The term “Foreign Exchange” sounds like something from a spy novel rather than describe the largest financial market in the world. The primary purpose of the foreign exchange market, also known as Forex, FX or the currency market, is to assist international trade and investment, by allowing businesses to convert one currency to another currency. For example, it allows a US business to import Japanese goods and pay in Japanese Yen, even though the business’s income is in US dollars. It also supports speculation, where traders attempt to profit from changing values of one currency to another.

Currency Pairs

As consumers, we determine the value of our currency by how much purchasing power it has. If we spend $50 on a bag of groceries, we can then judge the value of the US Dollar based on what we can buy. If we go into the same store to buy the same bag of groceries one month later and the cost is $51, we know that the value of the US Dollar has weakened. It just didn’t buy as much as it did previously.

In the FX markets, we judge the value of one currency based on its value with a different currency. This is why we see currencies quoted in pairs. For instance, the EUR/USD currency pair represents the value of Euro (EUR) in US Dollars (USD).

The first currency listed is the base currency which is what we are measuring while the second currency is known as the counter currency which is what we are using to measure the value of the first currency.

Here is a list of the symbols for some of the most heavily traded currencies in the FX market.

Symbol	Currency	Symbol	Currency
AUD	Australian Dollar	MXN	Mexican Peso
CAD	Canadian Dollar	NOK	Norwegian Krone
CHF	Swiss Franc	NZD	New Zealand Dollar
DKK	Danish Krone	SEK	Swedish Krona
EUR	Euro	SGD	Singapore Dollar
GBP	British Pound	TRY	New Turkish Lira
HKD	Hong Kong Dollar	USD	US Dollar
JPY	Japanese Yen	ZAR	South African Rand

Quotes/Charts

As we mentioned previously, while $1 is always worth $1, the buying power of that US Dollar can vary both in the US and in other countries. So in order to determine its value today, the FX market measures

the value of one currency against another currency. The EUR/USD measures the value of the Euro in US Dollars while the USD/JPY measures the value of the US Dollar in Japanese Yen. This really isn't all that different from a stock symbol. Just think of AAPL, the symbol for Apple Inc., as AAPL/USD which means that the quote represents the value of AAPL measured in US Dollars. An AAPL quote of 325 means that one share of AAPL is worth $325. A EUR/USD quote of 1.4100 means that one Euro is worth $1.41. A EUR/USD quote of 1.4101 means the Euro is worth $1.41 and 1/100th of a penny. However, in the FX markets, the last digit is not referred to as 1/100th of a penny, but rather a "pip" which stands for Percentage in Point. Many firms are now quoting 1/1000th of a pip. So a quote of 1.41011 would be $1.41 and 11/1000th of a pip. This is a typical quote window you will find in a Trading Platform for FX.

This is a quote for the EUR/USD currency pair. There are two prices in the quote window with the first being 1.40360. The quote window notes that this is the sell price which means you can sell the EUR/USD for 1.40360. This is $1.40 and 360/1000th of a penny or 36 pips. The next price is 1.40381, which is $1.40 and 381/1000th of a penny or 38 and 1/10th of a pip. This is the price where you can buy this pair. The difference between the buy price and the sell price is the spread, which is where the brokerage firm and banks make their money.

We can see the history of where the pair has traded on a chart as seen below. This is a daily chart of the EUR/USD and we can see that in general this chart has been moving up. This means that the EUR has been stronger than the USD. If the chart had been moving down, it would mean that the EUR has been weaker than the USD.

Trading FX

Trading FX is really no different from trading any other market. The idea is to buy at a lower price and sell at a higher price in order to profit. Like other markets, you can also sell first at a higher price and then buy it back later at a lower price to profit. So you can buy low and then sell higher to profit or you can sell high and then buy back lower to profit. This flexibility allows the trader to profit from any strong move that takes place.

There is no central market for the currency trading like there is for a stock market or a futures market. Trading is done between the largest banks in the world and is known as the Interbank Market. Only the biggest traders had access to this market up until recent technological advances offered the opportunity for individual traders to also gain access through different FX firms. This access has lowered the cost of trading for the individual which is one of the big reasons for its recent popularity and growth.

However, there are clearly other reasons why many traders prefer trading FX over stocks, futures or options.

1. The FX market is a true 24 hour-a-day market. This allows traders access to the market at all times. More on this later.
2. The Demo account. Those firms offering access to the FX markets will usually also offer a free practice account. This allows traders new to FX the chance to become more familiar with trading FX before using live funds.
3. Free Live Quotes/Free Live Charts. Not having to pay to access the market means more money for the trader.
4. Small account size. A trader can start with a smaller amount and still use acceptable money management because of the small trade size available in FX.
5. Day trade with any account balance. There are no restrictions to be a day trader in the FX markets.

Market Hours

Unlike most other financial markets, the FX market is open for trading 24 hours a day. The trading week begins on Sunday afternoon New York time and remains open 24 hours a day until it closes on Friday afternoon New York time. Three major trading periods define the daily FX market, namely the Tokyo Trading Session, the London Trading Session, and the New York Trading Session. Generally, the FX market is most active when sessions overlap with a US/Europe overlap between 8 AM – 12 PM (New York Time) and a Europe/Asia overlap between 2 AM – 5 AM (New York Time).

Tokyo Trading Session: 7:00 PM – 4:00 AM (EDT)

Tokyo is the first market to open at the beginning of the week and many large participants use the trade momentum there to develop their strategies and as a gauge for future market dynamics. Approximately 6% of the world's FX transactions are enacted in the Tokyo Trading Session.

London Trading Session: 3:00 AM – 12:00 PM (EDT)

London is the largest and most important trading center in the world, with about a 34% market share of the daily FX volume. Most of the world's largest banks keep their dealing desks in London because of that market share. The large number of participants in the London FX market and the high value of the transactions makes the London session more volatile than the other two sessions.

New York Trading Session: 8:00 am – 5:00 pm (EDT)

The second largest trading market, New York handles approximately 16% of the world's FX transactions. The majority of the transactions in New York occurs during the US/Europe overlap; with transactions slowing as liquidity dries up and European traders exit the market. Since California has never served as a

bridge between the US and Asia, there is a 50% drop in activity by midday. As a result, market developments in the afternoon during the New York session do not garner as much attention. The New York session is heavily influenced by the US equity and bond markets and pairs will often move closely in tandem with these capital markets.

What Makes Markets Move? Part 2

Every financial market moves based on supply and demand. If more traders want to buy a certain stock, commodity or currency than there are those willing to sell, then the market moves up in price until those buyers are able to buy. On the flip side, if more traders want to sell a stock, commodity or currency than there are those willing to buy, then the market moves down until the sellers are able to sell.

But what makes those traders want to buy or sell?

There are many reasons, but in the stock market, the driving force is company earnings. If the earnings of a company continue to grow, the odds are good that the stock price is also rising. Commodities are subject to availability, there is only so much corn or oil being produced and the price is based on that availability and demand.

The main driver of the value of a currency is the interest rate environment in that particular country or zone, especially when compared to the other currency in the pair. If interest rates are rising in New Zealand and falling in the US, then there is a good chance that the New Zealand Dollar is rising against the US Dollar. This would mean that the NZD/USD chart is showing a rising market. If interest rates are falling in the US and rising in Switzerland, then there is a good chance that the USD/CHF chart is showing a falling market. One also should keep in mind that traders look ahead, meaning that they may base today's trading decision on where they think interest rates will be in the near future, not necessarily today.

Why interest rates?

An interest rate is basically the cost of borrowing money. When a individual buys a house, they borrow the money and pay interest on that loan. When a government wants to borrow money, they issue bonds. The bond has a face value, which is the amount borrowed, and an interest rate, which is what they pay to the buyer of the bond. If you buy a $100,000 30-year US Treasury Bond with a 4% coupon, then you are lending the US Government $100,000 and they are paying you $4,000 a year for 30 years. At the end of that 30-year period, the US Government will then pay you back the $100,000. If you buy a $100,000 30-year US Treasury Bond with a 5% coupon, then you are lending the US Government $100,000 and they are paying you $5,000 a year for 30 years. At the end of that 30-year period, the US Government will then pay you back the $100,000.

So if the current interest rate on a 30-year bond is higher, then you earn more money when investing in that bond. That interest rate is determined by the financial markets rather than the government. The bond market is one of the largest financial markets in the world.

This is also where the FX market starts to come into play. If the interest rate on a US Treasury Bond is 4% and the interest rate on the equivalent German Bond (Bund) is 5%, then international money managers who invest in bonds will buy more German Bunds than US Treasuries Bonds.

But first they have to buy the Euro to buy German Bunds. If they are moving from the US Treasury market to the German Bund market, they first sell their US Treasuries, take those US Dollars and buy

Euros, and then buy the German Bunds. This results in a rising EUR/USD as the Euro strengthens while the USD weakens. There are so many of these professional money managers in the world, that they have a big influence on the value of a currency.

So remember, higher interest rates usually lead to a higher currency value while lower interest rates usually lead to a lower currency value.

The News

How do traders keep an eye on interest rates?

Remember that traders are thinking ahead, so they are trying to anticipate any change in the interest rate environment to note any change in the currency value.

This is where the economic calendar is key for traders. Interest rates will rise on a strengthening economy and a Central Bank which will keep the money supply flowing. Bond investors demand more income with higher inflation, so interest rates rise based on that demand. The economic calendar shows the pulse of an economy. If the US is expected to report a gain of 200,000 jobs in the monthly Nonfarm Payroll release, but instead reports a gain of 300,000 jobs, the USD will likely rally since that shows a strengthening economy. On the other hand, if the report showed 100,000 new jobs instead of the expected 200,000 gain, then the USD would likely fall since that number shows a weakening economy.

Every economic report is followed and analyzed as a potential clue to future interest rates which influences the currency value. Following these releases and interpreting their influence is an important part of trading FX and worthy of the attention of all traders.

Analyzing a market based on the economy, interest rates and the news is referred to a fundamental analysis. This is key since the fundamentals of the market usually determine the direction and strength of the trend and also the major tops and bottoms. How we get between those tops and bottoms is referred to as technical analysis and is the subject of the next lesson.

Uptrend and Downtrend

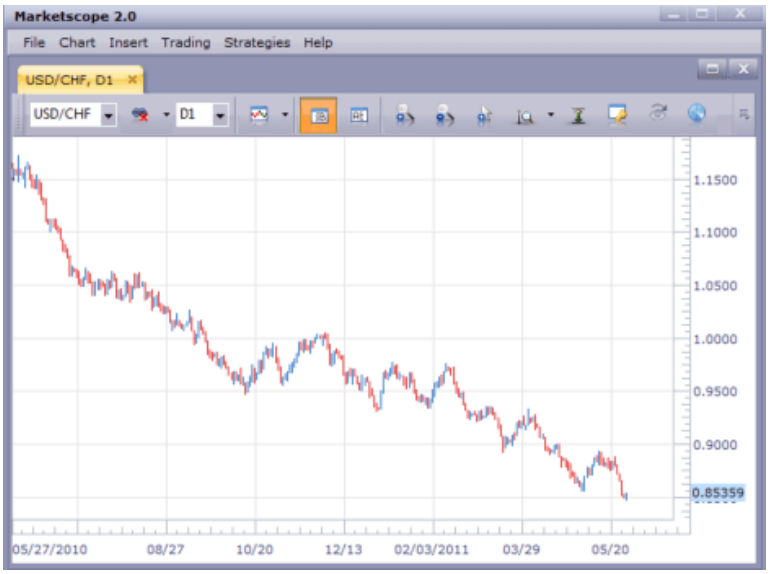
The direction of the trend of any financial market may be the most important piece of technical information we can use in our trading. Many of the most successful traders in the world will tell you that this is the only piece of technical information we can even begin to know. They will tell you that there is no way to know when a market will reverse or how long a move will last. All they know is that right now this is the direction of the trend and that the odds favor a continued move in that same direction rather than a change.

Think about that for a moment. Some of the most successful traders in the world will tell you that the only piece of technical information you can possibly know is the direction of the trend up until the moment you enter into a trade. There is no way to know if the trend will change soon, the level of the next reversal or how long a move will last. They will tell you that any attempt to predict the future is an exercise in futility and a waste of time.

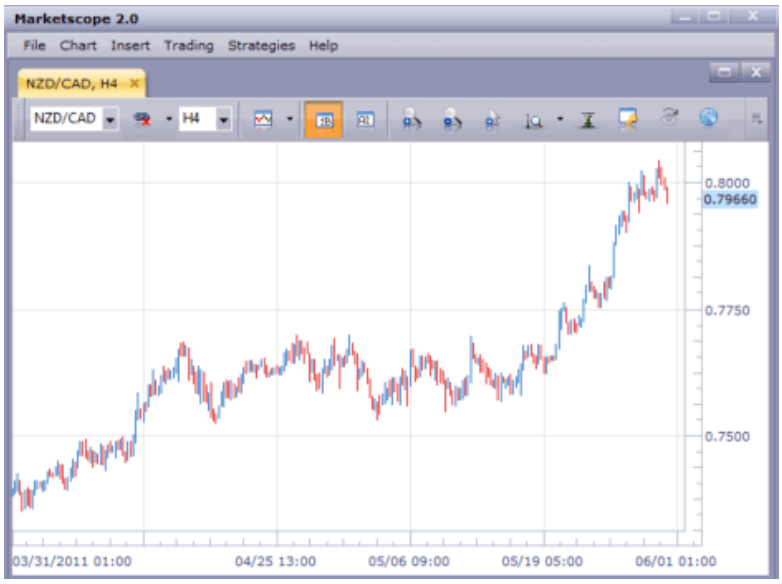
Then how do they make money trading?

The best traders react to what is happening now instead of trying to predict the future. The important first step is to find the strong trending markets since that may increase the chance of a continued move in that same direction.

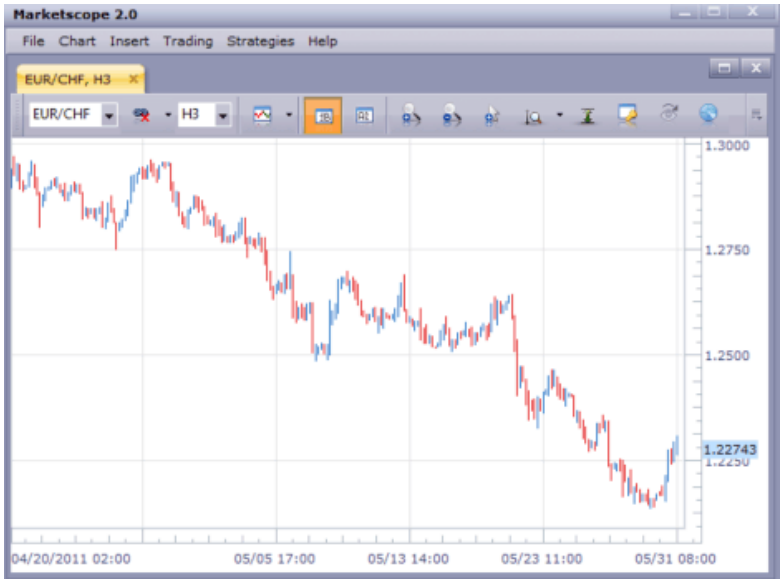
Let's take a look at some examples of strong trending moves.



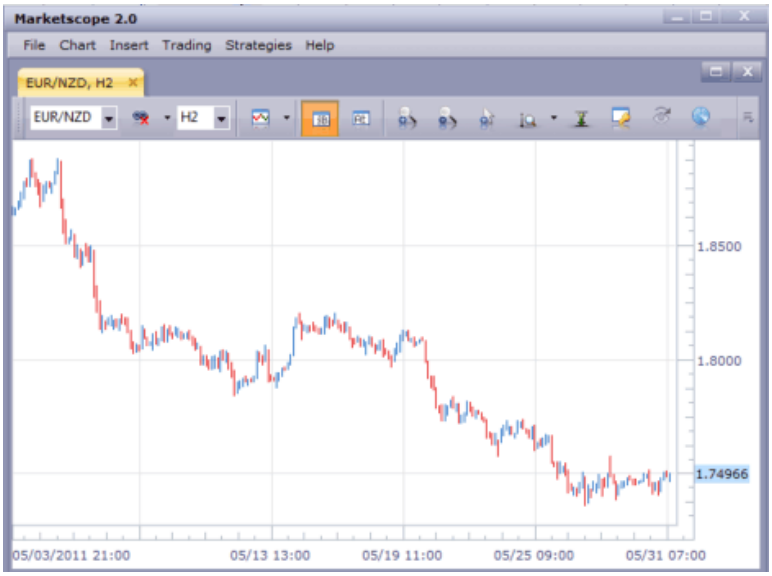
This is a daily chart of the USD/CHF. This market is trending down strongly which means that the USD is weaker than the CHF. When using a daily chart, plotting about one year of trading offers a good view to judge the trend.



This is a 4-hour chart of the NZD/CAD. Since the pair is moving up, this means that the NZD is stronger than the CAD. When using a 4-hour chart, using about 40 days of trading offers a good view to judge the trend.



This is a 3-hour chart of the EUR/CHF. Since the pair is moving down, this means that the EUR is weaker than the CHF. When using a 3-hour chart, using about 30 days of trading offers a good view to judge the trend.



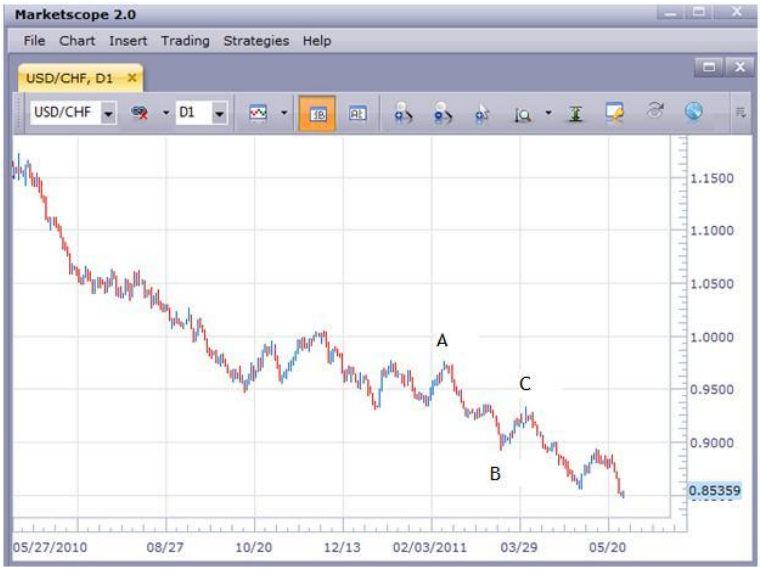
This is a 2-hour chart of the EUR/NZD. Since the pair is moving down, this means that the EUR is weaker than the NZD. When using a 2-hour chart, using about 20 days of trading offers a good view to judge the trend.

This is an hourly chart of the CHF/JPY. Since the pair is moving up, this means that the CHF is stronger than the JPY. When using an hourly, using about 10 days of trading offers a good view to judge the trend.

When identifying the trend, it does help to compare one chart with another. The goal is to find the strongest trending markets and to follow those until the trend weakens or you find a stronger trend. The best time frames for this are the daily, 4-hour, 3-hour, 2-hour and the hourly charts. Anything lower than the hourly and trading becomes more difficult because of the excess volatility the short time frame charts typically show.

Buy Setup

After having identified the strong trending markets, the next step becomes how to take trade it. This step can actually be fairly simple as one can simply look for what if referred to an "ABC" or "123″ move. The key is to only look for sells in a downtrend or buys in an uptrend. Remember, we are looking for the trend to continue rather than attempt to predict the end. Here is an example:



Here is the daily chart of the USD/CHF we saw in the previous lesson. The trend is down, so we are looking for a sell only. The move from A to B is the trending move while the move from B to C is the corrective move against the trend. It is that move against the trend that helps identify the trade setup. Many of the more successful traders classify themselves as "breakout traders". Meaning they simply sell on a move down through point B after having reversed at point C. Waiting for the market to move down through the previous low does serve as some sort of confirmation that the down trend is still intact. It also leads to consistent entries since there no need to guess where point B is located. Once the market moves down through point B, we also know where point C is located. That will take on added importance in the next lesson.

Buy Setups

Let's take a look at a couple of buy setups using the ABC approach.

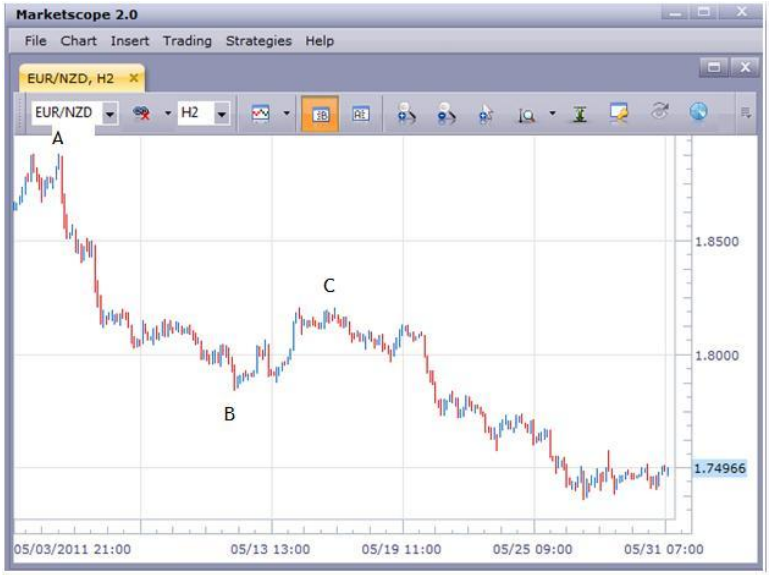
Here is the hourly chart of the CHF/JPY in the previous lesson. The trend is up, so we want to look for buys only. We can see that trending move from A to be B and the corrective move against the trend from B to C. The buy is the move up through point B on the breakout to a new high.

This is the 4-hour NZD/CAD from the previous lesson. We can see that the trend is up, so we are only looking for buying opportunities. We can also note the trending move from A to B and the corrective move against the trend from B to C. The buy is the move up through point B on the breakout. Notice how the market did not move straight up after buying. We will cover how to handle this type of situation in the next lesson.

Sell Setups

Let's take a look at another couple of sell setups using the ABC approach.

Here is the 3-hour EUR/CHF chart from the previous lesson. The trend is down, so we only look for sells. We can see the move from A to B as the trending move. The move from B to C is the corrective move against the trend. We would sell on a move down through point B on the breakout.



This is the 2-hour EUR/NZD chart from the previous lesson. We can see that the trend is down, so we are only looking for sells. The move from A to B is the trending move. The move from B to C is the corrective move against the trend. We sell on a move down through point B on the breakout.

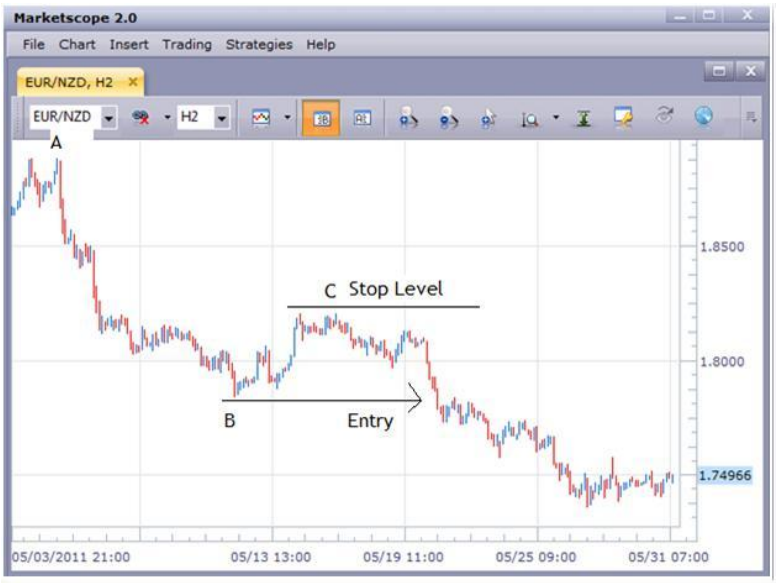
The key to these trade setups is finding the right pairs to trade. This of course, depends on the strength of the trend. Be picky about the trends you choose as there are always plenty of options.

Now that we have identified how to get into a trade, let's go over how to get out of the trade.

The key to a good exit strategy is to know where you are getting out of the trade before you get into the trade. You need to identify where you would get out with a loss or with a gain. By having an established exit strategy, you put yourself in a position to keep your emotions out of the decision making process. The last thing we want to do as a trader is to make decisions based on fear and greed. Experience tells us that those type of decisions are not part of a successful approach to trading. We want to know where we intend on exiting before we get into the trade, which means that our decision is based more on solid analysis, which can lead to better trading results.

Protective Stop Loss

The savvy trader knows where they will exit with a loss before they open the trade. They will immediately place the order in the market after entry. If you sell to open a new trade, then you place a protective buy stop order in the market to protect you if the market moves against you. The idea is to be close to your entry to keep the risk lower, but not so close that you are stopped out of every trade. Many new traders struggle with this, but if they used the "ABC" approach to identifying an entry, the initial protective stop loss placement is easy. Let's go back to our EUR/NZD chart from the previous lesson.



This 2-hour chart of the EUR/NZD shows the downtrend and the entry after having identified our "ABC" pattern. We sell on a move down through point B and then simply place our initial protective stop just above point C.

The thought process is that after the market moves down through point B, which offers a certain level of confirmation that the downtrend is intact, if the market were to reverse and move back up through point C, then the trend would not be as strong as we thought and it would be better to be out of the trade.

Let's look at a buy example:

This 4-hour chart of the NZD/CAD shows the uptrend and the entry after having identified our "ABC" pattern. We buy on a move up through point B and then simply place our initial protective stop just below point C.

Identifying your initial protective stop level is key to a trader's results. The difference between the entry price and the initial protective stop is the trader's risk on the trade. Without knowing the risk on a trade, it makes it more difficult to know where to exit with a profit.

Profit Target

Once you enter into a trade and then enter your initial protective stop loss order, many traders will now enter their limit order to take profits on the trade. There are many exit strategies. Some traders will stay in the trade as long as they feel the trend is still intact. This is fine for experienced traders, but new traders need something a little more "automatic" to make sure they remain consistent in their approach to trading. We recommend the use of a simple 1:2 risk: reward ratio. Otherwise, if your initial risk on the trade is 100 pips, then set your profit target for 200 pips. So the trader is looking for twice in profit, what they are willing to risk. The reason that this can be attempted is that the trades are all placed in the direction of the trend. That becomes the trader's edge. It is the trend that has the ability of offer twice the risk in potential profit. So picking the right trend to begin with does allow everything else to fall right into place.

Many successful traders will tell that there is only one guarantee in trading, which is if you trade, you will have losing trades. There is no way around this point. Many successful trend traders win less than 40% of their trades. The reason these successful traders are profitable when losing so many of their trades is Money Management. If finding the strongest trend to trade is the key to successful trading, using a solid money management approach may be a very close second in terms of importance. As a matter of fact, there are traders who are convinced that without a solid approach to money management, a trader has little chance to be consistently profitable. The key is to cut your losing trades quickly and to let your profitable trades run for as long as possible. This of course, is usually the opposite of how most new traders manage their trades. They have a tendency to let the losing trades run as they hope the market comes back to profitable territory or to close their winning trades early before they become losing trades. If you lose more on your losing trades than you win on your winning trades, you have to win more just to break even. The relationship between your initial risk and profit target is the risk: reward ratio we mentioned in the previous lesson.

Risk: Reward Ratio

Here are some examples of risk: reward ratios and how they can influence your trading results:

- If you risk 100 pips and look for 300 pips in profit, your risk: reward ratio is 1:3 or one pip of risk for every three pips in potential profit. A win percentage of 25% is needed to break even.
- If you risk 100 pips and look for 200 pips in profit, your risk: reward ratio is 1:2 or one pip of risk for every two pips in potential profit. A win percentage of 33% is needed to break even.
- If you risk 100 pips and look for 100 pips in profit, your risk: reward ratio is 1:1 or one pip of risk for every one pip in potential profit. A win percentage of 50% is needed to break even.
- If you risk 100 pips and look for 50 pips in profit, your risk: reward ratio is 2:1 or two pips of risk for every one pip in potential profit. A win percentage of 67% is needed to break even.
- If you risk 100 pips and look for 25 pips in profit, your risk: reward ratio is 4:1 or four pips of risk for every one pip in potential profit. A win percentage of 80% is needed to break even.

But of course, the goal is not to break even but rather to be consistently profitable. We do recommend using the 1:2 risk: reward ratio and to think about winning half of your trades. By trading with the trend and looking for more in profit than you are willing to risk, you can increase your chance of success in trading and that is what money management is all about.

Margin and Leverage

There is another aspect to money management other than the initial risk on a trade. You also have to decide how large of a position to open. Margin is a good faith deposit placed by the trader when opening up a new trade. The margin requirement is a small fraction of the position size. An example would be a $10,000 EUR/USD trade would only require a margin of $320. While this use of leverage allows the trader the opportunity for big profits on a modest account balance, there is also the

possibility of big losses. Many experienced traders risk no more than 5% of their account balance at any one time. Whether that means opening one trade risking 5% of looking to open five trades risking 1% each is up to the trader. But one of the keys to successful trading is to limit your risk and to let the profits take care of themselves. If you have an account balance of $5,000, you should risk no more than $250 at any one time. This allows the trader the ability to remain trading even after suffering a losing streak. Don't let one or two trades knock you out of the game. Being a consistently profitable trader takes some time, but by limiting your risk, you give yourself a better chance of gaining that experienced needed to move up to the next level of trading.