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# A Must Know Before Start Trading Forex

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## Description of the Forex

The Forex market, **established in 1971**, was created when floating exchange rates began to materialize. The Forex market is not centralized, like in currency futures or stock markets. Trading occurs over computers and telephones at thousands of locations worldwide.

The Foreign Exchange market, commonly referred as FOREX, is where banks, investors and speculators exchange one currency to another. The largest foreign exchange activity retains the **spot exchange** (i.e.., immediate) between five major currencies: US Dollar, British Pound, Japanese Yen, Euro and the Swiss Franc. It is also the largest financial market in the world. In comparison, the US stock market may trade $10 billion in one day, whereas the Forex market will trade up to **$2 trillion in one single day**. The Forex market is an opened 24 hours a day market where the primary market for currencies is the 24-hour Interbank market. This market follows the sun around the world, moving from the major banking centres of the United States to Australia and New Zealand to the Far East, to Europe and finally back to the Unites States.

Until now, professional traders from major international commercial and investment banks have dominated the FX market. Other market participants range from large multinational corporations, global money managers, registered dealers, international money brokers, and futures and options traders, to private speculators.

There are three main reasons to participate in the FX market. One is to facilitate an actual transaction, whereby international corporations convert profits made in foreign currencies into their domestic currency. Corporate treasurers and money managers also enter the FX market in order to hedge against unwanted exposure to future price movements in the currency market. The third and more popular reason is speculation for profit. In fact, today it is estimated that less than 5% of all trading on the FX market is actually facilitating a true commercial transaction.

The FX market is considered an Over The Counter (OTC) or 'Interbank' market, due to the fact that transactions are conducted between two counterparts over the telephone or via an electronic network. Trading is not centralized on an exchange, as with the stock and futures markets. A true 24-hour market, Forex trading begins each day in Sydney, and moves around the globe as the business day begins in each financial center, first to Tokyo, London, and New York. Unlike any other financial market, investors can respond to currency fluctuations caused by economic, social and political events at the time they occur - day or night.

## The Market Hours

The trading begins once the markets are officially open in Tokyo, Japan at 7:00 PM Sunday, New York time.

Afterwards, at 9:00 PM EST, Singapore and Hong Kong opens followed by the European markets in Frankfurt at 2:00 AM and in London at 3:00 AM.

When the clock reaches 4:00 AM, the European markets are in the hot spot and Asia just concluded its trading day.

Around 8:00 AM on Monday, the US markets opens in New York while Europe is slowly going down. Australia will take the lead around 5:00 PM and when it is 7:00PM again, Tokyo is ready to reopen.

## Benefits of Forex Trading vs. Equity Trading

- 24 hour trading
- Liquidity
- Leverage
- Lower transaction costs
- Equal access to market information
- Profit potential in both rising and falling markets

**24-hour trading**
The main advantage of the Forex market over the stock market and other exchange-traded instruments is that the Forex market is a **true 24-hour market**. Whether it's 6pm or 6am, somewhere in the world there are always buyers and sellers actively trading Forex so that investors can respond to breaking news immediately. In the currency markets, your portfolio won't be affected by after hours earning reports or analyst conference calls.

**Liquidity**

With a daily trading volume that is **50 times larger than the New York Stock Exchange**, there are always broker/dealers willing to buy or sell currencies in the FX markets. The liquidity of this market, especially that of the major currencies, helps ensure price stability. Investors can always open or close a position, and more importantly, receive a fair market price.

Because of the lower trading volume, investors in the stock market and other exchange-traded markets are more vulnerable to liquidity risk, which results in a wider dealing spread or larger price movements in response to any relatively large transaction.

**Leverage**

Leveraged trading, also called margin trading, allows investors in the Forex market to execute trades up to $250,000 with an initial margin of only $250. However, it is important to remember that while this type of leverage allows investors to maximize their profit potential, the potential for loss is equally great. A more pragmatic margin trade for someone new to the FX markets would be 5:1 or even 10:1, but ultimately depends on the investor's appetite for risk. On the other hand, a 100:1 leverage would be the foremost suggested margin trading to use for the best risk and reward return.

**Lower transaction costs**

It is much more cost efficient to invest in the Forex market then the stock market, in terms of both commissions and transaction fees.

**Equal access to market information**

Professional traders and analysts in the equity market have a definitive competitive advantage by virtue of that fact that they have first access to important corporate information, such as earning estimates and press releases, before it is released to the general public. In contrast, in the Forex market, pertinent information is equally accessible, ensuring that all market participants can take advantage of market-moving news as soon as it becomes available.

**Profit potential in both rising and falling markets**

In every open FX position, an investor is long in one currency and short the other. A short position is one in which the trader sells a currency in anticipation that it will depreciate. This means that potential exists in a rising as well as a falling FX market. The ability to sell currencies without any limitations is one distinct advantage over equity trading. It is much more difficult to establish a short position in the US equity markets, where the Uptick rule prevents investors from shorting stock unless the immediately preceding trade was equal to or lower than the price of the short sale.

## Currency pairs

The currencies are always traded in pairs. For example, EUR/USD, which means Euro over US dollars, would be a typical pair. In this case, the Euro, being the first currency can be called the **base currency**. The second currency, by default USD, is called the **counter or quote currency**.

As mentioned, the first currency is the base, therefore in a pair you can refer the amount of that currency as being the amount required to purchase one unit of the second currency.

So, if you want to buy the currency pair, you have to buy the EURO and sell the USD simultaneously. On the other hand, if you are looking forward to sell the currency pair, you have to sell the EURO and buy the USD.

**The most important thing to understand in a currency pair, or more precisely in a Forex transaction, is that you will be selling or buying the same currency.**

## Major currencies

| Symbol | Currency |
|---|---|
| GBP | British Pound |
| USD | US Dollar |
| EUR | Euro |
| JPY | Japanese Yen |
| CAD | Canadian Dollar |
| CHF | Swiss Franc |
| AUD | Australian Dollar |

Ex.: EUR/USD = Euro/US Dollar

**Pip**
Price Interest point (Pip) is the term used in currency market to represent the smallest price increment in a currency. It is often referred to as ticks or points in the market. In EUR/USD, a movement from .9018 to .9019 is one pip. In USD/JPY, a movement from 128.50 to 128.51 is one pip.

**Volume**
The trading volume measures how much “money” is being traded. During some types of news breaks and when the New York’s exchange is open, the volume is obviously higher. The volume indicates us that more things can change. There no real strong correlation for volume, good trades is being developed even when the Forex volume is relatively low.

**Buying and Selling short**
Buying = term to use when buying a currency pair to open a trade.
Selling short = term to use when selling a currency pair to open a trade.
Both terms, refer to things we do to open a trade.
On the other hand, to exit a trade, you will have to use the terms "selling" and "buying-back". The term "selling" refers to what we do to exit a trade that initially started by "buying". The term "buying-back" refers to what we do to exit a trade that initially started by "selling-short".
Basically the term, "selling-short" can be referred to the futures and commodities market. For instance the mentality of buying a field to plant vegetables that will grow in the future is the same thing than buying a currency and to predict that it will eventually go short.

**Bid/Ask Spread**
A spread is the difference between the bid and the ask price. The bid price is the price at which you may sell your currency pair for. The ask price is the price at which you must buy the currency pair. The ask price is always higher then the bid price. Profits in the market are made from charging the ask price for a currency pair and buying it from someone else at the bid price.
The bid/ask spread increases when there is uncertainty about what is going to happen in the market.

## Technical Definitions

**Trading Platform**
A trading platform is, along with the charts, one of the most important tools that a trader will be using while trading on the Forex market. By definition, a trading platform is an exchange account where you can buy and sell a currency.

**Entry Stop**
An entry stop is executed when the exchange rate breaks through a specific level. The client placing a stop entry order believes that when the market's momentum breaks through a specified level, the rate will continue in that direction. The execution of a stop entry order may involve a limited degree of slippage, usually two pips or less.

**Entry Limit**
An entry limit is executed when the exchange rate touches (not breaks) a specific level. The client placing a limit entry order believes that after touching a specific level, the rate will bounce in the opposite direction of its previous momentum. Limit entry orders are always executed at the specified level.

## Types of Forex Orders

**Market Order** – An order where you can buy or sell a currency pair at the market price the moment that the order is processed.

Example: If you are looking to place an order for JPY when the dealing price is 104.00/05, a market order will request to buy JPY at 104.00 or will request to sell JPY at 104.05.

**Entry order** – An order where you can buy or sell a currency pair when it reaches a certain price target. In theory, this can be any price. You can set an entry order for the low price of a time period or the high price of a time period.

“I want to buy this currency pair at a certain price, if it never reaches that price, I don’t want to purchase the pair”.

The entry order allows you to choose a price and place an order to buy at that price.

**Stop Order** - An order that becomes a market order when a particular price level is reached and broken. A stop order is placed below the current market value of that currency.

Example: If you have an open buy JPY position, which you bought at 104.00 and you want to set a stop order in case JPY’s value starts to depreciate (to stop your loss). Since the JPY’s currency appreciates when the dealing rate moves from 104.00 closer to parity with the USD (102 JPY/1USD), a movement in the opposite direction would necessitate a stop order. For instance, you could set a stop order rate to sell JPY at 103.50, thus closing your position at a 50-pip loss.
**Limit Order** - An order that becomes a market order when a particular price level is reached. A limit order is placed above the current market value of that currency.
Example: If you have an open buy JPY position, which you bought at 104.00, and you want to set a limit order to protect your profit, you would set a limit order at a number, which indicates that JPY has appreciated, such as 104.5. When the market reaches 104.5, your position will automatically be closed, resulting in a 50-pip gain.

## Players in the Forex Market

**Central Banks** - The national central banks play an important role in the (FOREX) markets. Ultimately, central banks seek to control the money supply and often have official or unofficial target rates for their currencies. As many central banks have very substantial foreign exchange reserves, their intervention power is significant. Among the most important responsibilities of a central bank is the restoration of an orderly market in times of excessive exchange rate volatility and the control of the inflationary impact of a weakening currency.

**Banks** - The Interbank market caters to both the majority of commercial turnover as well as enormous amounts of speculative trading. It is not uncommon for a large bank to trade billions of dollars daily. Some of this trading activity is undertaken on behalf of corporate customers, but a banks treasury room also conducts a large amount of trading, where bank dealers are taking their own positions to make the bank profits.

**Interbank Brokers -** Until recently, foreign exchange brokers were doing large amounts of business, facilitating Interbank trading and matching anonymous counterparts for comparatively small fees. With the increased use of the Internet, a lot of this business is moving onto more efficient electronic systems that are functioning as a closed circuit for banks only.

**Commercial Companies -** The commercial companies' international trade exposure is the backbone of the foreign exchange markets. A multinational company has exposure in accounts receivables and payables denominated in foreign currencies. They can be protected against unfavorable moves with foreign exchange. That is why these markets are in existence. Commercial companies often trade in sizes that are insignificant to short term market moves, however, as the main currency markets can quite easily absorb hundreds of millions of dollars without any big impact. It is also clear that one of the decisive factors determining the long-term direction of a currency's exchange rate is the overall trade flow.

Some multinational companies, whose exposures are not commonly known to the majority of market, can have an unpredictable impact when very large positions are covered.

**Retail Brokers -** The arrival of the Internet has brought us a host of retail brokers. There is a numbered amount of these non-bank brokers offering foreign exchange dealing platforms, analysis, and strategic advice to retail customers. The fact is many banks do not undertake foreign exchange trading for retail customers at all, and do not have the necessary resources or inclination to support retail clients adequately. The services of such retail foreign exchange brokers are more similar in nature to stock and mutual fund brokers and typically provide a service-orientated approach to their clients.

**Hedge Funds -** Hedge funds have gained a reputation for aggressive currency speculation in recent years. There is no doubt that with the increasing amount of money some of these investment vehicles have under management, the size and liquidity of foreign exchange markets is very appealing. The leverage available in these markets also allows such a fund to speculate with tens of billions at a time. The herd instinct that is very apparent in hedge fund circles was seen in the early 1990's with George Soros and others squeezing the GBP out of the European Monetary System.

**Investors and Speculators -** In all efficient markets, the speculator has an important role taking over the risks that a commercial participant hedges. The boundaries of speculation in the foreign exchange market are unclear, because many of the above mentioned players also have speculative interests, even central banks. The foreign exchange market is popular with investors due to the large amount of leverage that can be obtained and the liquidity with which positions can be entered and exited. Taking advantage of two currencies interest rate differentials is another popular strategy that can be efficiently undertaken in a market with high leverage. We have all seen prices of

30 day forwards, 60 day forwards etc, that is the interest rate difference of the two currencies in exchange rate terms.

## Daily or Position Trader, their strengths and weaknesses

*Day-trading overview*

Day-trading, which was once the exclusive domain of the floor trader, is now fair game for all speculators. Inspired in part by large intraday price swings, instant availability of quotes, affordable high-powered computers and competitive commissions, the new wave of day-trading methods and systems has attracted thousands of traders in recent years. The undeniable thrill of trading within the time span of one day is, however, a double-edged sword: one that can hurt as well as heal. To be successful, a day-trader must have the discipline of a machine, the instincts of a fox, the emotions of a rock, the skills of a surgeon and the patience of a saint. (And a little luck wouldn't hurt either.) The day trader works more with the emotions along with the fundamental analysis.

**Definition**
Very active currency trader who holds positions for a very short time and makes several trades each day. Day traders are individuals who are trying to make a career out of buying and selling stocks very quickly, often making dozens of trades in a single day and generally closing all positions at the end of each day. Day trading can be costly, since the commissions and the bid/ask spread add up when there are so many transactions.

*Position Trading Overview*
Position Trader looks for occasional significant moves that may unfold quickly or over time. It patiently waits for ideal trade setups to occur during minor and major trend reversals in certain sectors, indexes or entire broad markets. Determination of these potential setups is derived from technical indicators, chart patterns, point and figure charts and fundamental news events. Once a move shows sign of development, hourly and intraday charts are monitored for optimum entry.

**Definition**
Currency trader who, unlike most traders, takes a long-term, buy and hold approach. In currency trading, «long-term» refers to holding until the delivery date is close, usually 5-7 months.

Basically, a position trade approach is to enter the markets only during times of key reversal probability in order to capture large moves as they gradually or quickly unfold. It is designed for traders who favor a gradual, buy and hold approach when ideal trade conditions exist for high-odds success.