*Beat the Forex Dealer: An insider's look into trading today's foreign exchange market*
By Agustin Silvani


# a

# TRADING HOW TO'S

# How to Set Up Your Trading

With decent money management rules and some form of trading strategy in your pocket you are ready to begin conquering the FX market. Yet regardless of whether you are trading systematically or discretionary, before you begin trading for the day you must first feel confident in your trading environment. If the FX market is a battlefield, then you are the general and your positions are your troops, and you want to make sure that you have a firm grasp of the terrain before sending any of them in to fight. Having a set game plan enables you to not only react quickly in fast-moving markets, but it also helps take some of the decision making out of the equation by pre-planning the moves ahead of time.

There are a few, simple things that every trader should do in order to stay in complete control of their trading environment.

## UNDERSTAND THE BIG PICTURE

The best way to start your trading day is to begin by looking at charts from a big time frame to small. Start with the dailies, then zoom into the 4 hr, 1 hr, 15 min, etc. If you don't know where you've been, then you can't possibly know where you're going. FX trading is as much about reading the past as it is about interpreting the future, so make sure to ask yourself: are we in a ranging or trending market? Have any significant long-term patterns developed (see chart A.1)?

Only a cursory look is needed at the daily charts, but sometimes overnight moves will have created significant developments (broken trendlines, Fibonacci retracements, etc.) that will be missed if your attention is squarely focused on the short-term charts. The following steps should be taken to get a proper feel for the market:

### 1. Establish the general direction

Figuring out the general direction should be rather easy. Candlestick analysis and moving average ribbons (chart A.2) are elegant ways of identifying long-term patterns, reversals, or meaningful set-ups.


**Chart A.1** The break of long-term patterns (1-trendline, 2- previous top, Fibonacci) would be missed by concentrating entirely on short-term charts.

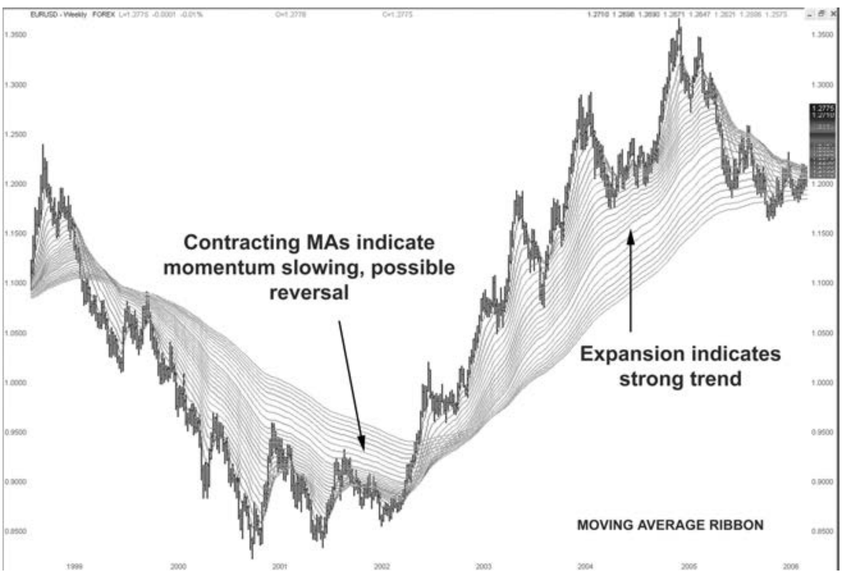


**Chart A.2** A moving average ribbon can instantly tell you if the market is trending strongly (MAs spread apart), or consolidating in preparation for the next large breakout (contracting MAs).

## 2. Figure out the daily trading range

A good daily trading range shows you where the vast majority of the moves are expected happen, and any moves outside of the range should be viewed as short-term abnormalities that can be faded.

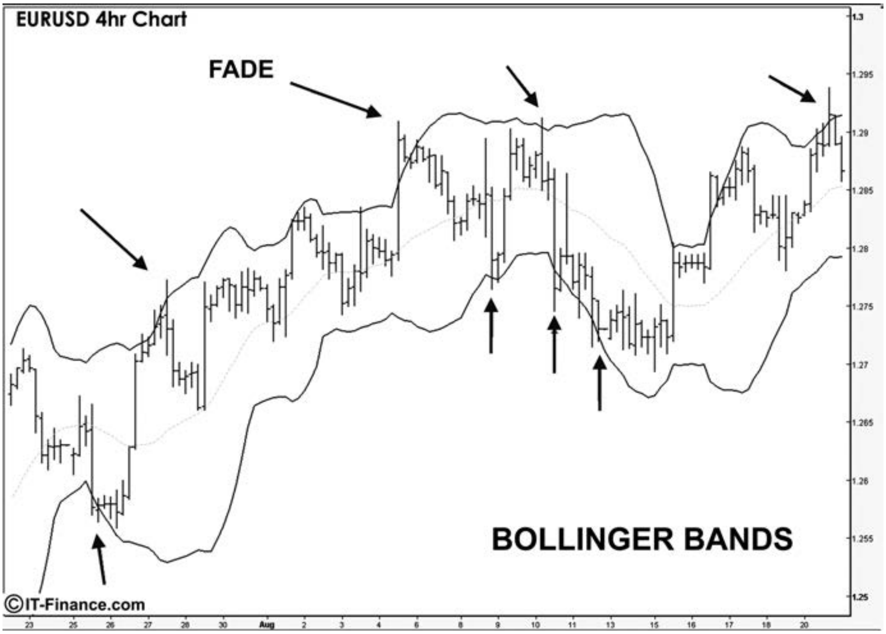


**Chart A.3** Bollinger Bands applied to 4hr charts give a good indication of the day's range and any extensions beyond this (arrows) can be faded for a quick move back within the bands.

## SCENARIO PLANNING

Once you have a general overview of the market, you can begin planning your trading responses to a number of different scenarios that may take place during the day. Not only does this exercise your mind, but asking yourself "what will happen if the Euro breaches 1.3560?" or "what will be the market reaction to a weak retail sales number?" also helps make your trading reaction to these events automatic.

Make sure that you know ahead of time what news is scheduled to be released, the market expectations, since all too often traders forget that there is more news out there than just the 08.30 NY releases, so keep an eye out for market moving events from Asia and Europe that may have a big impact on prices.

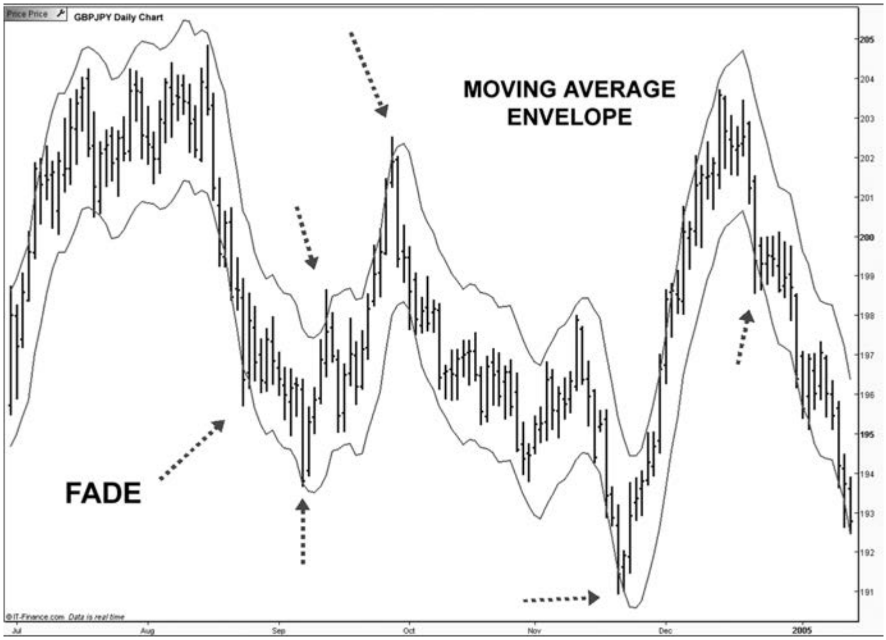


**Chart A.4** A moving average envelope contains most of the daily moves for even notoriously volatile pairs such as the sterling/yen.

If after all of this preparation the price action does not correspond to your scenario and game plan (you were bearish on cable but it blasted through several of your resistance levels) then you should take this as a red flag and probably sit on your hands until you can re-evaluate the day's events.

## STAY FOCUSED

Understanding the big picture does not mean understanding the *whole* picture. Since you cannot trade everything, focus on your favorite pairs and get to know them well. It takes a lifetime to understand a currency's behavior, how it reacts to things like oil prices, interest rates, etc., so concentrate on learning a few pairs very well instead of following everything half-hearted.

## ALWAYS TAKE NOTES

Although it may seem like a thankless task, keeping a trading journal is the best way to reap the benefits of the analysis you have just done above. After all, if you don't keep a written record how are you going to know if your thoughts were on the money, or if your tactics proved to be wrong? Keeping a record will keep you from repeating costly mistakes ("I've been in this situation before, what did I do in that case?") since it may be hard to remember your motivations for entering a trade post-fact. At the end of the day you are your best teacher, and before going home for the day you should make sure to write down your feelings on the majors and set some targets for the overnight market. This will create a continuity of thought and help you jump back into the market the following morning. You can also use this to fine-tune your forecasting and technical abilities.

# How to Trade Price Action

The sharp moves often seen in the FX markets can be difficult to trade and properly adjust to, even for advanced traders, but learning to read and interpret the price action in situations like these gives us a big leg-up. In a steep decline, for example, one must be careful to measure the reaction of the longs to know if the move has a chance to turn into a rout. By looking at the reaction of the longs as soon as the rate begins to extend south, you may be able to determine if the market is sitting on a large number of long positions or not.

Usually, if a spike lower is followed by a sharp V-shaped recovery, then you should be wary of shorting the pair. Masses of buyers entering the market at lower levels tells you that the market is not particularly long, and the lower prices represent "bargain" levels for those wishing to accumulate long positions.

On the other hand, if after the initial move lower any uptick is sold into, you can be fairly sure that the market is caught long and wrong. The longs realize that they hold bad trades, and are eagerly awaiting any uptick to offload some of their positions. This is when smart traders and dealers smell blood and go in for the kill.

Take a look at chart A.5 to see how the market reacts during sharp moves.

1. Sellers come into the market for whatever reason (news, etc.) and overwhelm any bids, driving the pair lower. When the pair slows down and consolidates the move, the reaction of the market here is critical.
2. No sharp recovery is seen, indicating that the nobody considers this correction to be a "cheap" buying level, and more likely than not some trapped longs are feeling the heat. The pair moves in a steady fashion as shorts take profit, reload, and short again. The pair will continue to move lower as long as there are more sellers than buyers, and it falls until some sort of equilibrium point is reached.
3. Normally the rate would rebound a bit from this area as shorts buy back their positions, but seeing the attractive round number nearby, stop hunters and retail "chasers" join the short selling party. The pair briefly breaches the round number, takes out any remaining stops and rebounds as dealers buy back their shorts. The longs have now either been stopped out or cut their losses.

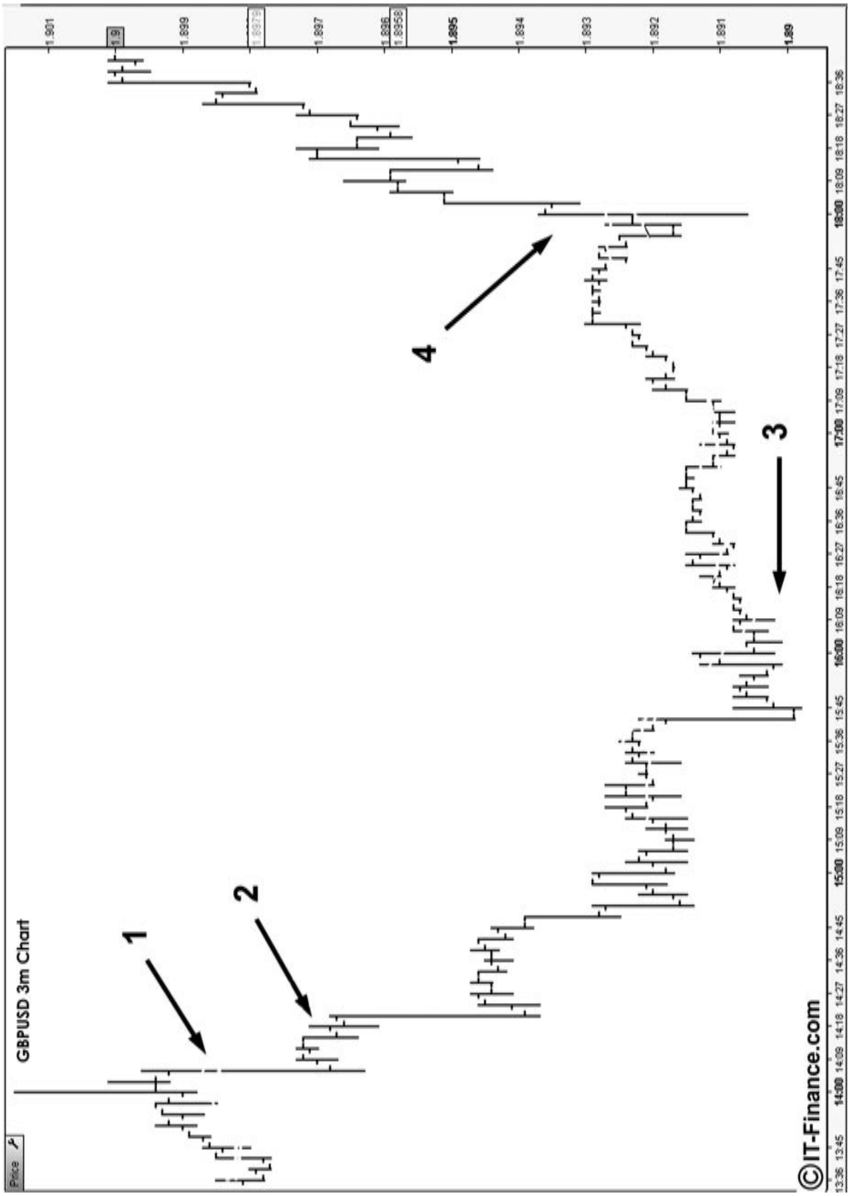


Chart A.5

After the last flurry of selling, the market is left leaning on the short side, with no fresh supply hitting the market. This imbalance in turn creates the perfect "short squeeze" set up. Since the market tends to follow the 'maximum pain' theory, it will now probably head north to try and cause some pain to the other side of the market. As soon as the dealers understand that the selling pressure has ended and the original longs have long been shaken out (remember, they have access to order flow), they slowly start to bid up the pair.

4. Expecting a continuation of the move, new shorts (chasers) are taken on a final move lower. The market at this point is oversaturated with shorts and a sharp V-shaped recovery takes place. Like dominos toppling over, the shorts are easily squeezed by the dealers. Squeezes tend to be sharp and vicious, reflecting the panic the shorts are in. Never underestimate the results of disorderly forced buying/selling, and never fade a squeeze; lest you end up getting "squeezed".

In this case, the original orderly down-move took approximately 2 hours to unfold while the short squeeze retraced the entire move in a mere 30 minutes. Simply comparing the two halves of the chart reveals the difference between orderly market moves and forced buying/selling (stops). A testament to the power of fear.

Moves like these are typical of a purely speculative market where "hot money" is out chasing prices and no real money or long-term fundamentally inspired bets are being placed. Basically the day to day chop of the FX markets.

So how does one trade these choppy markets?

## TECHNICAL HELP

Moving averages are one of the oldest tried-and-true indicators, but since they are lagging indicators to the short term trader they seem to be of little use. As with all price-driven indicators there are trade-offs, and one has to look at the MA itself to find good uses for such a tool.

The most widely looked at MAs are the 50, 100, and 200 day MA which are a simple, yet efficient ways to gauge trends, their strengths (measured as a % away for the MA), and reasonable support levels. All day-traders should know where these levels sit on the daily charts, because as widely followed indicators they attract stop hunters and should therefore be avoided.

Since moving averages essentially relate the past price action, they can also be used effectively intra-day for entering and exiting positions in one-way markets. During sharp moves, it can be difficult for a trader to properly enter a position since retracements are far and few, and the "it can't go higher/lower" mentality may set in.

For example, even though you were bearish on cable, at the end of the day you find yourself on the sidelines looking at a 200 point drop, or worse, caught trying to pick a bottom.

In this scenario, the MAs can be used as dynamic resistance levels to trade off of, with much better results than the stop-happy static support/resistance levels known to the whole market. Using the 10 and 20 you can effectively choose when to open and close your position based on price action, not just an arbitrary number. Refer to chart A.6.


**Chart A.6** Using moving averages during sharp moves.

1. The market breaks lower and you miss the initial short, but after a bearish cross you have the opportunity to enter a position once the price tests the 10d ma. This is the first dynamic resistance and should be sold into (a second can be sold at the 20). In this instance you have numerous chances to enter shorts. Notice how this beats simply selling the next break lower.
2. Once in a trade, choose to exit 1/2; of the position when the 10 is breached (closed bar), and the other half when the 20 gives way (3). After the 20 gives way the price action is telling you that there are more buyers than sellers out there, and the dynamics of the move have changed.

The advantages of using MAs in this manner is that it gives you dynamic levels to trade off and gauge price action, rather than agreeing on arbitrary levels or your ‘gut’ to tell you when you should take profit. By taking these decisions off of your shoulders and turning them into a systematic ones, you are less prone to take profits too early and it has the added benefit of placing less strain on your psyche. Take a look back at chart A.5 to see how effective the MAs were in protecting profits.

# How to Build a Position

Formulating good trading strategies and views on the market is all well and good, but if you don't have a proper way of entering your positions in an orderly manner then you may find your trade in the red the minute you enter the market.

## SCALING

It is common knowledge that the ideal way to trade is to gradually enter a position, and then gradually exit as your targets are met. In theory this approach is beautiful; in reality most traders will find it very hard to accomplish. It is hard to add an increasing amount to your position when it looks worst, and hard not to take profits once it moves into the black. The psychological aspect is often times too great and lucky are the few that can sit still while the market gyrations make your P/L swing like a kite in the wind.

One way to get around these considerations is to take small chunks out of the market instead of going for the entire move. Taking profit in a trade is very important not only for the balance sheet, but also for your psyche. Profit taking breeds a positive mentality that all traders need, and in case the position turns around and you end up with a loss, at least you put some pips away to soften the blow.

## BUILDING A POSITION

Trying to time the perfect entry/exit is a fruitless exercise engaged by traders that serves only to hinder your trading. Professional traders know that they are not likely to enter at the "exact" top or bottom, so instead they focus on figuring out the price range for their entry.

Let's take a look at a real-world example using the loonie (USDCAD):

Because of our technical analysis and interpretation of the price action, we think the loonie is poised to fall and enter a short position (chart A.7).

According to our money-management guidelines, our risk should be no more than $200 on a $10K account (2%). We have two options:

- One 100K lot with a 20 pip stop.
- Multiple mini lots with varied stops.


**Chart A.7**

You can immediately see the flexibility you give yourself by trading smaller lots, which is exactly the reason most retail traders should trade mini accounts. Your *total* risk should be what's important to you, not nailing the exact entry point. Most FX platforms these days calculate your average cost automatically, so figuring out the risk on multiple positions is fairly easy to accomplish.

Let's say we decide to trade 5 mini lots (leveraging 5 times). If we where to trade them all at once, then we would need to set a 40 pip stop. We are risking the same amount ($200) but at a lower risk profile. The more experienced you get with your trading, the more comfortable you will be in varying your entries and stops.

Of course, before we are even close to entering the trade we will already have charted out the day's trading levels which we can use to enter and exit the trade. With five lots to trade, we begin to enter incrementally higher amounts once our entry price is reached.


**Chart A.8**

1. **First sell order executed @ 1.1330**
   *Just getting our feet wet, making sure we have an "interest" in the market.*

Now, one of two things can happen. The more common one is to see the price shoot up as soon as we enter our short. This is when most traders scream "this always happens to me!", but in our case we are just happy to see better selling levels. On the other hand, if the pair proceeds to immediately plummet, then our position would already be in the black. Not a bad place to be. Starting small means putting yourself in a win-win situation.

2. **The loonie moves higher and we sell 2 more @ 1.1345**
   *We are now short 3, and we have two more bullets remaining.*

After a few minutes, the pair continues to move higher and is sitting at 1.1355, 25 pips above our original entry. If the rate continues to climb higher, we still have 2 more lots to better our cost, or if we feel uncomfortable with the trade we can choose to exit with a meager loss. Using the one-lot strategy, we would have already been stopped out.

3. **The pair finally begins to come off and gains downside momentum. We enter our final two shorts @ 1.1333**
*We are now short 5 avg. cost 37.*

Note that this is not "averaging down," which is a desperation move. This is building a position. We were able to get a better cost for our short (37 compared to the initial 30) and managed to ride the blip higher that stopped out many of your fellow traders.

Once the topside stops are taken out, the trade now has room to move on the downside. We exit according to our support levels, taking out 2/3 and leaving the rest with a stop at entry looking for lower levels.

Big traders rarely trade with fixed orders in the market (for fear of revealing their intentions), and enter and exit positions according to price action. This type of trading is probably best suited for experienced traders with established trading styles, while new traders are better-off trading with multiple fixed orders in the market which lets them focus on tweaking their analysis instead.

Building a position means establishing ranges for you to trade off of, rather than trying to define absolute values for the perfect entry. In the FX market there is so much intra-day noise that trying to find the perfect entry and exit of any trade is practically impossible; so why bother? Instead of thinking "at what price should I enter," you should be thinking "what is a good 10-15 pip range to enter/exit my positions?" As long as your analysis is correct most of the time, you should be able to make money most of the time as well.

## TRADE YOUR TIMEFRAME

Once in the trade, a crucial mistake some traders make is to trade out of their time frame. Once in a trade, it can be tempting to scour different charts in order to find some glimmer of hope that may turn that losing trade into a winner. A trade opened according to the 3 minute chart will turn sour, but a stubborn trader will not let go and turn to the 15 min or 30 min charts where the trade looks better. As you may have guessed, this never works and only opens the door to larger losses and more pain for the trader.

Learn to cut your losses short. If you opened your trade according to a signal from the 3 min chart, get out as soon as the 3 min chart tells you the trade is no good. It's no use to flip time frames until you find a chart that suits your needs; remember that you are following the price action, not the other way around.

The only time it's appropriate to switch time frame is when the trade is deep in-the-money. If the signal came from the 3 minute chart but extended farther than you thought, it may be reasonable to think that the move has further to go. Switching to a longer time frame may show you the market rolling over and confirming the signal. In this case it is wise to take some profit and let the rest run, but a good rule to follow is to get out according to the time frame you used to enter the trade. If your original analysis was incorrect, then you can't to turn a loser into a winner; no matter what fancy indicators or software you may use. Trash in . . . .trash out, as they say.

# How to Trade Out of a Losing Position

One of the most important lessons any trader needs to learn is how to effectively trade out of a losing position. Although this is usually the realm of money management techniques, at some point in their careers traders may find themselves with a trade that is deep underwater and that has the potential to wipe out their account.

Although it would be easy to note that if proper money management rules are followed this situation should never arise, in the real world traders do sometimes find themselves in these positions because of a slip in judgment, technical problem, or simply stubborn behavior. In any case, most traders do at some point find themselves with a run-away position, and what they do in such a scenario determines their longevity in the market.

When holding onto a big loser, most traders have two choices: cut the position immediately for a huge loss, or try to average down and hope for a turn around. Neither approach is particularly attractive, seeing as how you take a big monetary hit with one, or place all of your chips on the table and hope for the best with the other.

There is a third way: trading yourself out of the market. Great traders simply refuse to take an outright loss by way of a stop, and instead once they realize that the market has proven them wrong they begin to "lighten up" by slowly trading their way out of a losing position.

Once you realize your position is dead in the water, your mission then becomes to better your average cost *without* adding to the position. Adding to the position (averaging down) only creates more pain, and can quickly take away your flexibility as the loss grows and becomes unmanageable. So instead of adding, we need to cut part of it on a dip in order to gain more breathing room and be able to trade out of the rest.


**Chart A.9** The key to this strategy is flexibility.

Take a look at the chart at left to better illustrate this technique. Assume that you are short against the trend and you want to get out. You are faced with these options:

- Get out of everything and take a substantial loss.
- Hold onto it and hope the pair will collapse before you run out of margin.
- Cut part of the position on any reasonable dip.

The benefit of cutting part of your position on a dip is two-fold. First, although you are forced to take an initial loss, you free up liquidity and give yourself more flexibility to react to future price moves. Any move now is a good move. If the USDJPY bounces higher, you can re-load at better selling levels to improve your average cost. On the other hand, if it immediately collapses then great, it's moving in your direction.

The other great thing about cutting part of your position is that you instantly take some of the stress away. Keep in mind that one of the most stressful aspects of trading is the psychological impact a running loss may have on your trading. Faced with big losses, most traders are keen to stop the pain immediately, and thus take needless hits.

Once you have cut part of your position, you then proceed to make small trades and slowly better your average cost. Using intra-day volatility, you make small trades to effectively trade out of your position.

## THE RUN-AWAY TRADE

To better illustrate this technique, let's look at an example of the same USDJPY move that surely caused a lot of pain to many traders not following a flexible trading strategy (refer to chart A.10).

1. Around the beginning of October, we believe that USDJPY is overbought and in the process of topping out. We think the rate may fail near the 113.70 resistance level, so we take an initial short at 113.50. Our plan is to scale into the position and this is our first shot – always stay flexible.

In this swing trade, we are looking for a move back down to the 109 support level in the coming weeks. We are willing to risk 150 pips total, for a very reasonable 1:3 risk/reward ratio (risking 150, looking for around 450pips,). We realize that the market may overshoot the previous top (searching for stops), so we remain flexible and are prepared to add two more shorts higher.

2. After initially failing at the 113.70 resistance, the dollar rallies and takes out stops to print a new high of 114.20. So far it's no surprise, we knew this could happen and we take advantage of the higher levels to set our second short @ 114.10.

We are now short 2 at an average of 113.80 (113.50+114.10). Stop is 75 pips away (150 pips divided by 2 lots). Always keep an eye on your *total* exposure, since that is what is most important.

3. The dollar begins to sink as planned and the trade is now in the black. We are looking to add a third short if it breaks below the figure (113.00), since that will be an indication that momentum is picking up steam to the downside. Unfortunately the pair does not break the figure, but instead rebounds and is soon testing the highs once again.
4. During this rebound we can choose to either cut the trade at cost, or stick with it. Our gut is telling us that something is not right, but we believe the pair is still ripe for a reversal so we stick with the trade. The move might be taking longer than we thought, but techs still point to a decline and there seems to be some good supply near the previous highs. We decide to take our third (and final) short @ 114.40. We are now short 3 lots average 114.00, (113.50+114.10+114.40). Stops are set 50 pips away (150 pips divided by 3).
5. The dollar proceeds to tank, taking out stops and quickly jumping another big figure. At this point you decide to disregard your money management rules and remove your stops – *it's already up almost 600 pips, it can't go higher! The pair is so overbought that it has to correct, and I will cut my position when it does*.

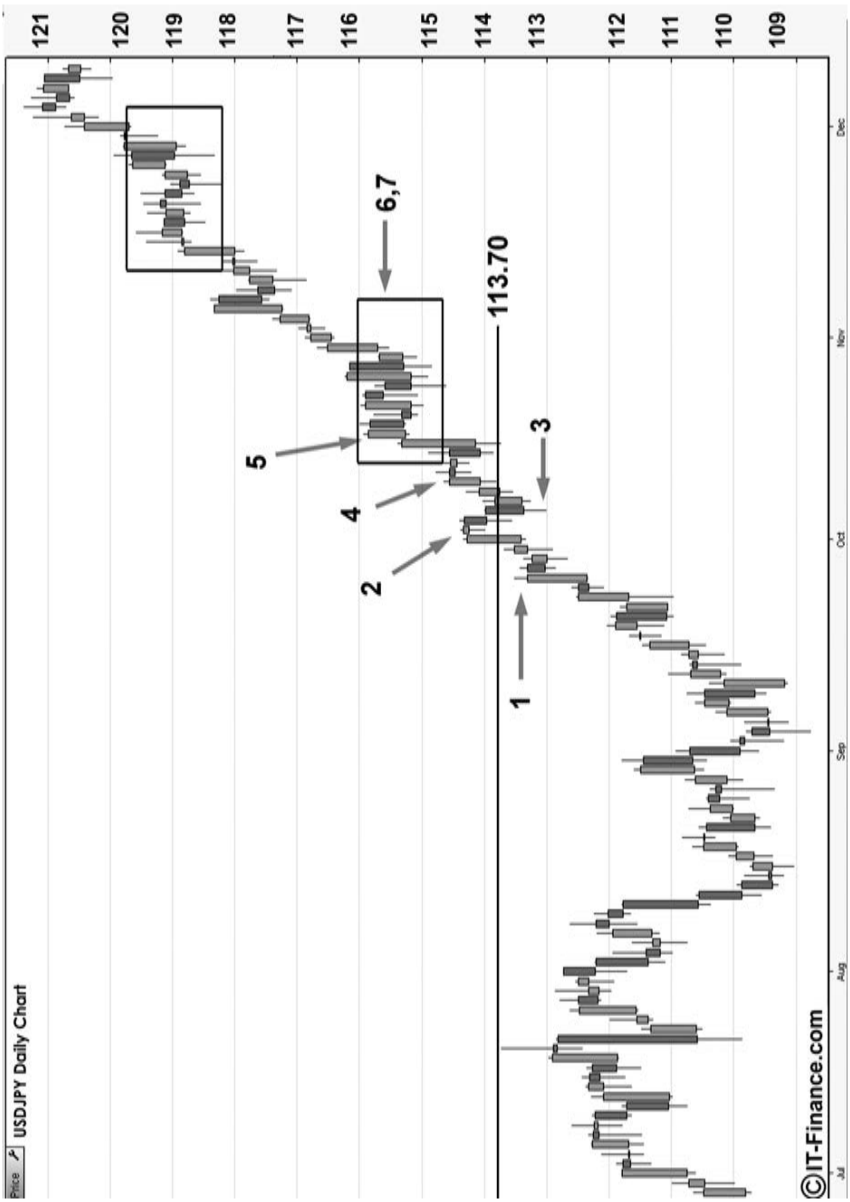
USDJPY Daily Chart
©IT-Finance.com
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Chart A.10

Trying to out-think the market is never a bright idea, since the market doesn't *have* to do anything. Whenever the market is faced with something it *can't* do, it quickly proceeds to do that exact thing. This is because the traders hoping for a reversal are all sitting on the same trade, and vulnerable.

We know we are in trouble. We are short average 114.00, and with dollar-yen printing 115.50 we have an unrealized 450 pip (150 × 3) loss ... well above the initial 150 that we were willing to risk. This simple trade is now looking like it may very well take a large chunk out of our account, and the stress level increases. We are tempted to simply stop the pain, get rid of it all and regroup. Stubborn traders may be tempted to double up and bet on a decline.

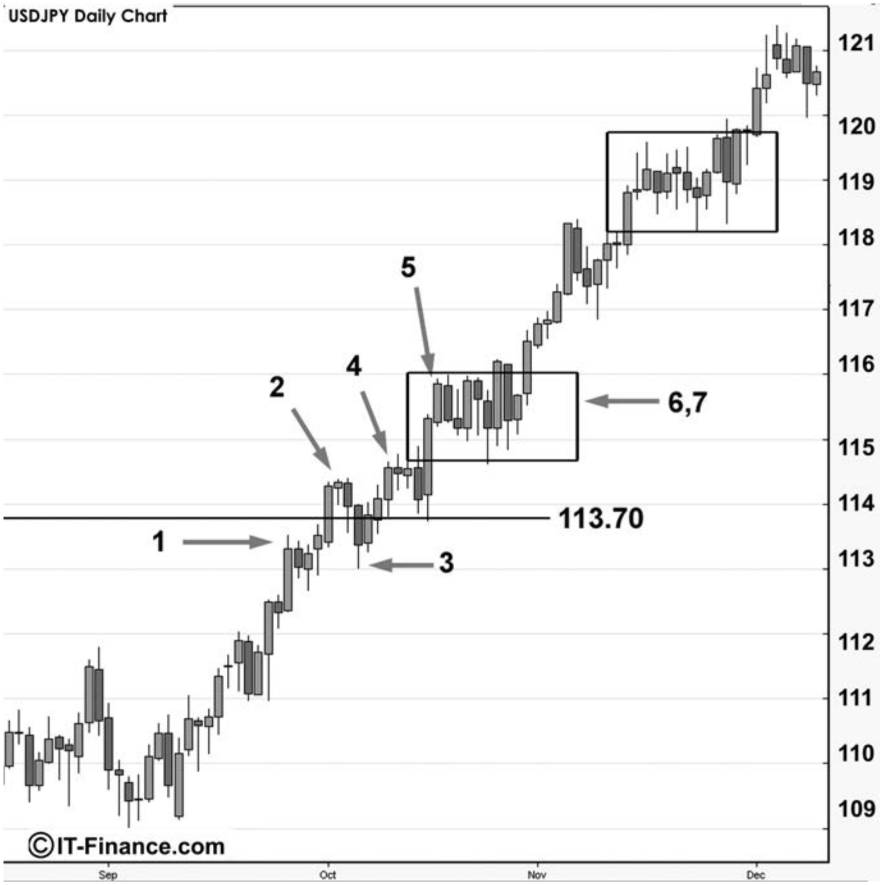


**Chart A.11**

Shrewd traders do neither. After getting over the initial shock of the situation we take a deep breath, some aspirin, and decide to take control of the situation; we're going to fight tooth and nail until we come out of this trade alive.

We re-analyze the situation from an objective point of view and realize that the market has effectively proven us wrong. Pride has no place in FX trading; the market proved us wrong and we move forward. The USDJPY is not going to reverse lower to 109, and if anything, it looks like it wants to go higher.

The one thing that saves us during these bad trades is the same thing that saves dealers, namely the fact that that currencies do not move straight up (or down), but rather have a tendency to make a move, consolidate, then continue. This stair-case pattern is evident in most financial instruments, and simply indicates the accumulation/distribution stages of a move. Longs may take some profit and shorts may get stopped out, and both need time to set new positions. You should consider these consolidation periods as your window of opportunity (box 6-7).

With our new understanding of the situation we look for a dip to free up part of our position. This soon happens and the pair dips to test the 115 level.

6. We get rid of one lot at 115.10. We take a realized loss of 160pips (first in, first out). Now we are short 2 lots avg. 114.25, with an unrealized loss of 170 pips. Taking the loss hurts, but we have now given ourselves more flexibility (and margin).

The flexibility we have given ourselves means that whatever the yen may do at this point, we can handle.

7. We wait for a range to develop. This soon takes place as a rough 100 point range develops and trades for almost 10 straight days. We recognize that a range has developed and begin to actively trade the third lot that we freed up. Shorting near 116, we buy it back near 115. This technique proves effective and we are nimble enough with intra-day trades to quickly pocket a good amount of pips to offset some of the loss. With some quick range-trading we have put on 7 trades averaging 30 pips each which wipes out our realized loss and brings our unrealized loss to a much more manageable 120 pips. Depending on our outlook, we can then choose to either cut the whole position (in accordance to our original 150 pip stop) or continue to trade this way until a good amount of pips have been pocketed to offset the loss.

The key here is to never *add* to your total exposure, but to manage it instead. By pocketing all of those small amounts, you are effectively bringing up your average cost and making it easier for you to get out with a reasonable loss. Getting out with a small loss when originally faced with a position deep in the red often feels better than taking a profit, since you know that you fought in a market that was against you; and survived. Further satisfaction comes from the fact that you know retail traders are getting wiped out as the pair moves higher!

**Remember these simple steps to trading out of a bad position**

- Unload part of your position on a dip
- Wait for a consolidation to take place and a range to form
- Trade the range with multiple quick ins-and-outs
- Minimize your loss and get out. Don't try to turn a losing trade into a winner!

## WHEN TO CUT AND RUN

Although you may be able to trade yourself out of most positions, there are times when you should take a loss and simply get out. If a sharp move happens for some unexpected reason (9/11, political event, etc.) then it's best to get flat as soon as possible. No one has time to evaluate the ramifications of such an event, so it is better to get out and re-evaluate later.

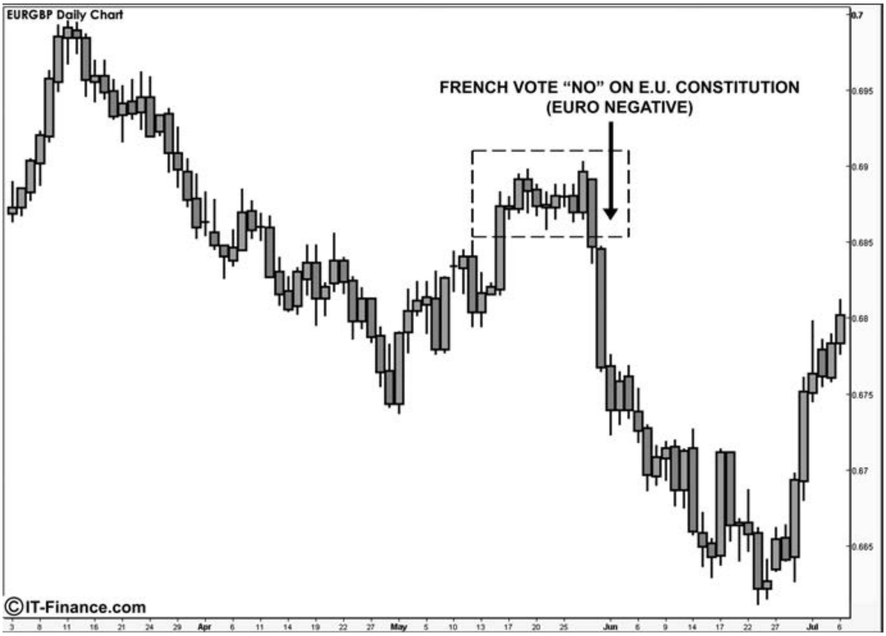


**Chart A.12** Political decisions can have long-lasting effects on a currency and should not be faded.

In general, if a trade feels off at some point, then you should think about getting out. It will probably save you much heartache in the long-run. The “gut” simply represents your subconscious mind, which is constantly processing and storing information that you may not be aware of. The longer you trade, the more reliable your gut reaction will be, since it will have accumulated a vast knowledge base of charts and patterns over all those years. You’ve probably seen similar set-ups before but cannot remember them, and your gut feeling is your subconscious flashing warning signs. This information should not be taken lightly and good traders learn to trust their instincts.