How to Trade Forex

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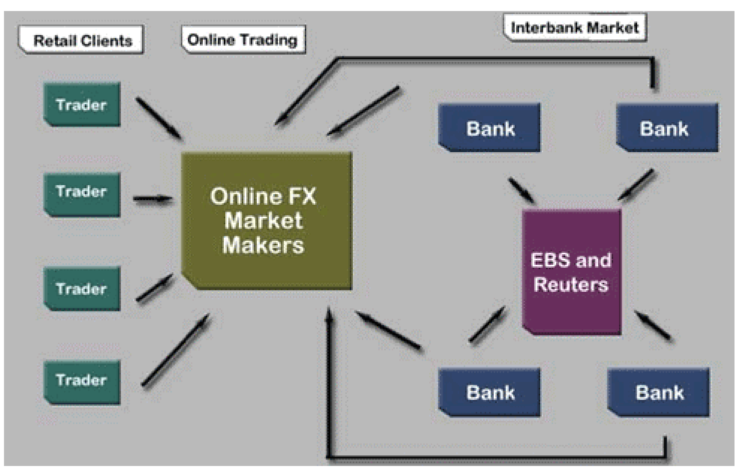
Chapter 1: What is Currency Trading & How Do I Know if it is Right for Me?

The investment medium of trading currencies, or forex trading as it is commonly called, has grown in enormous popularity over the past five years among investors the world over due to its flexibility and ease of access to sophisticated trading platforms and market data. The forex market is actually the largest and most liquid market on the planet, exchanging over $3.2 trillion a day in value between large and small traders alike.

Up until a decade ago, forex trading was primarily the province of very large international banks and financial institutions where the minimum contract lot size was one million units. Even the most wealthy individual had trouble dealing in this market due to the financial requirements present in the industry, but a few creative forex brokers began to aggregate trades in order to offer smaller lot sizes and once the Internet provided easy access, then retail forex trading was born.

The market is still dominated by large global banks. Over 50% of the trading is in the "Interbank" market where average transactions of $5 million and up are exchanged directly between banks alone. There is no central exchange to record volume or all transaction data. EBS and Reuters provide electronic networks to handle electronic communications, coordination and trading. Forex brokers, or online market makers, tie into this network and then offer retail services as depicted in the chart below:



Source: FXCM

Retail forex trading is not for everyone. It involves high risk, and for that reason, a beginner needs to receive specialized training in the craft and spend hours practicing on a free demo account with "virtual" cash to develop his skills and the consistency necessary to be successful in this trading regimen. During this training period, before any real money is ever put at risk, a beginner can determine if the trading life meshes with his own personality style. If it does, then it is worth a try to move forward.

Success in the world of forex trading is dependent on three factors: knowledge, experience, and the ability to control one's emotions. These three factors are required for success in any investment medium, but the high-stress trading environment that is the nature of forex exacerbates the importance of each. The majority of beginners in this field become impatient, leap into the market with six-guns blazing, and their inexperience and emotions soon send them packing to the poor house, demoralized and depleted of their investment capital. There is risk, but there is also reward if you take the time to learn the proper ways to approach this market.

Read as much as you can before taking a tutorial on the topic. Enroll in a class and learn from an expert. As in any technical and complex activity, you must accept your amateur status and be open to mentoring by a professional. His experience will help guide you down the correct learning path.

Many successful traders swear by their practice rituals. It is here on demo systems that you can develop and test your own personal disciplined approach to the market. This series of articles will help get you started. The following four parts will explain the what, why, when and how of forex training. It will be up to you to then invest more time perfecting your “Three Factor Formula”. Time invested on any one factor will also produce results on the other two. There are no shortcuts. Impatience and inexperience are your enemies. Deal with these two issues, and then deal in the currency markets.

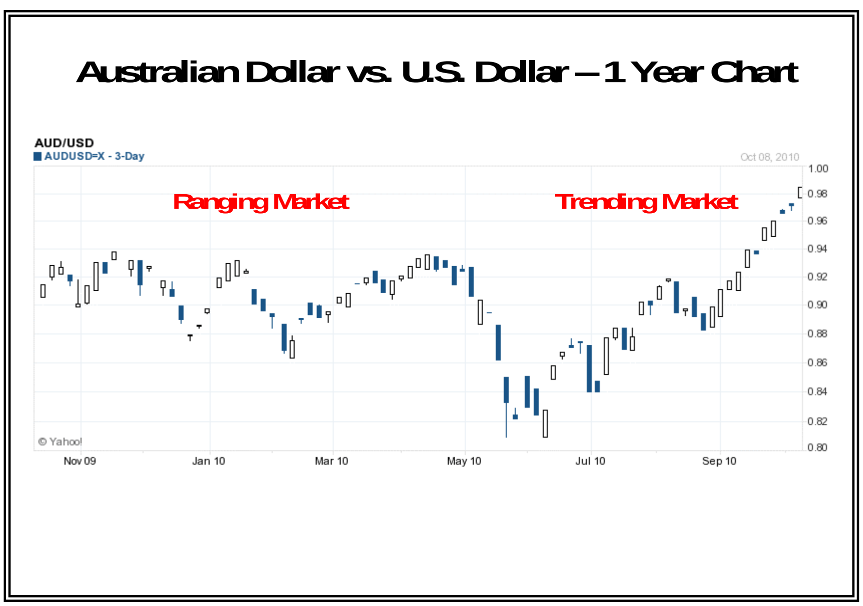
Chapter 2: What are the Basic Components of Forex Trading & the Market?

Currency trading has many similarities with trading stocks, but there are key differences that require a slightly modified perspective when approaching the forex market. With stocks, an investor can search for target companies by studying their financial statements, previous market trends in their sector, comparisons with competitors, and how other investors have bought and sold their stock offerings. However, currencies are always traded in pairs. The economies of each respective country become the focal point of study. Going long on one currency also means going short on the other. Prices represent a market valuation comparison of the health of the two opposing economies.

The major currencies and all others have a three-digit code set by an international standards organization. Some also have signs or graphic symbols that are often used to denote the currency's name. Samples of various currency symbols, slang names and signs for the eight major trading currencies are shown below:

AUD - Australian Dollar (or "Aussie")
CAD - Canadian Dollar (or "Loonie")
EUR - Euro (or "€")
JPY - Japanese Yen (or "¥")
GBP - British Pound (or "Sterling" or "£")
CHF - Swiss Franc (or "Swissie" or "S₣")
NZD - New Zealand Dollar (or "Kiwi")
USD - U.S. Dollar (or Greenback or "$US")

Here is a typical charting for price fluctuations for one leading currency pair for one year.



The pair shown is the "AUD/USD" pair. The first currency listed, "AUD", is always known as the "Base" currency, and the second one, the "USD", as the "Counter" currency. Price levels have varied between US$0.81 and US$0.96 on the chart over the one-year period. If you had wanted to go long in Australian Dollars back in June, you may have encountered a quote of “0.8200/0.8203”. The first figure is the “Bid” and the second figure is the “Ask”. The difference between the two is the “Spread”, 3 “pips” in this case. Forex brokers make their money on the spread.

In order to acquire a “position” in a currency pair, one must issue an order to his forex broker. There are a variety of these orders, and each trader must be fully fluent in how to utilize each one to his advantage. The common order types that you may encounter are as follows:

- Market order
- Limit order
- Stop-loss order
- Trailing-stop order
- Take profit order

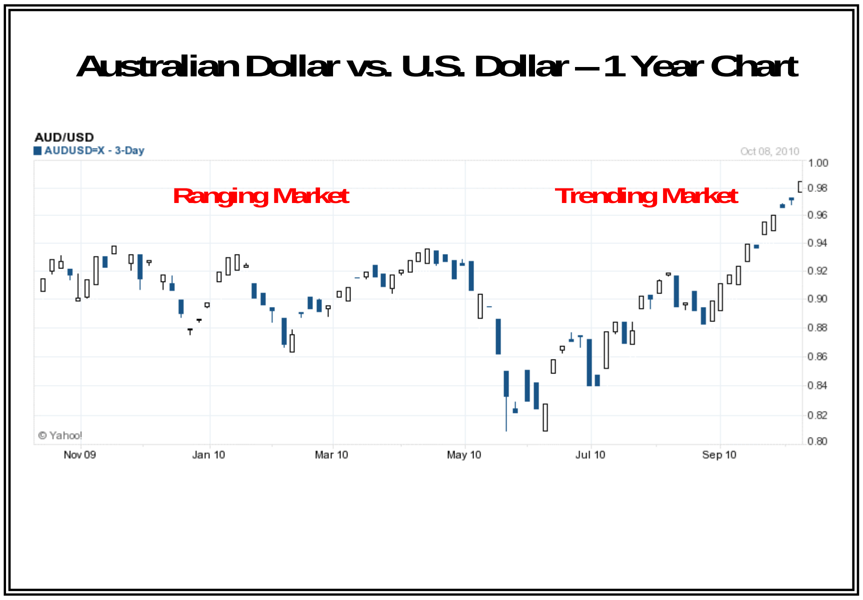
These orders are similar to stock trading. The first two allow flexibility in buying or selling, while the second three are risk management tools that allow you to protect against adverse movements in the market or lock in a profit target when a certain price level is reached. Each order type will also stipulate a “lot” size, or amount of currency based on your agreement with your broker. “Leverage”, similar to margin in stocks without the interest charge, will also depend on what your broker allows you to do.

Lastly, you will notice that price movements tend to move in wave patterns on the pricing chart. If the waves move in a “sideways” pattern, as in the first half of the chart, it is called a “ranging market”. If the movement is decidedly in one direction, as in the latter half of the chart, it is a “trending market”. In either case, your goal is to buy low and sell high, the simplest trading strategy for making money, but this goal is usually easier to achieve when the market is trending.

Next: Chapter 3 will discuss “why” the forex market moves the way it does.

Chapter 3: Fundamental Analysis – Understanding the "Why" of Forex Trading

In our last part, we focused on basic forex market terms, components, and execution orders that are necessary to gain access and operate in the market. The following graphic was also presented in that discussion:



The major currency pair, the "AUD/USD", is presented for a year with "candlesticks" depicting the price-range action over a 3-day period. In this chart the price action formed both a "ranging" and a "trending" pattern for the period. The question we wish to address at this point is, "Why did the prices move in this fashion?"

Fundamental analysis is all about the study of basic financial and economic information that can influence prices in a market. Public releases of important economic data do not physically move the market, but their impact on the trading psychology of traders will result in the pressure to buy or sell in the forex market. As in physics, natural forces produce waves in nature, and buying and selling forces do the same thing in financial markets.

A successful trade is often said to be 95% anticipation. If economic data moves the forex market, then a prudent trader will want to have a current calendar by his side and knowledge about when and how a specific change may influence the market ahead of its release. All countries have specific data release dates for key economic data. Although each may vary in importance due to a chosen currency pair, the status of each economy or the degree of change communicated, the following nine types of releases will always have a predictable impact, either positive or negative, on relative valuations:

1. Interest rate decisions by the Central Bank
2. Retail sales figures
3. Inflation (consumer price or producer price)
4. Unemployment

5. Industrial production and GDP releases
6. Business sentiment surveys
7. Consumer confidence surveys
8. Trade balance reports
9. Manufacturing sector surveys

These releases provide insights regarding a country's economic health. Analysts form opinions about how these data will affect a country's capital flows and international trade balances, thereby influencing the relative strength of its respective currency. However, there is one more fundamental that cannot be placed on a calendar, and that is a crisis. When a significant crisis occurs, capital tends to flee to safe havens, thereby disrupting financial markets and suspending the influence of other fundamentals until stability returns, sometimes several months later.

A crisis may or may not have a material impact on market forces, depending on whether it is confined to a local market alone or sends a shockwave across the globe. The form of a crisis may vary, including wars, political changes, elections, government takeovers, financial failure, natural disasters, or even fiscal or monetary policy changes.

The recent debt crisis in Greece and the Eurozone grabbed news headlines this past May of 2010 and caused a drop in Aussie Dollar valuations versus the greenback. In point of fact, capital flight increased demand for U.S. Treasury Bills and precious metals, thereby increasing demand for the U.S. Dollar in the process. This strengthening in the "USD" was temporary, however, as fundamentals resumed their influence in July. The Australian economy has been thriving, while the United States has done little to reduce its deficit, increase employment, or turn around its significant trade imbalance. These "fundamentals" caused traders to favor the "AUD" thereafter.

Understanding these trends and why they happen allows a trader to anticipate price action in the market. "Part 4" to follow will tell you "when" to trade, the necessary next step for profiting in the forex market.

Chapter 4: Technical Analysis–Understanding the "When" of Forex Trading

In our last part, we reviewed the reasons why currency prices move in their wavelike patterns, the study of fundamental analysis. Technical analysis is the tool that will guide your choice of optimum entry and exit points, the "when" of forex trading. When financial news happens, you do not have to predict price moves in the forex market. You can leave that to the analysts that study data and suggest trading strategies to large global banks and hedge funds. At a retail forex trading level, your goal is to react after these analysts and their traders create a predictable trend in the market.

Once again, let's return to our favored trading pair, the "AUD/USD" pair, but with a more current chart that includes a few technical indicators.

As we have already discussed, markets do tend to move in waves, and these wave patterns are consistent enough to be anticipated by the use of predicative modeling. Technical Analysis is the discipline that studies charts of past price behavior and pattern recognition to forecast future price performance. Although there are critics of the process, the craft has been proven to be consistent, never perfect, but a significant tool for supporting a forex trader's decision-making process in the market.

Sophisticated software does all the work for you to produce a chart like the one above after compiling a mountain of pricing data and performing a myriad of highly complex statistical calculations. There are literally thousands of technical indicators that have been developed over time. A few of the more popular ones are displayed here:

- Candlestick Formations

- Bollinger Bands
- Simple Moving Averages
- Relative Strength Index (RSI)

The little red and blue “boxes” are daily candlesticks that communicate opening and closing prices for the day, as well as the high and low for the trading period. The “red” box means the day closed at a lower than opening price, and “blue”, vice-versa. The gold lines are Bollinger Bands, a statistical measure of price activity. When these bands constrict, a reversal is indicated, followed by an expansion of the bands. Traders often follow simple moving averages of price over varying time periods, known as lagging indicators, since crossovers are good signals that a change in trend has been confirmed.

The “RSI” is displayed on the bottom of the chart. It is known as a momentum oscillator, a leading indicator that measures the relative strength of changes between higher and lower closing prices. The resulting curve “oscillates” between overbought and oversold conditions, signals that suggest an optimum entry or exit point is imminent. The RSI does not necessarily tell you the exact “when”, and for this reason, it is often used in combination with other indicators to validate the voracity of its signal.

To show how these work together, the RSI signaled an “oversold” condition in late May, confirmed by the crossover of the 50 and 100-day moving averages a few days afterwards. A trader would buy at this point, and then might have sold in early August in anticipation of an oversold condition. He would have re-entered the market a few weeks later when the moving average crossover re-occurred, riding the upward trend. “The trend is my friend,” is a trader’s favorite phrase, but the RSI is signaling “overbought” at present, thereby suggesting that an exit would be wise.

Technical analysis can get as complex as you want it, including Elliott Wave Theory and Fibonacci levels. These are just the “basics”. Part 5 will discuss how you use everything to be successful.

Chapter 5: Forex Trading – Putting Together Everything You Have Learned

The first four parts of this introduction to forex trading have focused on building an initial knowledge foundation for you from which you may now expand upon at will. As with any profession, there are various paths where additional specialization and learning can offer benefits and enhance your overall effectiveness. However, in order to put everything together, we must take time to review the other two key factors required for success, namely experience and controlling one's emotions.

Professional traders depend on their forex demo accounts to help them address both of these concerns. Hours of practice using "virtual" cash with real time market data is the only path for gaining experience without risking your investment capital. It allows one to test his trading strategy, fine tune it, and gain the necessary confidence and consistency to put real money at risk in the market. Traders also convert their strategy into a step-by-step plan such that they practice it until it becomes almost habitual, requiring very little thought when decision points occur. This process is the "tried and true" way to block your emotions from interfering with your trading regimen. There is a psychology to trading that can hamper your results, so take this advice seriously.

There are many forex broker review sites on the Internet that will guide you to an established U.S. firm that offers a free demo account for your use. Select one and sign up for your free account. Download the software and get acquainted with it. It is recommended that you focus on a single currency pair initially. The "GBP/USD" pair is a good starting point since the economies of both countries are in recovery mode and you need only study the news for two countries rather than all of Europe with the Euro. Your broker's website or others may have daily or weekly commentary that will give you a fundamental hint at potential trends that may transpire.

Select "hourly" for your timeframe reference. You can always change this option later. It is also advisable to check a potential trend in multiple timeframes to see if it is broad-based before trading. Set up your trading chart with the options that we have already discussed: candlesticks, Bollinger Bands, Simple Moving Averages (SMA), and the RSI indicator. Also add an ATR (Average True Range) indicator for the previous 20 trading periods. Now, we can set up a simple step-wise trading plan for you:

- Assess your downside risk as 70% of the ATR reading;
- Set your profit target at twice this figure;
- When RSI signals "oversold" and SMA's are near crossing, enter the market;
- Start with small lots first and execute a market order;
- Set a Stop-Loss order at 70% of ATR below entry point to market;
- When RSI signals "overbought" or profit target is reached, close position and take your gain. As you gain experience, you will learn to substitute a Trailing Stop-Loss order at this point and let your winner run.

Now, "Practice, Practice, Practice"! Fine-tune your plan as you go. If you notice that your mind is causing you to hesitate, then add more definition to your steps so that decisions are more business-like. You must be very disciplined in your approach to the market.

This five-part series has only been an introduction to the art of forex trading. If forex is not for you, there are always other options. If yes, then continue your learning process, find a good mentor, have fun, and earn the title of “Forex Trader”!