Finding Your Trading Style

by
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Do you like to fish, or do you prefer downhill skiing? How you answer that question may have a greater impact on your trading success than the most robust trading strategy you can devise. The FX market offers multiple avenues to trading success, but in order to take advantage of these opportunities, you must first understand your strengths and weaknesses. Most traders are taught that there is only one "proper way to trade". Nothing could be further from the truth. As an adult, you are highly unlikely to change your ways; markets, on the other hand, change all the time. Therefore, it is far easier to find a trading technique that is in sync with your personality than to try to conform to someone else's idea of a "proper trader".

Trading Strategies

So, why are fishing and downhill skiing so important? Believe it or not, this is a question about trend and counter-trend trading. Fishers trend, skiers fade. This is because fishing requires time, methodology and, most importantly, patience. Like trend traders, those who fish will cast their line many times before they get a bite. Downhill skiers, on the other hand, look for the quick thrill with a very specific goal - the end of the run. This psychological drive is similar to what drives faders - the quest for fast profits as currency prices make a quick retrace. Does fishing always lead to trend trading and skiing to counter-trending? Of course not. However, the activity you choose suggests a definite predilection for one style versus the other.

Timelines

The trend versus fade dynamic leads to the second important question that traders need to ask themselves. Are you more comfortable trading short-term or long-term time frames? Generally, traders who like to put on trend-based trades will work on longer timelines, if for no other reason than that trends in FX tend to develop over months rather than days. Faders who look for quick turns in market sentiment will usually operate on much shorter time frames.

Typically, the shortest effective time frame to trade the currency market is on the hourly charts with average risk/reward targets of at least 30 points, since the spread nature of the market means that trades that are any smaller are ineffective. For example, take the EUR/USD pair, which is the most liquid financial instrument in the world and typically trades 3 points wide on the bid/ask spread. A trader with a 10-point target and a 10-point stop would actually have to earn 13 points (10 points + 3 points of spread), but would be forced to stop out at only 7 points (10 points - 3 points of spread). After hundreds of trades, this negative skew in the risk/reward equation makes it very difficult to generate profits on such short time frames.

Type of Analysis

Once you have determined what time frame suits you best, the next question you must ask yourself is this: what type of analysis should you use to make proper trade selections? No issue creates more arguments on trading desks than the debate between fundamentalists and technicians.

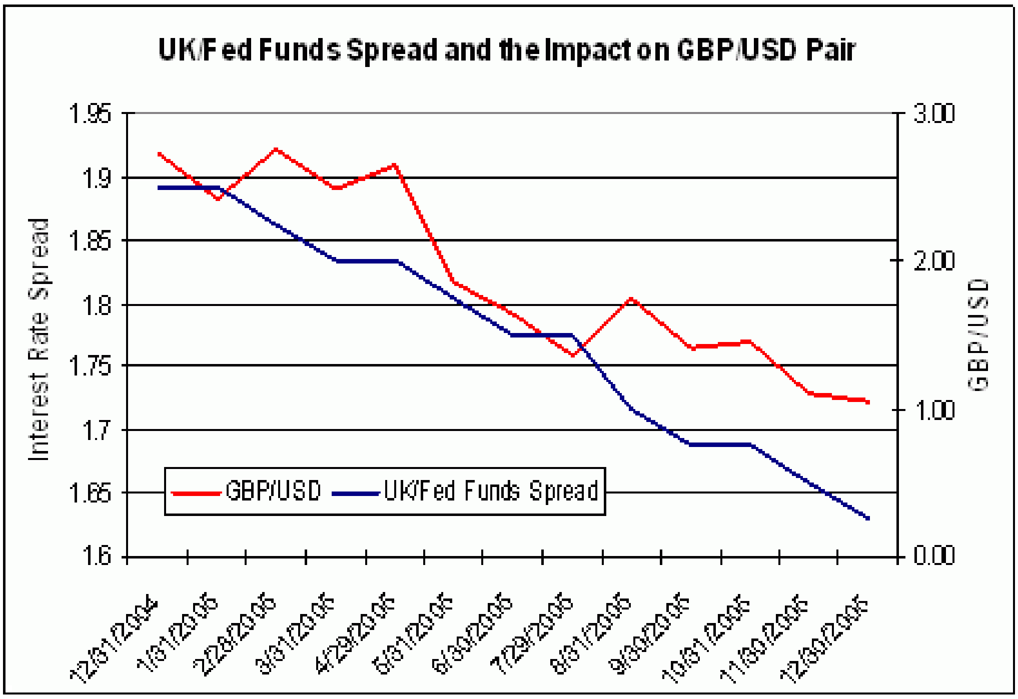
Fundamentalists scoff at technicians' attempts to forecast future price movement by looking at the present price action on the charts. Hard core proponents of fundamental analysis consider technical analysis not much better than the ancient ritual of divining the future from the entrails of dead animals. News, economic reports and commentary from monetary officials are the primary tools of fundamentalists. Technicians, for their part, dismiss most fundamental data as woefully inconclusive and contradictory, believing instead that any material news will be reflected in the price action of the currency pair and will therefore provide objective clues to future direction.

Which camp has got it right? Neither one. Trading on technicals or fundamentals alone is a sucker's game, akin to wanting to box for the world championship title with one arm tied behind your back. Fundamentalists can talk all they want about the secular global demand for oil that will drive the price of crude to $100/bbl and will take the Canadian dollar to parity with the greenback, but if they choose to short USD/CAD at a grossly oversold level as momentum shows large divergence on the charts, then they will likely lose money on the trade - even if their analysis is ultimately correct. Conversely, a technician could short a major Fibonacci cluster to his heart's content, but if a piece of economic news surprises the market to the upside, his shorts will be run over like jungle shrubbery after an elephant stampede as traders try to cover their positions, ignoring various resistance levels.

Fundamentals for Long, Technicals for Short

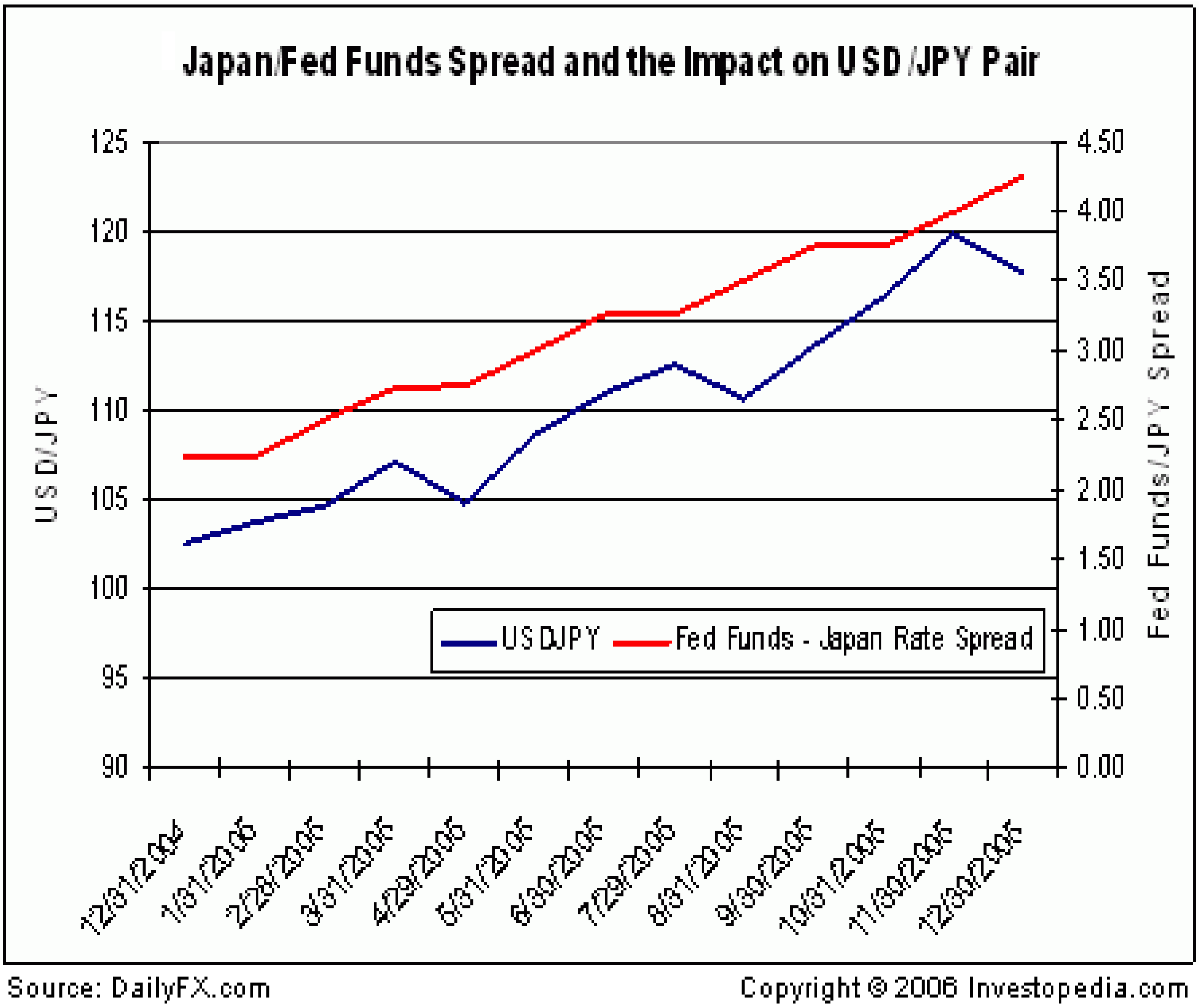
Despite these admonitions, the general rule of thumb is that fundamentals tend to have a stronger impact on longer-term trades, while technicals will be more important to consider for shorter-term trades. Over the long term, currency prices will respond to major economic events such as GDP growth, interest rates and current account balances.

Witness, for example, the move in the GBP/USD over 2005 (Fig. 1). During that time, the Federal Reserve Bank of New York proceeded to raise the Fed funds rate by 200 basis points, from 2.25% to 4.25%, while the Bank of England, facing a slowing economy and depressed consumer sentiment, chose to lower the U.K. rates from 4.75% to 4.5%. The interest differential between the two currencies compressed to nearly 0% (by the beginning of 2006, it had reached 0%). Traders who made a long-term bet that U.K. and U.S. short-term rates would converge profited handsomely as GBP/USD declined.



Source: DailyFX.com

The same dynamic took place in the USD/JPY, except in reverse (Fig. 2). As U.S. rates expanded while Japanese rates remained stationary at 0%, carry traders flocked to the pair, bidding it up by 20% in a matter of months. With analysts in 2006 forecasting the end of the U.S. tightening cycle and the beginning of the Japanese one, these long-term trends may well reverse moving forward, and traders making this fundamental call could reap large gains if their analysis proves to be accurate.



While price action reacts well to fundamental factors over longer-term time frames, technical analysis appears to have the upper hand on shorter time scales. Perhaps one reason why this occurs is that on smaller time frames, information from news flow is not nearly as active or as meaningful; therefore, prices tend to respect established support and resistance levels on the charts as currencies range in tightly defined zones. For example, in this hourly chart of the EUR/USD (Fig. 3), note how price reacts to the swing highs and swing lows, allowing the trader to profit from selling resistance and buying support

Figure 3

THE BOTTOM LINE

Whether you are a long-term fundamentalist or a short-term technician, the FX market can accommodate your style. Although the argument between the two camps will probably never be resolved, the one undeniable truth of trading is that you must use the style that best suits your personality. Otherwise, you are unlikely to succeed, regardless of the soundness of your approach. Therefore, the first question an FX trader should ask him or herself is not "Is this pair going to go up or down?", but "What kind of a trader am I?"

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