ULTIMATE GUIDE TO FOREX TRADING

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CHAPTER 1

THE BASICS OF FOREX

Currency Pair	Nickname
EUR/USD	Euro
GBP/USD	Cable
USD/JPY	Yen
USD/CAD	Loonie
USD/CHF	Swissy
AUD/USD	Aussie
NZD/USD	Kiwi
EUR/JPY	Euppy
EUR/GBP	Chunnel
GBP/JPY	Gopher
Pairs Without Nicknames	
EUR/AUD	EUR/CHF
EUR/CAD	GBP/NZD
GBP/AUD	GBP/CAD
GBP/CHF	AUD/JPY
CAD/JPY	NZY/JPY
AUD/NZD	

Why might you see different prices for different currencies?

Whether you are on the Internet or in the world going about your day, you may see different prices quoted for different currencies. That's because there are different markets for currencies.

The most popular market in the world is the spot forex market, which is the instant exchange of electronic currencies. This market tells you the market price if you want to buy or sell a currency pair right now.

There is also a currency futures market, with contracts traded at the CME Group. Currency futures have a specific delivery date that affects the quoted price. Namely, this is due to changes in interest rates between now and the future date that you wish to buy the currency. So while your foex broker may list EUR/USD for 1.17, the futures contract may have it priced at 1.1730.

Finally, there is a market for cash currency. The most common example of this would be airport currency exchange businesses, which price currency with a wide spread that allows them to make a profit on the exchange.

You should think of these as completely different markets and different products. They are not mispriced and do not offer retail traders the opportunity to profit between them.

What are some of the advantages of trading forex?

Forex trading has a number of advantages. Here are just a few:

1. **24-hour trading.** The forex market is open 24 hours a day from Sunday at 5 PM ET to Friday at 5 PM ET. This means that traders can trade forex part-time, during any free time.
2. **Low minimum trade sizes.** Forex trading also allows you to trade in very small sizes, which allow traders to open smaller accounts. Forex traders can open positions in standard lot sizes, mini lots or micro lots.

A standard lot is 100,000 units of the base currency, which is the first currency listed in a pair. In EUR/USD, a standard lot would be €100,000 (approximately $160,000). In any U.S. Dollar-based pair, like USD/JPY, USD/CAD, or USD/CHF, a standard lot is $100,000.

A mini lot is 10,000 units of the base currency, while a micro lot is just 1,000 units of a base currency. In accounts that offer 20:1 or 50:1 leverage, it takes just $20 or $50 in capital to open a micro lot position in USD-based pairs.

3. **High liquidity.** Unlike other markets that trade 24 hours a day, like futures markets, the forex market is highly liquid for much of the day, particularly during times when one major market overlaps with another. Those times include when the Asian trading session overlaps with the start of the European session (2 AM ET to 4 AM ET) and when the European session overlaps with the start of the U.S. session (8 AM ET to 12 PM ET).

4. **Easy to buy or sell.** Unlike in equities or options trading, in forex trading, it doesn't matter to your broker if you go long or short the currency pair. Regardless of which side of the trade you are on, the margin requirements are the same. This means that you can more easily capture rising or falling prices.

5. **Variety of currencies to choose from**. If a trader is bullish the U.S. Dollar, there are a variety of currency pairs to choose from to express that view — going short EUR/USD or GBP/USD or going long USD/JPY or USD/CAD among them.

What are some basic terms to know?

Pip — A pip is 1/100th of a point move in a currency pair. Traditionally, this would be the smallest movement in a currency. However, in recent years, brokers began trading in fraction of pips (called pipettes).

For currencies quoted to four decimal places, like EUR/USD, GBP/USD or USD/CAD, a pip is 0.0001, which is 1/100th of a 1-cent move. For Japanese Yen pairs, which are quoted in two decimals, a pip is the second decimal (0.01), again 1/100th of a 1-Yen move.

Pip Value — The value of a pip changes with the currency that is traded and the amount traded. For each standard lot (100,000 units) when the U.S. Dollar is not the base currency (e.g., EUR/USD, AUD/USD, NZD/USD), the pip value is equal to $10.

When the U.S. Dollar is the base currency, the pip value varies based on the exchange rate. To calculate the pip value of those currency pairs, follow this formula:

Pip Value = (Pip in decimal places * Trade Size) / Exchange Rate

For example, for 1 standard lot of USD/CAD at the price of 1.30, the pip value is:

Pip Value = (0.0001 * 100,000) / 1.30 = $7.69

Base Currency — The base currency is the first currency quoted in a pair. That means that in EUR/USD, the Euro is the base pair. You can read that as the number of U.S. Dollars per Euro. Similarly, USD/JPY is the number of Yen per U.S. Dollar.

The base currency does not have any relation to which currency is stronger than the other.

Currency Cross Pair — A cross pair is one that does not include the U.S. Dollar. EUR/JPY, EUR/GBP and AUD/JPY are all examples of crosses.

Spread (Bid-Offer Spread or Bid-Ask Spread) — There are different prices to buy a currency pair (go long) and sell a currency pair (go short). The difference between them is called the spread. The tighter the spread is, the better for the trader.

Spreads can vary by brokers. Typically, forex brokers that don't charge a commission will just add space to the spread, which is an unknown cost to the trader.

Leverage — Leverage is the amount of dollars that $1 can buy. In a Normal account, traders can employ 100:1 leverage, meaning that each $1,000 can buy
$100,000 worth of currency. Leverage can magnify returns. For example, a 1% move in a $100,000 position in your favor results in a $1,000 gain. Using 100:1 leverage, that could result in a 100% return on capital.

However, leverage can easily work against a trader as well. The same 1% move could wipe out the trader's entire capital.

Margin — Margin is the amount of capital that a broker holds to secure an open position. Margin guards the broker against losses incurred by the position. Margin directly relates to a trader's leverage. If a trader wants to open a $100,000 position and has 100:1 leverage, which most brokers offers, the broker would put aside $1,000 of capital from the account. As that position gains or loses value, the same $1,000 is used.

A broker may split margin into two subcategories: initial margin and maintenance margin. Initial margin is the amount that a broker will set aside to open a trade. Maintenance margin is the amount that a broker requires to keep a trade open.

Margin Call — A margin call is issued when the trader no longer has sufficient margin to cover any open positions. The broker may give the trader an opportunity to deposit more capital, but it may also close out the trade.

Rollover — Rollover is the time at which a position is extended without settling. At the rollover time, which is typically 5 PM ET but depends on the brokerage, interest will be charged or paid on the position.

If a trader is long a currency with high interest rates relative to a currency with low interest rates, she may be paid interest at this time. If a trader is short a currency with high interest rates relative to a currency with low interest rates, she may owe interest at this time.

Rollover may be for one or more days' interest. For example, typically on Wednesday, traders are charged 3x rollover to account for the weekends. However, this may change based on holiday schedules.

Traders will want to be aware of rollover as it can offer a very significant cost to trading.

Commission — Commission is the amount your broker charges to open or close a position on your behalf. Many forex brokers have moved away from charging flat commissions, instead, hiding the cost of opening and closing trades inside the bid-ask spread. Widening the bid-ask spread is an opaque way of charging commissions and does not allow traders to understand exactly how much they are paying their broker.

Hedging — Some brokers will allow traders to simultaneously hold open positions both long and short of the same currency pair. These positions offset one another, so that the net position will be the larger position minus the smaller position.

Traders that trade on varying timeframes can find hedging useful as it allows them to enter short-term trades without closing long-term trades.

However, hedging can be dangerous. It can inflate commissions and can even cause unexpected losses if the bid-ask spread widens. As a result, many regulators around the world have banned the practice of hedging.

Scalping — Scalping is a trading style that relies on profiting from small fluctuations in a currency. In forex, this could be anywhere from price moves of a few pips to 10-15 pips. Scalping traders need to keep a close eye on their risk-to-reward ratio and their commission costs. Since traders are looking to make a few pips, they should also keep very tight stops on their trades.

Lot — A lot is the amount of currency that is traded. There are three main sizes of forex lots: a standard lot, a mini lot and a micro lot. A standard lot is equivalent to 100,000 units of the base currency. A mini lot is 10,000 units of the base currency, and a micro lot is 1,000 units.

Equity — Equity is the total value of the trading account, including all open positions. If a trader has $100,000 in a trading account and is in open trades with profits of $1,000, her equity will be $101,000.

Free Margin — Free margin is the equity of a trading account minus any margin required to hold open positions. Free margin tells a trader how much margin is available to enter new positions.

Long — Buying a currency, expecting its price to increase. If you buy EUR/USD, you are long Euros. Typically, being long only relates to the base currency in a pair. However, if you sell EUR/USD, you can also say that you are long U.S. Dollars.

Short — Selling a currency, expecting its price to decline. If you sell EUR/USD, you are short Euros. Typically, being short only relates to the base currency in a pair. However, if you buy EUR/USD, you can also say that you are short U.S. Dollars.

Stop Loss — This is an order type that prevents further losses. A stop will take a trader out of her position when the price reaches a predetermined level. If you are long EUR/USD, a stop would be an order to sell EUR/USD at some point underneath the market price. Stops are recommended for all traders.

Limit — This is an order type that looks to enter a trade at a specific price or better. Typically, a limit order is used to lock in profits. In that case, a limit will take a trader out of her position when the price reaches a predetermined level. If you are long EUR/USD, a limit would be an order to sell EUR/USD at some point above the market price.

Risk-to-Reward Ratio — This is the most important metric in trading. The risk-to-reward ratio measures how much you lose on your average losing trade relative to how much you profit on your average winning trade. If your average winning trade makes $500 and your average losing trade loses $100, your risk-to-reward ratio is 1:5. This means that you can be in a winning trade just 16.7% of the time and still not lose money trading.

Winning Percentage — The winning percentage is a metric that tracks how frequently you have a trade that profits out of all of your trades. If, on average, you make money on five trades out of 10, your winning percentage is 50%. If you profit on eight trades out of 10, your winning percentage is 80%.

Slippage — Slippage is the difference between a quoted price that a trader sees on a screen and where that trade is executed. It can also be the difference between a trader's stop and where the stop is executed. Slippage may be exacerbated by fast-moving markets.

Gap Opening — Forex markets close at 5 PM ET on Friday and reopen Sunday at 5 PM ET. During this time, prices can move without actually trading. If the price of a currency pair changes over the weekend and opens on Sunday at a significantly different price, it is known as a gap opening. Less frequently, prices can also gap higher or lower when significant news is released.

CHAPTER 2

TRADING FOREX

What currency pairs are the most liquid?

The most liquid currency pair in the world is EUR/USD, followed by USD/JPY and then AUD/USD, according to FXSSI. However, any major currency pair will give you the benefits of high liquidity. Those benefits include tighter spreads, less chance for slippage and overall great execution.

Critically, liquidity is fairly consistent regardless of what time you trade overnight. While liquidity will be at its highest during the overlap between the European and U.S. trading sessions (8 AM ET to 12 PM ET) and the overlap between the Asian and European trading sessions (2 AM ET to 4 AM ET), traders should enjoy the benefits of liquidity through most of the 24 hours of trading.

What size do currencies trade in?

The most common trade size is a standard lot, which is 100,000 units of the base currency. In U.S. Dollar terms, the size of a standard lot changes with the currency pair. For example, in EUR/USD, the base currency is Euros. One standard lot is therefore €100,000, or approximately $160,000. In any of the pairs where the U.S. Dollar is the base currency (e.g., USD/JPY, USD/CAD), the size is consistent at $100,000.

Traders are also able to place trades in increments of mini lots (10,000 units) or micro lots (1,000 units).

When are the best times to trade?

There will be the most participants in the market on the times when the major trading centers overlap. Those include times when the European and U.S. trading sessions overlap (8 AM ET to 12 PM ET) and when the Asian and European trading sessions overlap (2 AM ET to 4 AM ET).

The worst time to trade may be between the U.S. trading session and when Japanese markets open (5 PM ET to 8 PM ET).

How do you calculate pip value?

The value of a pip changes based on the currency, the amount traded and the exchange rate. For U.S. Dollar accounts, the pip value of currency pairs not based in U.S. Dollars is consistent with the amount that is being traded. On one standard lot, the pip value is $10. The value of a mini lot ($1) and micro lot ($0.10) is consistent with how much is being traded.

When the U.S. Dollar is the base currency, the pip value varies based on the exchange rate. To calculate the pip value of those currency pairs, follow this formula:

Pip Value = (Pip in decimal places * Trade Size) / Exchange Rate

For example, for 1 standard lot of USD/CAD at the price of 1.30, the pip value is:

Pip Value = (0.0001 * 100,000) / 1.30 = $7.69

If you were in the same 1 standard lot of USD/CAD trade at 1.20, the pip value would be higher:

Pip Value = (0.0001 * 100,000) / 1.20 = $8.33

The pip value does not change based on whether you are long or short the currency.

What is the rollover? (What is the carrying cost?)

Each day, interest is charged on open positions, typically at 5 PM ET. That interest is dependent upon the interest rate differential between the two currencies in a trading pair.

These rollover rates are charged each day, even if there is no trading or banks are not open. For example, rollover rates apply to weekends, which means that typically there are three days of rollovers that post on Wednesday.

Rollovers are also calculated on holidays, which can impact how much interest is paid or received.

These amounts can be significant benefits or costs, and depending on the currency pair can account for multiple pips of profits or losses.

Notably, the interest that is paid by the lower yielding currency does not equal the interest that is received by the higher yielding currency, and there is the possibility that both sides of a trade will be charged interest. This is because of the bid-ask spread on overnight interest rate products.

Forex trading platforms typically have rollover rates easily accessible. For the rollover rate on the MetaTrader 4 Platform, follow these instructions:

1. In the 'Market Watch' window, right click (anywhere)
2. Select 'Symbols' and a new window should appear
3. Find the specific symbol you are interested in and select it
4. Click 'Properties' on the right
5. Scroll down to 'Swap Long' and 'Swap Short.' Those are the current rollover rates

What types of orders do traders place?

There are a number of different types of orders that traders can use to implement their preferred trading strategy.

Market Order — A market order executes a trade at the current market price, wherever that may be. This may be better or worse than the price that a trader sees on his or her screen.

> *Advantage:* this order executes immediately at the next traded price.
>
> *Disadvantage:* this order may execute at a price other than what the trader sees on their screen or at a price significantly worse than what a trader wants in a fast-moving or gapping market.

Limit Order — A limit order is a trade that is executed at or better than the trader's named price or not at all.

> *Advantage:* the trader gets to name her preferred price.
>
> *Disadvantage:* the trader is not guaranteed a fill if that price does not trade.

Stop Order — A stop order can either be placed as a stop limit or a stop market order. The most common is a stop market order, which will get the trader out of the market when a particular price is hit.

This is an order type that typically prevents additional losses. A stop will take a trader out of her position when the price reaches a predetermined level. If you are long EUR/USD, a stop would be an order to sell EUR/USD at some point underneath the market price. Stops are recommended for all traders.

Advantage: the trader knows that she will get out of the market after a price is hit.

Disadvantage: there is no guarantee to what that price will be.

Trailing Stop Order — A trailing stop is an order that changes based on movement in a currency pair. Traders decide the initial stop point and the number of pips they would like the stop to trail. Then, when the currency moves in their direction by that number of pips, the stop will automatically move by that predetermined amount.

If a trader is long USD/JPY, trading at 110 with a 50-pip trailing stop and an initial stop at 109.50, their stop will automatically move as USD/JPY moves higher. If USD/JPY gets to 110.50, the 109.50 stop will adjust to 110. It will stay there until it is hit or USD/JPY gets to 111, at which point the stop will adjust to 110.50. The stop will continue to trail the price until it is hit or the trader closes the trade or adjusts the strategy.

Advantage: ability to follow the market higher and lock in profits.

Disadvantage: stops are not based on technical support or resistance and instead based on movements in the underlying currency pair.

Good 'Til Canceled — Just as it sounds, this order is good until the trader cancels it. That means it remains open from day-to-day and over the weekend.

Advantage: if you want to get into the market at a specific price, you can place an order once and allow it to execute if the price gets to that level.

Disadvantage: if market conditions change, you will be responsible for canceling the order.

Good for the Day — This order is good for the trading day and will be automatically canceled at 5 PM ET.

Advantage: technical levels can change from day to day. This order ensures you don't forget to cancel an order you never intended to be filled.

Disadvantage: for stops or other orders that you want executed no matter what, you want to know that the order is there when you need it.

What are some technical indicators that forex traders use?

Simple Moving Averages — A simple moving average is the average price of a currency pair over a specific period. Many forex traders will use a 21-period moving average. For longer term trends, traders may look at 100-day and 200-day moving averages. The moving average shows price trend. The longer the period, the more significant the trend.

Traders may look to buy when price rises above a moving average or sell when price falls below a moving average. They may also enter trades when two moving averages cross over or under one another.

Exponential Moving Averages — An exponential moving average (EMA) is similar to a simple moving average, except that it weighs recent prices more heavily. An EMA still uses the prices over the past X periods of time, where X is any number and the period can be minutes, days, weeks or months (or even a number of ticks). The shorter the period, the more weighting that the closer time periods get.

Moving Average Convergence / Divergence (MACD) — The MACD is an indicator that gauges momentum of a trend, showing the relationship between two moving averages. The MACD subtracts the 26-day exponential moving average (EMA) from the 12-day EMA and compares it against a 9-day EMA. The 9-day EMA is used to trigger the buy or sell signals.

Bollinger Bands — A Bollinger Band has a moving average that is then bracketed in with an upper and lower band that fluctuates based on volatility. As volatility increases, the bands widen. As volatility decreases, the bands narrow. Traders use these levels as dynamic points of support and resistance.

Fibonacci Retracement / Fibonacci Extension Levels — Fibonacci levels are used to predict where a market may extend or retrace to, using the key Fibonacci ratios of 23.6%, 38.2%, 50%, 61.8% and 100%. These are basically measured move calculations from two extreme points on a chart — such as a recent peak and recent trough. The effectiveness of Fibonacci Retracement and Fibonacci Extensions depend heavily on the choice of those two points.

Ichimoku Cloud — The Ichimoku Cloud is another measure of trend and momentum that highlights potential bullish and bearish crossovers. The color of the cloud changes based on whether the indicator suggests there is a bullish or bearish trend, and the cloud itself indicates expected levels of support or resistance.

Relative Strength Index (RSI) — The RSI looks to identify when a currency is overbought or oversold. The RSI is an oscillator that offers a reading of 0 to 100. A value of 100 is considered overbought, indicating a reversal to the downside is likely. A value of 0 is considered oversold, suggesting a reversal to the upside is commonplace. Levels above 70 and below 30 are considered important inflection points.

CHAPTER 3

UNDERSTANDING THE FOREX MARKET

What factors drive the forex market?

Because of the diverse participants that trade forex markets, including banks, international corporations, central banks, international investors and retail traders, many factors impact the market — from long-term capital movement to day-to-day trade flows to speculation.

However, the most important driver of foreign exchange markets is interest rate policy. In general, traders prefer countries and currencies with higher interest rates over countries with lower interest rates. This flow of money is typically referred to as the “carry trade.”

Interest rates are set by the central banks inside each country. Each central bank makes policy decisions with different objectives in mind. In the United States, the Federal Reserve is tasked with a dual mandate of of maximum employment and stable prices. The Bank of Japan and European Central Bank, however, just have a mandate to achieve stable prices.

What are the most important economic numbers to forex traders?

The most important economic numbers are those that directly dictate interest-rate policy. That includes measures of inflation, like consumer and producer prices, quarterly GDP, and monthly employment figures.

It is important when analyzing economic data to understand that the market is a discounting mechanism. That means that at any given moment, you must understand what the consensus expectations are and where the actual data falls in order to accurately predict what that may mean for a currency pair.

How are currencies correlated?

In large part, all currencies are interrelated. That’s because there is a limited supply of capital and any number of places that the capital can be deployed.

However, understanding how currencies are correlated with one another can help forex traders maximize profits. For example, the Australian Dollar, Canadian Dollar and New Zealand Dollar are known as “commodity currencies” and generally move with one another. If there is a breakdown in that correlation, such as AUD and CAD strengthening while the NZD weakens, that can be an important signal. Traders can also use correlations to lower volatility of their portfolio or trades.

CHAPTER 4

ADVANCED FOREX TRADING

How much leverage should traders use?

Many traders are attracted to forex because it offers generous leverage with low minimum account sizes. However, leverage is a double-edged sword that can decimate an account just as quickly as it can build an account. And as it relates to building up a trading account, fast is often slow, and slow is fast. Therefore,we cautions traders to use an appropriate amount of leverage in their trading.

Instead of viewing trades in terms of maximum leverage, traders should think very carefully about their position sizing as they look to enter a trade. While there are a number of complex ways to determine what the appropriate position size is, such as the Kelly Criterion, it boils down to two questions. First is how much can you afford to lose on any one trade. Next is what is the point at which your trade is proven wrong.

By taking these two questions together, you can determine the appropriate size of your position (and therefore how much leverage you will use).

For example, if you determine that you can lose $100 on a EUR/USD trade and that the point at which your trade idea is proven wrong is 20 pips away, your position size is 50 micro lots. If you determine that you can lose $100 on a EUR/USD trade and that your trade idea will be invalidated 10 pips away, you can size your position to 1 standard lot.

Ultimately, a trader's particular strategy will determine what that amount of leverage is and whether it fluctuates or is consistent. If a trader is a scalper, then he may employ more leverage because his stops are closer to the entry point. His trades may also be more consistent. On the other hand, if a trader prefers a swing trading strategy, he may use less leverage that varies from position to position (based on where the recent swing high or low is).

Make no mistake about it, leverage has caused more trading accounts to blow up than any other single factor. When in doubt, use less leverage.

What are different forex trading strategies?

There are four major types of trading strategies: (1) scalping, (2) day trading, (3) swing trading, and (4) position trading. These are organized from the shortest holding period to the longest holding period.

Scalping — Scalping is the act of looking for a few pips in a trade at a time. These trades are typically held for just a few minutes and are based off of short-term charts. A scalping trader is likely to employ more leverage and make more trades each day than the three other types of traders. A scalper does not have a bias on the price and can be long one minute and short a few minutes later.

Day Trading — A day trader may enter trades at any point throughout the day, but will always close trades out before leaving overnight. This type of trader is looking to catch the primary trend for the day and may hold trades for anywhere from minutes to a few hours at a time. They are aware of long-term trends, but may take the other side if that's where prices are moving that day.

Swing Trading — A swing trader is a longer-term trader that looks to profit on moves over a couple days to a week in duration. This trader will look for inflection points, like buying as a currency pair breaks through major resistance or selling if it breaks below major support.

Position Trading — This trader thinks of trades in terms of long-term moves and may look to catch a trend for weeks or months. This trader is the most likely to scale into their position over time and tends to have a strong bias for where prices are heading.

Which trading strategy is best?

There is no trading strategy that is best for all traders or for all times. The best trading strategy is the one that is profitable and that you can stick to.

Here are five important questions to consider when implementing a trading strategy:

1. **What is the strategy that matches with my personality the best?** By far, the most important factor when it comes to a trading strategy is how it fits with your personality. Traders need a strategy that accentuates their strengths and minimizes their weaknesses. If they are impatient and prone to self-doubt, they'll likely want to stay away from a strategy where their holding period will be days. If, on the other hand, they are more deliberate and thoughtful and are not looking for constant action, then they may do well swing or position trading.

2. **What is the market state?** The market state will tell you if a currency pair is trending or range-bound. That can help inform what the best trading strategy is for this particular period of time. For example, if the market is consolidating within a range, it may not be an appropriate time to be heavily position trading. At the same time, it may offer some interesting opportunities to day or swing trade if the range is wide enough.

3. **Do I prefer fundamental or technical analysis?** The longer term the trade, the more that fundamental factors will play out in its success or failure. While a trader should always look at important support and resistance levels, such as prior day and prior week highs and lows, technical analysis can play out on a much tighter timeline.

4. **What is my risk tolerance?** The fact of the matter is that a swing and position trader cannot be in control of their trades at all points, while a scalper and day trader have much more control. Oftentimes, longer-term traders are able to effectively manage risk with stop loss orders; however, there are times when the market price may gap. This could inject additional risk to a swing or position trade. On a frequent basis, markets can gap higher or lower following significant news releases, such as economic data points. On a less frequent basis, markets may close on Friday and open at a completely different price on Sunday evening. In these cases, there is nothing the trader can do to ensure against unwanted losses.

5. **Are there any other factors at play?** Other factors may also impact a trader's strategy, such as the time of day she is available to trade or factors related to the currency spreads or commissions. For example, a trader may find it more challenging to scalp if her broker is not extremely competitive on commissions and spreads. That's because any profit made in the scalping will be given back to the market. Another trader may find it hard to swing trade if he is only available to trade for a couple hours a day.

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