreads may be very different and some orders may simply not be available. My advice is to go straight to a live account, but trade using a micro lot as a starting point as you get started. This will allow you to become familiar with the platform, with trading, with entering, managing and exiting positions, using the smallest financial risk possible.

When you have a live position, focus on the pips, not the dollar amount. This will help to reduce the trading emotions, which I will cover shortly in more detail.

Finally, keep a diary of your positions and why you opened them. This can be very simple, but will help you to improve from the insights gained when you look back at your trading history. Note down what you traded, and when, the entry trigger, and why you closed out, along with details of what happened next. This will then build into your own personal trading diary and also help to highlight possible problem areas. Perhaps you are being stopped out too often, in which case you may need to adjust your lot size and increase the pip loss per trade. Perhaps you are closing out too early and exiting strong positions too early. Perhaps you are trading with a bias, always short or always long.

All these things and many more will be revealed in your trading diary. It does not have to be pretty and no one else will ever see it, but keep one you must. It is the diary of your trading journey and will help you enormously as your skills and knowledge develop.

Finally, your trading plan is a living thing. Don't be afraid to make changes to it, to tailor it or adapt it, as your circumstances change and your knowledge grows. Nothing is cast in stone for ever and provided you maintain your money management rules, everything else can be modified to reflect changes in your personal life.

In the next chapter we're going to explore the emotional side of trading, and how to manage these emotions effectively. Understanding who you are, is the starting point, and from there everything else can be managed and tailored to enhance your trading success.

Chapter Ten

The Psychology Of Trading

If you personalize losses, you can't trade

Bruce Kovner (1945 -)

This is another very important chapter. It is even perhaps *the* most important, because it is the psychology behind trading which will ultimately determine whether you succeed or fail as a trader. Whilst being able to read a chart using price and volume is important, without an understanding of why trading really is 'all in the mind' you are doomed to fail, or locked into a cycle of behavior, which will destroy your wealth, and sometimes even your health. Trading, when distilled down, is really a question of how well you can manage your mind.

These may seem harsh words but they are a fact of life, and in this chapter I am going to try to explain to you why, as a trader, you need to treat the mental aspect of trading with as much respect as any technical or fundamental analysis of the market. I am also going to explain why you need to understand just as much about what is going on in your head when you trade, as you do about the market.

As traders we are constantly told that having the right 'mindset' is paramount to success. We are also told that a successful trader needs to be 'disciplined' and needs to remove all emotion from their trading decisions, which I can assure you, is easier said than done. Trading psychology books and manuals will also stress the importance of having a trading plan, as well as the significance of our personal beliefs about money and risk. Most books will also explain how such deeply held beliefs about money and risk can cause traders many problems, and because often these beliefs are unconscious, they only manifest themselves during the trading process.

In other words, because trading is about loss and risk it can, and does, make us face up to our innermost beliefs about ourselves, our view of the world and can even trigger deep fear and emotional responses more commonly associated with stress and trauma. In many ways trading is the mirror which reflects an internal world which we rarely consider or examine. Trading forces us to face up to these

inner thoughts and feelings. It is the mirror which we rarely view.

During my live webinars and seminars I always explain that trading is so stressful it can trigger our flight or fight response. This is the response that kept us safe during our early evolutionary history when most decisions were likely to be whether to face the 'tiger' (or other wild animal) and fight and face possible death, or run for safety, and live to fight another day.

In my rooms I also highlight what I call the 'unholy trinity' of trader fears. The first is the fear of a loss. The second is the fear of missing a trade, and the third, and perhaps the one which causes traders so many problems, is the fear of losing a profit. It is this fear which makes traders cut short their profits, and is the single reason brokers have given me as to why so many traders fail. However, before I move on to explain how to combat and overcome these fears I want to clarify how and why our 'trading brain' is so easily hijacked by these fears, and what happens when one of these fears is triggered.

But first a very short lesson in evolutionary biology.

Our brain is a truly wondrous organ, capable of great feats of imagination and creativity. Our brains also have an almost infinite ability to learn. We are the only creatures on this earth blessed with the ability to think highly complex and abstract thoughts. Our brains are designed to seek out novelty, and rewards social interaction with the release of the chemical oxytocin, which makes us feel good. We are biologically stimulated to love or hate what is most familiar to us, and we are built to form attachments and to value what we own.

We are also the only creatures able to delay gratification. Studies in the relatively new field of neuroeconomics have shown that forgoing a present reward for a larger reward later, requires intense activity in the mature part of the brain, namely the prefrontal cortex, located at the back of our frontal lobe, and is part of the neocortex. As the name suggests, the frontal lobe sits at the front part of our brain.

It is the prefrontal cortex which is also responsible for higher level thinking, as well as our ability to concentrate, plan and organize our responses to complex problems. It also searches memory for 'relevant experiences' or previous patterns, and it is capable of adapting strategies to accommodate fresh data whilst also housing working memory.

From the above description it is abundantly clear that this is the part of the brain

which should be engaged when we trade. It is the part of the brain which allows us to make cool, logical and common sense trading decisions based on a clear analysis of our charts. Sadly, it just does not happen, and the reason for this lies in our evolutionary history.

Moreover, this area of the brain is the most recently evolved as our brain is the result of a long process of evolution, with a timeline counted in millennia. In very simple terms, the easiest way to understand our brain evolution is to use the 'triune brain theory', first developed by Paul McLean. In this theory, evolution has delivered three distinct brains and stages of development which now co-exist inside our skull. These three do not operate independently, but are linked via a highly developed and complex web of neural pathways.

The first (and oldest) is the reptilian which controls our vital functions, such as breathing, heart rate and temperature. The second to emerge is known as the limbic and is made up of a group of structures which serve to evaluate sensory data quickly and trigger a motor response. In other words, assess a situation and prepare the body for either fight or flight. And finally, the third, the neocortex, which is the brain which sets humans apart. It is the neocortex that has allowed us to develop new levels of advanced behavior - particularly social behavior as well as allowing us to develop language and higher level consciousness.

As you will appreciate, the above explanation is an over simplification of the structure and function of our brains. However, it is a necessary first step in establishing the significance of understanding what is happening inside our head as we trade, and why it is just as important as understanding what is going on in the market.

For traders the area of the brain which can cause so many problems lies in the limbic system, and is known as the amygdala. This area is also often referred to as the brain's fear centre, and is responsible for producing the fight or flight reaction. As the 'fear centre' for the brain, the amygdala ensures we recognize and recall danger. It triggers our emotional fear responses by performing a 'quick and dirty' assessment of what is happening, and we respond even before we know it.

For example, if we are walking alone at night and we see a dark shadow, and perhaps hear an unexpected noise, our heart will start to race as fear begins to take hold and our body prepares to either run or stand and fight. At an earlier stage in our evolution, at a time when the local cats were more likely to be sabre

tooth tigers, it was those humans who reacted the fastest, and without thinking to such signals, who survived the longest.

So fear is there for a good reason. It is there to keep us safe and protect us, and has ensured our survival. This automatic response is so powerful it is triggered even when there is no direct danger. Charles Darwin proved this in his study of human emotions. In one experiment he placed his face behind the thick glass of a puff adder's enclosure and steeled himself to ignore the inevitable strike. However, when the adder did strike he jumped back, much to his own annoyance.

But, what does walking along a dark alley at night and Charles Darwin's reaction to a caged puff adder have to do with trading? And the answer is, in both these scenarios it is the amygdala taking control and responding to a threat or perceived threat. For traders the trigger could be the fear of a loss, or even a sudden movement on a chart. Either can trigger the fight or flight response, and the amygdala simply reacts in the way it has done for millennia, in an endeavor to keep us safe.

As traders we should know that trading is primarily about managing risk in a universe that is perpetually uncertain, sometimes random and very often totally irrational. However, our brain simply does not like it and therefore reacts accordingly, in an effort to keep us safe.

To me this analysis and interpretation behind the psychology of trading just makes sense, and I am indebted to a number of experts who have helped confirm and clarify this for me. These include Dr Bruce Hong, a self directed trader and doctor specializing in ER medicine. Sadly, his personal blog is no longer available online, but we are fortunate enough to have an archived interview he did with Stocktickr, in which he gives traders some extremely valuable insights and suggestions. In addition, there are some very useful comments Dr Hong posted on several trading blogs which explain how and why traders become so stressed.

In these comments Dr Hong gives the biological explanation of the stress response, and the effects of the adrenaline rush which follows. What I find so charming and endearing about Dr Hong is that he is the first to admit his own failings, as a trader. His tagline for his blog was "How good people (traders) develop bad habits - and how to overcome them". He was also searingly honest about his own 'bad' trading habits and his mistakes.

Dr Hong's comments were posted in response to what he perceived to be a misunderstanding of the biological role of the adrenaline rush, and an over simplified explanation of its effect. Dr Hong's explanation, from a medical and trading perspective, is invaluable and if you would like details, please drop me an email at anna@annacoulling.com and I will send you further information.

In the meantime here is short quotation which does not need any elaboration:

*“Adrenaline is released immediately upon a perceived stress. Even **thinking** about a threat can cause this. Man, as far as we know, is the only animal that can create his own stress, just by thinking about it!*

The adrenaline then causes immediate cortisol synthesis and release. As it increases heart rate, blood pressure and redirects flow away from the skin and digestive organs and to the muscles and the brain, the cortisol is transported directly to the brain. This takes time but, for all practical purposes, is instantaneous. There, cortisol mediates the changes in regional cerebral blood flow.

*But, it does some even more interesting things. As I said, it shifts blood away from the frontal cortex but it also makes the Amygdala **more responsive and more likely to establish memories**. The Amygdala is that portion of the brain that adds emotional context to newly formed memories. And then these memories, when recalled, are associated with those strong emotions. This, incidentally, is how we think that PTSD starts.*

*Even more important, **only one repetition** may be required to form a lasting memory. After all, how many times do you have to have a tiger jump out at you, before you learn to avoid tigers!”*

The most important section of this short explanation is the reference to memory, and how the amygdala adds the emotional context or wrapper, which for traders can be devastating. If it only needs a single repetition of a stressful experience to form a lasting memory, is it any wonder so many traders find it so difficult to ‘pull the trigger’ on a trade.

My second expert is Dr Joseph LeDoux. He is Professor of Neuroscience and Psychology at the Center for Neural Science at New York University. His approach is to try and establish a biological understanding of our emotions and has written how systems in our brains work in response to emotions, particularly fear. Professor LeDoux also uses music, not only to explore emotions, and he

also plays music about the mind and brain. His band, The Amygdaloids, uses music to convey complex scientific information in a user friendly way.

It was during my own investigations into Professor LeDoux's work that I first considered having music in the background while trading, instead of rolling financial news. From my own totally unscientific experiments I can honestly say that listening to Bach instead of Bloomberg really does work.

My third expert is Richard Friesen of www.mindmusclesacademy.com who I first came across in an article he wrote for Stocks, Futures and Options Magazine. The article was entitled 'Train your Brain' - How to Trade Using Instinct and Reason.

In many ways Richard's work brings it all together for traders. Not only is Richard an ex pit trader, but he now holds a Masters Degree in Clinical Psychology, along with certification in Gestalt Therapy and NLP (Neurolinguistic Programming). It is this background which has led to the development of training programs that produce profitable traders and trading systems, the latest of which is the Mind Muscles Training Program.

Richard has kindly given me permission to quote and reference his work, for which I am very grateful, but I would urge you to read the 'Train your Brain' article. It is difficult to find online, but I have uploaded my personal copy to Facebook, and if you would like to read the article, simply click the link here, and download the PDF:

https://www.facebook.com/learnforextrading?v=app_329898510397252

For me, the 'Train your Brain' article was the first step and so revealing. Not only does the article give a neat and clear explanation of our neural evolution, but more importantly it explains why we need to apply the correct brain process to the instrument we are trading. In other words, match the brain to the trade.

Richard's own experience as a pit trader bears this out. In open outcry a trader has to give his amygdala full rein. The pit is a 'jungle' where traders will be screaming and swearing at each other. The trader who doesn't make full use of his amygdala will simply get eaten, financially speaking. *"The floor trader on a futures exchange who scalps the nearby futures month and goes home flat each night needs the amygdala."* In open outcry a trader needs 'street smarts' which is why overly educated traders rarely succeed as they nearly always over rationalize, taking *"too long making a decision - also known as paralysis by*

analysis”.

By contrast, the brain process required for screen based trading could not be more different. Here it is the engagement of logic and reason which will ultimately deliver trading success. Unfortunately, as we now know this is easier said than done, as we are always at the mercy of our evolutionary biology, and once a stress response has been triggered it can difficult to know what to do. However, the good news is that any stress response or anxiety attack is actually quite straightforward to manage.

The first step is to recognize the classic symptoms. These can include feelings of panic, sweaty palms, a racing heart and an inability to stay still. This is hardly surprising given that adrenaline is being released and blood flow is towards our large muscle groups in readiness for ‘fight or flight’.

The next step is to neutralize these feelings as quickly as possible and the best (and only) antidote is oxygen, which is why deep, slow breathing is the solution. Deep, slow breathing also has the effect of communicating to the amygdala that perhaps this is not a matter of life or death. One of Dr Hong’s suggestions was jumping up and down, in an effort to dissipate the adrenaline as quickly as possible.

In an ideal trading world we would always feel calm and collected and ready to take trades in a cool and calculated manner, but the reality is that we are always susceptible to a stress response. It’s in our nature and it is the nature of trading.

Therefore, what we have to do is build and develop strategies which we can call on whenever such an event occurs. In other words, plan our trades so we do not get ambushed into an acute stress response. Good risk and money management (both detailed in other chapters), will not only keep any loss to a minimum, but also keep us from suffering a mental and financial meltdown. Furthermore, having a plan, and preferably one which has been rehearsed to help deal with stressful trading episodes will also help.

Outside of trading, the training pilots undergo to deal with emergencies offers us some great guidance. Pilots are trained in simulators to cope with all manner of potential emergencies, and in many ways as traders we too need to develop our own simulators. From experience I can also confirm that ex pilots often make the best traders.

In recent times, the textbook landing by Capt. Sullenberger on the Hudson River,

without loss of life is a perfect example of how the years of training in a simulator, ensured a successful outcome. However, as Capt. Sullenberger himself acknowledged, at the time *“it was the worst, sickening, pit-of-your-stomach, falling through the floor feeling I’ve ever felt in my life”*. Nevertheless, it was his ability to manage this terrible fear which led to a successful outcome.

In trading, emotion will always be there, lurking in the background. It is important to accept this fact. The next step is to recognize those feelings and sensations which can so easily overtake us, perhaps as the result of a bad trading decision. Trying to suppress these emotions simply does not work, and in fact will make things much worse as stress levels will just escalate. Therefore, it is important to have an appropriate plan to manage our emotions and any fallout caused by ‘emotional’ trades. And the question you are asking here, no doubt, is how?

Unfortunately, there is no simple answer, but as always recognizing the symptoms and their onset is half the battle. However, there are very simple ways to combat and reduce any emotional responses which cost nothing, and which we can all apply.

Rule Number One

The first, is to always apply the following rule, and is something I refer to in all my trading rooms which is this - I call it my ‘not about the money’ approach. Put simply, everything you need to do or think about when trading should be aimed at removing the monetary value. Why? Because this will instantly introduce the emotion of profit or loss, winning and losing, dollars in the ‘bank’, or worse still, dollars that ‘were in the bank’ but are no more (this is the emotional stress of ‘losing’ a profit). Remember, nothing is ‘in the bank’ until you have closed a position.

The first rule therefore in combating the emotional pressure of trading, is to think only in terms of trading units. In the forex world it’s pips. Imagine that I am talking to you now, and say to you that the position you have is 10 pips up. How do you feel about this statement? Is it an emotional statement? And the answer is **no**. It is a simple statement of fact, no more no less. Even the word ‘up’ is an ‘emotionless’ word.

Now imagine I said you were \$100 in profit. \$100 is money - we get emotional when money is mentioned. How about the word ‘profit’, another very emotional word. We like the word profit, it is an emotional word, it means we are doing

well, it is generating positive emotions. We immediately start to think what we are going to spend our 'profit' on - perhaps a holiday, a car, some luxuries, and then we start to think how pleased our family will be when we tell them. From there, we start to think - this is easy. Our mindset changes from logical detachment, to emotional engagement, and from there we are doomed.

The statement is the same. Ten pips up, may well be \$100 in profit if trading a full lot size, but the emotional response is very different, so my advice here is very simple. Always trade in terms of unit size and never, ever have a screen displaying anything which has changes in monetary value of open positions. Simply focus on the chart, and the number of pips up or down, and close every other window, particularly the Terminal window in MT4.

If you are interested in learning more about managing your most powerful trading weapon, your brain, you can find further details of my work with Richard on my site at: <http://www.annacoulling.com/trader-education/trading-psychology/>

Rule Number Two

Never refer to positions as 'winning' or 'losing'. These are emotional terms. In life there are winners and losers. How do you feel as a winner? Emotional, euphoric perhaps. You only have to look at the winners and losers on the sports field, perhaps in a final of a competition, to appreciate the emotional response to winning and losing. The winners jump for joy and hug one another, whilst the losers collapse to the ground, often in tears as their dreams have been shattered for another year.

Perhaps as a loser they now have to retire and face the prospect of never gaining a place in history, and having that winning medal to show to their children and grandchildren. The winners, on the other hand, are on an emotional high. They have secured their place in history and claimed a medal that nobody can ever take away, to say nothing of the money! All those years of training, hard work and self sacrifice, have paid off. For the losers, it is the realization that they were simply not good enough on the day, and all those years of toil have been in vain - perhaps it will be better next year!

This is all highly emotional. Why do you want to add emotion to your trading if it is not necessary?

Always refer to your positions, whether in your head or to friends and colleagues

as either ‘up’, or ‘down’. These are ‘emotionless’ words. We go up and down stairs, up and down in a lift. We sit up and lie down. These are words that have little emotion, and simply describe an action or a process. This may seem simplistic, but trust me, these simple tricks work!

Rule Number Three

The next rule is one that I often refer to in my trading rooms, and is the ‘that’s interesting’ rule, and I’ve since discovered it is also one of Richard’s expressions!!

We have an open position and the market suddenly moves against us. What is the immediate response in your head? Probably something like - oh my goodness, oh no (or probably worse!) Your heart rate will increase dramatically, your breathing will be short and your pulse will increase. Why? Because your brain, or at least the amygdala has taken over & delivered an emotional response.

But, how about this as an alternative response?

The market moves against you and your response is now - how interesting? The difference now is twofold. First, this is **not** an emotional response, but merely a statement of fact. Second, it is a question, and as such tricks your brain into an analytical response. Your brain is now considering the price action in a considered way, and not an emotional way.

The analogy here is of the interview. Imagine you are being interviewed live, perhaps on television. A stressful situation. The interviewer asks you a difficult or personal question, perhaps one you were not expecting, and to buy yourself some time, and simultaneously reduce the stress, you reply with ‘that’s an interesting question’. This is a trick to manage and reduce the stress of answering a difficult question. It also gives you some time to think, and in addition your brain is now focused on providing an answer. In other words, your brain is in analytical mode, and not in fight or flight mode. You have forced it to think. The sabre toothed tiger has been noted, but you are not in any immediate danger, and your brain is now analyzing alternative solutions to the problem.

Yes, it is a trick, but again it is a trick designed to stop the emotion of the situation taking hold and over-ruling logic and common sense. It is the approach that people who work in the emergency services have to develop, an analytical response to a stressful situation. It is the response that pilots develop, and is how Capt. Sullenberger managed to land safely on the Hudson river. The analytical

response overwhelms the emotional reaction. This is what we need to develop as traders, and this simple response, whether said out loud or in our heads, is enough to stop the stress response and give us those few seconds of thinking time, to calm the emotions.

Ultimately, all the financial markets are driven by two of the most powerful human emotions, namely fear and greed. Again, these are emotional words, and rightly so. The market never moves up or down in a straight line, and as a trader it is your job to remain calm at all times, and to manage the emotion from your own decisions. Staying in a trend and holding a position to maximize a return is one of the most difficult things to do. As I said in the introduction to this chapter, the hardest emotion of all to manage in trading, is to see a position that has been moving up nicely, suddenly stop, and start moving in the opposite direction.

Studying your volume and price bars and candles will give you the answer, but your emotions will need to be managed while your logical brain carries out the analysis. Here, your indicators and understanding of volume and price will also help enormously, but the simple tricks I have outlined above will also play their part.

This is why many traders turn to ‘black box’ systems and software. Simply because the responsibility for the decision making process is handed over to someone (or something) else. They are unable to deal with the emotions of trading, and therefore find it easier to abrogate this to a third party.

Whilst this solves the emotional problem associated with trading, it creates another more serious problem, which is simply that this approach guarantees failure. Mechanical systems do not work longer term. To succeed we have to make our own decisions, and to do this we have to be in control of our emotions. Volume price analysis will help you enormously for one very simple reason. VPA is an analytical process. In making a decision either to stay in or exit, your brain will be forced to think analytically and not emotionally. This in itself will help to remove the emotion from the situation, and you will find yourself making calm and logical trading decisions, very different to most other traders. This is one of the many huge benefits of the VPA approach. In taking an analytical approach to each price move, a forensic approach if you like, you are quite literally ‘managing your brain’. It is doing what **you** want, and not what **it** wants.

Managing your mind is the hardest aspect of trading. Reading this chapter in the cold hard light of day, you may be wondering why this should be so. But I can

assure you, once real money is in the market, the amygdala tries to take over. Trading, is a mind game, no more and no less. It is not about making or losing money, but in managing your mind. Manage your mind better than others around you, and you will succeed. VPA will help you achieve this - I can guarantee it!

Chapter Eleven

Choosing Your Broker

Markets can remain irrational longer than you can remain solvent

John Maynard Keynes (1883 - 1946)

This is perhaps one of the areas that receives the least amount of attention by new traders, both in terms of time and effort. Yet these are the people and companies that you are going to send your hard earned cash to, without a second thought.

In any other business, and this is a business, you would undertake due diligence, even if only at a superficial level. So why not here? I don't want to alarm or frighten you, but in the last few years there have been several high profile cases of brokers going bust, either through negligence, fraud or a combination of the two. Sadly, some of these have highlighted the short comings of the regulatory authorities themselves. Whilst we would all like to believe that these authorities are both powerful and effective, the reality is that they are often seen as incompetent and ineffectual. Within the forex brokerage world, there are still far too many firms run by one person, who only pays lip service to the various regulatory requirements. This is aside from any malpractice that occurs after you become a client, of which more later.

If the above sounds worrying - good. I have frightened you enough to make you think about this in more detail, rather than simply selecting a broker on the best spread, or the latest offer on a rebate. Even if you do your due diligence, there is no guarantee that the broker won't go bust. I have had one do just that in my own trading career, but was fortunate that my capital was protected under the FSA scheme which applied at the time, (I believe from memory this covered losses to a maximum of £30,000 per account). It was a London broker, with a good reputation, and it was unexpected at the time. So there are no guarantees. The best protection, is to ensure that you keep your accounts within the thresholds offered by the various regulatory schemes around the world. It does mean having multiple accounts, as you spread your risk, and does mean it limits trade size. Personally, I would prefer to do a little bit of extra work, in return for knowing that my capital is protected, should the worst happen.

The number of online brokers seems to increase daily, with marketing appearing in virtually all the media, including both online and offline, all with one simple objective. To get you to open your account with them. And with the advertising, come all the incentives of top up funds to your account once opened, reduced commissions for a limited period, or even a small percentage return of the spread on all your trades. Remember, there is no such thing as a free lunch, as all these are factored into the spread or commissions.

I'm not saying that any of these incentives are bad. Far from it! But, you have to know the type of broker you are proposing to deposit your hard earned cash with, as they are all very different, and in addition, there are a host of questions you should ask any broker **before** parting with any money.

The purpose of this chapter is to explain to you how orders are routed through the market, the various types of FX broker and their advantages and disadvantages, and the key things to look out for in choosing a broker. And finally to look at some of the marketing gimmicks they may use, in order to ensure that you open a live trading account.

Let's get started and I want to explain briefly how an order is routed through the market, and then to look at the four different types of FX broker, and how you can differentiate between them. This will put you in a strong position to ask the right questions, **before** opening your account!

If we start with the order itself, and what happens as soon as you click the buy or sell button on your keyboard. Well, in simple terms there are two ways that the order is what we call 'filled' - in other words, the point at which it becomes a live order in the market. This happens in one of two ways.

The order is either managed through what is referred to as a 'dealing desk' which is run and managed by your broker, or it is sent, what is called, 'straight through' to the interbank market - direct if you like.

Let's look at the first of these which is where your order arrives at a dealing desk at your broker. As the name suggests, this is a desk which is fully staffed by dealers, whose sole job is to manage orders, and to ensure that they make a profit for the broker.

As such, every forex broker dealing desk will have relationships with multiple banks in the interbank market who provide all the latest quotes to the broker's dealing desk.

Suppose you have placed an order to buy euros, as soon as the order arrives, the dealer will then look at his prices from the various banks and try to find a quote where he can buy at a lower price and sell to you for a profit to fill the order. Once found, the order is filled and the order is then live in the market, and you in turn have 'a position in the market'.

Now, let's suppose the market is moving fast, and you want to sell euros and you submit your order, which then arrives at the dealing desk to be filled. However, in a fast moving market the dealer is unable to find a price at which he can sell and make a profit. What does he do?

In this case, the dealer rejects your order and issues what is referred to as a 're-quote', rejecting your original order, (the price quoted on the screen) and quoting a worse price, which you can then accept or reject. This may happen once, twice or even several times when markets are volatile, making it difficult or even impossible for you to enter a position quickly, which could mean losing profits. This can also apply when trying to exit a position.

In addition to the above issue there is yet another, and it is this. As an alternative to passing your order through to the interbank market to be filled, your broker can simply elect to take the opposite side of your position, which means you are now trading against your broker. If you have a winning position, then the dealer loses, and conversely when you have a losing position then the dealer wins.

It is little wonder therefore, that the dealer working for the broker has more of an interest in you losing, than in you winning, as the more you lose, the more profit he or she makes for the broker. It's that simple, and given that most forex traders lose, there is little risk in taking the opposite side of most traders' positions.

Moving on, every forex broker will segregate their clients into two groups. The so called '**A book**' who generally win, and know what they are doing, and the '**B book**' clients who generally lose and have little or no idea of how the market works. What happens as a result, is that A book client orders are passed straight through to the interbank market, to be filled to offset the broker's risks, whilst the B book clients are counter traded in house, in order to increase the broker's profits.

Typically a forex broker with a dealing desk will manage between 60% and 70% of their B book clients in this way. This in turn means that if the B book clients suddenly start winning rather than losing, the broker then has to find a way to stop these winning positions increasing further, which is where price

manipulation and stop hunting become a tactic for the forex dealer.

Let's talk about these two issues for a moment and I will try to put this into context for you.

When your order is taken and filled by your dealer, if you are following your trading rules, then you will also have placed a stop loss order at the same time. On his screen, the dealer will then be able to see both the entry price, and also your associated exit price with your stop loss. Now remember also, that your broker is responsible for the prices you see quoted on your screen. Under normal market conditions, the prices quoted will be similar to those quoted by other brokers. After all, if they were not, clients would start to notice.

But what happens when the market is volatile, and what opportunities does this present to the dealer?

First, it is an excellent time to widen spreads dramatically and quickly, making it almost impossible to open or close positions. Some brokers even suspend their platforms, citing technical issues. I have had personal experience of this, and got so fed up I just closed my accounts.

Simultaneously, this also gives the dealer the opportunity to take out your stop loss. Volatile market conditions provide the perfect opportunities for price manipulation and stop hunting, which in essence is your broker taking your position out of the market, to make a profit for him or herself.

Whilst this practice is not as common as it once was, it still continues with the less scrupulous brokers, which is why it is all the more important to choose your forex broker with care. It is very hard to prove, either by you or by the regulatory authorities, which is why it still continues today. With so many forex traders losing, is it any wonder that the brokers can afford the huge costs of attracting a constant stream of new clients. They know that a large percentage are going to lose and therefore add yet more profits to their bottom line. It is changing, but only slowly.

The sad fact of life, is that most traders have little or no idea of how an order is processed or indeed the type of broker that they are using for their trading. If they had only taken a little time to understand how orders are managed and filled, then at least they would avoid many of the disasters and malpractices which still go on today. So I hope this chapter is starting to help in this respect!

Make no mistake. A broker with a dealing desk as I have described here, has a

clear conflict of interest. The dealer on the desk is there to make a profit, short and simple, and he or she will do anything to ensure they generate profits for the broker and not for you.

To help them achieve this you are also telling them exactly where your stop loss orders are in the market, which is generally too much of a temptation to be ignored by the dealer!

This is one of the ironies of trading in general. We are all used to seeing the authorities take an individual trader to task and make an example of them, generally to present an image that 'all is well'. Meanwhile, malpractice happily continues in the broker world. But this is the world in which we live and as a forex trader you need to be aware of these pitfalls. So what is the answer?

There is a second way an order is filled, and this is with a non dealing desk broker. In this case your order is transmitted straight through to the central interbank market, where it is filled at the best market rate with no dealer intervention. The bank that fills your order has no idea of who you are, or more importantly, where your associated stop orders are placed.

In other words, there is no conflict of interest, as no other party is involved in the transaction with your order filled entirely electronically and at the best market price.

These then are the two broad groupings for forex brokers, but in reality they fall into four 'sub classifications'. Let's take a look at each of these in more detail and the pros and cons of each type. The market maker, as you will see comes last in the list, and is really what we have been considering in the above, since they are effectively 'making a market' for you, using their dealing desk as the primary mechanism.

ECN Forex Trading Brokers

ECN is short for **E**lectronic **C**ommunications **N**etwork, and forex brokers who fall into this category will usually charge a small trading fee or commission. Remember, there is no such thing as a free lunch, and whilst 'free trading' may appear attractive superficially, remember that the costs will be hidden in the spreads.

The ECN broker can therefore be considered transparent. You have paid for a service, the trade, and the broker has made his or her money. In many ways this is just like trading stocks or futures. You are charged a commission and the trade

is executed. An ECN broker in the forex world works in the same way.

In return for this up front commission, they provide forex traders with a marketplace where all the participants, however large or small, can trade against each other by sending competing bids and offers into the system. In some ways, you can think of this as a 'central exchange' where traders buy and sell in complete anonymity and with transparency. All orders are matched between counter parties in real time, but in order for a forex trading broker to be classified as a true ECN, the brokerage must display something called DOM or '**Depth of Market**' in a data window, to show clients their own order size within the system, and allow other clients to trade against those orders. In other words, forex traders should be able to see the liquidity, and execute trades accordingly. Put simply, it means transparency!

ECN brokers will always offer variable spreads, and because they do not make their money on the spread between the bid and the ask, any trading style (including scalping) should be permitted. Some forex brokers do not permit this style of trading, and as you will see, when we reach the questions to ask, this is certainly on the list. In the last few years, the terms of trading have changed dramatically and there are key questions you need to ask before opening your account to guarantee that your style of trading is permitted by the broker.

An ECN broker can therefore be considered, in my view at any rate, as the purest form of broker. They make their money from the commissions charged and are therefore keen for their clients to succeed. After all, if you are successful then you will trade more actively and generate more commissions for the broker. It's a win/win situation.

However, many new forex traders have been 'sold' on the benefit of 'free' trading, and fail to realize the advantages of paying a small commission in return for a transparent and fair trading environment. It is only when forex traders have experienced their stops being hit with 'market spikes', irrational market moves against their positions, and endless 'server issues', that these same traders begin to appreciate the benefits of a true ECN broker.

As I said earlier - there is no such thing as a free lunch. That free lunch can become very expensive in the longer term.

Advantages of an ECN broker

- Trade using the best bid and ask quotes, live and direct from the interbank market - no re-quotes or slippage
- Tightest spreads which can be zero at times
- The ECN broker will not take a position against you, manipulate the price feed or take out your stops
- The prices quoted are likely to be more volatile and therefore better for scalping strategies
- Direct access to the interbank market for forex real time trading

Disadvantages of an ECN broker

- The trading platform may be more complex and not designed for retail traders
- The ECN broker may not provide 'free' forex charts
- There may be limited trading signals and trading tools such as news feeds
- There is generally a commission on each trade

STP Forex Brokers

STP (Straight Through Processing) brokers are often referred to, as if they were ECN brokers. This is not strictly true, even though STP forex brokers do route their clients' orders direct to their liquidity provider, or providers.

The STP broker is a hybrid of many things, and is probably more akin to a market maker (see below). In general terms, an STP broker will display his or her own quotes most of the time, which are based on the interbank rates, in much the same way as a market maker. Where the STP broker differs, is in the handling of your orders into the market. It is almost as though there is a fork in the road, with some orders going in one direction, and others taking an alternative route. In the case of the STP broker, some orders are routed into the interbank liquidity pool, whilst others will be held by the STP broker and either hedged or traded against you, a feature of the market maker which I will cover shortly.

This raises several questions, not least of which is how do you recognize which brokers are STP, and which are market makers, and if you are trading with an STP broker, how do you know where your orders will be routed or managed?

If we take the second of these questions first, there is always much debate about this, but it is generally agreed that A book clients (the successful traders) will be routed to the interbank market, whilst the B book clients (the small losing traders) will be held in house. The reasons behind this are relatively simple to understand. The A book clients are more successful and will generally be trading in larger lot size, so routing these orders into the market for a guaranteed spread in return is a low risk way of managing these trades, for a guaranteed return.

The B book clients on the other hand will generally be small orders, probably losing trades, and the STP broker has the option to trade against you, or hedge in

the market, but on a small size of trade and therefore lower risk. In this way the STP broker profits from losing trades from his B book clients, and from earning commissions on successful trades routed into the market.

Advantages of an STP broker

- Trade using the best bid and ask quotes, live and direct from the interbank market, provided you are an A book client
- Tightest spreads which may be zero if you are an A book client
- The prices quoted are likely to be more volatile and therefore better for scalping strategies
- Direct access to the interbank market for forex real time trading

Disadvantages of an STP broker

- The trading platform may be more complex and not designed for retail traders
- You will probably never know how your orders are managed by the broker, or whether you are an A book or B book client

Non Dealing Desk (NDD) Forex Brokers

As the name implies an NDD forex broker has no dealing desk and has more in common with an ECN broker, than a market maker broker. The NDD broker gets his liquidity quotes from the interbank market, and all orders are passed through direct into the market with no dealing desk intervention. The NDD broker then has two ways to profit from the trades executed, either by charging a commission as with an ECN broker, or by increasing the spreads like a market maker. The important points to note with a true NDD broker are as follows:

- Whist prices quoted are from the central pool of interbank liquidity, you are not trading in the pool itself, and being matched with other buyers and sellers, as is the case with an ECN
- There are no re-quotes with an NDD dealer – the price you submit your order, is the price quoted

As with an ECN broker, there is no dealing desk involved, and the NDD broker will not take a position against you. With no re-quotes, and interbank prices being quoted, you are always guaranteed a fast fill and transparent trading conditions, as with an ECN. In addition, true NDD brokers will continue to provide real time market quotes even during volatile trading conditions on major news releases, meaning that traders are generally not restricted in their strategies with this type of broker. The main advantages and disadvantages are as follows:

Advantages of an NDD broker

- No dealing desk - order transparency
- Real time quotes from the interbank liquidity pool
- No conflict issues of NDD brokers trading against you
- No re-quotes on forex trades

Disadvantages of an NDD broker

- May charge commission on each forex trade
- Probably a more complicated trading platform
- Often, no free charts or news feeds

Market Makers

Finally we have the market makers (or dealing desk) forex brokers who route client orders through their own dealing desk and quote fixed spreads. A dealing desk forex broker makes money via the spread as well as by trading against their clients. They are called market makers because they literally do 'make a market' for traders. When you want to sell, they buy and when you want to buy, they sell. In other words they will always take the opposite side of the trade, thereby creating the market.

This lack of transparency, anonymity, and clear conflict of interest can cause many problems, especially in fast moving markets, when dealing brokers may not have time to offset their risk. The result is often slow execution of trades, re quotes and slippage, all problems which have blighted the industry since its inception. This is not to say that you should always avoid dealing desk brokers, so long as you are aware of the drawbacks and adjust your trading strategies accordingly.

So, what is it about a market making broker that creates so much debate and distrust?

First, the market maker is getting his or her feed from the interbank market, but then re-quoting you, generally with a fixed spread, with any profit built into the price. Secondly, whilst the broker is standing as counter-party to the trade, and is therefore obliged to take your order and match it with an opposing order, this is

not passed into the interbank market for matching purposes, but held by the broker. As a result you are then trading directly against the forex broker which is where the conflict of interest arises. The broker will now be in a very strong position and has two choices to make – either hedge your trade, or trade against you.

Forex hedging is standard trading practice and a perfectly legitimate way to conduct business. Hedging is simply a trading mechanism meaning ‘hedging risk’ or ‘offsetting risk’. It just means buying or selling in another market to balance the risk.

Trading against you is not, although you will probably never find out for sure. Should the broker decide to trade against you, then he will almost certainly take out your stop loss at some point, delay quotes, allow slippage in quotes, freeze the trading platform in high volatile trading conditions, and finally move scalping forex traders to manual transactions which allows the broker full control over order fills and execution.

All of these tactics are employed at different times, mainly because the retail trader refuses to pay commissions on forex trading, because it has been marketed for so many years as commission free trading. As I have said before, there is no such thing as a ‘free lunch’ and I hope you can now start to see why!

Market maker brokers encapsulate many of the problems and issues we looked at earlier in the chapter. Slippage, which I did not mention, is simply another form of price manipulation, where price quotes change, between that which is quoted on the screen and your eventual order. For example, you may see a price of 1.2856 for the EUR/USD and buy at that price, but when the order is confirmed it appears as 1.2858. Only 2 pips, perhaps, but multiply this by a full lot, and this is \$20, or perhaps \$200 in multiple lots. This soon adds up. Consider also as a scalping trader, that 2 pips may be 25% or 50% of your trading target. As a longer term trader, slippage may be a minor issue - for a scalping or short term trader it is a very real problem and is another of the price manipulation problems, all forex traders face at one time or another.

Advantages of a market maker broker

- Simple forex trading platform
- Free forex charts and trading news feeds
- No commission charges on trades

- Higher leverages available

Disadvantages of a market maker broker

- Broker may trade against you
- Generally fixed spreads
- Forex rates may differ from the forex real time rates
- Scalping trades restricted or not allowed
- Spread slippage
- Price manipulation and stop losses triggered
- Price spreads will be worse than from an ECN

Having outlined the various types of brokers that you will find in the market, please remember, that some of these will be hybrids of the above. The forex market is changing all the time, and it is becoming increasingly difficult to 'pigeon hole' brokers, as the boundaries are increasingly becoming blurred. Another reason to make sure you do ask the right questions, **before** opening your account so that you are very clear on what your broker does, and does not do, when managing your positions in the market.

Now before moving on to consider those questions that I think you should ask, let me just highlight one other topic here, which is the vexed question of a demo account, its validity and some of the issues that you need to be aware of.

The first thing that perhaps is not immediately obvious, and certainly not if you are just starting out in the trading world, is that the demo account is the 'shop window' for the broker. It is the marketing tool which entices you in, and once you are in, then you are considered to be a 'hot prospect' as a new customer. Now the problem here is simply this. Given the demo account is the 'shop window' then it is very unlikely that you are going to see any of the issues highlighted above in terms of slippage, re-quotes, platform issues or anything else. It would not give a good impression!

Furthermore, the price feed used for the demo account, may not be the same as for the live feed, unless the broker makes this explicitly clear when asked. The question therefore is simply this - is there any benefit in having a demo account, for any other reason than to understand how the platform works? And the short answer is no.

By all means open a demo account to learn how to use the platform, but as a general rule, it will reveal little else and certainly not how the feed and quotes will be delivered in the real world. Leading on from this, is a much bigger question, and one I am often asked, which is this - 'should I start with a demo account to practice, or go straight to live trading?' My answer is always the same - start live trading as soon as possible, but with the minimum contract size available. And here are my reasons why.

First, there is no substitute for trading with real money. Trading in a demo account is not the same. You know and your brain knows that this is not real money and if you lose it all, it doesn't matter. Trading in a demo account will not generate the same emotions that you will need to manage when trading live. Short and simple. You will make decisions in a demo account that you would never make with your live account, simply because it is 'play money'. It is amazing how easy it is to make money in a demo account, and how hard it is in the real account, which reinforces the point I made in the last chapter in many ways. Trading is really a mind game. In the demo account, there is no emotion. You know it, and your brain knows it.

Second, the quotes in your demo account will be very different to those in the live account and will give you a false sense of security.

Third, one argument for using a demo account is for back testing. I do not believe that back testing has any value. If this is a term you have not come across before, it simply means testing a theory or strategy using historic data. This is something I have never done, nor propose to do in the future. The markets change second by second which is why I have explained that in your trading plan you need to take a discretionary approach, and not one based on prescribed entry and exit rules. If a strategy worked nine times when you test it using historic data, will it work on the tenth occurrence live in the market? It might, it might not. But the fact it has worked in the past is no guarantee that it will work in the future. If trading were that easy, all traders would be millionaires.

By all means use any demo account to understand how the platform works, and how to execute and manage trades, but as soon as you are ready, open your live account and start trading, with one proviso - start with the smallest lot size available. If this is a micro lot, and you are a complete novice - so much the better. Using real money, no matter how small, will then create the 'real environment' for you, with all the associated emotions and real world quotes.

This is just my personal view.

When I first started trading I spent several months in front of a chart with a live feed, not to practice any strategy, but to hone my skills on chart reading using price and volume. From there I moved to live trading the futures market at £10 per index point. An interesting way to learn, particularly as the orders were executed by phone to the floor of the exchange - but I digress!

Demo accounts have their place, but **only** to teach you the platform, and not for testing your trading skills or strategies.

Let's move on to consider the questions you need to ask your potential broker, and also the other places to find further information to help you make a decision. And the place to start here is with four sites as follows:

<http://www.nfa.futures.org>

<http://www.cftc.gov/index.htm>

<http://www.fsa.gov.uk>

<http://www.fca.org.uk>

The first is the National Futures Association, and the second is the US Commodities Futures Trading Commission, both of whom are involved in the regulation of forex and futures brokers around the world, but with a bias to the US. The third is the UK regulatory body, and whilst this is London based, many forex brokers, even those based elsewhere, prefer to have their companies regulated under the FSA as London is seen as both safe and secure for their clients. Finally we have one which is relatively new, called the Financial Conduct Authority which sits alongside the FSA and is now replacing it.

On these sites you will find a wealth of information about brokers and principals. The news sections will provide the latest on regulations and also on action taken against specific brokers and why. On the CFTC site the place to look here is under Market Reports, and the section on 'Financial Data for FCMs. Here you will find the latest monthly reports for some of the largest brokers in the world.

The sites listed above are the starting point. Many brokers around the world will be regulated locally. In Australia, regulation comes under the remit of the Australia Securities & Investments Commission:

<http://www.asic.gov.au>

Another popular location for forex brokers is Cyprus due to the tax advantages, and the regulatory body here is the Cyprus Securities & Exchange Commission:

http://www.cysec.gov.cy/default_en.aspx

Each country will generally have their own regulator, but those listed above are the principle ones to check first. There are many others, with several in Europe. If the broker you are considering is not listed with any of these, then simply ask them for details of who and where they are listed for regulatory purposes.

I'm sure it will come as no surprise given the areas of FX broker behavior that we have covered so far, that the regulatory authorities are constantly attempting to tighten controls, in order to enhance the reputation of the industry. An industry which has a tarnished reputation to say the least!

One of the more recent proposals from the regulators has been to reduce the leverage offered by US regulated brokers to a maximum of 50:1, which removed many of the more unscrupulous brokers offering 200:1 and more from the market. This now looks set to be reduced further to 10:1. Whilst this has provided some much needed common sense to this area of trading regulation, it has also had the effect of forcing some of these brokers to set up offshore, away from the regulatory authorities. This is another warning flag. If the broker is in an 'exotic' location - there may be a reason, other than the tax advantages some of these locations provide, so please check these very carefully, and if the leverage being offered on the account is higher than 50:1 - a second red flag!

In the same vein, in the US, the NFA has been raising the bar for market capitalization over the years, to try to ensure that those brokers who remain, are well funded with a strong balance sheet. The NFA has two classes of forex and futures brokers, one called FDM and the other an FCM. An FCM does not act as the direct counter party to any trades and under the current rules has a lower capital requirement of \$1 million, as opposed to \$20 million for an FDM. Little wonder that the NFA is now closing the loophole that many forex brokers have taken, which has been to declare themselves as an FCM broker and not an FDM. The deadline for the new regulations is June 30th 2013, with others due soon.

Finally, having established a short list we then get to the list of questions to ask, and things to do, which are as follows:

What is the net capital?

Establish the financial credentials of your proposed broker.

Is the company regulated?

All countries will vary in both their regulatory authorities and also the controls, procedures and compensation available to retail investors and traders. The following countries all have dedicated regulatory bodies, and you will need to check according to where the brokerage is based. Make sure the brokerage is not based offshore, with some form of onshore registration address.

The countries are as follows:

- United Kingdom
- United States
- Europe (Eurozone)
- Switzerland
- Australia
- Japan

For the US, make sure the company is both NFA and CFTC registered (Commodity and Future Trading Commission) or (FCM see below). In the UK it is the FSA (Financial Services Authority) or increasingly now, the FCA.

What type of broker?

Try to establish for yourself, by asking the right questions from the above, the classification for the broker. It can be a grey area, with some overlap, and it is becoming harder to distinguish one from another. If you are not sure, ask them to confirm things in writing, which should get you the right answer.

Leverage & margin rules?

Check out the margin and leverage rules very carefully. If you do not understand what these terms mean, I suggest you find out fast as they are the cornerstone of this market.

Costs of trading?

Before you open your account, make sure you are clear on the trading costs. For many brokers this will generally be zero, but check the spread offered as they may be higher than others in the market. Don't simply choose your broker on 'free' trading. Check also for any costs for orders particularly for stop loss, and

guaranteed stop loss orders. See also rollover costs.

Telephone support?

Not a big issue but certainly worth checking - internet connections can and do go down, and if you are stuck with no communication to open or close trades, this could be an issue. You should always have a mobile handy in case the trading platform goes offline at a critical point. If the company has no phone customer service, you have no chance of trading. Always bear this in mind.

Ease of Use?

In general you will find brokers who offer free trading provide very simple platforms such as MT4, which is the world's most popular platform for forex traders for that reason. An ECN broker platform may be more complex.

Trading platform reliability?

Ask the company to provide figures for the downtime of their platform - if they can't provide these figures go elsewhere!

Charts?

These will form the basis of your trading, and should cover time periods from 1 minute to 1 month. Some free charting packages are awful. In my view, once you have started, you are better off paying for a good charting package rather than the free ones which are offered by the dealing brokers. If you go for an ECN broker, then you will probably need to pay for them anyway.

Company history?

Ask the company to provide details of how long it has been in business, and visit some of the forums for general news and reviews about the particular company. Bear in mind though, that many of the comments will be from traders who feel hard done by, for one reason or another, so do take any comments with a pinch of salt. If the company has its own forum, this is well worth checking and asking the forum for any comments. Explain you are a new trader and would welcome comments - if asked in the correct thread of the forum you should get some helpful comments. In checking the company history look particularly for clues that the company is owned or run by one person, or family group. A company quoted on the local stock exchange is generally a good sign, although there are never any guarantees.

Trading reputation?

Again check the forums - traders will very quickly tell you whether this is a reputable company. Try to find independent reviews of brokerage companies against which to cross check these comments.

Trading style & order types?

This is very important and often overlooked until it is too late. Many companies will not allow traders to scalp, and some will expect you to execute a minimum number of trades per month. In addition, many companies do not like long term trades either. Please read the small print, or ask the company before you sign up, to explain the type of trading they allow, and if there are any restrictions, or required minimum numbers of trades. Simple stuff, but easily forgotten until it's too late! Hedging is also banned by many brokers now. As I explained earlier, a hedge is simply taking a position that offsets some of the risk. See below.

Type of account?

Check what types of account are available. A broker that offers both micro and mini accounts is perfect, as you can start with the micro and then graduate to the mini account (or full size) as your experience grows.

Interest on the account?

Well why not - after all it's your money. Most brokers do not pay any interest on the balance in your account, but the good ones do - so ask - but you will find more that don't pay than do. Personally if you trade with a large balance in the account as I do, then I like to see a bit of interest clicking up - even if it is only a few dollars a day.

Hedging trades?

Many brokers no longer allow you to hedge on the same pair. In other words you are not allowed to have a long trade and a short trade in the same pair. In these accounts, if you have a long trade open, and then open a short trade in the same pair, the position will automatically close out, as this is how you close trades anyway (by reversing the opening trade to close) - does this matter? - yes if you want to use hedging trades as part of your trading strategy. A hedge trade is simply one where the risk is reduced by 'hedging' or protecting your position.

Rollover?

Remember in forex you are trading a contract. Trades are simply speculative and are simple computer entries on a screen. It is assumed that you have no desire to exercise the contract and take physical delivery of the currency, so all open contracts are rolled over automatically at 5.00 p.m New York EST after each 24 hour period. At this point interest in the trade is calculated and will either be negative or positive. If it is a carry trade it will be positive, otherwise it will be negative. All this will happen automatically - you do not have to do anything as it is assumed that if the position is open, you want to roll it over into the next day's trading. In some accounts you will find transaction accounting very confusing when you close a position. I was recently invited to the launch of a new platform and it even confused the presenter!

In most accounts when you close a position the profit or loss is immediately accounted for, and the balance updated immediately. With this platform it was not - the reason being settlement dates. Now if you remember in the stock market we have settlement dates which are normally $T + 2$ days after the trade has been closed. With these sorts of forex accounts the trades are logged in your account, but are not settled in the account immediately. It can be very confusing when looking at the account as these trades will appear to still be 'open' when in fact they are closed. Personally I find this very confusing, and the chances are so will you, so check this out in your demo account and make sure that the accounting principles that operate here, are also the same in the real account!

There's a great deal to think about, before you choose your broker. Most new traders simply pick the one with the 'best offer' or the 'tightest spreads'. Stop and think before you decide, and do your due diligence - it will save you a huge amount of heartache and time in the future.

In the next chapter we're going to look at the currencies and currency pairs in more detail, as we edge towards the start of your new trading journey.

Chapter Twelve

Choosing Your Currency Pairs

When you know what not to do in order not to lose money, you begin to learn what to do in order to win. You begin to learn!

Jesse Livermore (1877 - 1940)

You have your plan, you've chosen your broker and set up your account, you understand the mechanics of the forex market, and equally important, you understand the emotional aspects of trading. So what now?

And the question you might ask now is - 'which currency pairs should I trade, and why'? This chapter is going to help to answer this question. It will also help to answer a further question many traders ask, which is this. If we are trading in a currency pair, such as the EUR/USD, how do we know if the move is driven by euro strength or weakness, or US dollar strength or weakness? In other words, if the pair is rising, is this euro strength driving the pair, or US dollar weakness? This is not a trick question, nor is it a philosophical one. As you will see in the next chapter, trading is about managing and quantifying risk. If you can identify which of these forces is driving the pair, then the risk on the trade is lower. It's that simple, since you are then trading with the dominant currency across the market, and I will show you how later in this chapter.

Let's start by considering the currency pairs available, and then we'll move on to consider my currency matrix.

Broadly speaking, there are three categories of currency pairs, namely the major currency pairs, the cross currency pairs and the exotic currency pairs. The 'majors' are simply those considered to be the most widely traded against the US dollar. The cross currency pairs are those which are 'non US dollar', and finally the exotic pairs are those which are relatively thinly traded, generally not widely quoted, and often very volatile as a result. If you are a novice trader the exotic currency pairs are most definitely not the place to start. The place to begin trading is with the major and cross currency pairs.

Major Currency Pairs

There are essentially seven major currency pairs, which are as follows:

- EUR/USD
- GBP/USD
- USD/JPY
- USD/CHF
- AUD/USD
- USD/CAD
- NZD/USD

EUR/USD

Every forex trader and every forex broker, focuses on this pair for many reasons. First, it is the pair which is traded the most heavily in the market, and is therefore the most liquid. Being the most heavily traded pair means that the spread is generally the tightest of all the currency pairs, which in turn makes it attractive for scalping traders. This is the pair that all the brokers focus on when marketing their platforms, with ultra low spreads designed to attract new clients.

With all this attention, and with the benefits of tight spreads on the quote and high liquidity, is this the place to start as a new trader? And my answer, perhaps surprisingly, is no. Had I been writing this book several years ago, then I would have said yes, with no hesitation, particularly for short term intra day trades. So what's changed?

That's a big question and one that I answer in detail in my other forex books, but let me give you a flavor here, which may prompt you to learn more. But in short, several events have occurred in the last few years which have changed the markets, and the forex markets in particular, forever in my opinion. The financial crisis which started in 2007, has resulted in long lasting ramifications, which have dramatically changed the forex world. Prior to these events unfolding, the market was certainly more predictable. Price behavior was more measured, and more influenced by the broader economic fundamentals. With the onset of the crisis, the currency markets have taken centre stage, as governments and central banks battle with the problems of stagnating economies and low inflation.

This in turn has led central banks, in particular, to venture into areas of uncharted territory, injecting currency into the economy, whilst simultaneously maintaining ultra low interest rates in an effort to stimulate demand. In simple terms, the

crisis triggered the philosophy - every man for himself! This has led to artificially weak currencies, economies and bond markets awash with money, and artificially low interest rates. In other words, anything but a 'free market economy'.

Coupled with this, in Europe, we have the euro, which, as I mentioned earlier in the book, is a political currency in every sense of the word. The crisis which has rocked the world has seen major economies in Europe stumble and start to topple, only avoiding collapse by the establishment of a bailout fund.

In the EUR/USD we have the US dollar on one side being managed by the Federal Reserve, and on the other, the euro, being managed and supported by the ECB. The European politicians have a vested interest in the euro too, with many reputations now at stake. The euro may ultimately survive, or it may not - the point is that for us as traders, it can be extremely sensitive to any comment from politicians or central bank officials, which is why, in my opinion at least, it may not be the place to start. I believe there are other, more 'straightforward' major pairs to trade, which follow more predictable price behavior.

I have been criticized in other books for making this point, but I have to stress I am not anti-Europe. Indeed I am Italian by birth, and spend much of my time in Italy. I am simply speaking here from a trading perspective. It's a view that is widely shared amongst fellow traders. Times have changed and we have to adapt and change as well. This pair will always offer the tightest spread, which is great for scalping, but be aware of the underlying forces which are far from obvious at first glance.

GBP/USD

The GBP/USD is a more 'measured' pair, and as I have said before, has much in common with Big Ben, the clock tower which sits in Parliament Square in London. The clock just ticks along, and this pair is much the same. Whilst the UK is in Europe, the government opted to retain the British pound, and as a result, it remains principally influenced by the economic landscape of the UK, and less so by Europe. It is therefore a steady pair to trade, and with the euro, will always be in focus as the European trading session moves to the London session at 8.am GMT and throughout the morning and into the US session later in the day. We saw this in the pie chart in chapter one.

Unlike the euro, the British pound has few political influences, and therefore any economic data, or comments from the central bank, has a more predictable

response in the exchange rate and consequent price behavior. The data may shock or surprise the market, which will react accordingly, but that reaction will be predictable against the data being released, and generally not leave you asking the question - why?

There is a relatively close correlation between the EUR/USD and the GBP/USD, but this can and does break down from time to time. Under normal market conditions, you should expect to see the two pairs move higher and lower in a positive correlation. In other words as one pair rises then so does the other. This relationship cannot be relied on, given the political overtones for the euro, and in the last few years there have been extended periods where one pair has risen and the other fallen and vice versa. The British economy is also heavily influenced by the European economy, as Europe remains a major export market, with the US retaining the number one position for exports from the UK. Economic data from Europe (and of course the US) therefore has a big impact on the British pound.

USD/JPY

This is another of the tricky pairs to trade, and there are several reasons why.

First, this is a pair of safe haven currencies. The US dollar is a safe haven currency owing to its status as the currency of first reserve, whilst the Japanese yen is also a safe haven currency, but for different reasons. The yen is generally the currency chosen by forex traders for the carry trade, a strategy that involves trading a high yielding currency against a low yielding currency. In other words, a large differential in interest rates. The interest rates in Japan have been low for many years, and the currency is therefore used as the funding currency for this strategy. The yen therefore reflects risk.

When traders are happy to take on risk, then they sell the Japanese yen and buy a high interest rate currency such as the Australian dollar, where the difference in interest rates between the two currencies might be 2% or 3%. As interest rates increase, which they undoubtedly will in the next few years, then this strategy will become ever more popular. This is one of the reasons the yen can be very volatile, as risk sentiment ebbs and flows in the market, so this is reflected in buying and selling of the Japanese yen.

The next factor is this - over 40% of the traders in the retail forex market are based in Japan. It is the largest FX market in the world.

As a nation, the Japanese will tend to move 'en masse' and are extremely sensitive to moves in equities, with investors moving rapidly from low risk into high risk and back again. The Nikkei 225 is an excellent barometer for moves in the Japanese yen. Japanese traders, by nature, are technical traders and one of the most popular indicators that virtually all Japanese traders use is the Ichimoku Cloud indicator. What this means is that price levels on the chart become 'self fulfilling prophecies' with this volume of traders, quite able to move the market on their own. The USD/JPY is therefore the most 'technical' of all the currency pairs.

As a major exporter, the Bank of Japan is also extremely conscious of the impact of a strong yen on Japan's export market. If the currency becomes too strong then the BOJ will step in and take action to weaken it accordingly. The effects are generally short lived, and anywhere in the 77 - 80 area is normally a signal for the BOJ to intervene.

The above factors all play out in the USD/JPY which is why it is simply not a case of following US dollar strength or weakness here. It is not that simple. With the other US dollar based major pairs, when the dollar strengthens or weakens, this is then reflected in the pair. With the USD/JPY this relationship becomes more complex, and even more so in the last few years as the US dollar has also joined the ranks of the 'funding currency' with US interest rates at a similar level to the Japanese.

USD/CHF

Again, as with the USD/JPY, this is 'safe haven' meets 'safe haven', but in the case of the Swiss franc, is underpinned by gold. This is one correlation that still holds good, with the USD/CHF moving inversely to the EUR/USD. As the USD/CHF moves lower, then the EUR/USD will move higher and vice versa.

Some forex traders believe they have stumbled on a magic hedge, when this relationship is first discovered, and that trading long (or short) in both provides the ideal 'safe bet'. I'm afraid this is completely wrong. This is simply constructing the EUR/CHF in another way, and using two pairs to do it, so an expensive way to trade a cross currency pair!

Over the longer term charts, the USD/CHF has reflected the strength in commodities, with strong buying on safe haven demand also moving the pair lower. However, as economies start to recover, and better returns become available elsewhere, then expect to see the Swiss franc being sold, as money is

moved out of safe haven and into higher yielding assets. Does this mean the euro will weaken against the US dollar - to which the answer is yes, provided the correlation continues to hold.

Something else that the pair has in common with the USD/JPY is that the central bank, the SNB, also intervenes routinely in the market.

AUD/USD

The AUD/USD is one of the three commodity currency pairs, with the USD/CAD and the NZD/USD being the other two, which is why I have grouped them together.

All these countries are major exporters of commodities, and are rich in natural resources, base and precious metals. What this tends to mean is that these currency pairs receive a 'double whammy' effect from the US dollar, with the pair driven by strength or weakness in the US dollar, along with associated moves in the commodity markets. Typically the relationship between commodities and the US dollar is inverse, so as the US dollar strengthens then commodity prices will weaken and vice versa. The Australian dollar is also extremely sensitive to demand and growth in China, one of its largest trading partners. China's demand for base commodities is almost insatiable, and whilst this is good news for the Australian dollar, any slow down in Chinese economic growth will impact the currency very quickly.

Australia has weathered the economic storm of the last few years relatively well, largely due to strong demand for commodities in the Far Eastern markets and China in particular. This in turn has led to interest rates remaining relatively high when compared to the rest of the world, with the Australian dollar adopted as the interest yielding currency of the carry trade I mentioned above. This factor, coupled with strong demand for commodities has seen the Australian dollar strengthen over the last few years against the US dollar.

If you are new to forex trading, then the AUD/USD is a good solid pair to trade, and with a little background knowledge of the commodity markets and economic influences, is another excellent place to start.

USD/CAD

The second of our commodity currency pairs is the USD/CAD and another solid pair if you are new to the world of forex trading. Canada, like Australia has weathered the financial storm well, and again it is commodities which have

provided some stability in the economy, with crude oil, the mainstay. The problem for Canada is that its nearest neighbor, the USA, is also its largest trading partner, so a slowdown in the US economy is not good news for Canada.

With oil dominating its commodity driven export market, it is no surprise to see the currency correlate with the price of oil, particularly in some of the cross currency pairs, which I will cover shortly.

One of the weekly economic releases that is a 'must watch' for USD/CAD traders is the oil stats, which reports on the weekly oil inventories at the Cushing oil hub in Texas. Whilst this release comes from the US authorities, its impact is seen more dramatically on the Canadian dollar rather than the US dollar. The release appears every Wednesday and the headline figure shows whether there has been a build in inventories or a fall. This is a simple stock take if you like of oil. If we have oil supplies building up in inventory, then this implies a lack of demand for the commodity, so the price of oil is likely to fall as a result. Conversely, if there has been a 'draw' in inventories, in other words the stockpile has fallen, then this implies that oil is in demand and oil prices are likely to rise. This will then be reflected in the Canadian dollar.

This is another excellent pair to start with as a novice trader, and also makes the link with oil, bringing commodities into your relational analysis.

NZD/USD

A very similar picture to the AUD/USD pair. A well managed economy which has survived the worst of the financial crisis, but once again it is China which influences the pair strongly. Another commodity currency and in its relationship with the US dollar, any effect is magnified as commodity prices rise and fall with strength or weakness in the US dollar. In addition, with China now taking over the number one spot as New Zealand's primary export market, any bad fundamental news here, will instantly impact the currency, along with the Australian dollar. As you would expect correlation between the two pairs is relatively strong, particularly over the longer term time frames, and once again, the pair get a double whammy from the US dollar and commodity relationship.

Whilst Australia's commodity exports are dominated by 'hard commodities', New Zealand's exports are the soft commodities of agriculture and related products such as milk and milk powder. One of the issues that blighted the New Zealand dollar prior to the financial crisis, was the high interest rates which made the currency the number one choice for the carry trade, with interest rate

differentials of 7% and above. With interest rates now below those of Australia, the New Zealand dollar is less volatile at present, but as economies recover over the next few years, this problem may arise once again as 'hot money' flows in from currency speculators, buying the New Zealand dollar once more. This is one of the features of currencies such as the New Zealand dollar and the Japanese yen, which give them a more volatile personality. When these longer term trends develop, they tend to run for extended periods, but equally, when the speculators close out, then these trends reverse very fast.

Again, a good solid currency pair to trade as you start, but watch the interest rates on the NZD. As they start to climb, and they will, then the currency will strengthen and strengthen fast against the yen, and other low yield currencies. But be careful. A fast move up, may be followed by an equally fast move down.

Cross Currency Pairs

Now we move from the major currency pairs to the cross currency pairs, and this essentially means any pair which does not have the US dollar. Many books at this stage might suggest that as a novice trader you stick to the majors and avoid the cross currency pairs. I do not subscribe to this view for several reasons.

It is certainly true that the spreads on the major pairs will be tighter than in the cross currency pairs, and this is generally the reason cited for trading these in preference to the cross pairs. However, this aside, there are many reasons for considering these pairs, even as a novice, provided you understand the characteristics of each, and accept some basic principles, such as wider spreads and a little less liquidity, which can make some of them more volatile.

However, against this, I would suggest the following argument.

It is a fact of life in the foreign exchange markets that 2007 changed the market, and the old values and methodologies have been swept aside as a result. Prior to these events, currency markets, broadly speaking, were 'free floating', where exchange rates were left to find their own levels, based on fundamentals, money flow, risk, supply and demand. In other words, a free market economy if you like, where simple market forces dictated the ultimate exchange rates. This was the principle on which the gold standards of the early 1970's were abandoned. Just like any other market, the principle was to allow market forces to dictate market prices, rather than to impose 'artificial' pegs, such as the gold standard.

Until 2007, this was the case - then came the financial meltdown, and the game

changed. No longer were exchange rates left to find their free market level, but manipulation, both covertly and overtly became the defining standard. And the reasons are very simple - self preservation, as central banks around the world battled to maintain their fragile economies, particularly those with strong export markets, and the so called 'race to the bottom' began. This was simply a process of implementing ultra low interest rates to protect exports. In addition, many banks began printing money (referred to as quantitative easing) by buying bonds, to stimulate inflation in stagnant economies, creating yet another artificial component in the currency markets.

One of the principle exponents of this policy has been the US Federal Reserve, which has systematically continued to print money, ever since, creating a false market for the currency of first reserve.

This is what I mean when I say a 'game changer'. The world of foreign exchange has changed, not forever, as 'normal' market condition will return in the next 5 to 10 years, but for the present and foreseeable future, this is a very different market. No longer are interest rates dictated by economic forces, they are dictated by self preservation. Equally, supply and demand of currencies is no longer left to the market. It is the remit of the central bank to protect the economy - self preservation again.

In such a world, the cross currency pairs offer an alternative, away from the artificial world of the US dollar. Whilst I would be the first to admit that they have some disadvantages, on balance, these are outweighed by the advantages, even if you are just starting out on your forex trading journey.

Let's take a look at some of the pairs I would suggest as possible starting points, and those to consider as alternatives to the major currency pairs.

EUR/GBP

The EUR/GBP is one of the less volatile cross currency pairs, and represents the economic dynamic between Europe and the UK. Whilst the euro is politically sensitive as a major, particularly against the US dollar, as a cross pair against the British pound, the characteristics change, with the pair returning to 'old school' price behavior based on economic and technical forces. In some respects the euro adopts the characteristics of the pound, and away from the influence of the US dollar, becomes more measured and predictable as a result. This is not an 'exciting' pair to trade, but then trading is about consistency, and not about the adrenaline rush!

This is a nice pair to trade as a novice. The price action is steady, and for intra day medium term trading, there are always plenty of opportunities, particularly based around the fundamental news releases in both Europe and the UK during these trading sessions. The pair does trend longer term, but in recent times has been 'rangebound', so shorter term or intra day is my suggestion here.

EUR/CHF

This is another pair in the same vein as the EUR/GBP. In this case it's the euro matched with the Swiss franc. This is a pair for longer term trading, as it can become becalmed for long periods of time, and move in a very narrow range. But as always patience is a virtue and for longer term traders, any breakout from these congestion phases is usually rewarded with a nice trend.

This is an interesting pair for several reasons. First, the Swiss franc has increasingly been seen as a safe haven currency over the last few years. Switzerland is seen as safe in every respect and with a stable economy and renowned banking system under pinned by gold, the Swiss franc has strengthened accordingly. The net result of this, has been that the Swiss National Bank has intervened on several occasions to prevent the currency strengthening further, and it does so in the full knowledge of the ECB. The recent floor has been in the 1.2000 region, but as the financial crisis begins to subside, then we may see the Swiss franc weaken as money flows out from the pair and back into higher risk assets in due course.

AUD/JPY

Now we move to some of the more volatile currency pairs, and there are several to choose from here, all based on the Japanese yen. The Aussie dollar however is always the starting point, as it is an excellent barometer of risk in the currency market. If the AUD/JPY is rising then the Australian dollar is being bought and the Japanese yen is being sold.

This reveals two things. As I mentioned earlier, the Aussie dollar is closely associated with commodities, therefore the currency is a measure of risk buying or selling, since commodities are seen as risk assets in general terms. Equally, and on the opposite side of the currency, selling or buying of the yen is also a measure of risk flow. Selling the yen implies investors and speculators ready to take on more risk, both in the carry trade and elsewhere, whilst buying of the yen implies the opposite.

The AUD/JPY therefore tends to provide a barometer of risk appetite across all the financial markets. As with all these relationships, they can and do change over time, and indeed the Australian dollar is another currency which is seen as a 'safe haven' largely as a result of the economic stability of the Australian economy in the last few years. However, this has to be counterbalanced by its close association with commodities and in particular China, and any slow down in economic growth here, will be reflected firmly in the Aussie dollar and the Aussie yen pair.

CAD/JPY

This is an interesting pair as it has a relatively close correlation to the price of oil. Canada is a major exporter, and the Japanese are major importers. If oil prices are rising, at the same time as the yen is being weakened by 'risk on' or politics, then the pair will move quickly. The weekly oil inventories release on the economic calendar will also play a part here, with any build in reserves, bad for the price of oil, and any draw, generally good. So, there are several influences, but as always with the yen crosses, if you get the direction right, then your account will start to build very quickly. Conversely, get it wrong and this is where your money management and risk management will really pay dividends.

There are many other cross currency pairs, with a variety of spreads and relationships. The ones I have outlined above are the starting point, and some of the more liquid that are traded in this group.

Exotic Currency Pairs

As a novice trader, this is **not** the place to start. Even full time traders struggle here. The returns on exotic pairs can be dramatic, but so can the losses. In the last few years many exotic currencies have seen huge inflows, driven by speculators searching out high interest rate bearing currencies. Prior to 2007, the New Zealand dollar was one of the most sought out currencies. With an interest rate of 8% and above, here was a stable major currency but one offering a high yield. However, just as with every other major currency, interest rates fell dramatically, and have remained low ever since, forcing speculators to search out higher yields elsewhere. The problem however, is that as a general rule, exotic currencies are thinly traded, and often extremely volatile, as currency flows in and out are primarily speculator driven, with risk appetite changing fast.

Those currencies which have attracted a great deal of attention over the last few years have been the Mexican peso, the Brazilian real, the South African rand and

the Korean won. The last of these is in fact often referred to as the 'VIX' of the currency world. The VIX is a 'volatility index' based on the buying and selling of options which gives traders a view on whether the market is complacent or fearful!

I would suggest that you do **not** consider these or any others as a novice. Start with the majors and some carefully selected cross pairs - there are more than enough to choose from!

The Currency Matrix

I mentioned at the start of this chapter that one of the issues that we face as traders in the forex market, is the problem of knowing which currency is driving the pair. When the GBP/USD is rising, is it strength and buying in the pound which is the dominant force, or is it selling and weakness in the US dollar. This problem is compounded by the fact that a currency can be bought or sold against a myriad of other currencies making it extremely difficult to identify where this buying or selling is taking place. A bank that wants to sell euros and buy US dollars for example, can do so directly, simply by selling the EUR/USD. However, in order to hide their activities from other large institutions, and also avoid moving the market against their own trading, this transaction may be executed using a second or even third currency.

Rather than go from A to B, the bank will get to B via C. If we go back to the above example of selling euros and buying US dollars, this can be achieved by selling euros and buying pounds in the EUR/GBP, and then selling pounds to buy US dollars in the GBP/USD. The result is the same - the route is very different. There are of course, additional costs of execution, but the benefit to the bank is that large transactions can be hidden in this way, well away from the prying eyes of competitive institutions. The Interbank market makers do this, day in and day out.

For single instrument traders in commodities stocks or bonds, this is not an issue, since all the buying and selling is executed through limited channels, either in the cash or futures markets. For foreign exchange traders, life is not that simple, as the alternative options to buy or sell are almost limitless. This is where the currency matrix comes to our aid.

The currency matrix is a very simple concept, yet very powerful, and the easiest way to explain it is with some examples.

Many forex traders, even more experienced ones, only ever look at one chart when trading, a huge mistake in my view. As you will see in the next chapter, using multiple timeframes is an important feature of my approach to trading, and I hope will become important to you too. The currency matrix uses multiple charts in a different way. In this case we use the same timeframe, but different currency pairs.

Suppose we are considering taking a position in the EUR/GBP. The pair is moving higher, and we want to establish whether this is euro strength or pound weakness. If this pair were a major, then life would be a little easier as we have the US dollar index as our starting point, but here things are more complex.

We turn instead to our currency matrix for the euro, which is six charts of the principle euro pairs. In this case we would have the following in our matrix, all on the same time frame which would be relative to our strategy:

- EUR/USD
- EUR/JPY
- EUR/CHF
- EUR/AUD
- EUR/CAD
- EUR/GBP

Suppose in all these pairs the euro was also rising. What conclusion can we draw from our matrix? Well, in simple terms, the euro is the driving force, as it is rising across all the other currency pairs. In this case, the other pairs are confirming this picture by virtue of the fact that the euro is rising against all these currencies as well, and not just against the UK pound. In other words, the euro is the driving force of the move higher.

The matrix will also tell you something else as well.

If one or more of the pairs is not rising in line with the others, then perhaps the move is lacking some momentum, and therefore unlikely to develop further. After all, if the market is buying euros across all the other pairs, this is a strong signal that the euro is being bought everywhere, and other currencies are being sold.

Finally, the currency matrix also reveals another facet. It reveals the best

currency pair to trade. If you are trading euro strength, it will be instantly self evident from the matrix, which of the euro pairs offers the best trading opportunities based on your analysis. The move higher in the EUR/GBP may be sluggish compared to a move higher in the EUR/JPY or the EUR/CAD. You may see a strong breakout in one pair, which offers a lower risk opportunity than in another, where perhaps the price action is running into a support or resistance area, or the volume is signaling weakness.

In other words, having a currency matrix reveals the complete picture of forex market behavior. The currency matrix is there to tell you what is going on ‘behind the scenes’, and not simply what you see in a single chart. What in effect you are doing in creating this simple matrix, is to ‘see’ the money flow for a particular currency, where the real buying and selling is taking place, and in doing so, reducing the risk on your trading position, which is something we are going to look at in detail in the next chapter. Trading is all about risk, and anything you can do, to help you gauge the risk on the trade and reduce it accordingly is immensely powerful.

In case you are still a little confused, let me give you another example for a Yen matrix. In this case we would have the following:

- USD/JPY
- EUR/JPY
- CHF/JPY
- CAD/JPY
- GBP/JPY
- AUD/JPY

Once again you would set this up with these charts using the same timeframe, and the timeframe would depend on your trading strategy. If your approach was short term or scalping then these would be anywhere between a few minutes and a few hours. For longer term trading you might have these on the daily timeframe.

Finally, whilst mentioning multiple charts, the above currency matrix is not the same as trading using multiple timeframes. This is the next stage. The first step is to undertake our initial analysis, perhaps using a currency strength indicator, which is invaluable in revealing individual currency strength and weakness. Step

two, is to then consider our currency matrix, for the ‘inside view’ on overall strength or weakness in our currency. Finally, in step three we arrive at our multiple charts (generally three) where we have our selected currency pair, but viewed in different timeframes.

The currency matrix is immensely powerful and very simple, and I am always amazed that more forex traders don’t validate currency strength and weakness in this way. To me, it just makes sense. If you are trading in the majors, then have a US dollar matrix, and this will also confirm the price movements in the US dollar index. Here, one will validate the other. We also have a yen index, so again, you can have this running in parallel with your yen matrix.

One of the hardest things to do when trading is to quantify the risk on the position before you take it in the market. I cover this in great detail in the next chapter, but the currency matrix is a powerful and simple way, to identify which currency is the primary driver.

This is what we are going to cover in detail next, along with all the other techniques, as we get started, and prepare to execute our first trades.

Chapter Thirteen

Let's Get Started

Risk comes from not knowing what you are doing

Warren Buffet (1930-)

As I have already said earlier in the book, there are only two risks in trading. The first is the financial risk, and managing that risk using simple rules. This is all part of your trading plan and money management once you have taken a position in the market. This risk is easy to define and easy to manage.

The second risk, is the risk you are taking on the position itself. Is this a high risk, a medium risk or a low risk. Everything you do as a trader should be geared to answer this simple question:

'how much risk am I taking on, in opening this position in the market?'

This is the only question we are ever trying to answer. Everything we do, from deciding on our approach to the market, to analyzing charts, assessing fundamental news, or using our indicators, is focused on answering this question. If the risk is high, then this is fine, as long as we understand that this is the case, and if so, we are unlikely to be holding this position very long. If the risk is low, then the chances are we will be considering this as a longer term position.

You may never have thought of it in these terms, but this is what trading is all about. Trying to quantify the risk on each and every trade, and then acting accordingly. After our analysis is complete we either make a decision to accept the risk and take the trade, or reject it, if we feel the risk is too high. And that, in simple terms, is all we are trying to do each time!

Therefore, let me start to walk you through the complete process from start to finish, to try to give you a better understanding of how all the pieces of this puzzle fit together. I accept that in doing so I have had to make some assumptions. For example, I cannot possibly cover every method or strategy, but the example I use here, will I hope, answer most, if not all of your questions.

The approach is universal. It is the one I use myself, and adapt slightly for other markets, but principally this is what I do every time I consider taking a new position in the market. It has taken me many years to develop, but it suits me, my trading style, and it works. There are many others, and many other techniques, but I hope this will at least give you the foundations for building or modifying what I cover here, to suit your own style of trading and method.

Step One

Step one - start with our major currency indices, and consider the timeframe most appropriate to your trading strategy. In the examples below we have both the US dollar index and the Yen index on 15 minute charts. You may also consider having two or three charts of each with different timeframes, just to give you the overall perspective. A 15 minute with perhaps a 60 minute and a daily chart will then provide you with a 'landscape' on the US dollar. You can also do the same with the Yen index.



Fig 13.10 - US dollar index 15 minute chart



Fig 13.11 - Yen index 15 minute chart

Step Two

Next, check the fundamental news releases for the trading day ahead, and also for the week. I always recommend Forex Factory, as I find it easy to use as it covers all the major news releases for the major global economies. Don't forget to click on the icon on the right hand side, which will then open the historic chart as shown below.

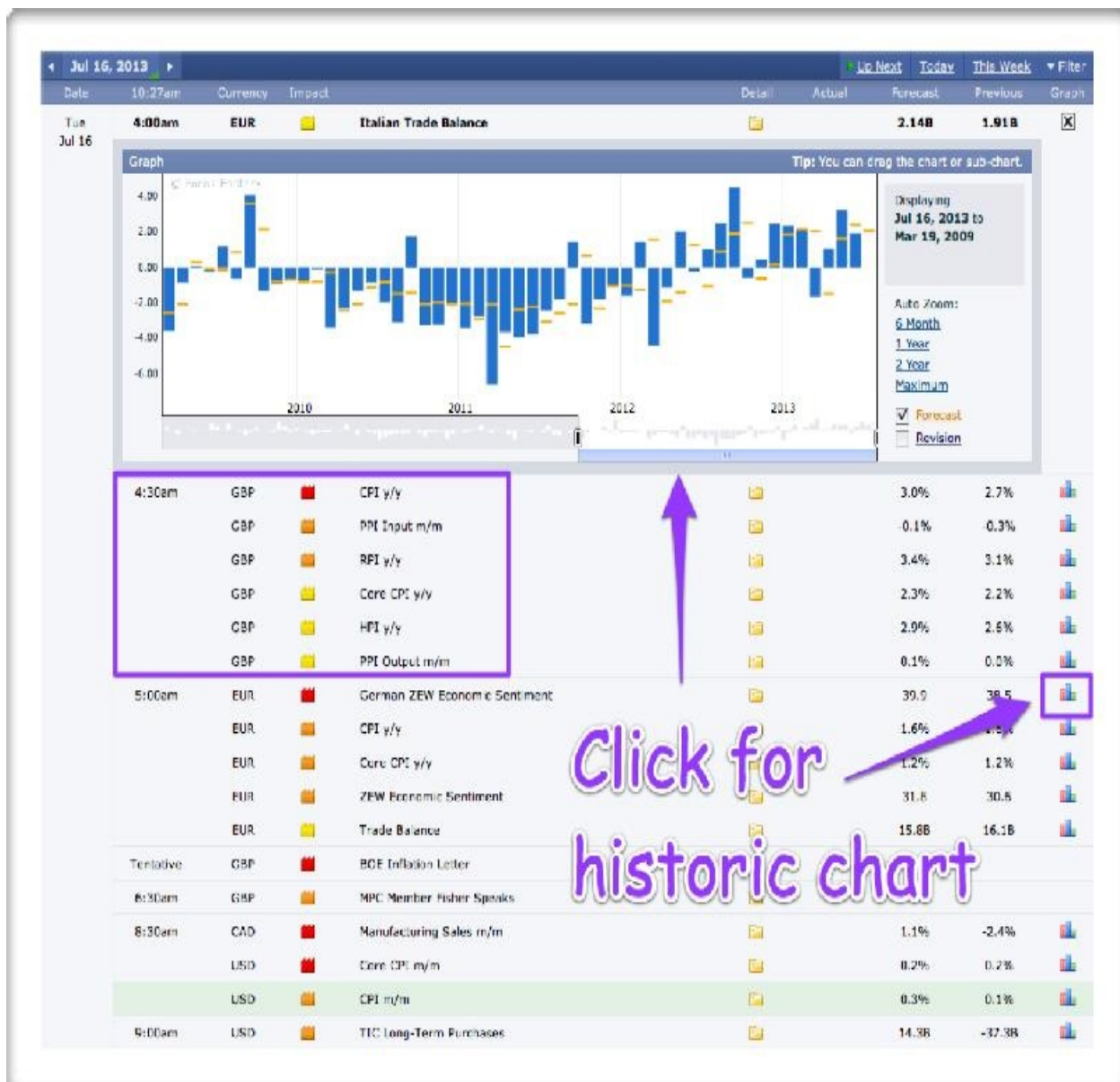


Fig 13.12 - Economic calendar Forex Factory

Step Three

Next we move to our trading platform and for the remainder of this example I am going to use the MT4 platform. At this stage we want to identify strength or weakness in the various currencies, and in particular whether a currency is oversold or overbought. In other words, whether a currency is approaching a possible reversal point, and therefore a potential trading opportunity. Whilst you can do this manually, and cross check with all the charts and timeframes, I personally use a currency strength indicator. This displays all the information visually and instantly, in any timeframe, which is how I believe currency

strength indicators should be used.

In other words, not only does an indicator have to provide information that helps you in your decision making, it must also be part of your methodology. In my opinion this is the correct way to use an indicator. My underlying methodology is volume and price, (and I hope it will become yours too) so any indicator is there either to provide a 'heads up' early warning signal, or help to validate the initial analysis.

This is the way I use indicators in my trading. They are **not** there to provide signals to be taken without thought. They are there to provide information and insights that would be difficult or impossible to produce manually or quickly. The analogy I often use here is of an old fashioned manual typewriter, and a modern pc. Both will produce the same result, a letter, but the second will do it a great deal quicker and editing is a little easier too!

In Fig 13.13, the indicator shows us strength and weakness in an individual currency, each of which is represented by a different color. In this example, using a 5 minute timeframe, the Japanese yen, the blue line, has moved into the overbought region, with the Aussie dollar (pink) and the New Zealand dollar (white), both moving into the oversold region.

EURUSD, M5

1.30652
1.30597
100

CSI 52.5804 67.7419 68.2576 65.2103 79.0684 42.2900 23.7433 24.7365

USD EUR GBP CHF JPY CAD AUD NZD

Overbought

JPY

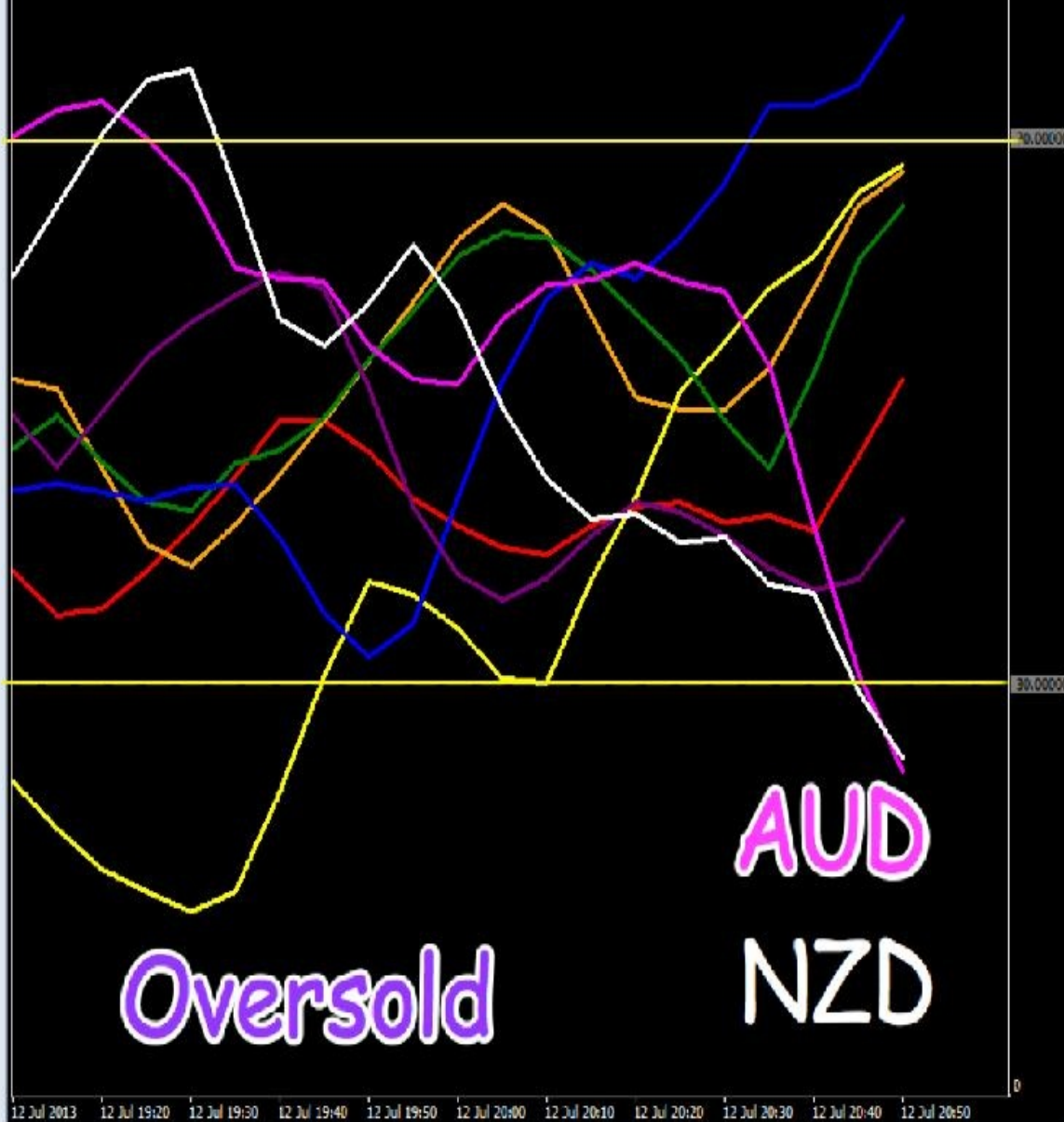


Fig 13.13 - Currency strength indicator 5 minute

This gives us our initial simple starting point for further analysis, and here we have two currency pairs to consider. The first is the AUD/JPY and the second is the NZD/JPY. Remember this is only on the 5 minute timeframe, so here we are looking at short term scalping opportunities. The currency strength indicator is our early warning radar, an advance warning of a possible change ahead in this timeframe. Now it's time to move to the next stage which is to consider these two pairs in more detail, and in particular using volume price analysis. Both of these will also be in our yen currency matrix, once we get to this stage.

Step Four

Suppose we decide to focus on the AUD/JPY for our analysis. Perhaps we are aware of a change in risk sentiment in other markets, and this is often the case when the US markets open and the fundamental data begins to appear. Markets react, and changes in sentiment are very common, with investors and speculators taking on more risk as a result.

Our starting point, is therefore the 5 minute chart to match our timeframe on our currency strength indicator. What is our volume and price relationship signaling at this stage?



Fig 13.14 - AUD/JPY 5 minute chart

Starting with the price action a little earlier in the session. Here we saw the pair trading sideways for an extended period of time, before finally breaking below the floor of support, shown with the yellow line on the chart. This breakout was accompanied by high volume, so we know from our volume price analysis, that this is a genuine move lower. The wide spread down candle, immediately below the yellow line, is associated with high volume, which is what we expect to see. The volume is validating the price so all is well. The pair then move lower again with another wide spread down candle, and this is where the pair moves into the yellow box, shown on the chart. This is the price action that the currency strength indicator is now signaling, a potential pause and reversal in the AUD/JPY from this level.

We are now paying attention, and initially we see a minor rally higher, with above average volume, (the two blue candles), but the second of these looks a little weak. After all, if we use the first candle as our 'yardstick', here we had a

relatively wide spread candle, and yet on the subsequent candle, the same volume produced a very narrow spread candle. Clearly there is some weakness in the move, and the selling pressure has not yet been absorbed.

This is one of the key points that I highlight repeatedly in my book, '**A Complete Guide To Volume Price Analysis**', a market, in whatever timeframe, will rarely turn on a sixpence (or a dime!). Selling pressure, (or buying pressure) takes time to be absorbed. It's a 'mopping up' exercise. The market stops, then rises, then falls back as the final elements of the selling are absorbed, and the market prepares to reverse. This is why you have to be patient and not jump in at the first sign of a potential reversal.

Our patience here is rewarded. Three candles later, we see the candle that really ***grabs our attention!*** Now we are seeing the selling being absorbed in preparation for the move higher. Here we have ultra high volume again, but look at the price action. It is a narrow spread down candle with a deep lower wick, which is exactly what we want to see. This is sending us a loud and clear signal that the buyers are taking control of the market. The sellers have been overwhelmed, and the buyers are coming in at this price level, and pushing the price higher.

This must be the case. After all, if this were selling volume, then the candle would be the same as the one, six candles earlier (wide spread and down). It is not, and in addition it has a deep lower wick. The buyers have 'bought the market', taking it back higher and closing near the open, so clearly this is buying volume and not selling volume. The next candle confirms this with a narrow spread down candle, and above average volume. Clearly the downwards momentum is running out of steam.

This looks like a promising picture. What do we do next?

At this point, all we have done is to consider one timeframe. The 5 minute on our currency strength indicator and the 5 minute chart for the AUD/JPY. Now it's time to start looking at other timeframes to confirm this potential set up, and to see what these charts are revealing.

Moving to the 15 minute chart for the same pair.



Fig 13.15 - AUD/JPY 15 minute chart

Now this is starting to look **very** interesting indeed. Why? Well let me explain.

The pair has been falling in this timeframe too with the move lower associated with rising volume, confirming a genuine move. The volume is validating the price action. We then approach the yellow box on the chart which is where volume and price grabs our attention. The first signal is the wide spread down candle, but look at the lower wick. The closing price has recovered almost half of the price action from the low of this candle, an early sign that buyers are entering the market. After all, if this were not the case, then the candle would have closed on the low of the session, given the associated volume. It hasn't. It has closed almost half way back up, so this must be buying. We then see a narrow spread down candle with high volume, before we get **really** excited - two hammer candles, one after the other. Now the bells are ringing loud and clear. We are seeing a buying climax in this timeframe, and this is looking very promising to take a position. A hammer candle, after a steep fall, such as this is a

strong signal, and two hammer candles together, adds further weight to the analysis.

Once again, the question is - what do we do next?

We are going to be focusing a great deal on the subject of risk in this chapter, and as I'm sure you remember from earlier in the book, there are only two risks in trading. The first is the financial risk which we define and manage within the rules laid out in our trading plan. This is straightforward and easy to measure and quantify. The second risk, is the risk on the trade itself. Is this a high risk, a medium risk, or a low risk opportunity? All we are trying to do now is to judge the probability of this being a positive, or a negative trade. We know we cannot have all positive trades, but in taking a position we are simply making a judgement based on our assessment of the risk. And we have already started to do this in several ways.

First, our currency strength indicator has given us a 'heads up' on the possible reversal in trend. It is not a signal to enter or exit, merely a 'guidance system' to point us in the right direction. Next we looked at our volume price analysis on the same timeframe, always the starting point as a volume based trader. What is this telling us? Is this a possible reversal in trend, and if so, can we qualify this analysis further? The answer is yes, by considering the 15 minute chart. This is giving us a strong signal of a potential trade, with a good chance of success. However, can we quantify that risk further, and if so how? The answer here is to look at an even slower timeframe, in this case the one hour chart. Why? Well let's take a look at the chart, and then I'll explain.



Fig 13.16 - AUD/JPY 60 minute chart

Each of the candles here is over a 1 hour period, so we are looking at several days of price action, and the question we are trying to answer in our own mind is quite simple. In considering this scalping position on a 5 minute chart, are we trading with the 'dominant' trend or against it? And two important trading concepts fall out from this simple question.

- Quantify the risk on the position
- Quantify the time in the market

In this example, we can see on the hourly chart that for the last few days the AUD/JPY has been moving lower. The market is bearish in this timeframe. If we are going to take a bullish position on our 5 minute chart, then we are trading against the dominant trend. In other words the risk on the trade is higher. Why? Because we are trading against the 'longer term' trend, what is known as counter

trend trading. In effect, what we are considering trading here, is a 'pullback' or a 'reversal' in a longer term trend. Therefore the risk on the trade is higher - it has to be, as we are trading against the dominant trend.

This leads us to a second important concept which is this. If we are trading against the dominant trend, then we know we are unlikely to be holding this position for very long. Why? Because, as we have already seen, we are trading against the major trend in a higher time frame, and are therefore trading on a pullback or a minor reversal, so any move is unlikely to last long, unless this is a change in the longer term trend as well.

These are two key questions which help to quantify the risk on taking this position. First, are we trading against the dominant trend? If we are, then the risk on the position is higher, it has to be! Second, if we are indeed trading against the dominant trend, then we are going to manage this position very closely. It is not a position we are going to let run and run. The risk will be far too high. This is all we are doing here. Attempting to quantify the risk in taking this position, before going ahead.

At this stage, you probably have several questions, which I will try to answer, and the one I am always asked is what timeframes to consider when looking at the 'dominant' trend. This is a difficult question, but my answer is always the same, as everything is relative to the timeframes being traded. After all, in the above example, you would not consider a weekly chart as the dominant timeframe. It is far too slow, and irrelevant to your trading chart. It tells you nothing of value. Trends can be on a 1 minute chart through to a weekly or a monthly chart, they are all trends, but occur in different timeframes, and whenever you take a position, you will always be trading against a trend in some higher timeframe. And the example I always use to explain this is gold.

If you took a monthly chart for gold, the commodity rose from \$250 per ounce to almost \$2,000 per ounce in a ten year period. No one would suggest that in this time frame, intra day trading shorting gold was a high risk trading position. It is all relative, and a combination of experience, and common sense.

A scalping trader on a 5 minute chart would consider a 60 minute chart as the dominant trend. A medium term trader using a 60 minute chart would consider the daily chart as their dominant trend. And a longer term daily trader would consider the weekly or perhaps the monthly as the dominant trend. There are no hard and fast rules here, just common sense. For a short term trade on a 5 minute

chart, the 30 minute chart would also be useful. It is simply to put the position into perspective. To frame the trade if you like, to give it context and meaning, and above all, to try to quantify the risk on the position. This is all we are trying to do here. To trade with the momentum of the market.

And finally, to answer a further point which often comes up on this issue. There is nothing wrong with trading against the dominant trend whatsoever. I do it all the time. But, and here's the corollary, I do it in the full knowledge that I am taking on more risk on the trade, and that I will probably not be holding this position for very long. At this juncture, what do we do next?

Remember the currency matrix? The matrix is what we check next to see whether the move in the AUD/JPY is the result of yen strength, or Aussie weakness.



Fig 13.17 - The Yen currency matrix

And the matrix is painting an interesting picture. If we work our way across from left to right, and top to bottom. The NZD/JPY and the AUD/JPY are very similar with strong volumes, and price action which is starting to flatten out. On the USD/JPY we can see that the buying of the yen here has already begun, a good sign that this pair is leading the way. This is also the same for the GBP/JPY

which has reversed ahead of the others. Finally the EUR/JPY and the CHF/JPY are much the same as for the NZD/JPY and AUD/JPY, with very similar volume profiles and price action. So what is the currency matrix telling us?

Very simply, all the yen pairs are reaching oversold positions, and are either preparing to reverse or, as in the case of the USD/JPY and the GBP/JPY, have already started to move higher. This is a good signal, and once again gives us the confidence to take the trade. The currency matrix is telling us that the move is yen driven, since this is appearing in all the other pairs. Once again, as with all this analysis, we are quantifying risk in preparation for taking a position in the market. These are all based on a 15 minute chart, but equally you could change these to the 5 minute, or any other timeframe you choose. The important thing is that you use the same timeframe for your matrix as the chart you are looking to take the trade in.

We are now ready to take a position in the market. We have completed our analysis, and based on this assessment of risk, we would either take the position, or reject it accordingly.

Let's take another example, just to demonstrate that the same process applies whatever your strategy. Here we are moving to a weekly timeframe, so if you are starting out and perhaps have a full time job, this longer term approach allows you to learn to trade, but continue to work, as you build up your knowledge and experience. However, the process is identical, and as always we start with our currency strength indicator, as our radar on the market of where to look first. It is just like the sonar device that trawler fishermen use to locate large shoals of fish. The only difference is that we are hunting for currencies!



Fig 13.18 - Currency strength indicator weekly

Once again, what we are looking for here are currencies which are either overbought or oversold at the extremes, but in this case on the weekly timeframe. Here we have the euro (the orange line) in the overbought area, along with the US dollar (the red line), and the Australian dollar (the pink line), in the oversold area. Here we have a choice, either the EUR/AUD or the AUD/USD. Let's take the AUD/USD as this is a major currency pair, and therefore more liquid as a result, but the EUR/AUD would be equally appropriate, although with a much wider spread.

Here is the weekly chart for the AUD/USD, and the question we need to ask ourselves, based on the currency strength indicator, is whether the time has come to buy the AUD/USD?



Fig 13.19 - AUD/USD weekly chart

This is a great chart, as it has several very interesting features, all of which are relevant in considering the future direction for the pair in this timeframe. First, the extended period of sideways congestion, which I have shown with the yellow and green lines, lasted several months, and really does demonstrate how patient you need to be when trading these timeframes. Notice the number of times the upper level of 1.0600 was tested, and each time failed, building further resistance at this level on each failure. Finally the pair broke below the floor of support (the yellow line), creating a nice price waterfall as the pair moved lower, and associated with rising volume, for much of the move, another case of volume validating the price action.

However, note the volume and price action of the last few weeks. First we have wide spread down candles, with very high volume as expected, but this is then followed by a narrow spread down candle, with identical volume. Is this the first sign of stopping volume, of buyers starting to come in at this level? Note also that this candle has an upper wick. The buyers have tried to push the market higher but failed, but it is a possible signal that bullish sentiment is starting to appear. This is followed by a similar candle, a down candle with a narrow spread, but with very high volume. The downwards price action is slowing, and the volume associated with these candles is starting to fall, not dramatically, but slowly.

Finally, we see our first up candle, in blue, and high volume, also in blue. This candle is often referred to as a gravestone doji candle and can be the pre-cursor to a reversal in trend. Why? Because it is the first strong signal that buyers are coming into the market, and in this case, it's associated with high volume too, an early warning to pay attention. Now we are looking for a follow through on this bullish sentiment, and the next candle, which has yet to complete on the week, is certainly confirming a picture which is developing nicely.

Given that we are looking at a weekly chart here, let's take a look at the timescales either side, using the daily and the monthly, in order to have a perspective against which to frame the weekly chart. And starting with the monthly chart, here we see the weekly price action, condensed into a handful of candles, with the recent negative sentiment contained in two wide spread down candles, but which are associated with rising volume.



Fig 13.20 - AUD/USD monthly chart

The blue candle is the month just forming, and as we can see, the price action has narrowed considerably, but with well above average volume already, even though this is only half way through the month. This could be the first signal of a change in trend in the longer term. In addition, the price action in this timeframe, is also approaching and testing a level of potential price support, which may provide an additional platform for any recovery from this level. It therefore appears that the monthly candle is confirming the weekly picture. Finally let's move to the daily chart for an 'exploded' view on the weekly.



Fig 13.21 - AUD/USD daily chart

Here we see an expanded view of the weekly chart. This gives us a very different perspective which is so important. When considering longer term timeframes, it is very easy to look at one candle on a weekly or a monthly chart, and to forget that within such a candle, you also have all the daily price movements. What is clear from the daily chart here, is that the AUD/USD is in an obvious period of consolidation. The ‘floor’ of the potential support area is now in place below, and the ‘ceiling’ of the price resistance is also clearly defined above. What is also evident here, looking at the general trend in volume from left to right, is that volumes have been rising generally. Notice in particular, (confirming what we saw on the weekly chart), that volumes over the initial downwards move have been rising, confirming a valid move. These volumes appear to have reached a maximum, and as the pair move into sideways congestion, we should expect to see further signals in preparation for a breakout and possible move back higher.

If I were looking at this and assessing the risk, my decision at this stage would

be to take a 'wait and see' approach. It is far too early to make a decision just yet, but it is certainly a pair to watch, and what I would be looking for here, are signs of a buying climax on the daily and weekly charts, and then confirmed in the monthly. In addition, I would also be watching for any breakout on the daily chart beyond the current ceiling of resistance. Provided any move away from this region was associated with high volume, this would give a strong entry signal for a longer term position. The point is this, that whatever timeframe you are trading, the approach and your analysis of the risk are the same. You are simply making a decision about the risk on the position, whatever the timeframe.

Finally, once again we would then move to the currency matrix, to look for any confirming clues or signals here, which could tip the risk more in our favor.



Fig 13.22 - AUD currency matrix

Wow, this gives us a huge amount of additional information, and really offers a 'six' dimensional view of the Aussie dollar, against all the other major currencies. Let's see what other information we can gather here in helping us to further quantify any risk on taking this position in due course.

And the first thing to note before we get started, is that unlike the previous example, where the counter currency was the yen in every case, here the counter

currency differs. Here we have four pairs with the Aussie dollar as the base currency, but then two pairs, the British pound and the euro, where the Aussie dollar moves to the counter currency. What this means is that these charts will be the inverse of the others. On one chart, weakness in the Aussie dollar will see the pair fall, whilst on another chart, the pair will be rising. This is great, as it gives us a much more rounded view of what is happening to the Aussie dollar. After all, on one chart we will be seeing a possible buying climax, whilst on the other, this will be mirrored with a selling climax, so a real 'multi dimensional' view of the currency, simply by considering the currency matrix.

Moving around the charts as before, and starting on the top left and then moving across, we have already considered the AUD/USD, and alongside this is the AUD/JPY. Not such a dramatic 'sell off' here, but nonetheless reflecting the weakness in the AUD. Note the rising volumes once again confirming the move towards a possible buying climax here, and of particular importance is the price congestion phase. Here we have three down candles, all with narrow spreads, and yet associated with very high volume. This is stopping volume and absorption of the selling pressure. It has to be because if the sellers were still in control, then the AUD/JPY would have moved lower on such volumes. It hasn't. It has moved into sideways consolidation at this level, and therefore this must be buying volume. However, note also the buying here, the blue volume bars, which are falling at present, so a possible sign that the market is not quite ready to rally higher just yet.

Moving to the AUD/CHF in the top right, once again we have a similar picture here, with strong and rising volumes and narrowing spreads, all signs of buying and stopping volume at this level. This is also confirmed with the AUD/CAD on the bottom left, with rising volumes and a series of narrow spread candles, although here, the pair have yet to find a sustained platform of support.

Finally, we come to the 'inverse' pairs, the GBP/AUD and the EUR/AUD. Here the price action is rising as the Aussie dollar weakens, and the great thing to note is that despite this, the picture is the same. Volumes have risen consistently as these pairs have risen, and now the weakness of the Aussie dollar is clear to see. The buyers who have taken these two pairs higher, are now starting to struggle at this level, with both pairs topping out and creating sustained areas of price resistance as a result. These are mirror images of the pairs above, and really confirm for you, that the trend that we have seen in the Aussie dollar is almost entirely driven by weakness in this currency, since it is reflected in all the other pairs in the matrix.

All we need to do, is be patient, and wait for the inevitable breakout which will come in due course, and which will duly appear, not just on the AUD/USD chart itself, but also on the currency matrix. This is the power of the matrix. It's a simple idea, but one which reveals so much, and gives you the confidence when taking a position, knowing that you have assessed the risk in a simple but logical way.

At this point I would like to introduce a further concept to you, but again one which is based on considering multiple charts and multiple timeframes. We are going to take another example shortly, and walk through the complete process from the initial analysis, to order entry, stop position and management, and finally the exit from the position. However, let me explain how you can also use different timeframes in another way, and here we are back at the start of our analysis with our old friend, the currency strength indicator. Please don't worry if you don't have one of these, there are plenty available on the internet. They all work in a very similar way and are well worth investigating, as they save a huge amount of time and effort. As with all indicators, it is possible to execute all the calculations manually, but it would be slow and time consuming. It's much easier with one of these!

Here we have three timeframes, a 15 minute, a 30 minute and a 60 minute, and all I want to focus on here is one currency, the British pound (GBP), which is the yellow line.



Fig 13.23 - Currency strength on 15 minutes

EURUSD, M30

CSI 60.4347 43.1742 85.0696 34.4603 19.6241 76.7329 30.7385 59.9530

USD EUR GBP CHF JPY CAD AUD NZD

GBP



30 min

18 Jul 2013 18 Jul 07:00 18 Jul 08:00 18 Jul 09:00 18 Jul 10:00 18 Jul 11:00 18 Jul 12:00

1.30783

100

70.00000

30.00000

0

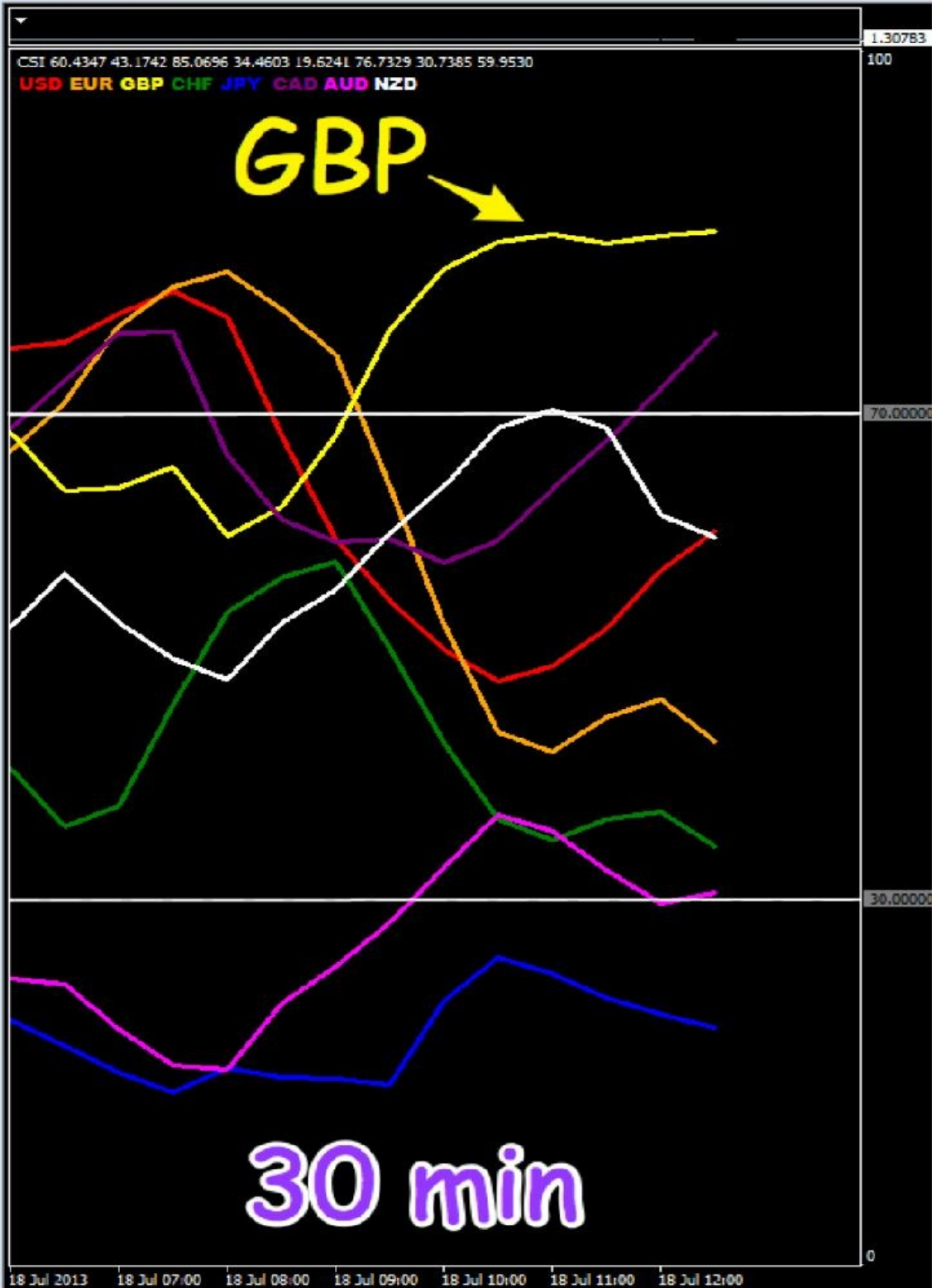


Fig 13.24 - Currency strength on 30 minutes

EURUSD,H1

1.30779

CSI 58.9278 45.0573 84.7690 35.6379 14.9015 61.5450 28.2225 66.4672

USD EUR GBP CHF JPY CAD AUD NZD

GBP



60 min

17 Jul 2013 18 Jul 01:00 18 Jul 03:00 18 Jul 05:00 18 Jul 07:00 18 Jul 09:00 18 Jul 11:00

0

30.00000

70.00000

100

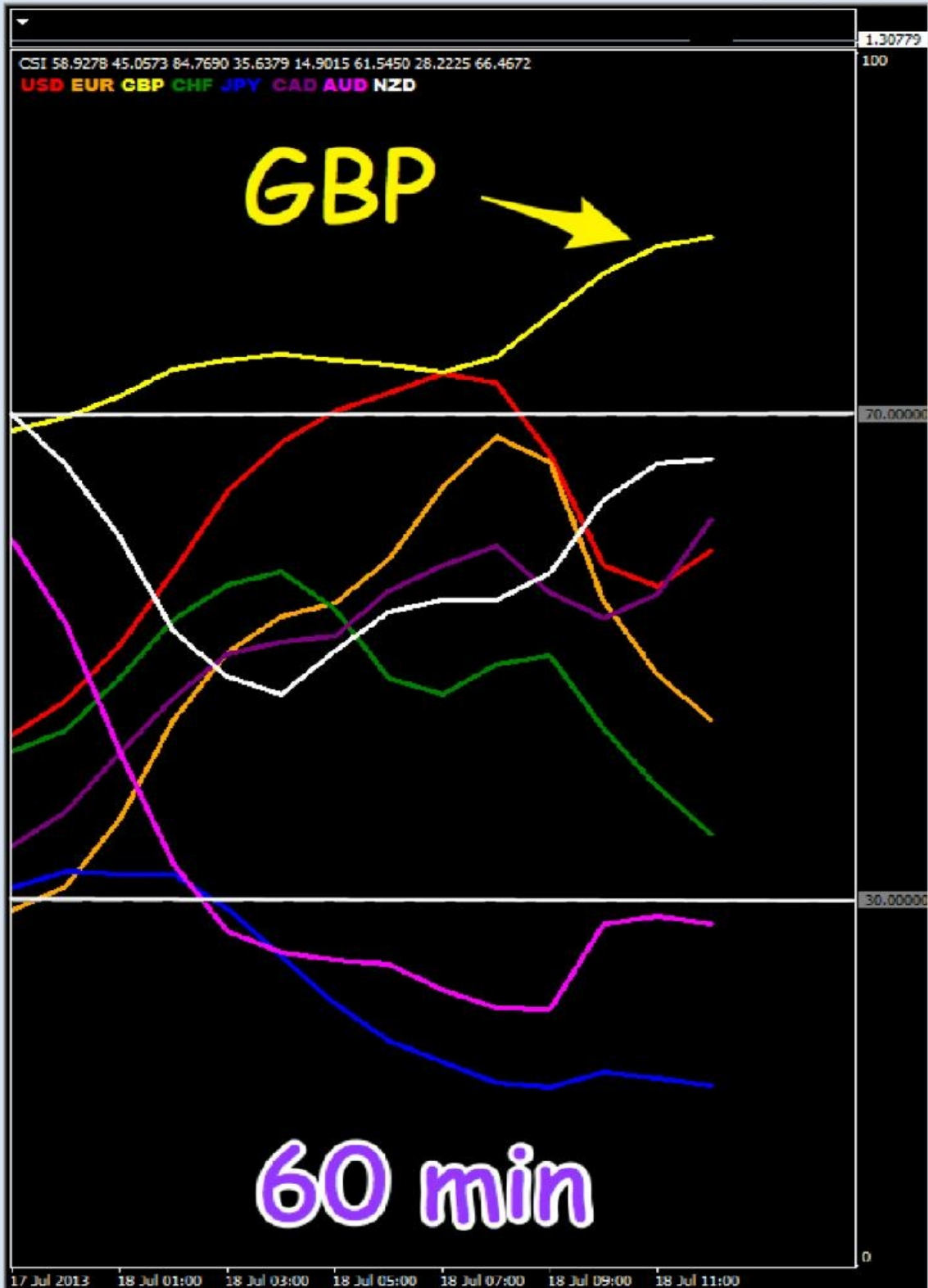


Fig 13.25 - Currency strength on 60 minutes

What are these three timeframes telling us about risk, and in particular any risk associated with taking a position in the British pound? And, the answer is very simple.

Suppose we were a scalping trader considering a short position in the pound - don't worry against what for now, as I just want to fix this principle in your mind for you. Here we can see that on the 15 minute timeframe, the pound has reached an overbought area, and has since 'rolled over', so we can safely assume that the pound, in this timeframe is being sold. Now let's move to our 30 minute chart, what's happening here? Well, the pound is still in the overbought region of the chart, but has yet to start moving lower in this timeframe. Finally we move to the 60 minute chart, and we can see once again, that the pound is heavily overbought in this timeframe, but has not yet started its move lower.

The question is this. How does this help? And the answer is very straightforward. If we are going to take a short position in the pound, wouldn't it be comforting to know that we are trading with the longer term trends as well? And this is precisely what is being revealed here. In taking a short position in a fast timeframe (perhaps on the 15 minute chart or even the 5 minute chart) we can be pretty sure, that in due course, the pound is going to reverse its trend in the slower timeframes as well. After all, no currency ever stays overbought or oversold for ever. They always have to snap back eventually, since unlike equity markets, a currency never goes to zero!

The analogy I use here is of a pebble in a pond. Imagine you are in a boat in the centre of a small pond, and you drop a large pebble into the water. The ripples from the pebble will move out and away from you, eventually reaching the side of the pond. This is what happens when we look at price action in multiple timeframes. Any change in trend happens first on your fastest timeframe, in this case the 15 minute chart, then gradually ripples out to your 30 minute chart, and finally it reaches your slowest chart, the 60 minute chart. This is what is happening here.

The change in sentiment for the pound, moving from buying to selling began with the currency rolling over in the 15 minute chart, but has not yet reached the 30 minute or the 60 minute.

However, with the currency now very 'over extended', this is now not a question of if, but when! In taking a short position on the pound therefore, we are able to

quantify the risk, simply by considering other timeframes in the currency strength indicator. It's as simple as that.

In other words, the risk on this position is low, since we are going to be trading with the dominant trend over the longer timeframes. This picture will also be reflected once we start to consider the charts in the different timeframes, but by using the indicator in this way, we get an immediate 'heads up' before taking our analysis further. This is the power of using multiple timeframes. Here we are trading with the dominant trend in both the 30 minute and the 60 minute, so we can conclude two things.

First, the risk on any position will be low. Second, we can hold this position for some time, as we are not counter trend trading, but trading with the longer term trend. Even if we see minor pullbacks or reversals on our faster charts, we can be comfortable in the knowledge that on our slower timeframes, the currency has some way to go before reaching the opposite region on the chart - in this case moving to oversold.

Naturally, there are never any guarantees in trading, and the currency may stay overbought for some time, but eventually it will move. It has to, and in many ways forex trading is really about timing, as ultimately, all traders are proved right, it's just their timing that was wrong!

Finally, in the above example the pair that probably looked the most interesting here was the GBP/JPY (the yellow and the blue lines).

I now want to consider some further examples in 'real time' and in the next few pages, I'm going to walk you through all the various aspects of identifying, entering, managing and then exiting positions, together with the elements you need to consider in a complete 'cycle' from start to finish. In other words, everything you need to think about and do, as you open and then close a position. And the starting point as always is our currency strength indicator.

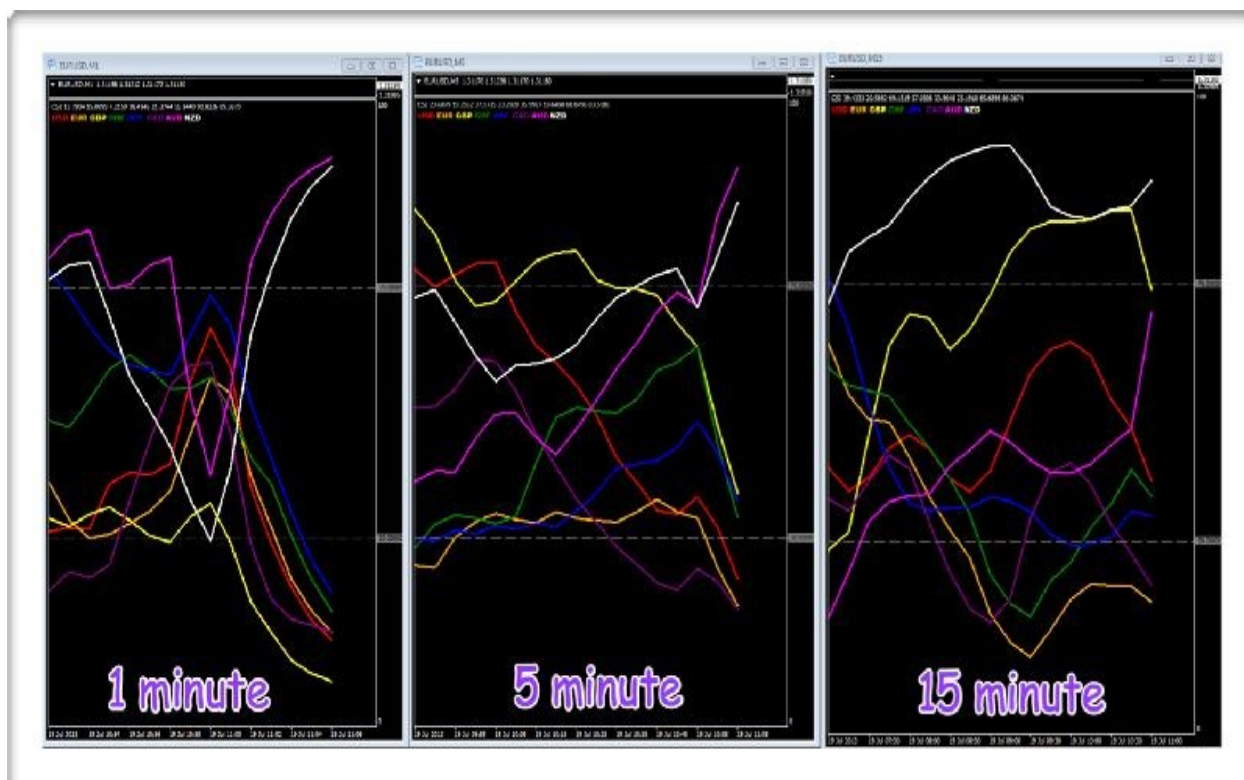


Fig 13.26 - Currency strength indicator, multiple timeframes

This is where we begin our analysis, and as I explained earlier in the chapter, using multiple timeframes applies to every aspect of our analysis, as well as in our trading methodology and approach. I can only stress again that trading success is about quantifying and managing risk, and if we can use tools and indicators to help us achieve this simple goal, then that's fine with me!

Let me just highlight the colors for you on the above indicators which will save me time, and I hope make this easier to follow for you as the reader. These are as follows:

- Red - US dollar
- Orange - euro
- Yellow - British pound
- Green - Swiss franc
- Blue - Japanese yen
- Maroon - Canadian dollar
- Pink - Aussie dollar

- White - New Zealand dollar

As you can see from the indicators, we have some interesting price action across the timeframes, and just as a side note, if you are using the MT4 platform, from which these images are taken, then the 1 minute, 5 minute and 15 minute timeframes are an excellent combination for intra day scalping. I'll explain more about the set up and approach as we move deeper into these examples, but it is a nice combination. The analogy I always use in my trading rooms is that of a three lane highway or motorway. You have three lanes of traffic, the slow, the medium and the fast. If you are driving in the middle lane, your medium speed chart, then on either side you have your fast and slow lanes, which will give you your perspective on the market. They are rather like the wing mirrors on your car, one left and one right, and as you drive along, you can see what is going on either side of you. It gives you this perspective, and is how you see the ripples of market sentiment moving from your fast chart, to your medium and ultimately to your slow chart. The pebble in the pond analogy.

However, back to our charts, and on the 1 minute we can immediately see some possible opportunities here. In the overbought region at the top we have the Aussie dollar and the New Zealand dollar, whilst at the bottom, in the oversold region, we have all the other currencies, so we are really spoilt for choice here. But what is happening on our 5 minute chart? And, here we have the Australian dollar climbing towards the overbought region along with the New Zealand dollar, whilst all the other currencies are diving towards the oversold area, with the US dollar, the euro and the Canadian dollar already deep in this region, with the others moving sharply lower to join them.

Finally, moving to our 'slowest' timeframe, the 15 minute chart, here we can see the New Zealand dollar has turned lower, but now appears to be pushing back higher into the overbought region, whilst the British pound has already started to turn lower. The other currencies still have some way to go before they reach the extremes on the chart. The US dollar is now moving lower once again having had a brief rally higher, whilst the Australian dollar is rising strongly, but it too has some way to go before it reaches a firmly overbought position. Moving to the oversold area, the euro is already there along with the Canadian dollar, and the Swiss franc and the Japanese yen look to be joining them shortly.

Clearly we are spoilt for choice, but there are several things to bear in mind.

First, let's focus on the US dollar, the red line. On the 5 minute chart, whilst it is

in the oversold region, it appears to have a little way to go before turning, whilst on the 15 minute chart, it has yet to reach this region, so this looks very promising for considering a long position on the US dollar. The second point with regard to the USD is that any spreads are likely to be much smaller, and in addition liquidity will be good, as we will be trading a major currency pair. The spread is an issue as a scalping trader, and something we always have to have in the back of our minds and as such, the US dollar should always be your initial focus of attention, before moving to the cross pairs, if nothing is available. In this case, it appears as though the US dollar may be setting up to reverse in due course.

Against the US dollar, we could consider the Australian dollar, which has yet to reach an overbought area on either the 5 minute or the 15 minute, but is already looking very 'over extended' on the 1 minute chart, with the US dollar at the bottom and the Australian dollar at the top. In addition to the AUD, the New Zealand dollar is also following a similar path, and on the 15 minute chart is deep in the overbought region, and this would be one to consider as well.

Now let's scroll forward 30 minutes, and see what happened as the markets moved on.

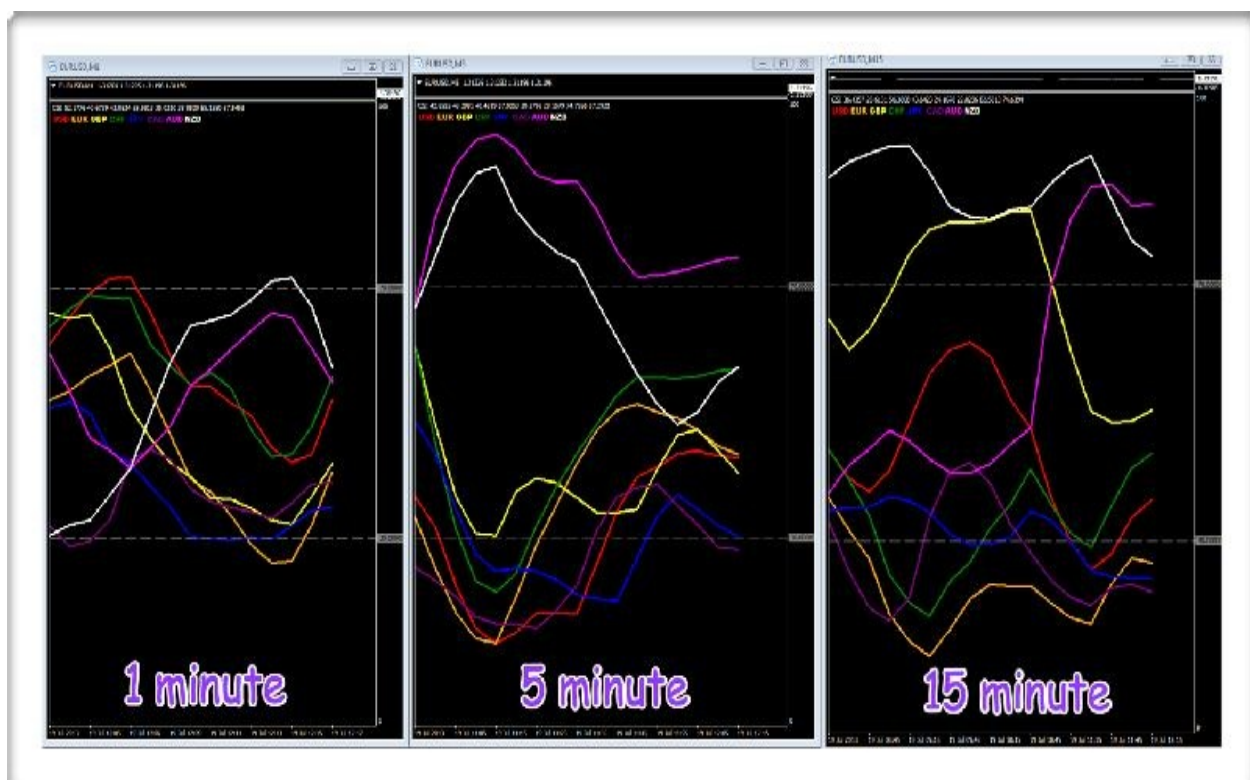


Fig 13.27 - Currency strength indicator, 30 minutes later

The period of price action being recorded here was late in the London session, and just ahead of the US session. There was little in the way of any significant fundamental data due, with the markets focusing instead on Day 1 of a planned G20 meeting, ahead of the weekend.

As we can see from the above charts, the AUD/USD certainly seems to have been a good choice. Let's look at what happened over this 30 minute period? Well, first the Aussie dollar **initially** continued higher into the overbought region, on both the 5 minute and the 15 minute charts. At the same time the US dollar **also** continued deeper into the oversold region, setting things up nicely.

Then as we scroll forwards in time, the Aussie dollar starts to fall on the 5 minute chart, with the US dollar gradually starting to rise simultaneously, on both the 5 minute, and 15 minute charts. But, as we can see, whilst the Aussie dollar has already turned on the 5 minute chart, it has yet to show any great momentum on the 15 minute chart.

Finally, and just to complete the picture, we can see that the Aussie dollar and the US dollar are moving in the middle region of the chart, and this simple reflects a period of price congestion in this faster timeframe.

Now let's move to the charts themselves and see how this price action plays out using volume price analysis. Please note, that whilst the charts are shown separately here, for trading, they would be on one screen, or on multiple screens.



Fig 13.28 - AUD/USD 1 minute chart

The volume and price action is shown by the yellow ellipse on the chart.

What is immediately obvious from the one minute chart is the sheer scale of the volume associated with the rapid move higher for the AUD/USD, but look at the price action near the top of this move. Here we have ultra high volume bars associated with narrow spread up candles. Clearly a move that is running out of steam. After all, look at the volume bars associated with the earlier price action - these are enormous, and sending a clear signal of a possible selling climax at this level. Now we have to be patient. As I have said many times before, markets do not reverse immediately. We have to be patient, and following this surge in volume, the pair are now moving sideways in this timeframe, and what we are looking for, is a breakout from the narrow congestion phase of price action as shown by the two green lines. These define the resistance and support regions on the chart as we wait for a break below the support region, for a continuation of the bearish trend.

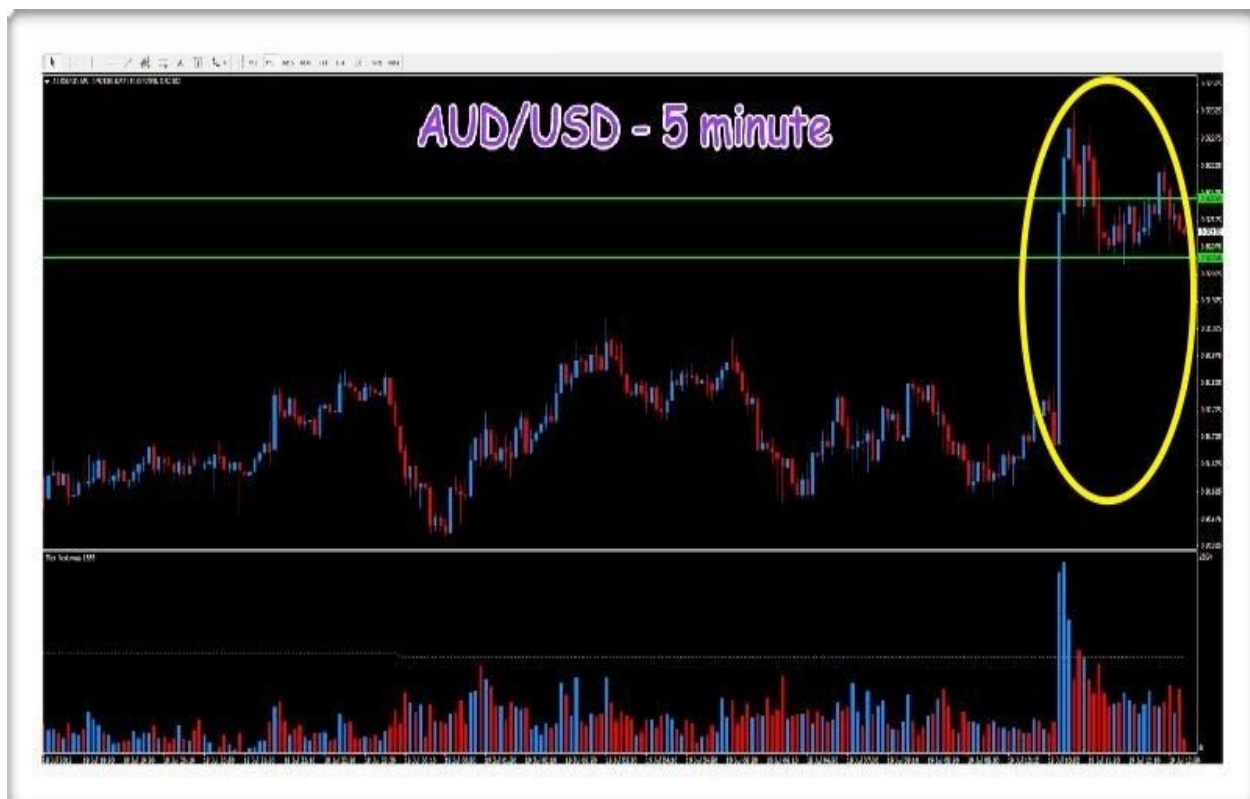


Fig 13.29 - AUD/USD 5 minute chart

Now we have moved to the 5 minute chart, which reflects the volume and price action in a slower timeframe. Here we have a similar pattern, with the initial surge higher on extremely high volume, signaling weakness as it reached the top on the third bullish candle in the move higher, before moving lower, and into the sideways congestion phase, mirrored on the currency strength indicator.

Finally we move to the 15 minute for our 'longer term' perspective.



Fig 13.30 - AUD/USD 15 minute chart

Here again we have the same picture, but the surge higher is condensed to one bar, with the price action again circled in yellow. However, what is also very interesting here, and gives us additional confidence, is the price action to the left of the chart. This was from a couple of days earlier - note the volume and price pattern. A huge surge in volume with a sudden and dramatic move higher, only for the market to consolidate and then move lower in due course following a congestion phase. The current price action looks like a repeat performance, and the volume bar on the left of the chart gives us our perspective for assessing today's volume bars. As traders we have to be patient and wait. If we are wrong, then we are wrong and we simply move on. Our stop loss, which I am going to cover in more detail shortly, will take us out of the market.

Now let's check on our USD currency matrix to see what the other major pairs are doing and whether there are any clues or signals there for us to follow.



Fig 13.31 - Currency matrix USD

And what an interesting picture it is too, and the reason I chose this trade was to highlight exactly this point. So what is happening with these major currency pairs?

First, the AUD/USD. We are waiting for the pair to move lower, and break through the potential platform of support, which has happened as I was writing. This position is now developing nicely. However, moving to the other pairs, is this move more reflective of Aussie dollar weakness or US dollar strength, as this will then dictate the risk on the position?

If we start with the EUR/USD what has happened here? Remember, the counter currency is the same as for the AUD/USD, so strength or weakness in the US dollar, should generally see the pair moving in a similar direction.

However, as we can see here, the EUR/USD is actually rising, so the US dollar is being sold here in favor of the euro, the opposite of what is happening in the AUD/USD, where the US dollar is being bought. Is this a warning signal? Perhaps? Moving to the top right hand corner of the matrix, the USD/JPY has been moving sideways for the day, and lacks any clear direction. Here there is little bias for the US dollar.

Next is the USD/CHF in the bottom left hand corner, and here we see the US dollar being sold again, this time against the Swiss franc, and moving inversely to the EUR/USD, as expected. Alongside is the GBP/USD, another pair lacking any firm momentum for the US dollar. Finally at the bottom right of the matrix we have the USD/CAD and here too we see the US dollar being sold, this time against the Canadian dollar.

To summarize. Of the six major currency pairs, three are seeing the US dollar being sold, two are moving sideways and one where the US dollar is being bought. And the one where the US dollar is being bought is the AUD/USD. At this point we need to ask ourselves, one simple question. What is the risk on this position? Is it high, medium or low? And to answer my own question, you should have realized by now, that the risk on this position is high.

Why?

It is the power of using a currency matrix. If the US dollar was being bought or sold universally across the major currencies, then the risk on any position would be low, since we know that the driving force is the US dollar. In this case, the AUD/USD is the only currency where the US dollar is being bought. From which we can deduce that this is a high risk trade. It has to be, since we are taking a position in a pair against the weight of the market, which is doing the opposite and selling the US dollar.

Whilst we were correct in our analysis, and would have made money here, the development of the trade was very slow, with several periods of sideways price action, and we'll take a look at those in a moment on one chart. But in addition, this lack of momentum in the US dollar was also very visible in our currency strength indicator.

And here I am considering the indicator on a 15 minute timeframe, but have taken the 5 minute chart for the AUD/USD, zooming into the chart as much as possible to highlight all the detail associated with the volume and price behavior.

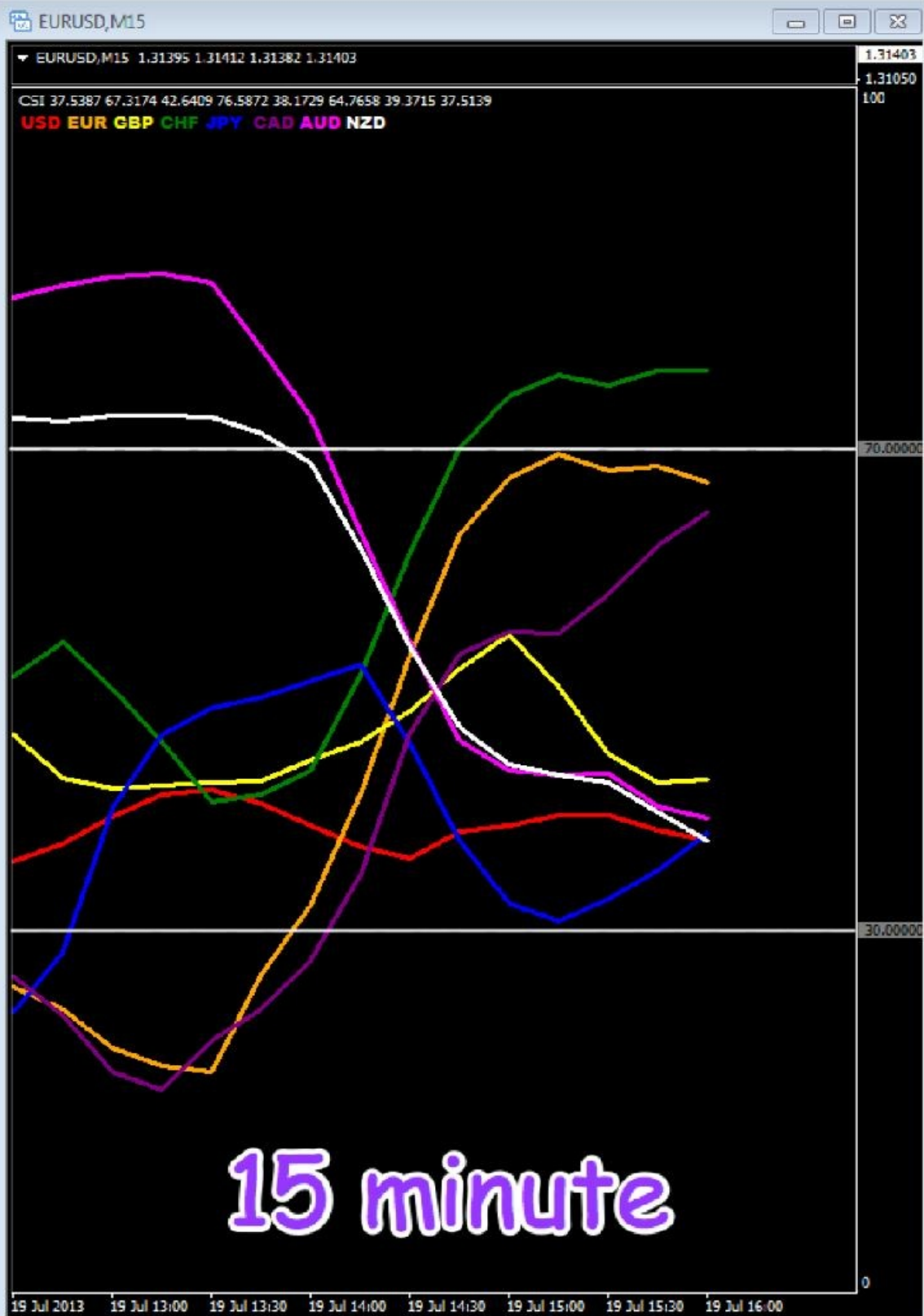


Fig 13.32 - Currency strength indicator five hours later

This really encapsulates the AUD/USD trade in a simple visual way. Fig 13.32 shows the journey of the two currencies over a five hour period throughout the remainder of the trading session.

First, we can see that the Aussie dollar (the pink line) has fallen over this period, moving from the overbought region where we first took notice, down towards the oversold region at the bottom of the chart. It still has some way to go before it reaches this area, and this was the price action we saw on the chart. However, as always in the currency market, it takes 'two to tango', and the red line, the US dollar, really tells it's own story. When we first considered this position as a possible trading opportunity, the US dollar was well established in the oversold region of the chart, and therefore potentially looking to reverse higher and back towards the overbought region in the longer term.

However, since then, all we have seen is the US dollar meander along, lacking both direction and momentum, and the reason for this is not hard to understand, once you consider the currency matrix. With the US dollar only being bought against the Australian dollar, and either having no direction or being sold, against the others, it is hardly any wonder that it lacks momentum!

This is the power of the currency matrix. It reveals the strength of buying and selling of currencies across **all** the major pairs, and in doing so, tells us so much as forex traders. Had we just focused on our chosen pair, in this case the AUD/USD, the consolidation phase would have been self evident, but with no other means of assessing risk. The matrix gives us that tool - the means to assess risk. This is why I wanted to use this example. It would have been very easy to find some simple examples where everything worked perfectly, with some nice positive trades. The forex market is far more complex, but with the simple device of a currency matrix, and reinforced with a currency strength indicator (if you choose to have one), the nuances and forces driving each pair become instantly visible.

Turning to the price action and associated volume for the same period, using the 5 minute chart, here we can see both in greater detail.



Fig 13.33 - AUD/USD 5 min chart, five hours later

The currency strength indicator gave us our initial 'heads up' and from there, one of the charts we considered was the 5 minute, as shown in Fig 13.33. The first signal to grab our attention was the volume. It's clear from the chart that we had a market moving sideways on average to low volume, when suddenly over a 15 minute period, sustained and massive volume appears on three successive candles. The second volume bar is actually higher than the first, but the price spread on the second candle is actually narrower than on the first. This sets alarm bells ringing as now we have a yardstick for the volume price relationship from the first candle, and our conclusion from the second candle is that the market is struggling to move higher at this level, and indeed within the volume bar, there must be some selling. If it were all buying, then the price spread would have been the same as on the first candle, and it isn't. The only conclusion we can draw is that there is weakness appearing, and this is possibly a trap up move with the Interbank market makers selling heavily into the move higher.

The third candle in this sequence then appears, and adds further weight to our analysis. The spread on this candle is much narrower than on the first two, but look at the volume, it is still extremely high, a very strong signal of potential weakness at this level. And the market duly starts to sell off, and begins to slide

lower, before moving into a period of sideways congestion. The volume has now returned to more 'normal' levels, as the price action moves higher and lower, creating the ceiling of resistance and floor of support which are so important in technical trading. For any continuation of the move lower, the green line, the support level, needed to be breached, which duly occurred, before the pair moved into a secondary period of consolidation at a slightly lower level on the chart.

And the reason? In this case the US dollar was not being bought or sold universally across the market. The net result was a much higher risk on the trade. In this case we would have been fine and made money, but this is not always the case. We may have decided to take the position anyway, knowing the risks. There is nothing wrong in taking this view. What I have tried to highlight here, is an easy way to assess the risks. Whether you choose to take such trades or let them pass, is a personal choice, and one that only you can make at the time. Any decision will depend on your attitude to risk, and whether you are perhaps a cautious trader, who only considers low risk trades, or one who is more aggressive and prepared to take on a little more risk. As always, there is no right or wrong answer here, only what is right for you.

So What Happened Next....?

Towards the end of the trading session the AUD/USD broke through the second level of price support with a wide spread down candle, almost taking the pair back to where it started.



Fig 13.34 - And finally!

In case you were wondering, this section of the chapter was written in real time. In other words, as the price action unfolded, so I described what was happening on the screen, something few other books have ever done. As the position progressed, I analyzed and wrote about the price action in this chapter. It was the only way that I could think of, to show you the processes in ‘real time’ starting from the point when the first signal is flagged, and then through the process of analysis and assessment as the subsequent price action unfolds. Fig 13.34 shows the price action towards the end of the session approaching the weekend, and as you can see, the pair finally lurched lower again. At this point, it is decision time. Do you close out, or leave this position open over the weekend?

This is a discretionary decision, with no right or wrong answer. It is a topic we will cover in the next section, as we start to consider the process of position management, and the decisions you have to make as the price action unfolds.

That was our AUD/USD trade. It worked out well, but was a higher risk proposition, and that risk was reflected in the time it took to develop. With little momentum, there was always the added danger of a sharp reversal at any point, which is why we always trade with a stop loss, which I am going to cover in the

next section. There we are. An interesting trading opportunity which delivered several important lessons.

Now that I've covered the basic concepts of how to judge the risk on a position before you enter the market, let's move on to one of the most difficult aspects of trading. As someone once said, getting in is easy, it's getting out which is the hard part, and this is indeed one of the truisms of trading. It's very easy to hit the buy or sell button and then start to wonder what to do next. And the reason it is so hard is not difficult to understand. This is the point at which your emotions start to take hold, and logic and common sense disappear.

And in case you had forgotten, let me just repeat my own thoughts on the whole subject. What I call the three simple steps to trading success. Getting in, staying in and getting out! There are many people who suggest that within your trading plan, you should follow a prescribed 'set up' before entering the market. Once in the market, you then follow another set of prescribed rules to manage and exit any position.

My view on these suggestions are very simple. If any prescribed set of rules worked consistently, then those traders using those rules would have crushed the financial markets by now. No such approach works, nor ever well. They may work for a time in certain markets, then fail. And this is the point. The market is different every day, constantly moving and shifting direction as it is driven by the twin emotions of fear and greed (or panic and complacency). Therefore, each and every decision you make in getting in, staying in and getting out, has to be discretionary, and based on what you see, not what your prescribed rule set may say. The only rules you follow 'blindly' are your money management rules, and trading with a stop loss, which goes without saying.

Therefore, taking each of these steps in turn, I want to cover the main points of these three stages.

Getting In

Opening a position is the easy part, we can all do that, almost without thinking, and this is the problem. It is what most traders do with little thought, and no planning whatsoever.

In the above AUD/USD trade, I hope I explained in detail the steps to take in assessing the risk on any opportunities, before you press the buy or sell button, but let me just recap the essential points as follows:

- Start with the economic calendar for the day ahead. Note key releases and keep these in mind as you will have to decide whether any positions are taken ahead of, or after the news. Always consider all releases, even those in countries whose currencies are not on your platform. Economic data from China will move the markets dramatically
- Begin your search by considering currencies which are overbought or oversold in multiple timeframes
- Then analyze the charts in multiple timeframes and look for confirming signals of volume and price, along with breakout patterns, plus support and resistance
- Check the strength or weakness of the currencies in the currency matrix for confirmation of momentum in all other pairs

Once you are happy, and have found what you believe is a low risk opportunity, then it's time to get in!

At this point you now have to consider your trading rules on money management, and this is where we need to talk in detail about the stop loss order, and in particular, where and how to place this in the context of your trade.

A stop loss order, is just that. It is your order in the market which, when triggered stops any further loss. It is the order which protects your trading capital, and you never, ever, open a new position without one. Some people refer to 'mental stops' - ignore them. If you do not have the discipline to place a stop loss order, then one thing is immediately clear. You do not have the mental strength to take a loss. If you did, then placing a stop loss order would not be an issue. It is an issue for these traders, who then avoid it, by pretending to themselves they have a 'mental' stop loss which they will then place if required. Guess what - they never do, because this highlights the much deeper issue that they have, namely of taking a loss in the first place. Trading is not for everyone. As you saw in the chapter on psychology, the mind is a complex and powerful force, and we are all different. The ability to take a loss is key. It is fundamental, which is why a 'mental stop loss' is nonsense and symptomatic of deeper issues.

- **Rule 1 - *NEVER OPEN A POSITION WITHOUT A STOP LOSS***

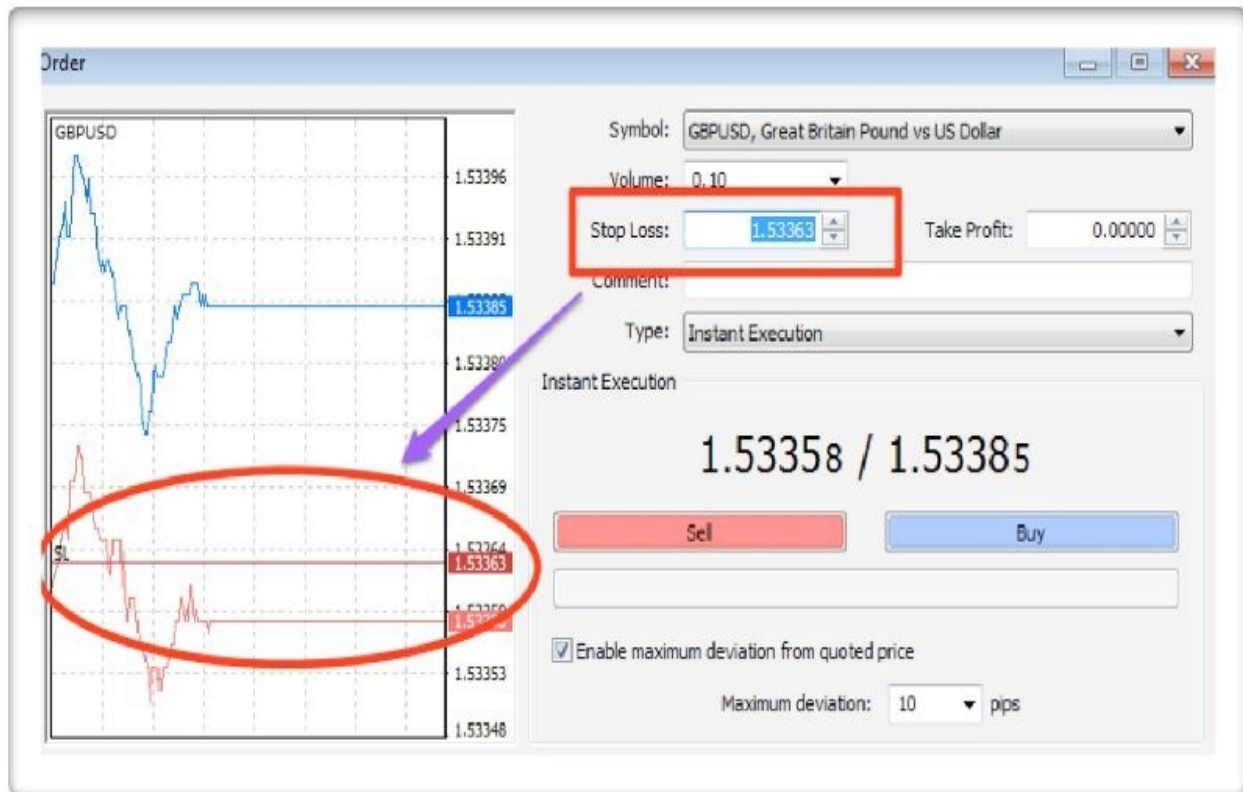


Fig 13.35 - The stop loss order in MT4

Fig 13.35 shows the entry order pane from the MT4 platform, and one of the many reasons this is such a great platform to use, is its simplicity of opening and closing positions. It really couldn't be any easier.

The stop loss order is placed at the same time as you open your position, and for a short position, will be placed above the market, and for a long position will be placed below. If you are short and the market moves against you, then it will be triggered and close your position, and equally if you are long, and the market reverses lower, then once again the order will be triggered.

Here is another rule, and the second one which always applies to any stop loss order.

- **Rule 2 - NEVER MOVE A STOP LOSS IN THE OPPOSITE DIRECTION TO THE POSITION**

And the reason for this is much the same as with the 'mental' stop loss. Suppose you have taken a long position in a currency pair and placed your stop loss 20 pips below the market. The position then starts to move against you and begins

to approach your stop loss order. You decide to move it lower, and away from danger. This is the same problem the 'mental stop loss' trader has. A fear of taking a loss, so the stop loss is moved lower, away from the market which is threatening to close the position. This is why you can never move a stop loss in the opposite direction to the position you have taken, as once again, it reveals deeper psychological issues.

Both of these rules should be written into your trading plan, and never broken. However, it is perfectly acceptable to move your stop loss in the **same** direction, as you are now moving it for a very different reason, namely to lock in profits. This is entirely different, and again is something I am going to cover shortly.

The stop loss then, is a very simple order in the market, which you place at the same time as opening any position, and which will protect your capital from any major loss. There are however, variants of the stop loss, and the one to mention here is the trailing stop loss. This is a little more tricky to open on the MT4 platform.

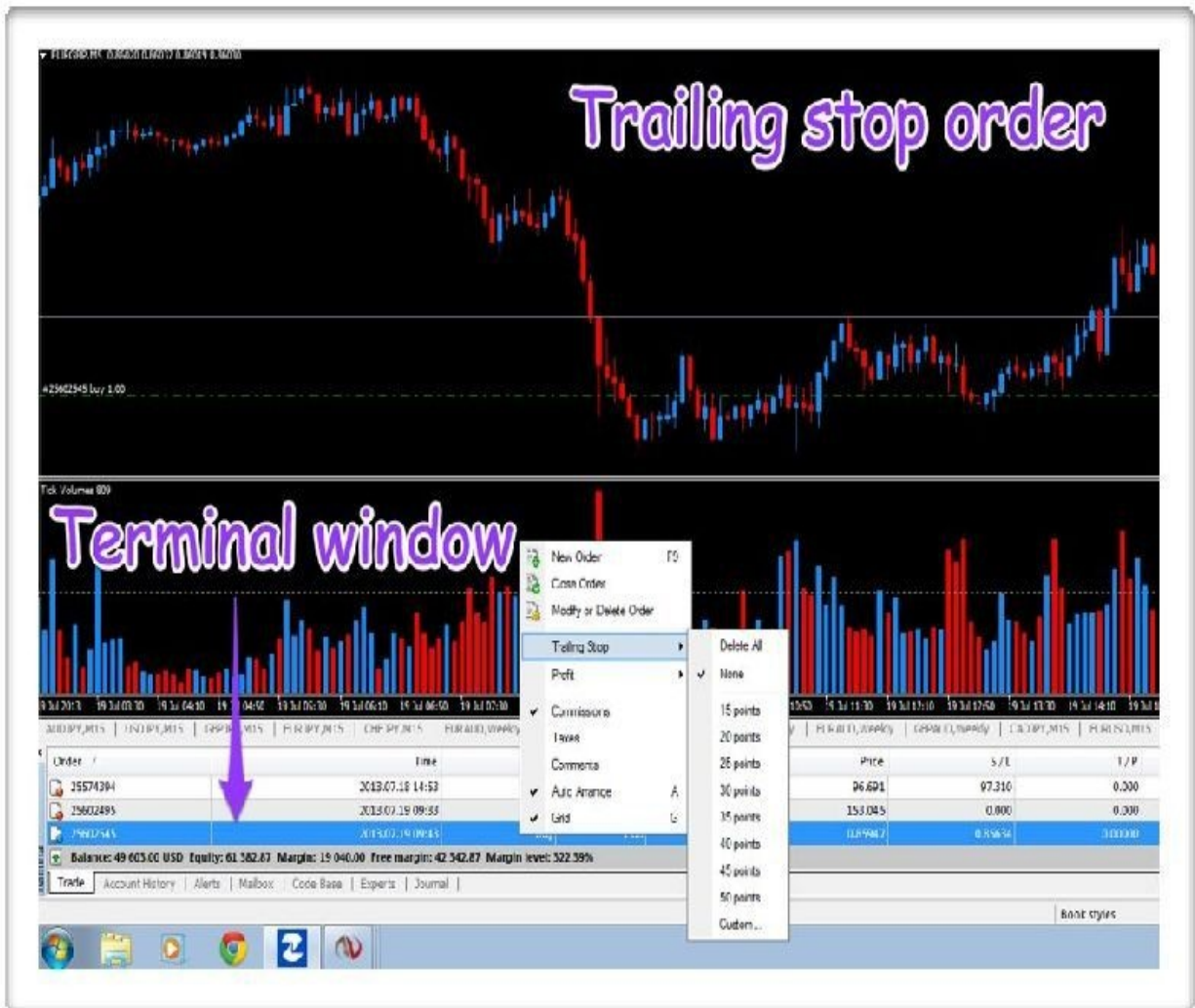


Fig 13.36 - Placing a trailing stop loss order using MT4

The trailing stop loss order is placed using the Terminal window, (left click on View>Terminal) which then displays live orders in the market. To place the trailing stop simply right click on the order, and then left click on the Trailing Stop option from the pop up window. The options shown in Fig 13.36 will then appear, where the trailing stop can be set to a specific number of pips or to a custom number of your choice.

What is the difference between a standard stop loss order, and a trailing stop loss order, and what are the pros and cons of both?

Whilst the stop loss order is designed to do one thing, to stop any further loss, the two orders work in different ways. The standard stop loss is placed in the market at one price, and then only moved, if and when you decide. The trailing stop loss moves automatically and 'trails' your position higher or lower. It is set

to a certain number of pips which are then maintained as the position moves. If you have a long position, and you have set your trailing stop loss at 20 pips, then the stop loss order will move higher, as the position moves higher.

It will maintain this relationship at all times, and does not move lower in the event of a pullback in the market. You can think of the trailing stop loss as an automated way of locking in any profit with the system managing this for you. The only decision you make is in placing the stop loss initially, and the distance from your position. Once set, the order stays in the market, until it is triggered and closes your position.

There is always a debate about whether a manual stop loss is better than an automated stop loss (trailing stop loss), and I have my own views on this, as you might expect. To nail my colors firmly to the mast (as always), I believe the manual stop loss is the better of the two, and here's my reason why. But, as always, this is a personal decision, and you may find that you prefer the automated approach with a trailing stop loss, and indeed this may be the best solution for you, particularly if you are working and only trading part time.

I am very fortunate and have the luxury of being able to sit in front of a screen all day, so order management for me is very easy. For others it is more difficult, so my comments here are really intended for the time you are able to devote to trading! And here the trailing stop loss has its place.

Let me start with what I believe is the ideal approach, and my reasons. I have used a manual stop loss system in all my trading for two reasons. First, as I have said I have the luxury of being able to sit in front of a screen all day. Second I believe it is the best approach for the simple reason that stop loss placement and management, is also an art and not a science.

The same is true of technical analysis, it is an art and not a science and never will be, so by setting a 'mechanical' order in the market implies that the market moves in prescribed increments. It does not, and just as in placing the stop loss, which is dictated (in my view) by the price action, so is the management of any stop loss thereafter. In other words, what I am suggesting here is that stop loss placement and subsequent management should be dictated by the price action, and not by you. I guess this is the same issue that I have with take target or profit levels set by traders. Why should the market know or care about what you want or decide that you want - it doesn't. Every decision needs to be discretionary, and this applies equally well to the placement and management of the stop loss.

I could write a book on this topic alone, but I'm going to summarize it here, so you can start to decide for yourself, which is the best approach for you, and also which suits your personal circumstances. As I said earlier, this is the goal, if you have the luxury of trading full time. If not, then the trailing stop may be the best solution to help as you learn.

The first question then is where do you place a stop loss? The second question which follows is how and when do I move it. Remember, this is an art not a science and there are no right or wrong answers. It takes practice and experience, and will also depend on the pairs being traded. Some will require wider stop loss positions, others can be placed with less width.

Again this will depend on the pairs and also your trading strategy which we discussed earlier in the book. But, your stop loss position, must fit in with your money management and trading rules to ensure that you are not breaking any of these.

Let's start with one or two examples which I hope will help to clarify and explain this key concept.



Fig 13.37 - Stop loss placement, short

In this example, from the USD/CAD on the 5 minute chart, suppose we have seen the the initial weakness, and then the ‘telegraph pole’ of volume in blue, sending a strong signal of a bearish market, and we decide to take a short position. We enter the market somewhere in the area marked with the yellow ellipse, but where to place the stop loss? And here the market has given us a natural price level, where it paused and reversed earlier in the session, shown with the yellow line.

This gives us our target, and we can then place our stop loss beyond this price, either close to or further away, depending on our money management rules and contract size being traded. In this case the distance is around 12 pips, so we may decide to move this further and allow for a 15 or 16 stop loss. But the key point is this. We have placed our stop loss based on what the market is telling us, and not what we think. Provided we adhere to our money management rules, then this can be moved further away, but the chart sets our minimum price level for

the stop loss position. The market has created this for us, naturally.

We would then manage the stop loss in the same way, using the market's own price patterns to tell us where and when to move it lower. In this case, we would almost certainly wait for the break below the congestion phase, and then move it down to just above this level. And the reason why is that once again, we are allowing the market to dictate these levels for us, and in creating support and resistance areas, these are also excellent reference points for stop loss management.

After all, once the market has broken out from a congestion phase, as here, and then moved lower, what better place is there to move a stop loss than just above the resistance level, which is now providing us with our own natural barrier in the event of any market reversal. This is yet another reason why support, resistance and congestion phases are so important to understand. Not only do they provide trading opportunities, they also offer natural levels for stop loss placement, and stop loss management as the position develops.

Moving to another example, this time with a trade to the long side, but the principles are exactly the same. We let the market dictate the optimal place for the stop loss.



Fig 13.38 - Stop loss placement, long

Once again this is an intra day trade, this time on the 15 minute chart of the GBP/JPY. The pair has fallen sharply, on narrowing spreads and rising volume, a strong signal of buying coming into the market. The last two hammer candles create the natural levels for our initial stop loss positioning, with the low of the wicks setting the price level for us. Our stop loss then goes below these hammer candles, with the market once again defining this for us. And several candles later, we can see why. A sharp move lower, with the market testing this level once again, before continuing on its way higher once more. Once again we have our stop loss in an area of 'natural protection', created by the market.

The important point is this, and why I prefer not to use an automated trailing stop loss. When using one, you will find your positions stopped out more often, as your MT4 platform does not make any discretionary decisions. It moves the stop loss up maintaining the relationship you have set, it has to, as it cannot make a decision on its own. In this example we would probably have been

stopped out in the pullback, whereas with a manual approach, we would now be considering moving our stop loss higher, following the break above the resistance level, which has created its own support area below.

Once you have decided on the level of your stop loss, then it is a simple calculation to make sure that the size of lot that you are trading, fulfills your money management rules, and which we looked at earlier in the book. If so, then you are ready to go.

As you will see in the next section, we use support and resistance levels in every aspect of our position management, and exit from the market. This underpins my own trading methodology. Let the market dictate these levels for you. It is much better at doing this than you can ever hope to do! The choice is yours and I do accept that a trailing stop loss has its place, particularly if you are working full time as well. It will certainly help to protect your positions while you are away, but please aim to move to a manual system as soon as you can. It will help you enormously and give you more consistent results in the long term.

Finally, just to round off this section on getting in, let's just consider the entry order itself.

There are many different types of orders, and I can honestly say that in almost 17 years of trading, I have only ever used one, namely a market order. You will come across many others, from limit orders, to one cancels the other orders, and several others. Of all of these, the market order is the simplest, and just like the stop loss order, the description tells you everything you need to know. When you place a market order the price is executed 'at the market', in other words at the current market price. This is the simplest of all order types, and as I say, the only one I have ever used. The reason - it is very simple and any position is filled at the market as soon as you press the buy or sell button. There are many other far more sophisticated ways of entering the market, but this is the one that I have used and recommend as you get started. It is both simple to use, and simple to understand. The only time it will not be executed immediately is if your broker rejects it and sends a re-quote, in which case it might be time to change your broker!

Staying In

We have pressed the button and our market order is now live, with our stop loss order also placed. What do we do next?

This is the stage where our emotional responses can start to take hold. We are now seeing our position move up and down, second by second, and everything we do from now on, until we have closed the position, is to manage our emotions, and make any decisions calmly and logically. After all, what is the worst that can happen? Are we going to lose all our money? No, we have a stop loss in the market, so what is there to worry about? The answer is nothing! The key now is to manage our position and neutralize some of these emotions from our decision making wherever possible. The first thing to do here is to switch off any screen which displays monetary value. In the MT4 platform this is easy, as the trading terminal is only displayed when selected as an option at the bottom of the screen. With other platforms it can be more of a problem. But remove it you must, as we only want to focus on pips not money when live in the market. It is a simple trick, but one that works well. Pips and money are very different, and as you get started, you will find it much less stressful to focus on the pips, and not the money. Try it and see for yourself!

We now have a position in the market and my own trading screen would look something like this:

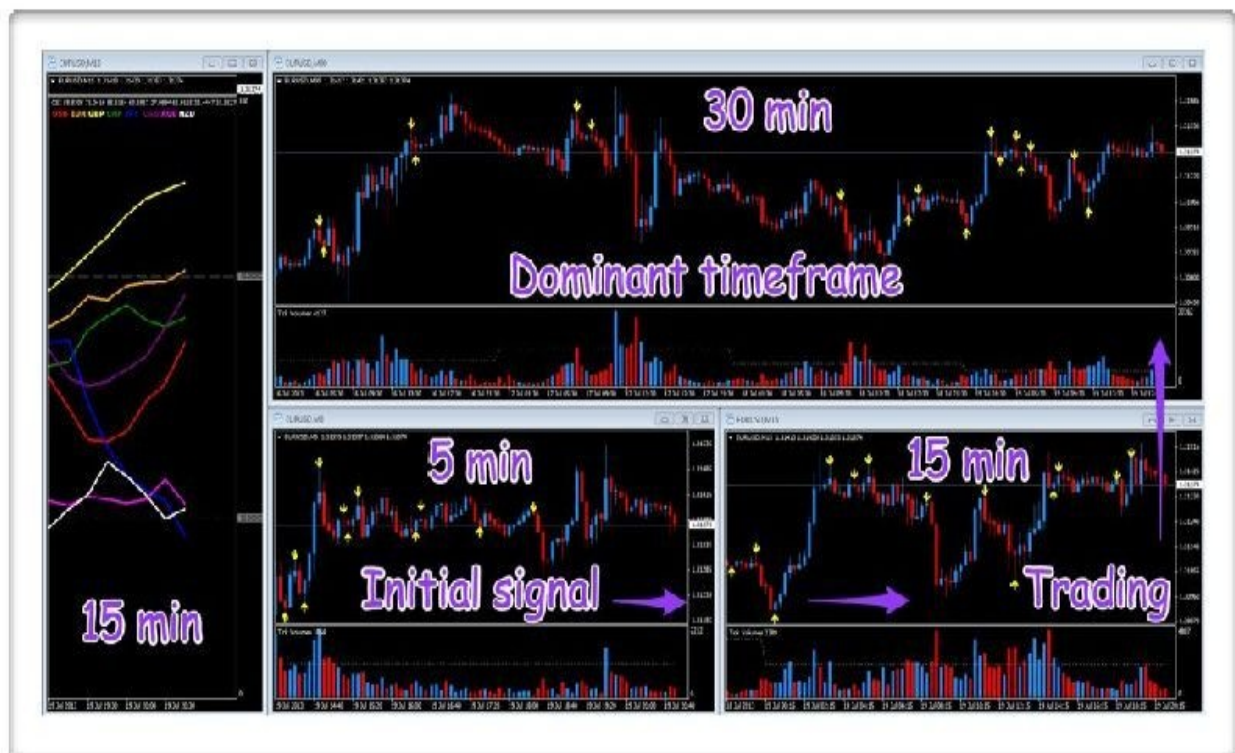


Fig 13.39 - Trading screen layout

This is from my MT4 platform, and as you can see has four screens.

On the left I have my currency strength indicator set at 15 minutes, which is the same as my trading timeframe chart. To the right of this I have three charts, for the same currency pair but set in three different timeframes. The one at bottom left is 5 minute, the chart at the bottom right is set to 15 minutes, and the one at the top is set to 30 minutes. I have only included the volume indicator for our volume price analysis, and a simple pivot indicator, which is dynamic and helps to define support and resistance regions as they build. I do use other indicators myself, but have left them off the charts for clarity.

You may decide to add your own indicators at this stage. There are many to choose from, and most are freely available in MT4 and other platforms. There is nothing wrong with using indicators such as Simple Moving Averages, Bollinger bands, Fibonacci levels, and many more, as long as they help you in the decision making process of your underlying trading methodology. My own method is based on volume price analysis in multiple timeframes, and every indicator I use is there to help support my analysis and validate my trading decisions.

We are now ready to manage our position, and eventually exit the position. Both are based on some very simple concepts, which are as follows:

- If the currency strength indicator is good enough to get us in, then it is good enough to keep us in, and get us out!
- If volume price analysis is good enough to get us in, then it is good enough to get us out
- If support and resistance is good enough for defining stop loss levels, then it is good enough to get us out

In other words, if we believe that the techniques and analysis are good enough to base our risk decisions on getting in, then equally, and by inference, they must be good enough to keep us in, and then get us out again.

So let's start by considering multiple timeframes, where we have two workspaces. The one in Fig 13.39, which is our 'trading workspace', and the other in Fig 13.40, which is our 'currency strength workspace'. Both are set to the same timeframe intervals of 5 min, 15 min and 30 min.

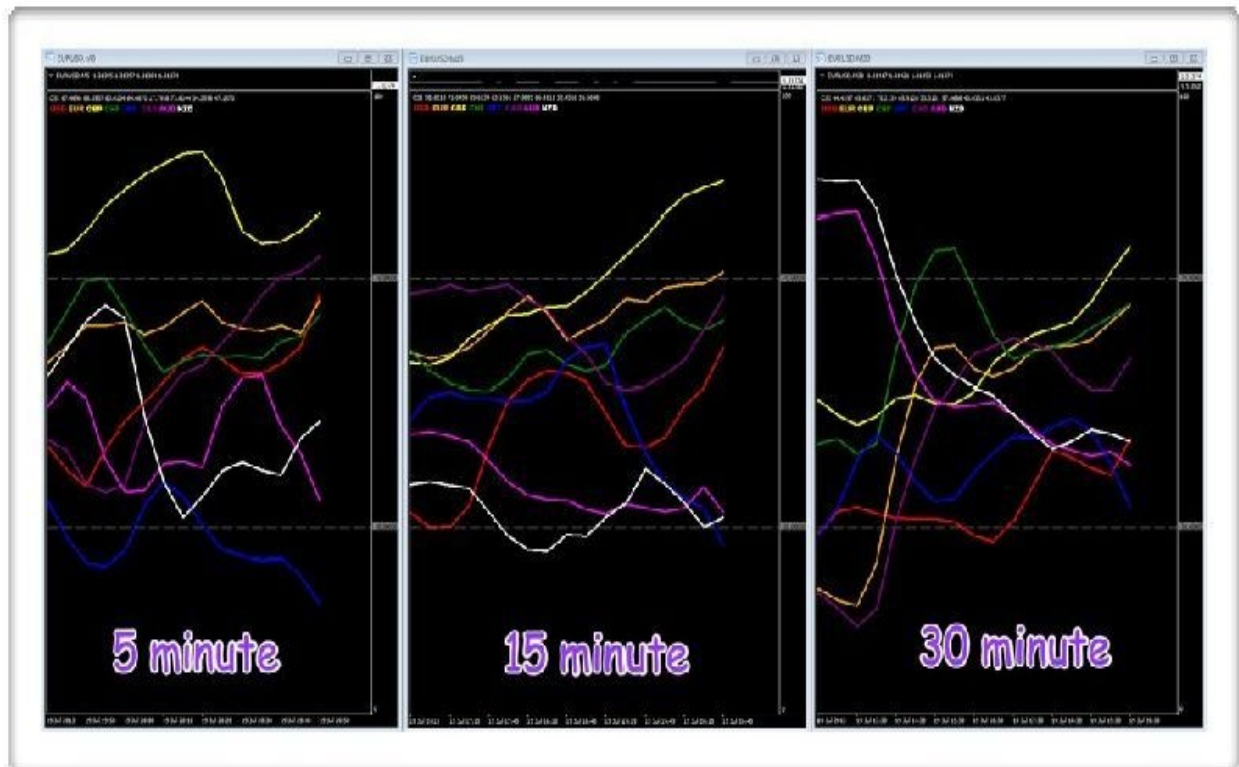


Fig 13.40 - Currency strength indicator, multiple timeframes

Starting with the trading workspace, and recalling the two analogies I used earlier, of a three lane highway, or the pebble in the pond. This is where it plays out for real.

Our ‘primary’ trading screen is the ‘middle lane’, which in this case is the 15 minute chart, but you could set up any combination you prefer to suit your own trading strategy. With the MT4 platform you are limited to the preconfigured chart times, so as a scalper you might prefer to create a 1 minute, 5 minute, 15 minute combination, whilst for longer term trend trading you might opt for 1 hour, 4 hour and daily chart. Whatever your chosen timeframes, the middle timeframe is your trading chart, whilst the two on either side, provide the faster and slower detail to help you manage your position, once you are in the market.

The fast chart, in this case the 5 minute chart, is a ‘close up’ view of the currency pair. The price action under the magnifying glass if you like. This is where you will see any possible changes in trend happen first, along with any minor reversals and pullbacks in the market. Any longer term reversal will then filter its way to the 15 minute chart, and ultimately to your 30 minute chart. Your fastest chart is really your ‘heads up’ to any possible major reversals, which will then ultimately appear on your slowest chart. If you are a novice trader, seeing

the market moves in 'high definition' on your 5 minute chart, can be a little off putting, and watching this too much can alarm you, particularly if a price move is against your position. The trick here is to focus on the slowest timeframe. This is your 'dominant' timeframe, and here it is the 30 minute chart. This is giving you your broader perspective on the price action - a more considered view, a longer term view, where the price action is 'calmed down', smoothed out and not so frenetic. This is one reason why longer term trading is often considered to be less stressful. When you think about it logically, there are six 5 minute candles contained in one, 30 minute candle, and in looking at one 30 minute candle, all the up and down price action is 'filtered out' into one simple bar.

As a trader then, once we have a position in the market, you will be scanning from the left to right and then back again, starting with the 5 minute chart, across to the 15 minute chart and then up to the 30 minute chart, before coming back down again. The question now is, what are we looking for?

Very simply, just as we considered volume and price as confirming our analysis from our currency strength indicator, now we are looking at this relationship to confirm our position, to validate any moves, and also for any signals of a major reversal against us. Therefore, if we are short and perhaps entered after a selling climax of volume, then we are now looking for the opposite, and a series of hammer candles and a buying climax which may signal the end of the move.

A market will never move higher or lower in a straight line, and in any minor reversal or pullback, we are again looking at our volume and price for confirmation that these are simply pause points, and not reversal points. To confirm this, once again we will be referring all our analysis across multiple timeframes. Remember that a two candle reversal on a 15 minute chart, is a shooting star or a hammer candle on a 30 minute chart, and this is one of the many advantages of trading using this arrangement of charts in multiple timeframes. It is very easy to see one of these candles in a single time frame, but less easy to spot these patterns of price action when combined into slower timeframes.

Next we have support and resistance. Here we move to our pivots which help to define the start of a congestion phase, and also define the upper and lower levels for us. Once a market moves into such a phase, we are then paying close attention across all our timeframes, and waiting for the breakout, which will either confirm the next leg up in the trend, or a possible reversal, which may be our clue to exit the market at this point. If we are long, and the market moves

into congestion, but then breaks to the upside and continues the trend, then we have two things to consider here:

- Is the breakout associated with strong and rising volume, which is then validating the move higher?
- And if so, should we move our stop loss to the underside of this region and protect some of our profit?

At this point, let me introduce the concept of a 'riskless' position.

Trading is all about managing risk. We have quantified the risk on the trade, and continue to do so throughout the life of any position, constantly checking and rechecking all our charts and indicators. However, we can also reduce the financial risk in a very simple way, and the goal here is to move to a position as quickly as possible, which has no financial risk. In other words, to a position which cannot lose. And it is very simple.

The goal on every position you enter in the market is to move your stop loss to a point at which your financial risk is zero. In other words, to have your stop loss, above or below, the point where you entered the market. If you have a long position, with perhaps a 20 pip stop loss initially, then you want to move the stop loss up gradually, until it is above the market price you entered the position. Your first move might be up 10 pips, in which case your maximum exposure is only 10 pips, then later you move it up a further 10 pips.

Now you are trading in a position which has no risk. The only loss you will suffer should the market reverse heavily against you, is the cost of the spread. Suddenly you have moved from trading a 1% exposure of your trading capital, (or whatever your own money management rule may be) to nothing, or almost nothing. On such a trade you know you cannot lose, and are in effect now trading with the market's money and not yours, which is a key point. You have transferred the risk to the market.

However, moving your stop loss is a fine judgement. Too close and you may get stopped out in any reversal. My advice is to wait for periods of price congestion and then to move it. You may never have the option of course, as other factors may come into play such as weak price action, volume spikes or a lack of volume. However, stop loss management should always be at the forefront of your mind, and the desire to move it to a position which guarantees a risk less trade, as trading with the market's money carries no risk, which is what we want,

every time! Whilst you will not be able to achieve this on every position, even moving your stop loss by a few pips reduces your financial risk, so always focus on this at all times.

Whilst monitoring our position in multiple timeframes, don't forget that we also have the multiple timeframes of the currency strength indicator, which will then give you an alternative perspective across the same timeframes as your charts. Once again, we use the same approach, and these should be set up to the same combination as for your charts.

Here we would be focused on the 15 minute indicator, with those either side acting as our 'wing mirrors' on the market and reflecting the faster and slower timeframes for the currencies being traded. As I said earlier, if the indicator is good enough to get us in, then it's good enough to get us out and we use it in just the same way as for the price/volume relationship on our charts. We are constantly scanning from the fast to the medium speed and then to the slow, to see where the currency, or currency pair is heading. The slow timeframe is once again our dominant, with the medium speed, the 15 minute in this case, matched to our 'trading chart', and the 5 minute showing all the pullbacks and reversals in the longer term trend. Ideally, what we are looking for here is the 'perfect' combination.

In other words, a currency and currency pair combination that is rising or falling in all the timeframes. This rarely happens since the fast timeframe will always reflect the price reversals which are part and parcel of the longer term trend. However, what is much more likely, is that the 15 minute and the 30 minute will be in agreement, and the decision you will need to make in managing the position, is what to do when your 'trading timeframe' on the indicator has reached an extreme, but your slower timeframe has some way to go before reaching an overbought or oversold region on the indicator. The decision here will be heavily influenced by the price action on the chart. If the price and volume is suggesting a possible pause point, then this may be a good point to exit the position. Alternatively, you may decide to tighten your stop loss, to lock in some extra profit. If the market continues in the same direction - great. If not, then you will be stopped out, but with profit in the position. Either way, it is a win/win for you.

The key point is this - that as the currencies you are trading start to approach the opposite regions to your entry, then this is giving you an early warning to pay close attention to your position. This includes not only considering your charts in

multiple timeframes, but also your currency matrix, which is the other primary tool in your arsenal.

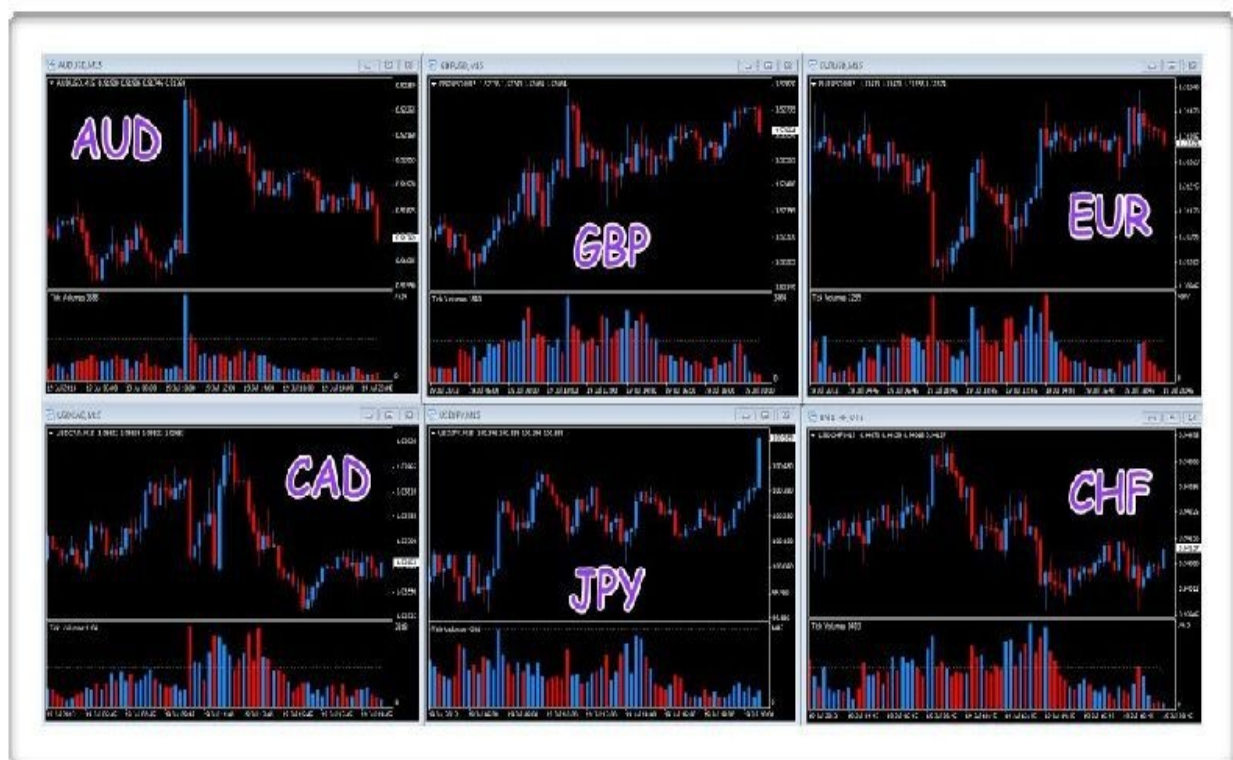


Fig 13.41 - Currency matrix 15 minute, major currency pairs

Returning to our AUD/USD trade that we followed earlier in the chapter, you can see here, that towards the end of the session, the buying in the US dollar against the Aussie dollar, was also reflected strongly in the USD/JPY pair, and this would have given us additional confidence for two reasons. First, we have confirmation of strong US dollar buying in another pair, which was lacking for much of the trade, and second, on the USD/JPY, this is a breakout from congestion, a strong signal of a move higher. The volume here is below average, which is only to be expected as this was the end of the trading session. Nevertheless, the same principles apply, and this is the power of the currency matrix at work once again.

To summarize. In staying in and managing our position, it is a constant phase of analysis. This is a good thing, as it helps to keep our brain in an analytical state and not an emotional one. We are looking across our charts in multiple timeframes for clues using volume and price. At the same time, we are watching our currency strength indicators, again in multiple timeframes. Finally, we are watching our currency matrix, but in **one** timeframe, our primary timeframe, and

again for clues and signals on volume and price, as well as unified strength or weakness in our currency. (You could of course set up more than one currency matrix using additional timeframes, but this can become a little unmanageable!). In addition, we are focused on areas of price support, both old and new, and watching for signs of price congestion using our dynamic pivot indicators. Once the market has broken out from congestion, if it is in our favor, then we look to tighten our stop loss, to move to a position with no financial risk as quickly as possible. If the break out is against us, it may be time to exit, but only after checking our other charts and also our currency strength indicators.

Managing any position is a dynamic process. It is constantly changing and evolving as new information arrives second by second. Trading using one chart will never give you this three dimensional view which is so powerful. Managing your positions using a multiple timeframe approach, with volume and price at the heart, will give you that perspective which is so important, and which will also help to keep you in for the longer term, whether this is minutes as a scalping trader, or hours and days for medium and longer term strategies. Whichever you chose, the approach is the same - there is **no** difference whatsoever.

Now let's look at the final step in the process, step 3, which is getting out!

Getting Out

First things first. When you close a position, you are in essence reversing your initial order. If your order to enter the market was a buy order, then to close the position you are going to sell, and likewise if your initial order to open was a sell order, then to close it is a buy order. On most platforms, you do not need to worry about this, as most will offer a very simple 'close order' option in the order management, and this is certainly true with the MT4 platform.

However, some more advanced trading platforms will require you to enter the opposite order, and for the same contract quantity. Here for example if you opened your position buying one micro lot, then you need to close it selling one micro lot. If you opened with 6 micro lots, then you need to close with 6 micro lots and so on. Some trading platforms will also require you to close any other 'working orders' in the market, of which a stop loss would be one.

The good news, with simple platforms such as MT4, is that you do not have to worry about this at all, and below in Fig 13.42 is the simple button that closes the order completely.

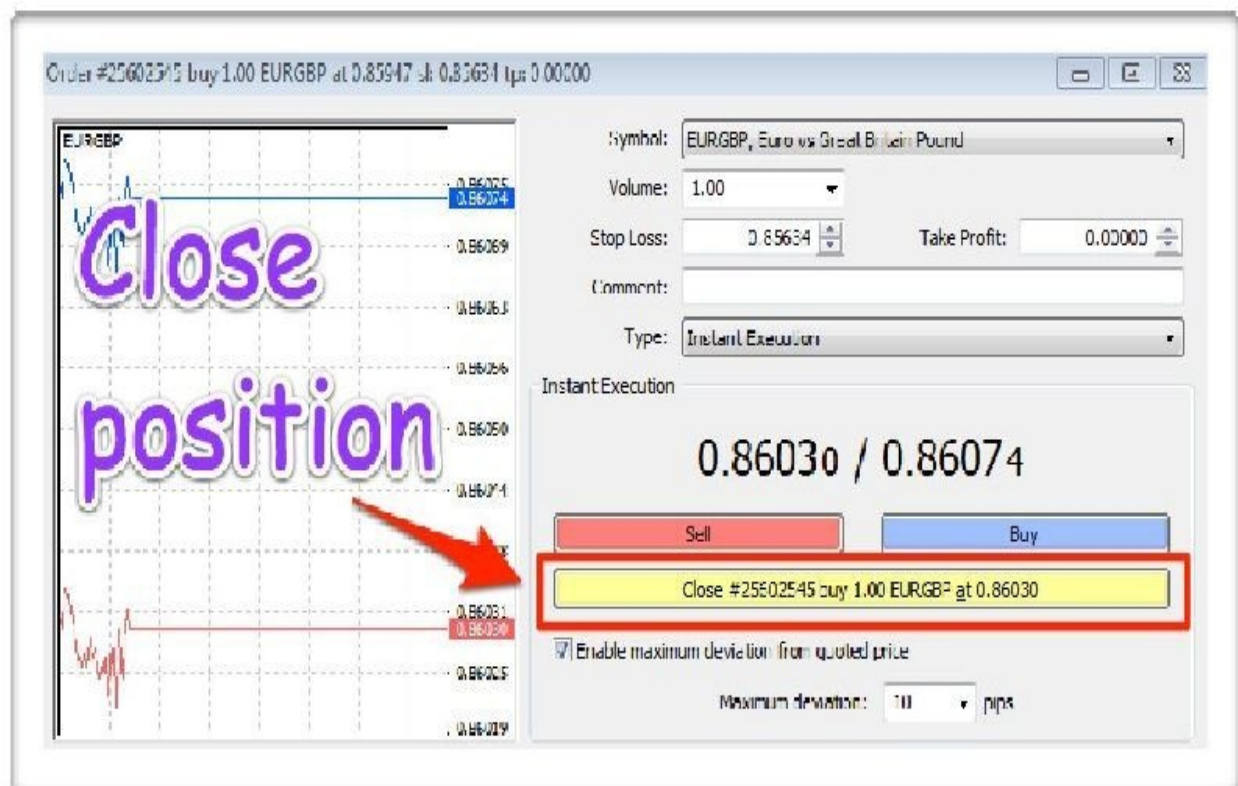


Fig 13.42 - Closing a position in MT4

This is when you decide to close the position yourself, but of course the market may make this decision for you by triggering your stop loss, and once again you will be out of the market.

There are one or two other factors which may influence your decision making in when, and whether, to close a position, and the first of these is news items, in the form of economic data, press releases, or statements. All of these will move the market, and you need to be very clear in your mind, before you enter the market, as to how you are going to handle these news releases. As forex traders, we cannot avoid them, which is why checking on the fundamental news each day is important, and needs to be included in your decision making process.

If you are an intraday scalping trader with tight stop losses, then trading through NFP for example is a pointless exercise, as you will get stopped out. No question. However, if you are a longer term trader, with positions which you plan to hold over hours and days, then you will almost certainly be able to absorb most, if not all, of the news and the associated market reaction. You have no choice if you are proposing to hold for the medium and longer term, and your stop loss placement will reflect this.

For scalping traders it is very different, and the decision is twofold. First, if there is a major news item ahead, do you enter or wait until the market has reacted and then settled? Second, and most relevant here, is if you have a position, and you know there is a major news release due (and the chances are that the market will be moving sideways anyway, waiting for the release), do you close out anyway, either at a profit or loss, or wait and see what happens? Again, there is no right or wrong answer here. You will need to assess each trade on its merit, and make a decision accordingly.

Other factors which you will also need to consider in closing a position are rollover, holding overnight, and end of the week. Again, for scalping traders, all of these should be avoided, and if you are holding positions longer term, a big decision here will be whether to hold positions over the weekend. Most professional traders do not, as there are too many factors which can come into play, and the market will then open 'gapped up' or 'gapped down' on the news. This can be anything from natural disasters, political or financial news, unexpected conflicts or even planned meetings (the G7 and G20 are commonly held over weekends, as are some of the major financial meetings) - so think carefully here.

Don't look back! It is very easy with hindsight to look back at a position and think to yourself, 'I wish.....'. Every trader when they start does this and it's called trader regret, and is much the same when we miss out on a nice trade. When you have closed a position, be grateful and move on. If you have made a profit - great. If you are out at break-even - that's fine. If you were taken out at a loss - that's good as your stop loss was doing the job of protecting your capital. In other words, all positive news. It is no good looking back and saying 'I wish I had stayed in longer'. If trading were about using hindsight then none of us would ever be wrong.

The chances are, as a new trader, you will get out too early most of the time. Holding a position and seeing it ebb and flow is hard as the market is designed to 'shake traders out'. It's why the market never goes up in a straight line or down in a straight line, and also why I urge you to use multiple timeframes. These will help give you a perspective on the 'longer term' price action, and also help you to manage your emotions by stepping back a little from the market action. This is what this approach is designed to do - to try to manage and reduce your emotional response to market behavior.

When you close a position, you will always have some doubts in your mind.

Have I done the right thing? Have I closed out too early? This is normal. Trading is not a science, it is an art, and your decision to close a position will have many influences. You make the decision based on your analysis and then move on. In trading, we never get in at the bottom, or get out at the top. All we hope for is to try to take the 'middle third' of any price move. The rest we give back to the market. If you have taken that middle third, be grateful and move on. If you have broken even or made a small loss, be grateful. You are learning, and your capital is intact and ready for the next opportunity.

Move on, and don't look back. Over time, your confidence will grow and your ability to hold a position through some volatile price action will also improve, as your confidence as a trader grows with time. The more you look at charts and live prices, the more you will develop an instinct, an intuitive feel, for the price action. It takes time, but it will come. You will develop a 'sixth sense' of what is going to happen next.

However, provided you can look at your decision to close, and understand why you took the decision based on cool logic and calm analysis, then you have nothing to regret. All you must do now, is to look forward to the next opportunity, as you build your track record of consistent trading decisions based on common sense, logic and your own trading indicators. The three step process of getting in, staying in and getting out, applies to every strategy, whether short, medium or long term. It is simply the charts and the indicators which will differ in the timeframes chosen. The approach however is identical, and works in exactly the same way.

Your decision to close a position will be based on many factors, but the primary ones will be as follows:

- What is volume price analysis telling me? Is the market pausing, about to turn, or perhaps just moving into a congestion phase, before continuing on its journey? Remember, VPA not only helps to get us in, but keeps us in and then gets us out. If we are long, and see selling coming into the market, and possible weakness, then it may be time to close. Equally, if we are short, and see buying coming in, again this may be a signal to consider closing our position
- What is happening in multiple timeframes? What is VPA telling me in multiple timeframes? Are we perhaps running into some areas of price congestion, where resistance or support may come into play? What is our

dominant timeframe telling us?

- What is happening in our currency matrix? Is the selling or buying universal across our pairs? Is it strong or is it looking weak? What is VPA telling us here and are we running into any potential areas of congestion?
- What is our currency strength indicator telling us? Are we approaching opposite extremes? Are we pausing? What is happening in our slower timeframes?
- What is happening on the news front? Are the markets waiting for some news? If so, perhaps it is time to close.

These are all the questions you will be asking yourself constantly as your positions develop in the market. The stop loss is there to remove that particular decision. Every other decision you take is a discretionary one, based on your own analysis. It is one of the many benefits of taking a volume based approach. Your trading brain is constantly in analytical mode, asking questions and finding answers and then making a decision accordingly. And this is the way it should be. No software, can ever get you in, keep you in and then get you out. It is for you to make these decisions. After all, you have the most powerful trading indicator available - your brain.

In the last chapter in the book I would like to cover the MT4 platform in a little more detail. This is one of the most popular forex trading platforms, and almost universally available to traders around the globe.

Chapter Fourteen

Getting Started With The MT4 Trading Platform

A speculator must not be merely a student. He must be both a student and a speculator

Jesse Livermore (1877-1940)

There are many trading platform to choose from, and over the years I have used several, but for me, the platform I always recommend for novice forex traders as they get started is the Metatrader MT4 platform. There are many reasons for this, but perhaps they can all be summed up in one word - simplicity! The platform has been around for many years, and is by far the most popular, but this does not necessarily make it the best. It does have its faults, and shortcomings, but for sheer simplicity and ease of use it is difficult to beat.

A further reason, is that it is one of the most widely offered by forex brokers around the world, and there are few who do not offer this platform as an option. When you first start, you will have enough to learn about trading, without having to struggle to learn how to use a complex platform. Everything from order entry, to managing and exiting positions is easy, and mostly intuitive. Reporting of live positions is clear. Order entry is simple, stop loss orders could not be easier, and closing positions is child's play. As someone who currently has three brokerage accounts, I can assure you that the MT4 is my favorite for speed and simplicity. It may not offer the sophistication of the others, but for simplicity, it cannot be beaten. The platform was originally launched in 2005 by Metaquotes Software, and with over 2 million users worldwide, has now become the 'de facto' standard in the forex world. Part of its popularity is as a result of the large and growing number of 3rd party indicators which are now available, and generally very competitively priced.

The platform is generally provided free, and it is an excellent place to start, before perhaps graduating to a more sophisticated platform as your experience grows.

The purpose of this chapter is to help you get started and to highlight some points to consider when choosing your broker, if you do decide to opt for the

MT4 platform. I have included a link at the end of this chapter to one of the best user manuals I have found which will help to explain all the features available on the platform, but I'm sure your broker will be able to help as well. The nicest thing of all of course, is that once you have learnt how to use the platform, then changing brokers is easy. Simply find another that you like, and off you go - no new platform to learn.

Here then are some ideas, suggestions, and recommendations when considering your MT4 platform and associated broker.

Demo Platform

If you are completely new to the world of forex trading, or if you have never used this platform before, then you will be pleased to know that every forex broker will offer a free demo of the MT4 platform. You will have to register first with the broker, generally with an email address and other details. You will then be free to trial the platform for a limited period.

Most demo platforms will stop working after 30 days, for the simple reason that the broker wants you to open a live account as soon as possible. However, increasingly, forex brokers are starting to offer demo platforms that only time out, if they are inactive for a period. Terms may vary, but generally these require that you log in at least once a month. An example here is the MT4 demo platform from Alpari. Provided you do, then the platform never times out, and you can then continue using it for as long as you wish.

Before you download the platform, do check the currency pairs offered. Some brokers are limited in the number of pairs available, and you do want a wide range of cross pairs, alongside the conventional majors. Something else to check is whether the broker quotes the currency pairs with a suffix or prefix on the end of the quote. I have never quite understood why they do this - it can be very annoying, as it causes problems with some third party software vendors. It's not a big issue, but worth checking.

Download Your Demo Platform

Having completed the registration process, you will then receive an email from them, with a download link. Click the link and the download will begin with an installation wizard. Simply follow the instructions and this should install your MT4 platform on your pc. A couple of things to note here.

First, you might wonder where this has been installed, and second you may be

wondering if you can install it anywhere else on your pc. Let me answer these questions for you.

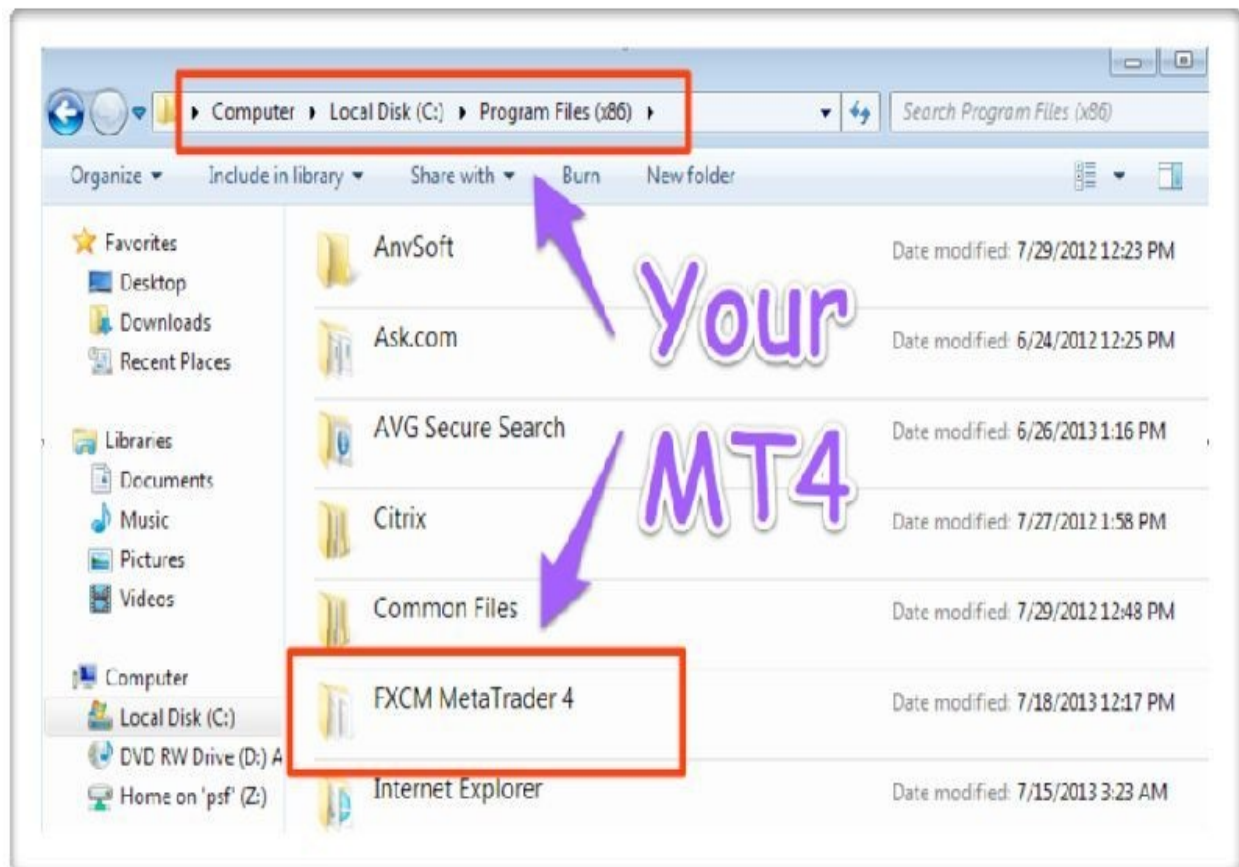


Fig 14.10 - Your MT4 download location

During the download of your MT4 platform, you will normally be asked to confirm the location for the program files and folders. Most MT4 brokers default this to the Program Files (x86) location on your pc, or the Program Files if you are running an older 32 bit version of Windows.

As you can see in Fig 14.10, here I have installed the FXCM platform, and generally the folder will include the name MetaTrader 4 or MT4 or similar, so it should be easy to see.

To navigate to this location on your pc simply follow these steps:

- Left click Start in your Windows menu
- Left click Computer from the pop up menu
- Left click on Local Disk (C:) in the left hand pane of the window

This will then display a menu with both the Program Files and Program Files (x86) folders. Simply double left click to open each one, and there you should find your MT4 download.

Some brokers do default the download to the C: location on your pc, in which case you should see it listed with the Program Files and Program Files (x86) folders above. You should also find that during the download and installation process, you now have an icon on your desktop for the MT4 platform. This is normally set as the default in the download wizard.

To access your MT4 platform simply click the icon on your desktop. This will then open your MT4 trading platform, which will have the default settings, and look similar to the image in Fig 14.11. Each broker will vary slightly, and some may deliver the platform with preconfigured charts loaded with one or two of the free indicators. This is what you should see:

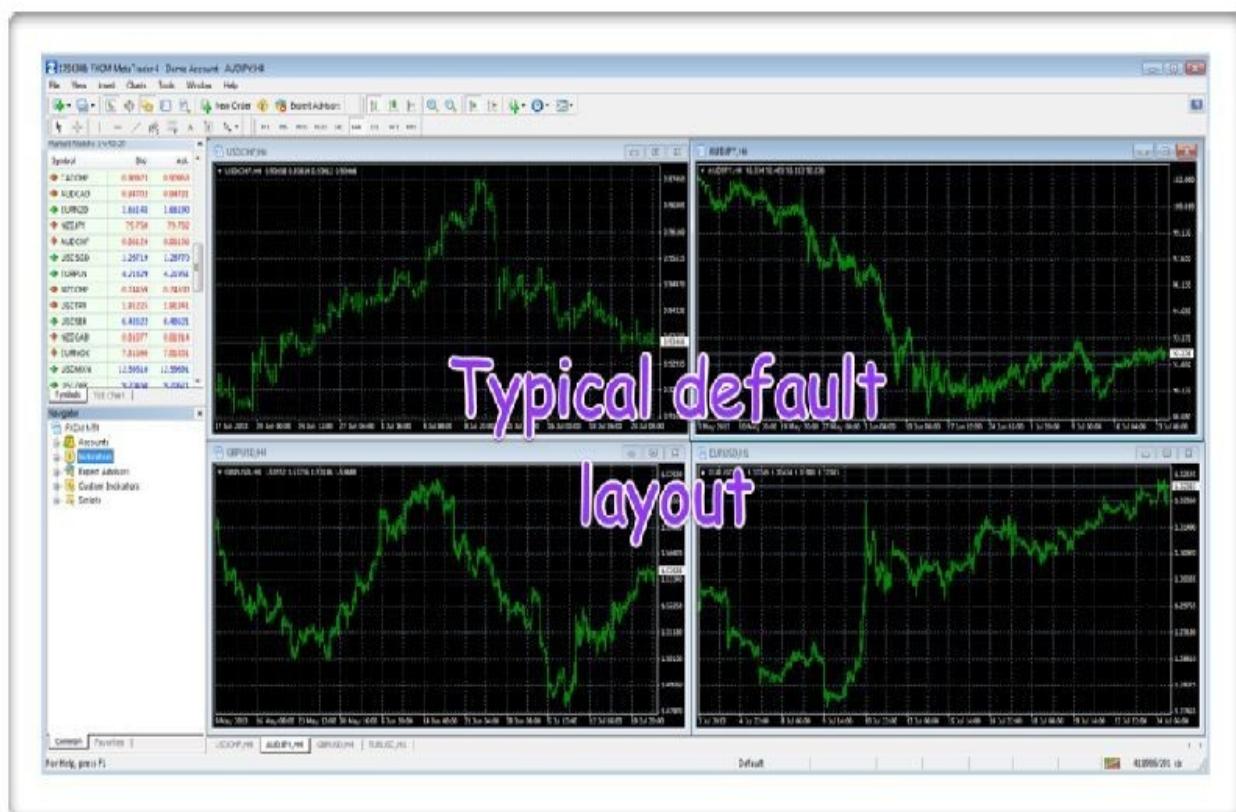


Fig 14.11 - Typical default layout MT4 platform

The trading platform is composed of three basic elements as follows:

- The live charts which appear in the centre of the trading area. You can have

as many or as few as you wish

- The left hand vertical window panes, which provide information on the account, access to the trading indicators and live data
- The bottom window pane which is generally closed, but which when open, extends horizontally across the full width of the trading screen, and contains information about open positions, a log of alerts and messages, and the trading account history

All three areas are managed from the top level navigation. Left click on View and the following pop up window will then appear as shown in Fig 14.12.

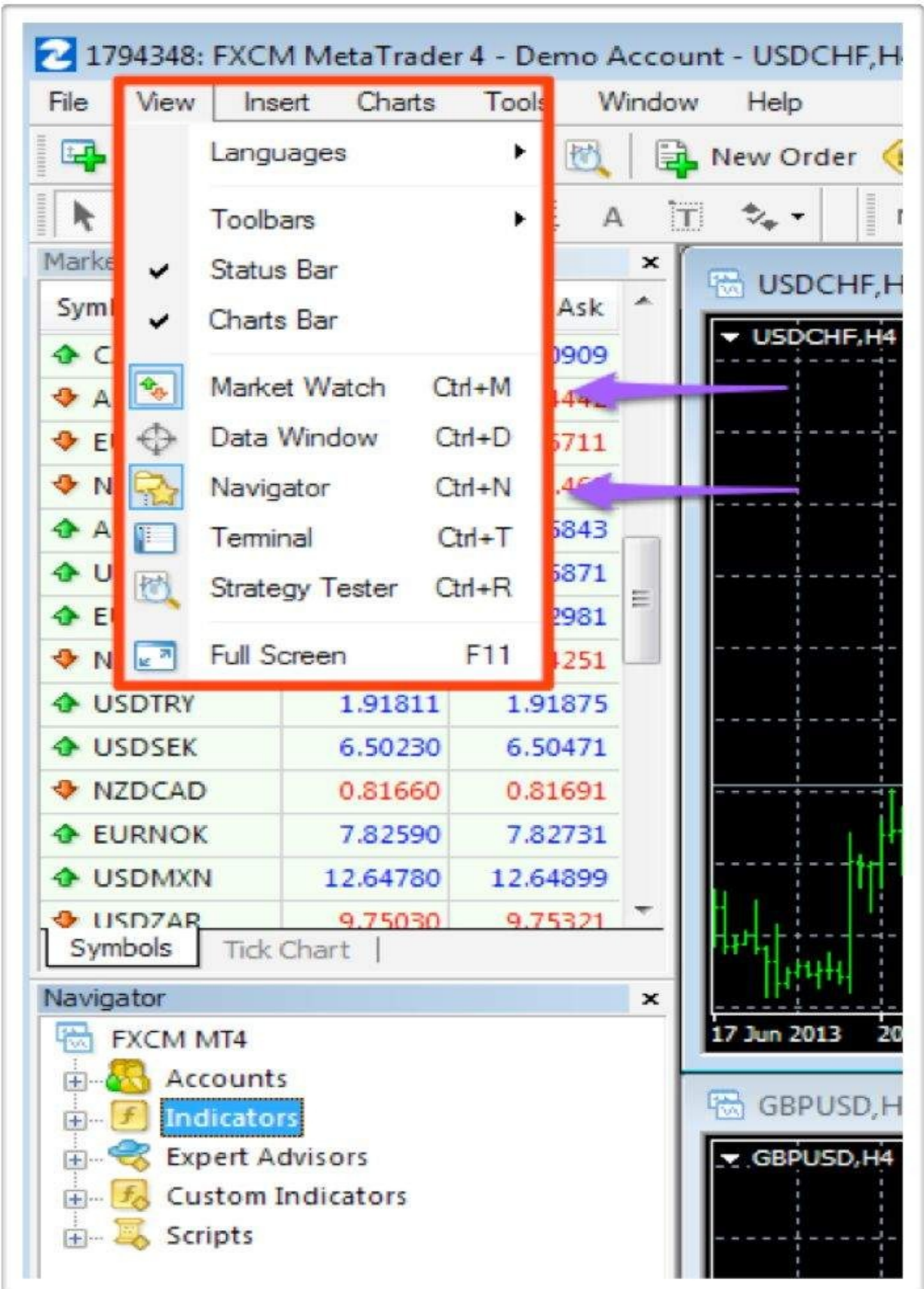


Fig 14.12 - View pop up window

From the pop up window, left click on Market Watch to display the live prices for all the currency pairs available. Left click on the Navigator option which will open this pane, below the Market Watch pane, as shown in Fig 14.12.

Once the Navigator window is open, left click on the + icon alongside to open the following window as shown in Fig 14.13. This is where you will find all the free indicators that are supplied with your MT4 platform.

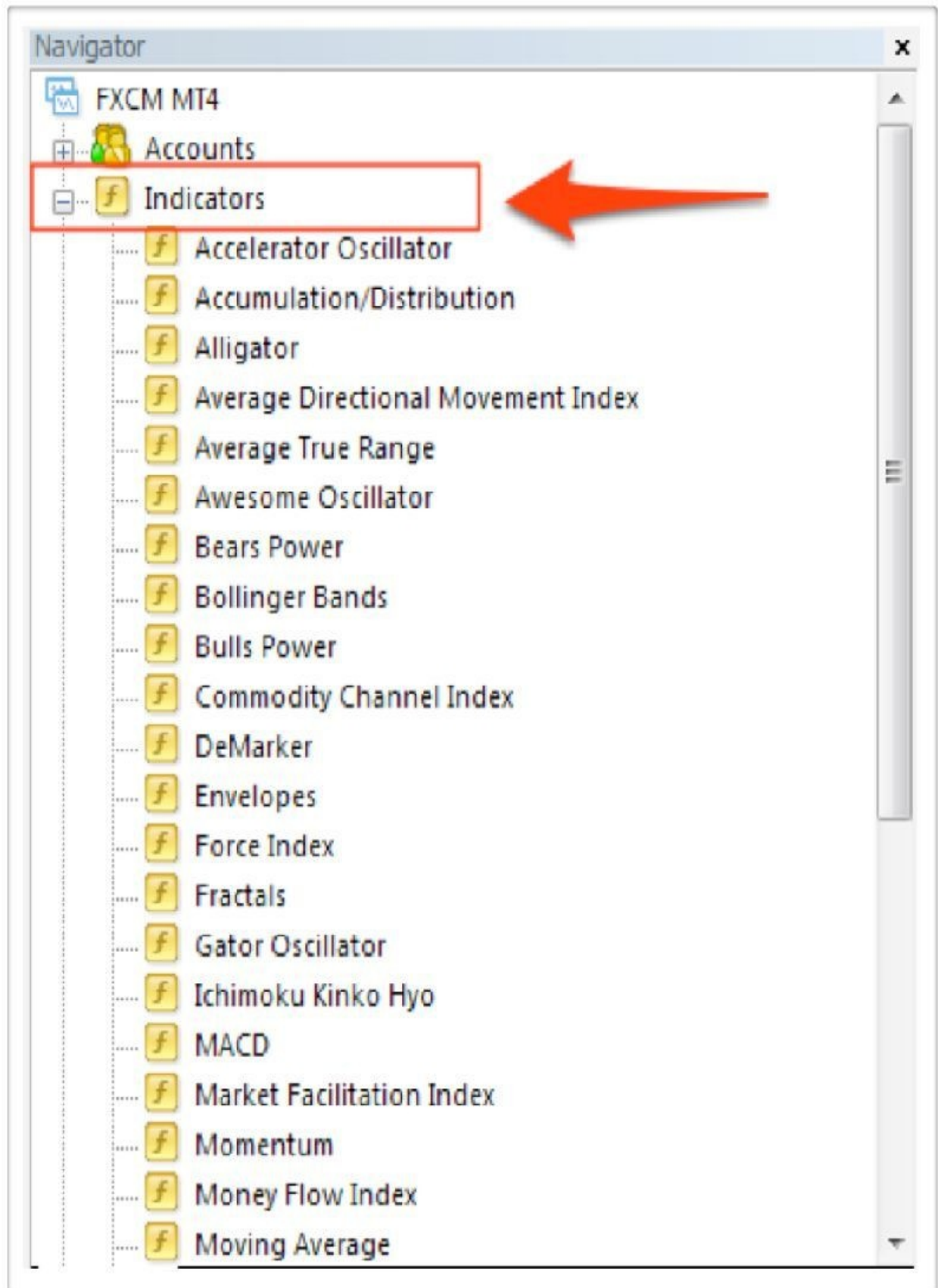


Fig 14.13 - Indicators window open

To add one of these indicators to a chart, simply left click on the indicator, then hold the left click down, and drag and drop the indicator to a chart. Once on the chart, release the left mouse key and left click OK in the pop up window. The indicator will then be active on your chart. Expert advisors, custom indicators and scripts are accessed and added to the charts in the same way. These all appear below the + Indicators, and again clicking on the + icon alongside each, will open the appropriate window.

To log in or to find the details of your account, left click on the + icon alongside Accounts, and this will display all the details in a separate window.

The other very important window is the Terminal window, which is accessed in the same way. Left click on View from the top level navigation, and then left click on Terminal in the pop up window. This will display the following window at the bottom of your trading platform, as shown in Fig 14.14.



Fig 14.14 - Terminal window

The Terminal window will appear at the bottom of your trading screen and generally has several tabs. Whilst these do vary from broker to broker, the most common ones used are as follows:

- **Trade** - this will display your trading balance, equity and free margin. It

will also display any open positions and the P & L on each, along with details of any associated orders such as stop loss orders. In addition, it will also display the size and quantity, whether the order was a sell or a buy order, the time and order reference

- **Account History** - this will display a complete history of all your recent positions
- **Alerts** - this will show any alerts you have set which is an option you have on your MT4 platform
- **Mailbox** - here you will receive emails from your MT4 broker. A welcome one will literally 'whistle in', as soon as you open your account!
- **Code Base** - this displays indicators developed by other traders and software developers for the MT4 platform
- **Experts** - this will display information about any third party indicators or expert advisors you may be running on your platform
- **Journal** - this displays the log of trades, actions on your platform, adding and removing indicators, and any associated errors
- **News** - some MT4 brokers provide a live news feed as part of the standard service

To close the terminal window and return to a full screen, left click on the small X at the top left of the Terminal window, and this will then close the window from view.

The Navigator window and the Market Watch windows can also be closed in the same way, by left clicking on the small X, this time in the right hand side of the pane. This will then give you the maximum space for your charts.

All the above can also be accessed from the toolbar using the icons which generally appear immediately below the top level navigation.

Managing And Configuring Charts

One of the unique aspects of the MT4 platform is that any change you want to make to customize your charts or change settings, can be done in several different ways, either from the toolbar, the pop up menus in the navigation, or directly from the charts themselves. You choose whichever option is quickest and easiest for you.

You can manage all aspects of your chart layouts, appearance, and settings,

either from the top level navigation menu, or from the toolbar of icons which sit immediately below, as well as from the charts themselves. The top level navigation is as follows:

- **File** - select new charts, log in to your account, and select saved Profiles with preconfigured charts
- **View** - displays the options to open the left hand vertical panes as discussed above, and also for specifying language options and customizing the toolbars
- **Insert** - add indicators and annotations to your charts
- **Charts** - customize your charts. Change from bar to line or candlestick displays, and in the Properties section, change default colors and displays. You can also select the Periodicity here for your charts timeframe
- **Tools** - one of the most important selections here is the Options tab in the pop up window. Left click on this and in the pop up window that appears select the Expert Advisors tab. Make sure the Allow DLL imports box is ticked, as this will then ensure any third party Expert Advisors or indicators will work correctly
- **Window** - will allow you to configure the layout of your charts to your own personal preference
- **Help** - this is where you will find help with online support, and if you click on the About option, this will also show you the version of MT4 that your broker is supporting. This appears at the bottom left as Version: 4.00 Build xxx with a date below. This will tell you whether your broker is offering the latest release of the software with all the up to date upgrades

As your trading platform collects and stores a great deal of data every time it is opened and closed, it is important to make sure that you keep any historic data to a minimum where possible, in order to maintain speed on your pc. Over time, this build up of historic data will slow down your pc, particularly if you are running the platform on a laptop.

In order to ensure that you keep the historic data to a minimum, go to Tools, left click and then left click on Options from the pop up window. Select the Charts tab. Change the following settings here:

- Max bars in history - enter 500 in the box alongside

- Max bars in chart - enter 500 in the box alongside

Left click on OK to save these changes. This will ensure that the load on your pc is kept to a reasonable level over time. You can increase this to 1000 if you wish or more, but I have found that this works fine for me, but please do make sure you change this setting to something reasonable. Some platforms are delivered with a default of 25,000 plus, which will slow your pc down dramatically over time.

Changing timeframes on charts is easily done using the toolbar at the top of the screen. You can detach this if you wish and place in other areas of the workspace, or on the chart itself. I always leave mine immediately below the top level navigation. To change the timeframe on a chart, simply left click to make it the active window, and then select one of the following:

- M1 - 1 minute
- M5 - 5 minutes
- M15 - 15 minutes
- M30 - 30 minutes
- H1 - one hour
- H4 - four hours
- D1 - one day
- W1 - one week
- M1 - one month

These are the standard settings. Simply left click on the time you want, and the chart will instantly load with the live data.

To change the properties and to configure your charts, simply right click on the chart and the following pop up window will appear as shown in Fig 14.15.



Fig 14.15 - Chart properties

The Properties option is the last one, right at the bottom of the pop up menu.

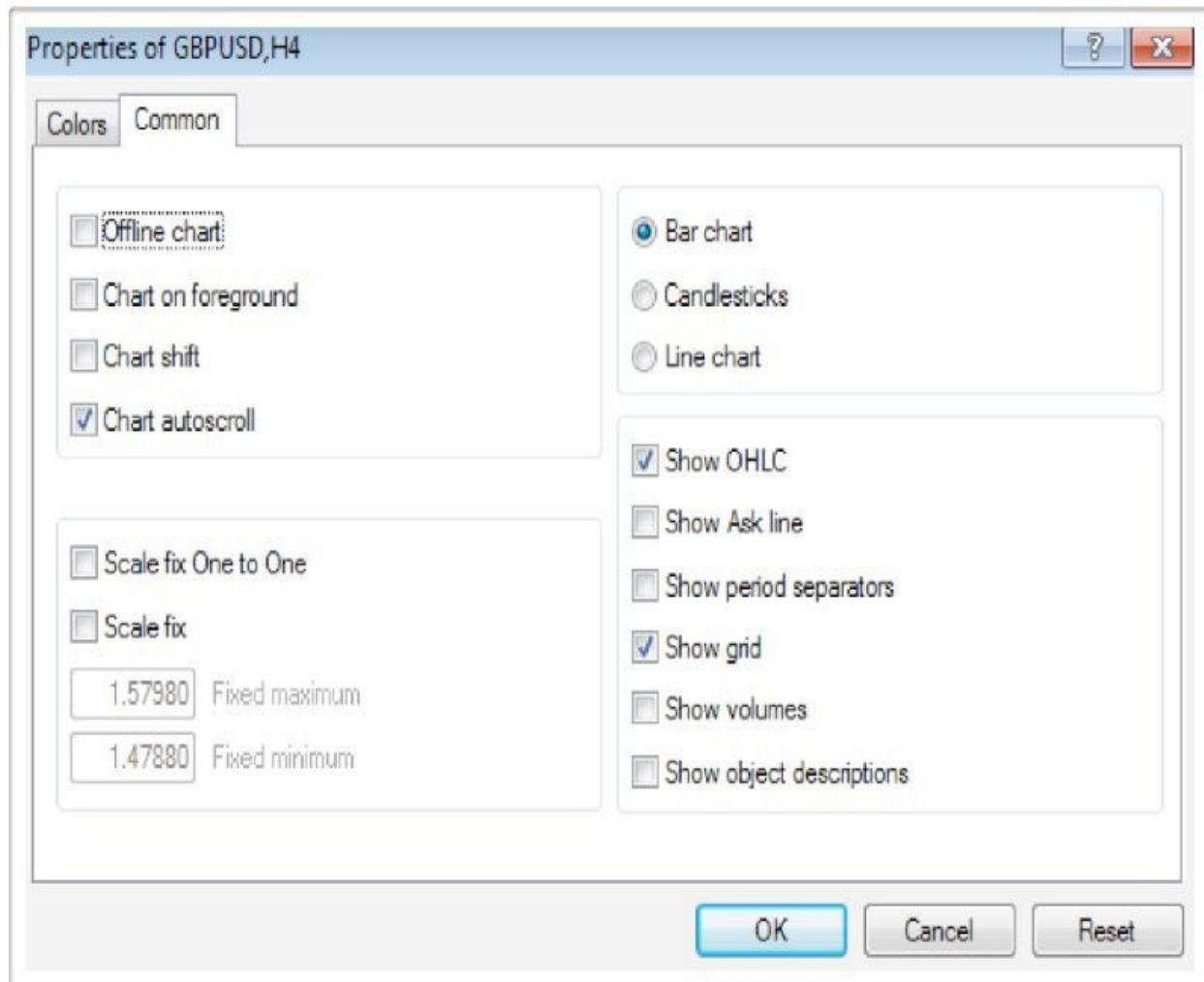


Fig 14.16 - Properties

Left click on the Properties option, and the window in Fig 14.16 will appear. The window has two tabs. The Common tab and the Colors tab. In the Common tab window, you can change from a bar chart, to a candlestick chart or a line chart as well as change various other options.

These include whether you would like the period separators to display, whether you want your charts to autoscroll with the live data, and several other options. Select the Colors tab, and here you can change all the colors for both the bars, and the background options. Two or three default configurations are generally supplied. My preference is plain black and then blue and red candles, but the choice is endless.

Trading

There are several ways to open a new position on the MT4 platform. A new

feature which has been added recently is one click trading, which you can add to any chart, and as the name suggests, simply open a position with one click.

However, if you are a novice trader I would urge you to use the following method which opens the window shown in Fig 14.17. This can be accessed either by left clicking on the 'New Order' icon in the toolbar at the top of the screen, or right click on the chart, and then hover over Trading, and from the pop up window left click on New Order. This will display the window in Fig 14.17.

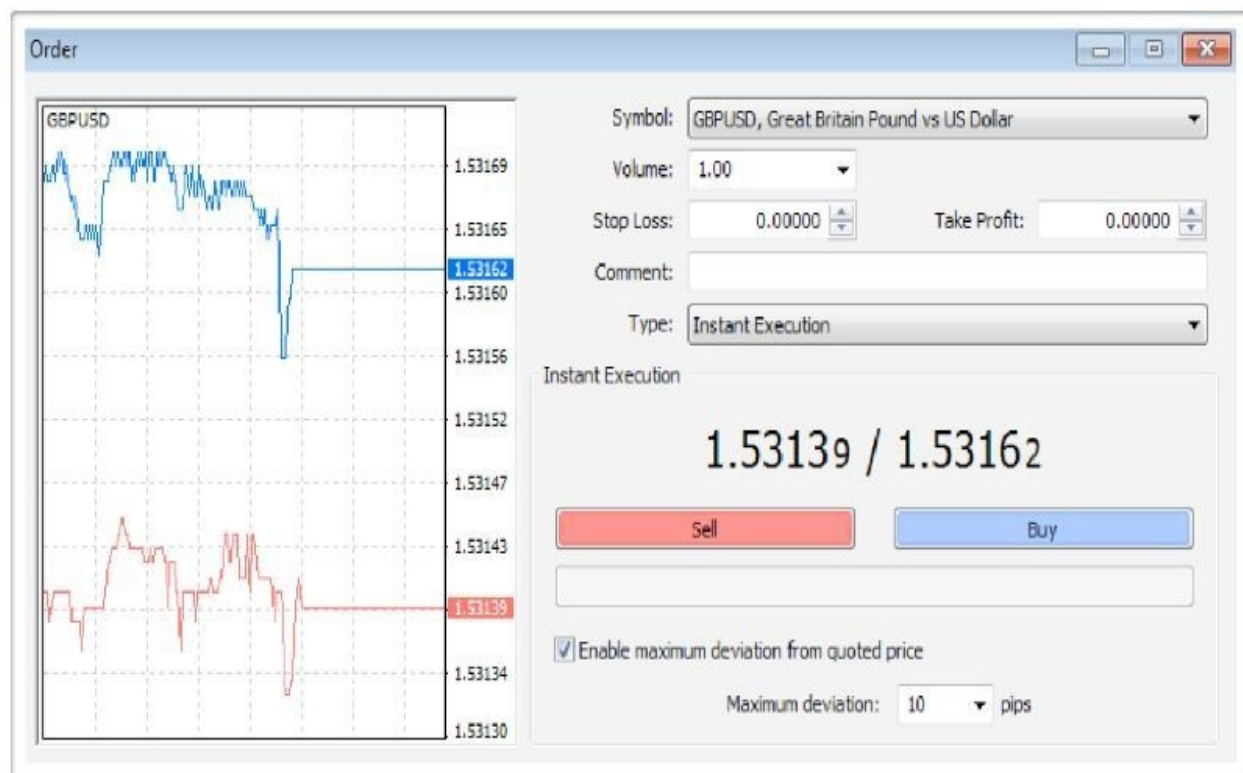


Fig 14.17 - Order window

This is the standard order window for opening positions in the market using MT4. On the left of the window is the live data window, and here you will see two lines, one red and one blue. These represent the live bid and the ask for the pair, and the difference between them is the spread.

On the right of the order screen at the top is the symbol you are proposing to trade. Here you can see we have the GBP/USD selected, and this is also shown at the top left of the live chart. To change to another pair, simply left click on the drop down arrow, and select another pair from the drop down window.

Below this is the box labelled Volume. This is where you select the size of your position. Most MT4 demo accounts will come automatically preconfigured with

a selection of lot sizes. Generally you will find several micro lots, and several full lots, with mini lots often missing completely, so that when you click on the drop down arrow, the window as shown in Fig 14.18 will appear.

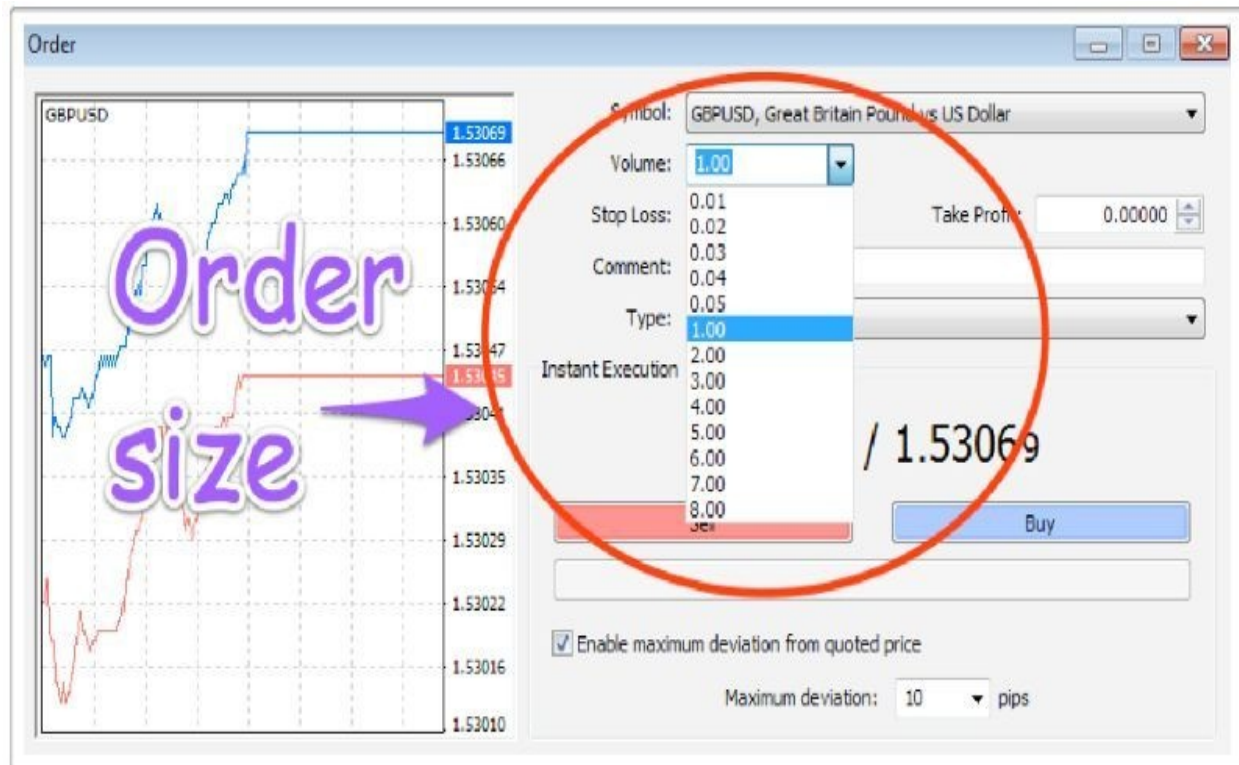


Fig 14.18 - Order size window

With this platform, the default is from one to five micro lots, and one to eight full lots. Just to refresh your memory, if you trade one micro lot which is 0.01 from the above, then this is equivalent to 10 cents per pip on the EUR/USD pair. The full lot, which is 1.00, is equivalent to \$10 per pip on the EUR/USD pair.

This does **not** mean you are restricted to just these two options, and to open a mini lot position, all you need to do is left click in the Volume window, and delete the current selection. Then enter the number of mini lot contracts, such as 0.10 for a single, 0.20 for two *etc.*

If you are trading regularly and want to default your contract size to one in particular, you can do this using the Tools > Options menu, and selecting the Trade tab in the Options window as shown in Fig 14.19.

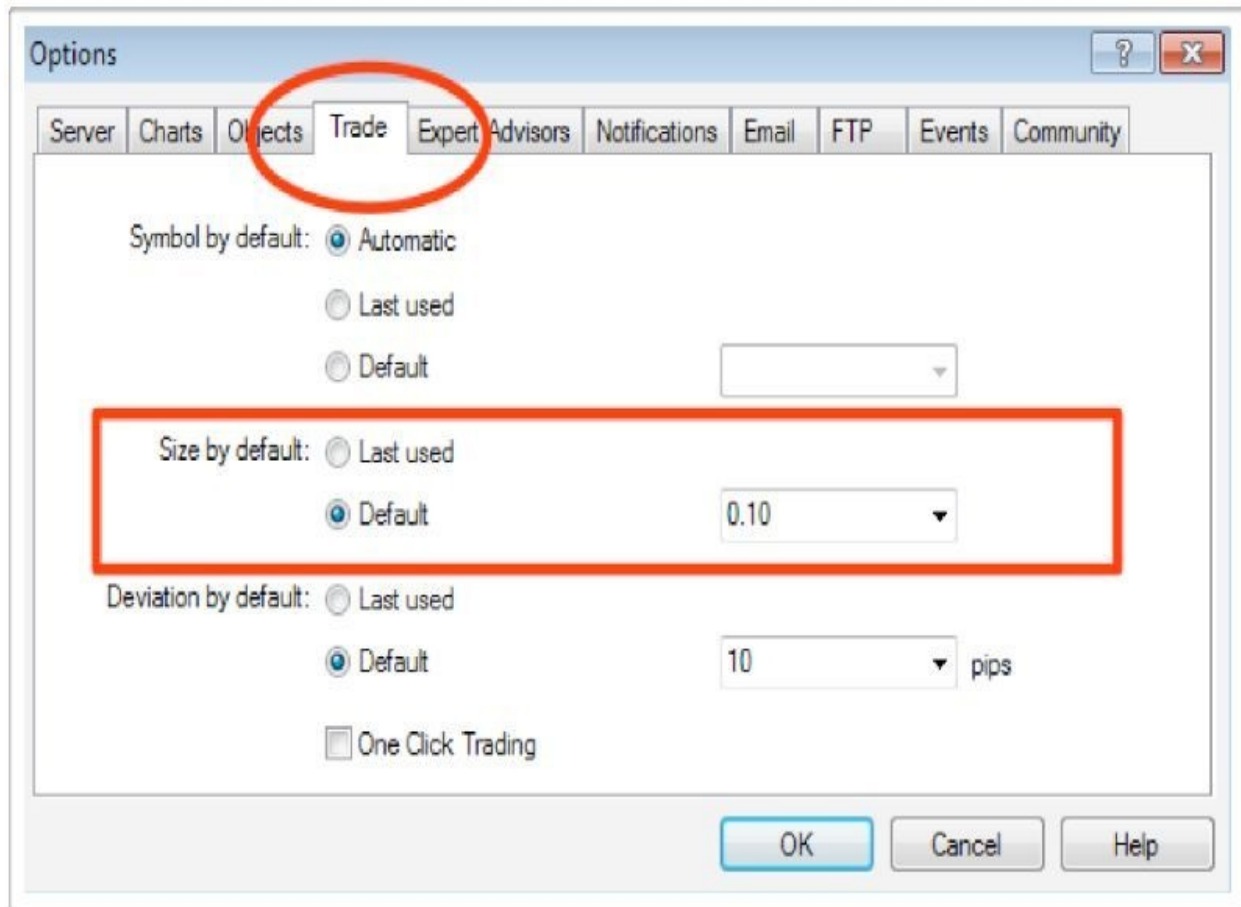


Fig 14.19 - Trade default window

In order to set your default, simply select the radio button Default option, and then enter your default selection. This can be any size of contract, either mini, micro or full lot size, and any multiple. Here you can see I have chosen one micro lot as my default, and then this will always appear in the Volume window in the Trading window. Remember, a mini lot is 0.10, a micro lot is 0.01 and a full lot is 1.00. Then you simply increase in the number you wish to trade. Do practice this on your demo account before your live account!

Having selected our contract size and quantity, it's time for the most important part of the trading window, the **stop loss**!

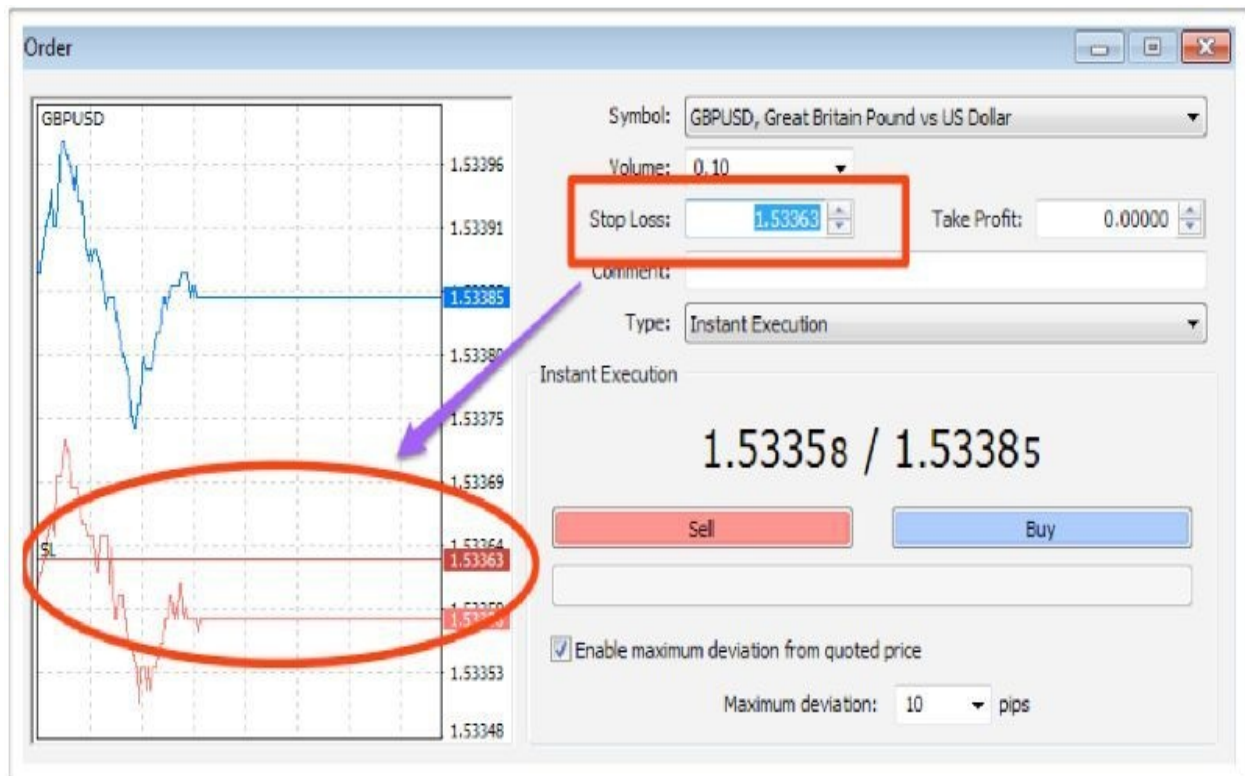


Fig 14.20 - Stop loss order

When you first open the Order window, the Stop Loss window will be blank and display as 0.00000. As soon as you left click on one of the up or down arrows alongside the window, then the order will update and appear at the bid price. At the same time, the stop loss will appear on the live chart on the left hand side of the order window as a red line, with a small SL immediately above on the left hand side. You can then use the up and down arrows to move the stop loss accordingly, which in turn will be reflected in the live chart pane.

The value will change in your Stop Loss window as the level moves up and down on the screen. If you are setting a wide stop loss, then it will probably disappear above or below the chart, but will appear on your trading charts once you complete your order.

If you are happy with your stop loss position, move to the next option below and leave this as the default of Instant Execution, which means that your order will be executed as soon as you select the Buy or Sell button. Once you have checked that you are happy with everything, and in particular that you have chosen the correct contract size and number, and your stop loss is correctly placed, then it's time to select the Buy or Sell button.

If you are going short, then it's the red Sell button, and if long, then it's the blue Buy button. As soon as you left click to place your order, the window shown in Fig 14.21 will appear.

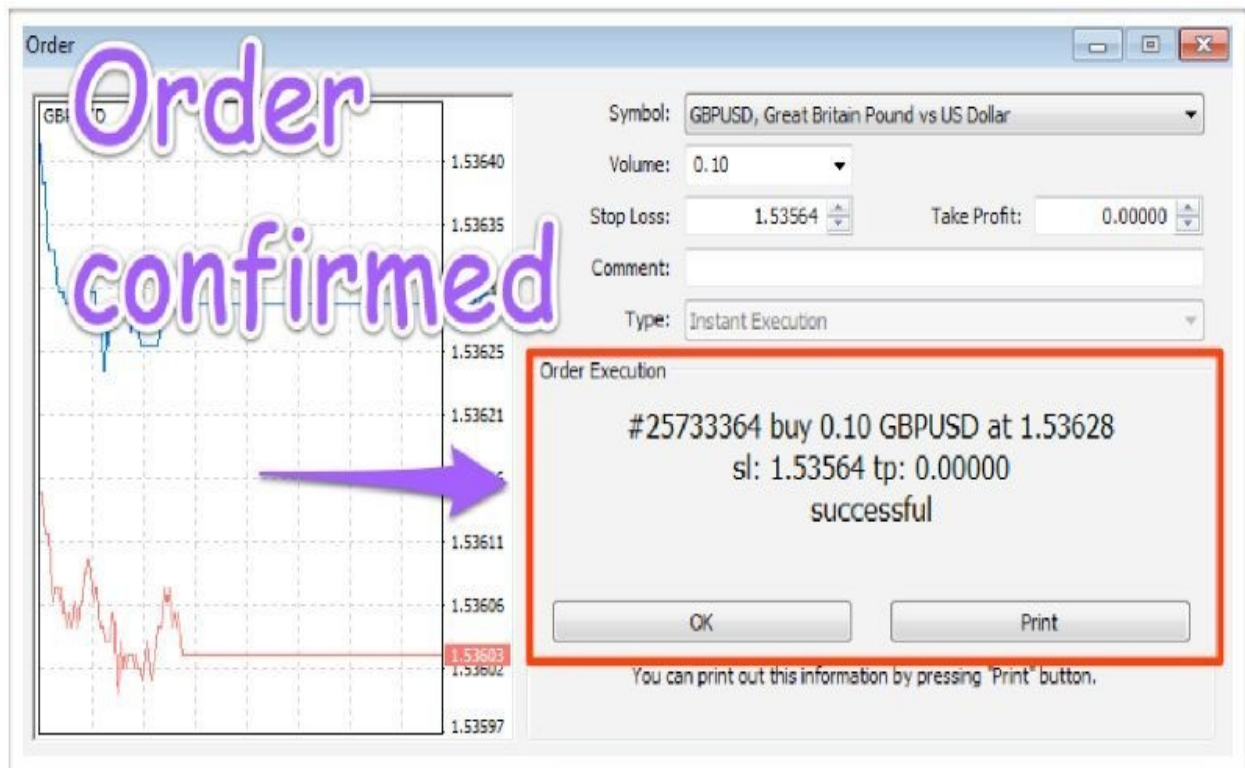


Fig 14.21 - Order confirmation

The order confirmation will immediately tell you, what you have bought or sold with a reference number, and at what price, along with details of the stop loss order.

Your trading chart will now look like Fig 14.22.



Fig 14.22 - Live order on the chart

In this case we have placed a buy order, and this is shown with the green dotted line, with the stop loss order below and displayed as the red dotted line. The current market price is shown with the solid line.

Now, you have several ways to modify or close your order.

First, to manage the stop loss as your position moves deeper into positive territory is easy in MT4, and one of the great features, making ongoing order management very simple.

Remember, you **never** move a stop loss in the opposite direction to your trade, only in the **same** direction. In this case we are in a long position, so will be moving the stop loss higher as the market moves higher, and further from our initial entry. To move the stop loss, hover your mouse pointer over the red dotted line until a small pop up box appears which says:

- Drag to modify
- Profit:

- Pips:

As soon as this window appears, hold down the left click on your mouse, and drag the stop loss to the next position (in this case higher) and release. Once you are happy, release the left click on your mouse and the order window will pop open, with the new position of your stop loss confirmed.

You can see in the example in Fig 14.23, we have moved our stop loss higher, and it is now above our initial entry position. We have locked in a guaranteed profit, and are now trading in a riskless position. We have reduced our financial risk to zero on this position, and have a guaranteed 11 pips at the moment. As the market continues to move higher, we can continue to move our stop loss in step with the market, or decide to close our position should we approach an area of price resistance, or our volume price analysis gives us strong signals of a potential pause or reversal. As you can see in this example, we have moved our stop loss just below the next logical level of price support, which the market has defined for us. As I explained earlier, we are allowing the market to define our stop loss management and placement, not us!!

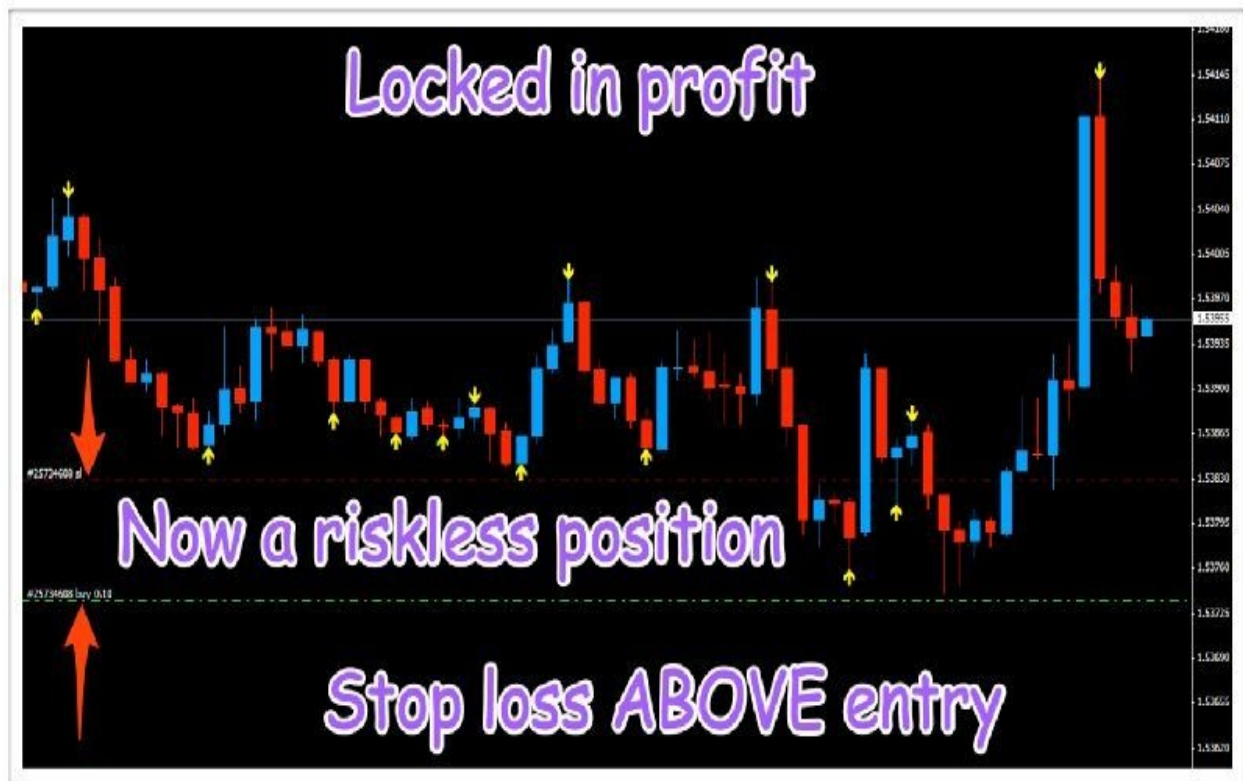


Fig 14.23 - Stop loss management

When you are ready to close your position, there are several ways to do this

easily and quickly. First, you can do this directly from the chart. Hover your mouse pointer over your buy or sell order on the screen, and a small vertical double arrow will appear. When it does, right click and the following pop up window will appear on your screen. This will give you two options, either to modify or close the order, along with options on a trailing stop.



Fig 14.24 - Close order option

Left click on the Close option, and your order window will appear as shown in Fig 14.25.

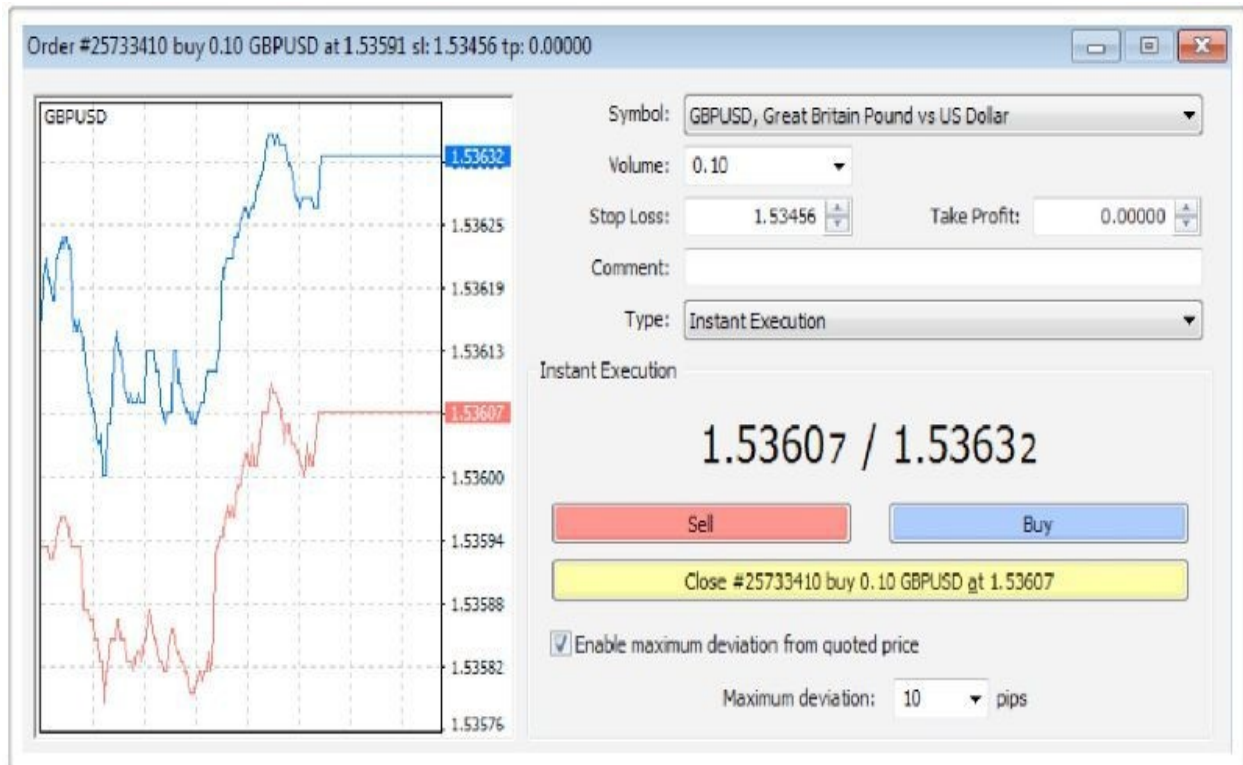


Fig 14.25 - Close order window

Left click on the yellow close order option at the bottom of the order window, and your position will be closed.

You can also access this order window by opening the Terminal at the bottom of your trading screen, right click on the live order, and from the pop up menu, left click on the Close Order option. This will display the same order window as above.

Once your position is closed, you can view all the details under the Account History tab in the Terminal window. And then it's on to take another position in the market!

Templates And Profiles

Templates and Profiles are another of the extremely useful features in MT4, which will help you speed up creating your default charts and workspaces.

The Template option is used to apply particular settings to a single chart, so here for example, if you have a preferred type of chart layout, with associated indicators, then this option gives you a very quick way to configure any chart with your own personal settings.

The Profile option is used to create workspaces with groups of charts together. This is the feature you would use to create your currency matrix for example with several charts, or alternatively your preferred trading layout perhaps, where you might have your currency strength indicator and three charts. These could also be configured for different timescales, and for different currency pairs. The options here are almost limitless, and whilst they may take some time to set up initially, once done, you can simply call them in using this powerful and flexible feature.

If we start with the Template option.

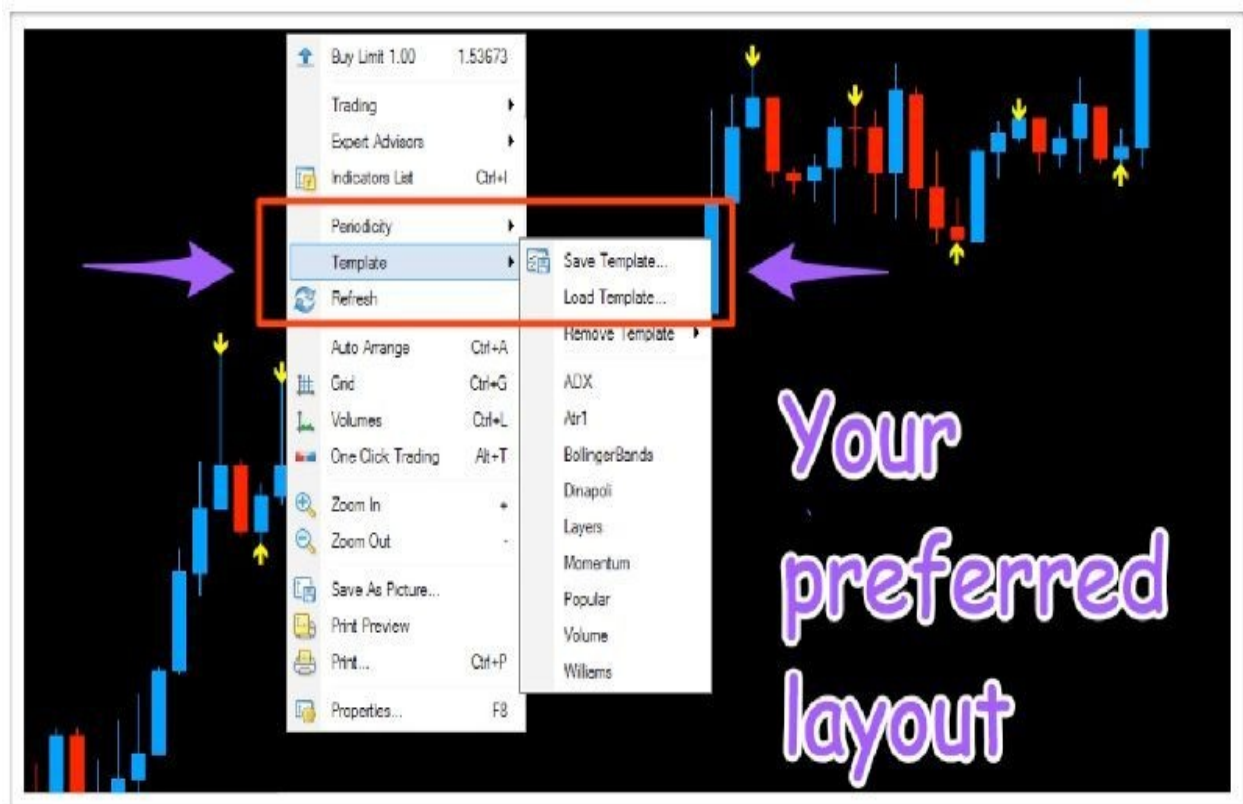


Fig 14.26 - Save template

First configure your chart to your personal preferences in terms of colors, candles, and chart options, as well as applying any indicators that you use regularly. When you are happy with the chart, simply right click, hover over the Template option, and a further pop up window will appear.

Left click on the Save Template option, and you will be prompted to give your saved template a File name. Once done, left click on the Save button and your template will be saved in the templates folder of your MT4 platform.

To load the template to a new chart, open the chart, and right click as before and hover over Template. This time left click on the Load Template option and the templates folder will open as shown in Fig 14.27.

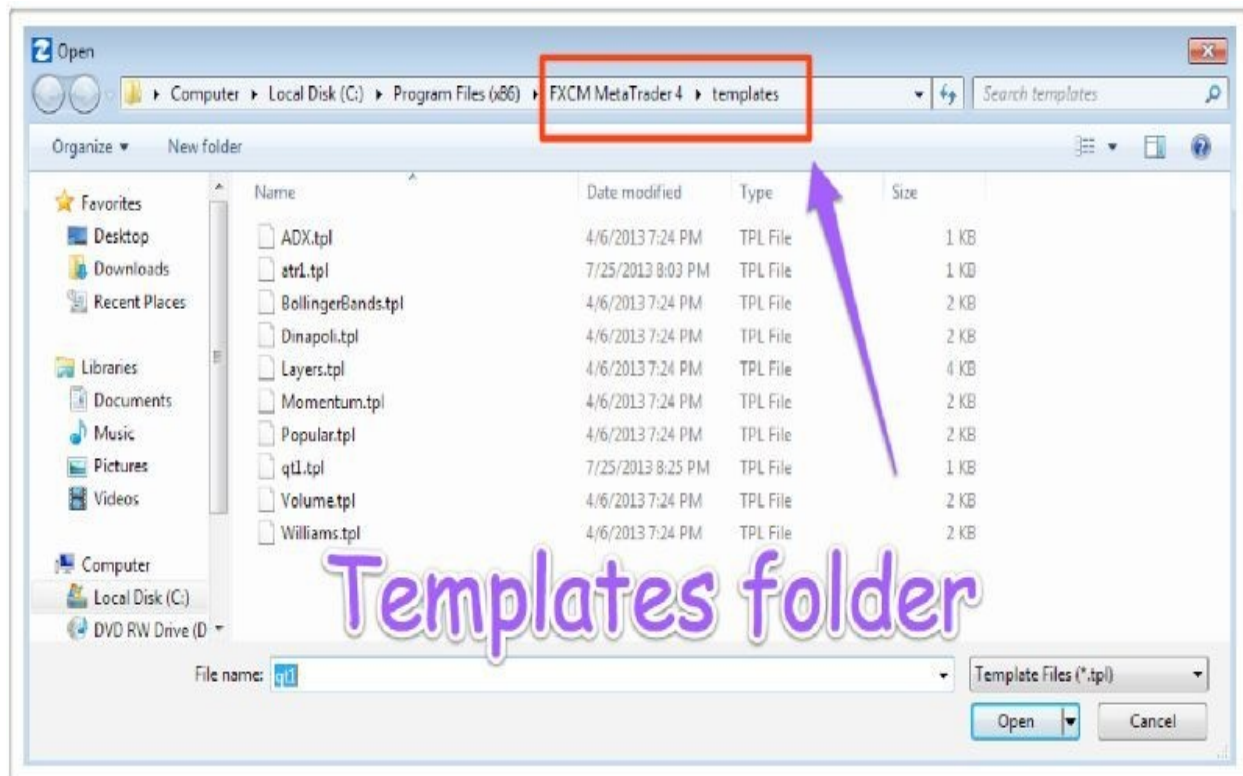


Fig 14.27 - Templates folder

Left click on the template you would like to apply to the chart, and then left click on the Open button at the bottom of the window. The template will then be applied to the chart and will be configured instantly with all your personal settings, preferences and trading indicators. You can use a template as many times as you wish and if you want to modify it in any way, simply make the changes to the chart, and then save the new template using a different name in the templates folder.

The Profiles option can be accessed in several ways, either from the toolbar icon at the top left of the trading screen, or from the File option in the top level navigation.

Once you have created your workspace of charts in a layout, it's time to save this as a profile. Go to the top level navigation and left click File. Hover over the Profiles option and from the pop up window, select the 'Save As' option:

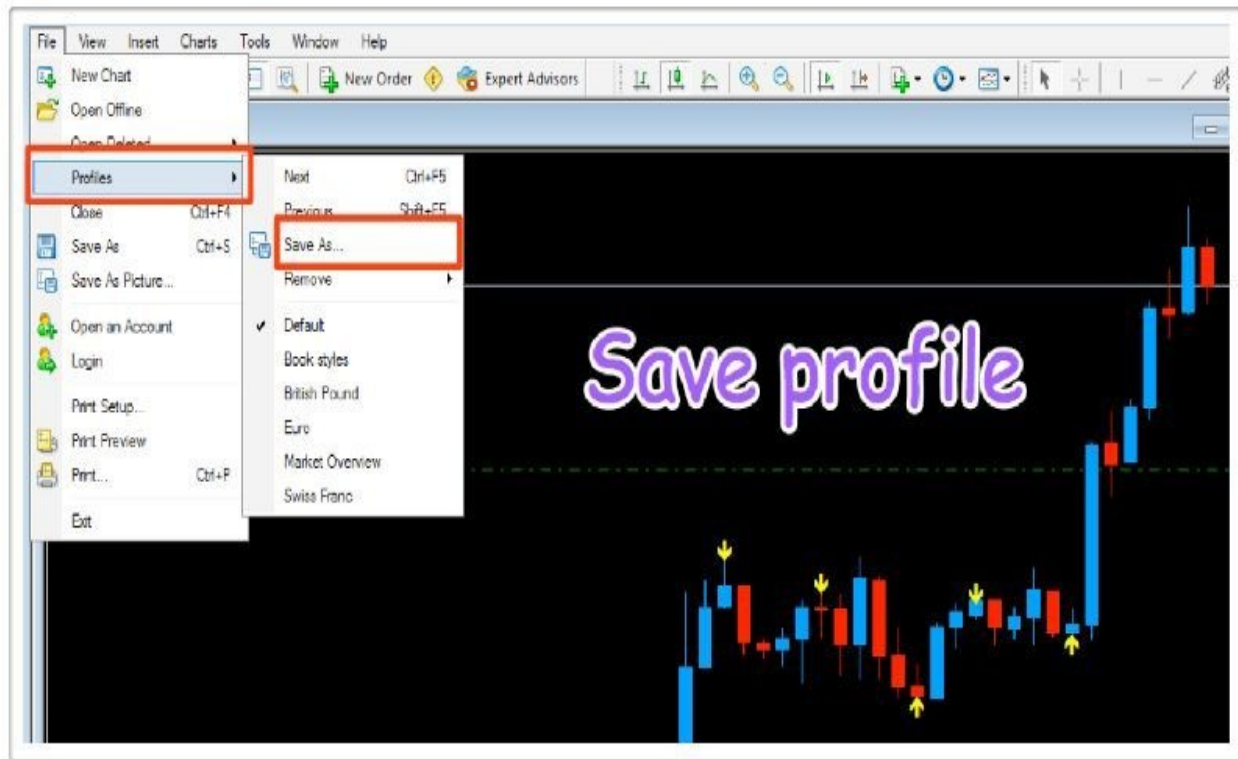


Fig 14.28 - Save profile

A window will pop up and you will be prompted to give your profile a name. Once you have done this left click on the OK button, and your profile will be saved.

To select a saved profile, left click on File and from the drop down menu, hover over the Profiles option again. In the pop up window you should now see your saved profiles. To select one of these simply left click and the chosen profile will then display with all the associated charts, indicators and preference settings.

I cannot recommend the MT4 platform too highly. It is simple to download and install, and very easy to configure and use. Most importantly however, it is the easiest platform I have found to execute and manage trading positions. There are many other platforms available, but this is the most popular, and I hope, from this brief introduction, that you can understand why. In this short chapter I have tried to cover the basics, so that you can get started quickly.

There are many more features and options that you will discover in using the platform every day, but I hope that the above has provided you with a 'quick start' guide. It's a super platform, and one that I always recommend for new forex traders. Yes, it has its faults and there are features missing that would make

it even better.

But, for simplicity and ease of use, it cannot be beaten at the moment. This is not to say that no one will develop a better platform - they will. Indeed, one that I am involved with at the moment is from a company called [Tradable](#). The approach here is innovative and creative, allowing traders to effectively 'build' their own platform using apps from the online store. The platform has already won several major industry awards, and is now being rolled out to major brokers around the world, and is the world's first truly 'open trading platform'.

Another company that I have worked with closely is [NinjaTrader](#). This is another extremely innovative and powerful trading platform, and in terms of the MT4 platform is really the next level up in terms of complexity. Once again, it is a free platform to download, and you can even use the free end of day data option, making the whole solution 100% free. Whilst the platform is a little more complex for the novice trader, it is worth the extra effort and for trading forex, adds the extra dimension of the futures markets for currency futures and options, as well as related markets such as commodities.

You will have to pay for the live forex data feed, and the one that both NinjaTrader and I recommend is from Kinetick. Amongst other things, this combination gives you the option to trade forex (and other markets) using tick charts, rather than time based charts. Support from the company is exceptional, and as I said earlier, the platform is free to download, and is the one I use for my own futures trading and is linked to my futures broker, Interactive Brokers. I am a [NinjaTrader partner](#) in their education program, and you can find me there by clicking on the link above and then selecting Educators from the menu.

And so we come to the end of the book.

I hope you have enjoyed reading it, and more importantly I fervently hope that it has helped to explain clearly and simply all the basics of forex trading, and in doing so, will provide you with a solid foundation as you begin your forex trading journey.

However, like every profitable endeavor, it takes time and effort, and a little hard work so I make no apology for the length or scope of this book. This book I hope, will provide the starting point for you, and in the last few months I have also written two other books which you may find useful as you build your trading knowledge.

The first of these is titled '[A Three Dimensional Approach To Forex Trading](#)'. It is a large book, and was written with one purpose in mind. To provide forex traders with a much broader perspective of the currency markets, a framework if you like of how the forex markets operate. The book explains in detail the forces which drive the market, and also explores those relationships with related markets, which then provide clues and signals as to future market direction.

The forex market, just like any other financial market is primarily about risk, which is then reflected in the price behavior of currencies. The Three Dimensional Approach book is not aimed at the beginner, but is there to help you develop and build your knowledge of this market, and I hope you will come to this book in due course, to expand your understanding further.

My second book is titled, '[A Complete Guide To Volume Price Analysis](#)'. This book will help to give you the complete picture for trading forex (and other markets) using volume price analysis, a subject I introduced here. Volume and price have been the cornerstone of my own trading approach, and I hope that in reading this and other books I have written, you will understand why. The MT4 platform lends itself perfectly, using the free volume indicator on the platform.

Finally, I would, of course, like to thank you for purchasing this book. If you do have any comments, questions or suggestions I would be delighted to hear from you. You can contact me on my personal email at anna@annacoulling.com and I guarantee that you will receive a reply. This book is based on my own personal trading experience, and from what I found has worked for me over the years. However, I am also conscious that it is impossible to cover all aspects of trading in one book.

If you have enjoyed the book, it would be great if you could spread the word to others, who may be thinking of becoming forex traders, but are not sure where to start. I would of course appreciate a review on Amazon, which will help others to find this book more easily. And I thank you in advance.

You can find details of all my other books on my personal site at <http://www.annacoulling.com> along with my regular market forecasts and analysis, and I look forward to hearing from you there.

Once again, thank you so much, and may I wish you every success in your own trading journey towards becoming a master forex trader.

Warmest regards, and many thanks again

Anna

PS - please do follow my market analysis on my personal site and check for the latest book, or join me on Twitter or Facebook.

And why not join me in one of my live webinars, where I apply all these techniques, and many more, using live charts in realtime. You can find the details here at <http://www.forexforbeginners.info>

I look forward to you joining me, and thank you once again.

<http://www.annacoulling.com>

<http://www.twitter.com/annacoull>

<http://facebook.com/learnforextrading>

Free Trading Resources

Appreciation is a wonderful thing. It makes what is excellent in others belong to us as well

Voltaire (1694 - 1778)

Acknowledgements & Free Resources

www.annacoulling.com

My own site for regular market analysis across all the markets including commodities and stocks. You can also contact me there (or leave comments on posts which are much appreciated) or email me personally on anna@annacoulling.com

www.cmegroup.com

The premier exchange for market analysis of all futures markets, and of course contract specifications. For currency traders the futures world is opening up as well, with the CME moving away from the once traditional large contracts, to offer micro and mini contracts for retail traders.

www.forexfactory.com

One of the best online resources for fundamental news and releases. Recently updated and revised with some of the fundamental news items being re-categorized.

www.forexticket.co.uk

This used to be called Mataf, but has recently changed to the above. An excellent site for checking on the latest correlations between currency pairs. This is under the Tools/Charts section on the site, and updated in real time.

www.fxstreet.com

One of the oldest and most respected forex portals, with an excellent forex education section. I provide my weekly analysis here as an expert contributor, and you will also see my Twitter feed on the home page, so don't be surprised when my face pops up there! I now also host the London meet up group on behalf of FXstreet. The group meets monthly and you can find further details

here - [FXstreet London MeetUp](#). If you are in or around the London area, I look forward to meeting you in person at the next session.

In addition FXstreet have recently launched a new service at www.forexstreet.net, a social network site, where forex traders can message one another, and contribute views, thoughts and analysis on the markets. And not just on forex, but commodities and related markets.

www.investing.com

A free trader resource covering virtually every global market, and of course the 'old style' USD index is also here. Here you will also find live futures prices, and charts for over 1,000 currency pairs. Again you will find my forecasts and analysis here!

[Metatrader 4 user guide](#)

Here you will find an excellent user guide which covers every aspect of the MT4 platform in detail.

www.mindmusclesacademy.com

My thanks to Richard Friesen for kindly giving me permission to include references to his work in this book. I would urge you to visit his site, and to learn more about how and why we react the way we do when trading. Richard is an ex pit trader, and so brings this unique experience to the world of trading psychology, and helping us to understand and deal with the emotions that we all face as traders. My warmest thanks to Richard.

www.ninjatrader.com

The NinjaTrader platform with the Kinetick data feed is one of the most powerful combinations in the market, and again is a free platform. You will have to pay for the Kinetick feed. This is your next step once you have learnt the basics using an MT4 platform, and want to move on to the next level - perhaps into futures!

Glossary

Appreciation:	Describes a currency strengthening in response to market demand.
Ask Price:	Lowest price acceptable to the buyer.
Back Office:	Settlement and related processes.
Bank Rate:	The rate at which a central bank lends money to its banks.
Base Currency:	Currency in which bank operates. It is also the first currency in any currency quotation.
Base Rate:	Term used in UK to calculate retail interest rates.
Basis Point:	A percentage change in interest rates. 25 basis points means 0.25%.
Bear:	Person who believes prices will fall.
Bear Market:	One characterized by falling prices.
Bid Figure:	Refers to first 3 digits of an exchange rate.
BIS:	Bank of International Settlement.
Bretton Woods:	A system of fixed currency exchange rate. No longer used.
Broker:	Executes orders to buy and sell currencies.
Bull:	Person who believes prices will rise.
Bull Market:	One characterized by rising prices.
Cable:	A term used to describe British Pound/US Dollar rate.
Central Bank:	Bank responsible for a country's monetary policy.
Counter currency:	The second currency which is quoted in a currency pair. The first is the base currency.
Counterparty:	Customer or bank which an fx deal is executed.
Cross Rate:	A pair which does not include the US dollar.
Currency:	A type of money a country uses.
Currency matrix:	Analysis of the strength or weakness of a currency, using multiple currency pairs
Currency Basket:	Various weightings of other currencies grouped together.
Deal Date:	Date of which a transaction is agreed upon.
Deal Ticket:	Primary method of recording a transaction.

Dealer:	Individual or firm acting as a principal.
Deficit:	Shortfall in balance of trade, balance of payments or government budgets.
Delivery:	Settlement of contract by delivery of underlying currency.
Delivery Date:	Date of maturity of a contract.
EFT:	Electronic fund transfer.
EMS:	European Monetary System.
European Union:	Formerly known as European Community.
Exchange Risk:	Potential loss incurred from adverse rate move.
Exotic:	A less broadly traded currency.
Expiry Date:	Date of expiry of option or futures contract.
FED:	US Federal Reserve.
Fixed Xchge Rate:	Official rate set by monetary authorities.
Flat/Square:	A neutral position in the market.
FOMC:	Federal Open Market Committee.
Foreign Exchange:	Purchase or sale of currency.
Forex:	An abbreviation of the above term.
Forward Contract:	Buying currency at an agreed price in the future.
Forward Points:	Interest rate differential between two currencies in points.
Forward Rate:	The exchange rate agreed for a future contract.
Front Office:	Activities carried out by the dealer.
Fundamental Analysis:	Analysis based on economic and political factors.
FX:	Foreign exchange.
GTC:	Good til cancelled - an order left to buy or sell at fixed price.
Indicative Quote:	Market makers price that is not firm.

Inflation:	Continued rise in prices and falling purchasing power.
Interbank Rates:	Rates quoted between large international banks.
Interest Rate Risk:	Potential loss from changes in interest rates.
Intervention:	Action by a central bank to manipulate value of its currency.
Kiwi:	Dealer slang for the New Zealand Dollar.
Lagging Indicator:	Statistic or trading indicator which lags behind the market and one based on historic data.
Leading Indicator:	Statistic considered to precede changes in economic growth or signaling where the market is going next. As trading indicators there are only two - volume and price.
Liability:	The liability to deliver on a futures contract.
Libor:	London interbank offer rate, based on quotes from 16 banks.
Limit Order:	An order to execute at a better rate than current level.
Long:	Position where trader has bought a currency expecting the pair to go higher.
Loonie:	Dealer slang for Canadian Dollar.
Margin:	Initial deposit to enter into a position with broker.
Margin Call:	Demand for additional funds to cover positions.
Maturity:	Date for settlement of a transaction.
Offer:	The rate at which dealer is willing to sell base currency.
OCO:	One cancels other. One order automatically cancels previous.
Open Position:	Any deal that has not been settled.
OTC:	Over the counter. Market conducted directly. No exchange.
Outright Forward:	Fx transaction involving purchase or sale at a future date.
Overbought:	A currency or pair that is over extended to the upside.
Oversold:	A currency or pair that is over extended to the downside.
Pip:	Smallest incremental move on exchange rate, now increased to a tenth of a pip.
Point:	100th part of 1%, normally 10000 of any spot rate. Position: Net total exposure in a given currency. A trader has 'a position' in the

	market.
Range:	Difference between highest and lowest price.
Rate:	Price of one currency in terms of another.
Reserve Currency:	Currency held by central bank as a store of international liquidity.
Resistance:	Price level at which selling is expected to take place.
Revaluation:	Increase in exchange rate as a result of official action.
Rollover:	Settlement of a deal is carried forward to a future date.
Selling Rate:	Rate at which bank is willing to sell foreign currency.
Settlement:	Physical exchange of one currency for another.
Settlement Date:	Date at which above is carried out.
Short:	Position where trader has sold currency expecting the pair to fall.
Slippage:	Difference between screen price and fill price.
Spot:	The most common forex transaction.
Spot Price Rate:	Price currently in the spot market.
Spread:	Difference between the bid and the ask.
Sterling:	The British Pound.
Stop Loss Order:	Automated order execution to exit a trade at a loss.
Support Levels:	Price levels at which buying is expected.
Swap:	Simultaneous purchase and sale of same amount of currency.
Swissy:	Market slang for Swiss Franc rate.
Technical Analysis:	The study of price that reflects the supply demand relationship.
Technical Correction:	An adjustment to price not based on market sentiment.
Tick:	Minimum change in price, up or down.
Trade Date:	The date on which a trade occurs.
Trailing Stop Loss:	A stop loss order that trails the market position by a fixed number of pips, as set by the trader.
Transaction	The date on which a trade occurs.

Date:

Value Date: Settlement date of a spot or forward contract.

Value Spot: Normally settlement two days from date of contract.

Volatility: A measure of fluctuation over a given period.

Whipsaw: Dealer slang for highly volatile price action.

Yard: Dealer slang for one billion dollars.

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