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Welcome to Forex

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Go to a dinner party and mention your involvement with forex and you're likely to get a few baffled looks. Most people don't have a clue what forex is or how it works. Worst of all, neither do most beginning forex traders. Understanding what makes these markets tick is a good step towards a successful trading record.

ANALYSIS

- Get the answers to the most frequent questions about the foreign exchange marketplace.

ACTION

- Learn more about the other forces that shape forex.
- Choose a few basic trading strategies to get started.
- Start trading, but don't bet the farm.

RELATED MATERIAL

Test-drive FX Engines for free online at www.fxengines.com to see the power of system building, system testing, and system automation.

ABOUT THIS REPORT

The Forex Report is a periodic publication that investigates advanced strategies for superior trading performance in the foreign exchange markets. These reports utilize advanced statistical and econometric modeling techniques to create new insight into the trading strategy of the average trader. This Core Concept Brief, Welcome to Forex, is intended for traders with all levels of forex trading experience and technical analysis understanding.

To learn more about The Forex Report or to register for delivery of all future reports by email, including Case Studies & Data Briefs, please visit www.fxengines.com.

ANALYSIS

Forex is full of many concepts that are foreign to traders who have previously specialized in stocks or commodities. Understanding these aspects of forex is a key to making you more comfortable in this new trading environment.

Q: What is forex?

A: Forex is the foreign exchange marketplace where currencies from different countries are valued and exchanged. Most people only know about forex to the extent that they have changed money going from one country to another. When they did so, they unwittingly played a role in the world's biggest marketplace. Forex trades almost $2 trillion per day, a total that exceeds all of the world's biggest – and better known – markets.

Since currencies are valued differently, there is a market in place to set those values. Where a market exists speculation inevitably follows. In this case, the market is hyper-active. Banks sending deposits around the world, corporations hedging their exposure to currency risk in different countries, government banks forwarding national economic goals through monetary policy, and massive investment funds playing the role of speculator. Not long ago, that was the extent of the market. It was the domain of the professional trader or banker.

The word "market" usually invokes the idea of a central market place like the New York or London exchanges. This is not the case in forex. Instead, forex functions through what is known as the "interbank" market. Interbank is a fancy way of saying that banks trade with each other, absent a central market place. This is one major reason why volume data is not available for forex. It's also the reason why retail investors and smaller traders were left on the sideline for so long.

In the 90's, a series of events unfolded that made forex available to retail investors. Deregulation led many companies to form pools of liquidity where retail investors could take advantage of the huge speculative opportunity in forex. These dealers offered high leverage, low minimums, and a new way to trade – 24/7.

Q: What are pairs and pips?
A: Each currency exists in the marketplace not on its own, but as a "cross" between itself and another currency. This is practical, since when you travel to Europe you want to exchange your money for Euros. If you have US Dollars, you will be exchanging money at the rate set by EURUSD. EURUSD is a "pair". It also happens to be the most popular pair. Most currencies are paired with EUR and USD, and to other currencies to a lesser extent. The "four majors" are EURUSD (Euro/Dollar), USDJPY (Dollar/Yen), GBPUSD (Pound/Dollar), and USDCHF (Dollar/Franc).

The bid-ask spread is usually lowest for the four majors, since their volume is the highest. With high volume the dealer is usually assured of having ample liquidity to meet your trading needs, so they charge you less through the spread. For more obscure, less traded pairs, the spread will be more, since dealers assume more risk in completing those transactions.

The spread itself is made up of pips. A pip is simply an incremental unit in forex. In stocks, you call them ticks or points. That makes sense because usually all stocks are quoted in the same currency. In forex, each currency may have a different incremental unit. For example, a quote in EURUSD might be 1.3240, versus a quote in USDJPY at 107.87. What is the incremental unit? There is no common unit, so one was created, and it was named a pip. A pip is always worth $10 if the pair ends in USD. If not, you will need to refer to a pip calculator to get the value, since these per pip values can vary, even within the same currency.

Q: How do you trade forex?
A: There are two major methods for trading forex: fundamental and technical.

Fundamental analysis relies upon a broad and near-expert understanding of multi-national macroeconomic statistics and events.
Fundamental traders believe that the value of a pair is determined by the underlying health of the two nations involved in the pair. A high value for GBPUSD, for example, would suggest a better economic outlook in Britain vis-à-vis the United States. Global events like news, catastrophes, politics or economic shocks all play a role in determining price.

Technical analysis is based on the mathematical analysis of price, and of many variables which all derive from price. Technical traders believe that technical indicators include fundamental analysis and also provide repeatable, tradable patterns. Technical traders use charts to determine support and resistance, draw trend lines, or analyze measures like moving averages, etc.

Whichever camp you belong to determines your trading approach. A fundamental trader may take the Warren Buffet approach and buy-and-hold a pair, expecting long term returns. A technical trader may play long term as well, but usually day trades. Some fundamental traders trade on news, which may just be certain days of the month.

Q: What is leverage?

A: Since dealers have ultimate control over accounts and trades, they are willing to loan money to the trader. That's called margin – basically a loan from the dealer to the trader, but based on the trader's equity. Normally if the trader wants to trade EURUSD he would need $100K, but not if the dealer offers margin. Margin is another word for leverage, with a little difference in concept.

Some dealers will allow you to trade a full standard contract with just $500 in margin available. That means the user has to have at least $500 (or really $500 + spread) in their account to trade. If at any time their account balance equals or drops below their margin requirement, the dealer will liquidate all of their positions. That's called a Margin Call. So if you traded 5 contracts with $4,000 in your account, you would be using $2500 in margin. If the trade went against you $1500, you would be taken out.

When you traded the one contract with $500 in margin, you controlled $100,000. That's leverage. It's 200:1 in this case (leverage = $100,000 divided by $ per contract as a % of total equity). In this example, you would only be employing 200:1 leverage if your account equity was $500. Most dealers have scaling margin which allows smaller accounts to use something like 200:1 and bigger accounts to use 50:1, or 10:1. If you had $20K in your account and played 40 contracts, that would be 200:1 leverage. $100K with 10 contracts is 10:1.

Leverage is one of the biggest reasons people trade forex, but it's also one of the biggest reasons people lose money. Be careful to manage your leverage position when trading, especially when starting out.

Q: What tools do I need when starting out?
A: First, common sense and good judgment! Dealers make it very easy for new traders to come in and make money, but many of those same features make it possible to lose money very quickly. Use the demo system to start, and then be sure to begin with one mini contract (controls $10,000, not $100,000 like the standard contract).

Beyond that, you will need a trading platform, charts, and/or a news service. Joining a trading community with forums is also a great way to learn.

Most dealers will provide a trading platform. Some offer an automated platform on their own, and others offer an automated platform through a third party. FX Engines offers its automated trading platform with many features for beginning traders, and routes all trades through FXCM, the world's largest dealer. Other automated trading platforms may be different.

Charts are sometimes offered through the trading platform, as is news. If not, check one of the many forex forums online to get a sense for what people think are good chart and news subscriptions, then give those a try.

Q: What's the most important element in trading forex?
A: Discipline. That's easy to say and much easier to practice in other markets. Forex makes it tougher because it's always open, and big moves are always happening. It's one of the reasons why an automated system is so valuable in forex.

Even if you forego automation, you need to develop a script for trading that you can always follow. Consistency is the key, and your ability to stay consistent will surely be challenged.

Learn all you can, build a system, and practice trading before you risk a dollar. The early losses that come from a rush to trading can damage confidence, and that can be difficult to repair. The markets are going nowhere – if you take the time to learn and then consistently apply your knowledge to this huge market your rewards will surely follow.

ACTION

Getting started in forex boils down to three simple steps.

1- LEARN

There are many sources online to help you get started, and many more from FX Engines and The Forex Report. Use all of these resources to learn more about forex and gain an understanding of the market you plan to trade.

2- BUILD

Find a system – we have systems published in Case Studies, or you can find them in forums, for free. In any case, get a starting point. Take a system that exists and try to see how it works, then improve it. Observe the system in live trading in a demo account. Work out all the kinks, build your script, then take it to market.

3- BEGIN

Find a trading partner. It can be a reputable dealer with manual trading or an automated platform like FX Engines (which also supports manual trading). Once you have the account set up and funded, trade ONE MINI CONTRACT. Do so until you have enough confidence to build. Build slowly, cut your losses and let your wins run. Once you have a working system, expand it.

RELATED MATERIAL

For other advanced studies on the forex market, go to www.fxengines.com and see:

The Forex Report: The Six Forces of Forex
The Forex Report – Data Brief: When to Trade

MORE INFORMATION

For more information about The Forex Report, visit www.fxengines.com or email info@fxengines.com. The Forex Report is available for distribution on third party websites as a co-branded offering. Contact us for more information.

THE FOREX REPORT

Analyzing statistical, econometric, and behavioral trends in the foreign exchange markets for insight into the optimal use of the FX Engines automated trading platform.

The information contained in this report is represented without warranty or any statement of its veracity. The contents of this report are intended to stimulate thinking on issues related to trading forex. This report does not suggest any particular action that could be utilized in live trading for profit or loss.

I can put it no better than Hoffer, who deferred to Montaigne:

"All I say is by way of discourse, and nothing by way of advice. I should not speak so boldly if it were my due to be believed."