

An Introduction to Foreign Currency Trading

BRIEF HISTORY OF THE MARKET:

Foreign exchange is the medium through which international debt is both valued and settled. It is also a means of evaluating one country's worth in terms of another's.

Cows, sheep, and camels were used as the first and oldest form of money. People have always bartered in order to sell finished products for money, to buy and sell commodities, or simply to profit from a transaction. Bartering existed for example during the cold war when the Russian rouble was not an exchangeable currency. The US delivered wheat to Russia in exchange for oil.

The barter system, however, lacks convertibility, portability, and divisibility (what is the value of a cow, how do you transport it, and is one cow worth three pigs?)

It was the introduction of paper money that allowed the development of international commerce as we know it today.

An important concept of early money was that it was fully backed by a reserve of gold and was convertible to gold or silver at the holder's request.

The first paper bank notes appeared in China in 800 AD and currency exchange started between some countries.

During the 19th century, the expanding British Empire - and the finance needed to fuel the industrial revolution - increased the size and frequency of international money transfers. The "Dick Turpin" era meant that a substitute for the large scale transfer of coins and bullion had to be found. The bill of exchange and the cheque were born. As London built its reputation as the world's capital for trade and finance, the City became a centre for negotiation of financial instruments including foreign-drawn bills of exchange.

Gold was officially made the standard value in England in the nineteenth century. The value of paper money was tied directly to gold reserves in America. Features of the Gold Standard included fixed exchange rates in relation to gold. Any country with a balance of payments deficit had to surrender gold, thus reducing the volume of currency in the country, leading to inflation. The opposite of course applied with a balance of payments surplus. The Gold Standard ensured the soundness of each country's paper money and controlled inflation and interest rates.

The Gold Standard survived until the outbreak of World War I, after which foreign exchange as we know it today really began. The main currencies for trading purposes were the British Pound and the American Dollar.

Convertibility ended with the Great Depression and the major powers left the Gold Standard. As the political climate deteriorated and the world headed into a second war, foreign exchange markets all but ceased to exist. It was not until European and Far East reconstruction began that the Bretton Woods agreement devised a system of convertible currencies, fixed rates, and free trade.

The intent was to create a gold-based value of the American dollar and British pound and link the other major currencies to the dollar.

The Bretton Woods conference instigated the creation of the International Monetary Fund and the World Bank. The function of the IMF was to lend foreign currency to members who required assistance, funded by each member according to size and resources. As recovery began, trade expanded and foreign exchange dealings returned. While the amount of gold held in the American central reserves remained constant, the supply of dollar currency grew. The increased supply of dollars in Europe funded reconstruction in the 1950s.

By 1960, the dollar was supreme, and the American economy was thought to be immune to international developments. The growing balance of payments deficits in America did not concern the authorities. In 1967 the British pound was devalued as a result of high inflation, low productivity, and a worsening balance of payments. In the U.S. President Johnson was trying to finance "the great society" and fight the Vietnam War at the same time, causing a drain on the gold reserves.

Markets were becoming increasingly unstable. In May 1968, France underwent severe civil disorder. In 1969, France unilaterally devalued the franc and Germany was obliged to revalue the Deutschmark. As the American balance of payments worsened, money continued to flow into Germany. In April 1971, the German Central Bank intervened and the Deutschmark was revalued upwards against the dollar. Other currencies quickly followed. In August 1971 the Bretton Woods system collapsed, ending dollar convertibility into gold.

In February 1973 the dollar was devalued by 10%, and currencies now floated freely with occasional central bank intervention.

The Yom Kippur war in the Middle East created a tremendous demand for dollars and a four-fold increase in oil prices. Since oil was priced in dollars the currency soared.

The European Monetary System (EMS) and European Rate Mechanism (ERM) were established in 1979. In the EMS, member currencies were permitted to move within broad limits against each other and a central point. The ERM allowed changes in short-term interest rates, punishing speculators by raising rates in the weaker currencies to discourage short selling. The European Currency Unit (ECU) was a currency based on the weighted average of the currencies in the common market. An active market in ECU-denominated bonds developed, as well as a liquid spot and forward ECU FX market.

The Maastricht treaty in 1991 proposed that a single European Central Bank be established, and the Treaty of the European Union meant that fifteen countries signed for a single currency - the euro.

From the summer of 1992 to 1993, speculators proved that the market in FX was a far more potent force in driving interest rates than central banks. In 1992 Britain was forced out of the ERM.

The dollar reached its all-time low against the yen in 1995, resulting in a loss of competitiveness of Japanese products and a severe recession in Japan. Banks failed, real estate was sold off globally, and there were drastic changes in economic and interest rate policies.

In 1998, the Asian financial crisis, and the opinion that the Yen was severely overvalued, caused the yen to tumble against the dollar and other major currencies. Speculation in the marketplace had caused economic reform.

On 1st January 1999, the exchange rates of participating EMU currencies were irrevocably set and the euro was introduced as legal tender. The single currency in Europe formed one corner of the new triangular world of the dollar, the yen, and the euro.

Uncertainty about the European Central bank's policies and disagreements between the member governments weakened the value of the euro in FX markets.

The terrorist attacks on New York and Washington in 2001 severely tested the currency markets. Money flowed out of the dollar into safe havens such as the Swiss franc, and for the first time, the Euro.

We now live in a world of freely floating exchange rates. There is a far better understanding of monetary economics on the part of the world's governments, reduced dependence on artificial trade barriers or exchange controls, and a freedom and speed of international communication, which creates a single global foreign exchange market.

London will remain the largest FX centre, outperforming New York and Tokyo in volume.

Risk management will continue to be a key issue.

The American economy continues to slow.

Activity in the FX markets remains predominately the domain of large players such as Citibank and J.P.Morgan. However, with the advent of Internet trading and the availability of margin trading, the market is available to anyone with the relevant knowledge and experience.

A disciplined approach to trading must be followed as profit opportunities and potential losses are equal and opposite.

MARKET OVERVIEW

Simply defined, foreign exchange is the buying of one currency and the selling of another, always achieved in pairs - USD/JPY for example.

The market is on operation 24/7 from sunrise in Sydney to Tokyo, London, New York and Chicago to sunset in Los Angeles and Hawaii. The market is decentralized with no physical trading floor, although foreign currency futures are traded on the IMM in Chicago, SIMEX in Singapore, and LIFFE in London. The U.K. is in effect the geographic centre with America a distant second and Japan in third place with 84% of the worlds FX business executed in these centers. Zurich, Frankfurt, Singapore and Sydney follow.

The main instruments for FX trading today are:

SPOT - for cash settlement within two business days.

FORWARD - more than two business days.

SWAP - principle amount exchange on a specific date at a rate agreed at the conclusion of the contract, and a reverse exchange at a date further in the future.

CURRENCY SWAP - principal amount exchange at a pre-arranged exchange rate at maturity plus interest streams.

Also currency FUTURES and OPTIONS.

Approximately 80% of FX trades have a dollar leg. The dollar plays such a large role as it is used as an investment currency throughout the world, as a reserve currency by many central banks, a transaction currency for commodity markets, and is an intervention currency.

The EUR/USD is the most traded currency pair, followed by USD/JPY and GBP/USD.

The FX market is liquid and volatile with huge potential for profit or loss.

PARTICIPANTS IN THE MARKET

There are three main groups - banks, brokers and clients.

Governments sometimes have requirements for foreign currency for paying embassy salaries or foreign currency credit lines or to third world governments for industrial or agricultural development. FX rates are of particular concern to governments as changes can affect the health of a nation's markets and financial systems, as well as international investment flow and export / import prices. These factors impact economic growth. For example, suppose the Japanese yen moves from 120 yen per dollar to 110 over a few weeks. The yen is "strengthening" or becoming more expensive against the US dollar. This means that Japanese exports to America will become more expensive, export volumes to the US will decline and may lead to job losses in Japan. Higher US import prices may have an inflationary influence in America. American exports to Japan will become less expensive which might lead to an increase in American exports and boost American employment.

Central banks such as the Bank of England, the European Central Bank, the Bank of Japan, and the Federal Reserve Bank often enter the market to correct what are felt to be unnecessarily large movements. This intervention affects the present and future behavior of investors. Some of the Middle Eastern and Far Eastern central banks are more aggressive managers of their reserves and are more speculative risk takers. Their activities often disturb market equilibrium. In certain countries, central banks are often involved in local fixing sessions between commercial banks to ensure the supply and demand of foreign currency is balanced at a rate that is in line with current monetary policy.

Trading banks deal with each other on the "inter-bank market" where they make a two way price - a bid (buy) and an offer (sell.) These banks rely on knowledge of the market and their expertise in assessing trends in order to take advantage of them for speculative gain.

Commercial banks operate as international banks in the FX market and have large amounts of foreign exchange to transact on behalf of their clients.

Investment and Merchant banks (such as JPMorgan) service the financial needs of large corporations rather than retail clients. Their strength lies in their corporate finance and capital markets activities. They are frequently required to transact FX business - dealing direct or through the broker's market.

Brokering houses exist primarily to bring buyer and seller together at a mutually agreed price. They receive a commission from both sides and do not take positions in a currency.

The **International Monetary Market (IMM)** in Chicago trades currencies for contract amounts which are relatively small in size, with only four specific maturities a year.

Money Managers - tend to be large New York commission houses and are frequently very aggressive players in the FX market.

Corporations are the real end users of the FX market and affect supply and demand. By coming in to the market, they permanently change the liquidity of the currencies being dealt with.

Retail clients including smaller companies, hedge funds, fixed income brokers, charities and private individuals.

Others include stockbrokers, commodity firms, insurance companies, charities, private institutions, and private individuals.

All of the above tend to have some sort of underlying exposure to hedge, rather than just attempting to "buy low, sell high." However, foreign exchange is an ideal speculative tool, offering volatility, liquidity and easy margin or leverage. Up to 90% of the daily volume of trading activity in the FX markets is as a result of speculator activity.

The FX market provides the liquidity for all these market participants to convert their trade and financial flows from the currency of one financial center to the currency of another. These flows and the products available to facilitate their conversions (spots, forwards, swaps, futures) are also used to hedge or protect the values of cash flows, as these can be affected by the potential changes in the relationships of the currencies involved.

Market makers are market participants that buy AND sell currencies. As market makers, dealers generally, according to market practice, quote a two-way price to another market maker, but not to most corporations. Market makers are primarily major banks such as Citibank and JPMorgan Chase. Price takers are market participants who seek to either buy or sell currencies.

The major participants in the market play a number of roles depending on their need for foreign exchange and the purpose of their activities.

- International money centre banks and investment banks are market makers and deal with other market participants. Positions can be set up defensively in light of the banks' known requirements, or opportunistically, with dealers looking for short-term gain. Today, there are many intra-day traders who will close all short and long positions at the end of the day.
- Regional banks deal with market makers to meet their own (or clients) FX needs.
- Central banks handle FX transactions for their governments, state-owned entities, and other central banks. They also pay or receive currencies not usually held in reserves and stabilize markets through intervention.
- Corporations are generally price takers and use FX to convert trade or capital flow or to hedge a currency position.
- Brokers are the intermediaries and do not take positions. They provide market makers with a bid and/or offer quote that has been left with them by other market makers. (Bound by confidentiality not to reveal the name of one client to another until after a deal is complete.)
- Investors are usually managers of large investment funds and are a major force in moving exchange rates. They engage in hedging or speculation.

- Regulatory authorities such as the International Monetary Fund or the Bank for International Settlements can impose controls on FX by legislation or intervention via the central banks.
- Speculators seek excess profits as a reward for their activities.

Common transactions in today's FX market place include:

- Commercial transactions - by manufacturing companies, importers of goods, contractors involved overseas, insurance, shipping, air transport, and travel companies.
- Funding - by banks and multinationals for commercial loan and foreign investment portfolios.
- Hedging - usually done via products such as currency options which ultimately have an effect on the market.
- Portfolio investment - by banks and other entities investing overseas or dealing in foreign securities in order to establish positions or realize profits.
- Personal transactions - by tourists, immigrants / emigrants. Royalties, commissions, patents and copyrights from abroad.

There are three types of foreign exchange exposure: Transaction exposure (for example if a company imports goods from another country, but the offshore currency moves between the time the order is made and the time the payment is due.) This exposure can be mitigated via a product such as a forward contract.

Translation Exposure - impacts a company's balance sheet and results from the translation of foreign assets and liabilities into the company's home currency for accounting purposes.

This exposure can be mitigated via a product such as a forward contract or currency option.

Economic exposure - for instance a company has foreign exchange exposure arising from payables and receivables that are not yet booked but will most probably occur.

SPOTS, FORWARDS, SWAPS, FUTURES and OPTIONS

A **spot** transaction is where delivery of the currencies is two business days from the trade date.

A **forward** transaction is any transaction that settles on a date beyond spot.

A foreign currency **swap** is where two currencies are exchanged for an agreed period of time and re-exchanged at maturity at the same exchange rate.

A currency **future** obligates the owner to purchase a specified asset at a specified exercise price on the contract maturity date.

An **option** gives the owner the right but not the obligation to buy or sell a specified quantity of a currency at a specified rate on or before a specified date.

ESSENTIAL KNOWLEDGE

DEALING ROOMS: One of the most important aspects in the control of a dealing operation is the division of duties between dealing and back-office processing. Dealers only effect deals in the interbank market with clients, maintain sufficient informal records as required to monitor their positions, and complete source documents (deal tickets.) All processing, confirmation and settlement procedures are done by the back office.

The majority of institutions have some or all of the personnel as follows.

Spot dealers - whenever there is pressure on any currency, that pressure will be most noticeable on the currency's spot value. They are market makers.

Forward dealers - look at the relative currency rates over the standard forward period dates quoted by the market.

Money-market dealers - control the interbank deposit and loan positions of the bank.

Treasury product dealers - involved with other financial instruments and newer off-balance sheet products.

Corporate dealers - in effect they are middle men between the market makers and the clients.

Research personnel - assist the traders in their task with technical and statistical research, commentaries etc.

Position clerks - carry out all the clerical functions that require immediate execution.

THE BACK OFFICE is concerned with settlement of trades, confirmations, maturity files and reconciliations.

THE ROLE OF THE ADVISER: In general the following should be expected of your adviser (trader):

- Regular market updates
- Prompt and timely response to enquiries
- Sound advice on hedging strategies based on fundamental and technical analysis

In return, the adviser needs to know the following to enhance their service:

- Knowledge of the individual's philosophy to risk management
- The client's exposure situation - inflows / outflows by currency and timing
- Short or long-term trading strategy
- Legal / tax constraints

FOREIGN EXCHANGE DEALINGS: The internet is a very quick and easy way to make a foreign exchange transaction, with "click and deal" or "request for price" systems dominating. Use of the telephone allows for prompt and timely execution, but leaves room for errors in communication.

When asking for a quote, the following basic information needs to be conveyed to the market maker directly or to a corporate foreign exchange dealer: type of transaction, currency pair, and quantity. For example, a client would say: *"I want to buy JPY 100 million value spot - what is your quote please?"*

A market maker normally quotes a **two-way** price, where he is ready to bid for, or offer up to, some standard amount. The difference between the two prices is the **spread**. A trader tends to quote only the last two figures of the price, the pips, for example if the rate of dollars against the yen were 107.75/80, then the trader would quote 75/80. That is, he bids for dollars at 107.75 and offers dollars at 107.80.

The salesperson and trader can always change the price as long as the client has not firmly accepted the last quote made. It is not unusual for a client to shop around for quotes to obtain the best deal. Always ask for a two-way quote. In all cases, be clear in the details of the trade or the instructions given, in order to avoid costly errors.

TYPES OF ORDERS: A client may leave orders with the broker, generally there are four types:

Market orders - enables a client to execute a transaction at the best available price immediately. Timing is critical as the client is trying to establish or get out of a position as quickly as possible.

At best orders - usually for large transactions - enables the client to execute a transaction at the best available price.

Stop orders - used by clients to protect themselves against sudden price movements. Used to limit losses or protect profits on previously established positions, or to initiate new positions when market moves occur. They are contingent orders and are only executed when the stop price has traded or is touched. A buy stop is placed above the market price; a sell stop is placed below the market. A good trader never trades without a protective stop order.

Discretionary price order - in effect, a stop order, but the client will establish at the outset the price at which he or she wants to deal but will give the trader the discretion to do better if possible than the stated price.

A FOREX trader must use three types of orders: a Market Order, a Limit Order, and a Stop Order.

A clear understanding of what each order does is essential before executing orders.

Limit Orders are orders given to a broker to buy or sell currency lots at a certain price or better. They are generally used to acquire a specific price, avoiding slippage and unwanted order fills which can happen with market orders.

Also - **Cancel Replace Orders - for example, buy the pound at 1.810. Your protective stop loss order is 1.790. The market moves in your direction as projected. You now want to reduce your potential loss, so you cancel your stop order at 1.790 and replace it at 1.810 where you got in. You are now in a trade with no risk. As the market moves further north in your direction, you now want to lock in more profit. You cancel your stop loss order at 1.810 and replace it with a new 1.840 stop loss order so that you have locked in 30 pips in profit. Keep canceling and replacing your stop until you are finally stopped out.

ELECTRONIC FOREIGN EXCHANGE TRADING:

Not so long ago, banking institutions were the sole purveyors of the information vital to the transaction of business in the market.

Today, most clients are quite sophisticated; they know where the market is and what bid-offer spreads to expect when dealing. What distinguishes the best from the rest is the provision of high-quality information. Clients are looking for systems that are Internet enabled, scalable across regions, reliable and safeguarded against crashes. Investors can now gain live access to multi-contributor price feeds, which can be downloaded directly into spreadsheets. Up-to-the-minute political and economic developments are widely available through news sources. The internet is transforming today's market through the low demands it makes on staff and technology. Active traders can now exploit even the narrowest of margins.

There are three distinct types of internet trading platforms.

Click-'n'-deal - the prices are live and instantly tradable by just clicking on a currency pair.

Request-for-price - uses a chat function for requesting the prices.

Anonymous - trading between principles allowing traders to see every bid and offer in the book and thereby greatly increases market transparency.

An average individual armed with a computer, a mouse and an Internet connection can trade spot foreign exchange literally 24 hours a day, 7 days a week. It's common for trading platforms to offer 100-to-1 leverage, enabling trading of \$100,000 worth of foreign currency with only \$1,000 cash in the account.

One cannot hope to make extraordinary gains without taking extraordinary risks. Trading currencies is not easy (if it was, everyone would be a millionaire.) Trading takes time to master and there are absolutely no short cuts to this process.

The most enticing aspect of trading currencies is the high degree of leverage used. However, leverage is a double-edge sword. Just because one lot (\$100,000) of currency requires only \$1000 as a minimum margin deposit, it does not mean that a trader with \$10,000 in his account should easily be able to trade 10 lots or even 5 lots. One lot is \$100,000 and should be treated as a \$100,000 investment and not the \$1000 put up as margin.

A **mini account** trades in smaller contract sizes of 10,000 units, 1/10th the size of the standard account. Generally, traders with account balances less than \$10,000 should trade a mini account. The smaller trade size gives traders the opportunity to trade live with less overall risk or exposure to the market.

The key to trading is discipline.

Losses can AND WILL occur. A trader's ability to limit his losses is just as important as determining entry points

MARGIN TRADING (leveraged trading) is borrowing money from a broker to buy a stock, or commodity, or currency pair and using the investment as collateral. Investors generally use

margin to increase their purchasing power to enable them to own more stock or take larger positions in the market, without fully paying for it. Margin exposes investors to the potential for higher losses. In volatile markets, traders who put up an initial margin payment for a stock or currency position may be required to provide additional cash if the price of the stock falls.

An example:

If a client opens an account with \$100,000, with an agreed margin level of 5%, the client will be allowed to trade with 20 times the leverage (100 divided by 5.) The client can have open positions to the value of \$2,000,000. If a client made a \$20,000 profit one day, he could have an open position of \$2,400,000 ($100,000 + 20,000 = 120,000$ divided by 5 %.)

Initial margin represents the resources required to open a position.

Variation margin represents the current profit or loss being made on any open positions.

Maintenance margin is a minimum amount of collateral needed in the account.

As trading FX on margin can be very rewarding, a strict trading discipline should be adhered to. In order to limit the risks, a trader should continuously monitor the status of the positions against current market prices and should run stop-loss orders for each open position.

FUNDAMENTALS and TECHNICAL ANALYSIS

Foreign Exchange prices are relative prices, not absolute prices. They represent in the broadest sense a comparison of economies and all that this entails - for example, unemployment, inflation, wage performance, and budget balance.

The **fundamental approach** concerns currency forecasters looking at economic factors such as balance of payments, short-and long-term capital flows, level of reserves, overall economic performance, gross domestic product. Also industrial production, personal income, industrial output, retail sales and so on. Forecasters also believe that the higher a country's inflation rate relative to others, the faster will that country's currency depreciate This is the purchasing power parity (PPP) theory.

A country's social and political environment, and government policy (monetary and fiscal) also affect a country's exchange rate.

However, there are political events that cannot be foreseen such as the invasion of Kuwait in 1990, or the World Trade Center attack in 2001. In these cases traders will initially respond in "flight to quality" which usually means a move into the dollar, Swiss franc, or gold.

It is the subjective interpretation of these elements that makes a market and caused some of the violent gyrations.

The **technical approach** comprises charting and technical analysis. Charts are analyzed for moving averages, reversal formations, and trend lines. Technical analysis is the study and interpretation of price movements to determine future trends.

Fundamental analysis is generally a poor trading tool. Technical analysis is a tactical tool used by speculators and traders as the basis for position taking.

Data related to interest rates and international trade is looked at the closest.

Traditionally, if a country raises its interest rates, the currency of that country will strengthen in relation to other countries, as investors shift assets to that country to gain a higher return.

Hikes in interest rates, however, are generally bad news for stock markets. Some investors will transfer money out of a country's stock market when interest rates are hiked, believing that higher borrowing costs will affect the balance sheet negatively and result in devalued stock, causing the country's currency to weaken.

The trade balance shows the net difference over a period of time between a nation's exports and imports. When a country imports more than it exports, the trade balance will show a deficit, which is generally considered unfavorable. If the deficit is greater than market expectations then it will trigger a negative price movement.

ECONOMIC INFLUENCES ON THE MARKET:

Consumer Price Index - CPI is a measure of the average level of prices of a fixed market basket of goods and services purchased by consumers. Rising consumer price inflation is normally associated with the expectation of higher short-term interest rates and may be supportive of a currency in the short term. Longer term inflation has the opposite effect.

Durable Goods Orders - a measure of the new orders placed with domestic manufacturers for delivery of factory hard goods. Rising orders = stronger economic activity > higher short-term interest rates > supportive of a currency in the short term.

Gross Domestic Product - GDP is a broad measure of economic activity / strength of an economy. It consists of purchases of domestically produced goods and services. High GDP › higher short-term interest rates › supportive of a currency in the short term.

Housing Starts - a measure of the number of residential units on which construction has begun. High activity = stronger economic activity › higher short-term interest rates › supportive of a currency in the short term.

Payroll / Employment - a measure of the number of people being paid as employees by non-farm business. An important measure of economic activity. Large increases = stronger economic activity › higher short-term interest rates › supportive of a currency in the short term.

Producer Price Index - PPI is a measure of the average level of prices in a fixed basket of goods received in primary markets by producers. Rising PPI = higher inflation › higher short-term interest rates › supportive of a currency in the short term.

Retail Sales - a measure of total receipts of retail stores. It is an indicator of consumer spending = strong economy › higher short-term interest rates › supportive of a currency in the short term.

Trade Balance - a measure of the difference between imports and exports of tangible goods and services. Typically, a nation that runs a substantial trade balance deficit has a weak currency, but this can be offset by financial investment flows.

KEY FACTORS IMPACTING CURRENCIES:

YEN vs DOLLAR:

Japan is the economic engine for the region, so Asian currencies generally move with it. However economic problems or instabilities in countries within the region undermine the yen.

Main factors affecting the YEN vs DOLLAR are:

- Ministry of Finance
- Interest rates (set by the Bank of Japan)
- Japanese Government Bonds (JGBs) - a rising yield on the 10-year JGB will usually boost the yen and weigh on the dollar.
- Economic Planning Agency
- Ministry of International Trade and Industry
- The NIKKEI 225 Stock Index (a yen decline boosts stocks of export companies and boosts the index)
- Cross-rate effect - EUR/JPY
- Economic data
 - o GDP
 - o Tankan Survey
 - o International Trade
 - o Unemployment
 - o Industrial production
 - o Money Supply

EURO vs DOLLAR:

- European Central Bank
- Interest Rates
- 10-year government bond
- Cross-rate effect - EUR/JPY, USD/SFR
- Political factors
- Economic data (mostly from the largest economy - Germany.)
 - o GDP
 - o Inflation
 - o Industrial production
 - o Unemployment
 - o German IFO survey (business confidence)
 - o Budget deficits of the individual member countries

STIRLING vs DOLLAR:

- Bank of England
- Interest Rates
- Gilts (Government Securities)
- Treasury

- Sterling and European Membership (Sterling would depreciate if Britain were to become a member of the Euro.)
- The FTSE-100 stock index
- Cross-rate effect - EUR/GBP
- Economic data
 - o Unemployment
 - o Average earnings
 - o Retail sales
 - o PPI
 - o Industrial production
 - o GDP
 - o Purchasing manager' surveys
 - o Money Supply
 - o Housing Prices

THE DOLLAR:

- Federal Reserve Bank
- Federal Open Market Committee
- Fed Funds rate
- Discount rate
- 30-year Treasury Bond
- 10-year Treasury Note
- Treasury
- Stock Market (the DOW, S&P 500 and NASDAQ)
- Cross-rate effect - JPY/EUR
- Economic data
 - o Labour report
 - o CPI
 - o PPI
 - o GDP
 - o International trade
 - o NAPM
 - o Housing starts
 - o Industrial production
 - o Consumer confidence

TECHNICAL ANALYSIS:

This form of analysis examines the past price and volume data to forecast future price movements. It is based on three assumptions; that all publicly available information about a tradable currency is already in its price, prices move in trends or patterns, and history repeats itself.

Technicians look at charts to identify patterns or trends. They have found that currency prices do not fluctuate randomly, but instead follow distinct patterns, like the crests and peaks of waves.

BASIC THEORIES - The Dow Theory - states that prices fully reflect all existing information. Price waves consist of three types of magnitude: primary, secondary, and mirror. The time involved ranges from less than three weeks to over a year. The theory also identified retracement patterns, which are common levels by which trends pare their moves - 38.2%, 50%, and 61.8%.

Fibonacci retracement - used to determine how far a price has rebounded from its underlying trend. Most important retracement levels are 38.2%, 50%, and 61.8%.

Elliot Wave - technicians classify price movements in patterned waves that can indicate future targets and reversals. Waves moving with the trend are called *impulse* waves. Those moving against the trend are *corrective* waves. Time frames can range from 15 minutes to decades.

WHAT TO LOOK OUT FOR:

Find the trend - be aware of the overall market direction. Buy on the dips between rising trends and sell on the rallies during downward trends. Support and resistance are points where a chart experiences recurring upward or downward pressure. It is best to buy near support levels and sell near resistance levels that are unlikely to be broken. A support is a line joining all the bottoms and resistance is a line joining all the tops. Lines and channels - an

upward straight line is drawn by connecting at least two successive lows, with the second point higher than the first. The continuation of the line helps determine the path along which the market will move. A channel is defined as the price path drawn by two parallel trend lines. Moving averages tell the average price in a given point of time over a defined period of time.

FORMATIONS:

Head and shoulders - most often seen in uptrends. This formation tells the analyst there is a major change in trend.

The symmetrical triangle - indicates areas of indecision indicating that the forces of supply and demand at that moment are almost equal.

The descending triangle - generally considered bearish and usually seen in down trends.

The right-angle triangle - either bullish or bearish but most reliable when found in an uptrend.

The wedge - a falling wedge is generally considered bullish and is usually found in uptrends.

The channel formations are generally indecision areas that are usually resolved in the direction of the trend.

Flags and pennants appear to be breathing spaces and are typically seen after a large, quick move.

TECHNICAL INDICATORS:

Relative Strength Index - in effect like a rubber band that after a certain point, is forced to relax. It is a momentum indicator which measures a currency's price relative to itself. Today, buy signals are triggered around 20 and sell signals are triggered around 80.

Moving average - the average price of a currency at a specific point in time.

Bollinger bands - envelopes which surround the price bars on a chart, plotted at a fixed percentage above and below the moving average. They widen during volatile periods and contract during less volatile periods.

Moving Average Convergence Divergence - an oscillator which is derived by dividing one moving average by another.

Stochastics - compares where a currency's price has closed relative to its price range over a specifically identified period of time.

CONCLUSION

It is the mission of the trader to become a financially successful long-term trader. Success depends on creating a trading plan, and maintaining the discipline to trade the plan!

A trader must be committed to continued education. A trader must make logical decisions, void of emotion while trading.

A trader must map out a sensible equity management plan to insure a return on investment.

Trade no more than 20% of a margin account and expose no more than 5% of that account on any single trade.

Competent traders trade with control over his emotional distractions, utilizing proper equity management and achieving financial return.

Proficient traders make trades utilizing confidence, education, and experience and achieve financial returns.

Expert traders instinctively execute profitable trades without emotion.

The FOREX market is a group of approximately 4,500 currency trading institutions, including international banks, government central banks and commercial companies.

Historically, the FOREX market was not available for small speculators because of stringent financial requirements and minimum transaction sizes. Today, market maker brokers are allowed to break down the large interbank units and offer small traders the opportunity to buy or sell any number of these smaller units (lots.)

The FOREX is so large and is composed of so many participants, that no one player, even the government central banks, can control the market. The market is huge, and has grown in excess of 1.5 trillion daily.

Trading occurs over the phone and through computer terminals at hundreds of locations worldwide. The bulk of trading is between approximately 300 large international banks, which process transactions for large companies, governments, and for their own accounts. These banks are continually providing prices ("bid" to buy and "ask" to sell) for each other and the broader market. The most recent quotation from one of these banks is considered the market's current price for that currency. Various private data reporting services provide this "live" price information via the internet.

LIQUIDITY - FOREX traders never have to worry about being stuck in a position due to lack of market interest.

ACCESS - The market is open 24 hours a day from early Monday morning until mid morning Saturday. An individual trader can react to news when it breaks. There are FOREX dealers in every time

zone in every major market center willing to continuously quote buy and sell prices.

TWO WAY - currencies are traded in pairs, for example dollar / yen or dollar / pound. Every position involves the selling of one currency and the buying of another. The potential for profit exists because there is always movement in the exchange rates. In every currency trading transaction, one of the sides of the pair is always gaining and the other side is losing.

LEVERAGE - trading of FOREX is done in currency "lots." Each lot is approximately 100,000 U.S. dollars worth of a foreign currency. To trade on the FOREX market, a "margin account" must be established with a currency broker. This is, in effect, a bank account into which profits may be deposited and losses may be deducted. These deposits and deductions are made instantly upon exiting a position. In comparison to trading stocks and other markets, which may require a 50% margin account, FOREX speculators enjoy leverage of 1% to 2% of the \$100,000 lot value.

EXECUTION QUALITY - Confirmations of trades are immediate and the Internet trader has only to print a copy of the screen for a written record of all trading activities. A FOREX internet trader does not have to speak with a broker by telephone. The elimination of the middleman (broker salesman) lowers expenses and makes the process of entering an order faster and has eliminated the possibility for misunderstanding.

Unlike other markets, the FOREX does not charge commissions. The cost of a trade is represented in a Bid/Ask spread established by the broker (usually 4 or 5 pips.)

Each individual currency has its own "personality," and each offers a unique historical pattern of trends, providing diversified trading opportunities.

Participants in the FX market need to keep abreast of their **fundamental** knowledge as well as learn how to use basic **technical** tools. For example, if American economic growth is declining, the expected return on American assets will fall, and the dollar may fall relative to other

currencies. In periods where the yen strengthens, traders should be wary of an official policy response to drive the yen lower. A strong yen hurts Japanese exporters, but helps American exporters compete with Japan.

A currency trader also needs a global perspective. Interest rates are the most external information source. If the American Federal Reserve cuts rates, the dollar should weaken, but if the European Central Bank follows suit, the value of the currency may not change at all. A successful trader recognizes how fundamentals and technicals combine to indicate a trend reversal.

Be sure that you have a plan before you start to trade. The plan must include stop and limit levels for the trade, as your analysis should encompass the expected downside as well as the expected upside. Stops are there to be hit, and to stop you from losing more than a predetermined amount! If you can get 3 out of 6 trades to be profitable then you are doing well. Allow your profits on the winners to run and make sure that your losses are minimal. One of the most common mistakes that traders make is leveraging their account too high by trading much larger sizes than their account should prudently trade.

With the arrival of electronic trading, today's participants are looking for internet enabled trading platforms which are scalable across regions, reliable and safeguarded against crashes, and which can be integrated with various risk management systems. Foreign exchange is both a science and an art. Judgment and personal attitudes toward risk are required for consistent position management.

Sources: "A Foreign Exchange Primer" by Shani Shamah
<http://www.mtia.com.au/>
<http://www.fxcm.com/>