E-forex: Currency trading for the rest of us

Foreign exchange markets are no longer just the domain of large traders with multi-million dollar accounts and connections at big banks. The e-forex revolution is here and is providing traders of all sizes legitimate options for trading foreign exchange.

By Abe Cofnas

The world is not round – it can be best understood in three parts: The U.S. dollar, the Japanese yen and the euro.

An average individual armed with a computer, a mouse and an Internet connection can trade spot currencies from 19:00 (EST) on Sunday evening to 17:00 (EST) on Friday evening. It seems overnight an industry has sprung up to satisfy this market. Firms that didn't exist one or two years ago are growing at 20% per month.

Such firms often provide free charts, signals, quotes, technical analysis, full simulation platforms and sometimes even financing to open an account. Futures commission merchants and introducing brokers are racing to offer e-forex trading — as if trading and servicing exchange-traded futures accounts isn't difficult enough (see "The effects of FX," page 78).

What before was the domain of banks, corporations and funds is now accessible to everyone. E-forex, or direct access trading of spot currencies, is now easier than ever, and, like electronic trading of stocks, it is here to stay. It has the potential to revolutionize investment behavior and provide more trading opportunities than ever before.

Just consider the leverage. E-forex trading can boast levels far higher than futures and certainly equities. It's common for trading platforms to offer 50-to-1 and 100-to-1 leverage, enabling trading of $100,000 worth of a foreign currency (considered a one-lot) with only 2%, or $2,000, cash in the account. More than $1 trillion is traded throughout the world every day.

See spot trade Before you start to trade spot foreign exchange, you will need an understanding of this market and how it operates. Its features are distinct and different from futures trading. Here's a summary of the key differences:

• There is no official price for a spot currency. In the currency futures market, everyone sees the same price. In the spot currency market, rates are negotiated trades between buyer and seller. A quote delivered by a particular firm is a representation of the price.

• Spot currencies have no available volume data.

• The spot currency options market is not accessible to the retail public. OTC options on spot currencies are limited to large accounts. The Philadelphia Exchange offers exchange-traded currency options, but at this time most of the e-forex firms are not registered to offer this instrument. Further, most equity firms do not offer e-forex. The result is the retail trader is denied access to an important trading tool.

• There is little, if any, broker-assisted trading,

ONE SIDE OF THE BOAT

The chart shows the downward spiral of the euro in response to the better-than-expected NAPM report released on Sept. 4. This kind of move happens often in currencies.

Source: Actforex Java Charting Tool

resulting in the need for total self-learning.

• News is fragmented and difficult to access. Reuters and Bloomberg provide the news to institutions, but a retail trader without these services is trading in the dark. Too often, the news is too late in arriving to be of any real trading value.

These features are inherent in trading e-forex. But to be forewarned is to be forearmed. The opportunity to pinpoint several trading opportunities on a 24-hour basis with leverage of 100-to-1, enabling the trading of $100,000 of a foreign currency with only 2% cash in the account, is an overwhelming attraction for anyone who loves to trade.

Currencies & economic fundamentals An e-forex trader needs to brush up on fundamental knowledge as well as learn how to use basic technical tools. Currency prices often reflect the underlying strength or weakness of the country's economy. For example, the strength of the dollar reflected the boom of the U.S. economy over the past decade. If U.S. economic growth is declining or is expected to decline, the expected return on American assets will fall, and the U.S. dollar may be pressured relative to other currencies.

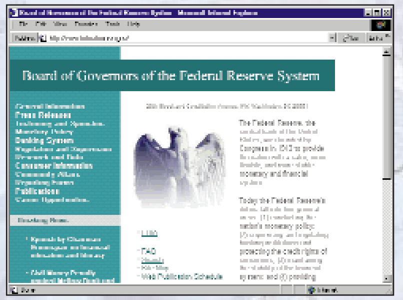
Knowledge of macroeconomic fundamentals is critical for trading any currency (see "The Fundamentals of Forex," *Futures*, May 2001). For example, Japan has suffered a no-growth economy for years, and its nominal interest rates have hovered near 0%. A trader needs to know that a strong yen is not a solution to these problems. Therefore, in periods where the yen strengthens, traders should be wary of an official policy response to drive the yen lower. Japan cannot tolerate a strong yen for long, and the Bank of Japan (BoJ) will do whatever is necessary to keep it within a target range. If a currency is very strong, the trader needs to know who is hurt and who is helped by that condition. A strong yen hurts the Japanese exporter who has to sell to the United States. It helps the U.S. car makers in competition with Japanese exports.

Euro traders need to recognize that even if the European economy is growing, the trading bias is for the dollar to rebound because European productivity is significantly less than American levels. The pattern for the euro has been a reversion to its trend after a news shock. The euro's reaction to American news surprises, such as the Sept. 4, 2001, National Association of Purchasing Managers report, indicates an inherently high volatility level for this currency (see "One side of the boat," left). It also suggests that euro traders tend to travel in large stampede-prone herds. The Sept. 11 events further confirmed to euro traders and, in general, all forex traders how the currency markets swing in relationship with and in reaction to the equity markets. Forex trading, while disrupted in New York, did not stop when the U.S. equity markets closed.

BOOKMARK IT!

The Web sites of the major central banks should be at the top of your bookmark list.

U.S. Federal Reserve Bank: www.federalreserve.gov



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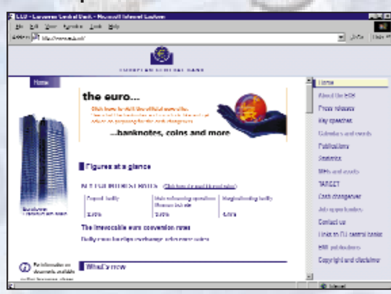
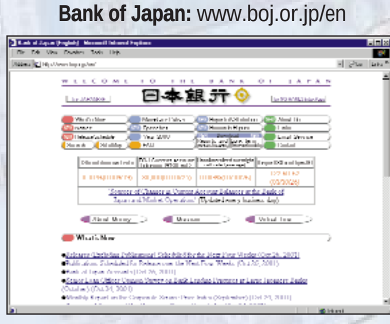


Bank of Japan: www.boj.or.jp/en



Currency traders need to develop a global perspective and a feel for intermarket relationships. Interest rate trends are the most important external information source. If the U.S. Federal Reserve cuts rates, then the dollar should weaken. However, if the European Central Bank (ECB) is expected to follow suit, interest rate trends will converge, and the value of the currency may not change at all. You need to follow not only Fed Chairman Alan Greenspan, but his counterparts in the ECB and the BoJ as well (see "Bookmark it!" left). Finally, though few e-forex firms track other markets, the savvy currency trader should monitor gold. If the price of gold rises in a given currency, it signals weakness therein. Nothing may signal an end to global deflation trends faster.

Technical factors Currencies tend to be trendier than either stocks or physical commodities. It is important to understand the trend from both a fundamental and a technical point of view. The factors relating two economies or two sets of interest rates are more persistent than, say, weather factors in grains, so this shouldn't be a surprise. Currencies cannot reverse trends that easily because economies do not reverse quickly relative to one another.

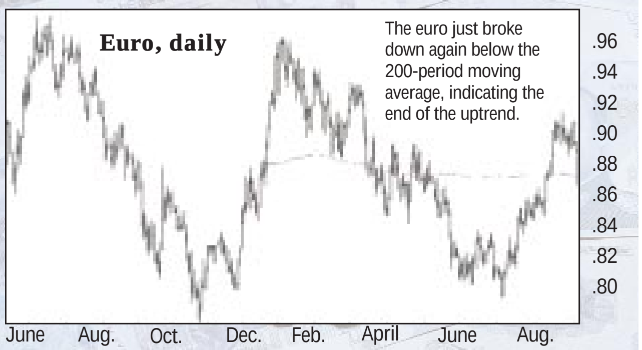
The forex trader likely will see a movement of data to try to offer better analytics, now available only to institutions. Quotespeed, currently a competitor to Bloomberg, includes point-and-figure analysis on spot currencies with its feed. Killney Investments offers a platform that allows advanced backtesting of indicators. The future looks bright for improvements in trading tools.

A successful trader will recognize how fundamentals and technicals combine to indicate a trend reversal. Of course, finding the trend reversal before it happens is the Holy Grail of trading, and you can't expect to be successful 100% of the time. That doesn't stop software developers from trying though.

One of the packages devoted to currency trend analysis specifically is the neural net-based program at www.profittaker.com. This software uses intermarket analysis to project moving averages of currency futures, using spot prices, gold, S&P,

THE FUND MANAGER'S GAME

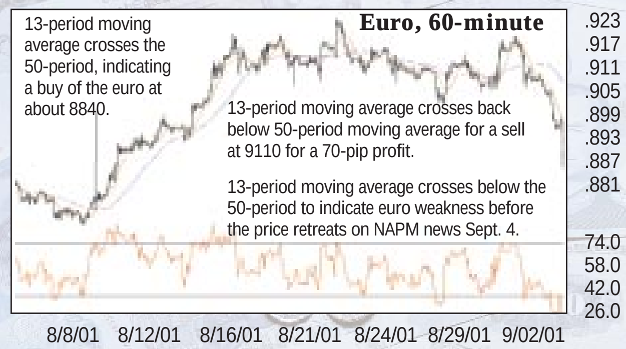
This is one example that illustrates how currencies can trade around the 200-day moving average, repeatedly regressing to the mean.



Source: Actforex Java Charting Tool

POWERS OF HOURS

The hourly time frame tends to capture most of the significant moves in currencies as well as provide some key support and resistance levels based on the bar highs.



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bonds and other variables for its forecast. Of course, other neural net software, such as Ward Systems Group's Neuroshell Trader, can be used to develop custom prediction models.

Trading guidelines Tackling any market is a challenge, but the difficulty can be alleviated somewhat by having a carefully constructed plan from which to operate. Here are some guidelines and steps that are useful in framing price action in currencies:

• Scan daily price chart action. Download the charts with your morning coffee and never ignore the action of the euro, Swiss franc, British pound and yen against the dollar. Plot a simple 200-day moving average to get the big picture. Big currency traders tend to be technical trend followers, and they will act on such simple signals as the crossover of a 200-day moving average. Buy it when it goes above, sell it when it goes below, and you'll be amazed at how tough this system is to beat (see "The fund manager's game," above).

• Read your favorite bank report. Every morning many of the large banks issue currency analyses. The Web site www.ecommerzbank.de/free/tech.pdf gives a good summary of the major currency markets.

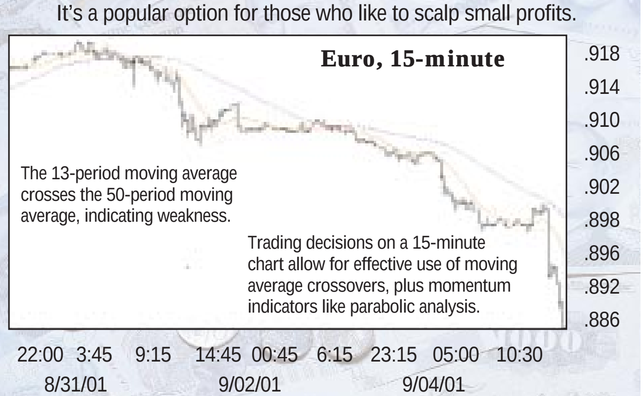
• Construct a 60-minute chart (see "Powers of hours," above). This time period is big enough to provide some important insights on the price action during the previous few hours. First, note the highs and lows of each 60-minute period. It is more difficult for the market to penetrate these 60-minute highs and lows than the ranges of the smaller time frames. Consider probable price action. The 60-minute chart will indicate levels whose rupture will lead to a new price direction.

There are many indicators viable for the 60-minute time frame, but a good start is a 13-/50-period moving average crossover. Simply look to buy when the 13-period average crosses above the 50-period average, and sell when it crosses below. The relative strength index (RSI) works well as a confirming tool. If the RSI crosses 50, it constitutes a signal, a bullish one when it crosses above and a bearish one when it crosses below. On the 60-minute chart, look to see if both the moving average crossovers and the RSI agree.

• Finally, take a look at a 15-minute chart (see "The 15-minute trader," below). Many traders try to get in and out of positions quickly. This is sometimes called "scalping." The 15-minute time frame is a good interval for this kind of trade. It is close to the action but leaves enough space for some objectivity and use of indicators. For this time frame, the 13-/50-period moving average crossover is useful as well; it can be enhanced greatly by a parabolic indicator, which keeps you in a position at all times. Currency markets move quickly intraday, and you have to pay to play.

THE 15-MINUTE TRADER

To supplement your 60-minute analysis, consider the 15-minute chart. It's a popular option for those who like to scalp small profits.



Source: Actforex Java Charting Tool

Your specific regimen will depend on your approach. Because currencies reflect economic realities and technical conditions, there are several trading styles you can consider.

Looking for breakout trades is a strategy that places orders to buy and to sell above and below the most recent points of resistance and support. It assumes that the currencies will move through one of the positions and keep going. It can be used for weekly, hourly and even 15-minute time periods. Its strength is that currencies move through support and resistance points. The weakness is too tight a stop can take your position out before it has a chance to profit.

Other traders will leg in and out of trades. This is a strategy that provides for multiple lot trading where lots are put on at different levels and times. For example, instead of buying three yen at one time, you trade one lot at the market,

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a second lot on the moving average crossover and a third lot on pure emotion.

Scalping or momentum trading seeks quick results. It is more difficult with currencies because volume data is missing. If scalping, get out quickly if you are wrong.

Trading & risk management Once a decision to trade has been made, the next step is to formulate a trading tactic. How many lots should traded. How should stops be used?

The most frequent error made by the beginning trader is position size. Trading one lot is the most popular. But trading one lot opens a trader up to sloppy, emotion-driven habits. For example, you may have a target of making $500 and have achieved it. Should you get in or out? What if you have promised your spouse a great dinner off your trading profits? You may wish to take the money and run, but what if your indicators still show to stay in the trade? What do you do? When trading a one lot, there is no clear answer. But when you add a second lot, you can use one lot to get in or out on the basis of emotion or cash management and the other lot for the technical indicator.

Generally, stops in currencies need to be much wider than a person initially assumes. A 50-pip stop, having a general value of $500 will allow for more of the volatility of the currency to be expressed without taking the trade out prematurely.

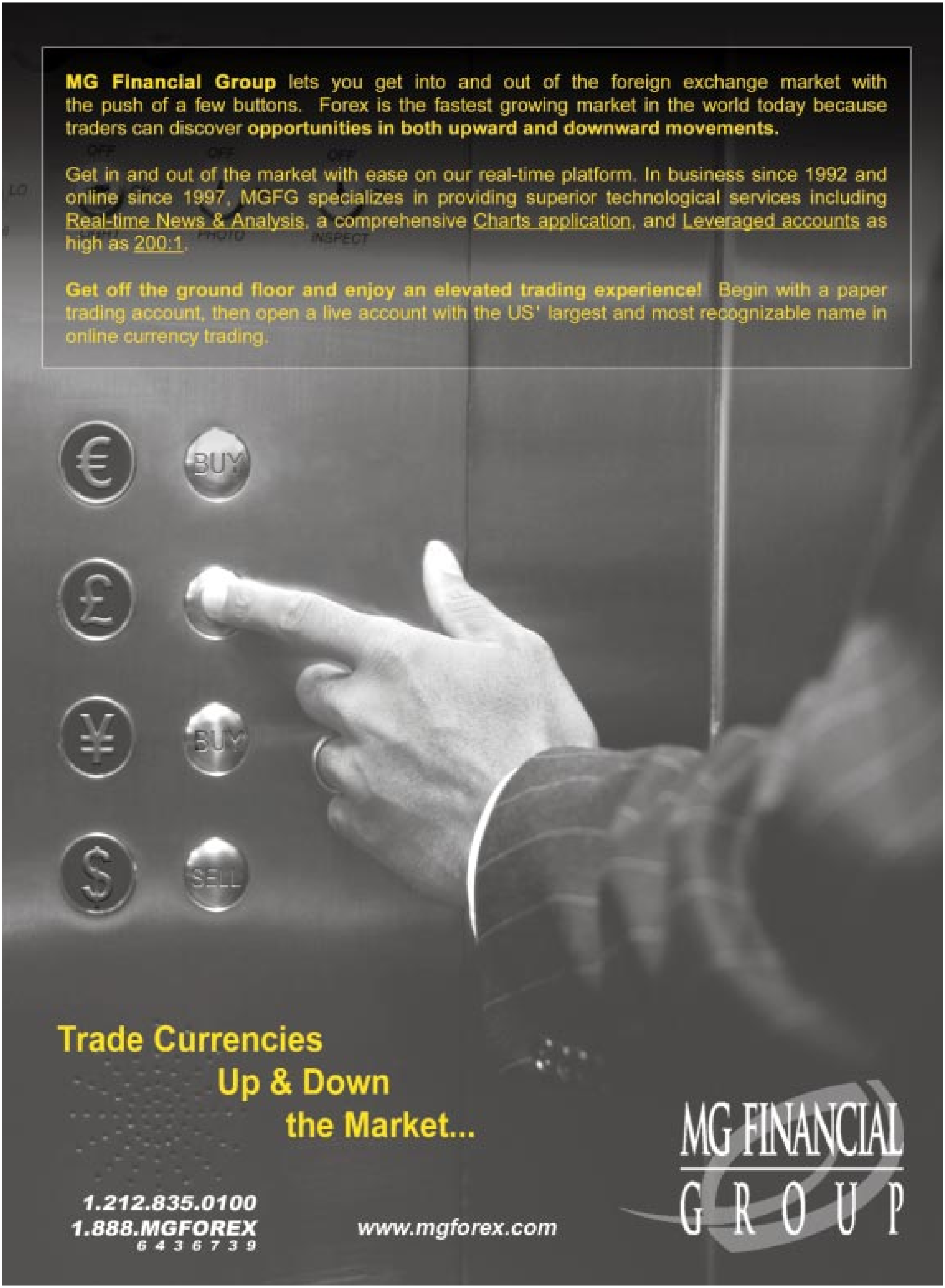
Ongoing improvement Education certainly is one of the most important challenges facing the currency trader. The e-forex platforms are designed to execute trades and not to educate the trader. The situation today for the beginner is like driving a car at night without a dashboard. A "digital dashboard" for currency trading is necessary to bring analysis and news to the trader without having to spend a great deal of time browsing the Web.

Still, there is one educational tool that the trading firms are best at providing. The e-forex trader has an advantage in access to demo, or paper trading, accounts. All of the e-forex firms offer a demo platform.

Although it sounds like a great learning tool, online paper trading has its pros and cons. Often a trader sees big gains in demo trading but loses money in real trading. This happens because demo trading removes the emotional conditions of a real trade. There is no fear or greed driving decisions. However, the demo platform can become an effective tool for training and improving your trading.

Use the demo to test new trading ideas, such as putting on two lots instead of one or putting on wider stops. Too often when people start trading, they abandon their demo account. In fact — and this should be emphasized — demo trading should be used all the time because trading is an on-going learning experience. **FM**

Abe Cofnas uses interactive chatrooms and whiteboarding technology in courses introducing forex and technical analysis at www.cms-forex.com, www.gaincapital.com and at www.dayforex.com. In the February issue, he will begin a bi-monthly column on trading the forex market. E-mail: forexlearningsystems@earthlink.net.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