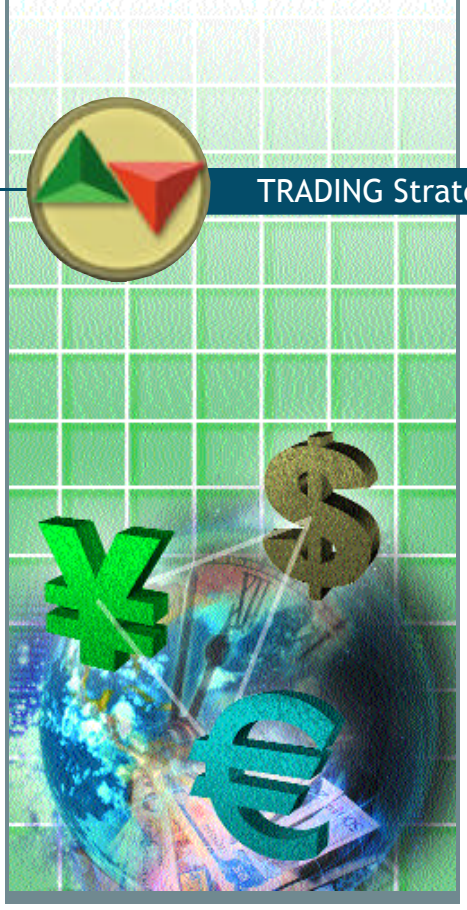


Cashing in on short-term CURRENCY TRENDS

Trends may be rarer than trading ranges, but that doesn't mean they can't be traded. This strategy uses two time frames to identify the trend, an overbought-oversold indicator to pinpoint entry and a trailing stop to protect gains on profitable trades.

BY TIMOTHY O'SULLIVAN

Many technical trading strategies revolve around the assumption that markets will hover within a given range — and with good reason. Seventy percent of the time markets will bounce back and forth between support and resistance levels, or fluctuate randomly. The rest of the time, market behavior is characterized by persistent price moves — trends — that shatter support and resistance levels.

Although these basic probabilities work against traders who try to exploit trends, the potential rewards can be worth the risk. It is possible to increase your ability to capitalize on trends by locating trend signals, identifying specific entry points within the trend and using risk management techniques to limit losses.

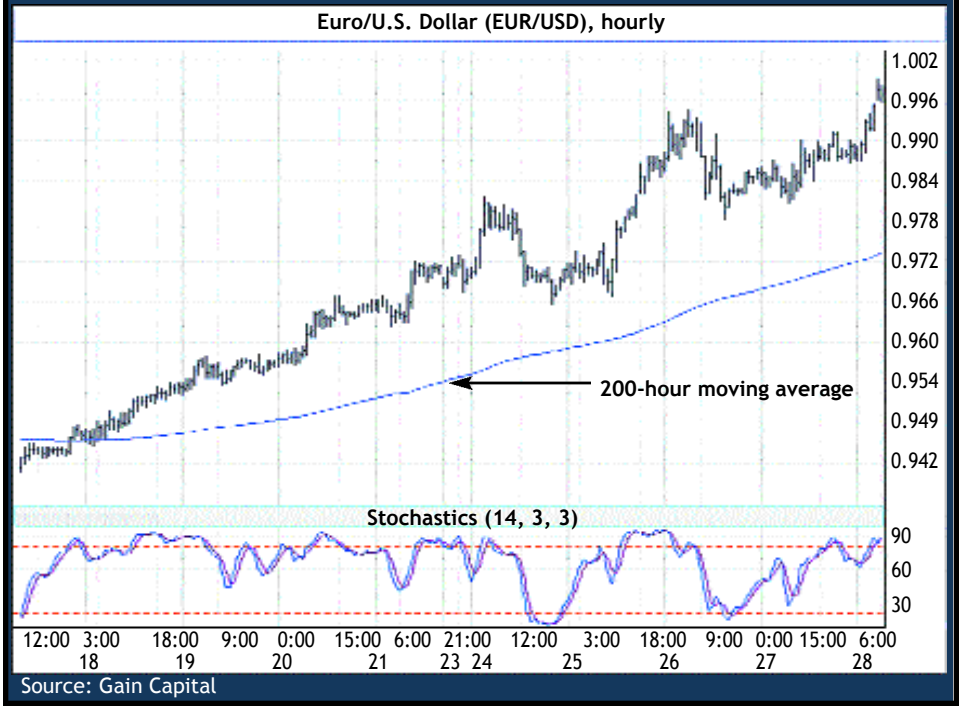
The following sections will explain how a trading system based on these concepts works especially well in the foreign exchange (Forex), or currency, market, particularly with the "major" currencies — the U.S. dollar, Euro, Japanese yen, British pound, Swiss franc, Canadian dollar and Australian dollar. More than 85 percent of transactions in the $1 trillion per day Forex market involve the majors.

Tools and rules

The strategy uses two charts with different time periods (10-minute and hourly), along with two technical indicators: a 200-bar moving average and a 14-bar slow stochastic study (see "Stochastic

FIGURE 1 LONG TRADE, HOURLY TREND

With price consistently above the 200-bar moving average, the hourly chart reflects the prevailing uptrend.



Source: Gain Capital

refresher," right).

Step 1: Identify a trend. Compare the moving averages on the 10-minute and hourly charts. A trend is in effect when price is consistently above/below the moving averages on both charts.

Step 2: Pinpoint entry. Once you've identified a trend, look for the following two conditions at the same time on the 10-minute chart: 1) the market is no more than 20 points above (to buy) or 20 points below (to sell) the moving average; and 2) the fast stochastic line crosses above the slow stochastic line below 20 (to buy) or crosses below the slow stochastic line above 80 (to sell).

These conditions indicate: 1) the currency is currently in a short-term uptrend or downtrend; and 2) the currency has paused or pulled back (reflected by the higher low stochastic reading and the fact that price is within 20 points of the moving average) and is poised to turn (because the fast stochastic line is crossing back above or below the slow line).

Step 3: Ride the trend. Set a trailing stop after the initial trade entry. On a long position, enter a stop-loss order 10 points below the 200-period moving average on the 10-minute chart. In the case of a short position, place the initial stop 10 points above this moving average. As the trade goes in your favor, raise (for a long trade) or lower (for a short trade) the stop to protect profits. For simplicity's sake, the following examples use a trailing stop 25 points from each new top or bottom. The charts in the next section illustrate the application of this strategy in two currency pairs.

Trade examples

The first example took place in the Eurocurrency-dollar (EUR/USD) currency pair during the fourth week of June 2002. (For those unfamiliar with currency quoting and charting conventions, see "Quoting currencies," p. xx.)

First, compare the hourly and 10-minute EUR/USD charts. Look for a time when price is above the 200-period moving averages on both charts. On the hourly chart (Figure 1, opposite page), the fact that price is almost exclusively above the 200-hour moving average indicates a persistent uptrend. On the 10-minute chart (Figure 2, top left), price moves (and remains above) the moving

continued on p. x

Stochastic refresher

The stochastic oscillator consists of two lines: %K and a moving average of %K called %D.

The basic stochastic calculation compares the most recent close to the price range (high of the range - low of the range) over a particular period. A basic five-bar stochastic calculation is the difference between the most recent bar's close and the lowest low of the last five days divided by the difference between the highest high and the lowest low of the last five days. The result is multiplied by 100. The formula for this calculation, which is %K, is:

$$\%K = 100*\{(C_t-L_n)/(H_n-L_n)\}$$

where

C_t = the most recent bar's closing price

L_n = the lowest price of the most recent *n* bars

H_n = the highest price of the most recent *n* bars
(for a stochastic calculated on daily bars, the default is five days)

The second line, %D, is simply a three-period moving average of %K:

average(%K,3)

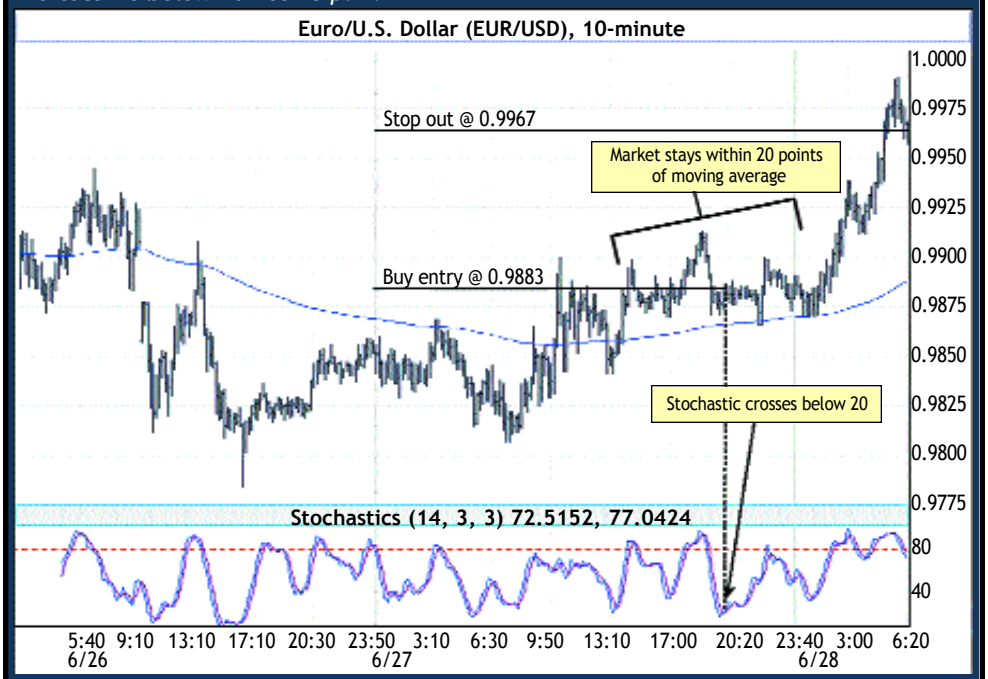
Because this basic "fast" stochastic calculation is very volatile, an additionally smoothed version of the indicator, where the original %D line becomes a new "slow" %K line and a three-period average of this line becomes the "slow" %D line, is more commonly used.

The stochastic can be made to reflect longer- or shorter-term price movement and to be less or more sensitive to small price fluctuations by increasing or decreasing the number of bars used to calculate %K and/or increasing or decreasing the length of the moving average used to calculate %D. For example, a stochastic using a 10-bar %K and a three-bar moving average for %D [stochastic(10,3)] would be shorter-term and more sensitive than a stochastic using a 20-bar %K and a five-bar moving average for %D [stochastic(20,5)].

Seventy percent of the time markets will bounce back and forth between support and resistance levels, or fluctuate randomly.

FIGURE 2 LONG TRADE, 10-MINUTE TREND

Price is also above the 200-bar moving average in the final third of the 10-minute chart. The market moves within 20 points of the moving average between 1 p.m. and midnight on June 27. The entry is finally signaled when the fast stochastic line crosses above the slow line (a sign of renewed upside momentum) when the indicator is below 20 near 8 p.m.



Source: Gain Capital

FIGURE 3 SHORT TRADE, HOURLY TREND

On June 27, the down trending USD/JPY traded consistently below the 200-hour moving average.

Source: Gain Capital

Although the basic probabilities work against traders who try to exploit trends, the potential rewards can be worth the risk.

average in the last third of the chart. The next step is to pinpoint the entry zone — when the market is within 20 points of the moving average on the 10-minute chart and the stochastic lines cross.

The range between 1 p.m. and midnight on June 27 meets these requirements. The entry point occurs when the fast stochastic crosses above the slow stochastic when the indicator is below 20. A long position is entered at .9883 around 8 p.m., with an accompanying stop-loss at .9858 (10 points below the 200-bar moving average value of .9868). The stop is then trailed upward as the market makes new peaks. The EUR/USD tops out at .9992, so the stop scaled up to .9967, where the position was closed for an 84-point ($840) gain.

Figures 3 and 4 illustrate a similar example in the dollar-yen rate (USD/JPY). The hourly chart (Figure 3, bottom left) shows price was trading well below the 200-bar moving average after June 21. On the 10-

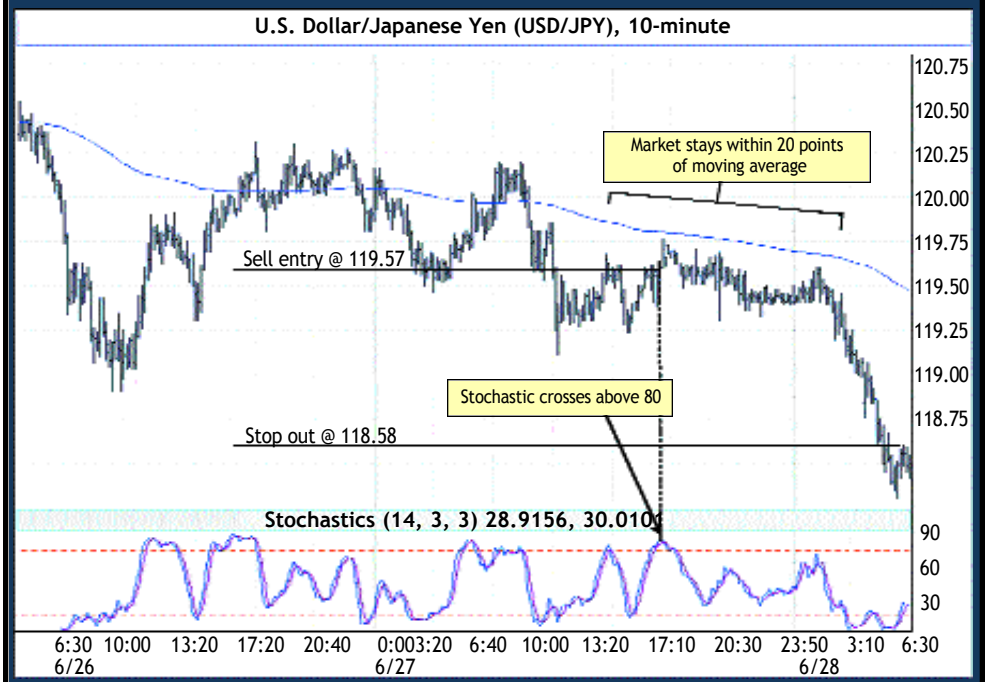
continued on p. x

minute chart (Figure 4, below), price fell below the moving average after 10 a.m. on June 27, indicating a sell opportunity. Also, price was within 20 points of the moving average at this point. A short trade was opened around 5 p.m. at 119.57 when the fast stochastic line crossed below the slow stochastic line when the indicator was above 80.

The trade was protected with a stop-loss order at 119.86. In this case, the stop remained intact until the following day, when USD/JPY began to decline. After trailing the stop down as the market continued to decline, profits were taken at 118.58 (25 points off the 118.33 low), for a gain of 99 points.

FIGURE 4 SHORT TRADE, 10-MINUTE TREND

On the 10-minute USD/JPY chart, a stochastic crossover (above 80) occurred around 5 p.m. — while price was below (but within 20 points of) the 200-bar moving average — signaling a short trade.



Source: Gain Capital

Search and exploit

This short-term trading method works well in the Forex market, but it is also applicable to others. Each step of the system helps identify areas where effective trades can be made. If at any point one of the criteria is not met, you'll instantly know not to make a trade. This model also gives you the freedom to experiment with different chart intervals. When you're equipped with a system that can help you catch the trend early, you can wait for the rest of the market to follow.

For information on the author see p. xx.

Quoting currencies

Because currencies are quoted in a different manner than equities, reading a foreign exchange quote may seem a bit confusing at first. However, it's really quite simple if you remember two things: 1) The first currency listed first is the *base* currency and 2) the value of the base currency is always 1.

For example, if you see a quote of USD/CAD 1.54825, that means that one U.S. dollar is equal to 1.54825 Canadian dollars. Likewise, USD/JPY 122.01 shows that one U.S. dollar is equal to 122.01 Japanese yen.

In every trade involving the U.S. dollar, the dollar will be the base currency, with three exceptions — the British pound (GBP), the Australian dollar (AUS) and the European currency unit, or Euro (EUR). In these cases, you might see a quote such as GBP/USD 1.4366, meaning that one British pound equals 1.4366 U.S. dollars.

Whenever the U.S. dollar is the base unit and a currency quote goes up, it means the dollar has appreciated in value and the other currency has weakened. If the USD/JPY quote we previously mentioned increases to 123.01, the dollar is stronger because it will now buy more yen than before.

However, in the three instances where the U.S. dollar is not the base rate, a rising quote means a weakening dollar, as it now takes more U.S. dollars to equal one pound, Euro or Australian dollar.

In other words, if a currency quote goes higher, that increases the value of the base currency. A lower quote means the base currency is weakening.

Trades that do not involve the U.S. dollar are called cross rates, but the premise is the same. A quote of GBP/CHF 2.4577 signifies that one British pound is equal to 2.4577 Swiss francs.