Although many short-term traders have turned from stocks to the cash foreign exchange markets, most are still not trading cross rates. Here's an example of how you can apply Fibonacci fan lines and retracement analysis to the components of a cross rate.

Crossing over to the forex market

BY GARY TILKIN

All currency trades are cross rates. For example, if you buy or sell Japanese yen, you are normally buying or selling it against the U.S. dollar.

However, the dollar does not have to be the other side of the trade. A cross rate trade can be made up of any two individual currencies. This type of trade has an important business purpose as it allows manufacturers or their customers to hedge their currency risk during the period between when the order is placed and payment is made.

Some novice traders think that trading the cross rates is either less risky than trading currencies vs. the U.S. dollar or that they are giving away too much profit potential. These assumptions are incorrect and could prevent the trader from realizing profit opportunities in cross rates.

ANALYZING AUD/JPY

Let's focus on an example of the Australian dollar/Japanese yen (AUD/JPY) cross rate that is expressed as the number of Japanese yen it takes to buy one Australian dollar. As the monthly chart shows (see "Leveling off," right), the cross rate made a high of ¥121.70 in 1990 and a low of ¥56.13 in 2000. Although all of the standard technical methods can be used to analyze the cross rates, one that is quite useful and reliable in the forex markets is the combination of Fibonacci fan lines and retracement analysis.

One advantage of trading cross rates is that you can analyze all of the components including the U.S. dollar (USD) — the AUD/JPY itself, AUD/USD and JPY/USD. This can help you not only determine whether to buy or sell but also how to time the entries and the exits. To be accurate in your Fibonacci analysis, you must have long-term data. Just like other technical methods, the longer-term analysis is more reliable than the short-term because the market noise is less of a factor.

For each cross rate or market that is traded, it is helpful to keep a file on the various Fibonacci levels. Most software programs and forex platforms have built-in Fibonacci analysis, but, nevertheless, many traders still use a spreadsheet program to calculate the retracement levels. Once you have determined the price extremes, you easily can calculate the retracement support or resistance levels.

"Leveling off" shows four retracement levels drawn from the 1990 high (¥121.70) to the 2000 low (¥56.13). The first, and often omitted, Fibonacci level is the 23.6% retracement resistance at ¥71.88, followed by the 38.2% at ¥81.62 and the 50% level at ¥89.64. When the cross rate came close to

When many stocks and stock indexes were moving up to astronomical heights in the late 1990s, day-traders were drawn to the stock market because of the leverage and liquidity that held the potential for dramatic profits with limited resources. Since the highs of early 2000, many short-term traders who survived the debacle in the stock market have turned to the cash foreign exchange markets, still the largest and most liquid market in the world. However, very few individual traders consider trading the non-U.S. dollar cross rates. Trading cross rates may expand your trading horizon.

retesting the lows in September 2001, a potential double bottom was forming, and these retracement levels took on a greater significance.

The Fibonacci fan lines bring the time component into play. These fan lines are derived by drawing a trendline between two price extremes. Then an "invisible" vertical line is drawn through the second extreme point. The three fan lines are then drawn from the first extreme point so they pass through the vertical line at Fibonacci retracement levels of 38.2%, 50.0% and 61.8%.

The weekly chart (see "Fanning out," right) provides a closer look at the cross rates, focusing on the 1997 peak and the 2000 low. Additional retracement levels are drawn using these two extremes, and the Fibonacci fan lines also are included. One of the key tenets of Fibonacci analysis is that, after one level of support or resistance is broken, a rally or decline to the next Fibonacci level is likely.

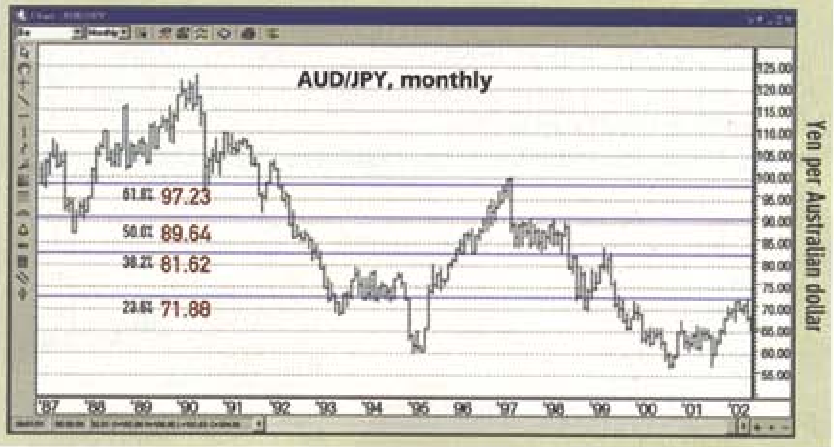
The 38.2% fan line (1) was overcome during the week of Nov. 12, 2001, with the close at ¥64.22 (point A). This generated several upside targets including the 50% fan line (2) that was then at ¥70.72. Equally important, the monthly 23.6% resistance level stood at ¥71.88, and the weekly 38.2% resistance, derived from the high at ¥97.72 and the low at ¥55.54, was at ¥72.24. Longs established on the opening the following week at ¥64.27, therefore, had a target zone at ¥70.72 to ¥72.24 with a midpoint of ¥71.48.

COMPLEMENTARY ANALYSIS

The Australian dollar peaked in early 2000 at $0.6687, but it dropped to a low of $0.4775 in April 2001 (see "Bottoming out," right). The 38.2% fan line was overcome in August 2001 (point A), suggesting the Australian dollar could be bottoming. When the 50% fan line was surpassed on Dec. 17, 2001 (point B), it projected the Australian dollar should move to 38.2% retracement of $0.5514, if not 50% retracement resistance at $0.5745.

LEVELING OFF

The AUD/JPY monthly chart shows the cross rate pausing at Fibonacci retracement levels drawn off the high and low.

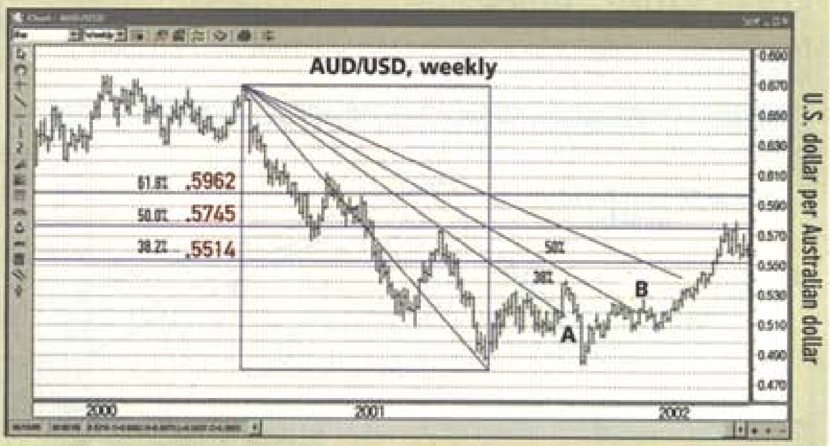


FANNING OUT

Bringing in a time element, Fibonacci fans provide more clues as to where the AUD/JPY cross rate might find support or resistance on the weekly chart.

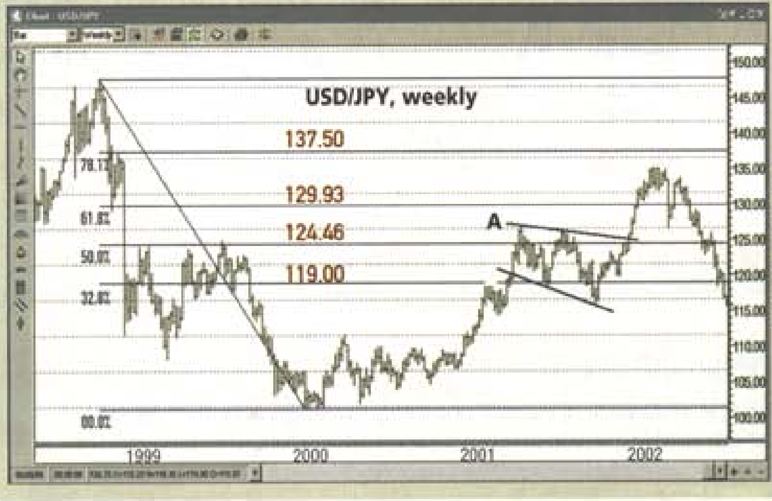
BOTTOMING OUT

The AUD/USD weekly chart provides additional evidence that the Australian dollar might be bottoming out.



U.S. DOLLAR INFLUENCE

The USD/JPY weekly chart provided additional evidence of a stronger dollar (weaker yen) that supported an AUD/JPY cross rate trade.



Looking at the U.S. dollar vs. the yen, the U.S. dollar bottomed in November 1999 as the dollar rose from ¥101.26 to a high of ¥126.84 in April 2001 on the weekly chart (see point A on "U.S. dollar influence," above). The dollar then weakened (the yen strengthened) as it formed a classic continuation pattern (short-term trendlines) and dropped just below the daily 38.2% retracement support at ¥117.12.

The stronger 50% support level at ¥114.81 was not tested before the U.S. dollar resumed its uptrend. The next upside target was the weekly 61.8% retracement resistance of the decline from ¥147.50 to ¥101.26, which stood at ¥129.93. The minor weekly 78.1% retracement level was at ¥137.50.

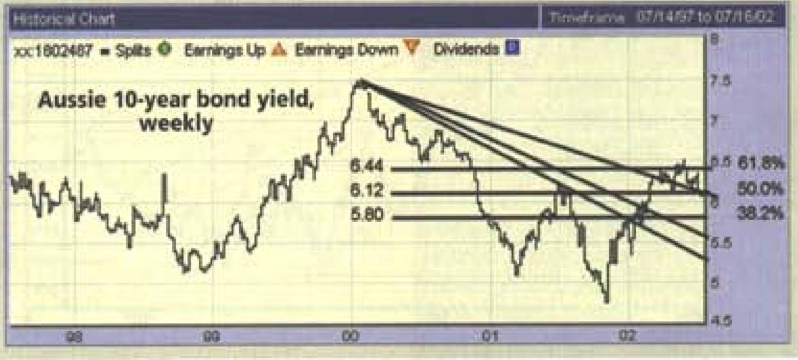
The analysis of the Australian dollar and yen, and other data, also supported buying the AUD/JPY. It is generally thought that the majority of cash forex traders make their decisions based on fundamental rather than technical information as technical analysis is still mistrusted by many institutions. Although technicals are vital, fundamental information should not be ignored. It also can be very valuable to look at fundamental data using technical analysis.

For forex traders, interest rate levels are always a factor. Fundamental traders often just want to buy the high-yielding currencies and sell the low-yielding currencies. However, without the input from technical analysis, this is a dangerous way to trade. When the interest rate analysis supports the technical position, it can add further validation to your trade decision.

In the case of the AUD/JPY, a good fundamental reason also favored buying the AUD/JPY. While interest rates in Japan have held below 2% since early 1999, the weekly chart of the Australian 10-year bond shows that the yields dropped from a high of 7.5% in early 2000 to a low of 4.75% in September 2001 (see "Supporting role," below). The yields started to rise in the latter part of 2001. The 38.2% fan line was broken in early 2002, and the 50% fan line was surpassed five weeks later. This indicated that yields should rise to 6.12%, the 50% retracement level, or even to 6.44%, the 61.8% retracement level.

SUPPORTING ROLE

The weekly chart of Australian bond yields also adds fundamental interest rate support for the AUD/JPY cross rate position.



DESIGNING THE TRADE

When the 38.2% fan line was overcome in mid-November 2001 (point A on "Fanning out"), it suggested that the cross rate was moving higher. At the same time, analysis of the Australian dollar and yen vs. the U.S. dollar also supported the view that the Australian currency would strengthen vs. the yen. From the Fibonacci analysis, you could calculate a variety of upside targets so that the trade could be analyzed from a risk/reward perspective.

For the AUD/JPY, the combination of the weekly fan lines and weekly/monthly Fibonacci retracement analysis provided a target zone in the ¥70.72-¥72.24 area with a midpoint of ¥71.48. The Australian dollar analysis suggested that it could rally to the $0.5514-$0.5745 level that represented the weekly 38.2% and 50% retracement resistance. The midpoint of this range was $0.5629.

As for the yen vs. the U.S. dollar, the