Study Basic Forex

For New Trader at CariGold.com Only!

Compiler: Matlan

Study Basic Forex With Matlan

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Introduction

How to use this e-book

This book has been compiled to help the Forex beginner, though experienced and professional traders may find it a handy reference. Beginners and novice traders are likely to benefit from reading the entire text, starting with Chapter 1, which provides a basic overview of what currency trading is, and how to get started.

The chapters are set out in a logical flow, but do not need to be read in order to make sense, as each works as a discrete unit unto itself. You may prefer to focus first on those chapters that you feel will complement your particular knowledge base best. With the help of this guide, you will soon be ready to start trading Forex – in fact. This basic Forex e-book will prove helpful as you read this book, and may serve as a valuable reference as you become an experienced currency trader.

I wish you success in your trading, and hope you find this book interesting, helpful and enjoyable.

e-book compiler;

Matlan

Subang Dua, Shah Alam, Selangor

Warning!!

Before you start, please remember: Forex trading (OTC Trading) involves substantial risk of loss, and may not be suitable for everyone. Before deciding to undertake such transactions, a user should carefully evaluate whether his/her financial situation is appropriate for such transactions.

Ultimate Business!

Secret Recipe for the Ultimate Business!

Here are the SECRET ingredients needed to create the Ultimate Business:

- You
- Computer
- Internet connection
- Desk (or sofa) and Ice Cream Soda plus Kerepok Lekor

That's it! No employees. No advertising. No cold calling. No inventory.

Imagine a business with just you, your computer, and a high-speed Internet connection?!

That's all you need trade in the foreign exchange market!!

In other words...

A properly trained Forex trader can potentially earn BIG PROFITS in every single month, week, or day! (Of course a poorly trained Forex trader can suffer BIG LOSSES as well.)

Let's continue with the TOP SECRET directions:

- Walk about ten steps and......
- Sit in front of your computer (or sit on your sofa and place laptop on your lap)
- Turn on computer and make sure Internet connection is working
- Open charts and trading platform
- Trade currencies
- Make money, money and MONEY!

Presto! You've just learned how to create the ultimate business.

Okay it's not that easy but you get the picture. Interesting!!!!, Let's we start.......

Consider the Following and Judge for Yourself

- You are your own boss!
- You don’t need any customers!
- You don’t need employees!
- You aren’t stress in traffic jammed.
- You can operate from home, work, vacation or anywhere else in the world as long as you have a high-speed Internet connection.
- You never have to worry about job security, harassment or any other employment-related anxiety.
- You never need to worry about employer payroll, strikes, theft, rent increases, health inspectors, lease problems, being sued, etc…
- You don't need to do any cold calling.
- You don’t need to attend any fortnightly meeting.
- You don’t need annually inventory.
- You don’t the word; “urgent”, “important”, “immediately” and “seriously”
- You decide which days you wish to work.
- You make the decision to take a vacation at a moment's notice.
- You are your own boss! ! ! ! ! ! ! !

The Skinny on Forex

What is FOREX?

The Foreign Exchange market, also referred to as the "FOREX" or "Forex" or "Retail forex" or "Spot FX" or just "Spot" is the largest financial market in the world, with a volume of about $3 trillion a day. If you compare that to the $25 billion a day volume that the New York Stock Exchange trades, you can easily see how enormous the Foreign Exchange really is. It actually equates to more than three times the total amount of the stocks and futures markets combined! Forex rocks!

What is traded on the Foreign Exchange?

The simple answer is money. Forex trading is the simultaneous buying of one currency and the selling of another. Currencies are traded through a broker or dealer, and are traded in pairs; for example the Euro dollar and the US dollar (EUR/USD) or the British pound and the Japanese Yen (GBP/JPY).

Because you're not buying anything physical, this kind of trading can be confusing. Think of buying a currency as buying a share in a particular country. When you buy, say, Japanese Yen, you are in effect buying a share in the Japanese economy, as the price of the currency is a direct reflection of what the market thinks about the current and future health of the Japanese economy.

In general, the exchange rate of a currency versus other currencies is a reflection of the condition of that country's economy, compared to the other countries' economies.

Unlike other financial markets like the New York Stock Exchange, the Forex spot market has neither a physical location nor a central exchange. The Forex market is considered an Over-the-Counter (OTC) or 'Interbank' market, due to the fact that the entire market is run electronically, within a network of banks, continuously over a 24-hour period.

Until the late 1990 only the a big guys could play this game. The initial requirement was that you could trade only if you had about ten to fifty million bucks to start with! Forex was originally intended to be used by bankers and large institutions - and not by us as a little guy. However, because of the rise of the Internet, online Forex trading firms are now able to offer trading accounts to 'retail' traders like us.

All you need to get started is a computer, a high-speed Internet connection, and the information contained within this site.

This e-book was created to introduce novice or beginner traders to all the essential aspects of foreign exchange, in a fun and easy-to-understand manner.

What is a Spot Market?

A spot market is any market that deals in the current price of a financial instrument.

Which Currencies Are Traded?

The most popular currencies along with their symbols are shown below:

Symbol	Country	Currency	Nickname
USD	United States	Dollar	Buck
EUR	Euro members	Euro	Fiber
JPY	Japan	Yen	Yen
GBP	Great Britain	Pound	Cable
CHF	Switzerland	Franc	Swissy
CAD	Canada	Dollar	Loonie
AUD	Australia	Dollar	Aussie
NZD	New Zealand	Dollar	Kiwi

Forex currency symbols are always three letters, where the first two letters identify the name of the country and the third letter identifies the name of that country's currency.

When Can Currencies Be Traded?

The spot FX market is unique within the world markets. It's like a Super Wal-Mart where the market is open 24-hours a day. At any time, somewhere around the world a financial center is open for business, and banks and other institutions exchange currencies every hour of the day and night with generally only minor gaps on the weekend.

The foreign exchange markets follow the sun around the world, so you can trade late at night (if you're a vampire) or in the morning (if you're an early bird). Keep in mind though, the early bird doesn't necessarily get the worm in this market - you might get the worm but a bigger, nastier bird of prey can sneak up and eat you too...

Time Zone	New York	GMT
Tokyo Open	7:00 pm	0:00
Tokyo Close	4:00 am	9:00
London Open	3:00 am	8:00
London Close	12:00 pm	17:00
New York Open	8:00 am	13:00
New York Close	5:00 pm	22:00

The Forex market (OTC)

The Forex OTC market is by far the biggest and most popular financial market in the world, traded globally by a large number of individuals and organizations. In the OTC market, participants determine who they want to trade with depending on trading conditions, attractiveness of prices and reputation of the trading counterpart.

The chart below shows global foreign exchange activity. The dollar is the most traded currency, being on one side of 89% of all transactions. The Euro's share is second at 37%, while that of the yen is at 20%.

Forex versus Futures

Forex versus Futures Advantages		
Advantage	Forex	Futures
24-hour Trading	YES	NO
Commission Free Trading*	YES	NO
Up to 400:1 Leverage	YES	NO
Price Certainty	YES	NO
Guaranteed Limited Risk	YES	NO

Liquidity

In the spot Forex market, almost $3 trillion is traded daily, making it the largest and most liquid market in the world. This market can absorb trading volume and transaction sizes that dwarf the capacity of any other market. The futures market traders a puny $30 billion per day. Thirty billion?!! Peanuts! The futures markets can't compete with its limited liquidity. The Forex market is always liquid, meaning positions can be liquidated and stop orders executed without slippage except in extremely volatile market conditions.

24-Hour Market

At 2:15 p.m. EST Sunday, trading begins as markets open in Sydney and Singapore. At 7 p.m. EST the Tokyo market opens, followed by London at 2 a.m. EST. And finally, New York opens at 8 a.m. EST and closes at 5 p.m. EST. So, before New York trading closes the Sydney and Singapore markets are back open - it's a 24 hour seamless market! As a trader, this allows you to react to favorable or unfavorable news by trading immediately. If important data comes in from England or Japan while the U.S. futures market is closed, the next day's opening could be a wild ride. (Overnight markets in futures currency contracts exist, but they are thinly traded, not very liquid, and are difficult for the average investor to access).

Commission Free Trading

You know what's great about trading currencies? You pay NO commissions! Because you deal directly with the market maker via a purely electronic online exchange, you eliminate both ticket costs and middleman brokerage fees. There is still a cost to initiating any trade, but that cost is reflected in the bid/ask spread that is also present in futures or equities trading. Brokers are compensated for their services through the bid-ask spread instead of via commissions.

Price Certainty

When trading Forex, you get rapid execution and price certainty under normal market conditions. In contrast, the futures and equities markets do not offer price certainty or instant trade execution. Even with the advent of electronic trading and limited guarantees of execution speed, the prices for fills for futures and equities on market orders are far from certain. The prices quoted by brokers often represent the LAST trade, not necessarily the price for which the contract will be filled.

Guaranteed Limited Risk

Traders must have position limits for the purpose of risk management. This number is set relative to the money in a trader's account. Risk is minimized in the spot FX market because the online capabilities of the trading platform will automatically generate a margin call if the required margin amount exceeds the available trading capital in your account. All open positions will be closed immediately, regardless of the size or the nature of positions held within the account. In the futures market, your position may be liquidated at a loss, and you will be liable for any resulting deficit in the account. That sucks

Impress Your Date with Your Forex Lingo

As in any new skill that you learn, you need to learn the lingo...especially if you wish to woo your love's heart. You, the newbie, must know certain terms like the back of your hand before making your first trade. Some of these terms you've already learned, but it never hurts to have a little review.

Major and Minor Currencies

The eight most frequently traded currencies (USD, EUR, JPY, GBP, CHF, CAD, NZD and AUD) are called the major currencies. All other currencies are referred to as minor currencies. Do not worry about the minor currencies, they are for professionals only. Actually, on this site we'll mostly cover what we call the Fab Five (USD, EUR, JPY, GBP, and CHF). These pairs are the most liquid and the sexiest.

Base Currency

The base currency is the first currency in any currency pair. It shows how much the base currency is worth as measured against the second currency. For example, if the USD/CHF rate equals 1.6350, then one USD is worth CHF 1.6350. In the Forex markets, the U.S. dollar is normally considered the “base” currency for quotes, meaning that quotes are expressed as a unit of $1 USD per the other currency quoted in the pair. The primary exceptions to this rule are the British pound, the Euro, and the Australian and New Zealand dollar.

Quote Currency

The quote currency is the second currency in any currency pair. This is frequently called the pip currency and any unrealized profit or loss is expressed in this currency.

Pip

A pip is the smallest unit of price for any currency. Nearly all currency pairs consist of five significant digits and most pairs have the decimal point immediately after the first digit, that is, EUR/USD equals 1.2538. In this instance, a single pip equals the smallest change in the fourth decimal place - that is, 0.0001. Therefore, if the quote currency in any pair is USD, then one pip always equal 1/100 of a cent.

One notable exception is the USD/JPY pair where a pip equals $0.01.

Bid Price

The bid is the price at which the market is prepared to buy a specific currency pair in the Forex market. At this price, the trader can sell the base currency. It is shown on the left side of the quotation.

For example, in the quote GBP/USD 1.8812/15, the bid price is 1.8812. This means you sell one British pound for 1.8812 U.S. dollars.

Ask Price

The ask is the price at which the market is prepared to sell a specific currency pair in the Forex market. At this price, you can buy the base currency. It is shown on the right side of the quotation.

For example, in the quote EUR/USD 1.2812/15, the ask price is 1.2815. This means you can buy one Euro for 1.2315 U.S. dollars. The ask price is also called the offer price.

Spread

The spread is the difference between the bid and ask price. The "big figure quote" is the dealer expression referring to the first few digits of an exchange rate. These digits are often omitted in dealer quotes. For example, the USD/JPY rate might be 118.30/118.34, but would be quoted verbally without the first three digits as "30/34".

Quote Convention

Exchange rates in the Forex market are expressed using the following format:

Base currency / Quote currency Bid / Ask

Transaction Cost

The critical characteristic of the bid/ask spread is that it is also the transaction cost for a round-turn trade. Round-turn means both a buy (or sell) trade and an offsetting sell (or buy) trade of the same size in the same currency pair. For example, in the case of the EUR/USD rate of 1.2812/15, the transaction cost is three pips.

The formula for calculating the transaction cost is:

Transaction cost = Ask Price – Bid Price

Cross Currency

A cross currency is any pair in which neither currency is the U.S. dollar. These pairs exhibit erratic price behavior since the trader has, in effect, initiated two USD trades. For example, initiating a long (buy) EUR/GBP is equivalent to buying a EUR/USD currency pair and selling a GBP/USD. Cross currency pairs frequently carry a higher transaction cost.

Margin

When you open a new margin account with a Forex broker, you must deposit a minimum amount with that broker. This minimum varies from broker to broker and can be as low as $100 to as high as $100,000.

Each time you execute a new trade, a certain percentage of the account balance in the margin account will be set aside as the initial margin requirement for the new trade based upon the underlying currency pair, its current price, and the number of units (or lots) traded. The lot size always refers to the base currency.

For example, let's say you open a mini account which provides a 200:1 leverage or .5%

margin. Mini accounts trade mini lots. Let's say one mini lot equals $10,000. If you were to open one mini-lot, instead of having to provide the full $10,000, you would only need $50 ($10,000 x .5 = $50).

Leverage

Leverage is the ratio of the amount capital used in a transaction to the required security deposit (margin). It is the ability to control large dollar amounts of a security with a relatively small amount of capital. Leveraging varies dramatically with different brokers, ranging from 2:1 to 400:1.

Margin + Leverage = Possible Deadly Combination

Trading currencies on margin lets you increase your buying power. Meaning that if you have $5,000 cash in a margin account that allows 100:1 leverage, you could purchase up to $500,000 worth of currency because you only have to post one percent of the purchase price as collateral. Another way of saying this is that you have $500,000 in buying power.

With more buying power, you can increase your total return on investment with less cash outlay. But be careful, trading on margin magnifies your profits AND losses.

Margin Call

All traders fear the dreaded margin call. This occurs when your broker notifies you that your margin deposits have fallen below the required minimum level because an open position has moved against you.

While trading on margin can be a profitable investment strategy, it is important that you take the time to understand the risks. Make sure you fully understand how your margin account works, and be sure to read the margin agreement between you and your broker. Always ask any questions if there is anything unclear to you in the agreement.

Your positions could be partially or totally liquidated should the available margin in your account fall below a predetermined threshold. You may not receive a margin call before your positions are liquidated (the ultimate unexpected birthday gift).

Margin calls can be effectively avoided by monitoring your account balance on a very regular basis and by utilizing stop-loss orders (discussed later) on every open position to limit risk.

Forex Trading is not a Get-Rich-Quick Scheme!

Protect Yourself Before You Wreck YourSelf

Before we go any further we are going to be 100% honest with you and tell you the following before you consider trading currencies:

All forex traders, and we mean *all* traders LOSE money on trades.

Ninety percent of traders lose money, largely due to lack of planning and training and having poor money management rules. Also, if you hate to lose or are a super perfectionist, you'll probably have a hard time adjusting to trading.

Trading forex is not for the unemployed, those on low incomes, or who can't afford to pay their electricity bill or afford to eat.

You should have at least $10,000 of trading capital (in a mini account) that you can afford to lose. Don't expect to start an account with a few hundred dollars and expect to become a kazillionaire.

The Forex market is one of the most popular markets for speculation, due to its enormous size, liquidity and tendency for currencies to move in strong trends. You would think traders all over the world would make a killing, but success has been limited to very small percentage of traders.

Many traders come with the misguided hope of making a gazillion bucks, but in reality, lack the discipline required for trading. Most people usually lack the discipline to stick to a diet or to go to the gym three times a week. If you can't even do that, how do you think you're going to succeed trading?

Short term trading IS NOT for amateurs, and it is rarely the path to "get rich quick". You can't make gigantic profits without taking gigantic risks.

A trading strategy that involves taking a massive degree of risk means suffering inconsistent trading performance and often suffering large loss. A trader who does this probably doesn't even *have* a trading strategy - unless you call gambling a trading strategy!

Forex Trading is not a Get-Rich-Quick Scheme!

Forex trading is a SKILL that takes TIME to learn.

Skilled traders can and do make money in this field. However, like any other occupation or career, success doesn't just happen overnight.

Forex trading isn't a piece of cake (as some people would like you to believe). Think about it, if it was, everyone trading would already be millionaires. The truth is that even expert traders with years of experience still encounter periodic losses.

Drill this in your head: there are NO shortcuts to Forex trading. It takes lots and lots of TIME to master.

There is no substitute for hard work and diligence. Practice trading on a DEMO ACCOUNT and pretend the virtual money is your own real money.

Do NOT open a live trading account until you are trading PROFITABLY on a demo account.

If you can't wait until you're profitable on a demo account, at least demo trade for 2 months. Hey, at least you were able to hold off losing all your money for two months right? If you can't hold out for 2 months, cut your hands off.

Concentrate on ONE major currency pair.

It gets far too complicated to keep tabs on more than one currency pair when you first start trading. Stick with one of the majors because they are the most liquid which makes their spreads cheap.

You can be a winner at currency trading, but as in all other aspects of life, it will take hard work, dedication, a little luck, a lot of common sense, and a whole lot of good judgment.

Are You Willing to Pay the Price?

HA! Made you click!

If you really thought there actually was a way for a lazy forex trader to get rich, SHAME ON YOU!

No such thing exists. The word "lazy" and "trader" is an oxymoron. You have to be willing to pay the price to become a trader.

Which brings us to our next lesson....?

So, you've gone through the School of Pipsology…five times, learned basic analysis and money management techniques, and maybe even opened up a demo account and started trading a plan you've created. (You do have a trading plan right?) Now you can sit back and relax because it's easy money from here on out, right?

Wrong!

You've just taken the first step.

You've only familiarized yourself with the very basic fundamentals of what it takes to become a professional trader. Now it's time to get on to the real work.

I'm sure you're now thinking, "There's more to learn?!"

Well, my friend, the learning never ends.

As with any profession, whether you're a doctor, lawyer, athlete, assassin, spy, ninja, ultimate fighter, musician or any other occupation that requires a high level of skill, you can never stop learning and practicing. Otherwise, your skills will deteriorate and you'll slowly forget what you've learned.

This lesson will give you a peek into what it takes – education, time, money and psychological stamina – to enter the most financially rewarding career on the planet: a professional trader.

Education

Imagine yourself in a legal situation and you decide to hire the cheapest lawyer you can find. On the day you have to stand in front of a jury, your lawyer says to you, “Don’t worry, while this is my first time, I’ve read ‘How to be an Awesome Lawyer in 28 Days for Idiots’ a couple of times, so I know what I’m doing. You’ll be fine.”

Do you think your investment in that lawyer will pay off?

Probably not.

You’ll probably end up in prison with a tattoo covered cellmate named “Killer” for the rest of your life.

Now I’m not a professional lawyer, but I’m pretty sure that it takes more than one book to become one. More likely, lawyers have read and studied a wide range of books, journals and case studies in order to fine-tune their practice. So why should it be any different to become a professional trader?

Trading involves becoming proficient in a multitude of disciplines, including fundamental analysis, technical analysis, sentiment analysis and self-awareness (also known as trading psychology or what I call “mental analysis”).

Within those disciplines are different topics that should be studied individually.

For instance, while the School of Pipsology does a fantastic job of introducing the Elliot Wave theory and making it easy to understand, there’s abundant amount of entire books written on that single subject. The same thing goes with many other technical tools (i.e. candlestick charting, Fibonacci numbers, pivot points, etc.), fundamentals and trading psychology.

If you limit your education to a basic high-level overview of a few subjects, how do you think that will help you acquire the skills needed to become a successful trader?

I’m not saying go out there and read everything there is to read on trading. While that would be ideal, realistically it’s not possible.

What I am saying is this...

Before you enter a single trade, read and study enough to know why a tool works, how it works and how well it has worked in many different situations. After you start trading your live account, continue reading and studying some more. The forex market is dynamic and continuously changing. (What market isn’t?) Being well versed in all the disciplines of trading gives you the ability to adapt and make quick decisions in this fast-paced market.

Time

Have you ever told yourself there's never enough time in the day? I think we've all thought that to ourselves at one point, but if you're not willing to shift your priorities to make time for trading, then forget about becoming a trader.

Sorry to put it so bluntly, but contrary to popular belief, trading is not a hobby.

Trading is not a hobby.

Trading is not a hobby unless you want to lose money.

Golf is my hobby. I pay to play golf. Golf is Tiger Wood's business. Tiger Woods is paid to play golf.

See the difference?

Trading is a business.

You have to devote yourself to trading just like you would with any other business in order to be successful.

So, it's time (pun intended) to ask yourself this: "Can I balance my time and change my life-style to make room for trading?"

I'd better hear a resounding "YES!"

But before you can even truly answer that question, you need to first figure out what your daily priorities are and determine whether or not you can make trading THE number one priority.

A good way to find this out for yourself is to list your daily activities, and then prioritize them. If your daily priorities take up all of your time, then forget about trading.

So, take a moment to figure out what is going on in your life because it's very important to balance your time and priorities, not just to become a successful trader, but also to live a content, meaningful life. We all want to be wildly profitable, and initially we may drop everything else to get there, but in the end an unbalanced life will lead to personal and/or professional failure.

Capital aka Cash Money

It takes money to make money. Everyone knows that, but how much does one need to get started in trading? The answer largely depends on how you are going to approach your new start-up business.

First, consider how you are going to be educated. There are many different approaches in learning how to trade: classes, mentors, on your own, or any combination of the three.

While there are many classes and mentors out there willing to teach forex trading, most will charge a fee. The benefit of this route is that a well-taught class or great mentor can significantly shorten your learning curve and get you on your way to profitability in a much shorter amount of time compared to doing everything yourself.

The downside is the upfront cost for these programs, which can range from a few hundred to a few thousand dollars, depending on which program you go with. For many of those new to trading, the resources (cash money) required to purchase these programs are not available.

For those of you unable or unwilling to pony up the cash for education, the good news is that most of the information you need to get started can be found for FREE on the internet through forums, brokers, articles and websites like BabyPips.com. We should all thank Al Gore for inventing the Internet. Without him, there would be no BabyPips.com

This is no one “correct” path.

As long as you are disciplined and laser focused on learning the markets, your chances of success increase exponentially. You have to be a gung ho student. If not, you’ll end up in the poor house.

Second, is your approach to the markets going to require special tools such as news feeds or charting software? As a technical trader, most of the charting packages that come with your broker’s trading platform are sufficient (and some are actually quite good). For those who need special indicators or better functionality, higher end charting software can start at around $100 per month. Maybe you’re a fundamental trader and you need the news the millisecond it is released, or even before it happens (wouldn’t that be nice!). Well, instantaneous and accurate news feeds run from a few hundred to a few thousand dollars per month. Again, you can get a complimentary news feed from your broker, but for some, that extra second or two can be the difference between a profitable or unprofitable trade.

Finally, you need money/capital/funds to trade. How much exactly? Well, let’s be honest here. If you’re consistent and practice proper money management techniques, and without even knowing your monthly expenses, then you can probably start off with $50k to $100k in trading capital. It’s common knowledge that most businesses fail due to undercapitalization, which is especially true in the forex trading business. So, if you are unable to start with a large amount that you can afford to lose, be patient, save up and learn to trade the right way until you are financially ready.

Psychology

Once you've made the time to get properly educated, demo trade, and save up sufficient capital, the time will come where you will have to tackle the markets. By this time you should've have learned the mechanics of trading and methods to analyze the market that you are most confident using.

But are you ready to risk your hard-earned money?

Can you put your money where your mouth is?

Can you handle the (emotional, psychological and financial/economic) pressure of the occasional losing streak and account drawdown?

Will you be able to control your excitement on a profitable trade?

Can you let go of your last trade and completely focus on your next opportunity?

What separates the profitable traders from the unprofitable ones is that profitable traders can handle the pressure of risk and control their emotions. They realize that losing is just a part of business. Those who have enough confidence in their methods and systems know that a drawdown is a short-term setback and they will soon recover.

This final crucial lesson can't really be taught. It will take time and experience. You have to put in the hours. You will have to go through a gazillion different trades and different market environments before you grasp and live these concepts. If you can't do this or aren't willing to, then ultimately, trading may not be for you.

Summary

For those willing to take the challenge and follow through, professional trading can be a worthwhile goal. But before you dive too deep into forex trading, dip your toe or get your feet wet in the shallow end first, and become familiar with the water. As you get more comfortable, make your way slowly to the deeper end. Take your time.

Be honest with yourself.

Be ready to sacrifice your time and money.

Never stop learning and, most importantly, never quit.

Winners never quit and quitters never win.

Pay the price of becoming top trader is extremely high, but certainly worth it.

Candlesticks

What is a Candlestick?

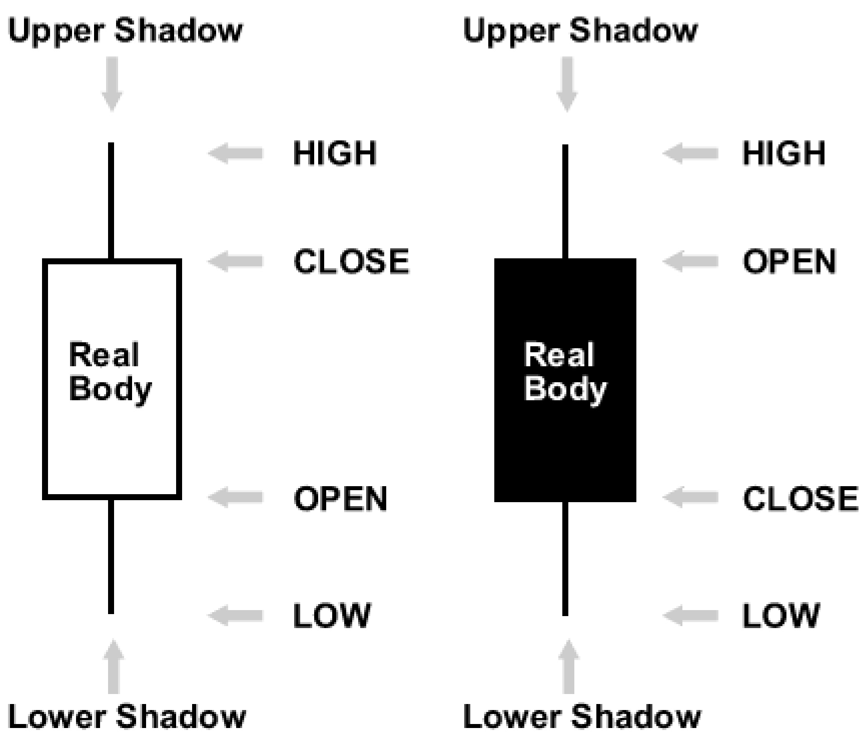
While we briefly covered candlestick charts in the previous lesson, we'll now dig in a little and discuss them more in detail. First let's do a quick review.

What is a Candlestick?

Back in the day when Godzilla was still a cute little lizard, the Japanese created their own old school version of technical analysis to trade rice. A westerner by the name of Steve Nison "discovered" this secret technique on how to read charts from a fellow Japanese broker and Japanese candlesticks lived happily ever after. Steve researched, studied, lived, breathed, ate candlesticks, began writing about it and slowly grew in popularity in 90s. To make a long story short, without Steve Nison, candle charts might have remained a buried secret. Steve Nison is Mr. Candlestick.

Okay so what the heck are candlesticks?

The best way to explain is by using a picture:



Candlesticks are formed using the open, high, low and close.

- If the close is above the open, then a hollow candlestick (usually displayed as white) is drawn.
- If the close is below the open, then a filled candlestick (usually displayed as black) is drawn.

- The hollow or filled section of the candlestick is called the “real body” or body.
- The thin lines poking above and below the body display the high/low range and are called shadows.
- The top of the upper shadow is the “high”.
- The bottom of the lower shadow is the “low”.

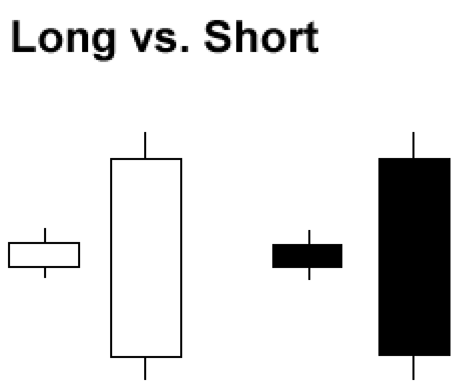
Sexy Bodies and Strange Shadows

Sexy Bodies

Just like humans, candlesticks have different body sizes. And when it comes to forex trading, there’s nothing naughtier than checking out the bodies of candlesticks!

Long bodies indicate strong buying or selling. The longer the body is, the more intense the buying or selling pressure.

Short bodies imply very little buying or selling activity. In street forex lingo, bulls mean buyers and bears mean sellers.



Mysterious Shadows

The upper and lower shadows on candlesticks provide important clues about the trading session.

Upper shadows signify the session high. Lower shadows signify the session low.

Candlesticks with long shadows show that trading action occurred well past the open and close.

Candlesticks with short shadows indicate that most of the trading action was confined near the open and close.

If a candlestick has a *long upper shadow and short lower shadow*, this means that buyers flexed their muscles and bided prices higher, but for one reason or another, sellers came in and drove prices back down to end the session back near its open price.

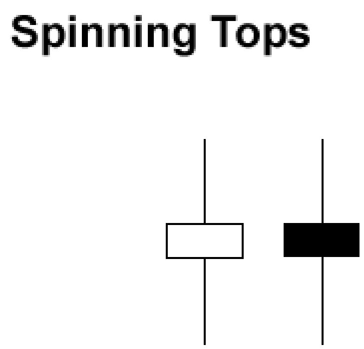
If a candlestick has a *long lower shadow and short upper shadow*, this means that sellers flashed their washboard abs and forced price lower, but for one reason or another, buyers came in and drove prices back up to end the session back near its open price.

Basic Candlestick Patterns

Spinning Tops

Candlesticks with a long upper shadow, long lower shadow and small real bodies are called spinning tops. The color of the real body is not very important.

The pattern indicates the indecision between the buyers and sellers



The small real body (whether hollow or filled) shows little movement from open to close, and the shadows indicate that both buyers and sellers were fighting but nobody could gain the upper hand.

Even though the session opened and closed with little change, prices moved significantly higher and lower in the meantime. Neither buyers nor sellers could gain the upper hand, and the result was a standoff.

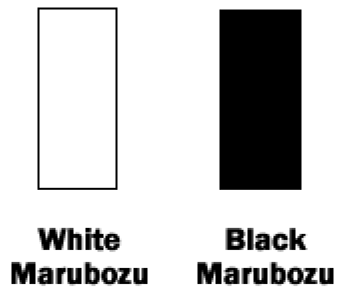
If a spinning top forms during an uptrend, this usually means there aren't many buyers left and a possible reversal in direction could occur.

If a spinning top forms during a downtrend, this usually means there aren't many sellers left and a possible reversal in direction could occur.

Marubozu

Sounds like some kind of voodoo magic huh? "I will cast the evil spell of the Marubozu on you!" Fortunately, that's not what it means. Marubozu means there are no shadows from the bodies. Depending on whether the candlestick's body is filled or hollow, the high and low are the same as it's open or close. If you look at the picture below, there are two types of Marubozus

Marubozu



White Marubozu contains a long white body with no shadows. The open price equals the low price and the close price equals the high price. This is a very bullish candle as it shows that buyers were in control the whole entire session. It usually becomes the first part of a bullish continuation or a bullish reversal pattern.

A Black Marubozu contains a long black body with no shadows. The open equals the high and the close equals the low. This is a very bearish candle as it shows that sellers controlled the price action the whole entire session. It usually implies bearish continuation or bearish reversal.

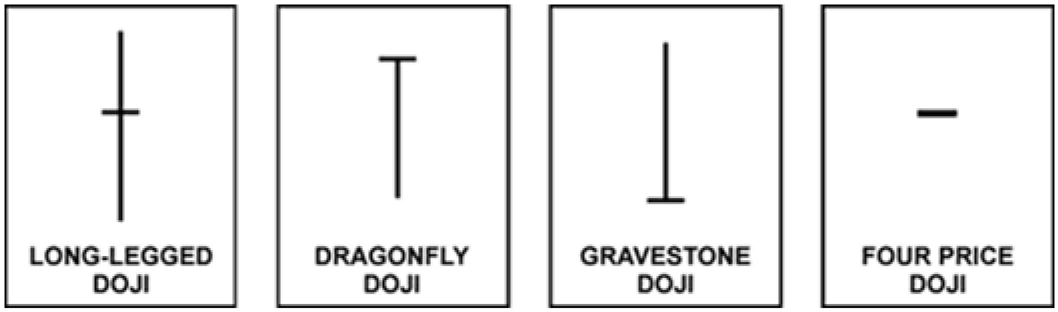
Doji

Doji candlesticks have the same open and close price or at least their bodies are extremely short. The doji should have a very small body that appears as a thin line.

Doji suggest indecision or a struggle for turf positioning between buyers and sellers. Prices move above and below the open price during the session, but close at or very near the open price.

Neither buyers nor sellers were able to gain control and the result was essentially a draw.

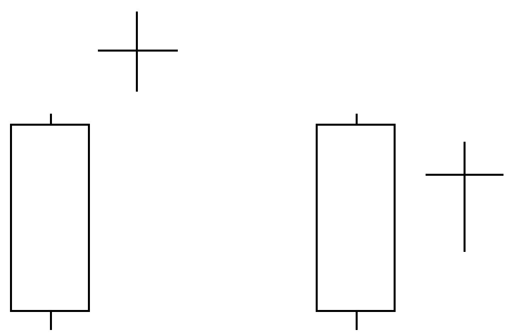
There are four special types of Doji lines. The length of the upper and lower shadows can vary and the resulting candlestick looks like a cross, inverted cross or plus sign. The word "Doji" refers to both the singular and plural form.



When a doji forms on your chart, pay special attention to the preceding candlesticks.

If a doji forms after a series of candlesticks with long filled bodies (like white marubozus), the doji signals that the buyers are becoming exhausted and weakening. In order for price to continue rising, more buyers are needed but there aren't anymore! Sellers are licking their chops and are looking to come in and drive the price back down.

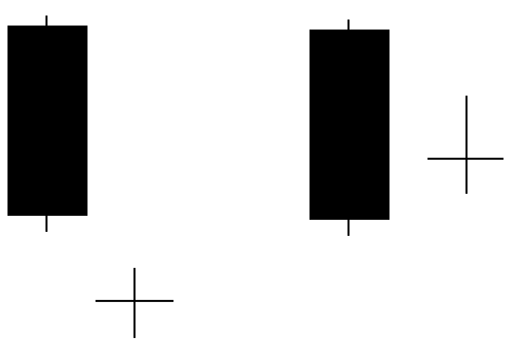
Long White Candle + Doji



Keep in mind that even after a doji forms, this doesn't mean to automatically short. Confirmation is still needed. Wait for a bearish candlestick to close below the long white candlestick's open.

If a doji forms after a series of candlesticks with long hollow bodies (like black marubozus), the doji signals that sellers are becoming exhausted and weakening. In order for price to continue falling, more sellers are needed but sellers are all tapped out! Buyers are foaming in the mouth for a chance to get in cheap.

Long Black Candle + Doji



While the decline is sputtering due to lack of new sellers, further buying strength is required to confirm any reversal. Look for a white candlestick to close above the long black candlestick's open.

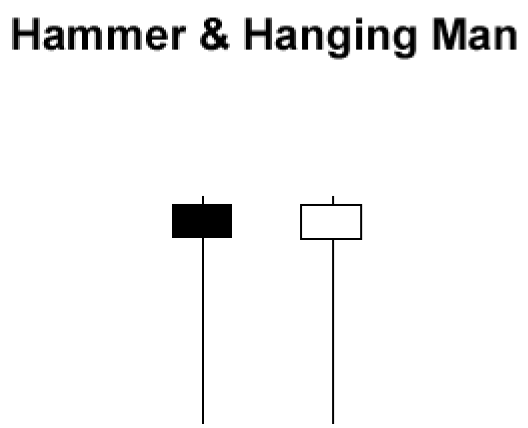
Reversal Patterns

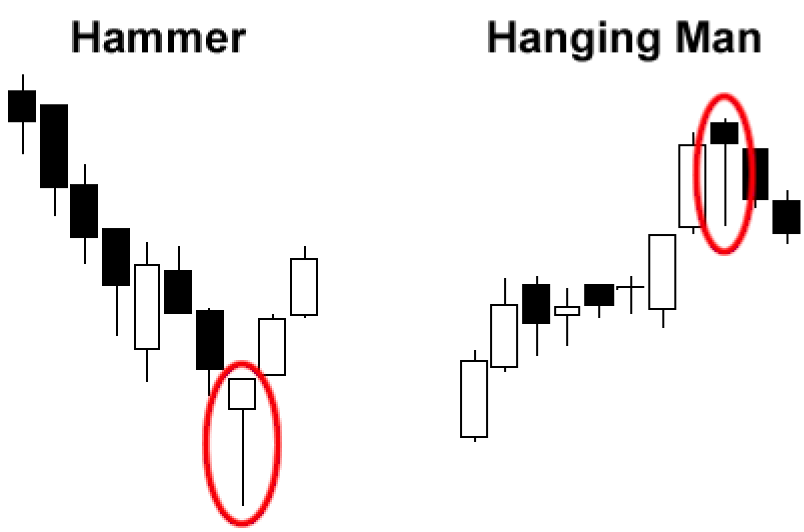
Prior Trend

For a pattern to qualify as a reversal pattern, there should be a prior trend to reverse. Bullish reversals require a preceding downtrend and bearish reversals require a prior uptrend. The direction of the trend can be determined using trendlines, moving averages, or other aspects of technical analysis.

Hammer and Hanging Man

The hammer and hanging man *look* exactly alike but have totally different meaning depending on past price action. Both have cute little bodies (black or white), long lower shadows and short or absent upper shadows.





The hammer is a bullish reversal pattern that forms during a downtrend. It is named because the market is hammering out a bottom.

When price is falling, hammers signal that the bottom is near and price will start rising again. The long lower shadow indicates that sellers pushed prices lower, but buyers were able to overcome this selling pressure and closed near the open.

Word to the wise… just because you see a hammer form in a downtrend doesn't mean you automatically place a buy order! More bullish confirmation is needed before it's safe to pull the trigger. A good confirmation example would be to wait for a white candlestick to close above the open of the candlestick on the left side of the hammer.

Recognition Criteria:

- The long shadow is about two or three times of the real body.
- Little or no upper shadow.
- The real body is at the upper end of the trading range.
- The color of the real body is not important.

The hanging man is a bearish reversal pattern that can also mark a top or strong resistance level. When price is rising, the formation of a hanging man indicates that sellers are beginning to outnumber buyers. The long lower shadow shows that sellers pushed prices lower during the session. Buyers were able to push the price back up some but only near the open. This should set off alarms since this tells us that there are no buyers left to provide the necessary momentum to keep raising the price. .

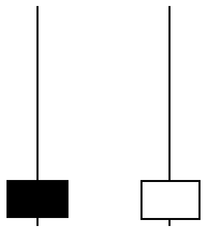
Recognition Criteria:

- A long lower shadow which is about two or three times of the real body.
- Little or no upper shadow.
- The real body is at the upper end of the trading range.
- The color of the body is not important, though a black body is more bearish than a white body.

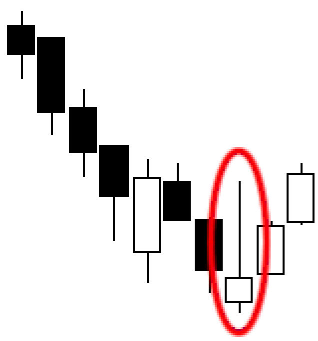
Inverted Hammer and Shooting Star

The inverted hammer and shooting star also look identical. The only difference between them is whether you're in a downtrend or uptrend. Both candlesticks have petite little bodies (filled or hollow), long upper shadows and small or absent lower shadows.

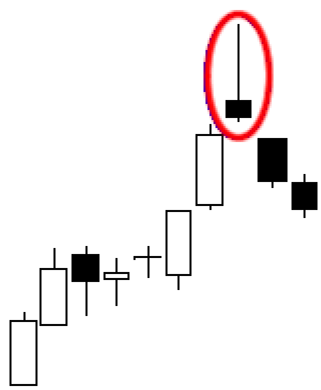
Inverted Hammer
Shooting Star



Inverted Hammer



Shooting Star

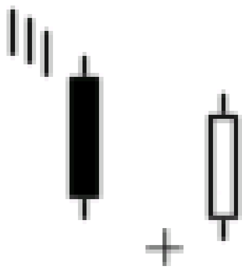


The inverted hammer occurs when price has been falling suggests the possibility of a reversal. Its long upper shadow shows that buyers tried to bid the price higher. However, sellers saw what the buyers were doing, said “oh hell no” and attempted to push the price back down. Fortunately, the buyers had eaten enough of their Wheaties for breakfast and still managed to close the session near the open. Since the sellers weren’t able to close the price any lower, this is a good indication that everybody who wants to sell has already sold. And if there’s no more sellers, who is left? Buyers.

The shooting star is a bearish reversal pattern that looks identical to the inverted hammer but occurs when price has been rising. Its shape indicates that the price opened at its low, rallied, but pulled back to the bottom. This means that buyers attempted to push the price up, but sellers came in and overpowered them. A definite bearish sign since there are no more buyers left because they’ve all been murdered.

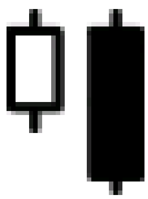
Abandoned Baby

Definition:
A reversal pattern characterized by a gap followed by a Doji, which is then followed by another gap in the opposite direction. The shadows on the Doji must completely gap below or above the shadows of the first and third candle.



Bearish Engulfing Pattern

Definition:
The market must be in clearly defined uptrend. The first candle is bullish. The second candle is bearish. The bearish candle engulfs the previous candle's body. The size of the candle being engulfed doesn't matter. Ignore the wicks. An even stronger signal occurs when the bearish candle engulfs the bodies of two or three previous candles. Indicates a bearish trend may be beginning.

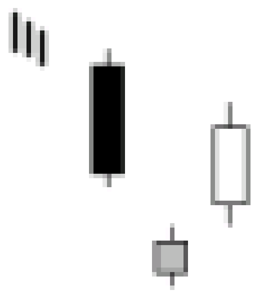


Morning Star

This is a bullish pattern signifying a potential bottom. A three candle bullish reversal pattern consisting of three candlesticks:

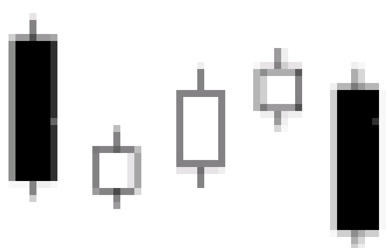
1. A long-bodied black candle extending the current downtrend
2. A short middle candle that gapped down on the open
3. A long-bodied white candle that gapped up on the open and closed above the midpoint of the body of the first candle.

The star can be a bullish (empty) or a bearish (filled in) candle.



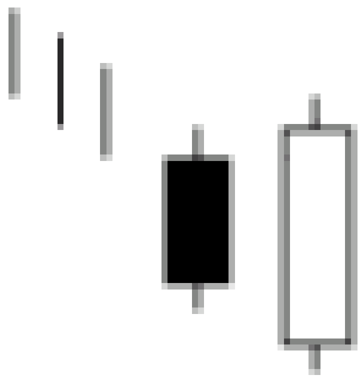
Falling Three Methods

A bearish continuation pattern. A long black body is followed by three small body candles, each fully contained within the range of the high and low of the first candle. The fifth candle closes at a new low.



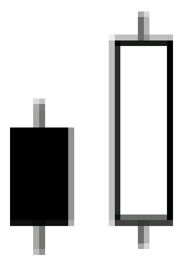
Engulfing Pattern

A reversal pattern that can be bearish or bullish depending upon whether it appears at the end of an uptrend (bearish engulfing pattern) or downtrend (bullish engulfing pattern). The first candle is characterized by a small body, followed by a candle whose body completely engulfs the previous candle's body.



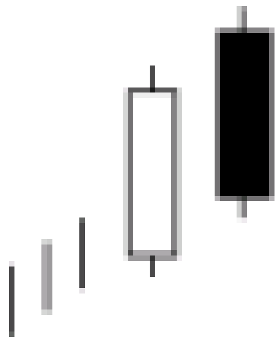
Bullish Engulfing Pattern

This pattern must occur after a signifcant downtrend. It occurs when a small bearish candle is engulfed by a large bullish candle. This signals a possible reversal. Ignore the wicks. An even stronger signal occurs when the bullish candle engulfs the bodies of two or three previous candles.



Dark Cloud Cover

A bearish reversal pattern that continues the uptrend with a long white body. The next candle opens at a new high then closes below the midpoint of the body of the first candle. The pattern is more signficant if the second candle's body is below the center of the previous body. The pattern is casting a “dark cloud” over the bullish trend that preceded it. Confirmation of the pattern is achieved when another black candle, of smaller size, forms after the second candle

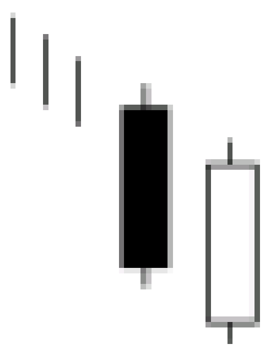


Piercing Line

A bullish two candle reversal pattern. During a downtrend:

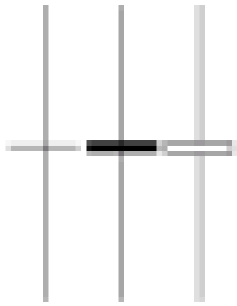
1. The first candle is a long bear candle followed by a long bull candle.
2. The bull candle opens lower than the bear's low but closes more than halfway above the middle of the bear candle's body.

This is a warning sign for sellers since a reversal to the upside might soon occur.



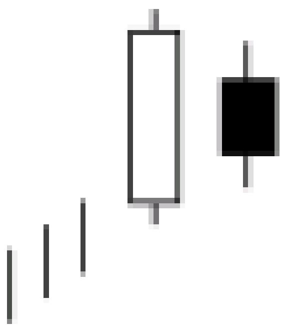
Long-Legged Doji

his candlestick has long upper and lower shadows with the Doji in the middle of the candle's trading range, clearly reflecting the indecision of traders.



Harami

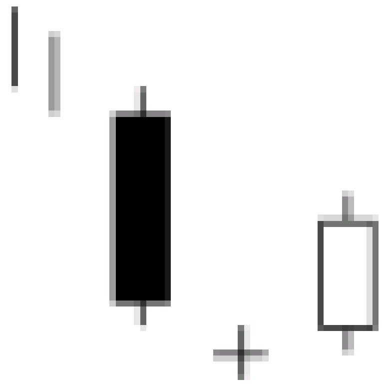
A two candle pattern that has a small body candle completely contained within the range of the previous body, and is the opposite color. Coming after a strong trend, this pattern indicates a decrease in momentum and possibly the end of the trend.



Morning Doji Star

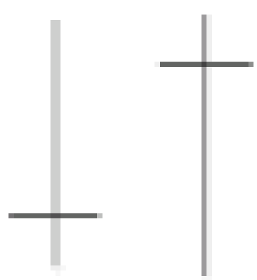
A three candle bullish reversal pattern that is very similar to the Morning Star.

1. The first candle is in a downtrend with a long black body.
2. The next candle opens lower with a Doji that has a small trading range.
3. The last candle closes above the midpoint of the first candle



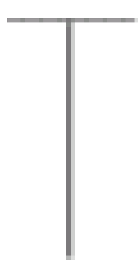
Doji

The doji is a warning sign of a pending reversal. The lack of a real body conveys a sense of indecision or tug-of-war between buyers and sellers and the balance of power may be shifting. The open and close are pretty much equal. The length of the upper and lower shadows can vary and the resulting candlestick looks like a cross, inverted cross or plus sign.



Dragonfly Doji

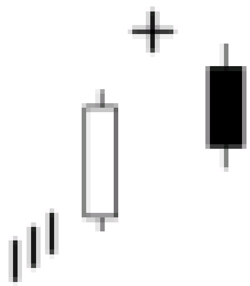
A doji where it opens and closes at or near its high. The candle ends up with a tall lower shadow and no body. It is usually seen at the bottom of a move. More bullish than a hammer.



Evening Doji Star

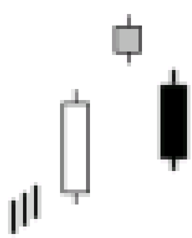
A three candle bearish reversal pattern similar to the Evening Star.

1. The uptrend continues with a large white body.
2. The next candle opens higher, trades in a small range, then closes at its open (Doji).
3. The next candle closes below the midpoint of the body of the first candle.



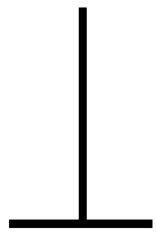
Evening Star

A bearish reversal pattern that continues an uptrend with a long white body candle followed by a gapped up small body candle, then a down close with the close below the midpoint of the first candle.



Gravestone Doji

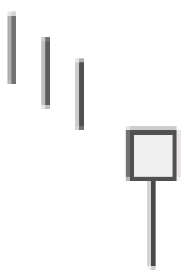
A doji candle that opens and closes at or near its low. The candle ends up having a long upper shadow and no body. It is usually seen at the end of an uptrend. This pattern is more bearish than a shooting star.



Hammer

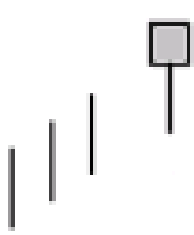
Hammer candlesticks form when prices moves significantly lower after the open, but rallies to close well above the intracandle low. The resulting candlestick looks like a square lollipop with a long stick. A hammer indicates that the market may be attempting to find a bottom, and that buyers are strengthening their position.

If this candlestick occurs after a significant uptrend, then it is called a Hanging Man. The body can be clear or filled in.



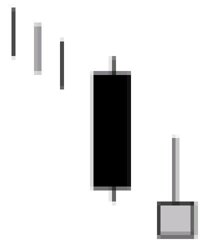
Hanging Man

Hanging Man candlesticks form when a security moves significantly lower after the open, but rallies to close well above the intracandle low. The resulting candlestick looks like a square lollipop with a long stick. If this candlestick forms during a decline, then it is called a Hammer.



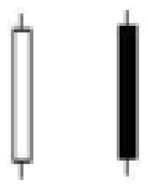
Inverted Hammer

A one candle bullish reversal pattern. In a downtrend, the open is lower, then it trades higher, but closes near its open.



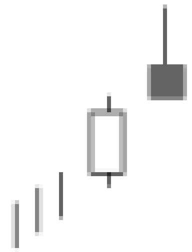
Long Candle

A long candle represents a large move from open to close, where the length of the candle body is long.



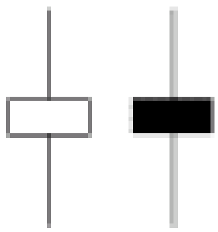
Shooting Star

A single candle pattern that can appear in an uptrend. It opens higher, trades much higher, then closes near its open. It looks just like the Inverted Hammer except that it is bearish. A shooting star can mark a top but is often retested.



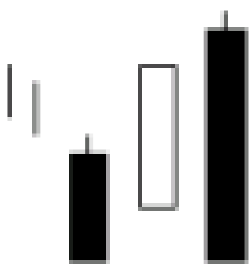
Spinning Top

Candlesticks that have small bodies with upper and lower shadows that exceed the length of the body. A very good reversal signal and can be any color. Spinning tops signal indecision. The smaller the body, the less direction the market has.



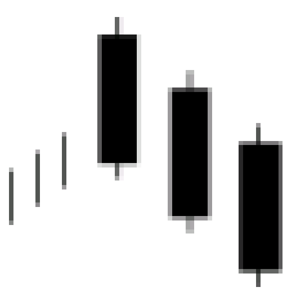
Stick Sandwich

A bullish reversal pattern with two black bodies surrounding a white body. The closing prices of the two black bodies must be equal. A support prices is apparent and the opportunity for prices to reverse is quite good.



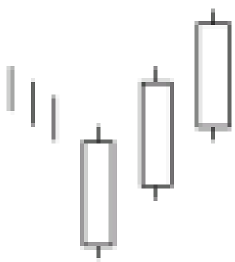
Three Black Crows

A bearish reversal pattern consisting of three consecutive black bodies where each candle closes near below the previous low, and opens within the body of the previous candle.



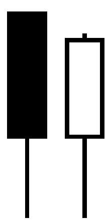
Three White Soldiers

A bullish reversal pattern consisting of three consecutive white bodies, each with a higher close. Each should open within the previous body and the close should be near the high of the candle.



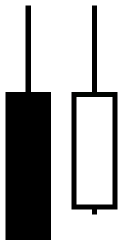
Tweezer Bottom

Two or more candlesticks with matching bottom. They can be composed of real bodies or shadows. These occur on consecutive or nearby candles. Indicates a bearish trend is ending, and perhaps a reversal is in the works.



Tweezer Top

Two or more candlesticks with matching tops. They can be composed of real bodies or shadows. These occur on consecutive or nearby candles.



Summary

Candlesticks are formed using the open, high, low and close.

- If the close is above the open, then a hollow candlestick (usually displayed as white) is drawn.
- If the close is below the open, then a filled candlestick (usually displayed as black) is drawn.
- The hollow or filled section of the candlestick is called the "real body" or body.
- The thin lines poking above and below the body display the high/low range and are called shadows.
- The top of the upper shadow is the "high".
- The bottom of the lower shadow is the "low".

Long bodies indicate strong buying or selling. The longer the body is, the more intense the buying or selling pressure.

Short bodies imply very little buying or selling activity. In street forex lingo, bulls mean buyers and bears mean sellers.

Upper shadows signify the session high.

Lower shadows signify the session low.

Candlesticks with a long upper shadow, long lower shadow and small real bodies are called spinning tops. The pattern indicates the indecision between the buyers and sellers

Leverage

Leverage the Killer

Most professional traders and money managers trade one standard lot for every $50,000 in their account.

If they traded a mini account, this means they trade one mini lot for every $5,000 in their account.

Let that sink into your head for a couple seconds.

If pros trade like this, why do less experienced traders think they can succeed by trading 100K standard lots with a $2,000 account or 10K mini lots with $250?

No matter what the forex brokers tell you, don't ever open a "standard account" with just $2,000 or a "mini account" with $250. The number one reason new traders fail is not because they suck, but because they are undercapitalized from the start and don't understand how leverage really works.

Don't set yourself up to fail.

We recommend that you have at least have $100,000 of trading capital before opening a "standard account", $10,000 for a "mini account", or $1,000 for a "micro account".

So if you only have $60,000, open a "mini account. If you only have $8,000, open a "micro" account. If you only have $250, open a "demo account" and stick with it until you come up with the additional $750, then open a "micro account".

If you don't remember anything else in this lesson, I plead that you at least remember what you just read above.

Okay, please re-read the previous paragraph and ingrain it in your memory. Just because brokers allow you to open an account with *only* $250 doesn't mean you should and I'm going to explain why.

I believe most new traders who open a forex trading account with the bare minimum deposit do so because they don't completely understand what the terms "leverage" and "margin" really are and how it affects their trading.

It's crucial that you're fully aware and free of ignorance of the significance of trading with leverage. If you don't have rock solid understanding of leverage and margin, I guarantee that you will blow your trading account.

Leverage Defined

The textbook definition of "leverage" is having the ability to *control* a large amount of money using none or very little of your *own* money and *borrowing* the rest.

For example, in forex, you can control $100,000 with a $1,000 deposit. Your leverage, which is expressed in ratios, is now 100:1. You're now controlling $100,000 with $1,000.

Let's say the $100,000 investment rises in value to $101,000 or $1,000. If you had to come up with the entire $100,000 capital yourself, your return would be a puny 1% ($1,000 gain / $100,000 initial investment). This is also called 1:1 leverage. Of course, I think 1:1 leverage is a misnomer because if you have to come up with the entire amount you're trying to control, where is the leverage in that?

Fortunately, you're not leveraged 1:1, you're leveraged 100:1. You only had to come up with $1,000 of your money, so your return is a groovy 100% ($1,000 gain / $1,000 initial investment).

Now I want you to do a quick exercise. Calculate what your return would be if you *lost* $1,000.

If you calculated it the same way I did, which is also called the correct way, you would have ended up with a -1% return using 1:1 leverage and a WTF! -100% return using 100:1 leverage.

You've probably heard the good ol' clichés like "Leverage is a double-edge sword." or "Leverage is a two-way street." Well....as you can see, these clichés weren't lying.

Margin

Margin Defined

So what about the term "margin"? Excellent question my bright padawan learner.

Let's go back to the earlier example:

"For example, in forex, you can control $100,000 with a $1,000 deposit. Your leverage, which is expressed in ratios, is now 100:1. You're now controlling $100,000 with $1,000."

The $1,000 deposit is "margin" you had to give in order to use leverage.

Margin is the amount of money needed as a "good faith deposit" to open a position with your broker. It is used by your broker to maintain your position. Your broker basically takes your margin deposit and pools them with everyone else's margin deposits, and uses this one "super margin deposit" to be able to place trades with the interbanks.

Margin is usually expressed as a percentage of the full amount of the position. For example, most forex brokers say they require 2%, 1%, .5% or .25% margin.

Based on the margin required by your broker, you can calculate the maximum leverage you can wield with your trading account.

If your broker requires 2% margin, you have a leverage of 50:1. Here are the other popular leverage "flavors" most brokers offer:

Margin Required	Maximum Leverage
5%	20:1
3%	33:1
2%	50:1
1%	100:1
.5%	200:1
.25%	400:1

Aside from "margin required", you will probably see other "margin" terms in your trading platform. There is much confusion about what these different "margins" mean so I will try my best to define each term:

Margin required: This is an easy one because I just talked about. It is the amount of money your brokers requires from you to open a position. It is expressed in percentages.

Account margin: This is just another phrase for your trading bankroll. It's the total amount of money you have in your trading account.

Used margin: The amount of money that your broker has "locked up" to keep your current positions open. While this money is still yours, you can't touch it until your broker gives it back to you either when you close your current positions or when you receive a margin call.

Usable margin: This is the money in your account that is available to open new positions.

Margin call: If the equity in the account drops below your usable margin, a margin call will occur and some or all open positions will be closed by the dealing desk at the market price.

Margin Call Example

Assume you are a successful retired British spy who now spends his time trading currencies. You open a mini account and deposit $10,000. When you first login, you will see the 10,000 in the "Equity" column of your "Account Information" window.

You will also see that the "UsedMrg" ('Used Margin') is "$0.00", and that the "UsblMrg" ('Usable Margin') is 10,000, as pictured below:

Accounts	Balance	Equity	Used Mrg	Usbl Mrg
007	$10,000.00	$10,000.00	$0.00	$10,000.00

Your Usable Margin will always be equal to Equity less Used Margin.

Usable Margin = Equity – Used Margin

Therefore it is the Equity, NOT the Balance that is used to determine Usable Margin. Your Equity will also determine if and when a Margin Call is reached.

As long as your Equity is greater than your Used Margin, you will not have Margin Call.
(Equity > Used Margin) = NO MARGIN CALL

As soon as your Equity equals or falls below your Used Margin, you will receive a margin call.
(Equity =< Used Margin) = MARGIN CALL, go back to demo trading

Let's assume your margin requirement is 1%. You buy 1 lot of EUR/USD.

Your Equity remains $10,000. Used Margin is now $100, because the margin required in a mini account is $100 per lot. Usable Margin is now $9,900.

Accounts	Balance	Equity	Used Mrg	Usbl Mrg
007	$10,000.00	$10,000.00	$100.00	$9,900.00

If you were to close out that 1 lot of EUR/USD (by selling it back) at the same price at which you bought it, your Used Margin would go back to $0.00 and your Usable Margin would go back to $10,000. Your Equity would remain unchanged at 10,000.

But instead of closing the 1 lot, you, the adrenalin junkie chopsocky retired spy that you are, get extremely confident and buy 79 more lots of EUR/USD for a total of 80 lots of EUR/USD. You will still have the same Equity, but your Used Margin will be $8,000 (80 lots at $100 margin per lot). And your Usable Margin will now only be $2,000, as shown below:

Accounts	Balance	Equity	Used Mrg	Usbl Mrg
007	$10,000.00	$10,000.00	$8,000.00	$2,000.00

Let me paint a horrific picture of a Margin Call which occurs when EUR/USD falls.

The EUR/USD starts to fall. You are long 80 lots, so you will see your Equity fall along with it. Your Used Margin will remain at $8,000. Once your equity drops below $8,000, you will have a Margin Call. This means that some or all of your 80 lot position will immediately be closed at the current market price.

Assuming you bought all 80 lots at the same price, a Margin Call will trigger if your trade moves 25 pips against you.

25 PIPS!

Humbug! The EUR/USD pair can move that much in its sleep!

How did I come up with 25 pips? Well each pip in a mini account is worth $1 and you have a position open consisting of 80 freakin' lots. So…

$1/pip X 80 lots = $80/pip

If EUR/USD goes up 1 pip, your equity increases by $80.

If EUR/USD goes down 1 pip, your equity decreases by $80.

$2,000 Usable Margin divided by $80/pip = 25 pips

Let's say you bought 80 lots of EUR/USD at $1.2000. This is how your account will look if it EUR/USD drops to $1.1975 or -25 pips.

Accounts	Balance	Equity	Used Mrg	Usbl Mrg
007	$10,000.00	$8,000.00	$8,000.00	$0.00

As you can see, your Usable Margin is now at $0.00 and you will receive a MARGIN CALL!

Of course, you're a veteran international spy, you've faced much bigger calamities. You've got ice in your veins and your heart rate is still 55 bpm.

After the margin call this is how your account will look:

Accounts	Balance	Equity	Used Mrg	Usbl Mrg
007	$8,000.00	$8,000.00	$0.00	$0.00

The EUR/USD moves 25 PIPS, or less than .22% ((1.2000 – 1.1975) / 1.2000) X 100% and you LOSE $2,000!

You blew 20% of your trading account! (($2,000 loss / $10,000 balance)) X 100%

In reality, it's normal for EUR/USD to move 25 pips in a couple seconds during a major economic data release.

Oh I almost forget…I didn't even factor in the SPREAD!

To simplify the example, I didn't even factor in the spread, but I will now to make this example super realistic.

Let's say the spread for EUR/USD is 3 pips. This means that EUR/USD really only has to move *22* pips, *NOT 25* pips before a margin call.

Imagine losing $2,000 in 5 seconds?!

This is what happened to our popular British spy all because he didn't understand the mechanics of margin and how to use leverage.

The sad fact is….most new traders don't even open a mini account with $10,000. Because our spy friend had at least $10,000, he was at least able to weather 25 pips before his margin call.

If he only started off with $9,000, he could only weather a 10 pip drop (including spread) before receiving a margin call. 10 pips!

More Leverage

Hopefully I've done my job and you now have a better understanding of what "margin" is. Now I want to take a harder look at "leverage" and show you how it regularly wipes out unsuspecting or overzealous traders.

We've all seen or heard online forex brokers advertising how they offer 200:1 leverage or 400:1 leverage. I just want to be clear that what they are really talking about is the maximum leverage you can trade with. Remember this leverage ratio depends on the margin required by the broker. For example, if a 1% margin is required, you have 100:1 leverage.

There is maximum leverage. And then there is your true leverage.

True leverage is the full amount of your position divided by the amount of money deposited in your trading account.

Huh?

Let me illustrate an example:

You deposit $10,000 in your trading account. You buy 1 standard 100K of EUR/USD at a rate of $1.0000. The full amount of your position is $100,000 and your account balance is $10,000. Your true leverage is 10:1 ($100,000 / $10,000)

Let's say you buy another standard lot of EUR/USD at the same price. The full amount of your position is now $200,000 and your account balance is still $10,000. Your true leverage is now 20:1 ($200,000 / $10,000)

You're feeling good so you buy three more standard lots of EUR/USD, again at the same rate. The full amount of your position is now $500,000 and your account balance is still $10,000. Your true leverage is now 50:1 ($500,000 / $10,000).

Assume the broker requires 1% margin. If you do the math, your account balance and equity are both be $10,000, the Used Margin is $5,000, and the Usable Margin is $5,000. In a standard account, each pip is worth $10.

Accounts	Balance	Equity	Used Mrg	Usbl Mrg
007	$10,000.00	$10,000.00	$5,000.00	$5,000.00

In order to receive a margin call, price would have to move 100 ips ($5,000 Usable Margin divided by $10/pip).

This would mean the price of EUR/USD would have to move from $1.0000 to $0.95000 – a price change of 5%.

After the margin call, your account balance would be $5,000. You lost $5,000 or 50% and the price only moved 5%.

Now let's pretend you ordered coffee at a McDonald's drive-thru, then spilled your coffee on your lap while you were driving, and then proceeded to sue and won against McDonald's because your legs got burned and you didn't know the coffee was hot. To make a long story long, you deposit $100,000 in your trading account instead of $10,000.

You buy just 1 standard lot of EUR/USD – at a rate of $1.0000. The full amount of your position is $100,000 and your account balance is $100,000. Your true leverage is 1:1.

Here's how it looks in your trading account:

Accounts	Balance	Equity	Used Mrg	Usbl Mrg
007	$100,000.00	$100,000.00	$1,000.00	$99,000.00

In this example, in order to receive a margin call, price would have to move 9,900 pips ($99,000 Usable Margin divided by $10/pip)

This means the price of EUR/USD would have to move from $1.0000 to $0.0100! This is a price change of 99% or basically 100%!

Let's say you buy 19 more standard lots, again at the same rate as the first trade. The full amount of your position is $2,000,000 and your account balance is $100,000. Your true leverage is 20:1.

Accounts	Balance	Equity	Used Mrg	Usbl Mrg
007	$100,000.00	$100,000.00	$20,000.00	$80,000.00

In order to be "margin called", price would have to move 400 pips ($80,000 Usable Margin divided by ($10/pip X 20 lots)

That means the price of EUR/USD would have to move from $1.0000 to $0.9600 – a price change of 4%.

If you did get margin called and your trade exited at the margin call price, this is how your account would like:

Accounts	Balance	Equity	Used Mrg	Usbl Mrg
007	$20,000.00	$20,000.00	$0.00	$0.00

You would have realized an $80,000 loss! You' would've wiped out 80% of your account and the price only moved 4%!

Do you now see the effects of leverage?!

Leverage amplifies the movement in the relative prices of a currency pair by the factor of the leverage in your account.

Here's a chart of how much your account balance changes if prices moves depending on your leverage.

Leverage	% Change in Currency	% Change in Account
100:1	1%	100%
50:1	1%	50%
33:1	1%	33%

20:1	1%	20%
10:1	1%	10%
5:1	1%	5%
3:1	1%	3%
1:1	1%	1%

Let's say you bought USD/JPY and it goes up by 1% from 120.00 to 121.20. If you trade one standard $100K lot, here is how leverage would affect your return:

Leverage	Margin Required	Return (Gain)
100:1	$1,000	+100%
50:1	$2,000	+50%
33:1	$3,300	+33%
20:1	$5,000	+20%
10:1	$10,000	+10%
5:1	$20,000	+5%
3:1	$33,000	+3%
1:1	$100,000	+1%

Let's say you bought USD/JPY and it goes *down* by 1% from 120.00 to 118.80. If you trade one standard $100K lot, here is how leverage would affect your return (or loss):

Leverage	Margin Required	Return (Loss)
100:1	$1,000	-100%
50:1	$2,000	-50%
33:1	$3,300	-33%
20:1	$5,000	-20%
10:1	$10,000	-10%
5:1	$20,000	-5%
3:1	$33,000	-3%
1:1	$100,000	-1%

The more leverage you use, the less "breathing room" you have for the market to move before a margin call.

You're probably thinking I'm a day trader, I don't need no stinkin' breathing room. I only use 20-30 pip stop losses.

Okay let's take a look:

Example #1

You open a mini account with $500 which trades $10K mini lots and only requires .5% margin.
You buy 2 lots of EUR/USD. Your true leverage is 40:1 ($20,000 / $500). You place a 30 pip stop loss and it gets triggered. Your loss is $60 ($1/pip x 2 lots).

You've just lost 12% of your account ($60 loss / $500 account). Your account balance is now $440.

You believe you just had a bad day. The next day, you're feeling good and want to recoup yesterday losses, so you decide to double up and you buy 4 lots of EUR/USD. Your true leverage is about 90:1 ($40,000 / $440). You set your usual 30 pip stop loss and your trade loses. Your loss is $120 ($1/pip x 4 lots).

You've just lost 27% of your account ($120 loss/ $440 account). Your account balance is now $320.

You believe the tide will turn so you trade again. You buy 2 lots of EUR/USD. Your true leverage is about 63:1. You set your usual 30 pip stop loss and lose once again! Your loss is $60 ($1/pip x 2 lots).

You've just lost almost 19% of your account ($60 loss / $320 account). Your account balance is now $260.

You're getting frustrated. You try to think what you're doing wrong. You think your setting your stops too tight.

The next day you buy 3 lots of EUR/USD. Your true leverage is 115:1 ($30,000 / $260). You loosen your stop loss to 50 pips. The trade starts going against you and it looks like you're about to get stopped out yet again!

But what happens next is even worse! You get a margin call!

Since you opened 3 lots with a $260 account, your Used Margin was $150 so your Usable Margin was a measly $110. The trade went against you 37 pips and because you had 3 lots opened, you get margin called. Your position has been liquidated at market price.

The only money you have left in your account is $150, the Used Margin that was returned to you after the margin call.

After four total trades, your trading account has gone from $500 to $150. A 70% loss! It won't be very long until you lose the rest.

Trade No.	Starting Account Balance	Number of Lots Used	Stop Loss Size (pips)	Trade Result	Ending Account Balance
1	$500	2	30	-$60	$440
2	$440	4	30	-$120	$320
3	$320	2	30	-$60	$260
4	$260	5	50	Margin Call	$150

A four trade losing streak is not uncommon. Experienced traders have similar or even longer streaks. The reason they're successful is because they use low leverage. Most cap their leverage at 5:1 but rarely go that high and stay around 3:1.

The other reason experienced traders succeed is because their accounts are properly capitalized!

While learning technical analysis, fundamental analysis, building a system, trading psychology is important, I believe the biggest factor on whether you succeed as a forex trader is making sure you capitalize your account sufficiently and trade that capital with smart leverage.

Your chances of becoming successful are greatly reduced below a minimum starting capital. It becomes impossible to mitigate the effects of leverage on too small an account.

Low leverage with proper capitalization allows you to realize losses that are very small which allows you to trade another day.

Example #2

Bill opens a $5,000 account trading $100,000 lots. He is trading with 20:1 leverage. The currency market moves on a regular basis anywhere from 70 to 200 pips in one day. In order to protect himself, he uses tight 30 pips stops. If the market goes 30 pips against him, he would be stopped out for a loss of $300.00. He felt that was reasonable but he underestimated how volatile this market is and found himself being stopped out frequently.

After being stopped out four times, he'd had enough. He's decided to give himself a little more room, handle the swings, increases his stop to 100 pips.

Bill's leverage is not 20:1 anymore, his account is down to $2,800 (his four loses at $300 each) and he's still trading one $100,000 lot. It's now over 25:1.

He decides to tighten his stops to 50 pips. He opens another trade using two lots and two hours later his 50 pip stop loss is hit and he losses $1,000. He now has $2,800 in his account. His leverage is 35:1.

He tries again with two lots. This time the market goes up 10 pips. He cashes out with a $200 profit. His account grows slightly to $3,000.

He opens another position with two lots. The market drops 50 points and he gets out. Now he has $2,000 left.

He thinks what the hell and opens another position. The market proceeds to drop another 100 pips and because he has $1,000 locked up as margin deposit, he only has $1,000 margin available, so he receives a margin call and his position is instantly liquidated.

He now has $1,000 left which is not even enough to open a new position.

He lost $4,000 or 80% of his account with a total of 8 trades and the market only moved 280 pips. 280 pips! The market moves 280 pips pretty darn easy.

Are you starting to see why leverage is the top killer of forex taders?

How Leverage Affects Transaction Costs

Besides amplifying your losses, leverage also has another way of killing you. It's a much slower kind of death, though, kinda like being constantly exposed to high levels of radiation. Most traders don't see it coming and by the time they notice it, they're dead.

This killer I'm talking about is the associated transaction cost of using high leverage. Not only does leverage amplify your losses, it also amplifies your transaction costs as a percentage of your account.

Let's say you open a mini account with $500. You buy five mini $10k lots of GBP/USD which has a 5 pip spread. Your true leverage is 100:1 ($50,000 total mini lots / $500 account). But check this....you paid $25 in transaction costs (($1/pip x 5 pip spread) x 2 lots)). That is 5% of your account!

With one trade, and the market not even moving yet, you're already down 5%! If your trades lose, your account balance shrinks. As your account balance shrinks, your leverage increases. As your leverage increases, the faster your transaction costs eats away at the little money you have left. This is the slow and silent killer I'm talking about.

The higher your leverage, the higher your transaction cost as a percentage of your trading capital.

If you have a mini account, and open a trade with a 5 pip spread, which equals $5 transaction cost, look at how the relative value of your transaction costs increases with more leverage.

Leverage	Margin Required (MR)	Cost as % MR
200:1	$50	10%
100:1	$100	5%
50:1	$200	2.5%
20:1	$500	1%
10:1	$1,000	.5%
5:1	$2,000	.25%
3:1	$3,300	.10%

Now you've learned how leverage can magnify your profits and losses, but also your transaction costs.

Leverage does not equal margin. Leverage is how many times you lever your whole account.

The maximum amount that you are allowed to lever is dependent on your margin requirement.

Don't Underestimate Leverage

Most beginners underestimate the potentially devastating damage leverage can wreak on their accounts. Understanding leverage enough to know when to use it and when NOT to use it is critical to your success!

Leverage is a very powerful tool but both old and new traders use it to destroy their trading capital simply because they take too lightly its destructive force or ignore it altogether. It's a pity, but the more of them the easier it is for us smart traders to make money. Sad but true.

High leverage is a favorite selling point for most forex brokers. Yes they pitch that you can make a huge killing using huge leverage, but know you could easily be killed by huge leverage as well.

Brokers want you to trade with a short-term mindset. They want you to trade as much as possible as often as possible. It's the only way they make money. One or two pips are important to them. The more you trade the more they make on the spread. It's not in their best interest to tell you to let your trades run longer than the same day.

If you want to give yourself the best chance to succeed, first learn to trade profitably *without* leverage.

Play it safe. Protect your capital.

When you can make more pips more than you lose *consistently, t*hen, and only then, should you use unleash this weapon of mass destruction called leverage. Destroy traders (or your broker) taking the opposite side of your trade. Don't destroy yourself.

Forex trading should be treated as a job or business. Don't think that just because brokers allow you to use high leverage with a low minimum deposit that you can "make a quick " or "get rich quick". Approach the currency markets with respect.

Be realistic in your expectations and be willing to properly educate yourself.

If you don't, you will die.

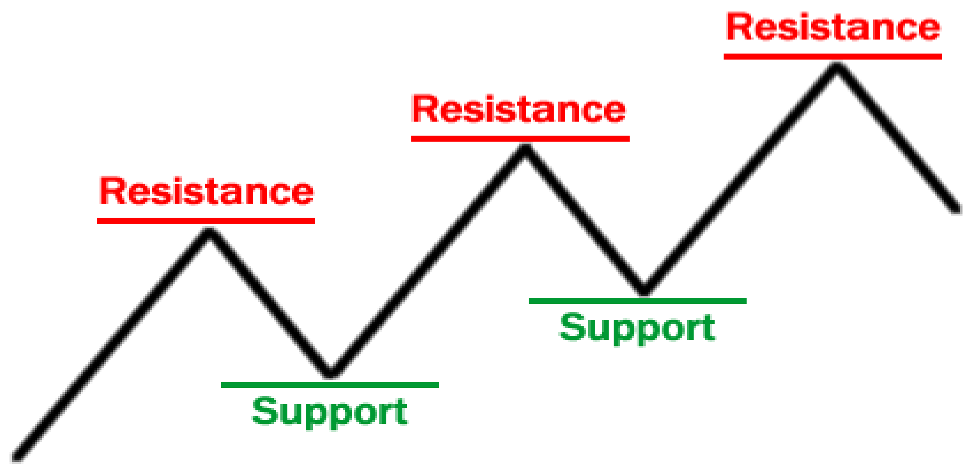
Okay, not really, but your account will die.

Technical Analysis

Support and Resistance

Support and resistance is one of the most widely used concepts in trading. Strangely enough, everyone seems to have their own idea on how you should measure support and resistance.

Let's just take a look at the basics first.



Look at the diagram above. As you can see, this zigzag pattern is making its way up (bull market). When the market moves up and then pulls back, the highest point reached before it pulled back is now resistance.

As the market continues up again, the lowest point reached before it started back is now support. In this way resistance and support are continually formed as the market oscillates over time. The reverse of course is true of the downtrend.

Plotting Support and Resistance

One thing to remember is that support and resistance levels are not exact numbers. Often times you will see a support or resistance level that appears broken, but soon after find out that the market was just testing it. With candlestick charts, these "tests" of support and resistance are usually represented by the candlestick shadows.

Notice how the shadows of the candles tested the 2500 resistance level. At those times it seemed like the market was "breaking" resistance. However, in hindsight we can see that the market was merely testing that level.

So how do we truly know if support or resistance is broken?

There is no definite answer to this question. Some argue that a support or resistance level is broken if the market can actually close past that level. However, you will find that this is not always the case. Let's take our same example from above and see what happened when the price actually closed past the 2500 resistance level.

In this case, the price had closed twice above the 2500 resistance level but both times ended up falling back down below it. If you had believed that these were real breakouts and bought this pair, you would've been seriously hurting! Looking at the chart now, you can visually see and come to the conclusion that the resistance was not actually broken; and that it is still very much in tact and now even stronger.

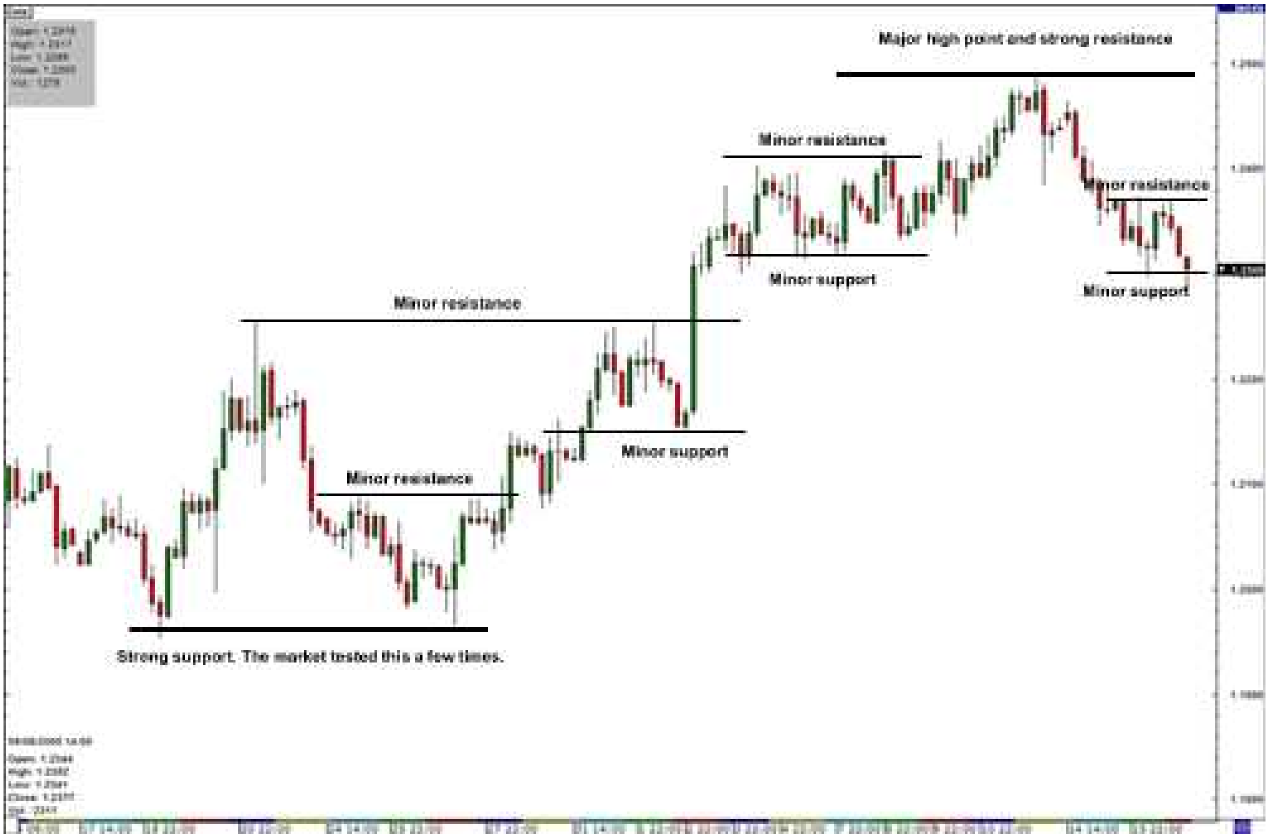
So to help you filter out these false breakouts, you should think of support and resistance more of as "zones" rather than concrete numbers. One way to help you find these zones is to plot support and resistance on a line chart rather than a candlestick chart. The reason is that line charts only show you the closing price while candlesticks add the extreme highs and lows to the picture. These highs and lows can be misleading because often times they are just the "knee-jerk" reactions of the market. It's like when someone is doing something really strange, but when asked about it, they simply reply, "Sorry, it's just a reflex."

When plotting support and resistance, you don't want the reflexes of the market. You only want to plot its intentional movements.

Looking at the line chart, you want to plot your support and resistance lines around areas where you can see the price forming several peaks or valleys.

Other interesting tidbits about support and resistance:

- When the market passes through resistance, that resistance now becomes support.
- The more often price tests a level of resistance or support without breaking it the stronger the area of resistance or support is.

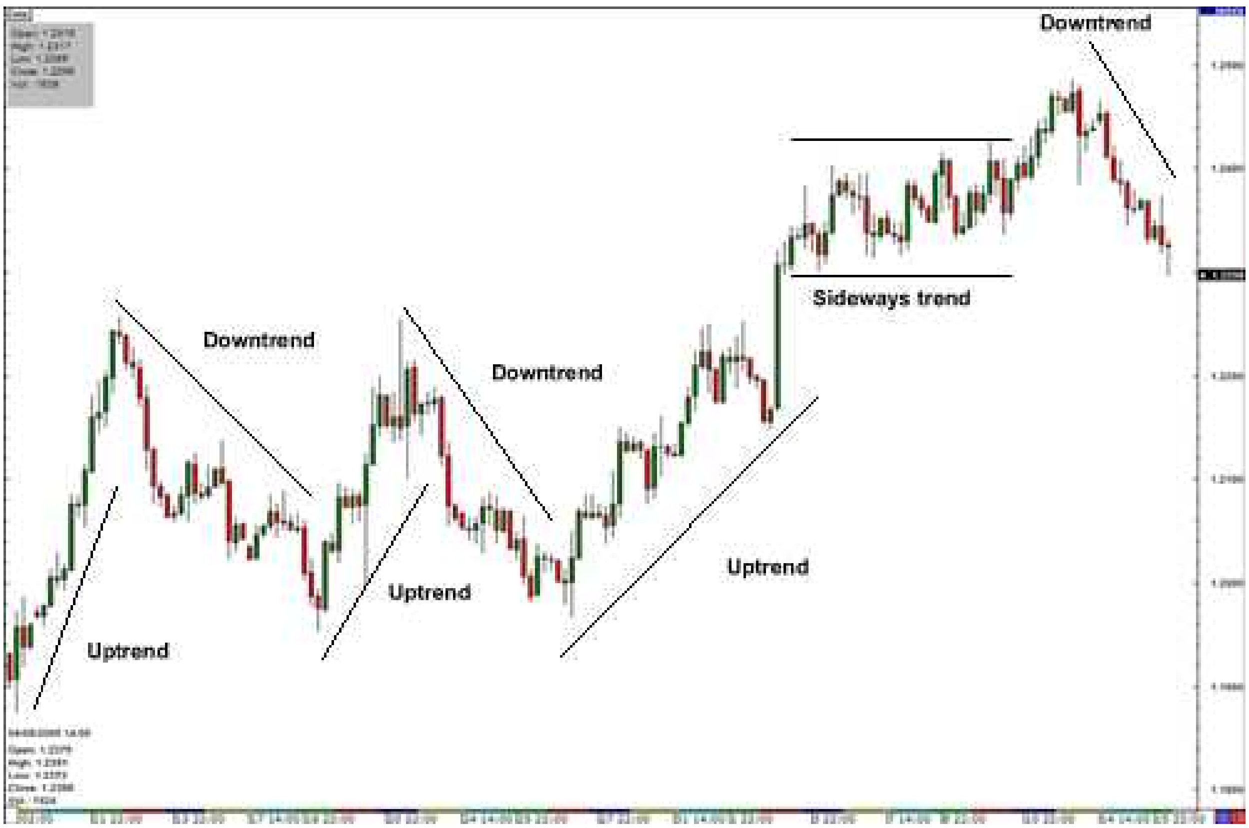

Major high point and strong resistance
Minor resistance
Minor resistance
Minor support
Minor support
Minor resistance
Minor support
Minor resistance
Strong support. The market tested this a few times.

Trend Lines

Trend lines are probably the most common form of technical analysis used today. They are probably one of the most underutilized as well.

If drawn correctly, they can be as accurate as any other method. Unfortunately, most traders don't draw them correctly or they try to make the line fit the market instead of the other way around.

In their most basic form, an uptrend line is drawn along the bottom of easily identifiable support areas (valleys). In a downtrend, the trend line is drawn along the top of easily identifiable resistance areas (peaks).



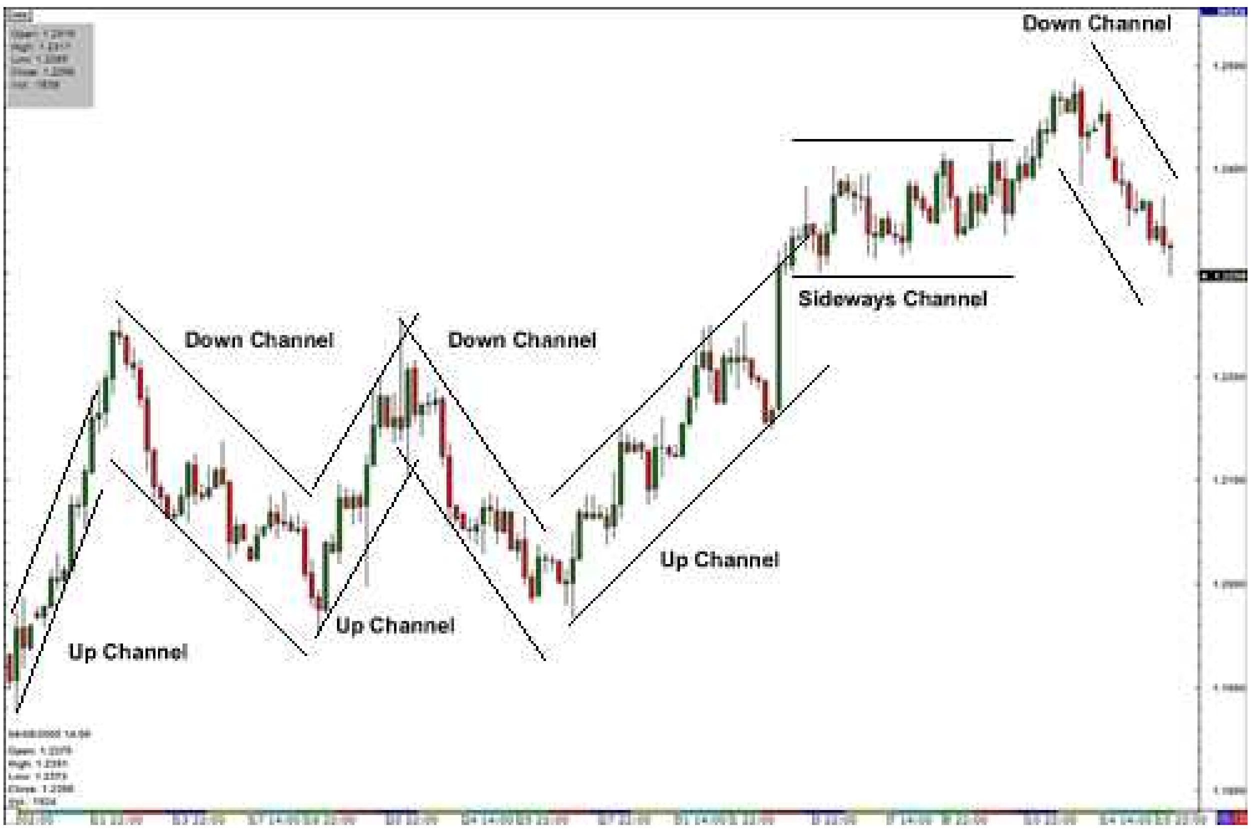
Channels

If we take this trend line theory one step further and draw a parallel line at the same angle of the uptrend or downtrend, we will have created a channel.

To create an up (ascending) channel, simply draw a parallel line at the same angle as an up-trend line and then move that line to position where it touches the most recent peak. This should be done at the same time you create the trend line.

To create a down (descending) channel, simple draw a parallel line at the same angle as the downtrend line and then move that line to a position where it touches the most recent valley. This should be done at the same time you created the trend line.

When prices hit the bottom trend line this may be used as a buying area. When prices hit the upper trend line this may be used as a selling area.



Summary

When the market moves up and then pulls back, the highest point reached before it pulled back is now resistance.

As the market continues up again, the lowest point reached before it started back is now support

In their most basic form, an uptrend line is drawn along the bottom of easily identifiable support areas (valleys). In a downtrend, the trend line is drawn along the top of easily identifiable resistance areas (peaks).

To create an up (ascending) channel, simply draw a parallel line at the same angle as an uptrend line and then move that line to position where it touches the most recent peak.

To create a down (descending) channel, simple draw a parallel line at the same angle as the downtrend line and then move that line to a position where it touches the most recent valley.

Fibonacci Who?

We will be using Fibonacci ratios a lot in our trading so you better learn it and love it like your mother. Fibonacci is a huge subject and there are many different studies of Fibonacci with weird names but we're going to stick to two: retracement and extension.

Let me first start by introducing you to the Fib man himself...Leonard Fibonacci.

Leonard Fibonacci was a famous Italian mathematician, also called a super duper uber geek, who had an "aha!" moment and discovered a simple series of numbers that created ratios describing the natural proportions of things in the universe

The ratios arise from the following number series: 1, 1, 2, 3, 5, 8, 13, 21, 34, 55, 89, 144 ......

This series of numbers is derived by starting with 1 followed by 2 and then adding 1 + 2 to get 3, the third number. Then, adding 2 + 3 to get 5, the fourth number, and so on.

After the first few numbers in the sequence, if you measure the ratio of any number to that of the next higher number you get .618. For example, 34 divided by 55 equals 0.618.

If you measure the ratio between alternate numbers you get .382. For example, 34 divided by 89 = 0.382 and that's as far as into the explanation as we'll go.

These ratios are called the "golden mean." Okay that's enough mumbo jumbo. Even I'm about to fall asleep with all these numbers. I'll just cut to the chase; these are the ratios you have to know:

Fibonacci Retracement Levels
0.236, 0.382, 0.500, 0.618, 0.764

Fibonacci Extension Levels
0, 0.382, 0.618, 1.000, 1.382, 1.618

You won't really need to know how to calculate all of this. Your charting software will do all the work for you. But it's always good to be familiar with the basic theory behind the indicator so you'll have knowledge to impress your date.

Traders use the Fibonacci retracement levels as support and resistance levels. Since so many traders watch these same levels and place buy and sell orders on them to enter trades or place stops, the support and resistance levels become a self-fulfilling expectation.

Traders use the Fibonacci extension levels as profit taking levels. Again, since so many traders are watching these levels and placing buy and sell orders to take profits, this tool usually works due self-fulfilling expectations.

Most charting software includes both Fibonacci retracement levels and extension level tools. In order to apply Fibonacci levels to your charts, you'll need to identify Swing High and Swing Low points.

A Swing High is a candlestick with at least two lower highs on both the left and right of itself. A Swing Low is a candlestick with at least two higher lows on both the left and right of itself.

Let's take a closer look at Fibonacci retracement levels...

Fibonacci Retracement

In an uptrend, the general idea is to go long the market on a retracement to a Fibonacci support level. In order to find the retracement levels, you would click on a significant Swing Low and drag the cursor to the most recent Swing High. This will display each of the Retracement Levels showing both the ratio and corresponding price level. Let's take a look at some examples of markets in an uptrend.

This is an hourly chart of USD/JPY. Here we plotted the Fibonacci Retracement Levels by clicking on the Swing Low at 110.78 on 07/12/05 and dragging the cursor to the Swing High at 112.27 on 07/13/05. You can see the levels plotted by the software. The Retracement Levels were 111.92 (0.236), 111.70 (0.382), 111.52 (0.500), and 111.35 (0.618). Now the expectation is that if USD/JPY retraces from this high, it will find support at one of the Fibonacci Levels because traders will be placing buy orders at these levels as the market pulls back.

Now let's look at what actually happened after the Swing High occurred. The market pulled back right through the 0.236 level and continued the next day piercing the 0.382 level but never actually closing below it. Later on that day, the market resumed its upward move. Clearly buying at the 0.382 level would have been a good short term trade

Let's check out what happened next. Now isn't that a thing of beauty! The market did try to rally but it barely past the 0.500 level spiking to a high 1.3227 and it actually closed below it. After that bar, you can see that the rally reversed and the downward move continued. You would have made some nice dough selling at the 0.382 level

Here's another example. This is an hourly chart for GBP/USD. We had a Swing High of 1.7438 on 07/26/05 and a Swing Low of 1.7336 the next day. So our Retracement Levels are: 1.7399 (0.618), 1.7387 (0.500), 1.7375 (0.382), and 1.7360 (0.236). Looking at the chart, the market looks like it tried to break the 0.500 level on several occasions, but try as it may, it failed. So would putting a sell order at the 0.500 level be a good trade?

If you did, you would have lost some serious cheddar! Take a look at what happened. The Swing Low looked to be the bottom for this downtrend as the market rallied above the Swing High point.

You can see from these examples the market *usually* finds at least temporary support (during an uptrend) or resistance (during a downtrend) at the Fibonacci Retracements Levels. It's apparent that there a few problems to deal with here. There's no way of knowing which level will provide support. The 0.236 seems to provide the weakest support/resistance, while the other levels provide support/resistance at about the same frequency. Even though the charts above show the market usually only retracing to the 0.382 level, it doesn't mean the price will hit that level every time and reverse. Sometimes it'll hit the 0.500 and reverse, other times it'll hit the 0.618 and reverse, and other times the price will totally ignore Mr. Fibonacci and blow past all the levels like similar to the way Allen Iverson blows past his defenders with his nasty first step. Remember, the market will not always resume its uptrend after finding temporary support, but instead continue to decline below the last Swing Low. Same thing for a downtrend. The market may instead decide to continue above the last Swing High.

The placement of stops is a challenge. It's probably best to place stops below the last Swing Low (on an uptrend) or above the Swing High (on a downtrend), but this requires taking a high level of risk in proportion to the likely profit potential in the trade. This is called reward-to-risk ratio. In a later lesson, you will learn more money management and risk control and how you would only take trades with certain reward-to-risk ratios.

Another problem is determining which Swing Low and Swing High points to start from to create the Fibonacci Retracement Levels. People look at charts differently and so will have their own version of where the Swing High and Swing Low points should be. The point is, there is no one right away to do it, but the bad thing is sometimes it becomes a guessing game.

Fibonacci Extension

The next use of Fibonacci you will be applying is that of targets. Let's start with an example in an uptrend.

In an uptrend, the general idea is to take profits on a long trade at a Fibonacci Price Extension Level. You determine the Fibonacci extension levels by using three mouse clicks. First, click on a significant Swing Low, then drag your cursor and click on the most recent Swing High. Finally, drag your cursor back down and click on the retracement Swing Low. This will display each of the Price Extension Levels showing both the ratio and corresponding price levels.

On this 1-hour USD/CHF chart, we plotted the Fibonacci extension levels by clicking on the Swing Low at 1.2447 on 08/14/05 and dragged the cursor to the Swing High at 1.2593 on 08/15/15 and then down to the retracement Swing Low of 1.2541 on 08/15/05. The following Fibonacci extension levels created are 1.2597 (0.382), 1.2631 (0.618), 1.2687 (1.000), 1.2743 (1.382), 1.2760 (1.500), and 1.2777 (1.618).

On this 1-hour USD/CHF chart, we plotted the Fibonacci extension levels by clicking on the Swing Low at 1.2447 on 08/14/05 and dragged the cursor to the Swing High at 1.2593 on 08/15/15 and then down to the retracement Swing Low of 1.2541 on 08/15/05. The following Fibonacci extension levels created are 1.2597 (0.382), 1.2631 (0.618), 1.2687 (1.000), 1.2743 (1.382), 1.2760 (1.500), and 1.2777 (1.618).

Now let's look at what actually happened after the retracement Swing Low occurred.

- The market rallied to the 0.500 level
- fell back to the retracement Swing Low
- then rallied back up to the 0.500 level
- fell back slightly
- rallied to the 0.618 level
- fell back to the 0.382 level which acted as support
- then rallied all the way to the 1.382 level
- consolidated a bit
- then rallied to the 1.500 level

You can see from these examples that the market often finds at least temporary resistance at the Fibonacci extension levels - not always, but often. As in the examples of the retracement levels, it should be apparent that there are a few problems to deal with here as well. First, there is no way of knowing which level will provide resistance. The 0.500 level was a good level to cover any long trades in the above example since the market retraced back to its original level, but if you didn't get back in the trade, you would have left a lot of profits on the table.

Another problem is determining which Swing Low to start from in creating the Fibonacci Extension Levels. One way is from the last Swing Low as we did in the examples; another is from the lowest Swing Low of the past 30 bars. Again, the point is that there is no one right way to do it, and consequently it becomes a guessing game.

Alright, let's see how Fibonacci extension levels can be used during a downtrend. In a downtrend, the general idea is to take profits on a short trade at a Fibonacci price extension level since the market often finds at least temporary support at these levels.

On this 1-hour EUR/USD chart, we plotted the Fibonacci extension levels by clicking on the Swing High at 1.21377 on 07/15/05 and dragged the cursor to the Swing Low at 1.2021 on 08/15/15 and then down to the retracement High of 1.2085. The following Fibonacci extension levels created are 1.2041 (0.382), 1.2027 (0.500), 1.2013 (0.618), 1.1969 (1.000), 1.1925 (1.382), 1.1911 (1.500), and 1.1897 (1.618).

Now let's look at what actually happened after the retracement Swing Low occurred.

- The market fell down almost to the 0.382 level which for right now is acting as a support level
- The market then traded sideways between the retracement Swing High level and 0.382 level

- Finally, the market broke through the 0.382 and rested on the 0.500 level
- Then it broke the 0.500 level and fell all the way down to the 1.000 level

Alone, Fibonacci levels will not make you rich. However, Fibonacci levels are definitely useful as part of an effective trading method that includes other analysis and techniques. You see, the key to an effective trading system is to integrate a few indicators (not too many) that are applied in a way that is not obvious to most observers.

All successful traders know it's how you use and integrate the indicators (including Fibonacci) that makes the difference. The lesson learned here is that Fibonacci Levels can be a useful tool, but never enter or exit a trade based on Fibonacci Levels alone

Fibonacci Arcs

Fibonacci arcs are created by first drawing an invisible trendline between two points (usually the high and low in a given period), and then by drawing three curves that intersect this trendline at the key Fibonacci levels of 38.2%, 50% and 61.8%. Transaction decisions are made when the price of the asset crosses through these key levels.

Fibonacci arcs are one of the four most commonly used Fibonacci studies for analyzing markets in terms of support and resistance levels. They are used to draw circular arcs that are probable values of support and resistance based on a market range. Fibonacci arcs are generated by first finding the low and high prices for a given market. A line drawn between these two points becomes the radius in a large circle. Taking one point at 0% and the other as 100%, three arcs are then drawn across this radius at the Fibonacci percentages of 38.2%, 50%, and 61.8% of the total length of the line. The price levels at which the arcs intersect with a time index are, in theory, strong areas of support or resistance for the market.

Another popular strategy is to combine Fibonacci arcs with Fibonacci fans, drawing both studies on the same chart. Fans of this method consider the points where both studies cross to be extremely strong areas of support and resistance.

One caveat when using Fibonacci arcs: since the arcs are literally drawn as circles across a chart, the points of intersection can vary depending on the chart's horizontal or vertical scale. A savvy trader will experiment with Fibonacci arcs applied to previous market data in order to determine a chart scale that seems the most effective, and then use that in future predictions of resistance and support.

Fibonacci Fan

Fibonacci fans name derives from the fanlike appearance of the three trend lines shown. The Fibonacci fans are drawn using typical tops or bottoms. The three Fibonacci fans project into the future with slopes at 38.2, 50 and 61.8% (additional levels are also available). As the daily prices pass these three fans, we make predictions about future price movements based upon whether there appears to be price resistance or support at these intersection points. If the prices hold at the fan line, there is support there, if they quickly move through the fan line, then you will not see support until the next fan line is met.

Fibonacci fans are among the four most popular Fibonacci studies, used to predict levels of support and resistance in a market. Fibonacci fans are generated by first finding the high and low of the market. An invisible vertical line running from the high price level to the low price level is drawn at the rightmost point, whether high or low. Three lines are then drawn from the leftmost point through the invisible vertical line, crossing the line at 38.2%, 50% and 61.8% of the total distance. (These are the classic Fibonacci study percentages, but other Fibonacci percentages are sometimes used.) These three Fibonacci fan lines predict strong levels of support and resistance for the market in the near future.

The Fibonacci fan also predicts the range of a market for a short period of time, as prices tend to "bounce" between the lowest and highest of the three Fibonacci fan lines, occasionally hovering or rebounding from the 50% line at the middle of the projection. Several traders also use Fibonacci fans in conjunction with Fibonacci arcs. Both Fibonacci studies are drawn on the same chart, and the points at which the projections

Summary

Fibonacci retracement levels are 0.236, 0.382, 0.500, 0.618, 0.764

Traders use the Fibonacci retracement levels as support and resistance levels. Since so many traders watch these same levels and place buy and sell orders on them to enter trades or place stops, the support and resistance levels become a self-fulfilling expectation.

Fibonacci extension levels are 0, 0.382, 0.618, 1.000, 1.382, 1.618

Traders use the Fibonacci extension levels as profit taking levels. Again, since so many traders are watching these levels and placing buy and sell orders to take profits, this tool usually works due self-fulfilling expectations.

Which Timeframe

Which Timeframe Should I Trade?

Welcome back to school freshman! As part of your initiation to high school you must pay BabyPips.com $1 million dollars so that we can sit in a mansion in St. Thomas and sip Mai Tais all day, MWUHAHAHA! (There's that evil laugh again).

But seriously, you can send it to our Paypal account. We 'll be waiting for it. Seriously. No joke. We're not kidding. What? You thought this stuff was free? Wait a minute..this stuff *is* free.... Sigh, nevermind. Okay back to work...

Which Timeframe?

One of the main reasons traders don't do well as they should is because they're usually trading the wrong timeframe for their personality. New traders will want to learn how to get rich quick so they'll start trading small timeframes like the 1-minute or 5-minute charts. Then they end up getting frustrated when they trade because it's the wrong timeframe for their personality.

Finally after a long period of timeframe unfaithfulness, we felt we were most comfortable trading the 1-hour charts. This timeframe is longer, but not too long, and trade signals were fewer, but not too few. We now have more time to analyze the market and didn't feel rushed anymore.

On the other hand, we have a friend who could never, ever, trade in a 1-hour timeframe. It would be way too slow for him and he'd probably think he was going to rot and die before he could get in a trade. He prefers trading a 10-minute chart. It still gives him enough time (but not too much) to make decisions based on his trading plan.

Another buddy of ours can't figure out how we can trade a 1-hour chart because he thinks it's too fast! He trades only daily, weekly, and monthly charts. His name is Warren Buffet. You might know him.

Okay, so you're probably asking what the right timeframe is for you. Well, buddy, if you had been paying attention, it depends on your personality. You have to feel comfortable with the timeframe you're trading in.

You'll always feel some kind of pressure or sense of frustration when you're in a trade because real money is involved. But you shouldn't feel that the reason for the pressure is because things are happening so fast that you find it difficult to make decisions or so slowly that you get frustrated.

When we first started trading, we couldn't stick to a timeframe. We started with the 15-minute chart. Then the 5-minute chart. Then we tried the 1-hour chart, the daily chart, and 4-hour chart.

Trading timeframes are usually categorized into three types:

1) Long-term
2) Short-term or swing
3) Intraday or day-trading

Which one is better? It depends on....

Timeframe Breakdowns

Which one is better?

It depends on your personality!

Let me give you a breakdown of the three to help you choose:

Timeframe	Description	Advantages	Disadvantages
Long-term	Long-term traders will usually refer to daily and weekly charts. The weekly charts will establish the longer term perspective and assist in placing entries in the shorter term daily. Trades usually from a few weeks to many months, sometimes years.	Don't have to watch markets intraday Fewer transactions means less paying of spreads	Large swings which require large stops Usually 1 or 2 good trades a year so patience is required Bigger account needed to ride longer term swings Frequent losing months
Short-term	Short-term traders use hourly time frames and hold trades for several hours to a week.	More opportunities for trades Less chance of losing months Less reliance on one or two trades a year to make money	Transaction costs will be higher (more spreads to pay) Overnight risk becomes a factor
Intraday	Intraday traders use minute charts such as 1-minute or 5-minute. Trades are held intraday and exited by market close.	Lots of trading opportunities Less chance of losing months No overnight risk	Transaction costs will be much higher (more spreads to pay) Mentally more difficult due to frequency of trading Profits are limited by needing to exit at the end of the day.

You have to decide what the correct timeframe is for YOU.

You also have to consider the amount of capital you have to trade. Shorter timeframes allows you to make better use of margin and have tighter stop losses. Larger timeframes require a bigger account so you can handle the market swings without facing a margin call.

When you finally decide on your preferred timeframe is when the fun begins. This is when you start looking at multiple timeframes to help you analyze the market.

"Long or Short?"

If you ever look at a currecny pair on different timeframes, you probably noticed that markets can move in different directions at the same time. A moving average may rise on a weekly chart, giving a buy signal, but fall on a daily chart, giving a sell signal. It may rally on an hourly chart, telling us to go long, but sink on a 10 minute chart, telling us to short. What the hell is going on?

Let's play a quick game called "Long or Short". The rules of the game are easy. You look at a chart and you decide whether to go long or short. Easy. Okay ready?

5 Minute Chart

Let's a take a look at a EUR/USD 5-minute chart on 11/03/05 around 4 am EST. Oooh it's so nice. It's trading above its 100 simple moving average which is bullish and look! It just broke out and closed above it's previous resistance! Perfect time to go long right? I'll take that as a yes.

Market Hours

So far, all the lessons we have taught you deal with "*how*" to trade the forex market. But another important lesson that you need to learn is "*when*" to trade the forex market.

Yes, it is true that the forex is open 24 hours a day, but that doesn't mean it's always active the whole day. You can make money in the forex when the market moves up, and you can even make money when the market moves down. However, you will have a very difficult time trying to make money when the market doesn't move at all. This lesson will help determine when the best times of the day are to trade.

Market Hours

Before looking at the best times to trade, we must look at what a 24hr. day in the forex world looks like. The forex can be broken up into three major trading sessions: the Tokyo Session, the London Session, and the U.S. Session. Below is a table of the open and close times for each session

Market Hours

Time Zone	EST	GMT
Tokyo Open	7 PM	0:00
Tokyo Close	4 AM	9:00
London Open	3 AM	8:00
London Close	12 PM	17:00
U.S. Open	8 AM	13:00
U.S. Close	5 PM	22:00

You can see that in between each session there is a period of time where two sessions are open at the same time. From 3-4 a.m. EST, both the Tokyo and London markets are open, and from 8-12 a.m. EST, both the London and U.S. markets are open. Naturally, these are the busiest times during the market because there is more volume when two markets are open at the same time.

Trading Sessions

Session	EUR/USD	GBP/USD	USD/CHF	USD/JPY
Tokyo	66	79	100	66
London	80	99	121	74
U.S.	67	78	101	60

Average pip range of the 4 majors during each session

As you can see, the London session usually shows the most movement.
Now let's see which days of the week are best for trading...

Best Days of the Week to Trade

Best Days of the Week to Trade Forex

Ok, so now we know that the London session is the busiest out of all the other sessions, but there are also certain days in the week where all the markets tend to show more movement. Below is a chart of average pip range for the 4 major pairs for each day of the week:

Trading Sessions

Day of the week	EUR/USD	GBP/USD	USD/CHF	USD/JPY
Sunday	24	31	36	25
Monday	92	110	141	95
Tuesday	102	128	162	104
Wednesday	101	123	158	106
Thursday	83	98	121	77
Friday	80	96	117	72

Average pip range of the 4 majors for each day of the week

You can see that during the middle of the week is where the most movement is seen on all 4 major pairs. Fridays are usually busy until 12pm EST and then the market pretty much drops dead until it closes at 5pm EST. This means we only work half-days on Fridays. The weekend always starts early! Yippee!

So based on these three simple pieces, we've learned when the busiest times of the market are. These are the best times to trade because they give us a higher chance of success.

If you're feeling down in the dumps and wish to lose money, these are the times to trade...

When to Trade if You Want to Lose Money

Here at BabyPips.com, we don't like to force our opinions on you. Instead, we want you to make your own decisions when it comes to your own trading. If you really do not want to trade during the busier times of the market when trade volume and pip movement is highest and where you will make money *easier*, then by all means, feel free to trade on these times mentioned below. We guarantee you'll have a more difficult time trading!

Fridays: Fridays are very unpredictable. This is a good day to trade if you want to lose all the profit you made during the rest of the week.

Sundays: There is very little movement on these days. Trade this day if you want to start off your week with NEGATIVE pips.

Holidays: Banks are closed which means very little volume for whatever country is having the holiday. Holidays are great to trade when you would rather lose your money than take a day off and enjoy the other finer things in life.

News Reports: No one really knows where the price will go when a news report comes out. You could lose a fortune trading during news releases if you don't know what you're doing. Price acts like a drunken monkey during these times and become unpredictable.

Can't Trade During Busy Market Hours?

What to do if you can’t trade during the busy market hours

If you live in a crappy time zone or you have a day job, then you probably can’t sit in front of a computer during the busy market hours. If this describes you, then I have a few solutions for you:

- Move to a better time zone. Move to London preferably. Sure you’d have to pack up and start a whole new life, but hey, at least you can trade right?
- Trade at work (be sure you have some “real” work ready just in case your boss sneaks up behind you and asks what you’re working on). I also recommed you master the ALT-TAB key combination (if you use Windows) so you can quickly switch windows at a moment's notice. This option can be the ultimate perk because your employer is basically paying you while you trade forex. Gettin' paid while gettin' paid if you know what I'm sayin'.
- Become a swing or position trader. As a swing/position trader, you won’t have to constantly monitor the markets and you can check or look at them when you get off work.
- Trade a different session even if it’s not the busiest one. If you can’t trade the London or U.S. session, then trade the Tokyo session. However, you should be disciplined and trade it every day. You will start to learn how it moves and can develop strategies that are specific to that session.

We think 3 and 4 are your best options, but again, the choice is up to you.

Even if you can’t trade, it’s good to watch the charts for a full session. By getting use to seeing the price movement in action, you can actually see the real story of the currency. Watching the charts live is very different then looking at past charts.

Even if you can’t actually trade the market, make mental notes of when you would take trades while you’re watching the charts live. Practice makes perfect, and the more you do it, the better you’ll get at it.

The Choice Is Yours

There you have it! We’ve given you all the information you need regarding when the best times to trade are. All you have to do now is decide whether or not you would rather trade when it’s easier to make money, or if you’d rather do it the hard way.

Summary

Busiest/Best times to trade:

- When 2 sessions are overlapping: 3 - 4am EST and 8am - 12pm EST
- The London session is the busiest out of the other two.
- The middle of the week typically shows the most movement.

Worst times to trade:

- Fridays
- Sundays
- Holidays
- News Events
- During Desperate Housewives, Raja Lawak, Akademi Fantasia or American Idol episodes

Indicators

Leading vs Lagging Indicators

We've covered a lot of tools that can help you analyze charts and identify trends. In fact, you may now have too much information to use effectively.

In this lesson, we're going to look at streamlining your use of these chart indicators. We want you to fully understand the strengths and weaknesses of each tool, so you'll be able to determine which ones work for you and your trading plan...and which ones don't.

Leading versus Lagging Indicators

Let's discuss some concepts first. There are two types of indicators: leading and lagging.

A leading indicator gives a buy signal before the new trend or reversal occurs.

A lagging indicator gives a signal after the trend has started and basically informs you "hey buddy, pay attention, the trend has started, you're missing the boat."

You're probably thinking, "Ooooh, I'm going to get rich with leading indicators!" since you would be able to profit from a new trend right at the start. You're right – you would "catch" the entire trend every single time, IF the leading indicator was correct every single time. But it's not.

When you use leading indicators, you will experience a lot of fake-outs. Leading indicators are notorious for giving bogus signals which will "mislead" you. Get it? Leading indicators that "mislead" you? Ha-ha. Man we're so funny we even crack ourselves up.

The other option is to use lagging indicators, which aren't as prone to bogus signals. Lagging indicators only give signals after the price change is clearly forming a trend. The downside is that you'd be a little late in entering a position. Often the biggest gains of a trend occur in the first few bars, so by using a lagging indicator you could potentially miss out on much of the profit. Which sucks.

Oscillators and Trend Following Indicators

For the purpose of this lesson, let's broadly categorize all of our technical indicators into one of two categories:

- Oscillators
- Trend following or momentum indicators

Oscillators are leading indicators.

Momentum indicators are lagging indicators.

While the two can be supportive of each other, they're more likely to conflict with each other. We're not saying that one or the other should be used exclusively, but you must understand the potential pitfalls of each.

Oscillators / Leading Indicators

An oscillator is any object or data that moves back and forth between two points. In other words, it's an item that is going to always fall somewhere between point A and point B. Think of when you hit the oscillating switch on your electric fan.

Think of our technical indicators as either being "on" or "off". More specifically, an oscillator will usually signal "buy" or "sell", with the only exception being instances when the oscillator is not clearly at either end of the buy/sell range.

Does this sound familiar? It should! Stochastic, Parabolic SAR, and the Relative Strength Index (RSI) are all oscillators. Each of these indicators is designed to signal a possible reversal, where the previous trend has run its course and the price is ready to change direction.

Let's take a look at a few examples.

On the 1-hour chart of USD/EUR below, we have added a Parabolic SAR indicator, as well as an RSI and Stochastic oscillator. As you have already learned, when the Stochastic and RSI begin to leave their "oversold" region that is a buy signal.

Here we get buy signals between the hours 3:00 am EST and 7:00 am EST on 08/24/05. All three of these buy signals occurred within one or two hours of each other, and this would have been a good trade.

We also got a sell signal from all three indicators between the hours of 2:00 am EST and 5:00 am EST on 08/25/05. As you can see, the stochastic indicator remained in the overbought for a pretty long time - about 20 hours. Usually when an oscillator remains in the overbought or oversold levels for a long period of time, that means there is a strong trend occurring. In this example, since Stochastic stayed overbought, you see there was a strong uptrend present.

Now let's take a look at the same leading oscillators messing up, just so you know these signals aren't perfect. Looking at the chart below, you can quickly see that there were a lot of false buy signals popping up. You'll see how one indicator says to buy, while the other one is still saying sell.

Around 1 am EST on 08/16/05, both RSI and Stochastic gave buy signals, while Parabolic SAR still showed a sell signal. Yes, Parabolic SAR gave a buy signal 3 hours later at 4 am EST, but then Parabolic SAR turned into a sell signal one bar later. If you actually look at the bar with the Parabolic SAR below it, notice how it's a strong looking red bar with very short shadows. Also, notice how the next bar closed below it. This would not have been a good long trade.

On the last two oversold (buy) signals given by Stochastic, notice how there is no indicator at all for RSI, but Parabolic SAR is giving sell signals. What's going on here? They are each giving you different signals

What happened to such a good set of indicators?

The answer lies in the method of calculation for each one. Stochastic is based on the high-to-low range of the time period (in this case, it's hourly), yet doesn't account for changes from one hour to the next. The Relative Strength Index (RSI) uses change from one closing price to the next. And Parabolic SAR has its own unique calculations that can further cause conflict.

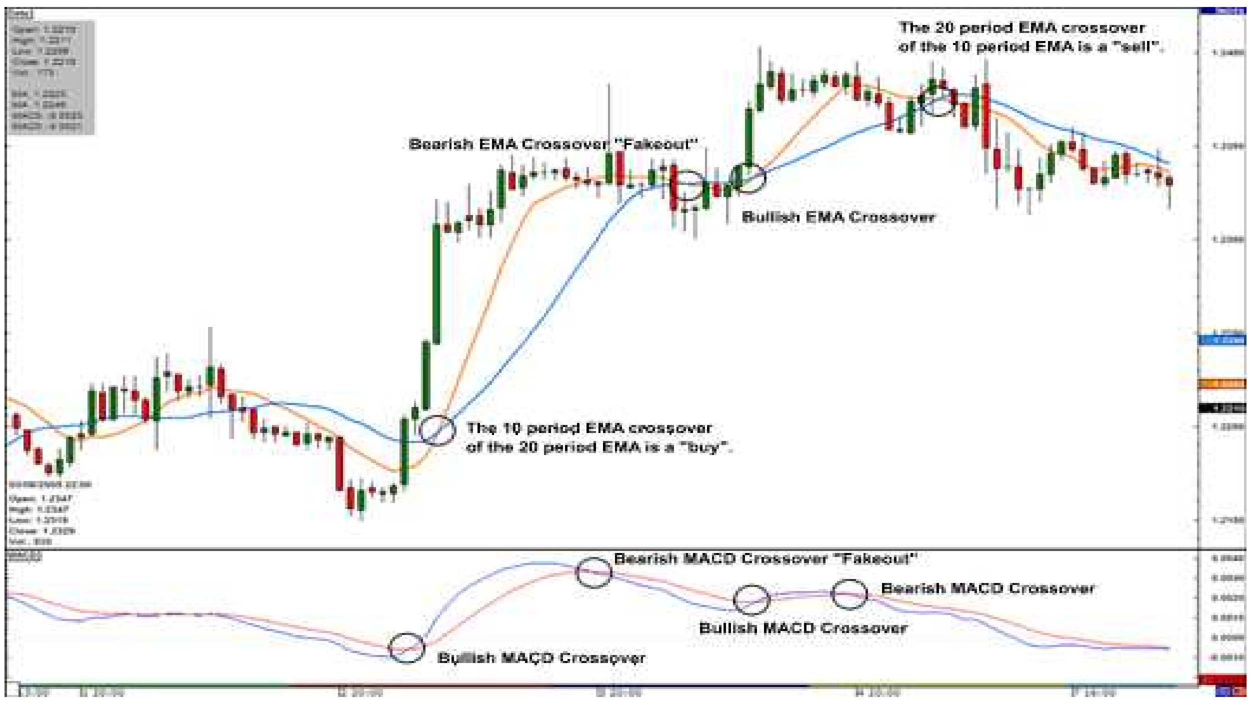
That's the nature of oscillators – they assume that a particular chart pattern always results in the same reversal. Of course, that's hogwash.

While being aware of why a leading indicator may be in error, there's no way to avoid them. If you're getting mixed signals, you're better off doing nothing than taking a 'best guess'. If a chart doesn't meet all your criteria, don't force the trade! Move on to the next one that does meet your criteria.

Momentum / Lagging Indicators

So how do we spot a trend? The indicators that can do so have already been identified as MACD and moving averages. These indicators will spot trends once they have been established, at the expense of delayed entry. The bright side is that there's less chance of being wrong.

On this 1-hour chart of EUR/USD, there was a bullish crossover for MACD at 3:00 am EST on 08/03/05 and the 10 period EMA crossed over the 20 period EMA at 5:00 am. These two signals were all accurate, but if you waited for both indicators to give you a bull signal, you would have missed out on the big move. If you calculate from the start of the uptrend at 10:00 pm EST on 08/02/05 to the close of the candle at 5:00 am EST on 08/03/05, you would have watched a gain of 159 pips while sitting on the sidelines.



Summary

The Million Dollar Question

How do you figure out whether to freaking' use oscillators, or trend following indicators, or both? After all, we know they don't always work in tandem.

This is probably the most challenging part about technical analysis. And why I call it the million dollar question.

We will provide the million dollar answer in a future lesson.

For now, just know that once you're able to identify the type of market you are trading in, you will then know which indicators will give accurate signals, and which ones are worthless at that time.

This is no piece of cake. But it's a skill you will slowly improve upon as your experience grows.

Summary

- There are two types of indicators: leading and lagging.
- A leading indicator gives a buy signal before the new trend or reversal occurs.
- A lagging indicator gives a signal after the trend has started
- Technical indicators into one of two categories: Oscillators and trend following or momentum indicators.
- Oscillators are leading indicators.
- Momentum indicators are lagging indicators.
- If you're able to identify the type of market you are trading in, you will then know which indicators will give accurate signals, and which ones are worthless at that time.

Pivot Points

Professional traders and market makers use pivot points to identify important support and resistance levels. Simply put, a pivot point and its support/resistance levels are areas at which the direction of price movement can possibly change.

Pivot points are especially useful to short-term traders who are looking to take advantage of small price movements.

Pivot points can be used by both range-bound traders and breakout traders. Range-bound traders use pivot points to identify reversal points. Breakout traders use pivot points to recognize key levels that need to be broken for a move to be classified as a real deal breakout.

Here is an example of pivot points plotted on a 1-hour EUR/USD chart:

How to Calculate Pivot Points

The pivot point and associated support and resistance levels are calculated by using the last trading session's open, high, low, and close. Since Forex is a 24-hour market, most traders use the New York closing time of 4:00pm EST as the previous day's close.

The calculation for a pivot point is shown below:

Pivot point (PP) = (High + Low + Close) / 3

Support and resistance levels are then calculated off the pivot point like so:

First level support and resistance:

First support (S1) = (2*PP) – High

First resistance (R1) = (2*PP) – Low

Second level of support and resistance:

Second support (S2) = PP – (High – Low)

Second resistance (R2) = PP + (High - Low)

Don't worry you don't have to perform these calculations yourself. Your charting software will automatically do it for you and plot it on the chart.

How to Trade with Pivot Points

Breakout Trades

The pivot point should be the first place you look at to enter a trade, since it is the primary support/resistance level. The biggest price movements usually occur at the price of the pivot point.

Only when price reaches the pivot point will you be able to determine whether to go long or short, and set your profit targets and stops. Generally, if prices are above the pivot it's considered bullish, and if they are below it's considered bearish.

Let's say the price is hovering around the pivot point and closes below it so you decide to go short. Your stop loss would be above PP and your initial profit target would be at S1.

However, if you see prices continue to fall below S1, instead of cashing out at S1, you can move your existing stop-loss order just above S1 and watch carefully. Typically, S2 will be the expected lowest point of the trading day and should be your ultimate profit objective.

The converse applies during an uptrend. If price closed above PP, you would enter a long position, set a stop loss below PP and use the R1 and R2 levels as your profit objectives.

Range-bound Trades

The strength of support and resistance at the different pivot levels is determined by the number of times the price bounces off the pivot level.

The more times a currency pair touches a pivot level then reverses, the stronger the level is. Pivoting simply means reaching a support or resistance level and then reversing. Hence, the word "pivot".

If the pair is nearing an upper resistance level, you could sell the pair and place a tight protective stop just above the resistance level.

If the pair keeps moving higher and breaks out above the resistance level, this would be considered an upside "breakout". You would also get stopped out of your short order but if you believe that the breakout has good follow-through buying strength, you can reenter with a long position. You would then place your protective stop just below the former resistance level that was just penetrated and is now acting as support.

If the pair is nearing a lower support

Theoretically Perfect?

In theory, it sounds pretty simple huh? Dream on, pal!

In the real world, pivot points don't work all the time. Price tends to hesitate around pivot lines and at times it's just ridiculously hard to tell what it will do next.

Sometimes the price will stop just before reaching a pivot line and then reverse meaning your profit target doesn't get reached. Other times, it looks like a pivot line is a strong support level so you go long only to see the price fall, stop you out, then reverse back into your direction.

You must be very selective and create a pivot point trading strategy that you intend to strictly follow.

Let's go look at a chart to see just how difficult and easy pivot points might be.

Ooooh pretty colors! We like...

Look at the orange oval. Notice how the PP was a strong support but if you went long on PP, it never was able to rise up to R1.

Look at the first purple circle. The pair broke down through PP but failed to reach S1 before reversing back to PP. On the second break down though (second purple circle), the pair did manage to reach S1 before once again reversing back to PP.

Look at the pink oval. Again, PP acted as strong support but never was able to rise up to R1.

On the yellow circle, the pair broke out to the downside again, sliced right through S1, and managed to fall all the way down to S2.

If you ever attempted to go long on this chart, you would have been stopped out every single time.

Personally, we would have not even thought about buying this pair - Why not? Well we have a little secret. What we didn't show you regarding this chart was that this pair was trending down for quite some time now.

Remember the trend is your friend. We don't like to backstab our friends, so we try our best to never trade against the trend.

In the next lesson, you will learn how to use multiple timeframes to trade with the correct trend direction so you're able to minimize possible mistakes such as the one above.

Forex Pivot Point Trading Tips

Here are some easy to memorize tips that will help you to make smart pivot point trading decisions.

- If price at PP, watch for a move back to R1 or S1.
- If price is at R1, expect a move to R2 or back towards PP.
- If price is at S1, expect a move to S2 or back towards PP.
- If price is at R2, expect a move to R3 or back towards R1.
- If price is at S2, expect a move to S3 or back towards S1.
- If there is no significant news to influence the market, price will usually move from P to S1 or R1.
- If there is significant news to influence the market price may go straight through R1 or S1 and reach R2 or S2 and even R3 or S3.
- R3 and S3 are a good indication for the maximum range for extremely volatile days but can be exceeded occasionally.
- Pivot lines work well in sideways markets as prices will most likely range between the R1 and S1 lines.
- In a strong trend, price will blow through a pivot line and keep going
- The simplicity of pivot points definitely makes them a useful tool to add to your trading toolbox. It allows you to see possible areas that are likely to cause price movement. You'll become more in sync to market movements and make better trading decisions.
- Learn to use pivot points along with other technical analysis tools such candlestick patterns, MACD crossover, moving average crossovers, Stochastics overbought/oversold levels. The greater the confirmation, the greater your probability of success!

Chart Pattern

Chart Pattern

By now you have an arsenal of weapons to use when you battle the market. In this lesson you will add yet another weapon: CHART PATTERNS!

Think of chart patterns as a land mine detector, because once you learn this, you will be able to spot "explosions" on the charts before they even happen, making you a lot of money in the process.

In this lesson, we will teach you basic chart patterns and formations. When correctly identified, it usually leads to a huge breakout or "explosion" in this case.

Remember, our whole goal is to spot big movements before they happen so that we can ride them out and rake in the cash! Chart formations will greatly help us spot conditions where the market is ready to break out.

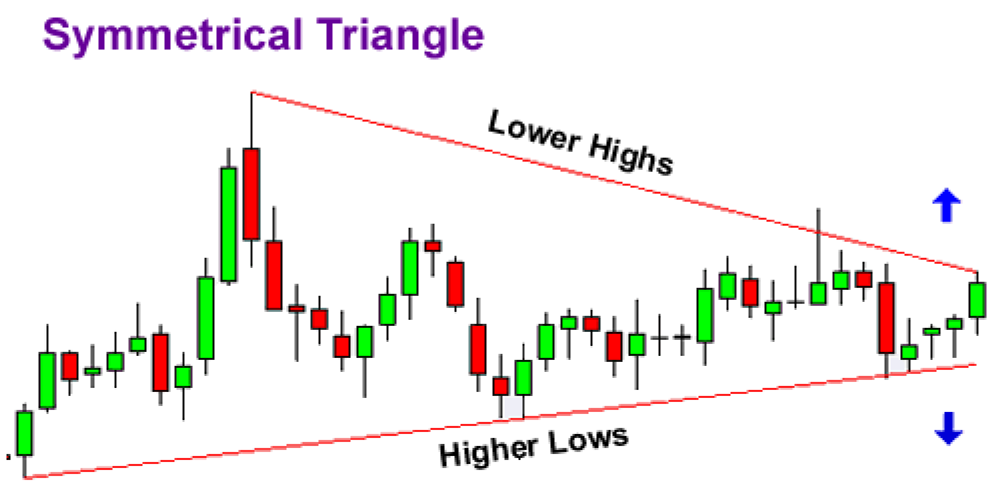
Here's the list of patterns that we're going to cover:

- Symmetrical Triangles
- Ascending Triangles
- Descending Triangles
- Double Top
- Double Bottom
- Head and Shoulders
- Reverse Head and Shoulders

Symmetrical Triangles

Symmetrical triangles are chart formations where the slope of the price's highs and the slope of the price's lows converge together to a point where it looks like a triangle. What is happening during this formation is that the market is making lower highs and higher lows. This means that neither the buyers nor the sellers are pushing the price far enough to make a clear trend. If this was a battle between the buyers and sellers, then this would be a draw.

This type of activity is called consolidation



In the chart above, we can see that neither the buyers nor the sellers could push the price in their direction. When this happens we get lower highs and higher lows. As these two slopes get closer to each other, it means that a breakout is getting near. We don't know what direction the breakout will be, but we do know that the market will break out. Eventually, one side of the market will give in

In this example, if we placed an entry order above the slope of the lower highs, we would've been taken along for a nice ride up. If you had placed another entry order below the slope of the higher lows, then you would cancel it as soon as the first order was hit.

Ascending Triangles

This type of formation occurs when there is a resistance level and a slope of higher lows. What happens during this time is that there is a certain level that the buyers cannot seem to exceed. However, they are gradually starting to push the price up as evident by the higher lows.

In the chart above, you can see that the buyers are starting to gain strength because they are making higher lows. They keep putting pressure on that resistance level and as a result, a breakout is bound to happen. Now the question is, "Which direction will it go? - Will the buyers be able to break that level or will the resistance be too strong?"

Many charting books will tell you that in most cases, the buyers will win this battle and the price will break out past the resistance. However, it has been my experience that this is not always the case. Sometimes the resistance level is too strong, and there is simply not enough buying power to push it through.

Most of the time the price will in fact go up. The point we are trying to make is that we do not care which direction the price goes, but we want to be ready for a movement in EITHER direction. In this case, we would set an entry order above the resistance line and below the slope of the higher lows.

In this scenario, the buyers won the battle and the price proceeded to skyrocket!

Descending Triangles

As you probably guessed, descending triangles are the exact opposite of ascending triangles (we knew you were smart!). In descending triangles, there is a string of lower highs which forms the upper line. The lower line is a support level in which the price cannot seem to break.

In the chart above, you can see that the price is gradually making lower highs which tell us that the sellers are starting to gain some ground against the buyers. Now most of the time, and we did say MOST - the price will eventually break the support line and continue to fall.

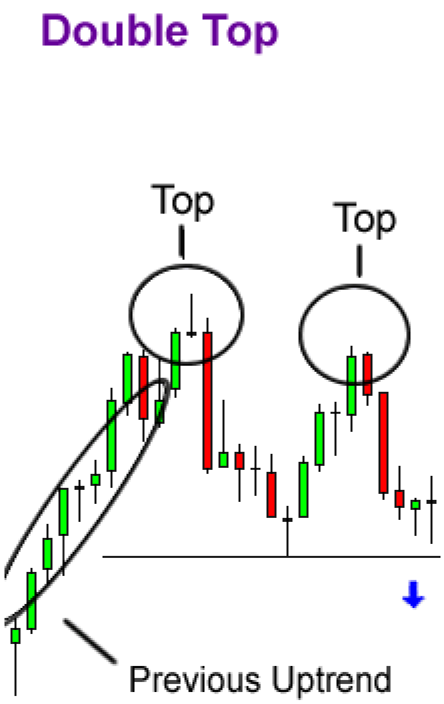
However, in some cases the support line is too strong, and the price will bounce off of it and make a strong move up.

The good news is that we don't care where the price goes. We just know that it's about to go *somewhere*. In this case we would place entry orders above the upper line (the lower highs) and below the support line.

In this case, the price did end up breaking the support line and proceeded to drop rather quickly. (*note- The market tends to fall faster than it rises which means you usually make money faster when you are short).

Double Top

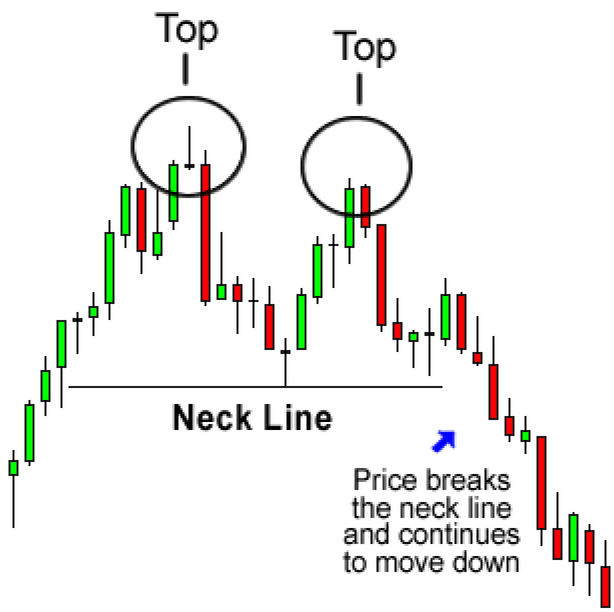
A double top is a reversal pattern that is formed after there is an extended move up. The "tops" are peaks which are formed when the price hits a certain level that can't be broken. After hitting this level, the price will bounce off it slightly, but then return back to test the level again. If the price bounces off of that level again, then you have a DOUBLE top!



In the chart above you can see that two peaks or "tops" were formed after a strong move up. Notice how the 2nd top was not able to break the high of the 1st top. This is a strong sign that a reversal is going to occur because it is telling us that the buying pressure is just about finished.

With double tops, we would place our entry order below the neckline because we are anticipating a reversal of the uptrend.

Double Top

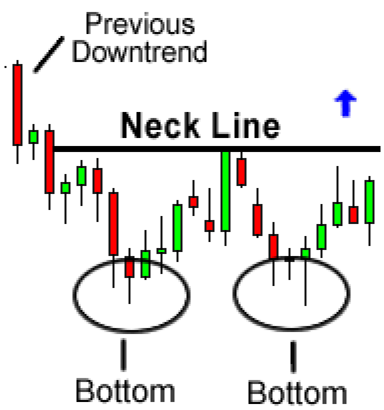


Wow! We must be psychic or something because we always seem to be right! Looking at the chart you can see that the price breaks the neckline and makes a nice move down. Remember, double tops are a trend reversal formation. You'll want to look for these after there is a strong uptrend.

Double Bottom

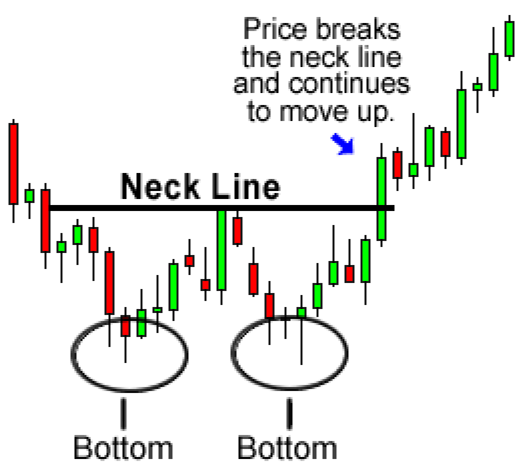
Double bottoms are also trend reversal formations, but this time we are looking to go long instead of short. These formations occur after extended downtrends when two valleys or "bottoms" have been formed.

Double Bottom



You can see from the chart above that after the previous downtrend, the price formed two valleys because it wasn't able to go below a certain level. Notice how the 2nd bottom wasn't able to significantly break the 1st bottom.

This is a sign that the selling pressure is about finished, and that a reversal is about to occur. In this situation, we would place an entry order above the neckline.

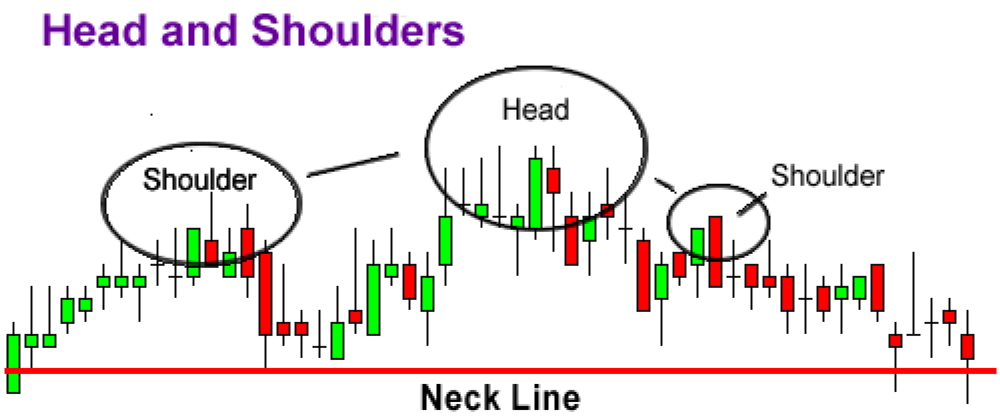


Would you look at that!

The price breaks the neckline and makes a nice move up. Remember, just like double tops, double bottoms are also trend reversal formations. You'll want to look for these after a strong downtrend.

Head and Shoulders

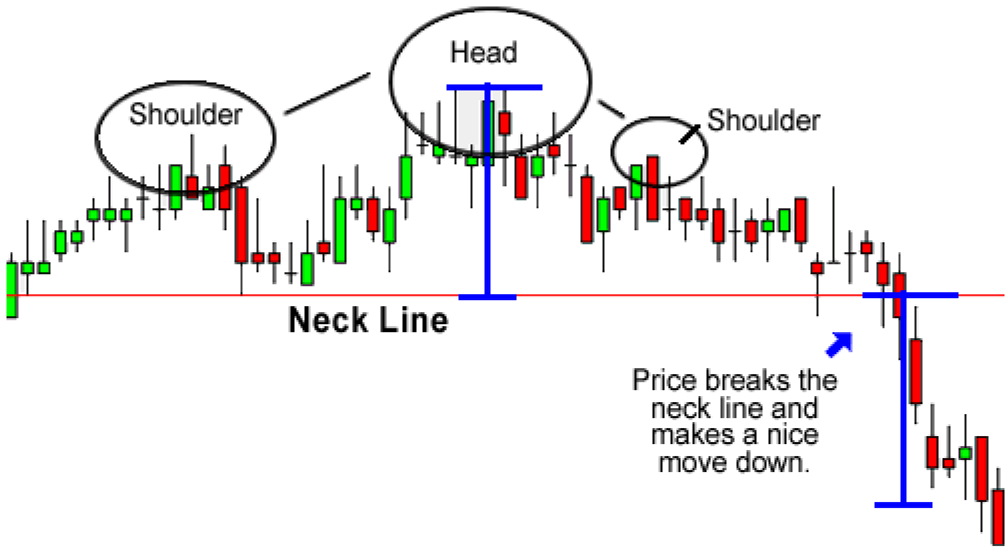
A head and shoulders pattern is also a trend reversal formation. It is formed by a peak (shoulder), followed by a higher peak (head), and then another lower peak (shoulder). A "neckline" is drawn by connecting the lowest points of the two troughs. The slope of this line can either be up or down. In my experience, when the slope is down, it produces a more reliable signal.



In this example, we can visibly see the head and shoulders pattern. The head is the 2nd peak and is the highest point in the pattern. The two shoulders also form peaks but do not exceed the height of the head.

With this formation, we look to make an entry order below the neckline. We can also calculate a target by measuring the high point of the head to the neckline. This distance is approximately how far the price will move after it breaks the neckline.

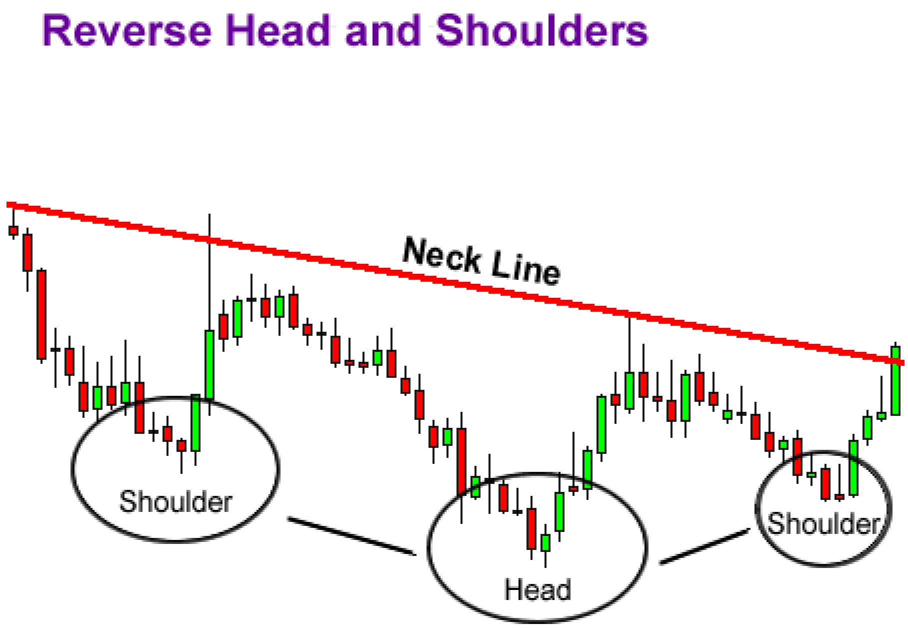
Head and Shoulders



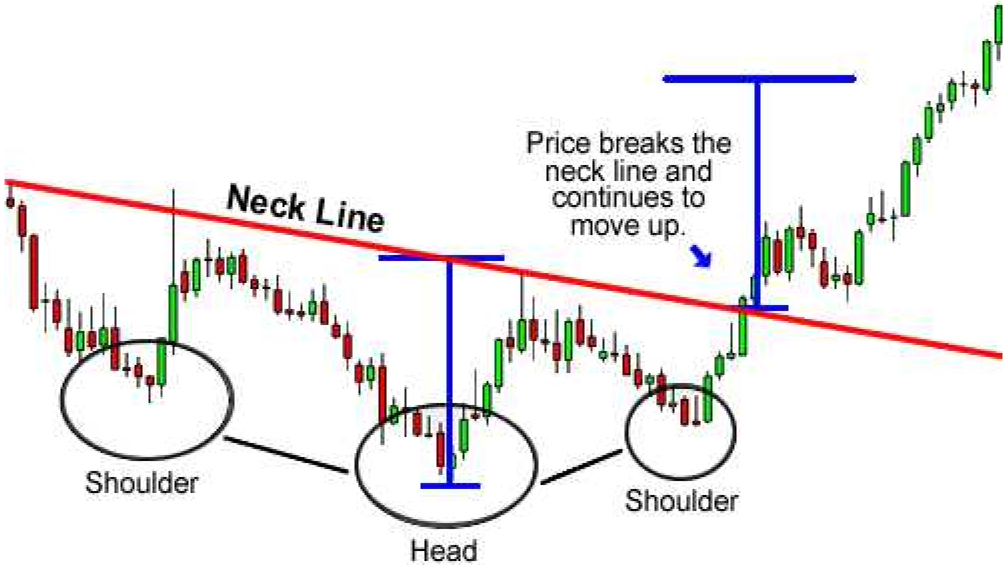
You can see that once the price goes below the neckline it makes a move that is about the size of the distance between the head and the neckline.

Reverse Head and Shoulders

The name speaks for itself. It is basically a head and shoulders formation, except this time it's in reverse. A valley is formed (shoulder), followed by an even lower valley (head), and then another higher valley (shoulder). These formations occur after extended downward movements.



Here you can see that this is just like a head and shoulders pattern, but it's flipped upside down. With this formation, we would place a long entry order above the neckline. Our target is calculated just like the head and shoulders pattern. Measure the distance between the head and the neckline, and that is approximately the distance that the price will move after it breaks the neckline.



You can see that the price moved up nicely after it broke the neckline. WE know you're thinking to yourself, "the price kept moving even after it reached the target."

And our response is, "DON"T BE GREEDY!"

If your target is hit, then be happy with your profits. However, there are strategies where you can lock in some of your profits and still keep your trade open in case the price continues to move your way. You will learn about those later on in the course.

Summary

Chart formations are like bazookas because they often create huge explosions on the chart.

Triangles

Symmetrical triangles

- Consist of lower highs and higher lows
- Place entry orders above the lower highs and below the higher lows

Ascending triangles

- Consist of higher lows and a resistance line
- It usually means that the price will break the resistance line and go higher but you should place entry orders on both sides just in case the resistance line is too strong.
- Place your entry orders above the resistance line and below the higher lows.

Descending triangles

- Consist of lower highs and a support line
- Usually mean that the price will break the support line and go lower but you should place entry orders on both sides just in case the support line is too strong.
- Place your entry orders above the lower highs and below the support line.

Bollinger Bands

Congratulations on making it to the 5th grade! Each time you make it to the next grade you continue to add more and more tools to your trader's toolbox. "What's a trader's toolbox?" you say... Simple! Your trader's toolbox is what you will use to "build" your trading account. The more tools (education) you have in your trader's toolbox (YOUR BRAIN), the easier it will be for you to build.

So for this lesson, as you learn each of these indicators, think of them as a new tool that you can add to that toolbox of yours. You might not necessarily use all of these tools, but it's always nice to have the option, right? Now, enough about tools already! Let's get started!

Bollinger Bands

Bollinger bands are used to measure a market's volatility. Basically, this little tool tells us whether the market is quiet or whether the market is LOUD! When the market is quiet, the bands contract; and when the market is LOUD, the bands expand. Notice on the chart below that when the price was quiet, the bands were close together, but when the price moved up, the bands spread apart.

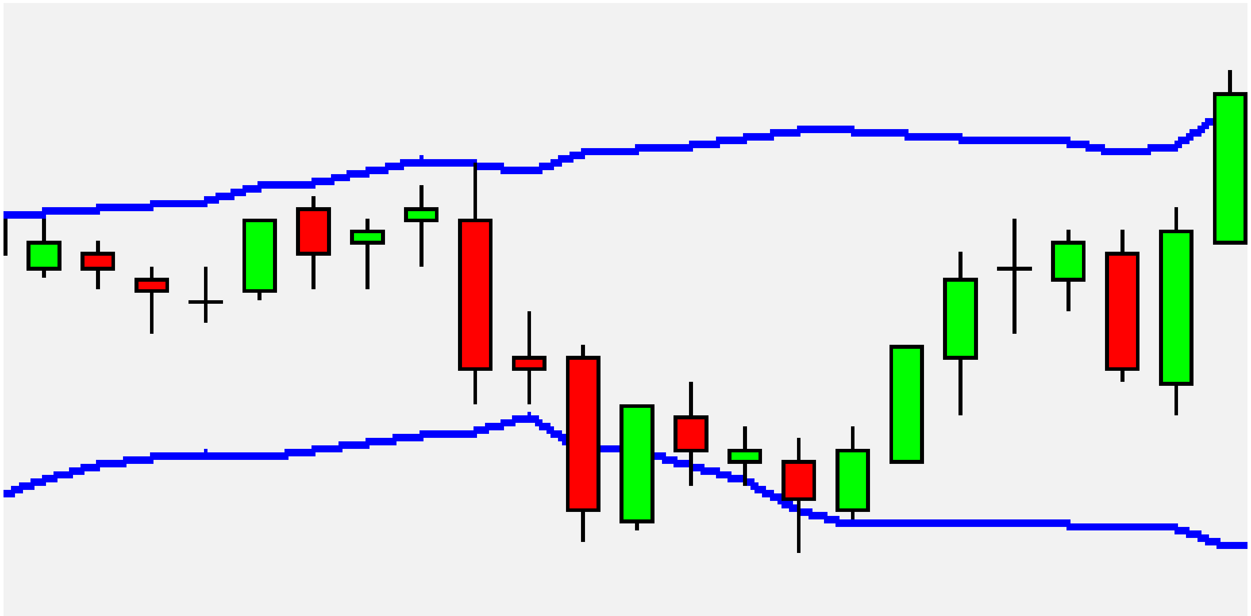
That's all there is to it. Yes, we could go on and bore you by going into the history of the Bollinger band, how it is calculated, the mathematical formulas behind it, and so on and so forth, but we really didn't feel like typing it all out.

In all honesty, you don't need to know any of that junk. We think it's more important that we show you some ways you can apply the Bollinger bands to your trading.

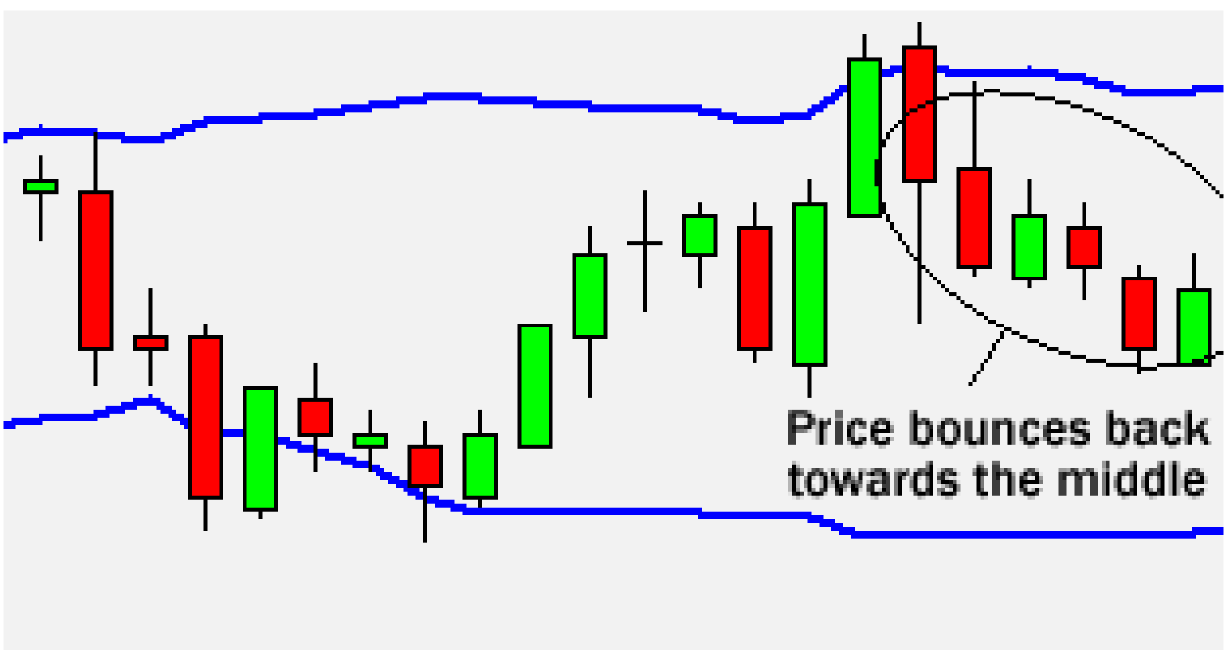
Note: If you really want to learn about the calculations of a Bollinger band, then you can go to www.bollingerbands.com

The Bollinger Bounce

One thing you should know about Bollinger Bands is that price tends to return to the middle of the bands. That is the whole idea behind the Bollinger bounce (smart, huh?). If this is the case, then by looking at the chart below, can you tell us where the price might go next?



If you said down, then you are correct! As you can see, the price settled back down towards the middle area of the bands.

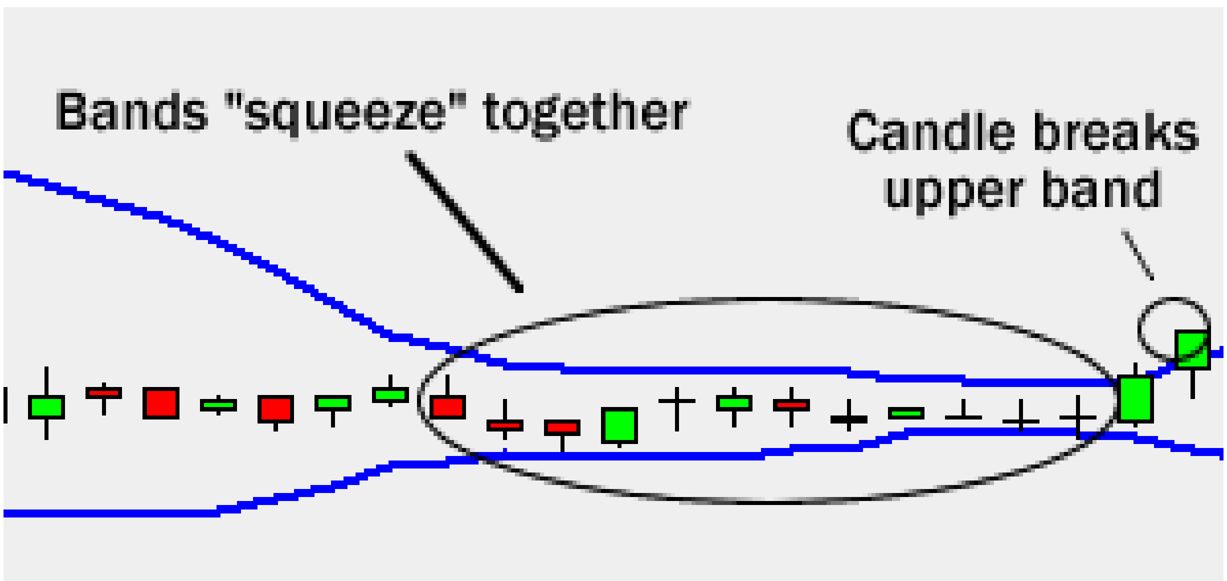


That's all there is to it. What you just saw was a classic Bollinger bounce. The reason these bounces occur is because Bollinger Bands act like mini support and resistance levels. The longer the time frame you are in, the stronger these bands are. Many traders have developed systems that thrive on these bounces, and this strategy is best used when the market is ranging and there is no clear trend.

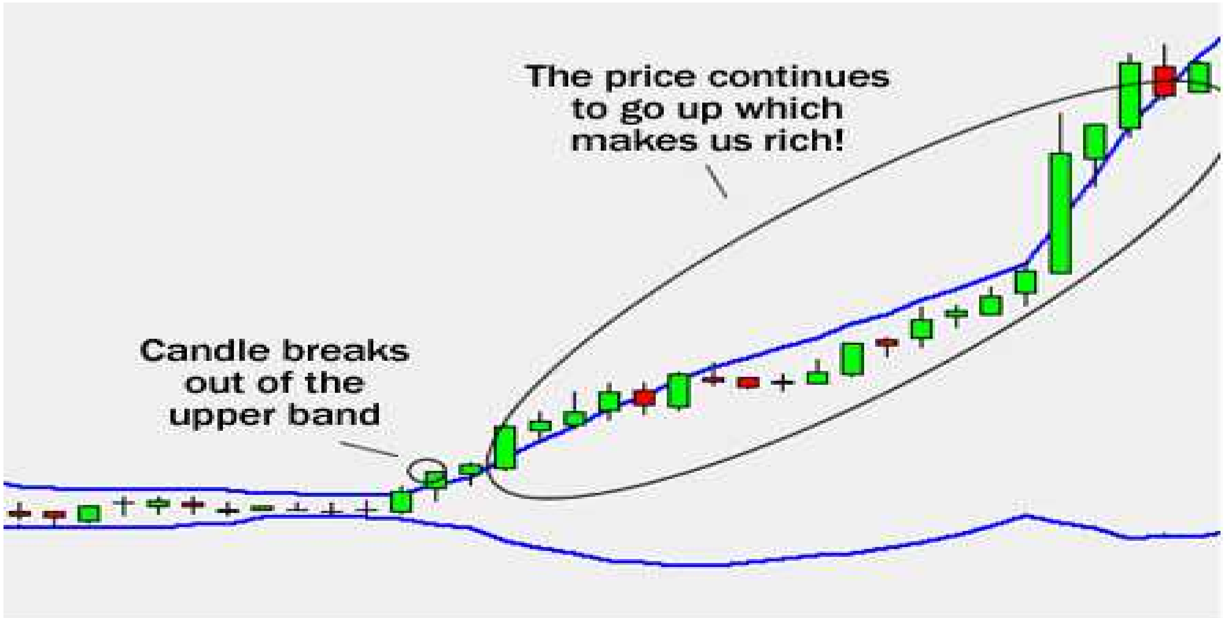
Now let's look at a way to use Bollinger Bands when the market does trend

Bollinger Squeeze

The Bollinger squeeze is pretty self explanatory. When the bands "squeeze" together, it usually means that a breakout is going to occur. If the candles start to break out above the top band, then the move will usually continue to go up. If the candles start to break out below the lower band, then the move will usually continue to go down.



Looking at the chart above, you can see the bands squeezing together. The price has just started to break out of the top band. Based on this information, where do you think the price will go?

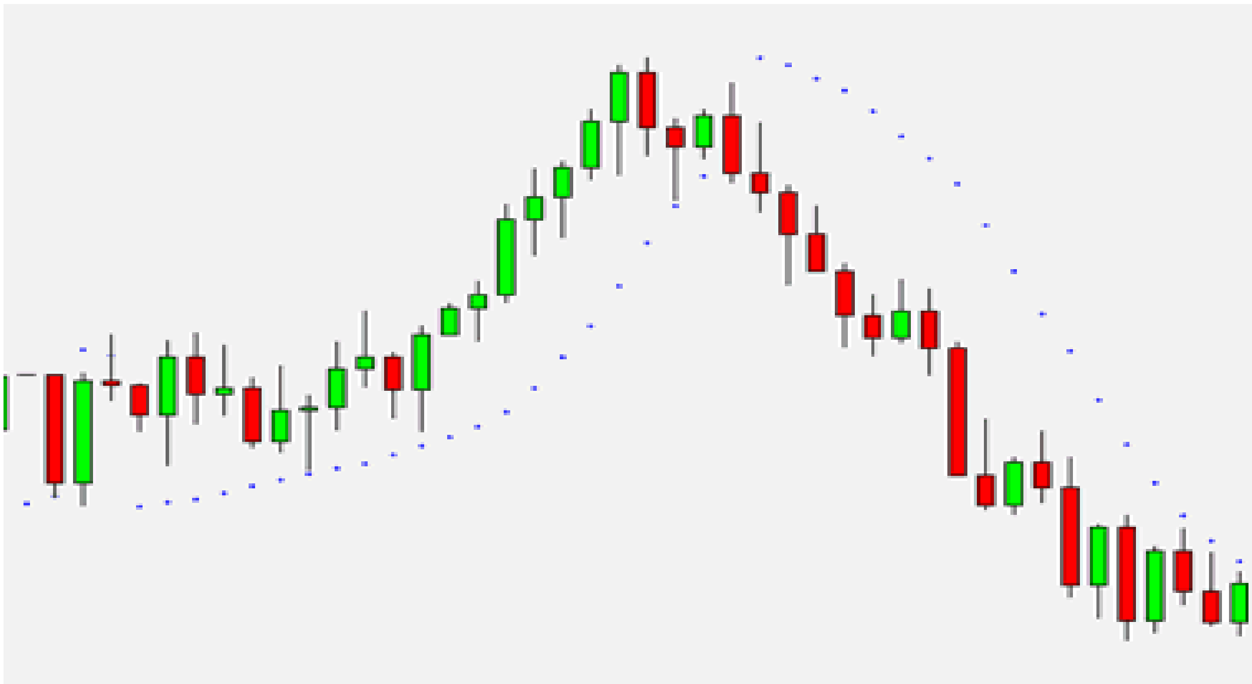


If you said up, you are correct! This is how a typical Bollinger Squeeze works. This strategy is designed for you to catch a move as early as possible. Setups like these don't occur everyday, but you can probably spot them a few times a week if you are looking at a 15 minute chart.

So now you know what Bollinger Bands are, and you know how to use them. There are many other things you can do with Bollinger Bands, but these are the 2 most common strategies associated with them. So now can put this in your trader's toolbox, and we can move on to the next indicator.

Parabolic SAR

Up until now, we've looked at indicators that mainly focus on catching the beginning of new trends. And although it is important to be able to identify new trends, it is equally important to be able to identify where a trend ends. After all, what good is a well-timed entry without a well-timed exit?



One indicator that can help us determine where a trend might be ending is the Parabolic SAR (Stop And Reversal). A Parabolic SAR places dots, or points, on a chart that indicate potential reversals in price movement. From the chart above, you can see that the dots shift from being below the candles during the uptrend, to above the candles when the trend reverses into a downtrend

Using Parabolic SAR

The nice thing about the Parabolic SAR is that it is really simple to use. Basically, when the dots are below the candles, it is a buy signal; and when the dots are above the candles, it is a sell signal. This is probably the easiest indicator to interpret because it assumes that the price is either going up or down. With that said, this tool is best used in markets that are trending, and that have long rallies and downturns. You DON'T want to use this tool in a choppy market where the price movement is sideways.

ElliotWave

Elliot Wave

Back in the old school days during the 1920-30s, there was this mad genius named Ralph Nelson Elliott. Elliott discovered that stock markets, thought to behave in a somewhat chaotic manner, actually, did not.

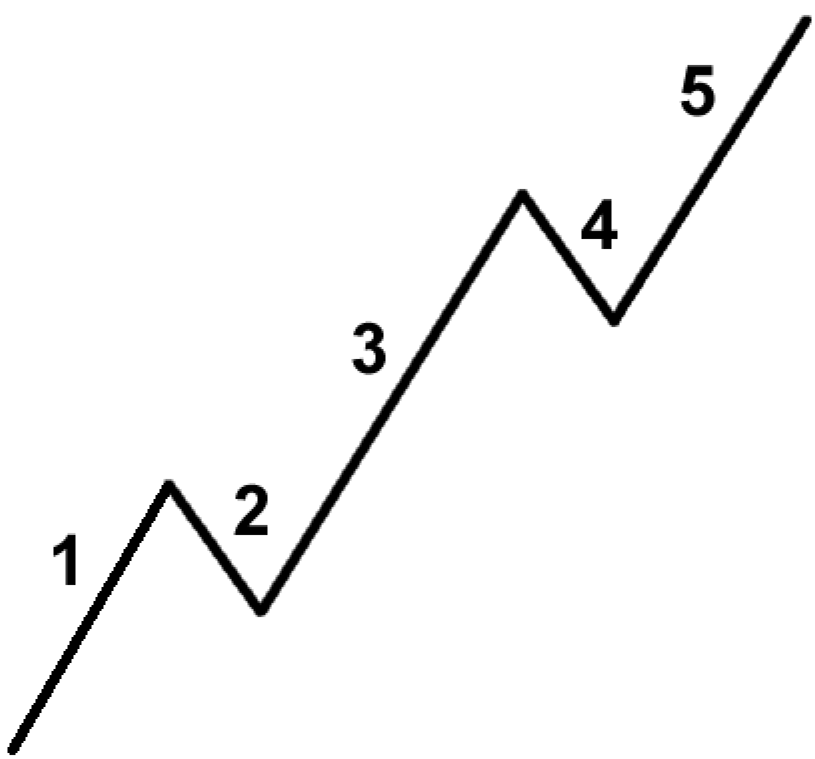
They traded in repetitive cycles, which he pointed out were the emotions of investors and traders caused by outside influences (ahem, CNBC) or the predominant psychology of the masses at the time.

Elliott explained that the upward and downward swings of the mass psychology always showed up in the same repetitive patterns, which were then divided into patterns he called "waves". He needed to claim this observation and so he came up with a super original name: The Elliott Wave Theory.

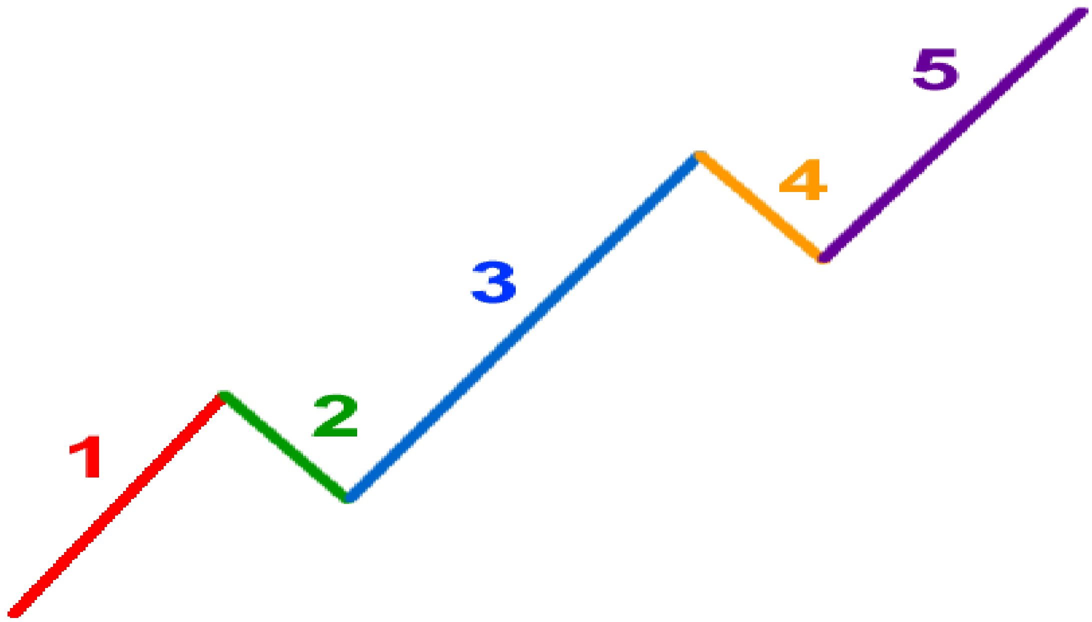
The 5 – 3 Wave Patterns

Mr. Elliott showed that a trending market moves in what he calls a 5-3 wave pattern. The first 5-wave pattern is called impulse waves and the last 3-wave pattern is called corrective waves.

Let's first take a look at the 5-wave impulse pattern. It's easier if you see it as a picture:



That still looks kind of confusing. Let's splash some color on this bad boy.



Ah magnefico! Me likes colors. It's so pretty! I've color-coded each wave along with its wave count.

Here is a short description of what happens during each wave. I am going to use stocks for my example since stocks is what Mr. Elliott used but it really doesn't matter what it is. It can easily be currencies, bonds, gold, oil, or Tickle Me Elmo dolls. The important thing is the Elliott Wave Theory can also be applied to the foreign exchange market.

Wave 1

The stock makes its initial move upwards. This is usually caused by a relatively small number of people that all of the sudden (for a variety of reasons real or imagined) feel that the price of the stock is cheap so it's a perfect time to buy. This causes the price to rise.

Wave 2

At this point enough people who were in the original wave consider the stock overvalued and take profits. This causes the stock to go down. However, the stock will not make it to its previous lows before the stock is considered a bargain again.

Wave 3

This is usually the longest and strongest wave. The stock has caught the attention of the mass public. More people find out about the stock and want to buy it. This causes the stock's price to go higher and higher. This wave usually exceeds the high created at the end of wave 1.

Wave 4

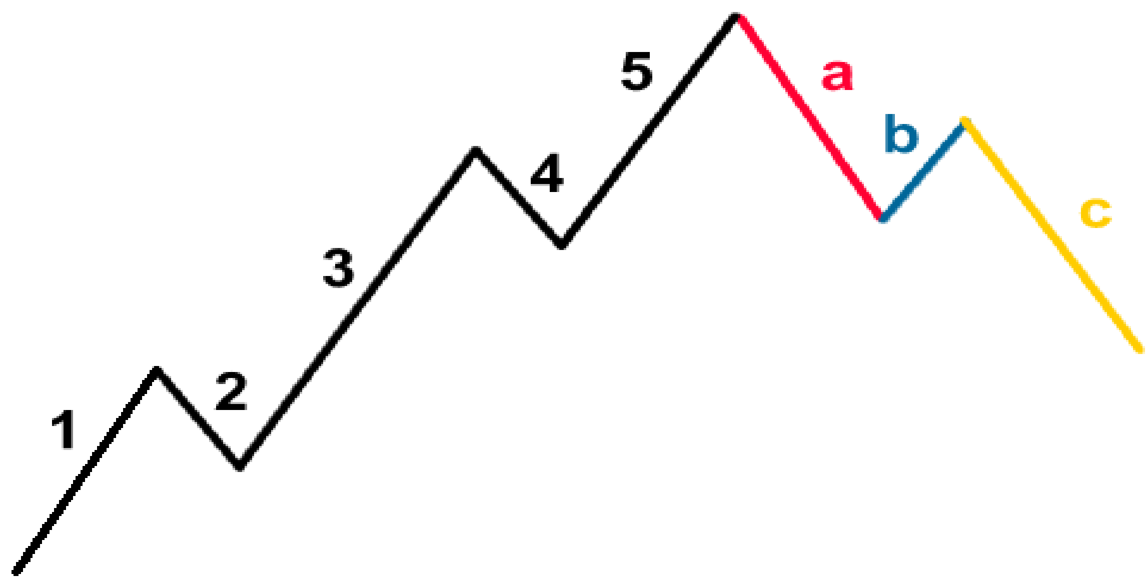
People take profits because the stock is considered expensive again. This wave tends to be weak because there are usually more people that are still bullish on the stock and are waiting to “buy on the dips”.

Wave 5

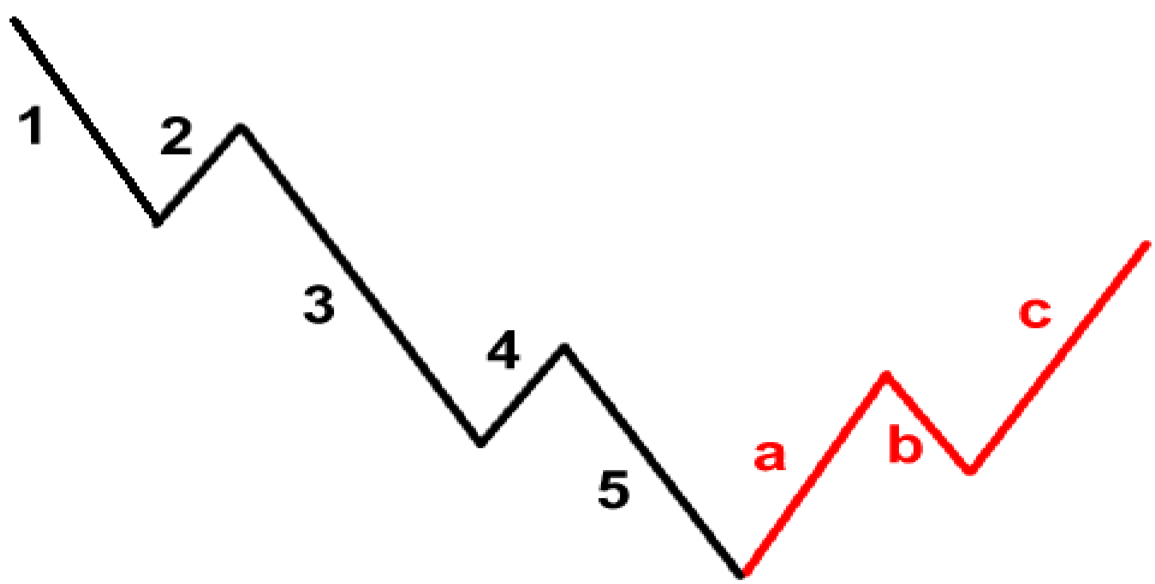
This is the point that most people get on the stock, and is most driven by hysteria. You usually start seeing the CEO of the company on the front page of major magazines as the Person of the Year. People start coming up with ridiculous reasons to buy the stock and try to choke you when you disagree with them. This is when the stock becomes the most overpriced. Contrarians start shorting the stock which starts the ABC pattern.

ABC Correction

The 5-wave trends are then corrected and reversed by 3-wave countertrends. Letters are used instead of numbers to track the correction. Check out this example of smokin' hot 3-wave corrective wave pattern!

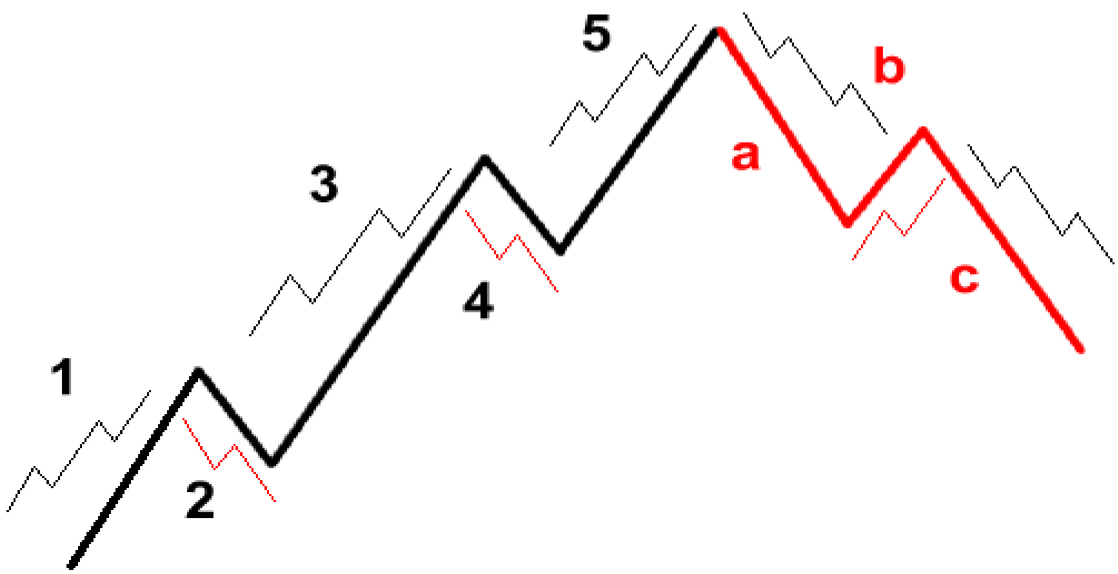


Just because I've been using a bull market as my primary example doesn't mean the Elliott Wave theory doesn't work on bear markets. The same 5 – 3 wave pattern can look like this:



Waves within a Wave

The other important thing you have to know about the Elliot Wave Theory is that a wave is made of sub-waves? Huh? Let me show you another picture. Pictures are great aren't they? Yee-haw!



Do you see how Wave 1 is made up of a smaller 5-wave impulse pattern and Wave 2 is made up of smaller 3-wave corrective pattern? Each wave is always comprised of smaller wave patterns.

Okay, let's look at a real example.

As you can, waves aren't shaped perfectly in real life. You'll also learn its sometimes difficult to label waves. But the more you stare at charts the better you'll get.

Okay, that's all you need to know about the Elliott Wave Theory. Remember the market moves in waves. Now when you hear somebody say “Wave 2 is complete.” You’ll know what the heck he is talking about.

If you wish to become an Elliott Wave Theory guru, you can learn more about it at www.elliottwave.com.

Summary

- According to the Elliott Wave Theory, the market moves in repetitive patterns called waves.
- A trending market moves in a 5-3 wave pattern. The first 5-wave pattern are called impulse waves. The second 3-wave pattern are called corrective waves.
- If you look hard enough at a chart, you'll see that the market really does move in waves

Trading the News

Trading the news is becoming a popular technique to trade the forex markets ... and why shouldn't it be? Time and time again you see currency pairs move 50 to 100 pips within minutes or even seconds after a major news release. When you see that, I bet you're thinking, "50 to 100 pips!? That's easy money!" Maybe it is, and maybe it isn't. It all depends on how prepared you are to trade a news release.

The goal of this lesson isn't to give you a specific "Trading the News" strategy. The goal is to point you in the right direction and show some of the risks involved with trading these events, because here at BabyPips.com, we want to help you help yourself in developing your own methods that fit YOU best.

Why Trade the News?

Trading news releases can be a significant tool in your trading arsenal. If you want, it can be your only weapon altogether. Economic news reports often spur strong short-term moves in the market, which are great trading opportunities for breakout traders. And with the forex being open 24 hours a day and a true worldwide market, there are plenty of opportunities almost every trading day to catch market volatility (aka a lot of pips!) kicked off by an economic news report.

Which Pairs Should I Trade?

Here is a list of the top currencies and countries in which you should focus on for news trading:

Symbol	Country	Currency	Nickname
USD	United States	Dollar	Buck
EUR	European Union	Euro	Fiber
JPY	Japan	Yen	Yen
GBP	Great Britain	Pound	Cable
CHF	Switzerland	Franc	Swissy
CAD	Canada	Dollar	Loonie
AUD	Australia	Dollar	Aussie
NZD	New Zealand	Dollar	Kiwi

Now, there are plenty more currencies available to trade, but this list is based on the size of each country's economy, frequency of news releases and the trading liquidity of their currency.

When are News Releases uh Released?

The list below displays the times when the most important economic data are released for each of the countries. Make sure you know them or go broke.

Symbol	Country	Time (GMT)
USD	United States	13:30 - 15:00
EUR	Germany	07:00 - 11:00
EUR	France	07:45 - 09:00
EUR	Italy	08:45 - 10:00
JPY	Japan	23:50 - 04:30
GBP	Great Britain	07:00 - 09:30
CHF	Switzerland	06:45 - 10:30
CAD	Canada	12:00 - 13:30
AUD	Australia	22:30 - 00:30
NZD	New Zealand	21:45 - 02:00

Tradeable Reports

With all of these countries to choose from, there are easily five to ten economic news releases almost every day! Also, the great thing about focusing on news releases is that they are scheduled in advance, so you know exactly when you can schedule your trading hours.

You may be thinking that five to ten news releases per day may be a lot to keep up with, but you really do not have to pay attention to every single report – you can pick and choose. There are a few key reports, most of which come out every month, that produce a significant amount of pip movement.

For this lesson, we will focus on U.S. news and economic reports, mostly because the U.S. dollar is involved in a majority of currency trades, and therefore tends to have the most significant impact on the currency markets. Here is a list of some of the top U.S. market moving reports:

- Employment Growth
- Interest Rate decisions
- Trade Balance
- Gross Domestic Product

- Retail Sales
- Durable Goods
- Inflation reports (Consumer Price Index and Producer Price Index)
- Foreign Purchases report (TIC Data)

Every country has a set of major reports similar to this list and can be as potentially volatile. Again, since these reports are scheduled in advance there are plenty of websites on the Internet with schedules and potential volatility rankings.

Things to Know When Trading News Reports

Now that we know "how" and "when" you can trade news reports, there are a few key concepts you should know before placing your first news trade.

- While the actual news number or report is essential to the long-term movement of a currency pair, in the short-term the difference between the market expectations and the actual release is what causes potential breakout opportunities. This means economic numbers and reports that come out as the market expected generally do not cause a strong market reaction.
- The quieter the market is before a news release, the more the market is poised for a significant move. Think about it: In a quiet market, less and less traders are buying and selling, possibly waiting for some sort of catalyst (like a news report maybe?). When this "catalyst" takes place, all of these traders waiting on the sidelines jump in at the same time causing a huge move in the market. So, the more traders wait (the quieter the market), the more will jump in after a news report (huge pips and a new Ferrari, right?).
- Depending on the significance of the economic report, and the amount of deviation of the actual to the forecasted number, news breakout opportunities are generally short-lived and may last for only a few minutes or even a few seconds. Trading news releases may be better suited for scalpers and day traders.

Trade at Your Own Risk!

Before I pursue anything, I like to know exactly what I'm getting into. The same especially goes for trading. We've heard the benefits and why we should "trade the news," but more importantly we should know the risks.

Slippage

Market volatility can increase geometrically during news releases, which means the price can move as little as 5 pips to 20 pips (or even 50 pips and more during major news releases) in the matter of seconds. If you try to get your order filled during this type of volatility, you will probably get filled at a much different price than you anticipated. This is especially risky with limit entry orders.

For example, I once placed an order with a broker (one that guaranteed fixed spreads, but not execution) 15 minutes before a major news release on EUR/USD. Right before the release, the market was at 1.2320. I set my limit order to go long at 1.2360, with a profit level of 1.2383. The news came out bad for the U.S. dollar, which caused the market to shoot up 80 pips as soon as it was released. My long order was triggered, but unfortunately, I got filled in at 1.2390 – 30 pips above my limit price!! After the market settled for a bit, my profit target price was executed at a loss because it was set below the price at which I got filled in. Fortunately, it was only a 7 pips loss, but it was a costly lesson learned.

Order Freeze

Some brokers prevent limit and market orders right before a major news release (some up to 30 minutes to an hour beforehand). This usually occurs with brokers who guarantee fixed spreads.The reason your trading platform "locks up" is not because the platform "crashed", it's because the spread is too wide and if the brokers offered them with their fixed spreads, they would lose money.

Volatility/ Whipsaws

During major news reports and economic releases the market can swing 20 to 50 pips in a second! News volatility can be very dangerous, even for experienced traders. You may catch the strong initial move, but like so many times in these situations, it can turn against you into a losing trade just as fast.

Spreads

Some brokers may guarantee execution but do not guarantee spreads, and during news events you'll see spreads widen dramatically (I've seen a 3-pip spread turn into a 14-pip spread during a report). If you like to take small profits like 5 to 10 pips, this will hurt your chances of profitability and possibly keep you in a potentially losing trade.

Trading Methods

News Trading Methods

Straddles

Straddles are really easy to set up and require very little thinking, but it is probably the riskiest method of trading the news. To set up a straddle, you basically put a limit order to go long a few pips above the market before a news report, and simultaneously put in a limit order to go short a few pips below the market. If the report creates enough volatility your orders will be automatically triggered, and your stops and profit levels will also be automatically executed if hit. Simple as that.

Again, it sounds easy, but be very cautious with this method in that both long and short orders can be triggered, and if profit targets and stops are set incorrectly, you can be stopped out for maximum loss on both orders. Also, you run the inherent risks of slippage.

"Trading the Numbers"

This seems to be a more preferred method by many, in that you determine whether or not the news report is worth trading at all – a lot less risky than straddles.

First, you must determine the significance of the news report being released. Not every news report release is tradable; either it wouldn't cause a stir in the market, or that the initial volatility would be so crazy that it would be too dangerous to enter a trade.

Ask yourself what kind of environment the market has been in recently. In other words, what has been affecting the market lately?

For example, maybe the Federal Reserve has been concerned with inflation. In this scenario, any inflation-related data (consumer price index, hints on future monetary policy) would be closely watched by the Fed – and what the Fed is watching, traders are watching. Any news reports of this level may be great opportunities to trade, as long as you are conscious of the risks.

The second step is to watch the news release and see if the report or economic number being released is inline with what the market is expecting. Obviously, if the report or number was a good one and/or a good surprise for a country, then you would go long its currency, and vice versa.

For example, in the next U.S. employment report, the market was expecting 200K new jobs, and the number came out at 300K. It's a surprise to the upside, and more jobs signal strength and growth in the U.S. You would go long as soon as the report is released and hope to catch a portion of the move. If the report came in pretty much as expected, then there would be no trade.

Summary

That's pretty much it....is it really that easy??? Heck no!! Well, maybe not at first. You'll have to practice and trade many different reports before you get a feel of which news reports will make the market move, how much of a surprise is needed for the market to move, and which reports to avoid. Like in any other trading method, your success depends on your preparation and confidence in your systems and methods. This will take time and practice. Do a little homework and study the economic indicators on why they are important. Nothing worth having comes easy, so stick with it and you'll find that trading news reports will be very rewarding once you get the hang of it.

Can You Handle the Truth?

Let's get into our favorite part of trading...creating your own trading system!

If you do a simple search in Google for "Forex trading systems" you'll find many many many people out there who claim to have the "Holy Grail" system that you can purchase for "only" a few thousand dollars.

These systems supposedly make thousands of pips a week and never lose. They will show you supposed "results" of their perfect system and it will make your eyeballs turn into dollar signs as you sit there and say to yourself, "Wow I can make all this money if I just give this guy $3,000. Besides, if his system making thousands of pips a week, I'll be able to make my money back in no time."

Slowww down cowboy. There are some things you should know before you give them your credit card number and make that impulse buy.

The truth is that many of these systems DO in fact work. The problem is that traders lack the discipline to follow the rules that go along with the system.

The second truth (there's such thing as a second truth?) is that instead of paying thousands of dollars to buy a system, you can spend your time developing your own system for free, and use that money you were going to spend as capital for your trading account.

The third truth is that creating systems is not even that difficult. What is difficult is following the rules that you set when you do develop your system.

There are many articles that sell systems, but we haven't seen any that teach you how to create your own system. This lesson will guide you through the steps you need to take to develop a system that is right for you. At the end of the lesson, we will give you an example of a system that we trade just so we can show you how awesome we are! (Insert evil laugh here.)

Goals of your trading system

I know you're saying, "DUH, my goal of my trading system is to make a billion dollars!" While that is a wonderful goal, it's not exactly the kind of goal that will make you a successful trader.

When developing your system, you want to achieve 2 very important goals:

- Your system should be able to identify trends as early as possible.
- Your system should be able to avoid you from whipsaws.

If you can accomplish those two things with your trading system, we GUARANTEE you will be successful. The hard part about those goals is that they contradict each other. If you have a system in which its sole purpose is to catch trends early, then you will probably get faked out many times.

On the other hand, if you have a system in which its sole purpose is to avoid whipsaws, then you will be late on many trades and will also probably miss out on a lot of trades.

Your task, when developing your system, is to find a compromise between the two goals. Find a way to identify trends early, but also find ways that will help you distinguish the fake signals from the real ones.

Always remember these two goals when you create your system. They will make you a lot of money!

Own System

Six Steps to Setting Up Your System

The main focus of this article is to guide you through the process of developing your system. While it doesn't take long to come up with a system, it does take some time to extensively test it. So be patient; in the long run, a good system can potentially make you a lot of money.

Step 1: Time Frame

The first thing you need to decide when creating your system is what kind of trader you are. Are you a day trader or a swing trader? Do you like looking at charts every day, every week, every month, or even every year? How long do you want to hold on to your positions?

This will help determine which time frame you will use to trade. Even though you will still look at multiple time frames (go back to 7th grade if you forgot), this will be the main time frame you will use when looking for a trade signal.

Step 2: Find indicators that help identify a new trend.

Since one of our goals is to identify trends as early as possible, we should use indicators that can accomplish this. Moving averages are one of the most popular indicators that traders use to help them identify a trend. Specifically, they will use 2 moving averages (one slow and one fast) and wait until the fast one crosses over or under the slow one. This is the basis for what's known as a "moving average crossover" system.

In its simplest form, moving average crossovers are the fastest ways to identify new trends. It is also the easiest way to spot a new trend.

Of course there are many other ways traders' spot trends, but moving averages are one of the easiest to use.

Step 3: Find indicators that help CONFIRM the trend.

Our second goal for our system is to have the ability to avoid whipsaws, meaning that we don't want to be caught in a "false" trend. The way we do this is by making sure that when we see a signal for a new trend, we can confirm it by using other indicators.

There are many good indicators for confirming trends, but I really like MACD, Stochastics, and RSI. As you become more familiar with various indicators, you will find ones that you prefer over others, and can incorporate those into your system.

Step 4: Define Your Risk

When developing your system, it is very important that you define how much you are willing to lose on each trade. Not many people like to talk about losing, but in actuality, a good trader thinks about what they could potentially lose BEFORE thinking about how much they can win.

The amount you are willing to lose will be different than everyone else. You have to decide how much room is enough to give your trade some breathing space, but at the same time, not risk too much on one trade. You'll learn more about money management in a later lesson. Money management plays a big role in how much you should risk in a single trade.

Step 5: Define Entries & Exits

Once you define how much you are willing to lose on a trade, your next step is to find out where you will enter and exit a trade in order to get the most profit.

Some people like to enter as soon as all of their indicators match up and give a good signal, even if the candle hasn't closed. Others like to wait until the close of the candle.

In my experience, I have found that it is best to wait until a candle closes before entering. I have been in many situations where I will be in the middle of a candle and all my indicators match up, only to find that by the close of the candle, the trade has totally reversed on me!

It's all really just a matter of trading style. Some people are more aggressive than others and you will eventually find out what kind of trader you are.

For exits, you have a few different options. One way is to trail your stop, meaning that if the price moves in your favor by 'X' amount, you move your stop by 'X' amount.

Another way to exit is to have a set target, and exit when the price hits that target. How you calculate your target is up to you. Some people choose support and resistance levels as their targets. Others just choose to go for the same amount of pips on every trade. However you decide to calculate your target, just make sure you stick with it. Never exit early no matter what happens. Stick to your system! After all, YOU developed it!

One more way you can exit is to have a set of criteria that, when met, would signal you to exit. For example, you could make it a rule that if your indicators happen to reverse to a certain level, you would then exit out of the trade.

Step 6: Write down your system rules and FOLLOW IT!

This is the most important step of creating your trading system. You MUST write your trading system rules down and ALWAYS follow it. Discipline is one of the most important characteristics a trader must have, so you must always remember to stick to your system! No system will ever work for you if you don't stick to the rules, so remember to be disciplined. Oh yea, did I mention you should ALWAYS stick to your rules?

How to Test Your System

The fastest way to test your system is to find a charting software package where you can go back in time and move the chart forward one candle at a time. When you move your chart forward one candle at a time, you can follow your trading system rules and take your trades accordingly. Record your trading record, and BE HONEST with yourself! Record your wins, losses, average win, and average loss. If you are happy with your results then you can go on to the next stage of testing: trading live on a demo account.

Trade your new system live on a demo account for at least two months. This will give you a feel for how you can trade your system when the market is moving. Trust me, it is a lot different trading live than when you're backtesting.

After two months of trading live on a demo account, you will see if your system can truly stand its ground in the market. If you are still getting good results, then you can choose to trade your system live on a REAL account. At this point, you should feel very confident with your system and feel comfortable taking trades with no hesitation. At this point, YOU'VE MADE IT!

Setup Your System in Six Steps

My "So Easy its Ridiculous" System

In this section I will give you an idea of what a trading system should look like. This should give you an idea of what you should be looking for when you develop your system.

Trading Setup

- Trade on daily chart (swing trading)
- 5 EMA applied to the close
- 10 EMA applied to the close
- Stochastic (10,3,3)
- RSI (14)

Trading Rules

Stop Loss = 30 pips Entry Rules

Enter long if:

- The 5 EMA crosses above the 10 EMA and both stochastic lines are heading up (do not enter if the stochastic lines are already in the overbought territory)
- RSI is greater than 50

Enter short if:

- The 5 EMA crosses below the 10 EMA and both stochastic lines are heading down AND (do not enter if the stochastic lines are already in oversold territory)
- RSI is less than 50

Exit Rules

- Exit when the 5 EMA crosses the 10 EMA in the opposite direction of your trade OR if RSI crosses back to 50

Okay, let's take a look at some charts and see this baby in action...

My So Easy It's Ridiculous' System

As you can see, we have all the components of a good trading system. First, we've decided that this is a swing trading system, and that we will trade on a daily chart. Next, we use moving averages to help us identify a new trend as early as possible.

The Stochastics help us determine if it's still ok for us to enter a trade after a moving average crossover, and it also helps us avoid oversold and overbought areas. The RSI is an extra confirmation tool that helps us determine the strength of our trend.

After figuring out our trade setup, we then determined our risk for each trade. For this system, we are willing to risk 30 pips on each trade. Usually, the higher the timeframe, the more pips you should be willing to risk because your gains will typically be larger than if you were to trade on a smaller timeframe.

Next, we clearly defined our entry and exit rules. At this point, we would begin the testing phase by starting with manual back tests.

Here are a couple of examples:

If we went back in time and looked at this chart, we would see that according to our system rules, this would be a good time to go long. To backtest, you would write down at what price you would've entered, your stop loss, and your exit strategy. Then you would move the chart one candle at a time to see how the trade unfolds.

In this particular case, you would've made a massive pip gain.* You could've bought yourself something nice after this trade! You can see that when the moving averages cross in the opposite direction, it was a good time for us to exit. Of course, not all your trades will look this sexy. Some will look like ugly heifers, but you should always remember to stay disciplined and stick to your trading system rules.

In this example, we can see that our criteria are met and at this point we would enter short. Now we would record our entry price, our stop loss and exit strategy, and then move the chart forward one candle at a time to see what happens. I'll bet you a $1000 that I'm right on this trade.

Well, isn't that amazing?! It just so happens that I'm right again! You can see that we would've stayed in this trade until the moving averages crossed again and RSI went back to 50.

We know you're probably thinking that this system is too simple to be profitable. Well the truth is that it is simple. You shouldn't be scared of something that's simple. In fact, there is an acronym that you will often see in the trading world called KISS. It stands for Keep It Simple Stupid!

It basically means that trading systems don't have to be complicated. You don't have to have a zillion indicators on your chart. In fact, keeping it simple will give you less of a head-ache.

The most important thing is discipline. We can't stress it enough. Well, yes we can.

YOU MUST ALWAYS STICK TO YOUR TRADING SYSTEM RULES!

If you have tested your system thoroughly through back testing and by trading it live on a demo for at least 2 months, then you should feel confident enough to know that as long as you follow your rules, you will end up profitable in the long run.

Trust your system and trust yourself!

Summary

There are many systems out there that work, but many traders lack the discipline to follow the rules and as a result, still end up losing money.

Your trading system should attempt to accomplish 2 goals:

A) Be able to identify a trend as early as possible

B) Be able to find ways to avoid whipsaws (confirm your trend)

If it is profitable, then you trade your system live on a demo account for at least 2 months. This will help you get an idea of how you would trade your system when the market is moving. It is a lot different trading live than manually back-testing.

Once you've demo traded your system for at least 2 months and you are still profitable, you are then ready to trade your system live with real money. However, you must always remember to stick to your rules no matter what

There are 6 steps to developing your system:

1) Find your timeframe
2) Find indicators to help you identify trends early
3) Find indicators to help you avoid whipsaws and confirm your trend
4) Define your risk
5) Define your entry and exit
6) Write your trading system rules down and ALWAYS stick to those rules!

There are 3 phases to testing your system:

a) Back test - go back and time and move your chart forward one candle at a time. Trade your system according to its rules and record your trades to see if it ends up being profitable.

b) If it is profitable, then you trade your system live on a demo account for at least 2 months. This will help you get an idea of how you would trade your system when the market is moving. It is a lot different trading live than manually back testing.

c) Once you've demo traded your system for at least 2 months and you are still profitable, you are then ready to trade your system live with real money. However, you must always remember to stick to your rules no matter what!

- end -

by: matlan