

Foreign Exchange Technical Market (Part two)

How To Scalp Fundamentally

While technical analysis is critical to currency trading - especially for pinpointing entries and exits - it is insufficient on its own for creating a comprehensive trading game plan. Market sentiment in FX is driven primarily by the economic and geopolitical news of the day. The key players in the currency market - Fortune 500 multinationals, the world's central banks, multibillion-dollar hedge funds and the top tier investment banks that service them - do not care if there is a double top in the EUR/JPY on the hourly candles. Instead, they formulate their trades by analyzing the most recent economic news and geopolitical developments, as well as the latest pronouncements from G-7 monetary authorities. Therefore, the proper approach to FX trading can be summarized as follows: trigger fundamentally, enter and exit technically.

Popular wisdom in the market states that traders who want to trade fundamentally should choose a longer time frame involving daily, or even weekly, charts. Those traders who want to trade more short term (hourly charts, for example) should focus strictly on technical setups. As with so much conventional wisdom in FX, this bit of advice couldn't be more wrong. For the purposes of this article, we define scalping in FX as using short-term time frames (usually hourly charts or smaller) to make trades with targets and stops approximately 20-30 points in length. Not only is it possible to scalp FX fundamentally, but retail traders actually have a significant advantage over larger market players when it comes to executing their trades.

Macroeconomic News Moves the Market

One of the great aspects of the currency market is that it trades off macroeconomic news that is transparent, impossible to fabricate and readily available to all market participants at the same time. (To learn more, see [Trading On News Releases](#).) The key news that drives the FX market is governmental economic data such as the latest employment statistics, GDP growth rates, trade balance reports, inflation readings and interest rate announcements. These reports are typically released every month and can be previewed on economic calendars such as the ones published on [Daily FX](#) and [FXStreet.com](#).

Not only is the release of this data planned well in advance, but it is also reported instantaneously through a variety of news outlets including Bloomberg, Reuters, Dow Jones and CNBC, making it universally accessible. There's no need for traders to know about a secret contract that Intel may have negotiated, or the super-cool new product that a company like Apple just prototyped at its labs in Cupertino, California. In FX, headline economic data really does move markets, and currency traders can take advantage of that fact. More importantly, individual traders often have a decided advantage in reacting to the news faster than the larger corporate and hedge fund players.

Retail Traders Can React Quickly

As the most liquid financial market in the world, forex trades almost US\$2 trillion each day in volume (in April 2004, the Bank for International Settlements (BIS) reported that the forex market traded US\$1.9 trillion a day). Most retail brokers will provide liquidity up to \$20 million, meaning that they will allow any trader to buy up to \$20 million worth of a currency pair at the current ask or to sell the same amount at the present bid. This trade size can accommodate 99% of all retail orders, making it easy for traders to open a position quickly without affecting the market. However, larger players that are looking to place trades worth hundreds of millions or even billions of dollars at a time will move markets. Therefore, by reacting quickly, retail traders in FX have a chance to front-run the big players and benefit from any momentum generated by that order flow. Economic news, whether favorable or unfavorable, can take up to several hours to fully filter through the market as traders adjust to the new information. This type of time frame offers astute retail traders a great opportunity to take advantage of the situation and scalp short-term profits as the pressure from the big players moves prices in the direction of the news.

How the Best Fundamental Scalps Occur

If event-driven scalping were as easy as buying good news and selling bad news, every FX trader would be inordinately rich. Of course, success is not that simple. First and foremost, good or bad economic results in and of themselves are usually meaningless to the market. FX markets trade on expectations and perception. Therefore, relative comparisons matter much more than absolute ones. For example, suppose the United States reported quarterly GDP growth of 5%, while the eurozone reported GDP results of only 1.5%. At first glance, it would appear that EUR/USD should decline because the U.S. results clearly show superior growth. However, if the market expected 7% GDP numbers from the U.S. and only 0.5% readings from the eurozone, the exact opposite might occur because eurozone news would have exceeded expectations, while U.S. results would have come up short.

However, playing the expectations game alone is not enough to create profitable trades. This is where technicals become integral to a successful fundamental setup. The best, most profitable fundamental scalps occur under technically extreme conditions. These highest-probability setups are created when a favorable fundamental surprise takes place under technically oversold conditions and vice versa. At that moment, the currency can bounce like a rubber ball off pavement, as every market participant who is short scrambles to cover his or her position. The same dynamic occurs in

reverse. If prices are extremely overbought and fundamental news shocks to the downside, most market players will rush for the exits, creating a stampede of sell orders that generates a strong momentum-driven move that can be profitably traded to the downside.

Notice that the trader in this situation would be using technicals for his or her entries, stops and exits, while using the fundamental data to trigger the trade, reasoning that disappointment from the ECB announcement would cause a retrace in the pair. Later on in the morning, ultra-dovish commentary by ECB chief Jean Paul Trichet helped push the pair much lower - the currency trader would have come out of the trade with a profit of 50 points in less than an hour.

GBP/USD prices had been rising steadily for days as the pair climbed over the important 1.7500 level. Prices were clearly overbought, with the pair trading near the upper Bollinger band. A trader might have reasonably expected the news to trigger a sell-off, as the market would have to reassess its optimistic view of the U.K. economy. However, if the trader jumped the gun and shorted the market right away instead of waiting for some technical confirmation of price weakness, he or she would have gotten into some trouble. Why? Because instead of trading lower, the pair burst higher as pound longs tried hard to ignore the negative news and made one last effort to rally prices. As a result, the trader who jumped the gun would've been stopped out, losing 30 points only to watch in dismay as, two hours later, the price action finally exhausted itself and the fundamental facts began to weigh on the market. Therefore, triggering fundamentally but entering without a sound technical signal can hurt the forex trader.

Conclusion

Trading FX is a multifaceted affair that requires both fundamental knowledge and technical expertise. Not only is scalping on economic news possible, it can be highly lucrative - as long as the trader pays attention to technicals as well as fundamentals. Like all worthwhile ventures in life, scalping fundamentally is not easy to achieve. It takes time and practice to learn this methodology, but those who are able to master this approach can enjoy long-term success in the currency market. For further reading, see [Scalping: Small Quick Profits Can Add Up](#) and [Introduction To Types Of Trading: Scalpers](#).

Get To Know the Major Central Banks

The one factor that is sure to move the currency markets is interest rates. Interest rates give international investors a reason to shift money from one country to another in search of the highest and safest yields. For years now, growing interest rate spreads between countries have been the main focus of professional investors, but what most individual traders do not know is that the absolute value of interest rates is not what's important - what really matters are the expectations of where interest rates are headed in the future. Familiarizing yourself with what makes the central banks tick will give you a leg up when it comes to predicting their next moves, as well as the future direction of a given currency pair. In this article, we look at the structure and primary focus of each of the major central banks, and give you the scoop on the major players within these banks. We also explain how to combine the relative monetary policies of each central bank to predict where the interest rate spread between a currency pair is headed.

Examples

Take the performance of the NZD/JPY currency pair between 2002 and 2005, for example. During that time, the central bank of New Zealand increased interest rates from 4.75% to 7.25%. Japan, on the other hand, kept its interest rates at 0%, which meant that the interest rate spread between the New Zealand dollar and the Japanese yen widened a full 250 basis points. This contributed to the NZD/JPY's 58% rally during the same period.

On the flip side, we see that throughout 2005, the British pound fell more than 8% against the U.S. dollar. Even though the United Kingdom had higher interest rates than the United States throughout those 12 months, the pound suffered as the interest rate spread narrowed from 250 basis points in the pound's favor to a premium of a mere 25 basis points. This confirms that it is the future direction of interest rates that matters most, not which country has a higher interest rate.

The Eight Major Central Banks

Editor's note: Information on central banks and key officials is accurate as of the time of writing (April 2006).

U.S. Federal Reserve System (The Fed)

Structure - The Federal Reserve is probably the most influential central bank in the world. With the U.S. dollar being on the other side of approximately 90% of all currency transactions, the Fed's sway has a sweeping effect on the valuation of many currencies. The group within the Fed that decides on interest rates is the Federal Open Market Committee (FOMC), which consists of seven governors of the Federal Reserve Board plus five presidents of the 12 district reserve banks.

Mandate - Long-term price stability and sustainable growth

Frequency of Meeting - Eight times a year

Key Policy Official - Ben Bernanke, Chairman of the Federal Reserve. Following former chairman Alan Greenspan's retirement in January 2006, U.S. President George W. Bush tapped Bernanke to head the Federal Reserve, given his four years of experience on the Fed Board of Governors. His views differ from Greenspan's in that he believes in inflation targeting and printing money to avoid deflation. The historic change of power at the U.S. central bank marks the first time in two decades that an academic, who may focus more on mathematical and econometric models, is chairing the Fed.

European Central Bank (ECB)

Structure - The European Central Bank was established in 1999. The Governing Council of the ECB is the group that decides on changes to monetary policy. The council consists of the six members of the executive board of the ECB, plus the governors of all the national central banks from the 12 euro area countries. As a central bank, the ECB does not like surprises. Therefore, whenever it plans on making a change to interest rates, it will generally give the market ample notice by warning of an impending move through comments to the press.

Mandate - Price stability and sustainable growth. However, unlike the Fed, the ECB strives to maintain the annual growth in consumer prices below 2%. As an export dependent economy, the ECB also has a vested interest in preventing against excess strength in its currency because this poses a risk to its export market.

Frequency of Meeting - Bi-weekly, but policy decisions are generally only made at meetings where there is an accompanying press conference, and those happen 11 times a year.

Key Policy Official - Jean-Claude Trichet, President of European Central Bank. Prior to succeeding Wim Duisenberg as ECB president in November 2003, Trichet was the president of Bank of France. He has a reputation for being a cautious and forthright banker, though many criticize his slow response to European economic stagnation and high unemployment. Typically seen as a hawk with a bias toward making preemptive moves to ward off inflation, Trichet has the huge responsibility of managing the monetary policy of 12 nations.

Bank of England (BoE)

Structure - The Monetary Policy Committee of the Bank of England is a nine-member committee consisting of a governor, two deputy governors, two executive directors and four outside experts. The BoE, under the leadership of Mervyn King, is frequently touted as one of the most effective central banks.

Mandate - To maintain monetary and financial stability. The BoE's monetary policy mandate is to keep prices stable and to maintain confidence in the currency. To accomplish this, the central bank has an inflation target of 2%. If prices breach that level, the central bank will look to curb inflation, while a level far below 2% will prompt the central bank to take measures to boost inflation.

Frequency of Meeting - Monthly

Key Policy Official - Mervyn A. King, Governor of the Bank of England. Prior to assuming the role of BoE governor on June 30, 2003, King was a professor at the London School of Economics. Initially joining the BoE in 1990, he became an executive director and chief economist in March 1991 and was promoted to deputy governor in 1997. King's "Goldilocks" monetary policy, which is neither too restrictive nor too accommodative, has propelled the U.K.'s economy into its longest streak of uninterrupted growth in 200 years.

Bank of Japan (BoJ)

Structure - The Bank of Japan's monetary policy committee consists of the BoJ governor, two deputy governors and six other members. Because Japan is very dependent on exports, the BoJ has an even more active interest than the ECB does in preventing an excessively strong currency. The central bank has been known to come into the open market to artificially weaken its currency by selling it against U.S. dollars and euros. The BoJ is also extremely vocal when it feels concerned about excess currency volatility and strength.

Mandate - To maintain price stability and to ensure stability of the financial system, which makes inflation the central bank's top focus.

Frequency of Meeting - Once or twice a month

Key Policy Official - Toshihiko Fukui, Governor of Bank of Japan. A lifelong bureaucrat, Fukui joined the bank of Japan in 1958 and held various posts before succeeding Masaru Hayami as governor on March 19, 2003. Although Fukui has a reputation for being conservative, he has implemented new policies geared toward greater transparency, such as publishing BoJ economic outlooks and detailed minutes of policy meetings. On March 9, 2006, he ended the five-year-old ultra-loose monetary policy and prepared for a return to conventional rate targeting.

Swiss National Bank (SNB)

Structure - The Swiss National Bank has a three-person committee that makes decisions on interest rates. Unlike most other central banks, the SNB determines the interest rate band rather than a specific target rate. Like Japan and the euro zone, Switzerland is also very export dependent, which means that the SNB also does not have an interest in seeing its currency become too strong. Therefore, its general bias is to be more conservative with rate hikes.

Mandate - To ensure price stability while taking the economic situation into account

Frequency of Meeting - Quarterly

Key Policy Official - Jean-Pierre Roth, Chairman of the Swiss National Bank. Roth has spent most of his professional career at the SNB, starting in 1979; he assumed the role of chairman of the governing board in 2001. Roth is also a member of the board of directors of the Bank for International Settlements and is governor of the International Monetary Fund.

Bank of Canada (BoC)

Structure - Monetary policy decisions within the Bank of Canada are made by a consensus vote by Governing Council, which consists of the Bank of Canada governor, the senior deputy governor and four deputy governors.

Mandate - Maintaining the integrity and value of the currency. The central bank has an inflation target that is currently set at 1-3%, and it has done a good job of keeping inflation within that band since 1998.

Frequency of Meeting - Eight times a year

Key Policy Official - David Dodge, Governor of the Bank of Canada. Princeton-educated Dodge held various public offices and taught at a few universities throughout the U.S. and Canada before taking office as the central bank governor in 2001. He is known for being frank and open about his beliefs, and has also been credited for carefully balancing inflation with currency appreciation.

Reserve Bank of Australia (RBA)

Structure - The Reserve Bank of Australia's monetary policy committee consists of the central bank governor, the deputy governor, the secretary to the treasurer and six independent members appointed by the government.

Mandate - To ensure stability of currency, maintenance of full employment and economic prosperity and welfare of the people of Australia. The central bank has an inflation target of 2-3% per year.

Frequency of Meeting - Eleven times a year, usually on the first Tuesday of each month (with the exception of January)

Key Policy Official - Ian Macfarlane, Governor of the Reserve Bank of Australia. Macfarlane has been with the RBA from 1979. Before becoming governor in 1996, he occupied a variety of positions at the RBA, from head of research to deputy governor. Considered to be an inflation hawk, Macfarlane has raised lending rates several times during his tenure, as the Australian economy - spurred by seemingly insatiable demand from China for a variety of commodities - is experiencing strong wage growth and a boom in capital spending that is creating capacity constraints throughout the economy.

Reserve Bank of New Zealand (RBNZ)

Structure - Unlike other central banks, decision-making power on monetary policy ultimately rests with the central bank governor.

Mandate - To maintain price stability and to avoid instability in output, interest rates and exchange rates. The RBNZ has an inflation target of 1.5%. It focuses hard on this target, because failure to meet it could result in the dismissal of the governor of the RBNZ.

Frequency of Meeting - Eight times a year

Key Policy Official - Alan Bollard, Governor of the Reserve Bank of New Zealand. Before his appointment as governor of the RBNZ in September 2002, Bollard served as secretary of the treasury, chairman of the NZ Commerce Commission and director of the NZ Institute of Economic Research. Known as a strong inflation hawk with extensive economic training, Bollard has condemned large current account deficits and raised New Zealand interest rates to a high level of 7.25%. (For further reading, see Current Account Deficits and Understanding The Current Account In The Balance Of Payments.)

Putting It All Together

Now that you know a little more about the structure, mandate and power players behind each of the major central banks, you are on your way to being able to better predict the moves these central banks may make. For many central banks, the inflation target is key. If inflation, which is generally measured by the consumer price index, is above the central bank's target, then you know that it will have a bias toward tighter monetary policy. By the same token, if inflation is far below the target, the central bank will be looking to loosen monetary policy. Combining the relative monetary policies of two central banks is a solid way to predict where a currency pair may be headed. If one central bank is raising interest rates while another is sticking to the status quo, the currency pair is expected to move in the direction of the interest rate spread (barring any unforeseen circumstances).

A perfect example is EUR/GBP in 2006. The euro broke out of its traditional range-trading mode to accelerate against the British pound. With consumer prices above the European Central Bank's 2% target, the ECB was clearly looking to raise rates a few more times. The Bank of England, on the other hand, had inflation slightly below its own target and its economy was just beginning to show signs of recovery, preventing it from making any changes to interest rates. In fact, throughout the first three months of 2006, the BoE was leaning more toward lowering interest rates than raising them. This led to a 200-pip rally in EUR/GBP, which is pretty big for a currency pair that rarely moves.

Trade to Your Taste

Do you like to fish, or do you prefer downhill skiing? How you answer that question may have a greater impact on your trading success than the most robust trading strategy you can devise. The FX market offers multiple avenues to trading success, but in order to take advantage of these opportunities, you must first understand your strengths and weaknesses. Most traders are taught that there is only one "proper way to trade". Nothing could be further from the truth. As an adult, you are highly unlikely to change your ways; markets, on the other hand, change all the time. Therefore, it is far easier to find a trading technique that is in sync with your personality than to try to conform to someone else's idea of a "proper trader".

Trading Strategies

So, why are fishing and downhill skiing so important? Believe it or not, this is a question about trend and counter-trend trading. Fishers trend, skiers fade. This is because fishing requires time, methodology and, most importantly, patience. Like trend traders, those who fish will cast their line many

times before they get a bite. Downhill skiers, on the other hand, look for the quick thrill with a very specific goal - the end of the run. This psychological drive is similar to what drives faders - the quest for fast profits as currency prices make a quick retrace. Does fishing always lead to trend trading and skiing to counter-trending? Of course not. However, the activity you choose suggests a definite predilection for one style versus the other.

Timelines

The trend versus fade dynamic leads to the second important question that traders need to ask themselves. Are you more comfortable trading short-term or long-term time frames? Generally, traders who like to put on trend-based trades will work on longer timelines, if for no other reason than that trends in FX tend to develop over months rather than days. Faders who look for quick turns in market sentiment will usually operate on much shorter time frames.

Typically, the shortest effective time frame to trade the currency market is on the hourly charts with average risk/reward targets of at least 30 points, since the spread nature of the market means that trades that are any smaller are ineffective. For example, take the EUR/USD pair, which is the most liquid financial instrument in the world and typically trades 3 points wide on the bid/ask spread. A trader with a 10-point target and a 10-point stop would actually have to earn 13 points (10 points + 3 points of spread), but would be forced to stop out at only 7 points (10 points - 3 points of spread). After hundreds of trades, this negative skew in the risk/reward equation makes it very difficult to generate profits on such short time frames.

Type of Analysis

Once you have determined what time frame suits you best, the next question you must ask yourself is this: what type of analysis should you use to make proper trade selections? No issue creates more arguments on trading desks than the debate between fundamentalists and technicians.

Fundamentalists scoff at technicians' attempts to forecast future price movement by looking at the present price action on the charts. Hard core proponents of fundamental analysis consider technical analysis not much better than the ancient ritual of divining the future from the entrails of dead animals. News, economic reports and commentary from monetary officials are the primary tools of fundamentalists. Technicians, for their part, dismiss most fundamental data as woefully inconclusive and contradictory, believing instead that any material news will be reflected in the price action of the currency pair and will therefore provide objective clues to future direction.

Which camp has got it right? Neither one. Trading on technicals or fundamentals alone is a sucker's game, akin to wanting to box for the world championship title with one arm tied behind your back. Fundamentalists can talk all they want about the secular global demand for oil that will drive the price of crude to \$100/bbl and will take the Canadian dollar to parity with the greenback, but if they choose to short USD/CAD at a grossly oversold level as momentum shows large divergence on the charts, then they will likely lose money on the trade - even if their analysis is ultimately correct. Conversely, a technician could short a major Fibonacci cluster to his heart's content, but if a piece of economic news surprises the market to the upside, his shorts will be run over like jungle shrubbery after an elephant stampede as traders try to cover their positions, ignoring various resistance levels. (For further reading, see [Introduction To Technical Analysis](#) and [Introduction To Fundamental Analysis](#).)

Fundamentals for Long, Technicals for Short

Despite these admonitions, the general rule of thumb is that fundamentals tend to have a stronger impact on longer-term trades, while technicals will be more important to consider for shorter-term trades. Over the long term, currency prices will respond to major economic events such as GDP growth, interest rates and current account balances.

Witness, for example, the move in the GBP/USD over 2005. During that time, the Federal Reserve Bank of New York proceeded to raise the Fed funds rate by 200 basis points, from 2.25% to 4.25%, while the Bank of England, facing a slowing economy and depressed consumer sentiment, chose to lower the U.K. rates from 4.75% to 4.5%. The interest differential between the two currencies compressed to nearly 0% (by the beginning of 2006, it had reached 0%). Traders who made a long-term bet that U.K. and U.S. short-term rates would converge profited handsomely as GBP/USD declined.

The same dynamic took place in the USD/JPY, except in reverse. As U.S. rates expanded while Japanese rates remained stationary at 0%, carry traders flocked to the pair, bidding it up by 20% in a matter of months. With analysts in 2006 forecasting the end of the U.S. tightening cycle and the beginning of the Japanese one, these long-term trends may well reverse moving forward, and traders making this fundamental call could reap large gains if their analysis proves to be accurate.

While price action reacts well to fundamental factors over longer-term time frames, technical analysis appears to have the upper hand on shorter time scales. Perhaps one reason why this occurs is that on smaller time frames, information from news flow is not nearly as active or as meaningful; therefore, prices tend to respect established support and resistance levels on the charts as currencies range in tightly defined zones. For example, in this hourly chart of the EUR/USD, note how price reacts to the swing highs and swing lows, allowing the trader to profit from selling resistance and buying support.

Conclusion

Whether you are a long-term fundamentalist or a short-term technician, the FX market can accommodate your style. Although the argument between the two camps will probably never be resolved, the one undeniable truth of trading is that you must use the style that best suits your personality. Otherwise, you are unlikely to succeed, regardless of the soundness of your approach. Therefore, the first question an FX trader should ask him or herself is not "Is this pair going to go up or down?", but "What kind of a trader am I?"

Money Management Matters

Put two rookie traders in front of the screen, provide them with your best high-probability set-up, and for good measure, have each one take the opposite side of the trade. More than likely, both will wind up losing money. However, if you take two pros and have them trade in the opposite direction of each other, quite frequently both traders will wind up making money - despite the seeming contradiction of the premise. What's the difference? What is the most important factor separating the seasoned traders from the amateurs? The answer is money management.

Like dieting and working out, money management is something that most traders pay lip service to, but few practice in real life. The reason is simple: just like eating healthy and staying fit, money management can seem like a burdensome, unpleasant activity. It forces traders to constantly monitor their positions and to take necessary losses, and few people like to do that. However, as Figure 1 proves, loss-taking is crucial to long-term trading success.

Note that a trader would have to earn 100% on his or her capital - a feat accomplished by less than 1% of traders worldwide - just to break even on an account with a 50% loss. At 75% drawdown, the trader must quadruple his or her account just to bring it back to its original equity - truly a Herculean task!

The Big One

Although most traders are familiar with the figures above, they are inevitably ignored. Trading books are littered with stories of traders losing one, two, even five years' worth of profits in a single trade gone terribly wrong. Typically, the runaway loss is a result of sloppy money management, with no hard stops and lots of average downs into the longs and average ups into the shorts. Above all, the runaway loss is due simply to a loss of discipline.

Most traders begin their trading career, whether consciously or subconsciously, visualizing "The Big One" - the one trade that will make them millions and allow them to retire young and live carefree for the rest of their lives. In FX, this fantasy is further reinforced by the folklore of the markets. Who can forget the time that George Soros "broke the Bank of England" by shorting the pound and walked away with a cool \$1-billion profit in a single day? But the cold hard truth for most retail traders is that, instead of experiencing the "Big Win", most traders fall victim to just one "Big Loss" that can knock them out of the game forever.

Learning Tough Lessons

Traders can avoid this fate by controlling their risks through stop losses. In Jack Schwager's famous book "Market Wizards" (1989), day trader and trend follower Larry Hite offers this practical advice: "Never risk more than 1% of total equity on any trade. By only risking 1%, I am indifferent to any individual trade." This is a very good approach. A trader can be wrong 20 times in a row and still have 80% of his or her equity left.

The reality is that very few traders have the discipline to practice this method consistently. Not unlike a child who learns not to touch a hot stove only after being burned once or twice, most traders can only absorb the lessons of risk discipline through the harsh experience of monetary loss. This is the most important reason why traders should use only their speculative capital when first entering the forex market. When novices ask how much money they should begin trading with, one seasoned trader says: "Choose a number that will not materially impact your life if you were to lose it completely. Now subdivide that number by five because your first few attempts at trading will most likely end up in blow out." This too is very sage advice, and it is well worth following for anyone considering trading FX.

Money Management Styles

Generally speaking, there are two ways to practice successful money management. A trader can take many frequent small stops and try to harvest profits from the few large winning trades, or a trader can choose to go for many small squirrel-like gains and take infrequent but large stops in the hope the many small profits will outweigh the few large losses. The first method generates many minor instances of psychological pain, but it produces a few major moments of ecstasy. On the other hand, the second strategy offers many minor instances of joy, but at the expense of experiencing a few very nasty psychological hits. With this wide-stop approach, it is not unusual to lose a week or even a month's worth of profits in one or two trades.

To a large extent, the method you choose depends on your personality; it is part of the process of discovery for each trader. One of the great benefits of the FX market is that it can accommodate both styles equally, without any additional cost to the retail trader. Since FX is a spread-based market, the cost of each transaction is the same, regardless of the size of any given trader's position.

For example, in EUR/USD, most traders would encounter a 3 pip spread equal to the cost of 3/100th of 1% of the underlying position. This cost will be uniform, in percentage terms, whether the trader wants to deal in 100-unit lots or one million-unit lots of the currency. For example, if the trader wanted to use 10,000-unit lots, the spread would amount to \$3, but for the same trade using only 100-unit lots, the spread would be a mere \$0.03. Contrast that with the stock market where, for example, a commission on 100 shares or 1,000 shares of a \$20 stock may be fixed at \$40, making the effective cost of transaction 2% in the case of 100 shares, but only 0.2% in the case of 1,000 shares. This type of variability makes it very hard for smaller traders in the equity market to scale into positions, as commissions heavily skew costs against them. However, FX traders have the benefit of uniform pricing and can practice any style of money management they choose without concern about variable transaction costs.

Four Types of Stops

Once you are ready to trade with a serious approach to money management and the proper amount of capital is allocated to your account, there are four types of stops you may consider.

1. Equity Stop - This is the simplest of all stops. The trader risks only a predetermined amount of his or her account on a single trade. A common metric is to risk 2% of the account on any given trade. On a hypothetical \$10,000 trading account, a trader could risk \$200, or about 200 points, on one mini lot (10,000 units) of EUR/USD, or only 20 points on a standard 100,000-unit lot. Aggressive traders may consider using 5% equity stops, but note that this amount is generally considered to be the upper limit of prudent money management because 10 consecutive wrong trades would draw down the account by 50%.

One strong criticism of the equity stop is that it places an arbitrary exit point on a trader's position. The trade is liquidated not as a result of a logical response to the price action of the marketplace, but rather to satisfy the trader's internal risk controls.

2. Chart Stop - Technical analysis can generate thousands of possible stops, driven by the price action of the charts or by various technical indicator signals. Technically oriented traders like to combine these exit points with standard equity stop rules to formulate chart stops. A classic example of a chart stop is the swing high/low point.

3. Volatility Stop - A more sophisticated version of the chart stop uses volatility instead of price action to set risk parameters. The idea is that in a high volatility environment, when prices traverse wide ranges, the trader needs to adapt to the present conditions and allow the position more room for risk to avoid being stopped out by intra-market noise. The opposite holds true for a low volatility environment, in which risk parameters would need to be compressed.

One easy way to measure volatility is through the use of Bollinger bands, which employ standard deviation to measure variance in price.

4. Margin Stop - This is perhaps the most unorthodox of all money management strategies, but it can be an effective method in FX, if used judiciously. Unlike exchange-based markets, FX markets operate 24 hours a day. Therefore, FX dealers can liquidate their customer positions almost as soon as they trigger a margin call. For this reason, FX customers are rarely in danger of generating a negative balance in their account, since computers automatically close out all positions.

This money management strategy requires the trader to subdivide his or her capital into 10 equal parts. In our original \$10,000 example, the trader would open the account with an FX dealer but only wire \$1,000 instead of \$10,000, leaving the other \$9,000 in his or her bank account. Most FX dealers offer 100:1 leverage, so a \$1,000 deposit would allow the trader to control one standard 100,000-unit lot. However, even a 1 point move against the trader would trigger a margin call (since \$1,000 is the minimum that the dealer requires). So, depending on the trader's risk tolerance, he or

she may choose to trade a 50,000-unit lot position, which allows him or her room for almost 100 points (on a 50,000 lot the dealer requires \$500 margin, so \$1,000 – 100-point loss* 50,000 lot = \$500). Regardless of how much leverage the trader assumed, this controlled parsing of his or her speculative capital would prevent the trader from blowing up his or her account in just one trade and would allow him or her to take many swings at a potentially profitable set-up without the worry or care of setting manual stops. For those traders who like to practice the "have a bunch, bet a bunch" style, this approach may be quite interesting.

Conclusion

As you can see, money management in FX is as flexible and as varied as the market itself. The only universal rule is that all traders in this market must practice some form of it in order to succeed.

Wading Into the Currency Market

Whenever you devote money to trading, it is important to take it seriously. Many traders are getting into the forex (FX) market for the first time and are basically starting from square one. But new traders don't have to be left in the dark when it comes to learning to trade currencies; unlike with some of the other markets, there are a variety of free learning tools and resources available to light the way. You can become FX-savvy with the help of virtual demo accounts, mentoring services, online courses, print and online resources, signal services and charts. With so much to choose from, the question you're most likely to ask is, "Where do I start?" Here we cover the preliminary steps you need to take to find your footing in the FX market.

Finding a Broker

The first step is to pick a market maker with which to trade. Some are larger than others, some have tighter spreads and others offer additional bells and whistles. Each market maker has its own advantages and disadvantages, but here are some of the key questions to ask when doing your due diligence:

- Where is the FX market maker incorporated? Is it in a country such as the U.S. or the U.K., or is it offshore?
- Is the FX market maker regulated? If so, in how many countries?
- How large is the market maker? How much excess capital does it have? How many employees?
- Does the market maker have 24-hour telephone support?

In order to ensure that the money you are sending will be safe and that you have a jurisdiction to appeal to in the event of a bankruptcy, you want to find a large market maker that is regulated in at least one or two major countries. Furthermore, the larger the market maker, the more resources it can put toward making sure that its trading platforms and servers remain stable and do not crash when the market becomes very active. Third, you want a market maker with a larger number of employees so that you can place a trade over the phone without having to worry about getting a busy signal. Bottom line, you want to find someone legitimate to trade with and not a bucket shop.

Checking Their Stats

In the U.S., all registered futures commission merchants (FCMs) are required to meet strict financial standards, including capital adequacy requirements, and are required to submit monthly financial reports to regulators. You can visit the website of the Commodity Futures Trading Commission (an independent agency of the U.S. government) to access the latest financial statements of all registered FCMs in the U.S.

Another advantage of dealing with a registered FCM is greater transparency of business practices. The National Futures Association keeps records of all formal proceedings against FCMs, and traders can find out if the firm has had any serious problems with clients or regulators by checking the NFA's Background Affiliation Status Information Center (BASIC) online.

Test Drive

Once you've found a broker, the next step is to test drive its software by opening a demo account. The availability of demo or virtual trading accounts is something unique to this market and one that you want to exploit to your advantage. Your goal is to learn how to use the trading platform and, while you're doing that, to find the trading platform that suits you best. Most demo accounts have exactly the same functionalities as the live accounts, with real-time market prices. The only difference, of course, is that you are not trading with real money.

Demo trading allows you not only to make sure that you fully understand how to use the trading platform, but also to practice some trading strategies and to make money in the paper account before you move onto a live account funded with real money. In other words, it gives you a chance to get a feel for the FX market. (To learn more, see Demo Before You Dive In.)

Do Your Research

When you trade, you never want to trade impulsively. You need to be able to justify your trades, and the way to find justification is by doing your research. There are many books, newspapers and other publications with information about trading the FX market. When choosing a source to consult, make sure it covers:

- The basics of the FX market
- Technical analysis
- Key fundamental news and events

Since the FX market is primarily a technically-driven market, the best book that you can read as a new trader is one on technical analysis. The better you get at technical analysis, the better you can trade the FX market from a speculative perspective. (For further reading, see our [Introduction To Technical Analysis](#).)

When it comes to newspapers, seasoned foreign exchange traders typically refer to the Financial Times and the Wall Street Journal simply because they contain international news. Trading FX involves looking beyond mere economics, since politics and geopolitical risks can also affect a currency's trading behavior. Therefore, it's also important to keep up with major non-financial news sources such as the International Herald Tribune and the BBC (online, on TV or on the radio) for the big stories of the day.

One of the most popular magazines among FX traders is the Economist, because it covers many macro themes; however, currency-specific and trading magazines are also popular.

Once you have a solid foundation in FX trading, you need to keep up to date on daily fundamental and technical developments in the FX market. A variety of free FX-specific research websites, which can be found easily on the internet, will do the trick.

Education and Mentoring Programs - Are They Worth It?

The benefit of online or live courses over books, newspapers and magazines is that you can get answers to the questions that perplex you. Hearing or seeing other people's questions is also extremely valuable, since no one person can think of every possible question. In a classroom setting, either online or live, you can learn from the experiences and frustrations of others. As for a mentor, he or she can draw on personal experience and hopefully teach you to avoid the mistakes he or she has made in the past, saving you both time and money.

What about Trading Systems and Signals?

Many traders wonder whether it is worthwhile to buy into a system or a signal package. System and signals fall into three general categories depending on their methodology: trend, range or fundamental. Fundamental systems are very rare in the FX market; they are mostly used by large hedge funds or banks because they are very long term in nature and do not give many trading signals. The systems that are available to individual traders are typically trend systems or range systems - rarely will you get one system that is able to exploit both markets, because if you do, then you have pretty much found the holy grail of trading.

Even the largest hedge funds in the world are still looking for the switch that can identify whether you are in a trend or a range-bound market. Most large hedge funds tend to be trend following, which is why hedge funds as a group did so poorly in 2004, when the market was trapped in a tight trading range. Range-bound systems will only perform well in range-bound markets, while trend systems will make money in trending markets and lose money in range-bound markets. So when you buy into a system or a signal provider, you should try to find out whether the signals are mostly range-bound signals or trend signals. This way you can know when to take the signals and when to avoid them. (To learn more, see [Identifying Trending & Range-Bound Currencies](#).)

Trading Setups - Finding What Works Best for You

Every trader is different, but the best trading style is probably a combination of both technical and fundamental analysis. Fundamentals can easily throw off technicals, while technicals can explain movements that fundamentals cannot. Smart traders will always be aware of the broader fundamental picture while using their technicals to pinpoint good entry and exit levels; combining both will keep you out of as many bad trades as possible, and it works for both day traders and swing traders. Most free charting packages have everything that a new trader needs, and many trading platforms offer real-time news feeds to keep you up to date on economic news. (For further reading, see [Devising A Medium-Term Forex Trading Strategy](#).)

Conclusion

Learning to trade in the FX market can seem like a daunting task when you're just starting out, but thanks to the many practical and educational resources available to the individual trader, it is not impossible. Learning as much as possible before you put actual money at risk should be at the forefront of your agenda. Print and online publications, trading magazines, personal mentors, online demo accounts and more can all act as invaluable guides on your journey into currency trading.

Consolidation - Trade The Calm, Profit From The Storm

Much like the first dynamite compound invented by Swedish chemist and engineer Alfred Nobel, consolidation periods and patterns in the currency markets can explode, leading to great profit opportunities for the FX trader. Sometimes suggestive of indecision, consolidation periods are great for capturing potential because the burst of directional action that follows can last for an extended period. Understanding and trading on consolidation patterns will give the currency trader in the know two "edges". First, the trader can hold his or her initial position for a shorter amount of time, thus minimizing the risk of holding positions in the case of higher rollover interest. Second, the profit potential from such a position can be big, as long as the trader follows strict, disciplined money management rules. Without money management, the trader might as well be playing with fire. Here we look at two different consolidation patterns and give you a step-by-step explanation of how to trade them.

The Flag - Continuation of the Trend

The flag formation is one of two consolidation patterns that can lead to great profit opportunities. Common in the currency markets, the flag formation serves as an indication of continuation (i.e. a continuation pattern). This type of consolidation occurs after a significant uptrend and is usually referenced as a stopping point before further strengthening momentum ensues. With this type of formation, the duration of the consolidation period is rather short and tends to go against the previous uptrend direction.

The flag formation offers opportunities to trade on a continuation basis, while the broadening formation offers opportunities in reversal situations. Either way, the trader will be taking advantage of the powerful directional bias that occurs following consolidative neutrality.

About the Author

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