added cost of subscribing to an independent and dedicated charting package, since the benefit of receiving an accurate picture of the market will more than offset the cost in the long run. Before choosing one, however, ask them who provides them with their streaming FX data feed.

KEEP DETAILED RECORDS

The next thing that traders can do to gain back some of the lost ground is to keep detailed trading records. The number one reason is that most slighted traders find it difficult to take action against their broker owing to lack of evidence. Clients may feel cheated when their orders are not filled correctly, orders disappear from their screen, or when they find open trades suddenly closed, but it is all very difficult to prove. When you call your broker to complain you may state that "my order disappeared!", to which they may reply "do you have proof?" This often turns the matter into a your-word versus their-word scenario, which is why it becomes imperative to keep good trading records.

An easy way to do this is to take screen shots. You can find and download a variety of applications on the web, and taking screen shots of your orders in the market, trades, or any other important market activity (like unlawful price spikes) gives you a solid foundation on which to argue any future disagreement. Professionals do it and so should you.

OFFICIAL ACTIONS

If you feel you have been wronged and cannot come to a suitable agreement with your broker, do not hesitate to contact either the CFTC or the NFA. Although most brokers will usually fold when threatened with official action, if they instead choose to call your bluff go directly to these agencies since both offer programs that may help clients resolve disputes with brokers. You do not need to hire a lawyer to file a complaint, and usually taking this initial step is enough to scare a broker into a (reasonable) settlement, since the last thing they want on their official record is another disgruntled trader.

The NFA offers an arbitration program to help customers and NFA Members resolve disputes. Information about NFA's arbitration program is available by calling NFA at 800-621-3570 or visiting the Dispute Resolution section of its web site at www.nfa.futures.org.

Similarly, the CFTC offers a reparation program for resolving disputes. If you want information about filing a CFTC reparations complaint, contact the CFTC's Office of Proceedings at 202-418-5250 or visit the CFTC's website at www.cftc.gov.

In addition, if you suspect any wrongdoing or improper conduct by your FCM, you may file a complaint with the NFA and CFTC by telephone or online:

www.nfa.futures.org/basicnet/complaint.aspx
www.cftc.gov/enf/enfform.htm

Your broker is banking on the fact that most clients do not go through the hassle of reporting their bad habits, so do everyone a favor and contact the authorities if you suspect suspicious activity. In the end, it is up to traders to monitor and stay on top of all forex brokers.

TRADE WITH THE CME

If you are fed up with your broker's obnoxious habits, an obvious alternative to trading with an off-exchange broker is to trade through an exchange. The Chicago Mercantile Exchange operates its own clearing house and virtually eliminates credit risk by acting as the counterparty to every transaction. An additional benefit to the individual is that your funds are held in segregated accounts, meaning that they are protected in case of bankruptcy (unlike on-line brokers). Hedge funds and individual traders have used the CME for years to transact their FX business, so take a look at their FX offering and see if it is right for you.

OPENING A TRADING ACCOUNT

Make sure to check your broker first. Visit the NFA/CFTC/SFA websites and don't trade with any firms not under their oversight. Better yet, perform your own due diligence and go visit their office!

Don't judge a broker's execution by their demo accounts. Demos are marketing gimmicks meant to lure people into trading. The execution on your demo account will be perfect, unlike when you go "live".

Always remember that the cost of switching is low, but the cost of staying with an unfair broker is huge!

Use your trading platform ONLY to enter and exit positions

Constantly looking at your changing P/L will prove hard on your psyche and makes many traders enter/exit their positions too soon. Professionals don't fix their attention on their P/L, but rather on the price action.

The blinking prices and constant swings in equity are used by brokers to distract the trader and amplify the gambling instinct. Try instead to think of the moves in terms of pips, not dollars and cents.

TRADING HABITS

Of course the number one thing traders can do to shift the odds in their favor is to become better traders. This sounds obvious, but it is true. It is much easier to place the blame on bad dealers, systems providers, etc., than on yourself, and for all of the shoddy dealings a retail trader may receive, at the end of the day it is usually their lack of experience and/or bad trading habits that are responsible for the miserable results.

The learning curve can be steep and uncompromising, and in this market there is no free lunch to be had. All traders, even the most successful ones, have paid their "tuition" to the market and all realize that the key to becoming successful is survival. Simply put, the longer you stay in the market the better your chances are of turning into a great trader. For new traders this means establishing your survivability in the market and for experienced traders it means not falling into bad habits.

Obviously, even with all of the sophisticated charting and analytical software available nowadays success is still extremely difficult to accomplish, and moving up the learning curve can take a degree of dedication, capacity, and motivation that many traders simply do not possess. This leads many retail traders to "outsource" the analytical work to a third party, which can prove extremely hazardous since before you know it you find yourself blindly following the advice of some market guru, expert, or system. If it were only so easy! The actual decision-making process is the hardest part of trading, so make sure that you keep a firm grasp on it.

Once we put aside all of the nonsense handed out by brokers and gurus, it is time to get into the meat of becoming a great FX trader. What exactly does it take to post steady profits in this business? What trading rules do professionals adhere to? What FX tricks exist out there that can help improve your performance?

The second half of this book is intended to give active traders the information and tools they need to survive in the FX market and begin developing their own habits and techniques that will turn them into successful traders.

III

JOINING THE 10 %

11
Becoming a Great Trader

Anyone who has ever traded knows that it can be an exhausting psychological battle that leaves you mentally and physically spent at the end of the day. Although trading is not easy, many people choose to make it even harder for themselves by simply jumping in without taking a second to understand the different styles and how they relate to their personality. By trading "against the grain", you are setting yourself up for a constant personal psychological battle (should I cut or stay) that often leads to bad decision making, losses, and unhappiness.

Matching up your personality with your trading style helps to minimize these personal battles, and if you are a new trader, the first step should be to figure out what kind of trader you have inside you.

TRADING TO YOUR STRENGTHS

Assuming you think you have the skills and drive needed to become a great trader, figuring out what kind of trader you want to be (more than just a "winning trader"!) is a critical step that requires some personal reflection. Although this does not require you to travel to the Gobi Desert to find yourself, you should spend some time figuring out what trading approach best suits your personality.

For example, if you feel you are patient, methodical, and can generally keep your emotions in check, then you may benefit from trading on a longer time frame approach. Do you prefer to play chess or video games? On the other hand, if you are a high-energy, impatient, and emotional individual, you may choose to trade intra-day for the instant gratification it provides.

The difference between holding longer-term positions and going home every night flat is more than just a technical one, since watching profits fly away during momentary retracements can prove more painful to some than taking small losses intra-day. Needless to say, the best traders are completely detached and have absolutely no problem watching their P/L gyrate, but in reality they are few and far between.

All traders, whether self-taught or not, must at some point ask themselves this question: "Am I improving?" Answering this question honestly will save you a mountain of heartache down the road, since it is of no use to waste valuable time and money doing something that does not fit your skill set. If you feel that you are improving (measured by your P/L), then stick with it. If after several years you do not see any improvement in your trading, then you must have the courage to call it quits. Some people make good architects, some make good traders; it is as simple as that. I cannot make a jump-shot to save my life, so I make no pretension of an NBA career.

If, for whatever reason, you are set on becoming a trader, proper money management is by far the most important factor in achieving success. When you think about it, most traders spend most of their time trying to figure out *when* to trade, instead of *how much* to trade, which is surprising given that money management is the *only* thing a trader can actually control!

There is no guaranteed way to make money (except collecting spreads), and even the best and the brightest are often wrong more than they are right. The market is bigger than you, bigger than me, and definitely smarter than all of us. We are bound to be wrong and make mistakes, but proper money management techniques enable us to weather sustained drawdowns and live to fight another day. Funnily enough, the biggest public misconception about traders is that they regularly take huge risks, when in reality great traders aim to minimize their risk relative to their returns at any given moment.

Whether trading a mechanical system or in a discretionary fashion, all traders should know beforehand how much they are willing to wager. Ask yourself: how do I determine my position size? How do I set my stops? All too often traders choose arbitrary numbers that have little to do with proper money management, and exit according to their "pain threshold" instead. Our innate fear of failure makes us place too much importance on not losing, rather than learning to manage our losses comfortably.

The good thing about money management is that it is easy to implement. Although good trading systems may be impossible to find, good money management rules do exist, and the best way to see if your money management needs tweaking is by looking at your results. For example, if your losers are substantially smaller than your winners, then you may want to consider taking slightly larger positions. If you consistently post large winners and losers, you should consider taking smaller positions to mitigate the risk of ruin. Proper money management maintains the all-important risk – reward balance in check, and although your plans may vary from those I present here, the bottom line of any system should be the same: to minimize the chance of blowing-up. Long-term success in this business is achieved by accumulating steady profits and occasionally hitting the home-run trade, and the longer you stay in the market, the more times you get to swing at the ball.

OVERLEVERAGE

Some years ago, Procter & Gamble blindly entered into a series of leveraged derivative trades and discovered to their great surprise that leverage not only magnifies gains but, more importantly, it also magnifies losses, in their case to the tune of \$300 million. This incident brought to life the risks of leverage to the corporate crowd, but retail traders are still all too often unaware of the inherent risks. Leverage, or gearing, is a double-edged sword that should be used sparingly, something not helped by the fact that retail FX brokers constantly extol the virtues of 200-1 leverage. By making it seem that "with \$1000 dollars you can control \$200 000" is a good thing, they suck naïve traders into the leverage trap, since constantly overleveraging your trades is the equivalent of always driving at 100 mph... sooner or later you are going to crash and burn.

Taking a \$1000 starting balance, if you were to trade \$200 000 in EURUSD, a mere ten point move (a 0.1 % move) against you would translate into 20 % of your account equity getting wiped out. In fact, just by entering the trade (spread), you would already be down 6 % on the trade, which is much more than any permissible loss. Trading position sizes this big in relation to your account size mean that you are essentially trading yourself into a corner, and any market noise is bound to wipe out your account. The brokers love this, of course, since it means easy money for them. If you are overleveraging your trades, then you may as well be handing over your cash to your broker.

Professional money managers generally use no more than two to five times leverage, and the retail investor should definitely not use more than ten. To put that in perspective, using ten times leverage on a \$1000 account means that the price would have to move 1000 points against you before your account is wiped out. That is a lot of room to maneuver, and it gives the trader greater flexibility.

FLEXIBILITY

Choosing the right amount of leverage is the first critical step in maintaining your flexibility in the market, which is critical if you are to survive for the long-haul. Flexibility in trading means giving yourself options: options to enter a trade, to stay in it, and to exit. By becoming overexposed to any one position, you essentially remove options from your table until you are faced with an "all-or-nothing" trade, and in the FX world your survival is measured in days, not years.

Since the currency markets are not one-way streets, the normal gyrations of the market mean that, given time, you will usually have an opportunity to get out of a bad trade or enter a position that you may have missed. Most traders have had the frustrating experience of getting stopped-out, only to see the market return back to your entry at some point later in the day. The only way to get around these sometimes arbitrary market movements is to stay flexible and trade multiple lots.

By trading only one lot you are essentially making a 50/50 bet that the rate will move in your direction. Besides not being very wise (it has a negative expected outcome when you take the spread into consideration), it is also not much fun. You should try to think of your initial entry as your toe testing the temperature of the water in the pool. If you find out it is too cold, then you can sit it out, but if it is just the right temperature, then you are free to jump right in. Trading small until you think you have all of the information and confirmation you need gives you the flexibility to properly position yourself for the move, or pull out with a small loss if your analysis proved incorrect. As you may well know, for some reason the FX gods see fit to test our mettle every time we enter a trade by moving the market immediately against us, but trading multiple lots means that our first entry does not become critical and we give ourselves a cushion while the market decides where it wants to go. Trading in this way also means missing out on far fewer trades when compared to the all-in approach, since pulling the initial trigger becomes rather painless and makes the decision-making process much less stressful.

To properly trade multiple lots you must first calculate the total amount you are willing to risk before you enter your trade. Again, different traders take different risks, but it is safe to say that the intra-day trader should not risk more than 1–2 % of their account size on any one position. This means that for a $10 000 account, your loss should never be greater than $200 *on all lots combined*. Look back on your trading and see how big your losses typically are. If you are an intra-day trader and every time you lose you end up taking a 3–5 % hit, then you need to stop immediately and come up with better money management rules. This is the same type of analysis that professionals regularly run on their trading, and it proves very insightful since the reasons for your underperformance will most often be glaring.

Trading with proper money management rules will not guarantee you success, but it will prevent you from falling into the money trap. The "more I bet, the more I win" mentality is not for traders but for gamblers, and using their logic is a sure road to ruin. Avoiding this trap simply means learning to manage your losses by using simple guidelines:

- Never risk more than 2 % on any one position.
- Never trade more than five times leverage on any one position.
- Trade multiple lots with multiple entries.
- If you cannot afford multiple 100 000 lots, trade mini lots.

If you don't think trading mistakes will happen to you, just take a look at what some "pros" did:

2003: Shares in now-bankrupt internet firm Exodus surged more than 59000% after a bank trader accidentally bid $100 for shares that were trading around 17 cents at the time!

2002: A colossal blunder by Bear Stearns saw the firm sell $4 billion worth of stock at the closing bell instead of the intended $4 million! Fortunately for the firm, they were only filled on $600m or so of the orders before realizing their goof.

2001: Just before the close of the UK market, a fat-fingered Lehman Bros employee mistakenly sold $500m worth of stock – 100 times the intended amount. The slip-up temporarily dropped the FTSE more than 2%!

2001: An absent-minded UBS trader hoping to sell 16 shares of Japanese company Dentsu at 600000 yen each mistakenly sold 600000 shares at 16 yen each! Before he knew it, the trader was already $120m in the hole..

1998: Perhaps the most classic blunder of all time was made by a now-infamous Salomon trader who is said to have accidentally sold £850m worth of French government bonds......simply by leaning on his keyboard!

12
Picking the Right Approach

Although proper money management guidelines are the foundations needed to support any sort of trading strategy, at the core of all trading is the fundamental reasoning, a model or system used by traders to enter and exit positions. Broadly speaking, FX traders can be divided into the fundamentalist and the technical crowd. On the one hand, fundamentalists choose to place their bets based on macroeconomic factors such as interest rates, GDP, inflation, current account imbalances, etc., and their relation to a currency's intrinsic "value". Much like equity managers who like to buy "undervalued" companies, fundamental traders use economic models to forecast theoretical exchange rates and trade deviations from these.

The technical crowd, on the other hand, cares less about the underlying economic picture and instead prefers to rely on two things only: time and price. In their thinking, a currency's past behaviour is the best predictor of future exchange rates, so they focus on identifying purely mathematical reasons for entering/exiting trades, such as buying a currency after it moves X % in a one direction or using chart patterns to guide their trading.

Although the fundamentalist approach may seem like the more logical way to go, extensive research into the matter actually indicates that technical trading is a much more profitable way to trade FX. Although the "value investor" mindset may pay off in equities, it seems that this line of reasoning is utterly useless in forecasting exchange rates (especially in the short run) because of central bank intervention and other market nuances, and it gets decidedly beaten by using a simple randomizer model. This may explain why economists' forecasts are undeniably horrible, and to the short-term trader it means that they should focus their attention on the technical side of trading, if only for the simple reason that it seems to be more profitable. That being said, technical trading is no sure road to riches either.

USING TECHNICALS

Since the advent of trading, the trading community has been obsessed with ways of predicting or forecasting the future through their use of models. As computational power increased over time, so did the popularity of technical or quantitative trading models and now a wide variety of these are used, ranging from simple moving-average systems to complex neural network algorithms. Unfortunately most, if not all, models have built-in biases, so an unquestioning belief in them is extremely dangerous. To prove this point, a famous study was conducted where thousands of different indicators and technical tools were tested in an effort to find the best forecaster of US GDP growth. After an exhaustive search and countless regressions, one leading indicator was found that seemed to fit the data perfectly: buttermilk production rates in Bangladesh! Yet I still have not figured out how to get that on my Bloomberg.

Most risk models still in use today consider the one-day October 1987 market crash to be a one-in-a-billion event, or the statistical equivalent of getting hit by lightning and being attacked by a shark at the same time. Long Term Capital Management and other seemingly advanced hedge funds were done in by these "sigma-nine" events, something that probabilistically speaking is so unlikely (according to their risk models) that it simply does not happen. If that is the case, then how is it that we keep witnessing these "impossible events" over and over again?[1] It is certainly not due to a lack of intelligence or computing power on their part.

In order to understand better why all probability-driven models have limitations that will eventually lead them to fail spectacularly, it is useful to look at a very simple example. Imagine yourself sitting at a stop waiting for the bus to come. You know the frequency of the bus service (every ten minutes), but not the actual arrival time. If the buses run according to schedule, then the probability of a bus arriving in the first minute of you getting to the stop is one in ten. The longer you wait, the higher the chances of the bus arriving any minute, and if you have been sitting at the stop for nine minutes then you can be pretty sure that the next bus is around the corner (at least that is what the model predicts). More sophisticated models may take into account the average time it takes for a bus to arrive, or externalities such as weather and traffic, but either way the model still essentially says that the more you wait, the higher the probability of the bus arriving. Of course, the average person has enough common sense to begin to distrust the model once fifteen or twenty minutes have passed, and you begin to ask yourself, "Is this bus ever going to come?" Maybe it broke down or had an accident. Rest assured that after a sufficient amount of time has passed, there will be no one left at the bus stop – no

[1] Hedge fund managers have long made fun of the quant models, and often joke "This is terrible! Today I just had a loss that's a nine sigma event! That's the third time this year!" (even though it should only happen once in ten thousand years or more).

one except the model, that is. People are smart enough to realize when the rules of the game have changed (the bus schedule becomes useless after a certain amount of time has passed), while probability-driven models never take into account the fact that the model itself may be wrong and thus continue to wait for a bus that may, or may not, come. This critical flaw is essentially what makes model-driven trading approaches blow-up spectacularly, and common sense dictates that the world is simply a lot more complex than any risk-model builder would have you believe.

Technical trading proves especially attractive to retail traders because it offers a way to "make sense" out of a sometimes senseless market, and many find the possibility of discovering the "holy grail" of trading systems simply too good to pass up. Yet those obsessed with trying to find *the* indicator or trading system would be better served in spending that time trying to understand the market instead of trying to outsmart it, since the only money-making machines that I know of are owned by the central banks of the world.

The clear benefit that systematic trading gives us is order. Having a clear, organized, and coherent strategy is fundamental to trading success. Although in the end your "system" may or may not prove to be profitable, you should always have a clear understanding as to *why* you are entering the position, and technicals help us tremendously in this regard. Generally speaking, the simpler the model, the more elegant and useful it becomes, since charts filled with lines, indicators, and all kinds of technical tools only serve to distract the trader away from the crucial price action. At a time when quantitative trading has been finally accepted by the general trading community, the intrinsic virtues of technical analysis are hard to discern since often it is traders' combined actions that turn them into self-fulfilling prophecies. If everyone follows the same indicator, then when it flashes a buy signal everyone will go ahead and buy ... and surprise, the price goes up! A kind of "chicken and egg" scenario has emerged and, more importantly, the retail crowd's love of technical analysis has also turned "obvious" technical levels into a magnet for stop hunters. Many funds (including ours) actively front-run other people's models by anticipating the trading signals their systems will generate and then positioning themselves for the slight pop created by their execution. If anything, you should make a point to stay away from any clear technical levels, since the price action around these are bound to be full of dealer manipulation, which is why it is never wise to trade breakouts in FX. With the amount of price "management" that goes on in the forex world, false breaks are more often the norm than the exception. Chances are that other traders will have also identified the same important support/resistance levels that you did, and set their stops accordingly. Dealers know this, obviously, and routinely go after them, thus creating the false breaks.

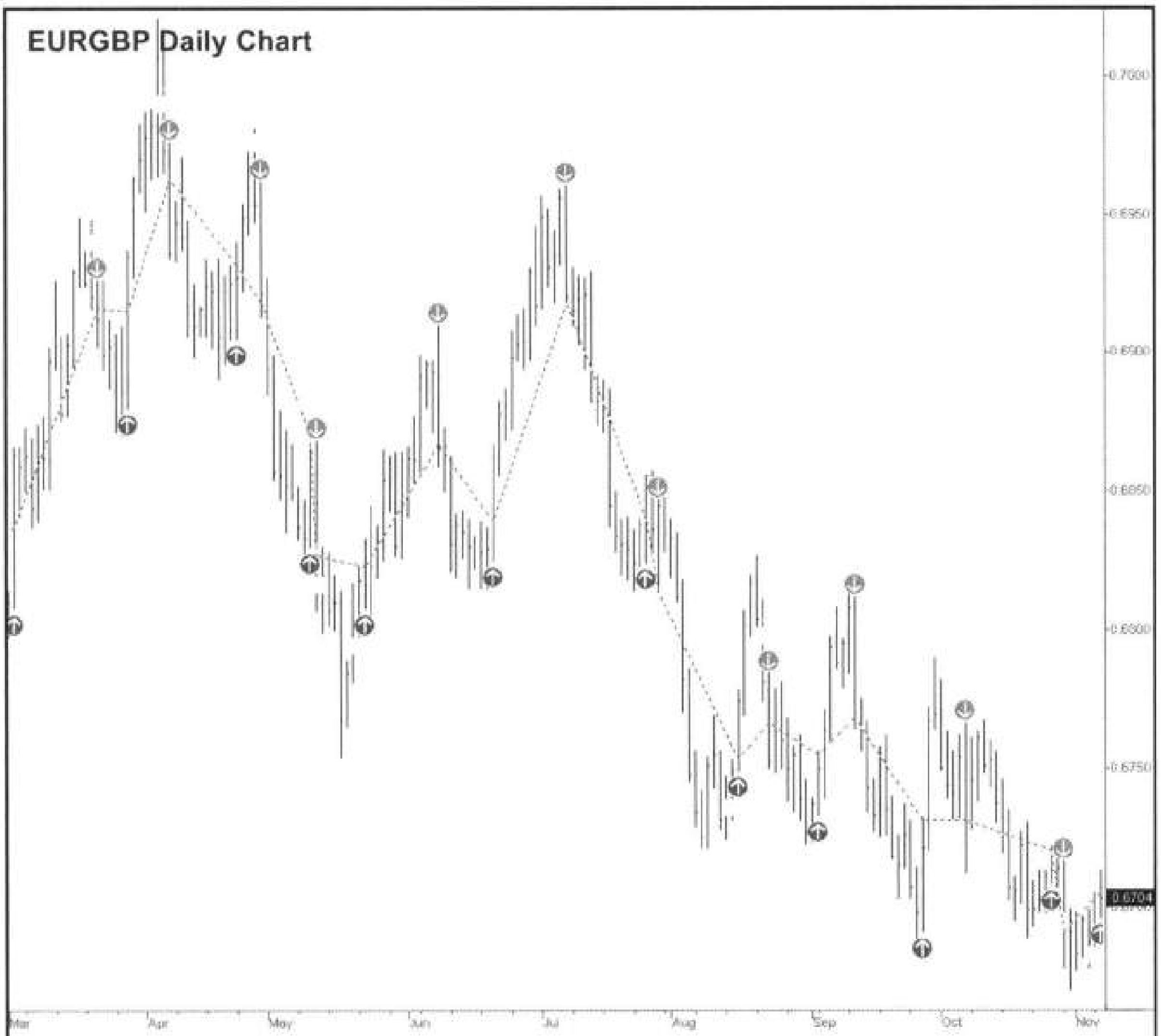
Learn to use technical indicators, but also learn when to ignore them. Find something that works for you and stick with it. We know that no strategy is always profitable, so the key for technical traders is to identify and understand your system's strengths and weaknesses. This lets you limit your exposure in traditionally bad times and double-up in the good ones. Does your system work best in high-volatility or slow markets? Does it work best in ranging or trending environments? Does it work best for USD pairs or others? These are the types of questions you should be asking of your system, since just like the blackjack player you want to end up betting only when the odds are in your favor. In isolation all technical tools are essentially the same, and only in their application will you find the true differentiator. This is why I think it is vital to keep a discretionary element to your trading, even if it is simply knowing when to turn your system "on" or "off". We know that the only instrument that can consistently beat the market is the human mind, so make sure to use it.

DISCRETIONARY TRADING

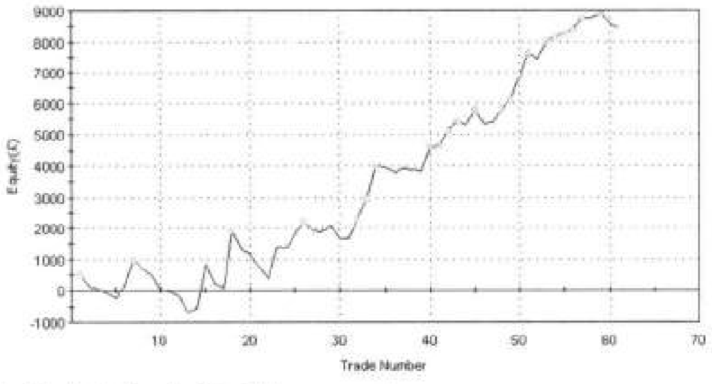
Purely discretionary traders rely on their experience, gut feeling, and reading of the price action to make trading decisions, and for FX traders this means coming to grips with what makes the market tick. Intra-day FX prices are shaped by flows, and as we know these flows may be the speculative bets of a large hedge fund or they may simply be the hedging activity of an exporter. Either way, supply and demand is what sets short-term prices, which is why we say that in FX there is no such thing as a fair price. Even if the macro backdrop favors a dollar decline, a large buy order will disrupt prices in the short run and drive the dollar higher until the demand is satisfied. For the intra-day trader the thinking behind these flows is not important; price is all that matters.

Getting a proper "feel" for the market comes down to understanding the price action. Price action is that magical thing that scares traders out of their positions and lures them into traps. Watching the bids and the offers get hit is the equivalent of the old-time tape reading made famous by Jesse Livermore and other "punters", who used to read the ticker tape attentively in an effort to gauge short-term price trends according to price and volume. Price action reflects the tug-of-war that is constantly going on between the buyers and the sellers in the market, and to the experienced trader it can also be a window into the market's footing.

Since short-term price movements are largely dictated by the maneuvering of the "big boys" in the market, it is in the interest of every small speculator to closely follow the price action in order to find the "footprints" that all large players inevitably leave behind. Needless to say, reading price action is easier in exchange-traded markets, where volume information is available and institutional block orders are more easily detected, but in FX those with no flow information can still glean the market's intentions by looking at the order flow information left behind in the form of chart patterns and noting how prices react near important pivot points. Correctly reading price action is not something that can easily be taught, and over time traders find that it is more of an art form than a science.



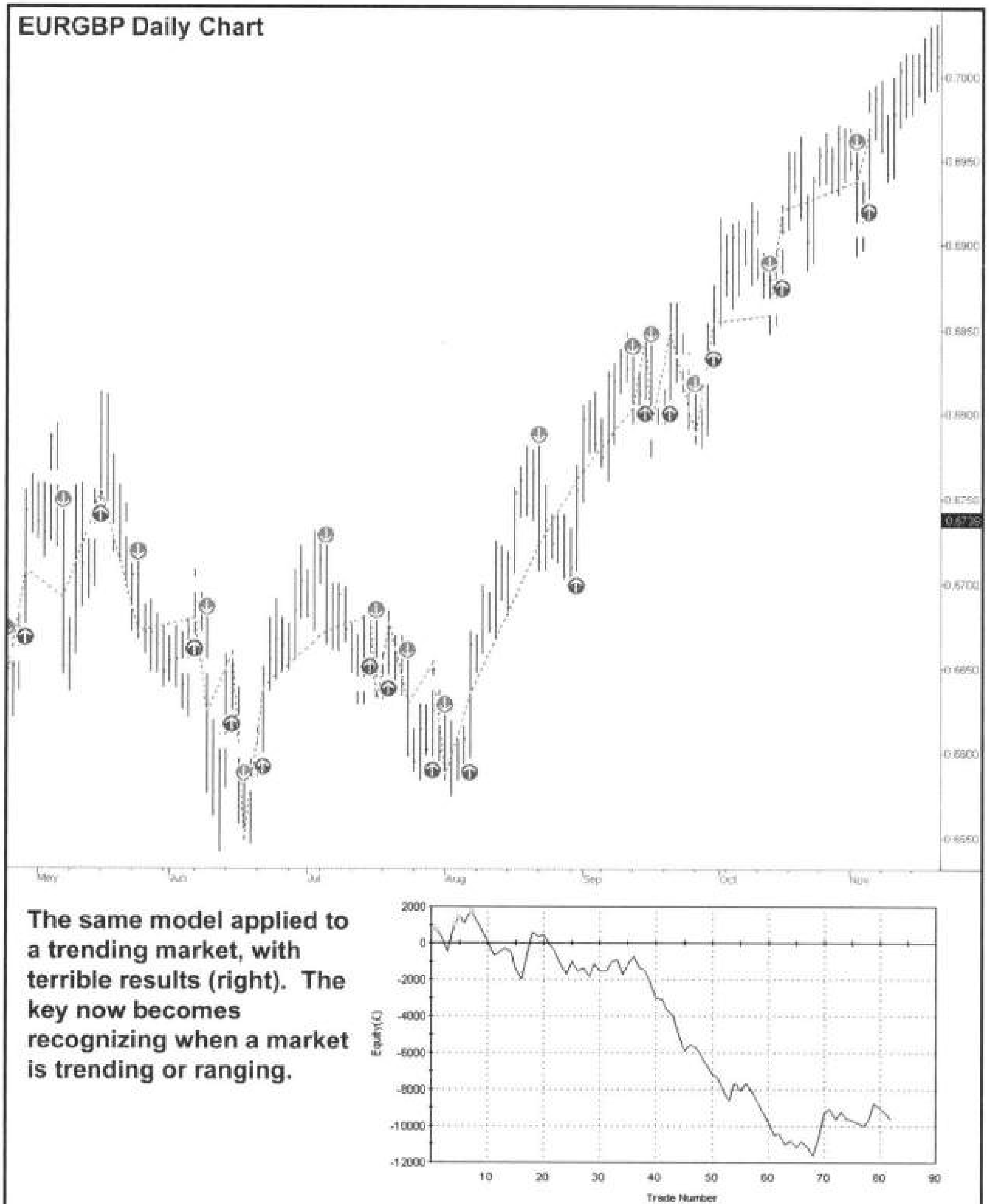
Results of one of MIGFX's proprietary trading models applied to a market with large swings. Results (right) prove to be very acceptable during this time frame.



source: graph and results calculated using Tradestation 8. All rights reserved.

All mechanical trading systems have built-in biases and flaws that you must be aware of.

One way to properly gauge the state of the market is by studying charts. Charts are so valuable to the intra-day trader because they paint a graphical representation of the price action, and over time telltale patterns emerge that can give us an insight into the market's footing and intention.

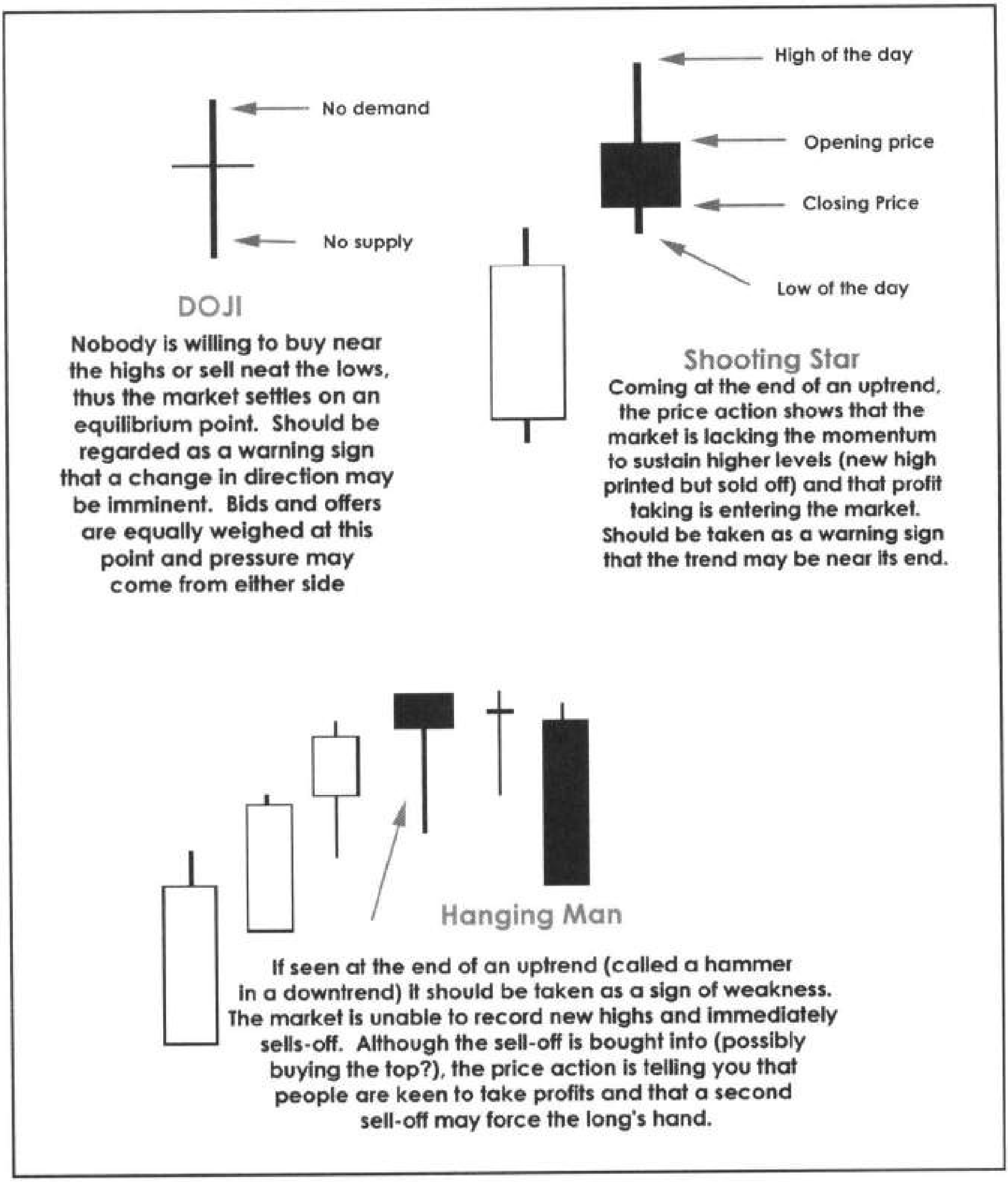


The same model applied to a trending market, with terrible results (right). The key now becomes recognizing when a market is trending or ranging.

source: graph and results calculated using Tradestation 8. All rights reserved.

Systematic trading systems are all bound to fail systematically sooner or later, which is why keeping a discretionary element is vital.

Familiarity with price action reading is the key to discretionary trading and allows traders to time more accurately their technically or fundamentally inspired entries and exits. The point is not necessarily to trade off the price action directly, but rather to learn to "predict" moves so that you can anticipate the market reaction and plan your response accordingly. With the help of a fast feed traders can learn to interpret the price action by simply looking at the way prices react near important levels.



Candlestick reading is a great way to visualize the price action and identify meaningful setups instantly.

For example, if a large option is rumored to lie near a big figure, the price action near the figure will usually let you know exactly what is being protected, and how vigorously. If the pair is sold off as it approaches the big figure but is then quickly bought back 10–20 pips lower, that may be a signal that the option protection guys are re-loading (selling near the figure and then covering their shorts). If this happens several times then you can be pretty certain that they are indeed protecting

Footprints that real-money driven moves leave behind.

Typical speculative price action.

their option, and you should keep an eye on the London or NY options cut after which the selling may disappear and the rate may be free to move higher.[2]

In order to read the price action properly, start by asking yourself these types of questions:

- What does the market do immediately after news is released?
  Initial move higher, followed by a rapid sell-off (dealers are fading the move: no real demand).
- How is the price behaving on approach to an important resistance level?
  Dips seem to be shallow and little retracement is seen (real money demand: dealers are working a mountain of buy orders and buy every dip).

The answers to these types of questions will give you an insight into the market's positioning and let you adjust your trading accordingly.

Those looking for more detailed trading techniques will find them in the Appendix of this book, where things such as how to enter/exit positions, set stops, and use price action effectively are addressed.

[2]A common option structure in the FX market is the "one touch" or "no touch" digital options, where a player bets that the price will (or will not) trade at a certain level before expiry (London or NY options cut). Thus, if the option buyer is betting on a certain level being hit, if they are large enough they will usually pro-actively gun for that level, while the option writer (typically a bank) will try to protect it until expiry so that they do not pay out.

IV

FX TRADING TIPS

13
Adapting to the FX Market

Traders entering FX from other capital markets quickly realize that trading currencies is a quite different beast altogether and that their tried-and-true techniques simply do not work as well as they did with equities, for example. This is because the forex market's unique structure sets it apart from the major exchange-traded markets around the world, and requires most traders to go through a period of adjustment.

Perhaps the most obvious distinction (and difficult to handle for individual traders) is the fact that the foreign exchange market trades continuously 24 hours a day, seven days a week. Global commerce does not take time off, and neither does FX. With the help of technology, trading now takes place around-the-clock, and although your broker may not accept orders over the weekend, you can rest assured that the FX market is awake and that someone, somewhere, is dealing.

TRADING DIFFERENT MONEY CENTERS

This continuous market action makes it difficult for new participants to adjust to, and new traders will find that their trading style and technical analysis often needs some tweaking in order to function properly. Since there is essentially no market "open" or "closed", technicians struggle to use their candlestick reading techniques, which are often not readily applicable. After all, everything is relative in FX, and a trader's open in Tokyo is not the same as a trader's open in London. Instead of relying on exchange-mandated hours, traders have to therefore find alternative ways to break down the day's trading.

A clever way to do this is to treat each trading session independently using 4 hour charts, which lets us divide the trading day into three eight-hour trading sessions. By doing this, we are better able to see each region's risk appetite and the long trading day now becomes more manageable. Since three major money centers are responsible for the vast majority of FX turnover, this lets us accurately divide it into the Asian, London, and New York trading sessions, and each of these has its own unique characteristics and trading style.

Asia

The majority of the turnover in this time zone is handled by Sydney, Tokyo, Hong Kong, and Singapore. Because each center's banks are in active competition with each other, this creates a more fragmented market when compared to the others and translates into jumpy price action and unsustainable moves. The main players in the Asian session are commercial names (exporters) and regional central banks, both of which love to enter the market in order to dampen volatility.

London

London's "City" still holds its traditional role as the FX capital of the world, having a deep, well-developed market and the ideal time zone for FX trading. Along with London, a host of other European financial centers such as Geneva, Paris, and Frankfurt add further liquidity to the market, creating a deep market across the board with every major FX player in operation. The moves that take place in London are generally "real money" inspired (supported by large corporate flows or M&A activity), which can have big impacts on intra-day price action, especially around the time of the London fix. All of this liquidity means that the moves generated in this session are all-important, since the amount of money needed to move a market this deep can tell us quite a bit about market sentiment and positioning.

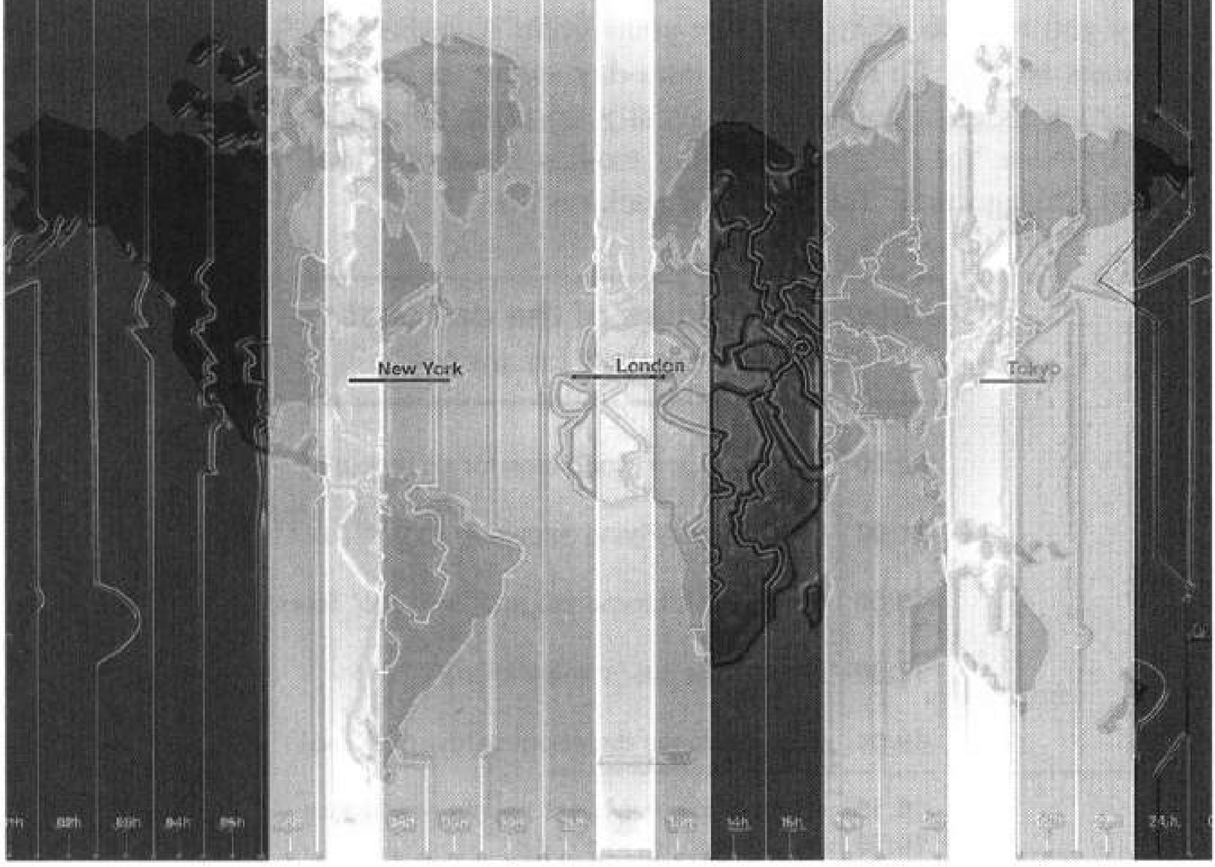
New York

Although New York comes in second to London in terms of volume, trading falls off precipitously after 12 pm. The market is at its deepest and most active in the morning "overlap" hours, when the big boys like to make their opinions known by trading yards at a time. Liquidity for Latin American currencies and the Canadian dollar (when Canadian banks are open) is also at its deepest here, meaning that if you are trading the Loonie, then you must trade these hours.

PASSING THE BATON

Although each of these trading sessions is in fact unique, their interplay creates some typical trading patterns that traders should be aware of. Starting with Asia, the day's trading characteristically opens with a flurry of early activity as dealers move rapidly to process their backlog of outstanding orders. To the yen or Aussie trader, the first couple of hours after Tokyo opens are all-important since they usually feature most of the fireworks in this session. The lack of market depth means that, more often than not, you will find Asian players testing the limits of any previous range (possibly recording marginal highs/lows), only to fall back and consolidate the move for the rest of the session since volatility-hating central banks and exporters love to turn this session into the day's consolidation session (especially if big moves were seen earlier in New York).

London, on the other hand, has always been the market trend-setter, and not just in fashion. Although the initial moves may not begin in London, this is where the large players operate and get a chance to swing their big sticks. Moves initiated and extended in London should be taken seriously since it is the only money center with deep enough pockets to overcome any "artificial" interference such as central bank interest. Thus you typically see mighty London picking a direction and sticking with it until New York enters the fray, making fading moves a dangerous sport during these hours.



Liquidity map. Light sections indicate deep liquidity, darker ones are "thin" market hours.

By the time North America opens for business, the FX baton has been passed around and by this time most intra-day bets have already been placed. This makes New York a tricky time zone trade, since large amounts of speculative money combined with important economic releases turns New York into the prime reversal session. In the first hour of trading, New York traders high on triple espressos will typically take it upon themselves to extend any moves initiated in London, trying to squeeze out the last pips from the market before the economic news hit the screens. However, because these releases can have dramatic effects on the dollar this rapid re-evaluation combined with dealer manipulation creates some difficult situations for day traders.

You often find reversals starting in this way: at around 10 am New York time, the major news releases have been out and traded on, leaving London traders with a day's worth of profits or losses to manage. Now, if you are a trader in Europe who is about to head home for the day, you know that liquidity dries up fast after the London fix so you will begin to slowly close your books around this time. You are careful to tip-toe your way out the door instead of rushing for the exits, since you know that any rush (meaning that the original move was artificial) will flood the market with supply and turn your winners into losers in mere minutes. Of course, everyone is thinking the same thing, and the greater fool theory takes over to get the ball rolling aided by the liquidity crunch. This creates a sudden rush in activity that can easily turn winners into losers or losers turn into disasters, which is why you want to make sure that your profits have been booked by the time the fix comes around. To the nimble intra-day swing traders these late morning New York reversals are a goldmine, especially since the remainder of the day is simply spent by New York dealers handling modest flows and jockeying with the IMM guys in Chicago until Tokyo comes back on line.

Important times of the day that all traders should be aware of

(GMT)	
00:00	Sydney Open (good time for an ambush)
11:00	LIBOR Spot Fixing (manipulation)
15:00	London FIX (corporate and "must do" flows)
17:00	NY options cut (manipulation)
18:00	Europe closes their books (reversal time)
19:15-19:30	Close of the IMM (last minute positioning by Chicago traders)
	Manipulation and abnormal moves are common during these times, so keep your eyes peeled and watch your stops!
	Check your own local time

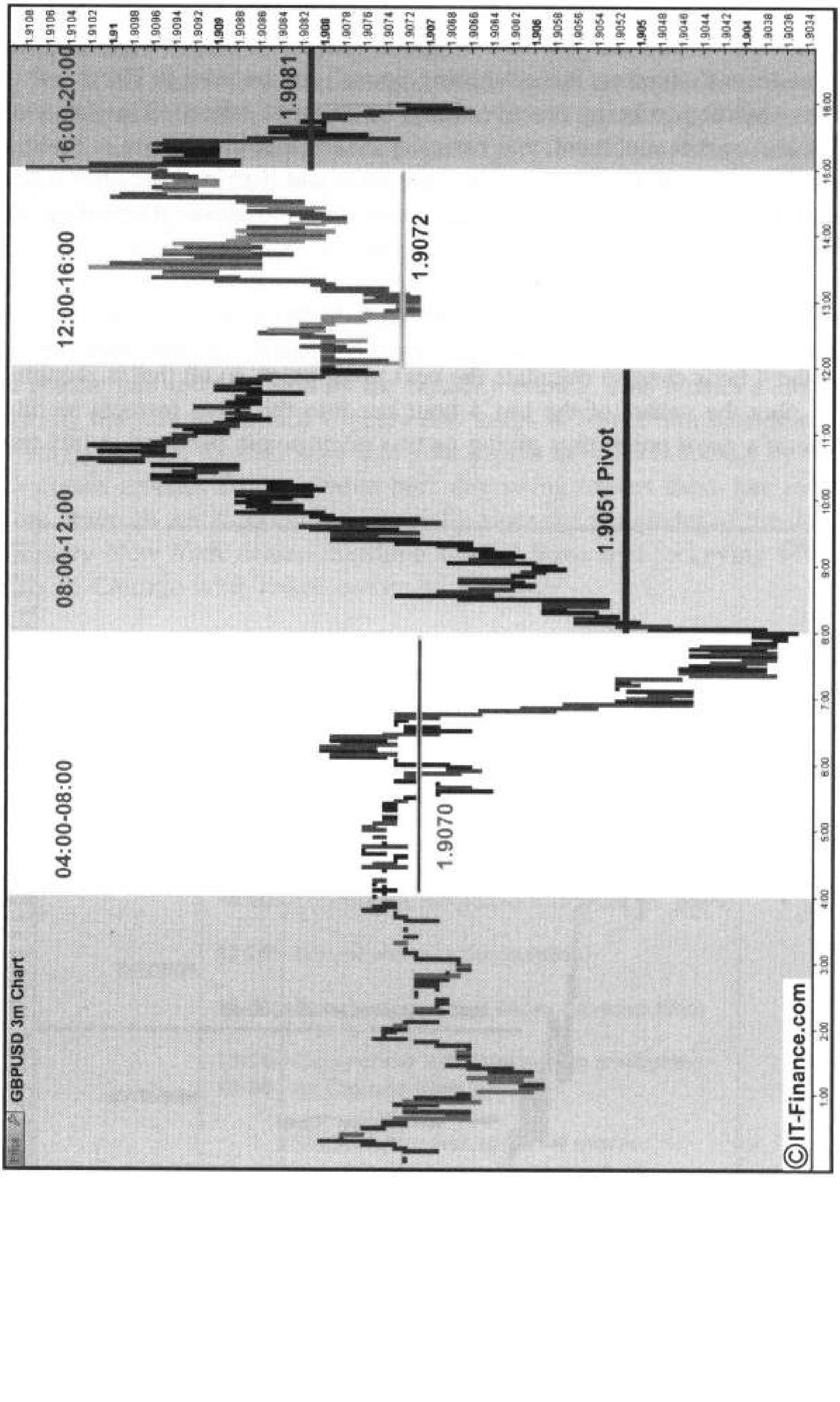
USING A ROLLING PIVOT POINT

One of the best ways to counter some of the technical problems discussed previously is to use a pivot point for each one of the day's trading sessions. A pivot point is that special line in the sand where most traders turn from being bearish to bullish (or vice versa), and just like in sports when you feel the momentum shift from one team to another, these "shifting points" can be used in FX to tell if sentiment has switched to being positive (long) or negative (short). This lets you get a feel for the market sentiment, and basically means that if the price is trading above the pivot, you want to play only the long side, and if below, the short side. There are several ways of calculating pivot points, with the classical one used by most Chicago boys being:

$$(\text{High} + \text{Low} + \text{Close})/3 = \text{Pivot}$$

We can use the 4 hour chart to calculate the next pivot point, so all that is required is simply to plug the values of the last 4 hour bar into the pivot formula to find the next session's pivot point, thus giving us two pivot points per session (six per trading day).

Once you have your pivot point, play the market from the long side if the price is above the pivot and from the short side if below.



A rolling pivot point recalculated every four hours is a good indicator of market sentiment and flows.

The thinking behind pivots is simple yet powerful: if buyers are willing to pay more for the same thing today than they were yesterday (or four hours ago), then at least for the time being flows must be positive. Although you should not trade the break of this pivot, it is, however, a nice way to manage the continuous market action by breaking down each money center's risk appetite and integrating it with your other analytical tools. By applying this filter to our technical signals, we are able to only accept "buy" entry signals if the price is trading above the pivot, and only accept "sell" signals if below, etc.

TIME MANAGEMENT

Although the FX market can accurately be described as a 24 hour market, no trader can possibly hope to keep up with this nonstop action. All FX traders suffer the consequences of following the market, and you can usually identify them by the bags under their eyes and the Reuters machine next to their bed. Depriving your body of much-needed sleep is something that many new retail traders overlook to their detriment, and understanding when *not* to trade can be just as important as when to trade.

Professional FX operations keep up with the market by employing 24 hour trading desks with two or three shifts, splitting up the day's time between traders. Although they may keep some odd hours, FX dealers still wake up, go to work, and go home. Similarly, a retail trader cannot possibly hope to keep up with the whole market and must learn to manage their time accordingly (especially for those trading from home). Spending 20 hours a day in front of the screen is simply not a good way to foster long-term success, since it will eventually eat into your decision-making (and social!) skills.

New traders must become comfortable with the fact that moves will occasionally be missed, but in general all traders should try to trade the London–NY overlap, since that is where the market is at its deepest and the moves offer the best opportunities for day traders. If seen on a graph, the daily currency trading turnover would feature spikes of activity during the major money center hours and flatline near some predictable times of illiquidity and abnormal moves. San Francisco never blossomed into the bridge between NY and Tokyo, leaving a liquidity gap between 3 and 7 pm (NY time), making for thin markets and abnormal spikes caused by stop-hunting.

You want to make it a point to trade no more than two of the three trading sessions, and learn to manage your time so that you above all avoid the boring and illiquid hours between openings. Since the body is pre-wired to seek out stimulation at all times there is possibly nothing worse for a trader's mind than boredom, and instead of sitting on your hands you will find yourself needlessly entering the market in search of some action. For this reason, low-interest times should be avoided at all costs, and even if you have open positions you should simply set your stops/limits and go away. More likely than not you will find the price exactly where you left it.

14 Trading Thin Markets

Thin markets are the FX equivalent of shark-infested waters. When markets are referred to as being "thin" or "light", it means that there is simply not enough liquidity (buyers and sellers) to create a deep and balanced market. In these situations, transactions that would normally be absorbed by an active market can have unusually large and usually unpleasant ramifications on price. Thin markets are often used to run stops by dealers and specs alike, since this is when they get most bang for their buck. Thus liquidity-challenged hours (late NY, Sydney) are prone to see jumps, gaps, and generally unaccounted for moves.

How to identify thin markets

- Prices have not moved more than 10 pips in two hours.
- Prices are jumping back and forth 50 pips at a time.

Hours

- Once the Europeans go home and the New Yorkers settle in for their afternoon nap, you can actually hear the liquidity dry up if you stand close enough to your monitor.
- The late Asian session also tends to be a lot less liquid than the London or NY hours, especially outside the majors.

Events

- Before/after major news releases. It makes sense that markets would be thin right before a major economic release, since most people do not want to take a position (gamble) right before the numbers. Prices become jumpy, spreads widen, and stops get killed.

Seasonal

- Bank holidays, month of August, the week between Christmas and New Year.

How to trade thin markets

- The easiest thing to do is to avoid them.
- If holding a position, take some exposure off the table or place your stops out of the reach of stop hunters. You can also hedge your position with a highly correlated pair (i.e. EURUSD and USDCHF). The last thing you want is to have your position taken out by a single blip.

Typical price action on US data-heavy Fridays.

TAKING ADVANTAGE OF THIN MARKETS

On a Friday when important news has been released (deficit, NFP, etc.), prices tend to move one way, then the other, then the other, until finally deciding on one direction. After the big move the pair becomes O/S (or O/B) on an intra-day basis, and some sort of support has been established that will presumably hold until the weekend. This is the kind of setup that dealers love to exploit, and if you recognize it so can you.

Looking for a quick trade before the weekend, Joe Trader will buy near the bottom (see above) hoping to catch a quick over-sold bounce. He places his stops below the day's support and is in the trade more because he is bored than because of his convictions. Smart traders will recognize this level and know that before everyone heads home for the day one final stop-hunting move is probably on the cards.

After London goes home for the weekend, and about the time New Yorkers start checking their clocks, the dealers will pounce. If there are enough stops gathered nearby to garner their attention, they will quickly set up a coordinated attack and take them out in the blink of an eye. All that you have to do is identify the setup and go short with the dealers as soon as the rate approaches the support level, knowing that the support is artificial and the move should give you a quick 10–20 pip move (just enough to run Joe's stops). Since the buildup to these moves tends to be rather slow (although the actual stop run in instantaneous), it is best to simply set orders in the market and wait for the price to come to you. The first sell order would be placed at/near the support level, with a take profit some pips below (exactly the opposite of Joe's orders). Having them as limit/stop orders will ensure that they get executed since some brokers like to shift to "manual execution" when they are about to run stops.

Once the stops are filled, the price goes back to where it was, and the market proceeds to die for the rest of the day. Your profit take order is done and you are free to enjoy the rest of your Friday afternoon.

Towards the end of the day dealers easily take out Joe's attempt to pick a bottom.

15
Using the Crosses

Finding the right pair to trade should be of utmost importance to all individual traders. Opportunity cost is a real cost for most traders and funds committed to any one position are funds that cannot be used in other (possibly more profitable?) trades. Since in FX every pair is in one way or another connected to the others, traders who adopt a dollar-centric view risk missing promising trades and not understanding the real potential some opportunities offer. Although most of the dealing is done through direct dollar buying/selling, one should constantly keep an eye on the crosses in order to gauge a currency's true strength/weakness,[1] which in the end will tell you which pair is best to trade.

A very reasonable way to trade equities is to trade from big to small. For example, through your analysis you determine that the stock market in general should rise, but knowing that you have limited funds, you need to choose your stocks carefully. It would therefore be advisable to look at sector-specific indices and find the most promising of the bunch. From there, you would look within the index and find the most attractive company(s) in which to invest directly. This "big-to-small" thinking is very solid and should be applied to FX.

Even if not trading them directly, cross movements should never be overlooked, since the movements of the crosses can often hide the footsteps of large players choosing to position themselves in a stealthy manner rather than through one of the majors. If someone is looking to load up on euros, for example, they may try to fly under the radar by buying euros against Swiss francs, sterling, yen, or other more obscure crosses. These are bets on broad-based euro strength (for fundamental reasons) spread out over a number of currencies (a basket) rather than taking a direct dollar negative position.

The crosses can also prove incredibly important to swing or momentum traders, since they can be used as forecasting tools and show you which currency is leading

[1] I personally do not like to use the USD Index (USDX) to gage the USD's broad strength/weakness, since the basket is heavily euro-weighted and essentially makes the index a mirror of the EURUSD.

the pack. Traders that overlook the importance of the crosses are often stuck with positions that do not move, while the rest of the market takes off in their desired direction.

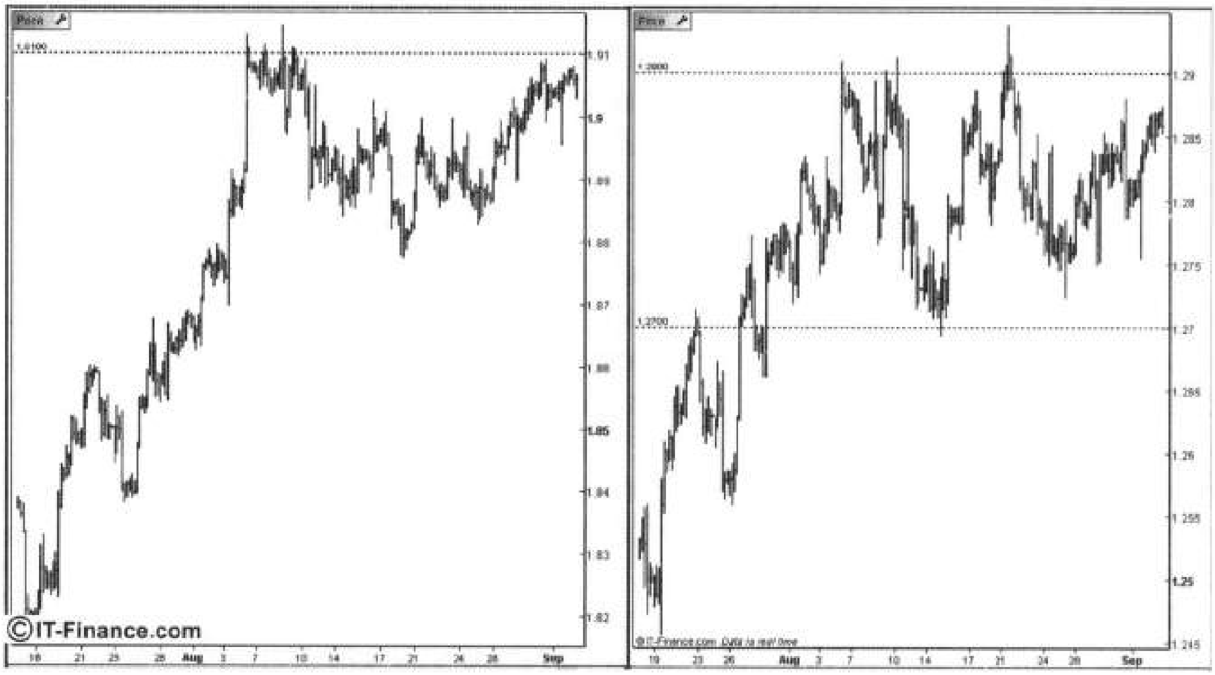
PRESSURE VALVES

If the dollar is rallying against everything, but cable does not seem to be moving much, then one look at its crosses will show you where the selling pressure is being absorbed. Maybe sterling is rallying strongly against the euro or against the yen; in the end it does not matter. All that matters is that your cable short is barely in the black, and probably poised to bounce back strongly when the demand for dollars is exhausted.

With limited funds you always want to pick the pair that will move the most, but how exactly do you come to a reasonable conclusion? That is where the crosses come in.

Cross movements either work to amplify the move or minimize the effects. If the euro is dropping against the dollar, for example, but rising against the pound, the net effect will be to limit the size of the EURUSD fall. When this cross is rising, it is telling us that the euro is outperforming the pound, and vice versa.

Look at an example below of using the crosses. You are certain that the next few days will be a period of dollar strength (for whatever reason), but faced with



Which one to trade? We turn to the crosses for help.

It is reasonable to assume that EURGBP will bounce from the area of strong support.

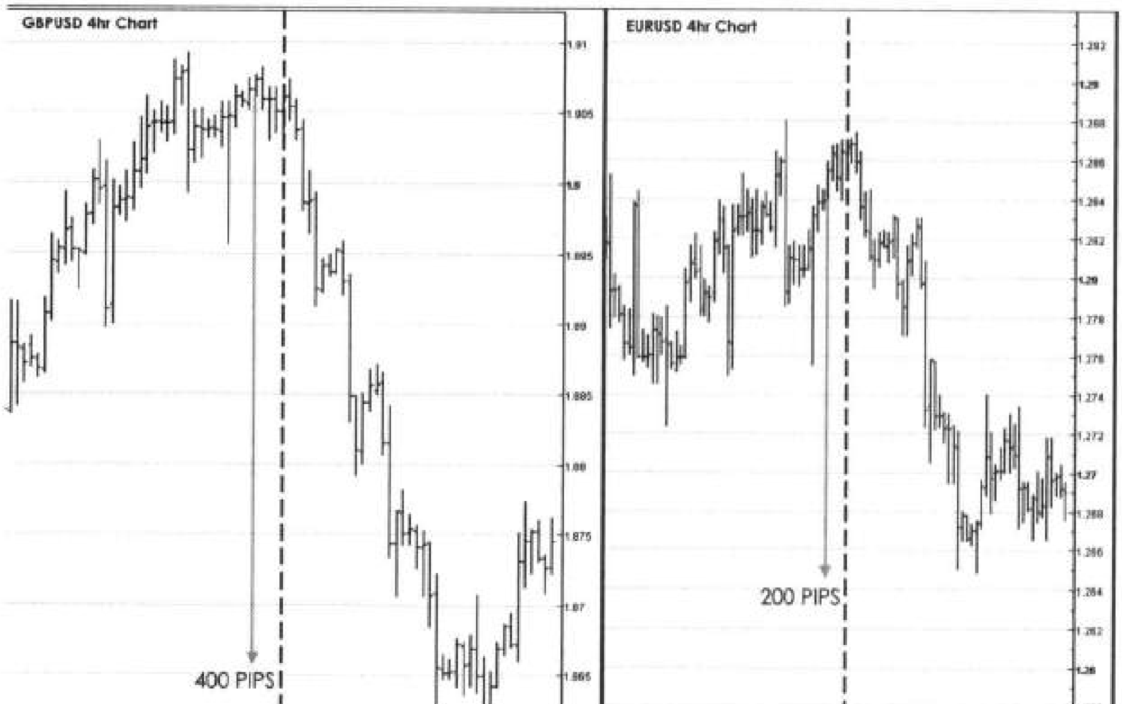
limited resources you cannot take a broad-based USD bet. You only have enough ammunition to trade one pair, and decide to either short the euro or cable. The question then becomes, which one?

By looking at the EURGBP chart above, we notice that its sharp fall has it testing the area of strong support near .6720. Chart patterns and oversold technical readings means that we can reasonably assume that this area of support will hold and that the cross may stage a brief rebound. Of course we can either anticipate this move or wait for the price action to confirm our thoughts. Either way, a rising EURGBP means that sterling is likely to be the weaker of the two.

Any EURUSD selling pressure (euro sells) is likely to be offset somewhat by the rebounding cross (euro buys), while GBPUSD sales (sterling sales) will only be amplified by the cross sales (sterling sales). Since EURGBP is likely to bounce, it would therefore make sense to short cable instead of euro.

In the aftermath, we can see that EURGBP did indeed bounce as expected (see below), and the added selling pressure on sterling caused GBPUSD to drop nearly 200 pips more than EURUSD! If at the very beginning we had instead chosen to randomly pick one of the two pairs to short, we may have missed out on a great trade.

EURGBP bounces at least temporarily from its support.

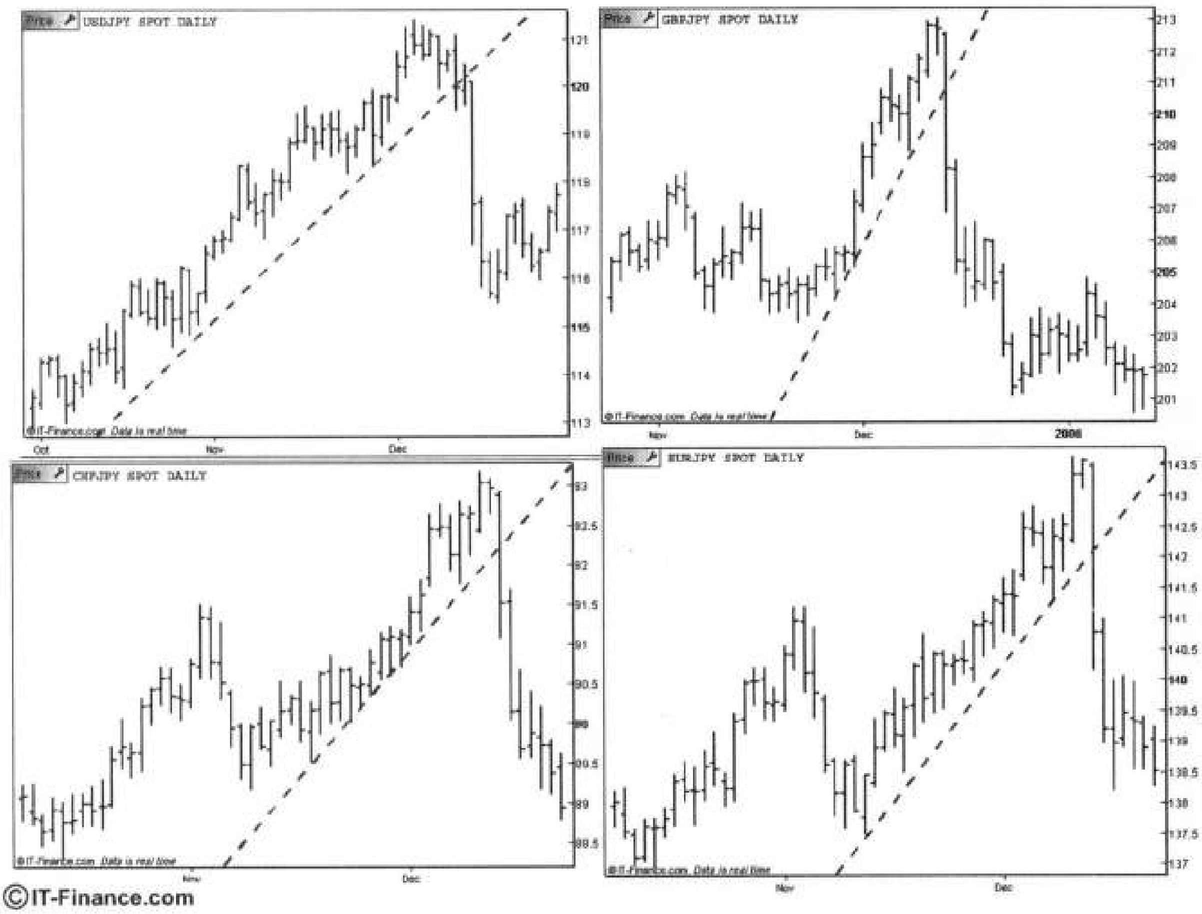


The difference in picking the right pair can prove significant!

Every trader should have currency pages set up within their charting software that focus on these key crosses:

EURO	STERLING	YEN	SWISSY
EURUSD	GBPUSD	USDJPY	USDCHF
EURCHF	GBPCHF	EURJPY	EURCHF
EURJPY	GBPJPY	GBPJPY	GBPCHF
EURGBP	EURGBP	CHFJPY	CHFJPY

Looking at the cross charts in a daily and 4 hour time frame will instantly give you an idea of the relative strength of a currency and show you who is leading the pack in the near term.



©IT-Finance.com

Looking at a yen page, we can instantly see that the yen strengthened across the board, confirming the yen as the primary driver. If some of the charts were dropping and some were rising, on the other hand, this would indicate that the market was concentrating on another currency.

16
All About Stops

Does active stop hunting really take place? Of course it does! Dealers are as much information peddlers as they are price quoters, and every dealing desk has their partners in crime: either important clients or other friendly desks to whom they communicate their client's positions and stops. Stop hunting takes place all day, every day, and there are some prop desks that actually specialize in hunting for stops for short-term gains. Sometimes no communication is needed, since dealers know that Joe Trader places his stops at such obvious levels that they become perfect targets.

It is amusing to see that most brokers actively preach to their clients the value of placing tight stops as a way to control risk, but in reality they are just looking for stop levels to shoot for. Tight stops more often hurt the trader than they help him, since the intra-day FX market is filled with random moves (noise) that routinely wipe out the retail crowd's 10 pip stops.

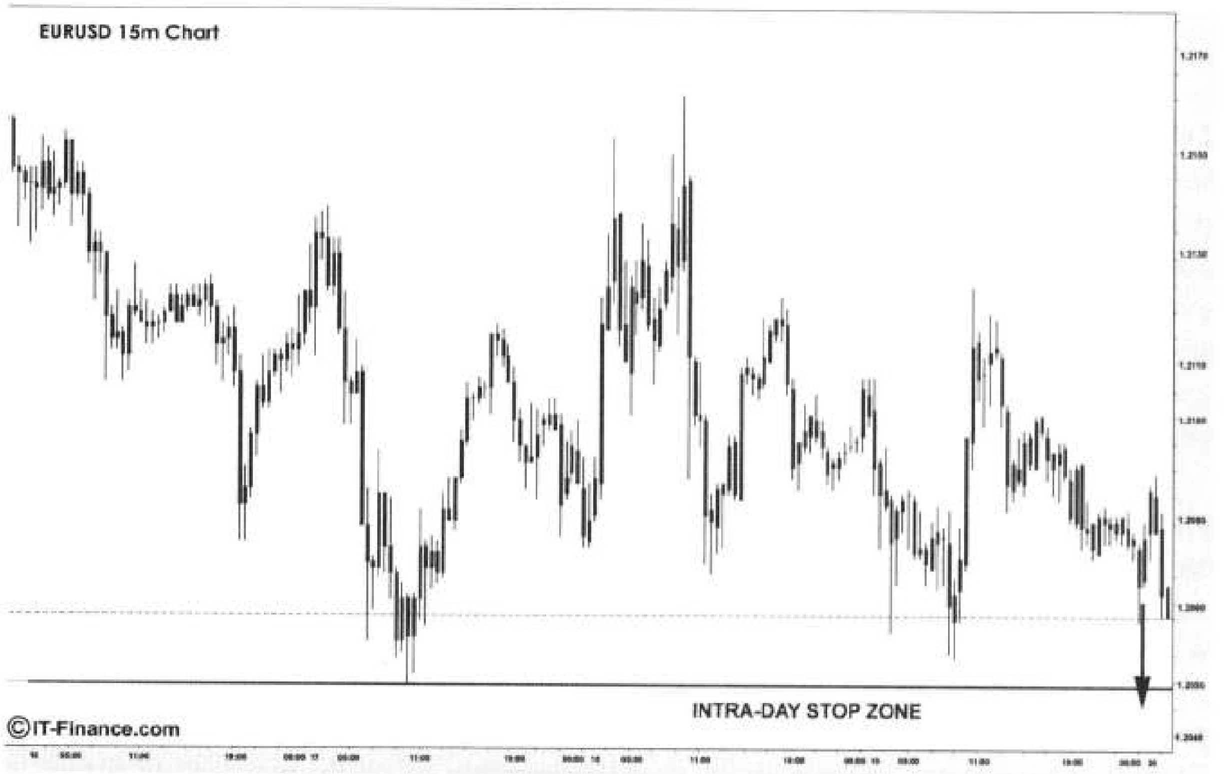
Like all players in the market, stop hunters have limited ammunition and are prone to act during certain market hours in order to achieve the maximum effect. Illiquid or extremely volatile times enable operators to easily manipulate prices in the short run, either by quoting off-market prices or by moving the market with large orders. Thin market hours are especially vulnerable to manipulation, and early Sydney and late NY should be avoided by traders. The rollover hour[1] is also particularly prone to manipulation as inexperienced spec traders place short-term trades hoping to take advantage of the rollover interest, only to see them get blown away by the dealers. Only pigs waiting to get slaughtered place intra-day carry trades.

STOP LEVELS

The intra-day FX market is so full of market noise that knowing where to place stops (or not place them) has become increasingly important. Prices tend to jump 10

[1]Usually 5 pm NY time, when overnight positions are "rolled over" and interest is credited/debited.

or 20 pips for no apparent reason (most likely because of flows) and retail traders often find their stops being constantly taken out even though the market may be moving in their desired direction. Ideally, you should aim not to leave any fixed stops in the market. Although professional money managers often trade with stops, they leave the orders on *their* computers instead of with their brokers (making them invisible), and more often than not trade with no stops at all. Trading in this way involves viewing your positions not as one-off trades that either go right or wrong, but rather as continuous views that are to be constantly traded around until the preferred outcome materializes (see the Appendix for tips on trading out of a losing position).



Stop hunting near an obvious support point. Dealers know the size and location of the stops sitting below the support zone and decide to go after them.

Unless trading long-term, placing a trailing stop is also not advisable since you effectively give up control of your position and simply choose to exit at a random number, which may or may not have anything to do with the price action. Place it too close and you will get hit too early; place it too far and you will forego some profits if the rate quickly retraces. A static 10–20 pip stop is also arbitrary and can actually turn a winner into a loser very quickly.

Your stop points should therefore be based on dynamic levels rather than arbitrary static numbers. Dynamic stop levels such as moving averages, Bollinger bands,

As you can see, dealers quickly trip stops, after which the price is then free to move according to regular market flows.

SARs, etc.,[2] are all good ways to manage risk while letting the market do what it does. The more experienced a trader you become, the more you will come to realize that trading with fixed stops in the market may actually hurt you more than help, both psychologically and profit-wise.

Don't Feed the Stop Hunters!

Avoid placing stops in these situations:

- close to/at round numbers
- before/after news releases
- times of thin liquidity

[2]All indicators are readily available in most charting packages. Use default settings or tweak them according to your timeframe.

Stop hunting before news releases. In this sequence the dealers see their client base going long sterling into the news release, so they decide to take out their stops just before the number is published. If a dealer thinks that the economic data are not likely to have a big impact on prices, their tactic is to sell aggressively right before the news (using an illiquid market), trip the stops, and then take back their positions. This is why it is prudent never to enter a trade right before news releases!

17
Characteristics of FX Trends

When properly formed, FX trends tend to be particularly vicious and one-way, and routinely wipe out speculators who commit the trading sin of trend fading. It is important, therefore, to learn to identify trends early in their development and distinguish them from short-term price moves.

FX trends usually start slowly. FX trends are special because they often emerge as the unintended consequence of another action in the world's capital markets. Since foreign exchange is merely a facilitator and still not used extensively to place outright speculative bets, an indirect event such as a booming local stock market can also leave behind a massive FX trend in its wake. If Japanese stock markets are strong and global equity funds want to buy into the bull market, they will be forced to exchange their local currency for yen in order to purchase Japanese stocks. Although they are not intentionally betting on yen strength, if strong enough these flows will come to dominate the FX market. Since the initial moves of an FX trend are usually underpinned by steady real-money buying such as yield hunters, hedgers, or value investors, you have to keep one eye on the macro situation by looking for signs that the "smart money" is moving in to take advantage of a situation.

The longer the trend, the longer the correction/consolidation. Most fundamentally driven trends do not simply make U-turns. Before taking the next leg higher/lower, the market needs time to digest the initial move and draw in more buyers/sellers, or remove the fundamental reason (yield difference) in order to reverse the direction.

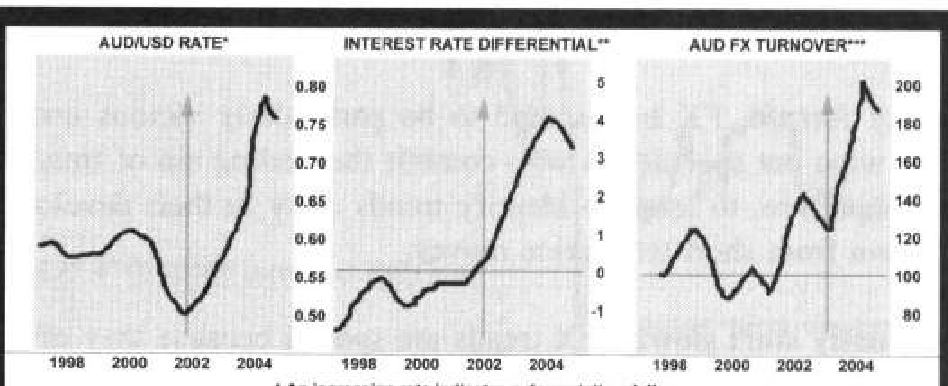
If the public realizes that a trend has developed, it is too late. As they say, a *Newsweek* cover is the kiss of death for any trend. By the time the general public comes to realize what a great opportunity something is, professionals have long been in the trade and are waiting to cash in by unloading on to the retail crowd.

It's all connected!

Usual market correlations to keep in mind when trading

US Bond Yields :	Yields UP / USD UP
Gold Price:	Gold UP / USD DOWN / AUD UP / CAD UP
Crude Oil Price:	Crude UP / USD DOWN / CAD UP (USDCAD DOWN)
CRM Index:	CRM Index UP / USD DOWN / AUD UP / CAD UP
Emerging Mkts:	Emerging Mkts DOWN, USD UP

All traders should include bond and gold prices in their market monitors. In times of slow growth (yield hungry), the currency market typically waits for the bond market reaction before committing positions. In this way, bond yields can be used as leading indicators in economic data-heavy days.



* An increasing rate indicates a depreciating dollar
** Three-month Australian dollar Libor minus US dollar Libor.
*** Indexed to first quarter of 1998 = 100 in Australian dollars.

Sources : BIS Quarterly Review, Dec 2004. Galati, Melvin. Bloomberg, Australian FMA

Situations like these are important for the individual investor to understand since trends are hard to stop overnight. Once the yield difference shifts in the AUD's direction in 2002, all kinds of buyers plow into the market.

In this case of the Aussie dollar uptrend, we can see a couple of interesting things happen in 2002 when the yield advantage between the USD and the AUD shifted in the Aussie's favor and set a chain of events in motion that are sometimes impossible to stop. The initial buyers of the AUDUSD are mainly yield-hungry but conservative real-money managers (i.e. pension funds), who decide to switch some of their US dollars into the higher-yielding Australian dollar. Theirs is a bet that the money they make from the yield difference will more than make up for any exchange rate losses suffered. This sudden demand for Aussie dollars momentarily pumps up the AUDUSD rate, which attracts more active managers such as hedge funds that like to play short-term trends. Of course, their buying further inflates the AUDUSD rate, which is now in a full-fledged up trend, and finally forces the hand of Australian exporters who were hedged at lower levels and must now enter the market to cover future cash flows (buying AUD). This chain of events can be clearly seen in the rapid increase in turnover and the rising AUDUSD rate, which at some point becomes self-sustaining and far from the original "yield play" that some were after. All types of players are now long AUDUSD for various reasons, and these kinds of trends stop only when the fundamental backdrop is taken away (yield difference) either in a real or perceived manner, and more often than not they end in tears.

TREND EXAMPLE

Let us take a look at a real-world example of a USDJPY move seen during the last quarter of 2005.

An extended move in USDJPY exhibits all the typical signs of FX trends.

1. Accumulation Stage (USDJPY 109-115)

From September to November, institutional and real money buyers begin to sell yen across the board. Two things fueled this "insider" move, Japan's zero interest rate policy and the rally in commodities. An oversimplified view of the events would go something like this: with their zero interest rate policy, Japan is basically giving away money and everyone and their grandmother is using the yen to finance their carry trades. Wanting to pad their P/L before the year end (remember it is

Q4), fund managers take out yen-denominated loans and convert them into USD (driving USDJPY higher) in order to buy dollar-denominated commodities such as oil, gold, and copper for their portfolios. When the price reaches the top of the range near 114, the usual range-capping suspects (Japanese exporters) are not present, meaning that they are either fully hedged or that they expect the yen to continue depreciating.

2. Hot Money Stage (USDJPY 115-116)

Speculators enter the fray. Momentum funds pile into the long side of the trade and continue to do so until the market tells them otherwise. Retail specs, on the other hand, take notice of the overbought readings and think that the rate is ripe for a correction since it has already gone up "too much". Those that fade the move here are faced with two outcomes: death by a thousand stops or death by averaging down. Either way, those that do not swallow their pride and recognize that they were wrong are soon forced into an all-or-nothing trade.

3. Throwing in the towel (USDJPY 120-121)

A last gasp higher takes whatever stops were left in the market. Notice all of the shooting star candles near the top, a sign that after three months and ten big figures those holding long positions are beginning to cash out on any blips higher. Everybody seems to be long now, and the trend will seemingly go on "forever".

4. Reversal (USDJPY 120)

In December, the market makes a sudden 180 degree turn and drops nearly 500 pips in two days. The long-awaited reversal finally came (although several hundred pips above what the retail crowd thought) as the result of some kind of catalyst that changed the underlying equation supporting USDJPY. More often than not this is a shift in government policy or some other external factor that forces the real money crowd's hand (such as a big coupon payment/redemption). In this case, the catalyst was the seemingly uneventful fact that the Bank of Japan raised the minimum margin requirements for the Tokyo metals market in order to limit speculation. Although it is nothing huge like a surprise rate hike, the slight change forced hedge funds to cash in on some of their long gold positions in order to meet the new margin requirements of the exchange.

Since the change was announced during the weekend, when Monday morning came around the market was flooded with a sudden, massive sell interest that soon snowballed into outright pandemonium in the gold market. The market headed towards free-fall and traders rushed to unwind their positions before it was too late, with the end result being that gold dropped *20%* that day! When the gold positions were unwound, the dollars received were converted back into yen in order to pay back the JPY-denominated loans that were taken out in the first place, and this massive yen buying caused the USDJPY to take a steep tumble. Although the margin requirement change may have been responsible for only the first 150–200 pips of the move, it was enough to get the ball rolling and shift the trend dynamics. This should bring home the fact that little things can have big implications, so be on the lookout for abnormal price moves in other markets that could have an eventual impact on FX prices.

Not surprisingly, I did not hear any comments about this gold story from any analysts, either before or after the fact... they probably blamed it on some technical pattern, economic fundamentals, or growth rates.

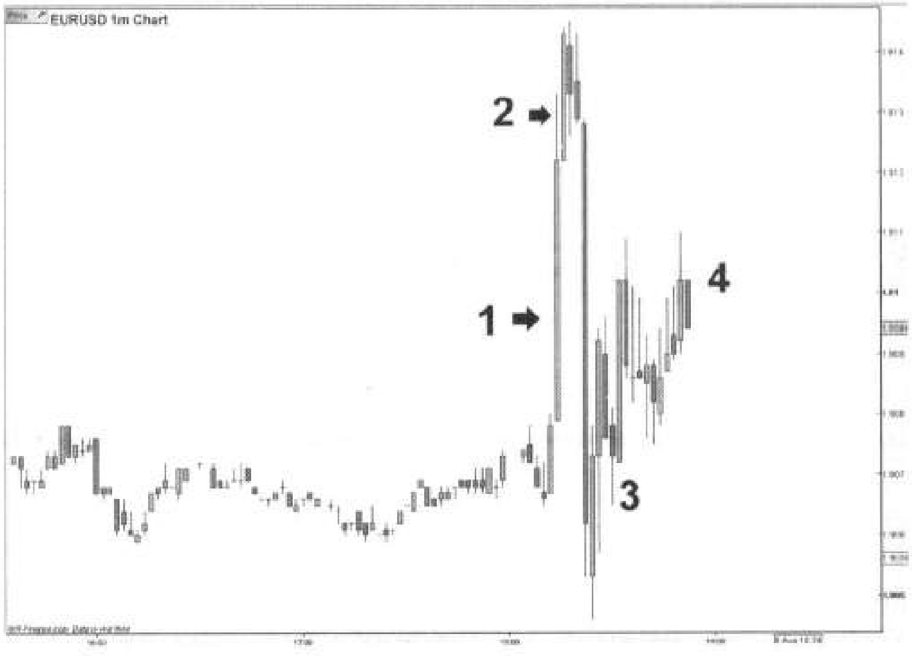
18
Trading the FED

Whenever the Federal Market Open Committee (FOMC) meets to set interest rates in the US, trading proves tricky, to say the least. These days the FED goes out of its way to telegraph the moves well in advance, so the market has switched from the nail-biting hike or no hike scenario to looking and analyzing every single word in the accompanying statement. This evaluation and re-evaluation of what the Fed actually "means" translates into a free-for-all immediately following the release, and dealers are hard at work chopping up players on both sides of the market while the FX heavy-hitters sit and deliberate whether the statement was "hawkish" or "dovish".

What should one do in a situation like this, when the price jumps 50 pips one minute and then dives 50 the next? Simple: wait for the dust to settle and let the price action guide your moves. Since traders like to limit their exposure before any FED release, the market will tend to trade a reasonably tight range the day(s) before any announcement, and these range extremes can be used effectively to trade with the dealers, and against the general public.

This is how Joe Trader would trade this FOMC release. When the FOMC announces its quarter-point rate hike (the market bought on the rumour and is now selling the fact) Joe goes long at the next tradable price (1, 2). Stops are placed at a "safe" distance and the EURUSD spends the next five minutes whipping back and forth, wiping clean any stops in an 80-point range.

After ten minutes, the pair moves higher again and Joe is convinced that this time the move is for real, so he sets his stops below the previous low, away from the noise (3, 4). Dealers see the spec market go long EURUSD so they are happy to fade the move higher and target the downside stops (5). Intra-day stops are successfully tripped, and dealers take back their shorts for a nice profit and call it a day (6). Frustrated, Joe Trader throws in the towel, and the market is free to move back within the range again.



The minutes after an FOMC release.

Dealers gun for the obvious stop levels before returning to pre-FOMC levels.

This typical scenario plays out almost every time the FOMC meets to set rates, with the rate chopping around for a while after the decision until the market finally makes up its mind as to the statement. Since the statement came in with the market's expectations, the euro eventually finds itself at the same price it was prior to the announcement (even though it moved more than 200 pips round-trip!). In situations like these, when the market gets what they are expecting, then the usual scenario is for dealers to hit the intra-day stops on both sides of the intra-day range and then settle on the pre-FOMC equilibrium point. After all, if nothing changed then there is no reason for players to aggressively push the market one way or another.

THE TRADE

Trading like a dealer in this case would mean recognizing the stop-hunting push 30 min after the release and going short around 1.2820 or so, knowing that dealers are going for Joe's obvious stops sitting below the previous low of 1.2807 (see below). Take-profit orders for the shorts would be placed under the figure, for a nice 30 pip gain, which surely beats getting stopped out two or three times in 10 minutes.

Pre-FOMC, establish the range and fade the extremes.

Remember that you are a trader, not an economist. On the daily chart the wild gyrations will barely be visible, so use the 15 min charts to wait for the market to decide where it wants to go, and follow these simple dealer maxims:

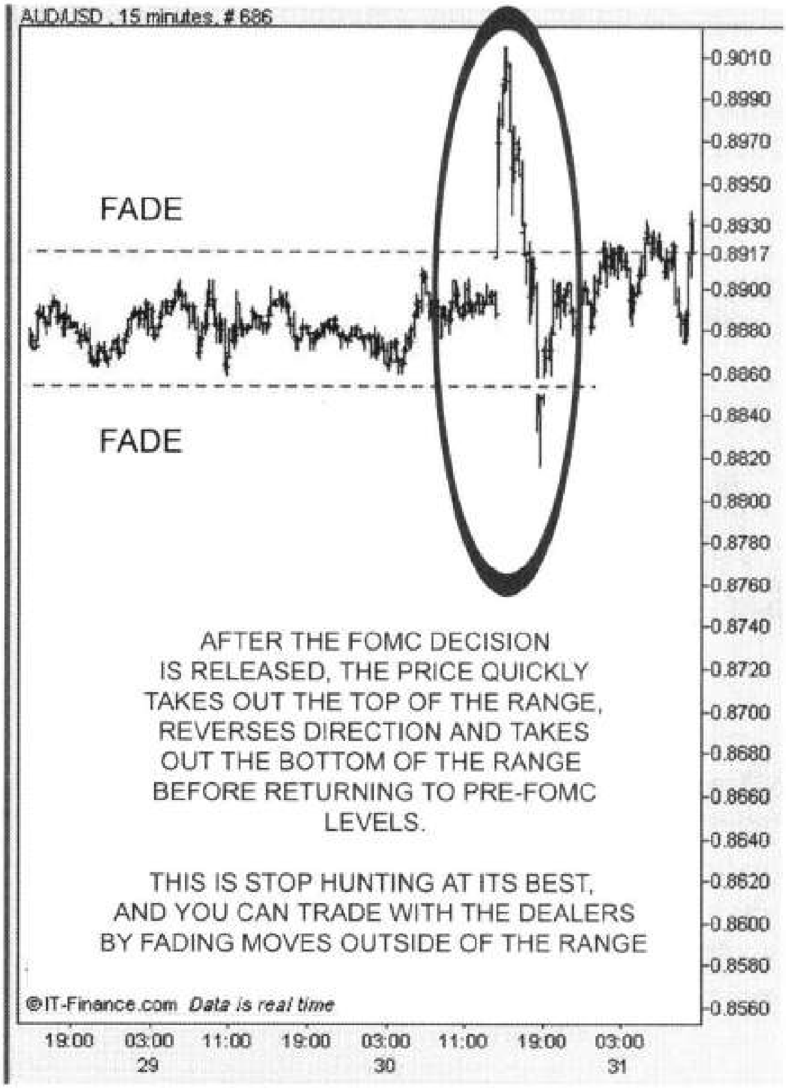
Never chase.

Never trust the first price.

The trade: recognize the obvious stop level and trade with the dealers.

If the statement was in line with market expectations, fade any move outside the range and remember the typical price action: the first 15 min will see the dealers hit the high stops, hit the low stops (or vice versa) and return to the pre-announcement level before making the big move. Recognize that these illiquid markets are a stop-running feast for dealers, so be sure to identify "typical" stop-loss levels (ordinarily below/above the previous highs/lows) and go after them along with the dealers.

Another typical FOMC setup.



Another example of FOMC trading.

19 Fading News

In the same vein as the FED trade, dealers often like to fade "headline" news numbers if they feel that the market is still in a clear trend. Depending on what the market is focusing (growth, inflation, etc.) some news releases tend to take on greater importance than others. In times of growth concerns, an always anticipated number is the non-farms payroll data, released on the first Friday of every month.

Whenever possible, trade in the prevailing market direction.

NFP days are known for their volatility, and traders routinely get chopped up trading the headline number. It is important to note that one piece of data is generally not enough to reverse a clear trend, so even though the number may come in worse than expected, it is still preferable to fade the release and trade in the prevailing trend. Only a monumentally bad piece of data or a series of bad releases can shake a currency from a clear trend, so take a clue from the dealers and fade the moves once the knee-jerk reaction is over.

In this case the setup is typical. The EURUSD comes into the all-important payroll numbers in a clear downtrend, which will only be reversed by some fundamental shift in expectations. The following price action can usually be seen before/after all eagerly awaited economic releases and should be traded accordingly.

Before the NFP number EURUSD settles into a range as traders limit their exposure. The range limits should be seen as obvious stop levels.

Bad data (but not that bad) and the immediate knee-jerk reaction is to sell USD. Dealers are happy to fade the move higher and are soon gunning for the intra-day stops.

Since news releases and other important events are "open season" on traders, you should always be on your toes. If you find that you are at your trading best during normal trading hours, then you should think about skipping data days altogether since the initial flurry of activity is often impossible to trade, especially because retail brokers tend to shut down their systems altogether to limit their exposure.

If you are coming into an important news event with a position, it is best to lighten up and remove or place stops far enough away so that dealers will not get to them. If you are eager to trade, then wait for the initial knee-jerk reaction to be completely reversed (on 3 min charts) and then enter your desired position. Use 15 min charts to trade the market, which will smooth out the market noise and make the market's intentions more evident.

After a flurry of activity, the euro returns to its established downward trend.

Always trade in the direction of the trend. Do not assume that one piece of news is enough to reverse an established trend (or range).

20
FX Analysts: Who Cares?

As more and more retail traders enter the FX market, a critical lack of market information has led to the rise of a new FX superstar: the analyst. Retail forex brokers are hiring and promoting the skill of these guys in droves, partially to offset their client's well-founded fears of the market. Don't know how to trade? Don't worry, we have the people that can teach you. Can't tell which way the euro is going? Don't worry, we have the experts.

Analysts are master peddlers of excuses and explanations as to what *did* happen, but will never really tell you what *will*. I would love to host a trading competition between those popular retail FX analysts and some of Malkiel's dart-throwing monkeys. Rest assured that my money is on the chimps.

Sadly, it seems as if the general investing public did not learn much of a lesson from the scandals following the internet boom era IPOs. If a firm is taking a company public, do you really think their analysts will give the stock anything but a "strong buy"? A similar conflict of interest arises in the retail FX world, now littered with analysts more than willing to share their views on TV, print, or chat rooms.

Let us take a look at these guys and gals to see exactly why it is that you should avoid listening to anything they say.

First of all, who are they? Not traders, that is for sure. A look at their bios will probably show you an ivy league degree and briefcase full of theoretical knowledge. Is any of this knowledge applicable to day-to-day FX trading? Probably not, but what do they care? They have a nice cushy salary that has nothing to do with the accuracy of their predictions. Trust me, if their forecasts were so good, they would have been smart enough to start their own fund long ago.

What are their job requirements? Look good on TV and write convincingly. Basically they must be able to spew mountains of meaningless FX jargon and economic figures in order to back up their views.

So what is their job? Like any job in the world, their role is simple: to make money for the company. How do they do this? By providing traders with "valuable" information intended to make them trade more. Notice that they are always full of great trading ideas, but never once have I heard one say "stay flat". Since brokers only make money when you trade, in their opinion there will always be something worth trading. A wise trader will never trade from the advice of their broker.

I will let you in on the FX market's little dirty secret: some moves just "happen" and nobody really knows why! Since corporate flows routinely make a mess of intra-day markets, most moves have no fundamental or technical reason behind them, yet no self-respecting analyst will ever be caught without a neat explanation at hand.

Take a look at some of their great analyses. The chart below is from the Friday Non-Farms Payroll before a long holiday weekend in the US. Just by looking at the chart, we can see the price flat-lining until the payroll data comes out, followed by immediate dollar buying and then a gradual retracement of the move by the day's end. If any analyst had just mentioned that, they would have received a gold star in my book. But alas, their overwhelming need to show their FX knowledge urges them to fill the trader with tons of superfluous – and downright false – information.

Here is what one prominent FX analyst had to say about the day's events:

> The dollar immediately gained ground after the above-mean NFP numbers were taken by the macro crowd as a sign that US economic growth is not showing any signs of slowing down. Investors bought dollars aggressively across the board, betting on a strong US economy. Towards the end of the day, so-so confidence numbers forced institutional investors to re-think their strategy and they took back some of their dollar longs as the new data did not meet their expectations of a robust US economy.

Sorry? Do these people really think that insurance companies, pension funds, etc., trade off tick charts? The thinking of macro funds therefore goes something like this: "The US economy is stronger than what people thought; let's buy USD. Oh wait! Apparently it's not. I'll take back my position".

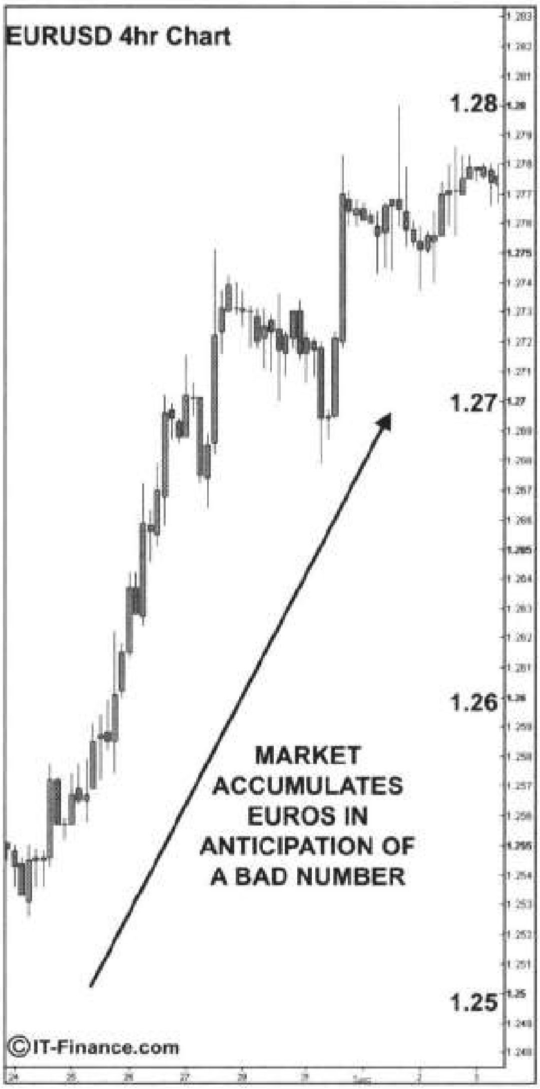
Long-term players are exactly that – long-term. One number will not change anyone's view of the economy, and certainly no one in their right mind would place a trade based on US economic prospects only to reverse them after another number comes out. Notice they did not even mention the fact that it was the Friday

Analysts will always have an explanation for the day's moves, even if none exists.

before Labor Day weekend ... meaning that it is doubtful that institutional traders were even at their desks!

If we look at the same move from a price-action perspective, however, we can get a much more reasonable (and probable) explanation for the day's events:

- From the EURUSD's rise in the days before the data release, we can be sure that the market has positioned itself for the possibility of a *terrible* number (the previous five releases had been worse than expected). The market was therefore long EURUSD going into the release.
- Payrolls actually come out better than expected, and those betting on a weak number are forced to lighten up their positions.
- As dealers begin to close their books early ahead of the long weekend, a short squeeze develops that catches the intra-day crowd wrong-footed.
- Once the top-side stops have been run, the price returns to its pre-NFP equilibrium level. No macro fund was anywhere to be seen.



Steady euro buying.

If you still choose to blindly follow the forecasts of experts, then you may be interested in a recent survey conducted by the *Economist.* The UK magazine asked four ex-finance ministers, four captains of industry, four Oxford economics students, and four garbage collectors to predict GDP, inflation, and oil prices for the coming year. Not surprisingly, the garbage collectors came in first place ... the finance ministers came in last.

V

DEALER TRADES

21 Trading Against Dealers

If you are trading through a dealer, then you are essentially trading against him. It is a bit simplistic, but if you buy, he sells, and one of you is going to end up wrong. In the world of spot trading dealers have a big advantage over the average trader: order-flow information.

Imagine a poker game where you can see everyone's cards but are allowed to keep yours tight to your chest. How your playing would change! Knowing the other player's intentions would enable you to fold, bluff, and, more importantly, call their bluffs with ease. In this scenario you would be hard-pressed not to leave the table with a nice chunk of change, which is exactly the position FX dealers occupy. With the spreads they collect and the order-flow information they possess, dealing desks are such guaranteed money-makers that banks have the luxury of staffing them with tens of pimply-faced dealers who may or may not end up being good traders.

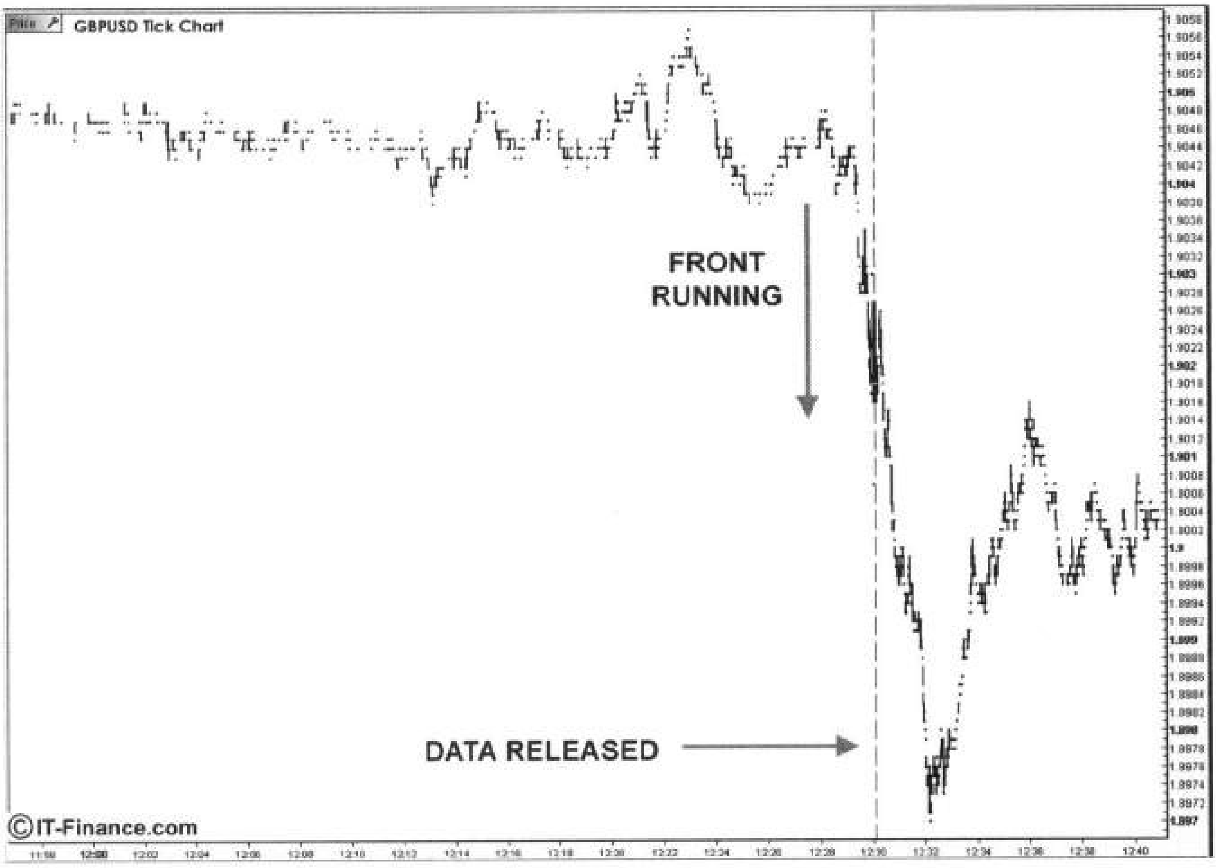
THE INFORMATION FLOW

Flow information is *the* most valuable commodity for intra-day FX traders, since in the end large flows are what shape intra-day prices. If your contacts are telling you that all they see are buy orders, then you can be fairly sure that the pair is going up. If, on the other hand, they tell you that everyone who wanted to buy already has, then you might think that the market is saddled with longs and ripe for a reversal. As we can see in the charts below, a large flow placed strategically can have a meaningful effect on prices, and a market participant aware of these flows can simply position themselves ahead of time to enjoy a free ride at another's expense. The easiest and lowest-risk trades all involve taking advantage of your customers, since by doing this you are essentially taking the risk off your books and passing it on to your client. A market maker with a big order on his book knows that it is his most precious asset and may trade the information to hedge funds or other investors in exchange for business (commissions).

The vast majority of intra-day moves are the result of speculation, rumors, psychology, and a few facts (the Greenspan death rumor is a market classic), and the larger you are the higher up you are on this information chain. If some juicy bit of information is available ("company *X* needs to get rid of 3 billion euros by the end of the day"), the best customers will receive the "first call", after which the information eventually trickles down all the way until you see it on your news wire. By the time retail traders get in the loop, the info has already been out and traded on, which only helps to propagate the "buy the rumor, sell the fact" scenario.

Market-moving flows are free money for the dealers executing the orders.

Getting the first call on market-moving information can be incredibly valuable to short-term traders, since rumors that some UK clearer "must do" a large cable buy order before the London fix can have a direct impact on the price. Front-running is standard practice in the FX world, and dealers with large orders on their books are keen to "piggy-back" their customer's orders to receive a quick profit. Unfortunately, retail traders have virtually no access to this information and are therefore placed at a great disadvantage. Individual traders can, however, gain access to the CFTC's commitment of a trader's report, which highlights the future market's positioning on a weekly basis (www.cftc.gov). Although it may seem a bit dated, the weekly report will highlight any extreme positioning and can be seen as a warning sign. As a retail trader you may not have direct access to this privileged



Front-running news releases. Traders with privileged information sell seconds before the news is released and get a quick 20 pip head-start on the competition. Just another facet of the FX market.

information, yet the price action before the fixing times can also provide clues into a dealer's intentions.

Most FX operations trade on at least some flow information, and for many professional traders a typical day might start like this. Get into the office, quickly glance at what Tokyo did, have a chat with the overnight desk, then get on the phone and start making the rounds. Who's doing what? Where do you see stops? Etc. The responses may be anything from "dead market" to "these Russian guys have been buying all day" or "a yard of stops sitting under the figure". A couple of calls like that and you have a fair idea of where the market stands and where it wants to go.

TRADING LIKE A DEALER

As we have seen, traders and dealers are two very different breeds and a successful dealer would not immediately translate into a successful trader. In fact, most dealers would make terrible position traders. Making markets for corporate clients requires an entirely different skill set than what is required of a good money manager, for example, yet there are things that the average trader can take from dealers