MY FOREX TRADING BIBLE

Contents

What Is Forex?

If you've ever traveled to another country, you usually had to find a currency exchange booth at the airport, and then exchange the money you have in your wallet (if you're a dude) or purse (if you're a lady) or man purse (if you're a metrosexual) into the currency of the country you are visiting.

You go up to the counter and notice a screen displaying different exchange rates for different currencies. You find "Japanese yen" and think to yourself, "WOW! My one dollar is worth 100 yen?! And I have ten dollars! I'm going to be rich!!!" (This excitement is quickly killed when you stop by a shop in the airport afterwards to buy a can of soda and, all of a sudden, half your money is gone.)

When you do this, you've essentially participated in the forex market! You've exchanged one currency for another. Or in forex trading terms, assuming you're an American visiting Japan, you've sold dollars and bought yen.

Before you fly back home, you stop by the currency exchange booth to exchange the yen that you miraculously have left over (Tokyo is expensive!) and notice the exchange rates have changed. It's these changes in the exchanges rates that allow you to make money in the foreign exchange market.

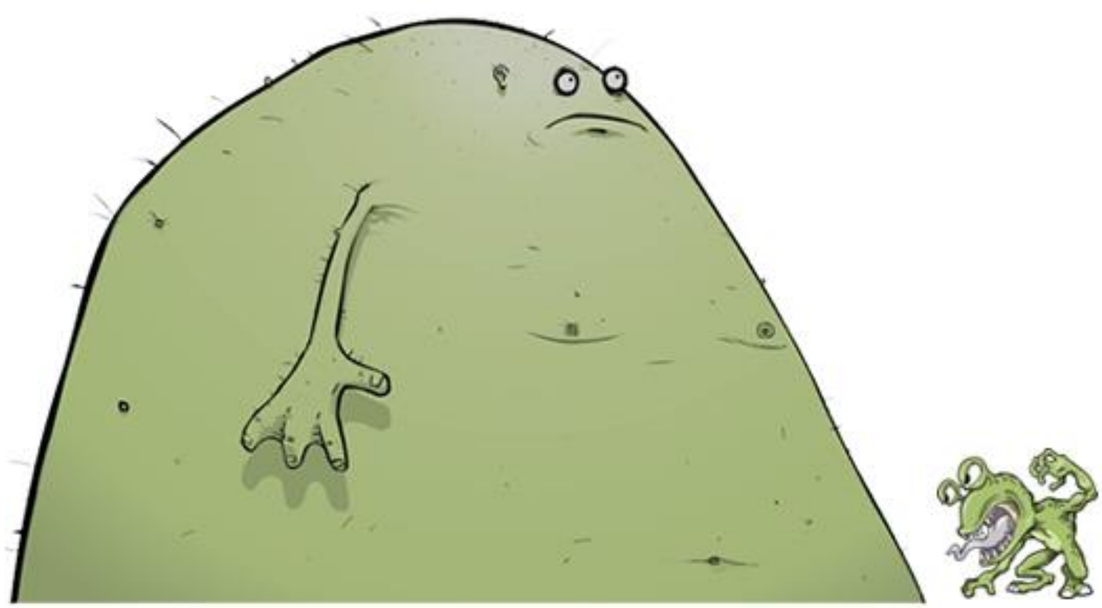
The foreign exchange market, which is usually known as "forex" or "FX," is the largest financial market in the world. Compared to the measly $22.4 billion a day volume of the New York Stock Exchange, the foreign exchange market looks absolutely ginormous with its **$5 TRILLION** a day trade volume. Forex rocks our socks!

Let's take a moment to put this into perspective using monsters…

The largest stock market in the world, the New York Stock Exchange (NYSE), trades a volume of about $22.4 billion each day. If we used a monster to represent NYSE, it would look like this…

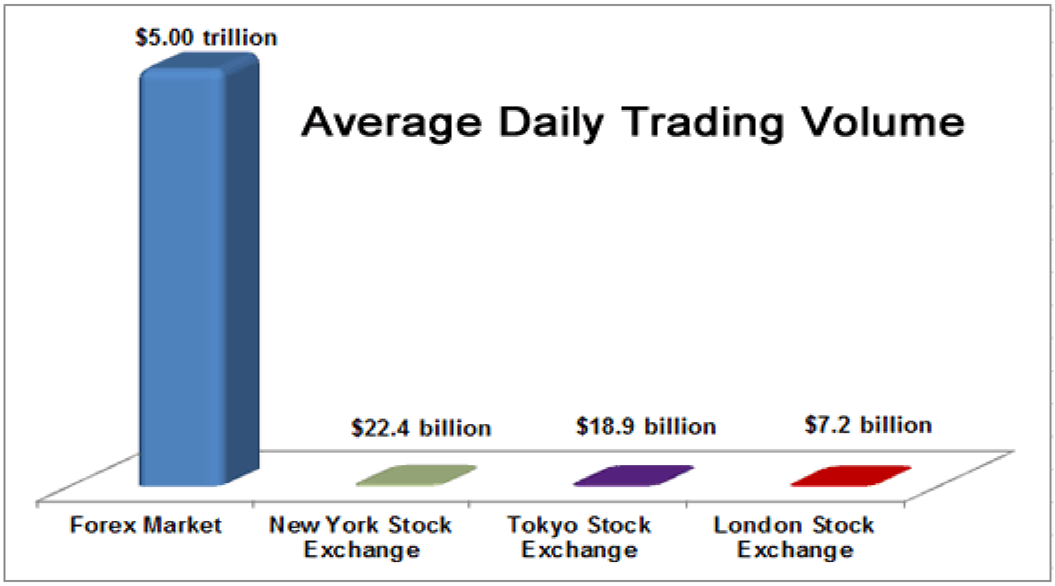
You hear about the NYSE in the news every day… on CNBC… on Bloomberg…on BBC… heck, you even probably hear about it at your local gym. "The NYSE is up today, blah, blah". When people talk about the "market", they usually mean the stock market. So the NYSE sounds big, it's loud and likes to make a lot of noise.

But if you actually compare it to the foreign exchange market, it would look like this…



Oooh, the NYSE looks so puny compared to forex! It doesn't stand a chance!

Check out the graph of the average daily trading volume for the forex market, New York Stock Exchange, Tokyo Stock Exchange, and London Stock Exchange:



The currency market is over 200 times BIGGER! It is HUGE! But hold your horses, there's a catch!

That huge $5 trillion number covers the entire global foreign exchange market, BUT retail traders (that's us) trade the spot market and that's about $1.49 trillion. So you see, the forex market is definitely huge, but not as huge as the media would like you to believe.

Do you feel like you already know what the forex market is all about? We're just getting started! In the next section we'll reveal WHAT exactly is traded in the forex market.

What Is Traded In Forex?

The simple answer is **MONEY**.

Because you're not buying anything physical, forex trading can be confusing.

Think of buying a currency as buying a share in a particular country, kinda like buying stocks of a company. The price of the currency is usually a direct reflection of the market's opinion on the current and future health of its respective economy.

In forex trading, when you buy, say, the Japanese yen, you are basically buying a "share" in the Japanese economy. You are *betting* that the Japanese economy is doing well, and will even get better as time goes. Once you sell those "shares" back to the market, hopefully, you will end up with a profit.

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

By the time you graduate from this School of Pipsology, you'll be eager to start working with currencies.

Major Currencies

Symbol	Country	Currency	Nickname
USD	United States	Dollar	Buck

EUR	Euro zone 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

Currency symbols always have 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.

Take NZD for instance. NZ stands for New Zealand, while D stands for dollar. Easy enough, right?

The currencies included in the chart above are called the "majors" because they are the most widely traded ones.

We'd also like to let you know that "buck" isn't the only nickname for USD.

There's also: greenbacks, bones, benjis, benjamins, cheddar, paper, loot, scrilla, cheese, bread, moolah, dead presidents, and cash money.

So, if you wanted to say, "I have to go to work now."

Instead, you could say, "Yo, I gotta bounce! Gotta make them benjis son!"

Or if you wanted to say, "I have lots of money. Let's go to the shopping mall in the evening."

Instead, why not say, "Yo, I gots mad scrilla! Let's go rock that mall later."

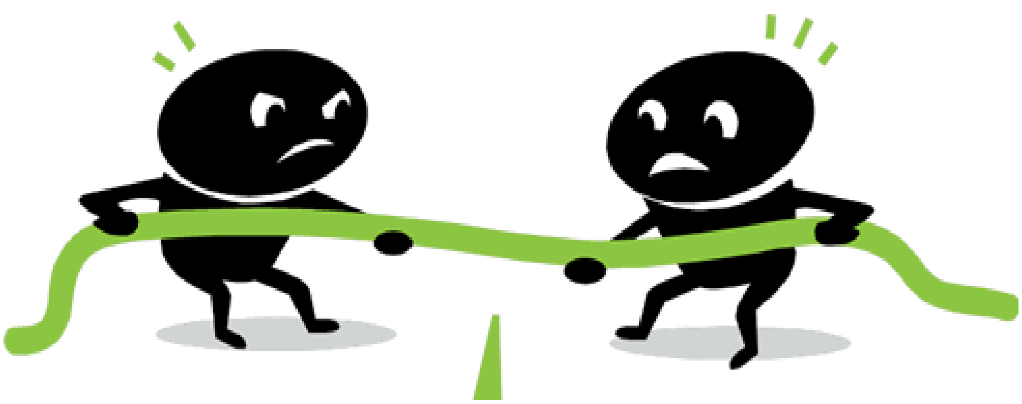
Did you also know that in Peru, a nickname for the U.S. dollar is Coco, which is a pet name for Jorge (George in Spanish), a reference to the portrait of George Washington on the $1 note?

They call me Coco yo!

Buying And Selling In Currency Pairs

Forex trading is the simultaneous buying of one currency and selling another. Currencies are traded through a broker or dealer, and are traded in pairs; for example the euro and the U.S. dollar (EUR/USD) or the British pound and the Japanese yen (GBP/JPY).

When you trade in the forex market, you buy or sell in currency pairs.



Imagine each currency pair constantly in a "tug of war" with each currency on its own side of the rope. Exchange rates fluctuate based on which currency is stronger at the moment.

Major Currency Pairs

The currency pairs listed below are considered the “majors”. These pairs all contain the U.S. dollar (USD) on one side and are the most frequently traded. The majors are the most liquid and widely traded currency pairs in the world.

Currency Pair	Countries	FX Geek Speak
EUR/USD	Euro zone / United States	“euro dollar”
USD/JPY	United States / Japan	“dollar yen”
GBP/USD	United Kingdom / United States	“pound dollar”
USD/CHF	United States/ Switzerland	“dollar swissy”
USD/CAD	United States / Canada	“dollar loonie”
AUD/USD	Australia / United States	“aussie dollar”
NZD/USD	New Zealand / United States	“kiwi dollar”

Major Cross-Currency Pairs or Minor Currency Pairs

Currency pairs that don’t contain the U.S. dollar (USD) are known as cross-currency pairs or simply as the “crosses.” Major crosses are also known as “minors.” The most actively traded crosses are derived from the three major non-USD currencies: EUR, JPY, and GBP.

Euro Crosses

Currency Pair	Countries	FX Geek Speak
EUR/CHF	Euro zone / Switzerland	“euro swissy”
EUR/GBP	Euro zone / United Kingdom	“euro pound”
EUR/CAD	Euro zone / Canada	“euro loonie”
EUR/AUD	Euro zone / Australia	“euro aussie”
EUR/NZD	Euro zone / New Zealand	“euro kiwi”

Yen Crosses

Currency Pair	Countries	FX Geek Speak
EUR/JPY	Euro zone / Japan	“euro yen” or “yuppy”
GBP/JPY	United Kingdom / Japan	“pound yen” or “guppy”
CHF/JPY	Switzerland / Japan	“swissy yen”
CAD/JPY	Canada / Japan	“loonie yen”
AUD/JPY	Australia / Japan	“aussie yen”
NZD/JPY	New Zealand / Japan	“kiwi yen”

Pound Crosses

Pair	Countries	FX Geek Speak
GBP/CHF	United Kingdom / Switzerland	“pound swissy”
GBP/AUD	United Kingdom / Australia	“pound aussie”
GBP/CAD	United Kingdom / Canada	“pound loonie”
GBP/NZD	United Kingdom / New Zealand	“pound kiwi”

Other Crosses

Pair	Countries	FX Geek Speak
AUD/CHF	Australia / Switzerland	“aussie swissy”
AUD/CAD	Australia / Canada	“aussie loonie”
AUD/NZD	Australia / New Zealand	“aussie kiwi”
CAD/CHF	Canada / Switzerland	“loonie swissy”
NZD/CHF	New Zealand / Switzerland	“kiwi swissy”
NZD/CAD	New Zealand / Canada	“kiwi loonie”

Exotic Currency Pairs

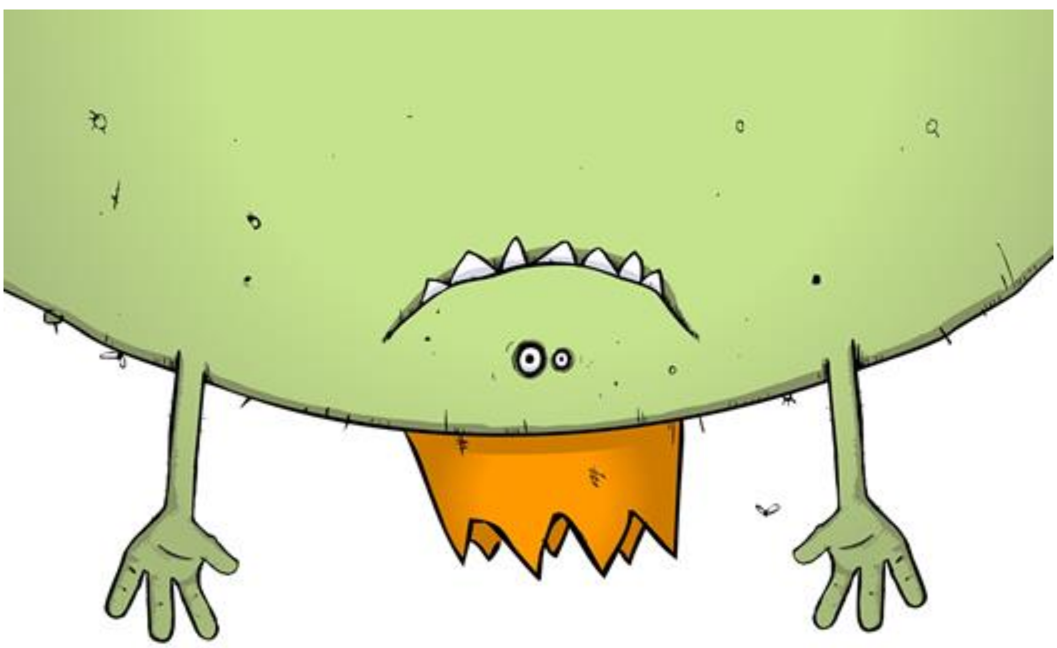
No, exotic pairs are not exotic belly dancers who happen to be twins. Exotic currency pairs are made up of one major currency paired with the currency of an emerging economy, such as Brazil, Mexico, or Hungary. The chart below contains a few examples of exotic currency pairs. Wanna take a shot at guessing what those other currency symbols stand for?

Depending on your forex broker, you may see the following exotic currency pairs so it's good to know what they are. Keep in mind that these pairs aren't as heavily traded as the "majors" or "crosses," so the transaction costs associated with trading these pairs are usually bigger.

Currency Pair	Countries	FX Geek Speak
USD/HKD	United States / Hong Kong	
USD/SGD	United States / Singapore	
USD/ZAR	United States / South Africa	"dollar rand"
USD/THB	United States / Thailand	"dollar baht"
USD/MXN	United States / Mexico	"dollar peso"
USD/DKK	United States / Denmark	"dollar krone"
USD/SEK	United States / Sweden	
USD/NOK	United States / Norway	

It isn't unusual to see spreads that are two or three times bigger than that of EUR/USD or USD/JPY. So if you want to trade exotics currency pairs, remember to factor this in your decision.

Market Size And Liquidity



Unlike other financial markets like the New York Stock Exchange, the forex 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.

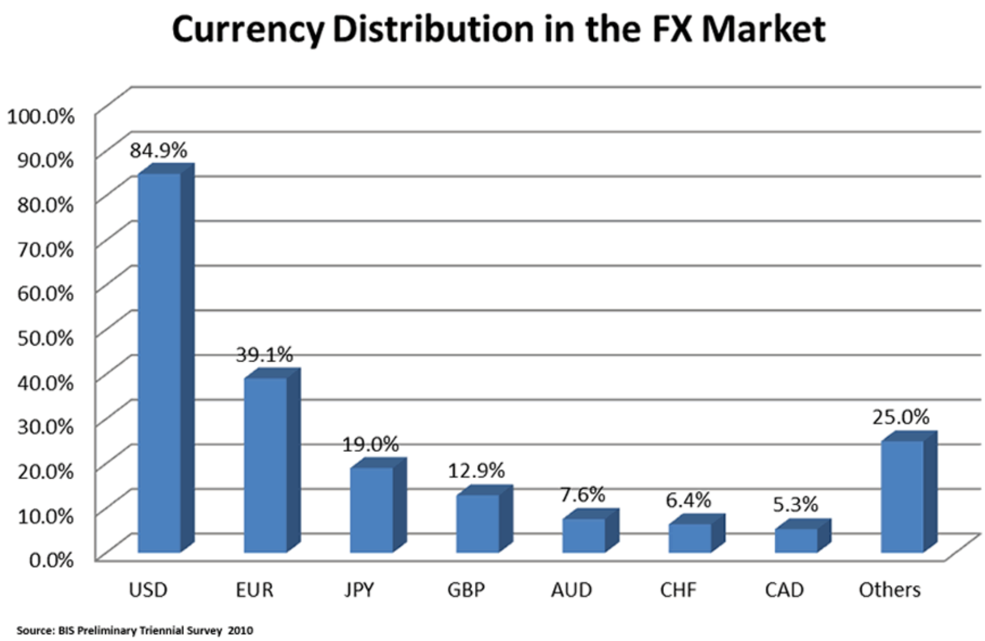
This means that the spot forex market is spread all over the globe with no central location. They can take place anywhere, even at the top of Mt. Fuji!

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 the ten most actively traded currencies.

The dollar is the most traded currency, taking up 84.9% of all transactions. The euro's share is second at 39.1%, while that of the yen is third at 19.0%. As you can see, most of the major currencies are hogging the top spots on this list!

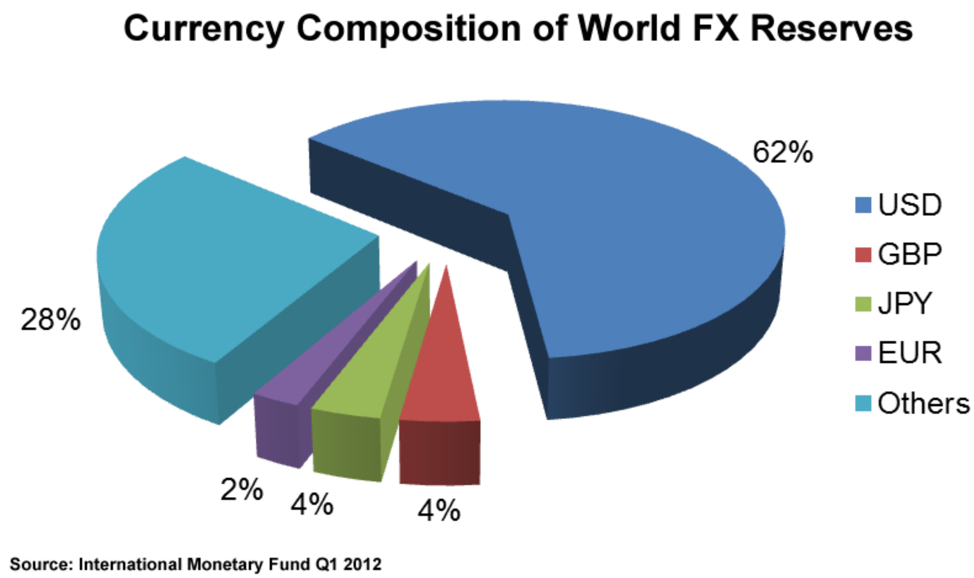


**Because two currencies are involved in each transaction, the sum of the percentage shares of individual currencies totals 200% instead of 100%*

The chart above shows just how often the U.S. dollar is traded in the forex market. It is on one side of a ridiculous 84.9% of all reported transactions!

The Dollar is King in the Forex Market

You've probably noticed how often we keep mentioning the U.S. dollar (USD). If the USD is one half of every major currency pair, and the majors comprise 75% of all trades, then it's a must to pay attention to the U.S. dollar. The USD is king!



In fact, according to the International Monetary Fund (IMF), the U.S. dollar comprises roughly 62% of the world's official foreign exchange reserves! Because almost every investor, business, and central bank own it, they pay attention to the U.S. dollar.

There are also other significant reasons why the U.S. dollar plays a central role in the forex market:

- The United States economy is the LARGEST economy in the world.
- The U.S. dollar is the reserve currency of the world.
- The United States has the largest and most liquid financial markets in the world.
- The United States has a super stable political system.

- The United States is the world's sole military superpower.
- The U.S. dollar is the medium of exchange for many cross-border transactions. For example, oil is priced in U.S. dollars. So if Mexico wants to buy oil from Saudi Arabia, it can only be bought with U.S. dollar. If Mexico doesn't have any dollars, it has to sell its pesos first and buy U.S. dollars.

Speculation in the Forex Market

One important thing to note about the forex market is that while commercial and financial transactions are part of trading volume, most currency trading is based on speculation.

In other words, most trading volume comes from traders that buy and sell based on intraday price movements.

The trading volume brought about by speculators is estimated to be more than 90%!

The scale of the forex market means that liquidity– the amount of buying and selling volume happening at any given time – is extremely high.

This makes it very easy for anyone to buy and sell currencies.

From the perspective of an investor, liquidity is very important because it determines how easily price can change over a given time period. A liquid market environment like forex enables huge trading volumes to happen with very little effect on price, or price action.

While the forex market is relatively very liquid, the market depth could change depending on the currency pair and time of day.

In our forex trading sessions part of the school, we'll tell you how the time of your trades can affect the pair you're trading.

In the meantime, here are a few tricks on how you can trade currencies in gazillion ways. We even narrowed it down to four!

Different Ways To Trade Forex

Because forex is so awesome, traders came up with a number of different ways to invest or speculate in currencies. Among these, the most popular ones are forex spot, futures, options, and exchange-traded funds (or ETFs).

Spot Market

In the spot market, currencies are traded immediately or "on the spot," using the current market price. What's awesome about this market is its simplicity, liquidity, tight spreads, and round-the-clock operations. It's very easy to participate in this market since accounts can be opened with as little as a $25! (Not that we suggest you do) – you'll learn why in our Capitalization lesson! Aside from that, most brokers usually provide charts, news, and research for free.

Futures

Futures are contracts to buy or sell a certain asset at a specified price on a future date (That's why they're called futures!). Forex futures were created by the Chicago Mercantile Exchange (CME) way back in 1972, when bell bottoms and platform boots were still in style. Since futures contracts are standardized and traded through a centralized exchange, the market is very transparent and well-regulated. This means that price and transaction information are readily available.

Options

An "option" is a financial instrument that gives the buyer the right or the option, but not the obligation, to buy or sell an asset at a specified price on the option's expiration date. If a trader "sold" an option, then he or she would be obliged to buy or sell an asset at a specific price at the expiration date. Just like futures, options are also traded on an exchange, such as the Chicago Board Options Exchange, the International Securities Exchange, or the Philadelphia Stock Exchange. However, the disadvantage in trading forex options is that market hours are limited for certain options and the liquidity is not nearly as great as the futures or spot market.

Exchange-traded Funds

Exchange-traded funds or ETFs are the youngest members of the forex world. An ETF could contain a set of stocks combined with some currencies, allowing the trader to diversify with different assets. These are created by financial institutions and can be traded like stocks through an exchange. Like forex options, the limitation in trading ETFs is that the market isn't open 24 hours. Also, since ETFs contain stocks, these are subject to trading commissions and other transaction costs.

Advantages Of Forex Trading

There are many benefits and advantages of trading forex. Here are just a few reasons why so many people are choosing this market:

No commissions

No clearing fees, no exchange fees, no government fees, no brokerage fees. Most retail brokers are compensated for their services through something called the "bid-ask spread".

No middlemen

Spot currency trading eliminates the middlemen and allows you to trade directly with the market responsible for the pricing on a particular currency pair.

No fixed lot size

In the futures markets, lot or contract sizes are determined by the exchanges. A standard-size contract for silver futures is 5,000 ounces. In spot forex, you determine your own lot, or position size. This allows traders to participate with accounts as small as $25 (although we'll explain later why a $25 account is a bad idea).

Low transaction costs

The retail transaction cost (the bid/ask spread) is typically less than 0.1% under normal market conditions. At larger dealers, the spread could be as low as 0.07%. Of course this depends on your leverage and all will be explained later.

A 24-hour market

There is no waiting for the opening bell. From the Monday morning opening in Australia to the afternoon close in New York, the forex market never sleeps. This is awesome for those who want to trade on a part-time basis, because you can choose when you want to trade: morning, noon, night, during breakfast, or in your sleep.

No one can corner the market

The foreign exchange market is so huge and has so many participants that no single entity (not even a central bank or the mighty Chuck Norris himself) can control the market price for an extended period of time.

Leverage

In forex trading, a small deposit can control a much larger total contract value. Leverage gives the trader the ability to make nice profits, and at the same time keep risk capital to a minimum.

For example, a forex broker may offer 50-to-1 leverage, which means that a $50 dollar margin deposit would enable a trader to buy or sell $2,500 worth of currencies. Similarly, with $500 dollars, one could trade with $25,000 dollars and so on. While this is all gravy, let's remember that leverage is a double-edged sword. Without proper risk management, this high degree of leverage can lead to large losses as well as gains.

High Liquidity.

Because the forex market is so enormous, it is also extremely liquid. This is an advantage because it means that under normal market conditions, with a click of a mouse you can instantaneously buy and sell at will as there will usually be someone in the market willing to take the other side of your trade. You are never "stuck" in a trade. You can even set your online trading platform to automatically close your position once your desired profit level (a limit order) has been reached, and/or close a trade if a trade is going against you (a stop loss order).

Low Barriers to Entry

You would think that getting started as a currency trader would cost a ton of money. The fact is, when compared to trading stocks, options or futures, it doesn't. Online forex brokers offer "mini" and "micro" trading accounts, some with a minimum account deposit of $25.

We're not saying you should open an account with the bare minimum, but it does make forex trading much more accessible to the average individual who doesn't have a lot of start-up trading capital.

Free Stuff Everywhere!

Most online forex brokers offer "demo" accounts to practice trading and build your skills, along with real-time forex news and charting services.

And guess what?! They're all free!

Demo accounts are very valuable resources for those who are "financially hampered" and would like to hone their trading skills with "play money" before opening a live trading account and risking real money.

Now that you know the advantages of the forex market, see how it compares with the stock market!

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Forex vs. Stocks

There are approximately 4,500 stocks listed on the New York Stock exchange. Another 3,500 are listed on the NASDAQ. Which one will you trade? Got the time to stay on top of so many companies?

In spot currency trading, there are dozens of currencies traded, but the majority of market players trade the four major pairs. Aren't four pairs much easier to keep an eye on than thousands of stocks?

Look at Mr. Forex. He's so confident and sexy. Mr. Stocks has no chance!

That's just one of the many advantages of the forex market over the stock markets. Here are a few more:

24-Hour Market

The forex market is a seamless 24-hour market. Most brokers are open from Sunday at 4:00 pm EST until Friday at 4:00 pm EST, with customer service usually available 24/7. With the ability to trade during the U.S., Asian, and European market hours, you can customize your own trading schedule.

Minimal or No Commissions

Most forex brokers charge no commission or additional transactions fees to trade currencies online or over the phone. Combined with the tight, consistent, and fully transparent spread, forex trading costs are lower than those of any other market. Most brokers are compensated for their services through the bid/ask spread.

Instant Execution of Market Orders

Your trades are instantly executed under normal market conditions. Under these conditions, usually the price shown when you execute your market order is the price you get. You're able to execute directly off real-time streaming prices (Oh yeeeaah! Big time!).

Keep in mind that many brokers only guarantee stop, limit, and entry orders under normal market conditions. Trading during a massive alien invasion from outer space would not fall under "normal market" conditions. Fills are instantaneous most of the time, but under extraordinarily volatile market conditions, like during Martian attacks, order execution may experience delays.

Short-Selling without an Uptick

Unlike the equity market, there is no restriction on short selling in the currency market. Trading opportunities exist in the currency market regardless of whether a trader is long or short, or whichever way the market is moving. Since currency trading always involves buying one currency and selling another, there is no structural bias to the market. So you always have equal access to trade in a rising or falling market.

No Middlemen

Centralized exchanges provide many advantages to the trader. However, one of the problems with any centralized exchange is the involvement of middlemen. Any party located in between the trader and the buyer or seller of the security or instrument traded will cost them money. The cost can be either in time or in fees.

Spot currency trading, on the other hand, is decentralized, which means quotes can vary from different currency dealers. Competition between them is so fierce that you are almost always assured that you get the best deals. Forex traders get quicker access and cheaper costs.

Buy/Sell programs do not control the market.

How many times have you heard that “Fund A” was selling “X” or buying “Z”? The stock market is very susceptible to large fund buying and selling.

In spot trading, the massive size of the forex market makes the likelihood of any one fund or bank controlling a particular currency very small. Banks, hedge funds, governments, retail currency conversion houses, and large net worth individuals are just some of the participants in the spot currency markets where the liquidity is unprecedented.

Analysts and brokerage firms are less likely to influence the market

Have you watched TV lately? Heard about a certain Internet stock and an analyst of a prestigious brokerage firm accused of keeping its recommendations, such as “buy,” when the stock was rapidly declining? It is the nature of these relationships. No matter what the government does to step in and discourage this type of activity, we have not heard the last of it.

IPOs are big business for both the companies going public and the brokerage houses. Relationships are mutually beneficial and analysts work for the brokerage houses that need the companies as clients. That catch-22 will never disappear.

Foreign exchange, as the prime market, generates billions in revenue for the world’s banks and is a necessity of the global markets. Analysts in foreign exchange have very little effect on exchange rates; they just analyze the forex market.

Advantages	Forex	Stocks
24-Hour Trading	YES	No
Minimal or no Commission	YES	No
Instant Execution of Market Orders	YES	No
Short-selling without an Uptick	YES	No
No Middlemen	YES	No
No Market Manipulation	YES	No

In the battle between forex vs. stocks, it looks like the scorecard between Mr. Forex and Mr. Stocks shows a strong victory by Mr. Forex! Will it go for 2-0 with Mr. Futures?

Forex vs. Futures

The forex market also boasts of a bunch of advantages over the futures market, similar to its advantages over stocks. But wait, there's more… So much more!

"Hey Mr. Futures, don't our short shorts look cool?"

Liquidity

In the forex market, $4 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 trades a puny $30 billion per day. Thirty billion? Peanuts!

The futures markets can't compete with its relatively limited liquidity. The forex market is always liquid, meaning positions can be liquidated and stop orders executed with little or no slippage except in extremely volatile market conditions.

24-Hour Market

At 5:00 pm EST Sunday, trading begins as markets open in Sydney. At 7:00 pm EST the Tokyo market opens, followed by London at 3:00 am EST. And finally, New York opens at 8:00 am EST and closes at 4:00 p.m. EST. Before New York trading closes, the Sydney market is 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 the United Kingdom 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.)

Minimal or no commissions

With Electronic Communications Brokers becoming more popular and prevalent over the past couple of years, there is the chance that a broker may require you to pay commissions. But really, the commission fees are peanuts compared to what you pay in the futures market. The competition among brokers is so fierce that you will most likely get the best quotes and very low transaction costs.

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 forex 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.

During normal market conditions, all open positions will be closed immediately (during fast market conditions, your position could be closed beyond your stop loss level).

In the futures market, your position may be liquidated at a loss bigger than what you had in your account, and you will be liable for any resulting deficit in the account. That sucks.

Advantages	Forex	Futures
24-Hour Trading	YES	No
Minimal or no Commission	YES	No
Up to 500:1 Leverage	YES	No
Price Certainty	YES	No
Guaranteed Limited Risk	YES	No

Judging by the Forex vs. Futures Scorecard, Mr. Forex looks **UNBEATABLE**! Now meet the winners who trade the forex market.

Forex Market Structure

For the sake of comparison, let us first examine a market that you are probably very familiar with: the stock market. This is how the structure of the stock market looks like:

"I have no choice but to go through a centralized exchange!"

By its very nature, the stock market tends to be very monopolistic. There is only one entity, one specialist that controls prices. All trades must go through this specialist. Because of this, prices can easily be altered to benefit the specialist, and not traders.

How does this happen?

In the stock market, the specialist is forced to fulfill the order of its clients. Now, let's say the number of sellers suddenly exceed the number of buyers. The specialist, which is forced to fulfill the order of its clients, the sellers in this case, is left with a bunch of stock that he cannot sell-off to the buyer side.

In order to prevent this from happening, the specialist will simply widen the spread or increase the transaction cost to prevent sellers from entering the market. In other words, the specialists can manipulate the quotes it is offering to accommodate its needs.

Trading Spot FX is Decentralized

Unlike in trading stocks or futures, you don't need to go through a centralized exchange like the New York Stock Exchange with just one price. In the forex market, there is no single price that for a given currency at any time, which means quotes from different currency dealers vary.

"So many choices! Awesome!"

This might be overwhelming at first, but this is what makes the forex market so freakin' awesome! The market is so huge and the competition between dealers is so fierce that you get the best deal almost every single time. And tell me, who does not want that?

Also, one cool thing about forex trading is that you can do it anywhere. It's just like trading baseball cards. You want that mint condition Mickey Mantle rookie card, so it is up to you to find the best deal out there. Your colleague might give up his Mickey Mantle card for just a Babe Ruth card, but your best friend will only part with his Mickey Mantle rookie card for your soul.

The FX Ladder

Even though the forex market is decentralized, it isn't pure and utter chaos! The participants in the FX market can be organized into a ladder. To better understand what we mean, here is a neat illustration:

At the very top of the forex market ladder is the interbank market. Composed of the largest banks of the world and some smaller banks, the participants of this market trade directly with each other or electronically through the Electronic Brokering Services (EBS) or the Reuters Dealing 300-Spot Matching.

The competition between the two companies – the EBS and the Reuters Dealing 3000-Spot Matching – is similar to Coke and Pepsi. They are in constant battle for clients and continually try to one-up each other for market share. While both companies offer most currency pairs, some currency pairs are more liquid on one than the other.

For the EBS plaform, EUR/USD, USD/JPY, EUR/JPY, EUR/CHF, and USD/CHF are more liquid. Meanwhile, for the Reuters platform, GBP/USD, EUR/GBP, USD/CAD, AUD/USD, and NZD/USD are more liquid.

All the banks that are part of the interbank market can see the rates that each other is offering, but this doesn't necessarily mean that anyone can make deals at those prices.

Like in real life, the rates will be largely dependent on the established **CREDIT** relationship between the trading parties. Just to name a few, there's the "B.F.F. rate," the "customer rate," and the "ex-wife-you-took-everything rate." It's like asking for a loan at your local bank. The better your credit standing and reputation with them, the better the interest rates and the larger loan you can avail.

Next on the ladder are the hedge funds, corporations, retail market makers, and retail ECNs. Since these institutions do not have tight credit relationships with the participants of the interbank market, they have to do their transactions via commercial banks. This means that their rates are slightly higher and more expensive than those who are part of the interbank market.

At the very bottom of the ladder are the retail traders. It used to be very hard for us little people to engage in the forex market but, thanks to the advent of the internet, electronic trading, and retail brokers, the difficult barriers to entry in forex trading have all been taken down. This gave us the chance to play with those high up the ladder and poke them with a very long and cheap stick.

Now that you know the forex market structure, let's get to know them forex market playaz!

Forex Market Players

Now that you know the overall structure of the forex market, let's delve in a little deeper to find out who exactly these people in the ladder are. It is essential for you that you understand the nature of the spot forex market and who are the main forex market players.

Until the late 1990s, only the "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 "little guys." However, because of the rise of the internet, online forex brokers are now able to offer trading accounts to "retail" traders like us.

Without further ado, here are the major forex market players:

1. The Super Banks

Since the forex spot market is decentralized, it is the largest banks in the world that determine the exchange rates. Based on the supply and demand for currencies, they are generally the ones that make the bid/ask spread that we all love (or hate, for that matter).

These large banks, collectively known as the interbank market, take on a ridonkulous amount of forex transactions each day for both their customers and themselves. A couple of these super banks include UBS, Barclays Capital, Deutsche Bank, and Citigroup. You could say that the interbank market is THE foreign exchange market.

2. Large Commercial Companies

Companies take part in the foreign exchange market for the purpose of doing business. For instance, Apple must first exchange its U.S. dollars for the Japanese yen when purchasing electronic parts from Japan for their products. Since the volume they trade is much smaller than those in the interbank market, this type of market player typically deals with commercial banks for their transactions.

Mergers and acquisitions (M&A) between large companies can also create currency exchange rate fluctuations. In international cross-border M&As, a lot of currency conversations happens that could move prices around.

3. Governments and Central Banks

Governments and central banks, such as the European Central Bank, the Bank of England, and the Federal Reserve, are regularly involved in the forex market too. Just like companies, national governments participate in the forex market for their operations, international trade payments, and handling their foreign exchange reserves.

Meanwhile, central banks affect the forex market when they adjust interest rates to control inflation. By doing this, they can affect currency valuation. There are also instances when central banks intervene, either directly or verbally, in the forex market when they want to realign exchange rates. Sometimes, central banks think that their currency is priced too high or too low, so they start massive sell/buy operations to alter exchange rates.

4. The Speculators

"In it to win it!"

This is probably the mantra of the speculators. Comprising close to 90% of all trading volume, speculators as forex market players come in all shapes and sizes. Some have fat pockets, some roll thin, but all of them engage in the forex simply to make bucket loads of cash.

Don't worry… Once you graduate from the Forex Trading Bible, you can be part of this cool crowd! Of course, how can you be one of the cool cats if you don't even know your forex history?

Know Your Forex History!

At the end of the World War II, the whole world was experiencing so much chaos that the major Western governments felt the need to create a system to stabilize the global economy.

Known as the "Bretton Woods System," the agreement set the exchange rate of all currencies against gold. This stabilized exchange rates for a while, but as the major economies of the world started to change and grow at different speeds, the rules of the system soon became obsolete and limiting.

Soon enough, come 1971, the Bretton Woods Agreement was abolished and replaced by a different currency valuation system. With the United States in the pilot's seat, the currency market evolved to a free-floating one, where exchange rates were determined by supply and demand.

At first, it was difficult to determine fair exchange rates, but advances in technology and communication eventually made things easier.

Once the 1990s came along, thanks to computer nerds and the booming growth of the internet (cheers to you Mr. Al Gore), banks began creating their own trading platforms. These platforms were designed to stream live quotes to their clients so that they could instantly execute trades themselves.

Meanwhile, some smart business-minded marketing machines introduced internet-based trading platforms for individual traders.

Known as “retail forex brokers”, these entities made it easy for individuals to trade by allowing smaller trade sizes. Unlike in the interbank market where the standard trade size is one million units, retail brokers allowed individuals to trade as little as 1000 units!

Retail Forex Brokers

In the past, only the big speculators and highly capitalized investment funds could trade currencies, but thanks to retail forex brokers and the Internet, this isn’t the case anymore.

With hardly any barriers to entry, anybody could just contact a broker, open up an account, deposit some money, and trade forex from the comfort of their own home. Brokers basically come in two forms:

1. Market makers, as their name suggests, “make” or set their own bid and ask prices themselves and
2. Electronic Communications Networks (ECN), who use the best bid and ask prices available to them from different institutions on the interbank market.

Market Makers

Let’s say you wanted to go to France to eat some snails. In order for you to transact in the country, you need to get your hands on some euros first by going to a bank or the local foreign currency exchange office. For them to take the opposite side of your transaction, you have to agree to exchange your home currency for euros at the price they set.

Like in all business transactions, there is a catch. In this case, it comes in the form of the bid/ask spread.

For instance, if the bank’s buying price (bid) for EUR/USD is 1.2000, and their selling price (ask) is 1.2002, then the bid/ask spread is 0.0002. Although seemingly small, when you’re talking about millions of these forex transactions every day, it does add up to create a hefty profit for the market makers!

You could say that market makers are the fundamental building blocks of the foreign exchange market. Retail market makers basically provide liquidity by “repackaging” large contract sizes from wholesalers into bite size pieces. Without them, it will be very hard for the average Joe to trade forex.

Electronic Communications Network

Electronic Communication Network is the name given for trading platforms that automatically match customer's buy and sell orders at stated prices. These stated prices are gathered from different market makers, banks, and even other traders who use the ECN. Whenever a certain sell or buy order is made, it is matched up to the best bid/ask price out there.

Due to the ability of traders to set their own prices, ECN brokers typically charge a VERY small commission for the trades you take. The combination of tight spreads and small commission usually make transaction costs cheaper on ECN brokers.

Of course, it's not enough to know the big guys in the biz. As Big Pippin once said, "Trading requires timing." Do you know WHEN you should trade?

Forex Trading Sessions

Now that you know **what** forex is, **why** you should trade it, and **who** makes up the forex market, it's about time you learned **when** you can trade.

It's time to lean about the different forex trading sessions.

Yes, it is true that the forex market is open 24 hours a day, but that doesn't mean it's always active the whole day.

You can make money trading when the market moves up, and you can even make money when the market moves down.

BUT you will have a very difficult time trying to make money when the market doesn't move at all.

And believe us, there will be times when the market is as still as the victims of Medusa. This lesson will help determine when the best times of the day are to trade.

Forex Market Hours

Before looking at the best times to trade, we must look at what a 24-hour day in the forex world looks like.

The forex market can be broken up into four major trading sessions: the Sydney session, the Tokyo session, the London session, and Pipcrawler's favorite time to trade, the New York session. Below are tables of the open and close times for each session:

Summer (approx. April – October)

Time Zone	EDT	GMT
Sydney Open	6:00 PM	10:00 PM

Sydney Close	3:00 AM	7:00 AM
Tokyo Open	7:00 PM	11:00 PM
Tokyo Close	4:00 AM	8:00 AM
London Open	3:00 AM	7:00 AM
London Close	12:00 PM	4:00 PM
New York Open	8:00 AM	12:00 PM
New York Close	5:00 PM	9:00 PM

Winter (approx. October – April)

Time Zone	EST	GMT
Sydney Open	4:00 PM	9:00 PM
Sydney Close	1:00 AM	6:00 AM
Tokyo Open	6:00 PM	11:00 PM
Tokyo Close	3:00 AM	8:00 AM
London Open	3:00 AM	8:00 AM
London Close	12:00 PM	5:00 PM
New York Open	8:00 AM	1:00 PM
New York Close	5:00 PM	10:00 PM

Actual open and close times are based on local business hours. This varies during the months of October and April as some countries shift to/from daylight savings time (DST). The day within each month that a country may shift to/from DST also varies.

You can see that in between each forex trading session, there is a period of time where two sessions are open at the same time. During the summer, from 3:00-4:00 am EDT, the Tokyo session and London session overlap, and during both summer and winter from 8:00 am-12:00 pm ET, the London session and the New York session overlap.

Naturally, these are the busiest times during the trading day because there is more volume when two markets are open at the same time. This makes sense because during those times, all the market participants are wheelin' and dealin', which means that more money is transferring hands.

Now, you're probably looking at the Sydney open and thinking why it shifts two hours. You'd think that Sydney's open would only move one hour when the U.S. adjusts for standard time, but remember that when the U.S. shifts one hour back, Sydney actually moves forward by one hour (seasons are opposite in Australia). You should always remember this if you ever plan to trade during that time period.

Let's take a look at the average pip movement of the major currency pairs during each forex trading session.

Pair	Tokyo	London	New York
EUR/USD	76	**114**	92
GBP/USD	92	**127**	99
USD/JPY	51	**66**	59
AUD/USD	77	**83**	81
NZD/USD	62	**72**	70
USD/CAD	57	**96**	96
USD/CHF	67	**102**	83
EUR/JPY	102	**129**	107
GBP/JPY	118	**151**	132
AUD/JPY	98	**107**	103
EUR/GBP	78	**61**	47
EUR/CHF	79	**109**	84

From the table, you will see that the European session normally provides the most movement.

Let's take a more in-depth look at each of the session, as well as those periods when the sessions overlap.

Tokyo Session

The opening of the Tokyo session at 12:00 AM GMT marks the start of the Asian session. You should take note that the Tokyo session is sometimes referred to as the Asian session because Tokyo is the financial capital of Asia.

One thing worth noting is that Japan is the third largest forex trading center in the world.

This shouldn't be too surprising since the yen is the third most traded currency, partaking in 16.50% of all forex transactions. Overall, about 21% of all forex transactions take place during this session.

Below is a table of the Asian session pip ranges of the major currency pairs.

Pair	Tokyo

EUR/USD	56
GBP/USD	54
USD/JPY	30
AUD/USD	65
NZD/USD	58
USD/CAD	39
USD/CHF	40
EUR/JPY	57
GBP/JPY	72
AUD/JPY	65
EUR/GBP	23
EUR/CHF	–

These pip values were calculated using averages of past data from the month of May 2012. Take note that these are **NOT ABSOLUTE VALUES** and can vary depending on liquidity and other market conditions. Also, the session range for EUR/CHF has not been included since the Swiss franc has been pegged to the euro at 1.2000 during the period.

Here some key characteristics that you should know about the Tokyo session:

- Action isn't only limited to Japanese shores. Tons of forex transactions are made in other financial hot spots like Hong Kong, Singapore, and Sydney.
- The main market participants during the Tokyo session are commercial companies (exporters) and central banks. Remember, Japan's economy is heavily export dependent and, with China also being a major trade player, there are a lot of transactions taking place on a daily basis.
- Liquidity can sometimes be very thin. There will be times when trading during this period will be like fishing – you might have to wait a long, long time before getting a nibble.
- It is more likely that you will see stronger moves in Asia Pacific currency pairs like AUD/USD and NZD/USD as opposed to non-Asia Pacific pairs like GBP/USD.
- During those times of thin liquidity, most pairs may stick within a range. This provides opportunities for short day trades or potential breakout trades later in the day.
- Most of the action takes place early in the session, when more economic data is released.
- Moves in the Tokyo session could set the tone for the rest of the day. Traders in latter sessions will look at what happened during the Tokyo session to help organize and evaluate what strategies to take in other sessions.
- Typically, after big moves in the preceding New York session, you may see consolidation during the Tokyo session.

Which Pairs Should You Trade?

Since the Tokyo session is when news from Australia, New Zealand, and Japan comes out, this presents a good opportunity to trade news events. Also, there could be more movement in yen pairs as a lot of yen is changing hands as Japanese companies are conducting business.

Take note that China is also an economic superpower, so whenever news comes out from China, it tends to create volatile moves. With Australia and Japan relying heavily on Chinese demand, we could see greater movement in AUD and JPY pairs when Chinese data comes in.

Now let's check out how you can trade the London session.

London Session

Just when Asian market participants are starting to close shop, their European counterparts are just beginning their day.

While there are several financial centers all around Europe, it is London that market participants keep their eyes on.

Historically, London has always been at a center of trade, thanks to its strategic location. It's no wonder that it is considered the forex capital of the world with thousands of businessmen making transactions every single minute. About 30% of all forex transactions happen during the London session.

Below is a table of the London session pip ranges of the major currency pairs.

Pair	London
EUR/USD	83
GBP/USD	82
USD/JPY	36
AUD/USD	60
NZD/USD	64
USD/CAD	66
USD/CHF	58
EUR/JPY	80
GBP/JPY	102
AUD/JPY	86
EUR/GBP	40
EUR/CHF	–

These pip values were calculated using averages of past data from the month of May 2012. Take note that these are **NOT ABSOLUTE VALUES** and can vary depending on liquidity and other market conditions.

Also, the session range for EUR/CHF has not been included since the Swiss franc has been pegged to the euro at 1.2000 during the period.

Here are some neat facts about European session:

- Because the London session crosses with the two other major trading sessions–and with London being such a key financial center–a large chunk of forex transactions take place during this time. This leads to high liquidity and potentially lower transaction costs, i.e., lower pip spreads.
- Due to the large amount of transactions that take place, the London trading session is normally the most volatile session.
- Most trends begin during the London session, and they typically will continue until the beginning of the New York session.
- Volatility tends to die down in the middle of the session, as traders often go off to eat lunch before waiting for the New York trading period to begin.
- Trends can sometimes reverse at the end of the London session, as European traders may decide to lock in profits.

Which Pairs Should You Trade?

Because of the volume of transactions that take place, there is so much liquidity during the European session that almost any pair can be traded.

Of course, it may be best to stick with the majors (EUR/USD, GBP/USD, USD/JPY, and USD/CHF), as these normally have the tightest spreads.

Also, it is these pairs that are normally directly influenced by any news reports that come out during the European session.

You can also try the yen crosses (more specifically, EUR/JPY and GBP/JPY), as these tend to be pretty volatile at this time. Because these are cross pairs, the spreads might be a little wider though.

Next up, we have the New York session, a jungle where dreams are made of. Hey, isn't that an Alicia Keys song?

New York Session

Right as European traders are getting back from their lunch breaks, the U.S. session begins at 8:00 am EST as traders start rolling into the office. Just like Asia and Europe, the U.S. session has one major financial center that the markets keep their eyes on. We're talking of course, about the "City That Never Sleeps" – New York City baby! The concrete jungle where dreams are made of!

Below is a table of the New York session pip ranges of the major currency pairs.

Pair	New York

EUR/USD	77
GBP/USD	68
USD/JPY	34
AUD/USD	68
NZD/USD	62
USD/CAD	67
USD/CHF	56
EUR/JPY	72
GBP/JPY	77
AUD/JPY	71
EUR/GBP	36
EUR/CHF	–

These pip values were calculated using averages of past data from the month of May 2012. Take note that these are **NOT ABSOLUTE VALUES** and can vary depending on liquidity and other market conditions. Also, the session range for EUR/CHF has not been included since the Swiss franc has been pegged to the euro at 1.2000 during the period.

Here are some tips you should know about trading during the New York session:

- There is high liquidity during the morning, as it overlaps with the European session.
- Most economic reports are released near the start of the New York session. Remember, about 85% of all trades involve the dollar, so whenever big time U.S. economic data is released, it has the potential to move the markets.
- Once European markets close shop, liquidity and volatility tends to die down during the afternoon U.S. session.
- There is very little movement Friday afternoon, as Asian traders are out singing in karaoke bars while European traders head off to the pub to watch the soccer match.
- Also on Fridays, there is the chance of reversals in the second half of the session, as U.S. traders close their positions ahead of the weekend, in order to limit exposure to any weekend news.

Which Pairs Should You Trade?

Take note that there will be a ton of liquidity as both the U.S. and European markets will be open at the same time. You can bet that banks and multinational companies are burning up the telephone wires. This allows you to trade virtually any pair, although it would be best if you stuck to the major and minor pairs and avoid those weird ones.

Also, because the U.S. dollar is on the other side of the majority of transactions, everybody will be paying attention to U.S. data that is released. Should these reports come in better or worse than expected, it could dramatically shake up the markets, as the dollar will be jumping up and down.

Confused on which sessions start when? We made the next section just for you!

Best Times of Day to Trade Forex

Quick pop quiz! What time of the day are TV ratings highest? If you said during prime time, then you would be correct!

What does this have to do with trading sessions? Well, just like TV, “ratings” (a.k.a. liquidity) are at their highest when there are more people participating in the markets.

Logically, you would think that this happens during the overlap between two sessions. If you thought that way, you’d only be half right. Let’s discuss some of the characteristics of the two overlap sessions to see why.

Tokyo – London Overlap

Liquidity during this session is pretty thin for a few reasons. Typically, there isn’t as much movement during the Asian session so, once the afternoon hits, it’s pretty much a snooze fest. With European traders just starting to get into their offices, trading can be boring as liquidity dries up.

This would be an ideal time to take a chill pill, play some putt-putt or look for potential trades to take for the London and New York sessions.

London – New York Overlap

This is when the real shebang begins! You can literally hear traders crack their knuckles during this time, because they know they have their work cut out for them. This is the busiest time of day, as traders from the two largest financial centers (London and New York) begin duking it out.

It is during this period where we can see some big moves, especially when news reports from the U.S. and Canada are released. The markets can also be hit by "late" news coming out of Europe.

If any trends were established during the European session, we could see the trend continue, as U.S. traders decide to jump in and establish their positions after reading up what happened earlier in the day. You should watch out though, at the end of this session, as some European traders may be closing their positions, which could lead to some choppy moves right before lunch time in the U.S.

Best Days of the Week to Trade Forex

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. Know the best days of the week to trade forex.

Below is a chart of average pip range for the major pairs for each day of the week:

Pair	Sunday	Monday	Tuesday	Wednesday	Thursday	Friday
EUR/USD	69	109	142	136	145	144
GBP/USD	73	149	172	152	169	179
USD/JPY	41	65	82	91	124	98
AUD/USD	58	84	114	99	115	111
NZD/USD	28	81	98	87	100	96
USD/CAD	43	93	112	106	120	125
USD/CHF	55	84	119	107	104	116
EUR/JPY	19	133	178	159	223	192
GBP/JPY	100	169	213	179	270	232
EUR/GBP	35	74	81	79	75	91
EUR/CHF	35	55	55	64	87	76

As you can see from the chart above, it would probably be best to trade during the middle of the week, since this is when the most action happens.

Fridays are usually busy until 12:00 pm EST and then the market pretty much drops dead until it closes at 5:00 pm EST. This means we only work half-days on Fridays.

The weekend always starts early! Yippee!

So based on all these, we've learned when the busiest and best days of the week to trade forex are. The busiest times are the best times to trade because they give you a higher chance of success.

Managing Yo Time Wisely

Unless you're Edward Cullen, who does not sleep, there is no way you can trade all sessions. Even if you could, why would you? While the forex market is open 24 hours daily, it doesn't mean that action happens all the time!

Besides, sleep is an integral part of a healthy lifestyle!

You need sleep to recharge and have energy so that you can do even the most mundane tasks like mowing the lawn, talking to your spouse, taking the dog for a walk, or organizing your stamp collection. You'll definitely need your rest if you plan on becoming a hotshot trader.

Each trader should learn when to trade.

Actually, scratch that.

Each trader should know when to trade and when **NOT** to trade.

Knowing the optimal times you should trade and the times when you should sit out and just play some Plants vs. Zombies can help save you a pound of moolah (pun intended).

Here's a quick cheat sheet of the best and worst times to trade:

Best Times to Trade:

- When two sessions are overlapping of course! These are also the times where major news events come out to potentially spark some volatility and directional movements. Make sure you bookmark the Market Hours cheat sheet to take note of the Opening and Closing times.
- The European session tends to be the busiest out of the three.
- The middle of the week typically shows the most movement, as the pip range widens for most of the major currency pairs.

Worst Times to Trade:

- Sundays – everyone is sleeping or enjoying their weekend!
- Fridays – liquidity dies down during the latter part of the U.S. session.
- Holidays – everybody is taking a break.
- Major news events – you don't want to get whipsawed!
- During American Idol, the NBA Finals, or the Superbowl.

Can't seem to trade during the optimal sessions? Don't fret. You can always be a swing or position trader. We'll get back to that later. Meanwhile, let's move on to how you actually make money in Forex. Excited? You should be!

How to Make Money Trading Forex

 In the forex market, you buy or sell currencies.

Placing a trade in the foreign exchange market is simple: the mechanics of a trade are very similar to those found in other markets (like the stock market), so if you have any experience in trading, you should be able to pick it up pretty quickly.

The object of forex trading is to exchange one currency for another in the expectation that the price will change, so that the currency you bought will increase in value compared to the one you sold.

Example:

Trader's Action	**EUR**	**USD**
You purchase 10,000 euros at the EUR/USD exchange rate of **1.1800**	+10,000	-11,800*
Two weeks later, you exchange your 10,000 euros back into U.S. dollar at the exchange rate of **1.2500**	-10,000	+12,500**
You earn a profit of **$700**	0	+700

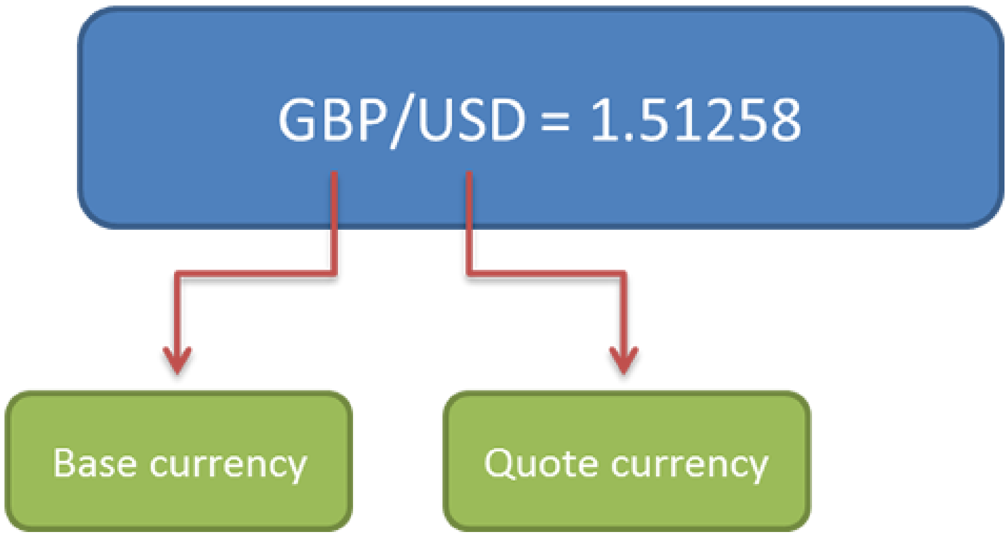
*EUR 10,000 x 1.18 = US $11,800

** EUR 10,000 x 1.25 = US $12,500

An exchange rate is simply the ratio of one currency valued against another currency. For example, the USD/CHF exchange rate indicates how many U.S. dollars can purchase one Swiss franc, or how many Swiss francs you need to buy one U.S. dollar.

How to Read a Forex Quote

Currencies are always quoted in pairs, such as GBP/USD or USD/JPY. The reason they are quoted in pairs is because in every foreign exchange transaction, you are simultaneously buying one currency and selling another. Here is an example of a foreign exchange rate for the British pound versus the U.S. dollar:



The first listed currency to the left of the slash ("/") is known as the **base currency** (in this example, the British pound), while the second one on the right is called the **counter or quote currency** (in this example, the U.S. dollar).

When buying, the exchange rate tells you how much you have to pay in units of the quote currency to buy one unit of the base currency. In the example above, you have to pay 1.51258 U.S. dollars to buy 1 British pound.

When selling, the exchange rate tells you how many units of the quote currency you get for selling one unit of the base currency. In the example above, you will receive 1.51258 U.S. dollars when you sell 1 British pound.

The base currency is the "basis" for the buy or the sell. If you buy EUR/USD this simply means that you are buying the base currency and simultaneously selling the quote currency. In caveman talk, "buy EUR, sell USD."

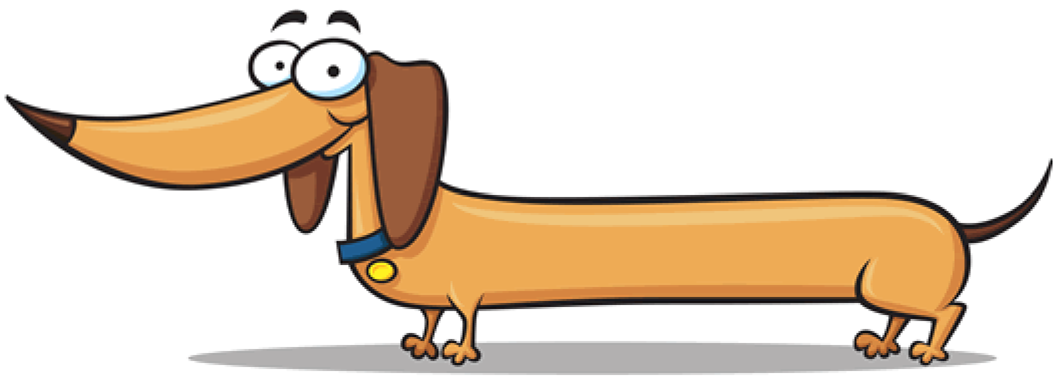
You would buy the pair if you believe the base currency will appreciate (gain value) relative to the quote currency. You would sell the pair if you think the base currency will depreciate (lose value) relative to the quote currency.

Long/Short

First, you should determine whether you want to buy or sell.

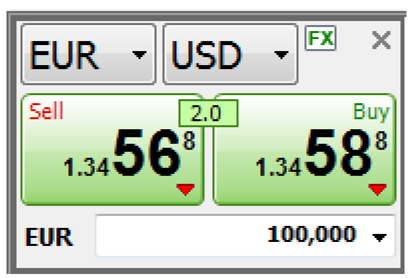
If you want to buy (which actually means buy the base currency and sell the quote currency), you want the base currency to rise in value and then you would sell it back at a higher price. In trader's talk, this is called "going long" or taking a "long position." Just remember: **long = buy.**

If you want to sell (which actually means sell the base currency and buy the quote currency), you want the base currency to fall in value and then you would buy it back at a lower price. This is called “going short” or taking a “short position”. Just remember: **short = sell.**



“I’m long AND short.”

Bid/Ask



“How come I keep getting quoted with two prices?”

All forex quotes are quoted with two prices: the bid and ask. For the most part, the **bid** is lower than the **ask** price.

The **bid** is the price at which your broker is willing to buy the base currency in exchange for the quote currency. This means the bid is the best available price at which you (the trader) will sell to the market.

The **ask** is the price at which your broker will sell the base currency in exchange for the quote currency. This means the ask price is the best available price at which you will buy from the market. **Another word for ask is the offer price.**

The difference between the bid and the ask price is popularly known as the **spread**.

On the EUR/USD quote above, the bid price is 1.34568 and the ask price is 1.34588. Look at how this broker makes it so easy for you to trade away your money.

If you want to sell EUR, you click “Sell” and you will sell euros at 1.34568. If you want to buy EUR, you click “Buy” and you will buy euros at 1.34588.

Now let's take a look at some samples.

Know When to Buy or Sell a Currency Pair

In the following examples, we are going to use fundamental analysis to help us decide whether to buy or sell a specific currency pair.

If you always fell asleep during your economics class or just flat out skipped economics class, don't worry! We will cover fundamental analysis in a later lesson.

But right now, try to pretend you know what's going on…

EUR/USD

In this example, the euro is the base currency and thus the "basis" for the buy/sell.

If you believe that the U.S. economy will continue to weaken, which is bad for the U.S. dollar, you would execute a **BUY** EUR/USD order. By doing so, you have bought euros in the expectation that they will rise versus the U.S. dollar.

If you believe that the U.S. economy is strong and the euro will weaken against the U.S. dollar you would execute a **SELL** EUR/USD order. By doing so you have sold euros in the expectation that they will fall versus the US dollar.

USD/JPY

In this example, the U.S. dollar is the base currency and thus the "basis" for the buy/sell.

If you think that the Japanese government is going to weaken the yen in order to help its export industry, you would execute a **BUY** USD/JPY order. By doing so you have bought U.S dollars in the expectation that they will rise versus the Japanese yen.

If you believe that Japanese investors are pulling money out of U.S. financial markets and converting all their U.S. dollars back to yen, and this will hurt the U.S. dollar, you would execute a **SELL** USD/JPY order. By doing so you have sold U.S dollars in the expectation that they will depreciate against the Japanese yen.

GBP/USD

In this example, the pound is the base currency and thus the "basis" for the buy/sell.

If you think the British economy will continue to do better than the U.S. in terms of economic growth, you would execute a **BUY** GBP/USD order. By doing so you have bought pounds in the expectation that they will rise versus the U.S. dollar.

If you believe the British's economy is slowing while the United States' economy remains strong like Jack Bauer, you would execute a **SELL** GBP/USD order. By doing so you have sold pounds in the expectation that they will depreciate against the U.S. dollar.

USD/CHF

In this example, the U.S. dollar is the base currency and thus the "basis" for the buy/sell.

If you think the Swiss franc is overvalued, you would execute a **BUY** USD/CHF order. By doing so you have bought U.S. dollars in the expectation that they will appreciate versus the Swiss Franc.

If you believe that the U.S. housing market weakness will hurt future economic growth, which will weaken the dollar, you would execute a **SELL** USD/CHF order. By doing so you have sold U.S. dollars in the expectation that they will depreciate against the Swiss franc.

Margin Trading

When you go to the grocery store and want to buy an egg, you can't just buy a single egg; they come in dozens or "lots" of 12.

In forex, it would be just as foolish to buy or sell 1 euro, so they usually come in "lots" of 1,000 units of currency (Micro), 10,000 units (Mini), or 100,000 units (Standard) depending on your broker and the type of account you have (more on "lots" later).

"But I don't have enough money to buy 10,000 euros! Can I still trade?"

You can with margin trading!

Margin trading is simply the term used for trading with borrowed capital. This is how you're able to open $1,250 or $50,000 positions with as little as $25 or $1,000. You can conduct relatively large transactions, very quickly and cheaply, with a small amount of initial capital.

Let us explain.

Listen carefully because this is very important!

1. You believe that signals in the market are indicating that the British pound will go up against the U.S. dollar.
2. You open one standard lot (100,000 units GBP/USD), buying with the British pound at 2% margin and wait for the exchange rate to climb. When you buy one lot (100,000 units) of GBP/USD at a price of 1.50000, you are buying 100,000 pounds, which is worth US$150,000 (100,000 units of GBP * 1.50000).**If the margin requirement was 2%, then US$3,000 would be set aside in your account to open up the trade (US$150,000 * 2%). You now control 100,000 pounds with just US$3,000.**We will be discussing margin more in-depth later, but hopefully you're able to get a basic idea of how it works.
3. Your predictions come true and you decide to sell. You close the position at 1.50500. You earn about $500.

Your Actions	**GBP**	**USD**
You buy 100,000 pounds at the exchange rate of **1.5000**	+100,000	-150,000
You blink for two seconds and the GBP/USD exchange rates rises to **1.5050** and you sell.	-100,000	+150,500
You have earned a **profit of $500**.	0	+500

When you decide to close a position, the deposit that you originally made is returned to you and a calculation of your profits or losses is done.

This profit or loss is then credited to your account.

What's even better is that, with the development of retail forex trading, there are some brokers who allow traders to have custom lots. This means that you don't need to trade in micro, mini or standard lots! If 1,542 is your favorite number and that's how many units you want trade, then you can!

Rollover

No, this is not the same as rollover minutes from your cell phone carrier! For positions open at your broker's "cut-off time" (usually 5:00 pm EST), there is a daily rollover interest rate that a trader either pays or earns, depending on your established margin and position in the market.

If you do not want to earn or pay interest on your positions, simply make sure they are all closed before 5:00 pm EST, the established end of the market day.

Since every currency trade involves borrowing one currency to buy another, interest rollover charges are part of forex trading. Interest is paid on the currency that is borrowed, and earned on the one that is bought.

If you are buying a currency with a higher interest rate than the one you are borrowing, then the net interest rate differential will be positive (i.e. USD/JPY) and you will earn funds as a result.

Conversely, if the interest rate differential is negative then you will have to pay.

Ask your broker or dealer about specific details regarding rollover.

Also note that many retail brokers do adjust their rollover rates based on different factors (e.g., account leverage, interbank lending rates). Please check with your broker for more information on rollover rates and crediting/debiting procedures.

Here is a chart to help you figure out the interest rate differentials of the major currencies. Accurate as of 07/25/2014.

Benchmark Interest Rates

Country	Interest Rate
United States	0.25%
Euro zone	0.15%
United Kingdom	0.50%
Japan	0.10%
Canada	1.00%
Australia	2.50%
New Zealand	3.50%
Switzerland	0.00%

Later on, we'll teach you all about how you can use interest rate differentials to your advantage.

What is a Pip in Forex?

Here is where we're going to do a little math. You've probably heard of the terms "pips," "pipettes," and "lots" thrown around, and here we're going to explain what they are and show you how their values are calculated.

Take your time with this information, as it is required knowledge for all forex traders. Don't even think about trading until you are comfortable with pip values and calculating profit and loss.

What the heck is a Pip? What about a Pipette?

The unit of measurement to express the change in value between two currencies is called a "pip." If EUR/USD moves from 1.2250 to 1.2251, that .0001 USD rise in value is ONE PIP. A pip is usually the last decimal place of a quotation. Most pairs go out to 4 decimal places, but there are some exceptions like Japanese Yen pairs (they go out to two decimal places).

Very Important: There are brokers that quote currency pairs beyond the standard "4 and 2" decimal places to "5 and 3" decimal places. They are quoting **FRACTIONAL PIPS**, also called "pipettes." For instance, if GBP/USD moves from 1.51542 to 1.51543, that .00001 USD move higher is **ONE PIPETTE.**

As each currency has its own relative value, it's necessary to calculate the value of a pip for that particular currency pair. In the following example, we will use a quote with 4 decimal places. *For the purpose of better explaining the calculations, exchange rates will be expressed as a ratio (i.e., EUR/USD at 1.2500 will be written as "1 EUR/ 1.2500 USD")*

Example exchange rate ratio: USD/CAD = 1.0200. To be read as 1 USD to 1.0200 CAD (or 1 USD/1.0200 CAD)

(The value change in counter currency) times the exchange rate ratio = pip value (in terms of the base currency)

[.0001 CAD] x [1 USD/1.0200 CAD]

Or Simply

[(.0001 ~~CAD~~) / (1.0200 ~~CAD~~)] x 1 USD = 0.00009804 USD per unit traded

Using this example, if we traded 10,000 units of USD/CAD, then a one pip change to the exchange rate would be approximately a 0.98 USD change in the position value (10,000 units x 0.0000984 USD/unit). (*We use "approximately" because as the exchange rate changes, so does the value of each pip move*)

Here's another example using a currency pair with the Japanese Yen as the counter currency.

GBP/JPY at 123.00

Notice that this currency pair only goes to two decimal places to measure a 1 pip change in value (most of the other currencies have four decimal places). In this case, a one pip move would be .01 JPY.

(The value change in counter currency) times the exchange rate ratio = pip value (in terms of the base currency)**[.01 JPY] x [1 GBP/123.00 JPY]**

Or Simply

[(.01 ~~JPY~~) / (123.00 ~~JPY~~)] x 1 GBP = 0.0000813 GBP

So, when trading 10,000 units of GBP/JPY, each pip change in value is worth approximately 0.813 GBP.

Finding the Pip Value in your Account Denomination

Now, the final question to ask when figuring out the pip value of your position is, "what is the pip value in terms of my account currency?" After all, it is a global market and not everyone has their account denominated in the same currency. This means that the pip value will have to be translated to whatever currency our account may be traded in.

This calculation is probably the easiest of all; simply multiply/divide the "found pip value" by the exchange rate of your account currency and the currency in question.

If the "found pip value" currency is the same currency as the base currency in the exchange rate quote:

Using the GBP/JPY example above, let's convert the found pip value of .813 GBP to the pip value in USD by using GBP/USD at 1.5590 as our exchange rate ratio. If the currency you are converting to is the counter currency of the exchange rate, all you have to do is divide the "found pip value" by the corresponding exchange rate ratio:

.813 GBP per pip / (1 GBP/1.5590 USD) Or

[(.813 ~~GBP~~) / (1 ~~GBP~~)] x (1.5590 USD) = 1.2674 USD per pip move

So, for every .01 pip move in GBP/JPY, the value of a 10,000 unit position changes by approximately 1.27 USD.

If the currency you are converting to is the base currency of the conversion exchange rate ratio, then multiply the "found pip value" by the conversion exchange rate ratio.

Using our USD/CAD example above, we want to find the pip value of .98 USD in New Zealand Dollars. We'll use .7900 as our conversion exchange rate ratio:

0.98 USD per pip X (1 NZD/.7900 USD) Or

[(0.98 ~~USD~~) / (.7900 ~~USD~~)] x (1 NZD) = 1.2405 NZD per pip move

For every .0001 pip move in USD/CAD from the example above, your 10,000 unit position changes in value by approximately 1.24 NZD.

Even though you're now a math genius–at least with pip values–you're probably rolling your eyes back and thinking, "Do I really need to work all this out?" Well, the answer is a big fat NO. Nearly all forex brokers will work all this out for you automatically, but it's always good for you to know how they work it out.

If your broker doesn't happen to do this, don't worry – you can use our Pip Value Calculator! Aren't we awesome?

In the next section, we will discuss how these seemingly insignificant amounts can add up.

What is a Lot in Forex?

In the past, spot forex was only traded in specific amounts called lots. The standard size for a lot is 100,000 units. There are also a mini, micro, and nano lot sizes that are 10,000, 1,000, and 100 units respectively.

Lot	Number of Units
Standard	100,000
Mini	10,000
Micro	1,000
Nano	100

As you may already know, the change in currency value relative to another is measured in "pips," which is a very, very small percentage of a unit of currency's value. To take advantage of this minute change in value, you need to trade large amounts of a particular currency in order to see any significant profit or loss.

Let's assume we will be using a 100,000 unit (standard) lot size. We will now recalculate some examples to see how it affects the pip value.

1. USD/JPY at an exchange rate of 119.80(.01 / 119.80) x 100,000 = $8.34 per pip
2. USD/CHF at an exchange rate of 1.4555(.0001 / 1.4555) x 100,000 = $6.87 per pip

In cases where the U.S. dollar is not quoted first, the formula is slightly different.

1. EUR/USD at an exchange rate of 1.1930(.0001 / 1.1930) X 100,000 = 8.38 x 1.1930 = $9.99734 rounded up will be $10 per pip
2. GBP/USD at an exchange rate or 1.8040(.0001 / 1.8040) x 100,000 = 5.54 x 1.8040 = 9.99416 rounded up will be $10 per pip.

Your broker may have a different convention for calculating pip value relative to lot size but whichever way they do it, they'll be able to tell you what the pip value is for the currency you are trading is at the particular time. As the market moves, so will the pip value depending on what currency you are currently trading.

What the heck is leverage?

You are probably wondering how a small investor like yourself can trade such large amounts of money. Think of your broker as a bank who basically fronts you $100,000 to buy currencies. All the bank asks from you is that you give it $1,000 as a good faith deposit, which he will hold for you but not necessarily keep. Sounds too good to be true? This is how forex trading using leverage works.

The amount of leverage you use will depend on your broker and what you feel comfortable with.

Typically the broker will require a trade deposit, also known as “account margin” or “initial margin.” Once you have deposited your money you will then be able to trade. The broker will also specify how much they require per position (lot) traded.

For example, if the allowed leverage is 100:1 (or 1% of position required), and you wanted to trade a position worth $100,000, but you only have $5,000 in your account. No problem as your broker would set aside $1,000 as down payment, or the “margin,” and let you “borrow” the rest. Of course, any losses or gains will be deducted or added to the remaining cash balance in your account.

The minimum security (margin) for each lot will vary from broker to broker. In the example above, the broker required a one percent margin. This means that for every $100,000 traded, the broker wants $1,000 as a deposit on the position.

How the heck do I calculate profit and loss?

So now that you know how to calculate pip value and leverage, let’s look at how you calculate your profit or loss.

Let’s buy U.S. dollars and Sell Swiss francs.

1. The rate you are quoted is 1.4525 / 1.4530. Because you are buying U.S. dollars you will be working on the “ask” price of 1.4530, or the rate at which traders are prepared to sell.
2. So you buy 1 standard lot (100,000 units) at 1.4530.
3. A few hours later, the price moves to 1.4550 and you decide to close your trade.

4. The new quote for USD/CHF is 1.4550 / 1.4555. Since you're closing your trade and you initially bought to enter the trade, you now sell in order to close the trade so you must take the "bid" price of 1.4550. The price traders are prepared to buy at.
5. The difference between 1.4530 and 1.4550 is .0020 or 20 pips.
6. Using our formula from before, we now have (.0001/1.4550) x 100,000 = $6.87 per pip x 20 pips = $137.40

Remember, when you enter or exit a trade, you are subject to the spread in the bid/offer quote. When **you buy a currency, you will use the offer or ask price** and when **you sell, you will use the bid price**.

Next up, we'll give you a roundup of the freshest forex lingos you've learned!

Impress Your Date with Forex Lingo

As in any new skill that you learn, you need to learn the lingo… especially if you wish to win 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 do 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 or the "majors." These are the most liquid and the most sexy. All other currencies are referred to as minor currencies.

Base Currency

The base currency is the first currency in any currency pair. The currency quote 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 market, 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.

Notable exceptions are pairs that include the Japanese yen where a pip equals 0.01.

Pipette

One-tenth of a pip. Some brokers quote fractional pips, or pipettes, for added precision in quoting rates. For example, if EUR/USD moved from 1.32156 to 1.32158, it moved 2 pipettes.

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/Offer Price

The ask/offer 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 1.2815 U.S. dollars. The ask price is also called the offer price.

Bid/Ask 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.” In this example, USD/JPY has a 4-pip spread.

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 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 (spread) = 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 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 0.5% 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 0.5% = $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 500:1.

Now that you've impressed your dates with your forex lingo, how about showing her the different types of trade orders?

Types of Forex Orders

The term "order" refers to how you will enter or exit a trade. Here we discuss the different types of forex orders that can be placed into the forex market.

Be sure that you know which types of orders your broker accepts. Different brokers accept different types of forex orders.

There are some basic order types that all brokers provide and some others that sound weird.

Forex Order Types

Market order

A market order is an order to buy or sell at the best available price.

For example, the bid price for EUR/USD is currently at 1.2140 and the ask price is at 1.2142. If you wanted to buy EUR/USD at market, then it would be sold to you at the ask price of 1.2142. You would click buy and your trading platform would instantly execute a buy order at that exact price.

If you ever shop on Amazon.com, it's kinda like using their 1-Click ordering. You like the current price, you click once and it's yours! The only difference is you are buying or selling one currency against another currency instead of buying a Justin Bieber CD.

Limit Entry Order

A limit entry is an order placed to either **buy below the market** or **sell above the market** at a certain price.

For example, EUR/USD is currently trading at 1.2050. You want to go short if the price reaches 1.2070. You can either sit in front of your monitor and wait for it to hit 1.2070 (at which point you would click a sell market order), or you can set a sell limit order at 1.2070 (then you could walk away from your computer to attend your ballroom dancing class).

If the price goes up to 1.2070, your trading platform will automatically execute a sell order at the best available price.

You use this type of entry order when you believe price will reverse upon hitting the price you specified!

Stop-Entry Order

A stop-entry order is an order placed to buy above the market or sell below the market at a certain price.

For example, GBP/USD is currently trading at 1.5050 and is heading upward. You believe that price will continue in this direction if it hits 1.5060. You can do one of the following to play this belief: sit in front of your computer and buy at market when it hits 1.5060 OR set a stop-entry order at 1.5060. You use stop-entry orders when you feel that price will move in one direction!

Stop-Loss Order

A stop-loss order is a type of order linked to a trade for the purpose of preventing additional losses if price goes against you. **REMEMBER THIS TYPE OF ORDER**. A stop-loss order remains in effect until the position is liquidated or you cancel the stop-loss order.

For example, you went long (buy) EUR/USD at 1.2230. To limit your maximum loss, you set a stop-loss order at 1.2200. This means if you were dead wrong and EUR/USD drops to 1.2200 instead of moving up, your trading platform would automatically execute a sell order at 1.2200 the best available price and close out your position for a 30-pip loss (eww!).

Stop-losses are extremely useful if you don't want to sit in front of your monitor all day worried that you will lose all your money. You can simply set a stop-loss order on any open positions so you won't miss your basket weaving class or elephant polo game.

Trailing Stop

A trailing stop is a type of stop-loss order attached to a trade that moves as price fluctuates.

Let's say that you've decided to short USD/JPY at 90.80, with a trailing stop of 20 pips. This means that originally, your stop loss is at 91.00. If the price goes down and hits 90.60, your trailing stop would move down to 90.80 (or breakeven).

Just remember though, that your stop will STAY at this new price level. It will not widen if market goes higher against you. Going back to the example, with a trailing stop of 20 pips, if USD/JPY hits 90.40, then your stop would move to 90.60 (or lock in 20 pips profit).

Your trade will remain open as long as price does not move against you by 20 pips. Once the market price hits your trailing stop price, a **market order** to close your position at the best available price will be sent and your position will be closed.

Weird Forex Orders

"Can I order a Grande extra hot soy with extra foam, extra hot split quad shot with a half squirt of sugar-free white chocolate and a half squirt of sugar-free cinnamon, a half packet of Splenda and put that in a Venti cup and fill up the "room" with extra whipped cream with caramel and chocolate sauce drizzled on top?"

Ooops, wrong weird order.

Good 'Till Cancelled (GTC)

A GTC order remains active in the market until you decide to cancel it. Your broker will not cancel the order at any time. Therefore, it is **your responsibility** to remember that you have the order scheduled.

Good for the Day (GFD)

A GFD order remains active in the market until the end of the trading day. Because foreign exchange is a 24-hour market, this usually means 5:00 pm EST since that's the time U.S. markets close, but we'd recommend you double check with your broker.

One-Cancels-the-Other (OCO)

An OCO order is a mixture of two entry and/or stop-loss orders. Two orders with price and duration variables are placed above and below the current price. When one of the orders is executed the other order is canceled.

Let's say the price of EUR/USD is 1.2040. You want to either buy at 1.2095 over the resistance level in anticipation of a breakout or initiate a selling position if the price falls below 1.1985. The understanding is that if 1.2095 is reached, your buy order will be triggered and the 1.1985 sell order will be automatically canceled.

One-Triggers-the-Other

An OTO is the opposite of the OCO, as it only puts on orders when the parent order is triggered. You set an OTO order when you want to set profit taking and stop loss levels ahead of time, even before you get in a trade.

For example, USD/CHF is currently trading at 1.2000. You believe that once it hits 1.2100, it will reverse and head downwards but only up to 1.1900. The problem is that you will be gone for an entire week because you have to join a basket weaving competition at the top of Mt. Fuji where there is no internet.

In order to catch the move while you are away, you set a sell limit at 1.2000 and at the same time, place a related buy limit at 1.1900, and just in case, place a stop-loss at 1.2100. As an OTO, both the buy limit and the stop-loss orders will only be placed if your initial sell order at 1.2000 gets triggered.

In conclusion…

The basic forex order types (market, limit entry, stop-entry, stop loss, and trailing stop) are usually all that most traders ever need.

Unless you are a veteran trader (don't worry, with practice and time you will be), don't get fancy and design a system of trading requiring a large number of forex orders sandwiched in the market at all times.

Stick with the basic stuff first.

Make sure you fully understand and are comfortable with your broker's order entry system before executing a trade.

Also, always check with your broker for specific order information and to see if any rollover fees will be applied if a position is held longer than one day. Keeping your ordering rules simple is the best strategy.

DO NOT trade with real money until you have an extremely high comfort level with the trading platform you are using and its order entry system. Erroneous trades are more common than you think!

Demo Trade Your Way to Success

You can open a demo accounts for FREE with most forex brokers. These "pretend" accounts have the full capabilities of a "real" account.

But why is it free?

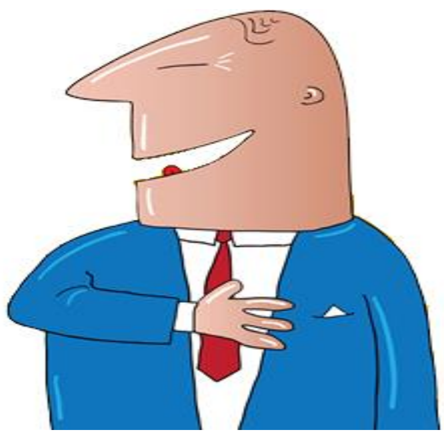
It's because the broker wants you to learn the ins and outs of their trading platform, and have a good time trading without risk, so you'll fall in love with them and deposit real money. The demo account allows you to learn about the forex market and test your trading skills with ZERO risk.

Yes, that's right, ZERO!

YOU SHOULD DEMO TRADE UNTIL YOU DEVELOP A SOLID, PROFITABLE SYSTEM BEFORE YOU EVEN THINK ABOUT PUTTING REAL MONEY ON THE LINE.

WE REPEAT – YOU SHOULD DEMO TRADE UNTIL YOU DEVELOP A SOLID, PROFITABLE SYSTEM BEFORE YOU EVEN THINK ABOUT PUTTING REAL MONEY ON THE LINE.

"Don't Lose Your Money" Declaration



Now, place your hand on your heart and say…

"I will demo trade until I develop a solid, profitable system before I trade with real money."

Now touch your head with your index finger and say…

"I am a smart and patient forex trader!"

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

If you can't wait until you're profitable on a demo account, at least demo trade for two 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 two months, just donate that money to your favorite charity or cut your hands off.

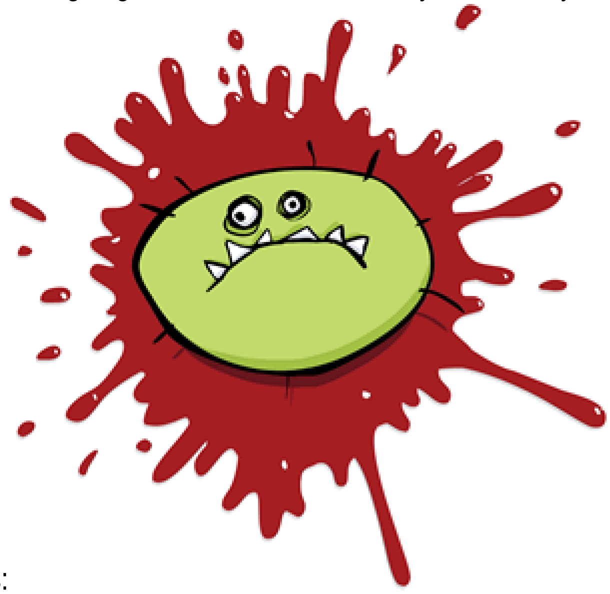
Concentrate on ONE major currency pair.

It gets far too complicated to keep tabs on more than one currency pair when you first start demo 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.

Forex Trading is NOT a Get-Rich-Quick Scheme

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



consider trading currencies:

1. **All forex traders, and we do mean ALL traders, LOSE money on trades.**

   Ninety percent of traders lose money, largely due to lack of planning, training, discipline, and having poor money management rulesIf you hate to lose or are a super perfectionist, you'll also probably have a hard time adjusting to trading because all traders lose a trade at some point or another.

2. **Trading forex is not for the unemployed, those on low incomes, are knee-deep in credit card debt 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 gazillionaire.

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.

The problem is that many traders come with the misguided hope of making a gazillion bucks, but in reality, they lack the discipline required for really learning the art of 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 one of the most difficult, but financially rewarding, endeavors known to man?

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 large losses. 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 **PRACTICE** and **EXPERIENCE** to master.

There is no substitute for hard work, deliberate practice, and diligence.

Practice trading on a **DEMO ACCOUNT** until you find a method that you know inside and out, and can comfortably execute objectively. Basically, find the way that works for you!!!

History of Retail Forex Trading

It seems brokers love to hunt.

Now that you know a little about forex, you're probably itching to start your pippin' adventures. But before you set off on your journey, you need one more thing… An actual account with a broker!

Of course, we want you to work with a broker that will provide the right services for your individual needs, so we decided to come up with this section to walk you through the right things to consider when choosing!

But first, we'll begin by revisiting the pages of history to find out how brokers came to life. Name the best thing that the mighty powers of the Internet have brought us. YouTube, Facebook, Twitter, Forexfactory.com… Yes, those are all awesome. But what we want talk about is the greatest gift to forex junkies like you and me: **Retail FX trading!**

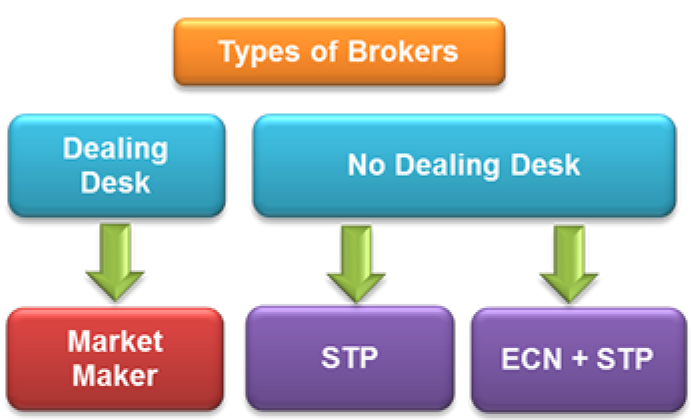
In fact, forex junkies probably wouldn't exist if not for the birth of online forex brokers. You see, back in the 90s, it was much more difficult to participate in the retail FX market because of higher transactions costs. At that time, governments were like strict parents keeping a watchful eye on exchanges, restricting their activities. After time, the CFTC decided that enough is enough. They passed a couple of bills, namely the Commodity Exchange Act and the Commodity Futures Modernization Act, and opened the doors for online forex brokers.

Since almost everyone had access to the worldwide web, opening an account with a forex broker was simple and convenient. Various forex brokers started popping up here and there, eager to take advantage of the booming forex industry. But now that there are many choices out there, it's a little tougher to distinguish between the good brokers and the evil ones. We're not kidding about the evil ones, which are also known as bucket shops, and we'll delve into that a little later.

Forex Broker Types: Dealing Desk and No Dealing Desk

The first step in choosing a broker is finding out what your choices are. You don't just walk into a restaurant, knowing what to order right away, do you? Not unless you're a frequent customer there, of course. More often than not, you check out their menu first to see what they have to offer.

There are two main types of brokers: **Dealing Desks (DD)** and **No Dealing Desks (NDD)**. Dealing Desk brokers are also called *Market Makers*, while No Dealing Desks can be further subdivided into *Straight Through Processing (STP)* and *Electronic Communication Network + Straight Through Processing (ECN+STP)*.



What is a Dealing Desk Forex Broker?

Forex brokers that operate through Dealing Desk (DD) brokers make money through spreads and providing liquidity to their clients. Also called "market makers," Dealing Desk brokers literally create a market for their clients, meaning they often take the other side of a clients trade. While you may think that there is a conflict of interest, there really isn't. Market makers provide both a sell and buy quote, which means that they are filling both buy and sell orders of their clients; they are indifferent to the decisions of an individual trader.

Since market makers control the prices at which orders are filled, it also follows that there is very little risk for them to set FIXED spreads (you will understand why this is so much better later). Also, clients of dealing desk brokers do not see the real interbank market rates. Don't be scared though, the competition among brokers is so stiff that the rates offered by Dealing Desks brokers are close, if not the same, to the interbank rates.

Trading using a Dealing Desk broker basically works this way:

Let's say you place a buy order for EUR/USD for 100,000 units with your Dealing Desk broker. To fill you, your broker will first try to find a matching sell order from its other clients or pass your trades on to its liquidity provider, i.e. a sizable entity that readily buys or sells a financial asset.

By doing this, they minimize risk, as they earn from the spread without taking the opposite side of your trade. However, in the event that there are no matching orders, they will have to take the opposite side of your trade. Take note that different brokers have different risk management policies, so check with your broker regarding this.

What is a No Dealing Desk Broker?

As the name suggests, No Dealing Desk (NDD) brokers do NOT pass their clients' orders through a Dealing Desk. This means that they do not take the other side of their clients' trade as they simply link two parties together.

NDDs are like bridge builders: they build a structure over an otherwise impassable or hard-to-pass terrain to connect two areas. NDDs can either charge a very small commission for trading or just put a markup by increasing the spread slightly.

No Dealing Desk brokers can either be STP or STP+ECN.

What is an STP broker?

Some brokers claim that they are true ECN brokers, but in reality, they merely have a Straight Through Processing system.

Forex brokers that have an STP system route the orders of their clients directly to their liquidity providers who have access to the interbank market. NDD STP brokers usually have many liquidity providers, with each provider quoting its own bid and ask price.

Let's say your NDD STP broker has three different liquidity providers. In their system, they will see three different pairs of bid and ask quotes.

	Bid	Ask
Liquidity Provider A	1.2998	1.3001
Liquidity Provider B	1.2999	1.3001
Liquidity Provider C	1.3000	1.3002

Their system then sorts these bid and ask quotes from best to worst. In this case, the best price in the bid side is 1.3000 (you want to sell high) and the best price on the ask side is 1.3001 (you want to buy low). The bid/ask is now 1.3000/1.3001.

Will this be the quote that you will see on your platform?

Of course not!

Your broker isn't running a charity! Your broker didn't go through all that trouble of sorting through those quotes for free!

To compensate them for their trouble, your broker adds a small, usually fixed, markup. If their policy is to add a 1-pip mark-up, the quote you will see on your platform would be 1.2999/1.3002. You will see a 3-pip spread. The 1-pip spread turns into a 3-pip spread for you.

So when you decide to buy 100,000 units of EUR/USD at 1.3002, your order is sent through your broker and then routed to either Liquidity Provider A or B.

If your order is acknowledged, Liquidity Provider A or B will have a short position of 100,000 units of EUR/USD 1.3001, and you will have a long position of 100,000 units of EUR/USD at 1.3002. Your broker will earn 1 pip in revenue.

This changing bid/ask quote is also the reason why most STP type brokers have variable spreads. If the spreads of their liquidity providers widen, they have no choice but to widen their spreads too. While some STP brokers do offer fixed spreads, most have **VARIABLE** spreads.

What is an ECN Broker?

True ECN brokers, on the other hand, allow the orders of their clients to interact with the orders of other participants in the ECN.

Participants could be banks, retail traders, hedge funds, and even other brokers. In essence, participants trade against each other by offering their best bid and ask prices.

ECNs also allow their clients to see the "Depth of Market." Depth of Market displays where the buy and sell orders of other market participants are. Because of the nature ECN, it is very difficult to slap on a fixed mark-up so ECN brokers usually get compensated through a small **COMMISSION**.

Dealing Desk vs. No Dealing Desk Forex Brokers

Which type of broker should I choose? A dealing desk broker? Or a no dealing desk broker?

That's completely up to you! One type of broker isn't better than the other because it will all depend on the type of trader you are. It's up to you to decide whether you'd rather have tighter spreads but pay a commission per trade, versus wider spreads and no commissions.

Usually, day traders and scalpers prefer the tighter spreads because it is easier to take small profits as the market needs less ground to cover to get over transaction costs.

Meanwhile, wider spreads tend to be insignificant to longer term swing or position traders.

To make your decision-making easier, here's a summary of the major differences between Market Makers, STP brokers, and STP+ECN brokers:

Dealing Desk (Market Maker)	No Dealing Desk (STP)	No Dealing Desk (STP+ECN)

Fixed Spreads	Most have variable spreads	Variable spreads or commission fees
Take the opposite side of your trade	Simply a bridge between client and liquidity provider	A bridge between client and liquidity provider and other participants
Artificial quotes	Prices come from liquidity providers	Prices come from liquidity providers and other ECN particpants
Orders are filled by broker on a discretionary basis	Automatic execution, no re-quotes	Automatic, no re-quotes
		Displays the Depth of Market (DOM) or liquidity information

Brokers are not evil… Well most of them aren't!

Contrary to what you may have read elsewhere, forex brokers really aren't out to get you. They want to do business with you, and not run you out of business! Think about it, if you lose all your money in trading, they too will lose customers.

The ideal client of dealing desk brokers is the one who more or less **breaks even**. In other words, a client who neither wins nor losses at the end.

That way, the broker earns money on the client's transactions, but at the same time, the client stays in the game by not blowing out his account. In essence, brokers want their clients to keep coming back for more (trading)!

6 Crucial Things to Consider When Choosing a Forex Broker

The retail forex market is so competitive that just thinking about having to sift through all the available brokers can give you a major headache.

Choosing which forex broker to trade with can be a very overwhelming task especially if you don't know what you should be looking for.

In this section, we will discuss the qualities you should look for when picking a broker.

1. Security

The first and foremost characteristic that a good broker must have is a high level of security. After all, you're not going to hand over thousands of dollars to a person who simply claims he's legit, right?

Fortunately, checking the credibility of a forex broker isn't very hard. There are regulatory agencies all over the world that separate the trustworthy from the fraudulent.

Below is a list of countries with their corresponding regulatory bodies:

- **United States:** National Futures Association (NFA) and Commodity Futures Trading Commission (CFTC)
- **United Kingdom:** Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA)
- **Australia:** Australian Securities and Investment Commission (ASIC)
- **Switzerland:** Swiss Federal Banking Commission (SFBC)
- **Germany:** Bundesanstalt für Finanzdienstleistungsaufsicht (BaFIN)
- **France:** Autorité des Marchés Financiers (AMF)
- **Canada:** Autorité des Marchés Financiers (AMF)

Before even THINKING of putting your money in a broker, make sure that the broker is a member of the regulatory bodies mentioned above.

2. Transaction Cost

No matter what kind of currency trader you are, like it or not, you will always be subject to transaction costs.

Every single time you enter a trade, you will have to pay for either the forex spread or a commission so it is only natural to look for the most affordable and cheapest rates. Sometimes you may need to sacrifice low transaction for a more reliable broker.

Make sure you know if you need tight spreads for your type of trading, and then review your available options. It's all about finding the correct balance between security and low transaction costs.

3. Deposit and Withdrawal

Good FX brokers will allow you to deposit funds and withdraw your earnings hassle-free. Brokers really have no reason to make it hard for you to withdraw your profits because the only reason they hold your funds is to facilitate trading.

Your broker only holds your money to make trading easier so there is no reason for you to have a hard time getting the profits you have earned. Your broker should make sure that the withdrawal process is speedy and smooth.

4. Trading Platform

In online forex trading, most trading activity happens through the brokers' trading platform. This means that the trading platform of your broker must be user-friendly and stable.

When looking for a broker, always check what its trading platform has to offer.

Does it offer free news feed? How about easy-to-use technical and charting tools? Does it present you with all the information you will need to trade properly?

5. Execution

It is mandatory that your broker fill you in the best possible price for your orders.

Under normal market conditions (e.g. normal liquidity, no important news releases or surprise events), there really is no reason for your broker to not fill you at, or very close to, the market price you see when you click the “buy” or “sell” button.

For example, assuming you have a stable internet connection, if you click “buy” EUR/USD for 1.3000, you should get filled at that price or within micro-pips of it. The speed at which your orders get filled is very important, especially if you’re a scalper.

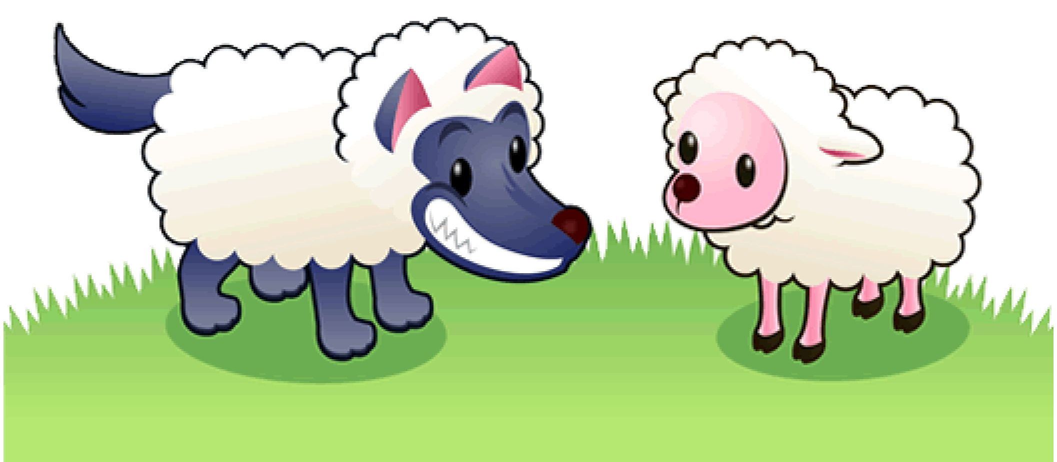
A few pips difference in price can make that much harder on you to win that trade.

6. Customer Service

Brokers aren’t perfect, and therefore you must pick a broker that you could easily contact when problems arise.

The competence of brokers when dealing with account or technical support issues is just as important as their performance on executing trades. Brokers may be kind and helpful during the account opening process, but have terrible “after sales” support.

Beware of Forex Bucket Shops



Here are the bad guys we keep mentioning earlier. Forex bucket shops are brokerage firms that have “questionable” trading practices (e.g., unusually frequent price misquotes or re-qoutes, slippage only favorable to the broker, stop hunting, etc.).

Have you ever seen Boiler Room?

Aww come on, don’t tell me you missed Ben Affleck’s legendary speech about money?!

“They say money can’t buy happiness? Look at the smile on my face. Ear to ear, baby!”

And it’s precisely this greedy, money-oriented philosophy that drives the people operating bucket shops.

The name comes from brokers back in the day who used to put their clients’ phone-in orders on slips and then dropped them (the slips, not the clients) in a tiny bucket instead of actually executing them.

Without putting the orders out into the free market, the client is actually betting against the forex bucket shop operators who are also known as bucketeers.

These old school bucketeers do not usually disclose the real price of the asset that their client is trading, which means that they could tell the client that the price moved or didn’t move–whatever was in favor of the broker!

But thanks to the invention of the internet–and improving regulations and enforcement–newbies have less to worry about these days. Unfortunately, bucket shops are still out there so beware!

Luckily for you, we at BabyPips.com are more than willing to help you avoid entrusting your hard-earned cash to these nasty bucketeers.

To help you separate the good brokers from the bad ones, make your way to the Forex Brokers Forum, where fellow forex traders kindly share their feedback and experiences about a vast collection of brokers.

So, before you deposit your money with just anyone, make sure to do your due diligence and espionage so that you avoid fraudulent brokers and forex scams. Mind you, there are plenty out there and we’ll look more into that later on!

How to Protect Yourself Against Forex Broker Scams

While you may feel like a dwarf among big bad brokers, it doesn’t mean that you have to take their abuse! If you are disheartened because it seems that brokers have all the advantage, rest assured that there are a few simple measures to help even the odds.

Compare Price Feeds

Imagine a horse with blinders. This horse's vision is limited to what's in front of him. If there is a hurdle in front, this horse has no other choice but to exert the additional effort needed to jump over it. This horse is a very sad horse.

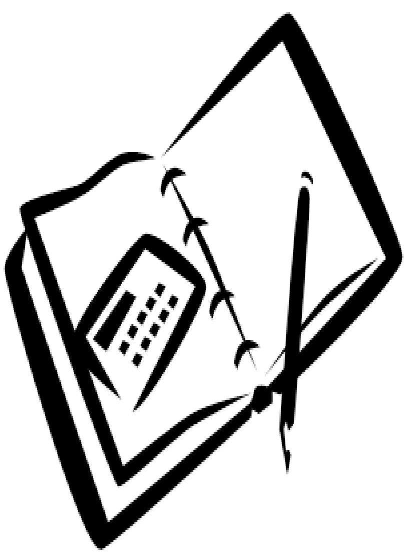
If you only use the price feed on your trading platform, you are basically trading like a horse with blinders on.

You have no idea what's going on in the rest of the forex world because you have limited yourself to your broker's price feed. If your broker chooses to widen spreads, manipulate rates, and run your stops, you have no way of knowing if the move resembled the general market.

You do not want to be a sad horse. Because you are a smart trader, you want to have the most complete view of the market as possible.

The best way to do this is to subscribe to a second, third, or even fourth price feed. That way, you get another view of the market, and you'd have a chance to confirm whether price really moved the way it did.

Record Everything



Always keep a detailed journal tracking ALL of your transactions! Always, always, always! Like in a courtroom, you need evidence to make a case. You may **FEEL** cheated, but if you have nothing to back it up, then that feeling will remain just a feeling.

The easiest way to keep records is to take a **screenshot** of each order you put, each trade you take, and other suspicious broker activity like odd price feeds.

Not only is this good trade journaling, but it will come in handy if have been victimized by an errant fill. By properly tracking the trades you take, you can assure yourself that you will always have evidence needed to support your case in the event that you file a dispute with your broker.

File Legal Action

If you cannot settle your conflict with your broker, then it is time for you to take legal action. Most brokers give in when faced with the threat of legal action, but if they do not, you can approach either the Commodity Futures Trading Commission (CFTC) or the National Futures Associations (NFA).

The CFTC has a Reparations program that provides an "inexpensive, expeditious, fair, and impartial forum to handle customer complaints and resolve disputes between futures customers and commodity futures trading professionals." You can check out their program here.

Likewise, the NFA has an Arbitration/Mediation program that helps FCM's and their clients resolve disputes. For more information, just head on over to the NFA's website.

Good Trading Habits

Like a disciplined nun who wears a habit, you too should develop good trading habits. We know that joke doesn't make sense, but it sounded funny so we might as well put it here. In any case, even with the proper weapons to protect yourself against evil brokers, the most important thing is still to become a better trader.

Know that no matter how advanced your charting software is, no matter how much time you put into finding the right broker, no matter how complicated your trading system is, without proper discipline, you will end up losing.

It is very easy to put the blame on brokers, but at the end of the day, it is really your choices that get you to where you want to go.

How to Open a Forex Trading Account

After finding the right broker for you, you can open a forex trading account in three simple steps:

- **Selecting an account type**
- **Registration**
- **Activating your account**

Before trading a dime of your hard earned money, you may want to think about opening demo account. Actually, open up two or three demos – why not? It's all FREE! Try out several different brokers to get a feel for the right one for you.

Choosing an Account Type

When you're ready to open a live account, you have to choose which type of forex trading account you want: a personal account or a business (aka corporate) account.

In the past, when opening a forex trading account, you'd also have to choose whether you wanted to open a "standard" account, a "mini" account, or a "micro" account.

Now, that isn't much of a problem since most brokers allow you to trade custom lots. This is great for newbie and inexperienced traders who only have a small account of capital. This provides you great flexibility, as you won't have to trade bigger than you're comfortable with.

Also, always, always, always remember: **Always read the fine print.**

Some brokers have a "managed account" option in their application forms. If you want the broker to trade your account for you, you can pick this. But is this what you really want? After all, you didn't read through the whole School of Pipsology just to have someone else trade for you!

Besides, opening a managed account requires a pretty big minimum deposit, normally $25,000 or higher. Also, the manager will also take a cut out of any profits.

Lastly, make sure you open a **forex spot account** and not a forwards or futures account.

Registration

You will have to submit paperwork in order to open an account and the forms will vary from broker to broker. They are usually provided in PDF format and can be viewed and printed using Adobe Acrobat Reader program.

Also, make sure you know all the associated costs, like how much your banks charges for a bank wire transfer. You'd be surprised how much these actually costs, and they may actually take up a significant portion of your trading capital.

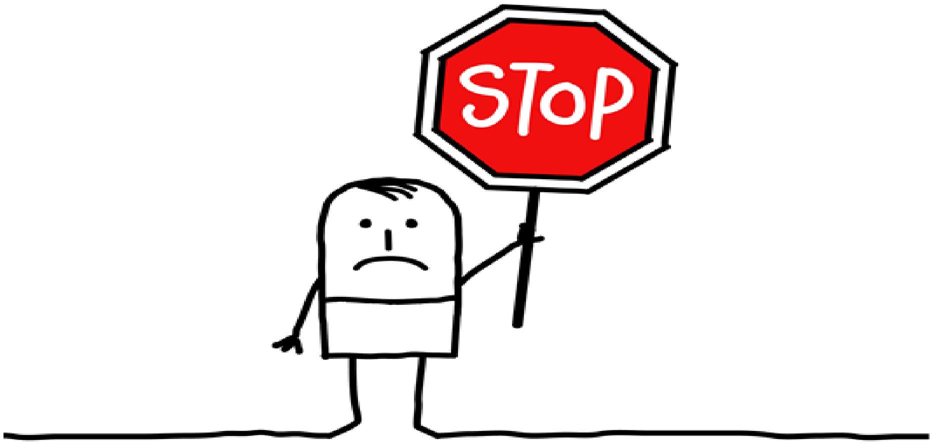
Account Activation

Once the broker has received all the necessary paperwork, you should receive an email with instructions on completing your account activation. After these steps have been completed, you will receive a final email with your username, password, and instructions on how to fund your account.

So all that's left is for you to login and start trading. Pretty easy huh?

Time to log in, pop open those charts, and start trading!

But wait just one minute



We strongly advise you DEMO trade first. There's no shame in demo trading – everyone has to start somewhere.

If you have been demo trading for at LEAST six months, then maybe you can dip your feet into live trading. Even then, we suggest you go in the shallow end and consider how much you want to risk.

Trading live is a different beast altogether. It's like the difference between sparring against your kid brother (or sister) and fighting Manny Pacquiao.

No matter how successful you were in demo trading, nothing can replace the feeling of having real money on the line.

3 Types of Forex Market Analysis

By now you've learned some history about the forex, how it works, what affects the prices, blah blah blah.

ZZZZZZZZZZZZZZZZZZZZZZZZZZZZZZZZZZZZZZZZZZZZZZZ.

This is all obviously super important, but know that you're now thinking…

BORING!

SHOW

ME

HOW

TO

MAKE

MONEY

ALREADY!!!!

Well say no more friends because here is where your journey as a forex trader begins…

This is your last chance to turn back…

Take the **red pill**, forget everything, and we'll take you back to where you were before.

You can go back to living your average life in your 9-5 job and work for someone else for the rest of your life…

OR…

You can take the **green pill**, which is fully loaded with the dollar extract, and learn how you can make money for yourself in the most active market in the world, simply by using a little brain power.

Just remember, your education will never stop. Even after you graduate from the School of Pipsology, you must constantly pursue as much knowledge as you can, so that you can become a true FOREX MASTER! The learning never ends!

Are you ready to make that commitment?

Now pop that green pill in, wash it down with some delicious chocolate milk, and grab your lunchbox… the School of Pipsology is now in session!

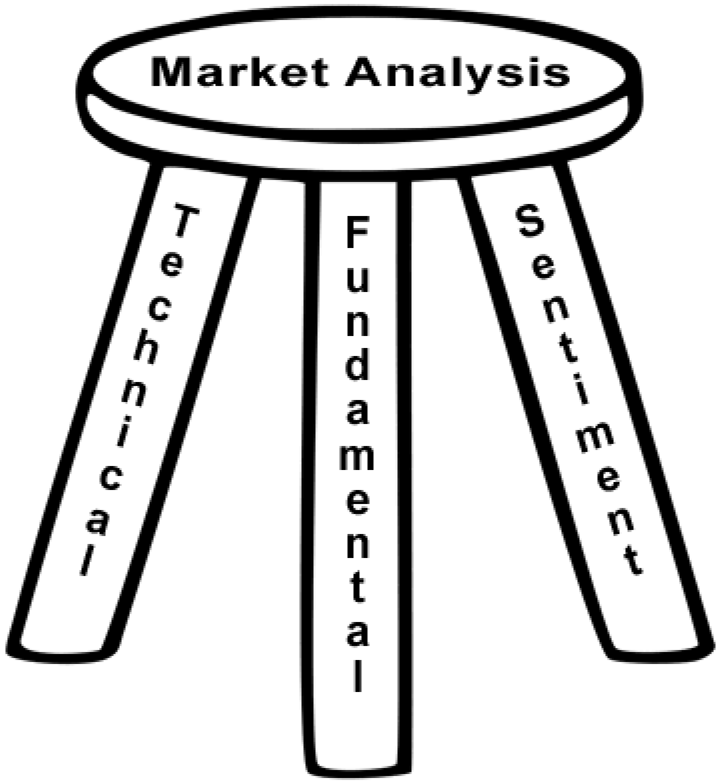
Note: the green pill was made with a brainwashing serum. You will now obey everything that we tell you to do! Mwuahahaha!

Three Types of Forex Market Analysis

To begin, let's look at three ways on how you would analyze and develop ideas to trade the market. There are three basic types of forex market analysis:

1. Technical Analysis
2. Fundamental Analysis
3. Sentiment Analysis

There has always been a constant debate as to which analysis is better, but to tell you the truth, you need to know all three.



It’s kind of like standing on a three-legged stool – if one of the legs is weak, the stool will break under your weight and you’ll fall flat on your face. The same holds true in trading. If your analysis on any of the three types of trading is weak and you ignore it, there’s a good chance that it will cause you to lose out on your trade!

Technical Analysis

Technical analysis is the framework in which forex traders study price movement.

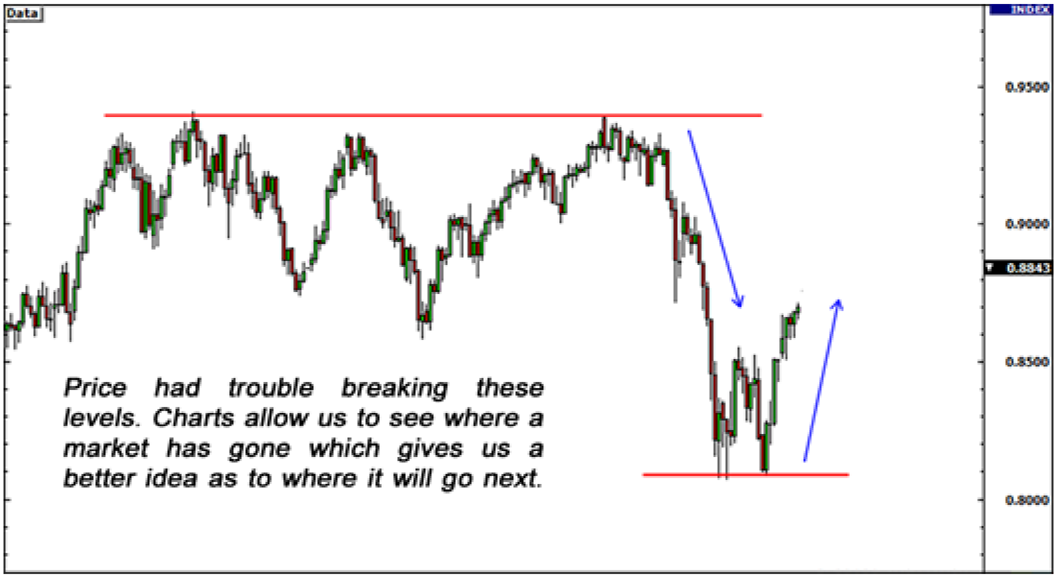
The theory is that a person can look at historical price movements and determine the current trading conditions and potential price movement.

The main evidence for using technical analysis is that, theoretically, all current market information is reflected in price. If price reflects all the information that is out there, then price action is all one would really need to make a trade.

Now, have you ever heard the old adage, “**History tends to repeat itself**“?

Well, that’s basically what technical analysis is all about! If a price level held as a key support or resistance in the past, traders will keep an eye out for it and base their trades around that historical price level.

Technical analysts look for similar patterns that have formed in the past, and will form trade ideas believing that price will act the same way that it did before.



In the world of currency trading, when someone says technical analysis, the first thing that comes to mind is a chart. Technical analysts use charts because they are the easiest way to visualize historical data!

You can look at past data to help you spot trends and patterns which could help you find some great trading opportunities.

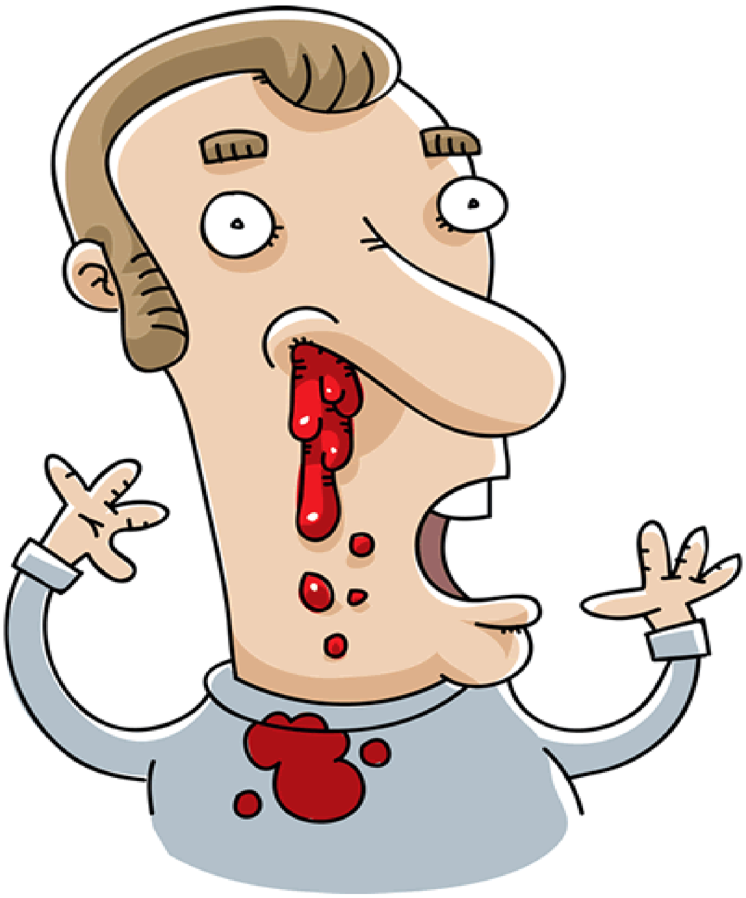
What's more is that with all the traders who rely on technical analysis out there, these price patterns and indicator signals tend to become self-fulfilling.

As more and more forex traders look for certain price levels and chart patterns, the more likely that these patterns will manifest themselves in the markets.

You should know though that technical analysis is VERY subjective.

Just because Ralph and Joseph are looking at the exact same currency chart setup or indicators doesn't mean that they will come up with the same idea of where price may be headed.

The important thing is that you understand the concepts under technical analysis so you won't get nosebleeds whenever somebody starts talking about Fibonacci, Bollinger bands, or pivot points.



Fibonacci? Bollinger bands? Pivot points?!

Now we know you're thinking to yourself, "Geez, these guys are smart. They use crazy words like 'Fibonacci' and 'Bollinger'. I can never learn this stuff!"

Don't worry yourself too much. After you're done with the School of Pipsology, you too will be just as… uhmmm… "smart" as us.

By the way, do you feel that green pill kicking in yet? Bark like a dog!

Fundamental Analysis

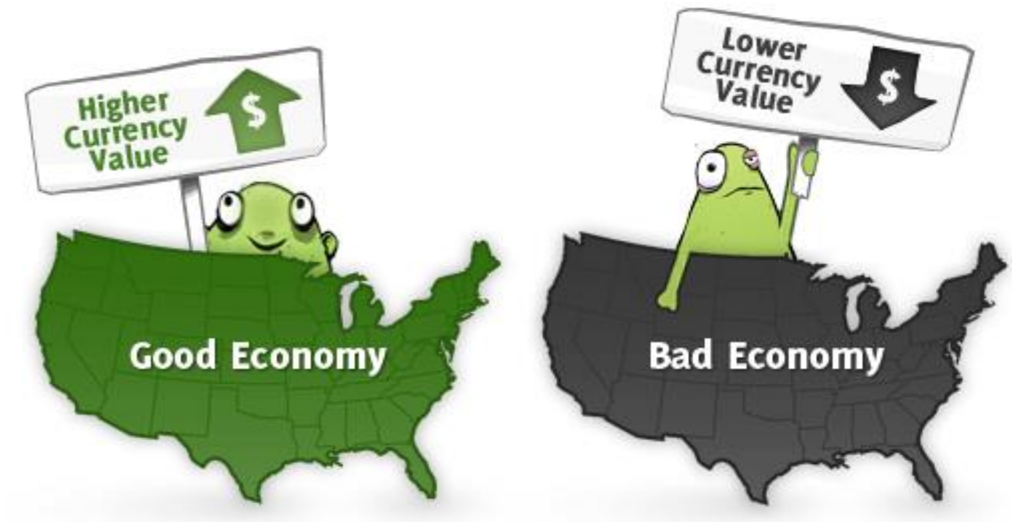
Fundamental analysis is a way of looking at the forex market by analyzing economic, social, and political forces that may affect the supply and demand of an asset. If you think about it, this makes a whole lot of sense! Just like in your Economics 101 class, it is supply and demand that determines price, or in our case, the currency exchange rate.

Using supply and demand as an indicator of where price could be headed is easy. The hard part is analyzing all of the factors that affect supply and demand.

In other words, you have to look at different factors to determine whose economy is rockin' like a Taylor Swift song, and whose economy sucks. You have to understand the reasons of why and how certain events like an increase in the unemployment rate affects a country's economy and monetary policy which ultimately, affects the level of demand for its currency.

The idea behind this type of analysis is that if a country's current or future economic outlook is good, their currency should strengthen. The better shape a country's economy is, the more foreign businesses and investors will invest in that country. This results in the need to purchase that country's currency to obtain those assets.

In a nutshell, this is what **fundamental analysis** is:



For example, let's say that the U.S. dollar has been gaining strength because the U.S. economy is improving. As the economy gets better, raising interest rates may be needed to control growth and inflation.

Higher interest rates make dollar-denominated financial assets more attractive. In order to get their hands on these lovely assets, traders and investors have to buy some greenbacks first. As a result, the value of the dollar will likely increase.

Later on in the course, you will learn which economic data points tends to drive currency prices, and why they do so. You will know who the Fed Chairman is and how retail sales data reflects the economy. You'll be spitting out interest rates like baseball statistics.

But for now, just know that fundamental analysis is a way of analyzing the potential moves of a currency through the strength or weakness of that country's economic outlook. It's going to be awesome, we promise!

Sentiment Analysis

Earlier, we said that price action should theoretically reflect all available market information. Unfortunately for us forex traders, it isn't that simple. The forex markets do not simply reflect all of the information out there because traders will all just act the same way. Of course, that isn't how things work.

This is why **sentiment analysis** is important. Each trader has his or her own opinion of why the market is acting the way it does. The market is just like Facebook – it's a complex network made up of individuals who want to spam our news feeds.

Kidding aside, the market basically represents what all traders – you, Pipcrawler, or Celine from the donut shop – feel about the market. Each trader's thoughts and opinions, which are expressed through whatever position they take, helps form the overall sentiment of the market regardless of what information is out there.

The problem is that as retail traders, no matter how strongly you feel about a certain trade, you can't move the forex markets in your favor. Even if you truly believe that the dollar is going to go up, but everyone else is bearish on it, there's nothing much you can do about it (unless you're one of the GSs – George Soros or Goldman Sachs!).

As a trader, you have to take all this into consideration. You need to perform sentiment analysis. It's up to you to gauge how the market is feeling, whether it is bullish or bearish, and you decide how you want to incorporate your perception of market sentiment into your trading strategy. If you choose to simply ignore market sentiment, that's your choice. But hey, we're telling you now, it's your loss!

Being able to gauge market sentiment aka sentiment analysis can be an important tool in your toolbox. Later on in school, we'll teach you how to analyze currency market sentiment and use it to your advantage, like Jedi mind tricks.

Which Type of Analysis for Forex Trading is Best?

Ahhhh, the million dollar question….

Throughout your journey as an aspiring forex trader you will find strong advocates for each type of analysis. Do not be fooled by these one-sided extremists! One is not better than the other…they are all just different ways to look at the market.

At the end of the day, you should trade based on the type of forex analysis you are most comfortable and profitable with.

To recap, **technical analysis** is the study of currency price movement on the charts while **fundamental analysis** takes a look at how the country's economy is doing.

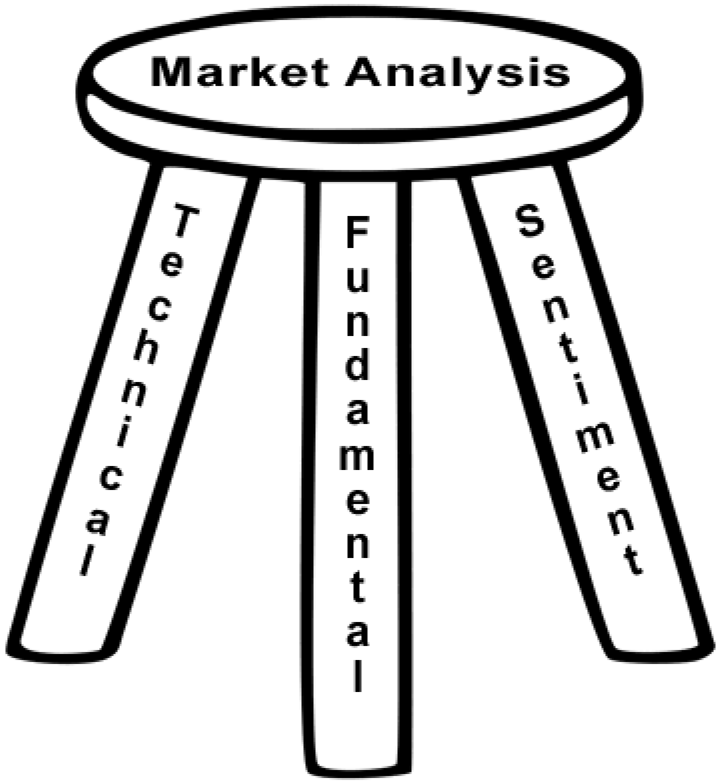
Market **sentiment analysis** determines whether the market is bullish or bearish on the current or future fundamental outlook.

Fundamental factors shape sentiment, while technical analysis helps us visualize that sentiment and apply a framework to create our trade plans.

Those three work hand-in-hand-in-hand to help you come up with good forex trade ideas. All the historical price action and economic figures are there – all you have to do is put on your thinking cap and put those analytical skills to the test!

Let me pull out that three-legged stool again just to emphasize the importance of all three types of analysis.

Take out one or two legs of the stool and it's going to be shaky, right?!



In order to become a true forex master you will need to know how to effectively use these three types of forex market analysis.

Don't believe us?

Let us give you an example of how focusing on only one type of analysis can turn into a disaster.

- Let's say that you're looking at your charts and you find a good trading opportunity.You get all excited thinking about the money that's going to be raining down from the sky.You say to yourself, "Man, I've never seen a more perfect trading opportunity in GBP/USD. I love my charts. Mwah. Now show me the money!"
- You then proceed to buy GBP/USD with a big fat smile on your face (the kind where all your teeth are showing).
- But wait! All of a sudden the trade makes a 100 pip move in the **OTHER DIRECTION**! Little did you know, one of the major banks in London filed for bankruptcy! Suddenly, everyone's sentiment towards Britain's market turns sour and everyone trades in the opposite direction!
- Your big fat smile turns into mush and you start getting angry at your charts. You throw your computer on the ground and begin to pulverize it. You just lost a bunch of money, and now your computer is broken into a billion pieces.And it's all because you completely ignored fundamental analysis and sentimental analysis.

(Note: This was not based on a real story. This did not happen to us. We were never this naive. We were always smart forex traders…. From the overused sarcasm, we think you get the picture.)

Ok, ok, so the story was a little over-dramatized, but you get the point.

Remember how your mother used to tell you as a kid that too much of anything is never good?

Well you might've thought that was just hogwash back then but in forex, the same applies when deciding which type of analysis to use.

Don't rely on just one.

Instead, you must learn to balance the use of all of them. It is only then that you can really get the most out of your trading.

Where do we go from here?

Now that you're done with Kindergarten and learned a little bit about each type of analysis, it's time to delve much deeper! Here's what's in store for the next few years of your life…

We're kidding, we're kidding! We're talking about the next few school years in the School of Pipsology.

Grade school will be all about basic technical analysis tools.

You'll learn all about the dynamics behind price action, such as support and resistance levels, candlestick formations, and common chart patterns. You'll experiment with leading and lagging indicators and discover how to use them in coming up with trade ideas. Sounds pretty exciting, doesn't it?

The remaining years of middle school and high school are devoted to studying more technical analysis tools.

We'll take a look at the more advanced forex tools also such as pivot points, divergences, Elliott Wave Theory, and Gartley patterns. Sounds fancy? It's because they are! Bet you can't wait to get started on those!

College will be a bit more complicated since you'll be tackling both fundamental and market sentiment analysis at the same time. Talk about hitting two birds with one stone! You're the stone and the birds are… well, you get the point.

A couple of reasons why we're putting fundamental and market sentiment analysis together:

- By the time you reach college, you'll be so hooked on learning more about forex that one lesson simply won't be enough.
- It is hard to draw the line between fundamental analysis and market sentiment analysis, but you'll get there with deliberate practice.

As we mentioned earlier, fundamental factors are mostly responsible for shaping forex market sentiment. Those two types of analysis would take up both freshman and sophomore year of college.

3 Types of Forex Charts and How to Read Them

Let’s take a look at the three most popular types of forex charts:

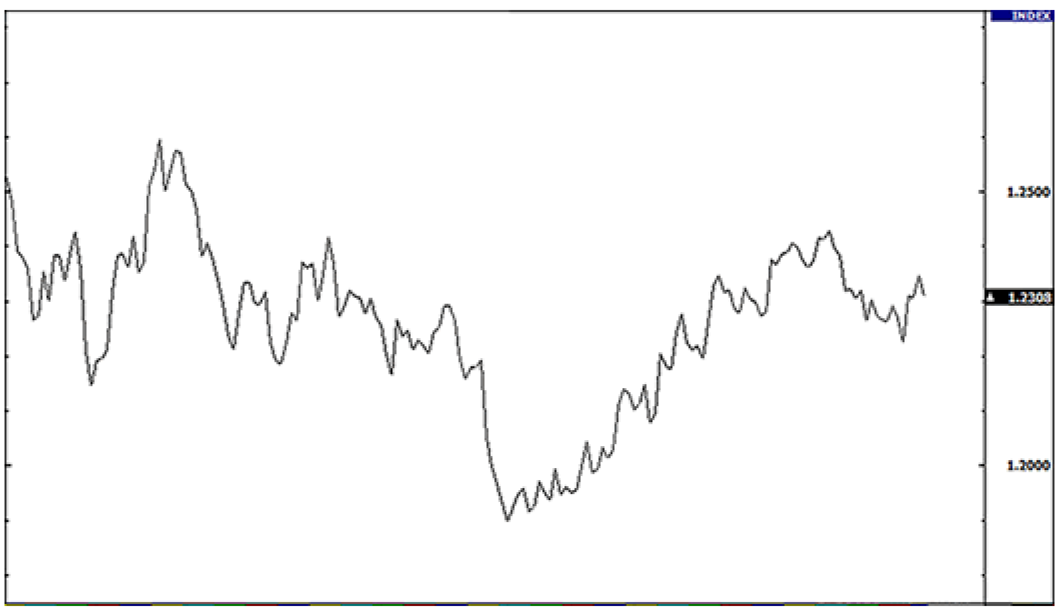
1. Line chart
2. Bar chart
3. Candlestick chart

Now, we’ll explain each of the forex charts, and let you know what you should know about each of them.

Line Charts

A simple line chart draws a line from one closing price to the next closing price. When strung together with a line, we can see the general price movement of a currency pair over a period of time.

Here is an example of a line chart for EUR/USD:



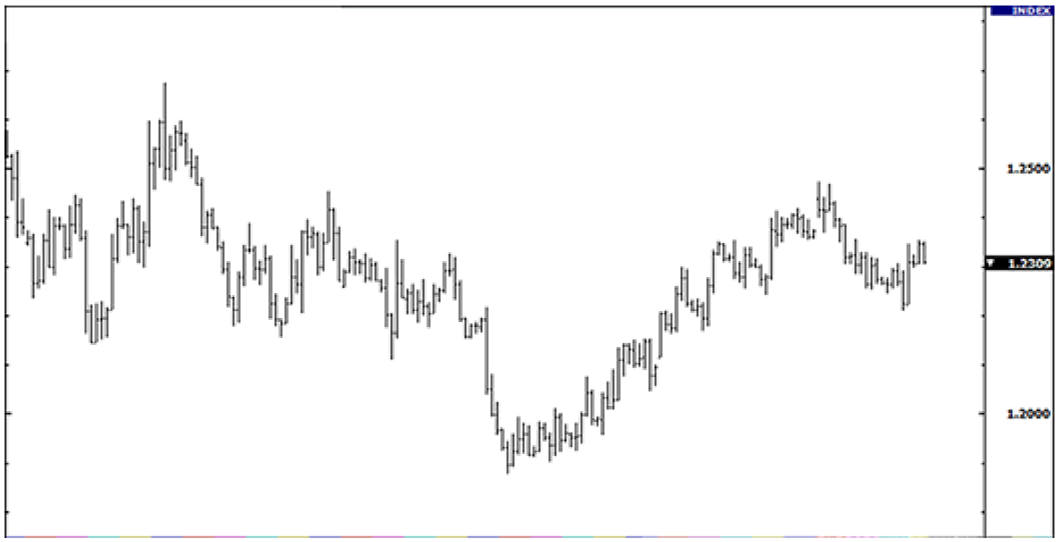
Bar Charts

A bar chart is a little more complex. It shows the opening and closing prices, as well as the highs and lows. The bottom of the vertical bar indicates the lowest traded price for that time period, while the top of the bar indicates the highest price paid.

The vertical bar itself indicates the currency pair’s trading range as a whole.

The horizontal hash on the left side of the bar is the opening price, and the right-side horizontal hash is the closing price.

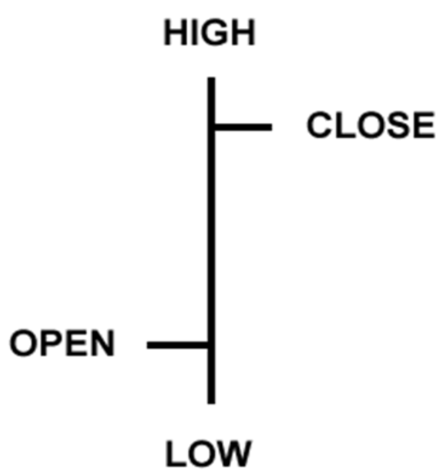
Here is an example of a bar chart for EUR/USD:



Take note, throughout our lessons, you will see the word “bar” in reference to a single piece of data on a chart.

A bar is simply one segment of time, whether it is one day, one week, or one hour. When you see the word ‘bar’ going forward, be sure to understand what time frame it is referencing.

Bar charts are also called “OHLC” charts, because they indicate the Open, the High, the Low, and the Close for that particular currency. Here’s an example of a price bar:



Open: The little horizontal line on the left is the opening price

High: The top of the vertical line defines the highest price of the time period

Low: The bottom of the vertical line defines the lowest price of the time period

Close: The little horizontal line on the right is the closing price

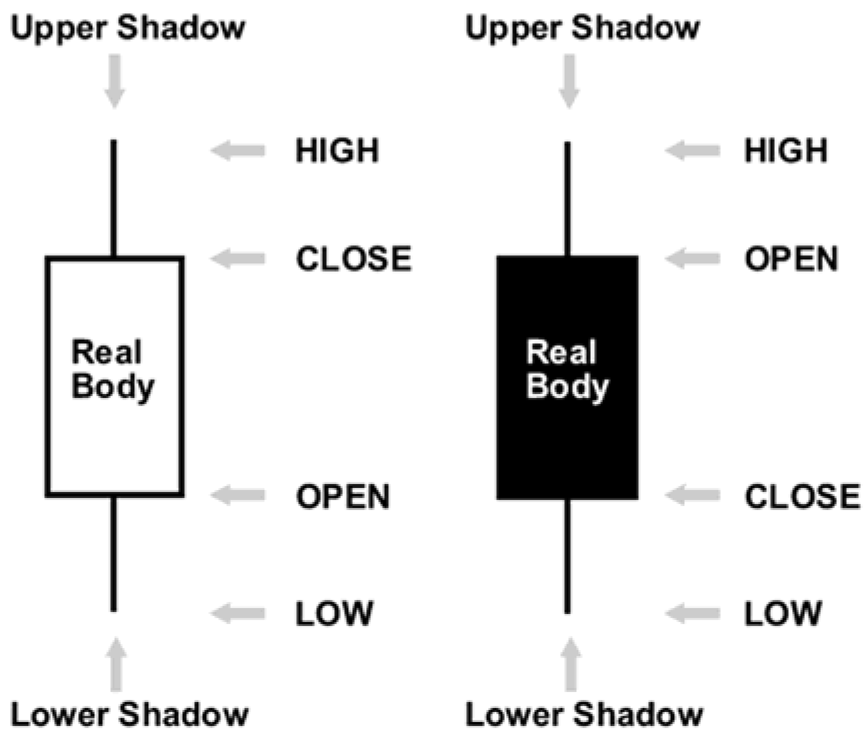
Candlesticks Charts

Candlestick charts show the same price information as a bar chart, but in a prettier, graphic format.

Candlestick bars still indicate the high-to-low range with a vertical line.

However, in candlestick charting, the larger block (or body) in the middle indicates the range between the opening and closing prices. Traditionally, if the block in the middle is filled or colored in, then the currency pair closed lower than it opened.

In the following example, the 'filled color' is black. For our 'filled' blocks, the top of the block is the opening price, and the bottom of the block is the closing price. If the closing price is higher than the opening price, then the block in the middle will be "white" or hollow or unfilled.



Here at My Forex Trading Bible, we don't like to use the traditional black and white candlesticks. They just look so unappealing. And since we spend so much time looking at charts, we feel it's easier to look at a chart that's colored.

A color television is much better than a black and white television, so why not splash some color on those candlestick charts?

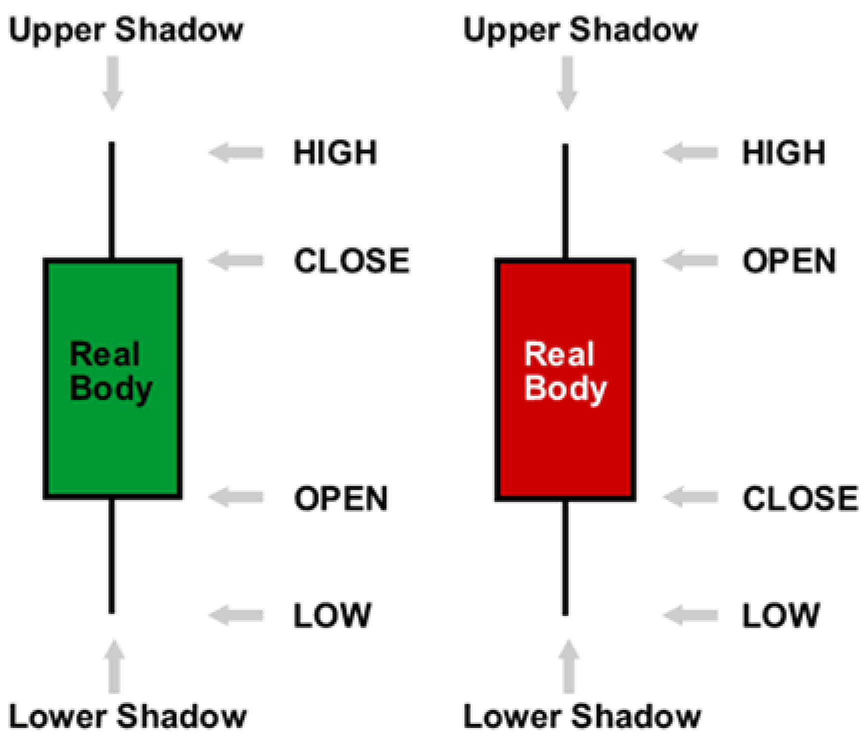
We simply substituted green instead of white, and red instead of black. This means that if the price closed higher than it opened, the candlestick would be green.

If the price closed lower than it opened, the candlestick would be red.

In our later lessons, you will see how using green and red candles will allow you to “see” things on the charts much faster, such as uptrend/downtrends and possible reversal points.

For now, just remember that on forex charts, we use red and green candlesticks instead of black and white and we will be using these colors from now on.

Check out these candlesticks…BabyPips.com style! Awww yeeaaah! You know you like that!



Here is an example of a candlestick chart for EUR/USD. Isn’t it pretty?

The purpose of candlestick charting is strictly to serve as a visual aid, since the exact same information appears on an OHLC bar chart. The advantages of candlestick charting are:

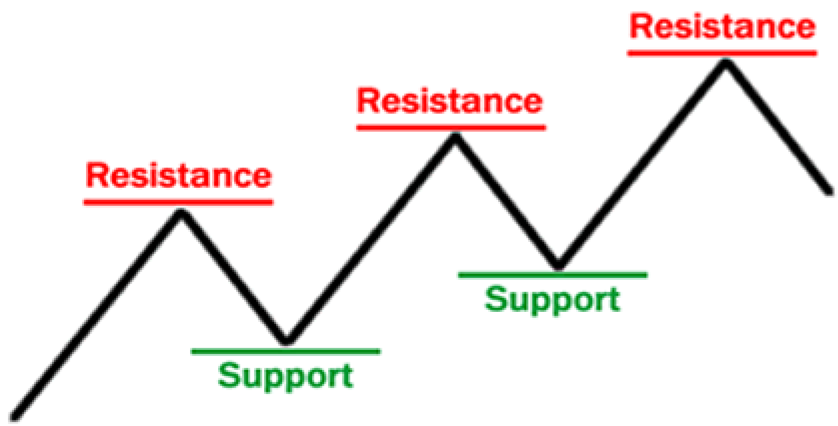
- Candlesticks are easy to interpret, and are a good place for beginners to start figuring out forex chart analysis.
- Candlesticks are easy to use! Your eyes adapt almost immediately to the information in the bar notation. Plus, research shows that visuals help with studying, so it might help with trading as well!
- Candlesticks and candlestick patterns have cool names such as the "shooting star," which helps you to remember what the pattern means.
- Candlesticks are good at identifying market turning points – reversals from an uptrend to a downtrend or a downtrend to an uptrend. You will learn more about this later.

Now that you know why candlesticks are so cool, it's time to let you know that we will be using candlestick forex charts for most, if not all of forex chart examples on this site.

Forex Support and Resistance

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

Let's 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 forex 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 forex market oscillates over time. The reverse is true for the downtrend.

Plotting Forex 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 1.4700 support level. At those times it seemed like the market was "breaking" support. In hindsight we can see that the market was merely testing that level.

So how do we truly know if support and resistance was 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 1.4700 support level.

In this case, price had closed below the 1.4700 support level but ended up rising back up above it.

If you had believed that this was a real breakout and sold this pair, you would've been seriously hurtin'!

Looking at the chart now, you can visually see and come to the conclusion that the support was not actually broken; it is still very much intact and now even stronger.

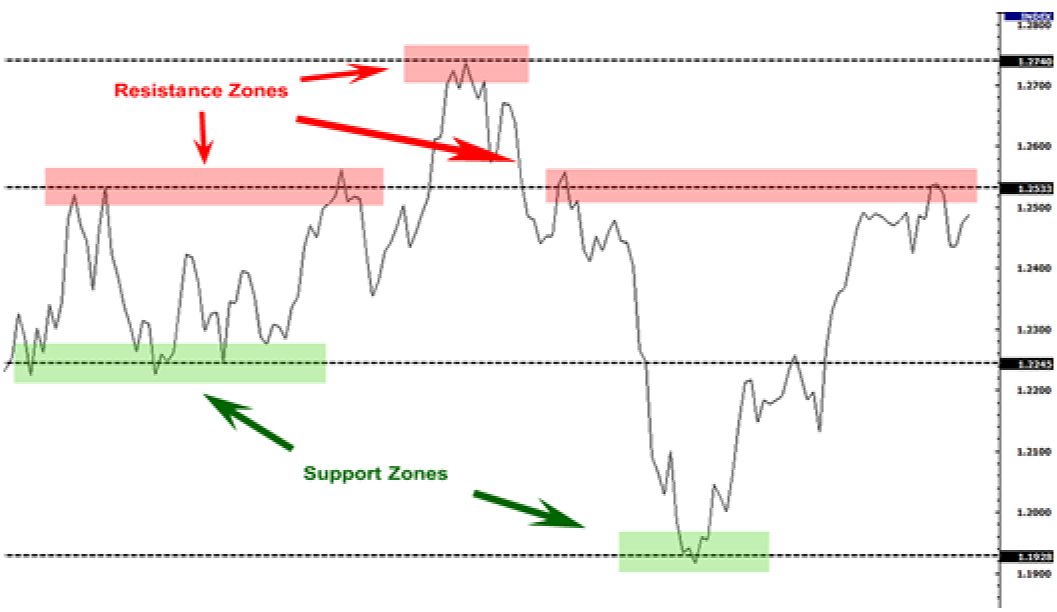
To help you filter out these false breakouts, you should think of support and resistance more of as "zones" rather than concrete numbers.

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, he or she simply replies, "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 *<u>intentional</u>* *movements.*

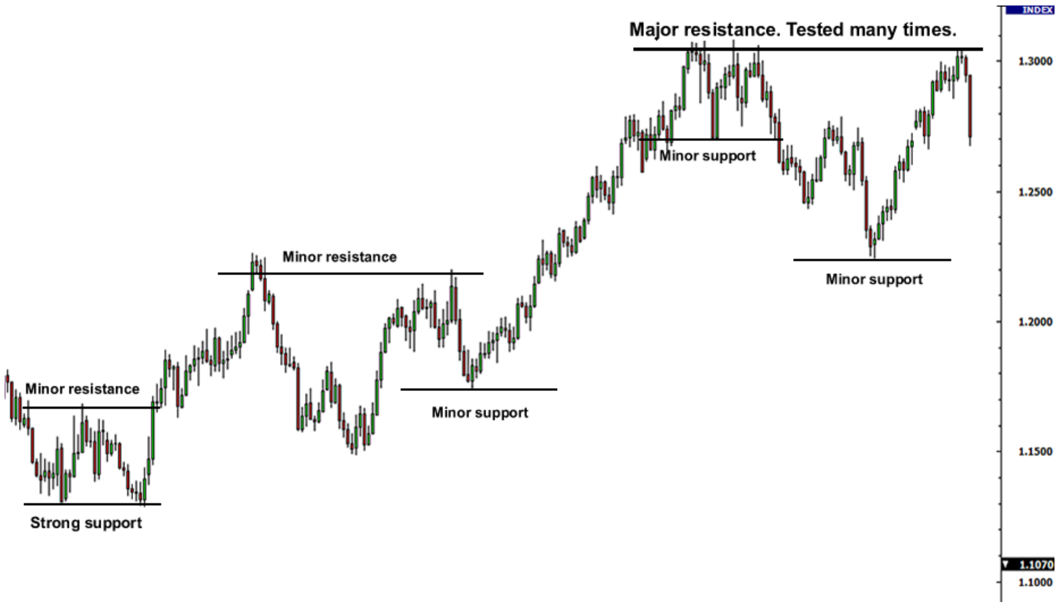
Looking at the line chart, you want to plot your support and resistance lines around areas where you can see the price forming several peaks or valleys.



Other interesting tidbits about forex support and resistance:

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

- When a support or resistance level breaks, the strength of the follow-through move depends on how strongly the broken support or resistance had been holding.



With a little practice, you'll be able to spot potential forex support and resistance areas easily. In the next lesson, we'll teach you how to trade diagonal support and resistance lines, otherwise known as forex trend lines.

Trend Lines

Trend lines are probably the most common form of technical analysis in forex trading. They are probably one of the most underutilized ones as well.

If drawn correctly, they can be as accurate as any other method. Unfortunately, most forex traders don't draw them correctly or 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).

How do you draw forex trend lines?

To draw forex trend lines properly, all you have to do is locate two major tops or bottoms and connect them.

What's next?

Nothing.

Uhh, is that it?

Yep, it's that simple.

Here are trend lines in action! Look at those waves!

Types of Trends

There are three types of trends:

1. Uptrend (higher lows)
2. Downtrend (lower highs)
3. Sideways trends (ranging)

Here are some important things to remember using trend lines in forex trading:

- It takes at least two tops or bottoms to draw a valid trend line but it takes THREE to confirm a trend line.
- The STEEPER the trend line you draw, the less reliable it is going to be and the more likely it will break.
- Like horizontal support and resistance levels, trend lines become stronger the more times they are tested.
- And most importantly, **DO NOT EVER** draw trend lines by forcing them to fit the market. If they do not fit right, then that trend line isn't a valid one!

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. No, we're not talking about ESPN, ABC, or Cartoon Network.

Still, this doesn't mean that you should walk away like it's a commercial break- channels can be just as exciting to watch as America's Next Top Model or Entourage!

Channels are just another tool in technical analysis which can be used to determine good places to buy or sell. Both the tops and bottoms of channels represent potential areas of support or resistance.

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. This should be done at the same time you create the trend line.

To create a down (descending) channel, simply 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 create 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.

Types of channels

There are three types of channels:

1. Ascending channel (higher highs and higher lows)
2. Descending channel (lower highs and lower lows)

3. Horizontal channel (ranging)

Important things to remember about drawing trend lines:

- When constructing a channel, both trend lines must be parallel to each other.
- Generally, the bottom of channel is considered a buy zone while the top of channel is considered a sell zone.
- Like in drawing trend lines, **DO NOT EVER** force the price to the channels that you draw! A channel boundary that is sloping at one angle while the corresponding channel boundary is sloping at another is not correct and could lead to bad trades.

How to Trade Support and Resistance

Now that you know the basics, it’s time to apply these basic but extremely useful technical tools in your trading. Because here at BabyPips.com we want to make things easy to understand, we have divided how to trade support and resistance levels into two simple ideas: the **Bounce** and the **Break**.

The Bounce

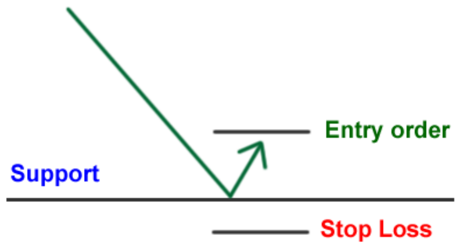
As the name suggests, one method of trading support and resistance levels is right after the bounce.

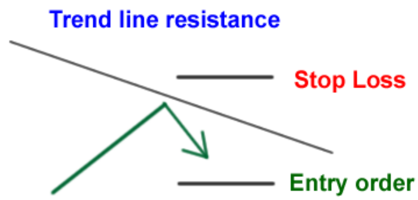
Many retail forex traders make the error of setting their orders directly on support and resistance levels and then just waiting to for their trade to materialize. Sure, this may work at times but this kind of trading method assumes that a support or resistance level will hold without price actually getting there yet.

You might be thinking, “Why don’t I just set an entry order right on the line? That way, I am assured the best possible price.”

When playing the bounce, we want to tilt the odds in our favor and find some sort of confirmation that the support or resistance will *hold*.

Instead of simply buying or selling right off the bat, wait for it to *bounce* first before entering. By doing this, you avoid those moments where price moves fast and break through support and resistance levels. From experience, catching a falling knife when trading forex can get really bloody…





The Break

In a perfect world, support and resistance levels would hold forever, McDonald's would be healthy, and we'd all have jetpacks. In a perfect forex trading world, we could just jump in and out whenever price hits those major support and resistance levels and earn loads of money. The fact of the matter is that these levels break… often.

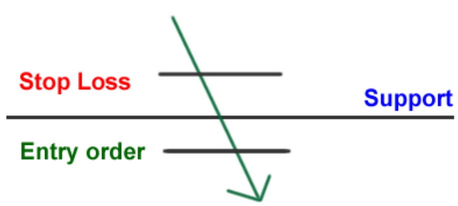
So, it's not enough to just play bounces. You should also know what to do whenever support and resistance levels give way!

There are two ways to play breaks in forex trading: the aggressive way or the conservative way.

The Aggressive Way

The simplest way to play breakouts is to buy or sell whenever price passes convincingly through a support or resistance zone. The key word here is convincingly because we only want to enter when price passes through a significant support or resistance level with ease.

We want the support or resistance area to act as if it just received a Chuck Norris karate chop: We want it to wilt over in pain as price breaks right through it.



The Conservative Way

Imagine this hypothetical situation: you decided to go long EUR/USD hoping it would rise after bouncing from a support level. Soon after, support breaks and you are now holding on to a losing position, with your account balance slowly falling.

Do you…

A. Accept defeat, get the heck out, and liquidate your position?

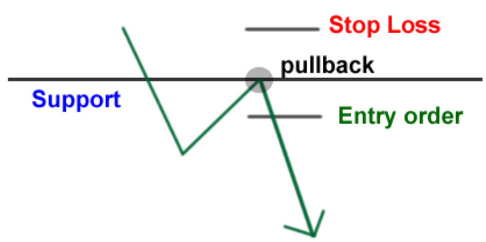
or

B. Hold on to your trade and hope price rises up again?

If your choice is the second one, then you will easily understand this type of forex trading method. Remember, whenever you close out a position, you take the opposite side of the trade. Closing your EUR/USD long trade at or near breakeven means you will have to short the EUR/USD by the same amount.

Now, if enough selling and liquidation of losing positions happens at the broken support level, price will reverse and start falling again. This phenomenon is the main reason why broken support levels become resistance whenever they break.

As you would've guessed, taking advantage of this phenomenon is all about being **patient**. Instead of entering right on the break, you wait for price to make a "pullback" to the broken support or resistance level and enter *after* the price bounces.



A few words of caution… IN FOREX, THIS DOES NOT HAPPEN ALL THE TIME. "RETESTS" OF BROKEN SUPPORT AND RESISTANCE LEVELS DO NOT HAPPEN ALL THE TIME. THERE WILL BE TIMES THAT PRICE WILL JUST MOVE IN ONE DIRECTION AND LEAVE YOU BEHIND. BECAUSE OF THIS, ALWAYS USE STOP LOSS ORDERS AND NEVER EVER HOLD ON TO A TRADE JUST BECAUSE OF HOPE.

Whoops, sorry about that folks, the caps lock key got stuck.

Summary: Trading Support and Resistance

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

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

One thing to remember is that horizontal support and resistance levels are not exact numbers.

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.

Another thing to remember is that when price passes through a resistance level, that resistance could potentially become support. The same could also happen with a support level. If a support level is broken, it could potentially become a resistance level

Trend Lines

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).

There are three types of trends:

1. Uptrend (higher lows)
2. Downtrend (lower highs)
3. Sideways trends (ranging)

Channels

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.

1. Ascending channel (higher highs and higher lows)
2. Descending channel (lower highers and lower lows)
3. Horizontal channel (ranging)

Trading support and resistance levels can be divided into two methods: the bounce and the break.

When trading **the bounce** we want to tilt the odds in our favor and find some sort of confirmation that the support or resistance will hold. Instead of simply buying or selling right off the bat, wait for it to bounce first before entering. By doing this, you avoid those moments where price moves so fast that it slices through support and resistance levels like a knife slicing through warm butter.

As for trading **the break**, there is the aggressive way and there is the conservative way. In the aggressive way, you simply buy or sell whenever the price passes through a support or resistance zone with ease. In the conservative way, you wait for price to make a "pullback" to the broken support or resistance level and enter after price bounces.

What is a Japanese Candlestick?

While we briefly covered Japanese candlestick charting analysis in the previous forex lesson, we'll now dig in a little and discuss them more in detail. Let's do a quick review first.

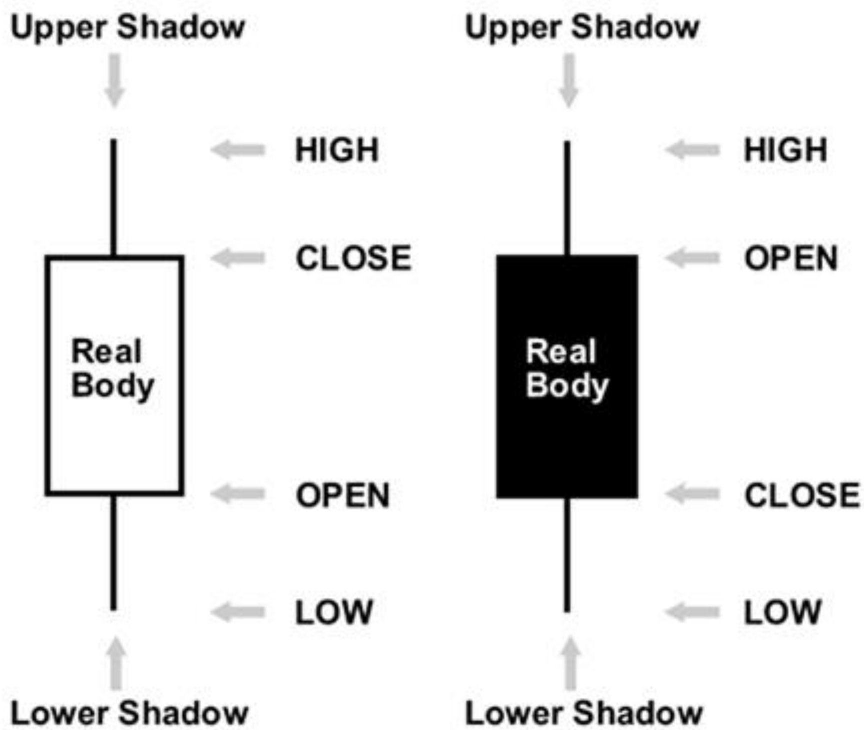
Japanese Candlestick Trading

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. That's right, rice.

A Westerner by the name of Steve Nison "discovered" this secret technique called "Japanese candlesticks," learning it from a fellow Japanese broker. Steve researched, studied, lived, breathed, ate candlesticks, and began to write about it. Slowly, this secret technique grew in popularity in the 90's. To make a long story short, without Steve Nison, candlestick charts might have remained a buried secret. Steve Nison is Mr. Candlestick.

Okay, so what the heck are Japanese candlesticks?

The best way to explain is by using a picture:

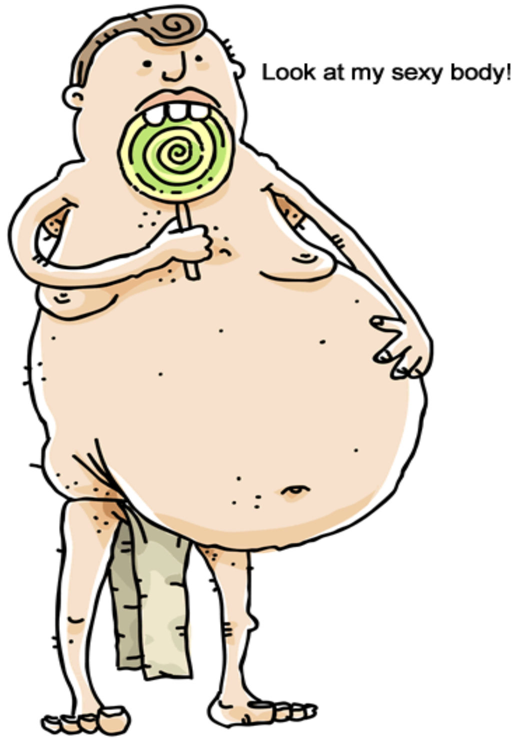


Japanese candlesticks can be used for any forex time frame, whether it be one day, one hour, 30-minutes – whatever you want! They are used to describe the price action during the given time frame.

Japanese candlesticks are formed using the open, high, low, and close of the chosen time period.

- 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"

Japanese Candlestick Anatomy

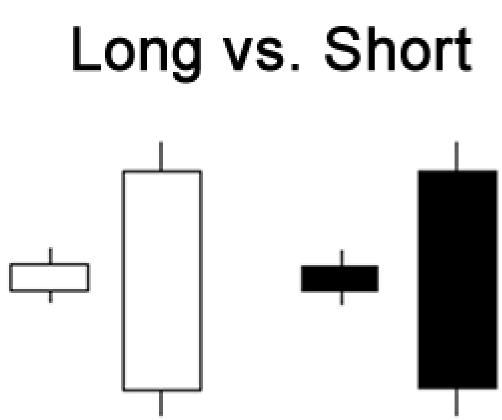


Sexy Bodies

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. This means that either buyers or sellers were stronger and took control.

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



Long white Japanese candlesticks show strong buying pressure. The longer the white candlestick, the further the close is above the open. This indicates that prices increased considerably from open to close and buyers were aggressive. In other words, the bulls are kicking the bears' butts big time!

Long black (filled) candlesticks show strong selling pressure. The longer the black Japanese candlestick, the further the close is below the open. This indicates that prices fell a great deal from the open and sellers were aggressive. In other words, the bears were grabbing the bulls by their horns and body-slamming them.

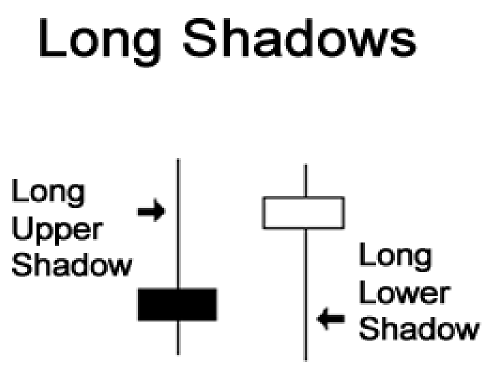
Mysterious Shadows

The upper and lower shadows on Japanese 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.

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



If a Japanese candlestick has a *long upper shadow and short lower shadow*, this means that buyers flexed their muscles and bid 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.

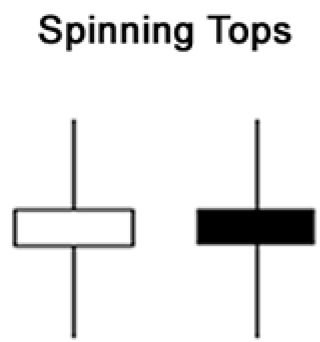
If a Japanese candlestick has a *long lower shadow and short upper shadow*, this means that sellers flashed their washboard abs and forced price lower, but for one reason or another, buyers came in and drove prices back up to end the session back near its open price.

Basic Japanese Candlestick Patterns

Spinning Tops

Japanese 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.

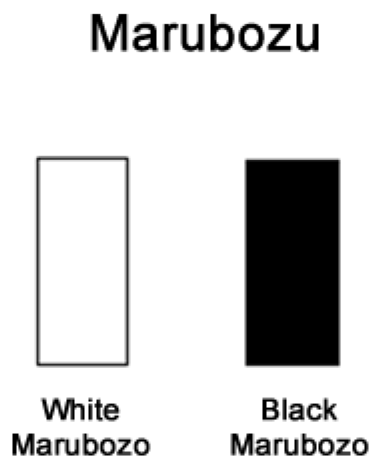
Even though the session opened and closed with little change, prices moved significantly higher and lower in the meantime. Neither buyers nor sellers could gain the upper hand, and the result was a standoff.

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 its open or close. Check out the two types of Marubozus in the picture below.



A **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 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 entire session. It usually implies bearish continuation or bearish reversal.

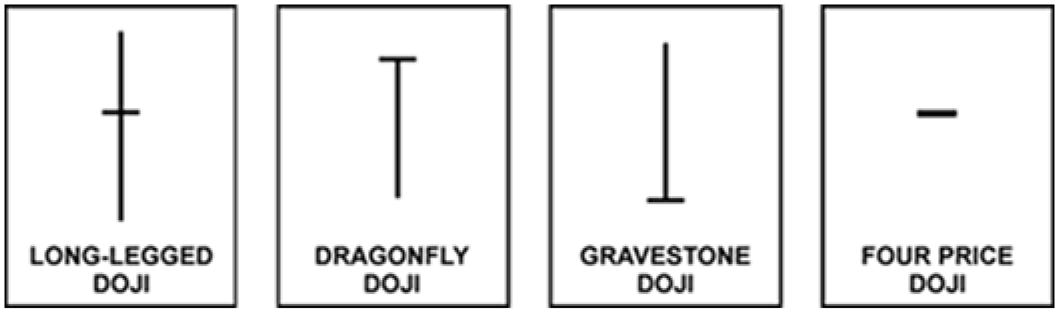
Doji

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

Doji candles 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.

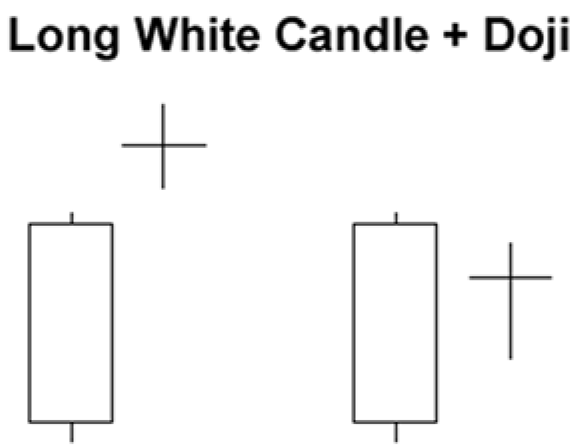
Neither buyers nor sellers were able to gain control and the result was essentially a draw.

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

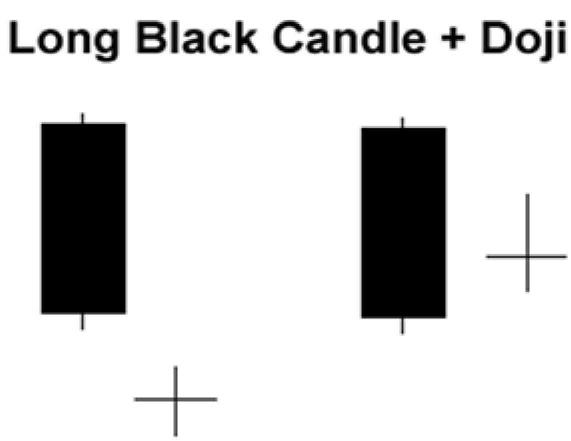


When a Doji forms on your chart, pay special attention to the preceding candlesticks.

If a Doji forms after a series of candlesticks with long hollow 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.



If a Doji forms after a series of candlesticks with long filled bodies (like Black Marubozus), the Doji signals that sellers are becoming exhausted and weak. 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.



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.

In the next following sections, we will take a look at specific Japanese candlestick pattern and what they are telling us. Hopefully, by the end of this lesson on candlesticks, you will know how to recognize different types of forex candlestick patterns and make sound trading decisions based on them.

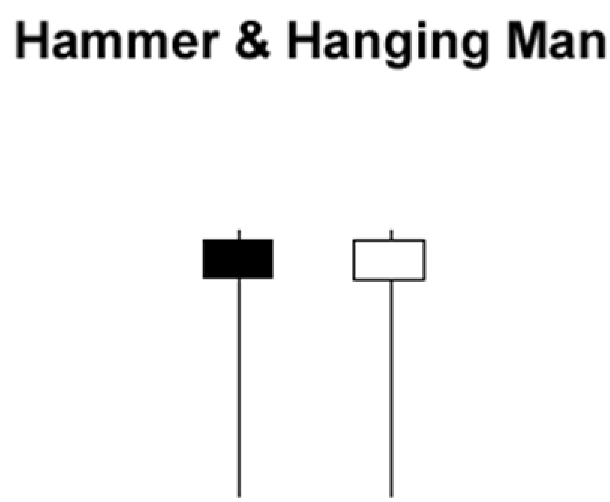
Single Candlestick Patterns

Learn how to use single candlestick patterns to identify potential market reversals.

Here are the four basic single Japanese candlestick patterns:

Hammer and Hanging Man

The hammer and hanging man look exactly alike but have totally different meanings 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.

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 typical example of confirmation would be to wait for a white candlestick to close above the open to the right 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.

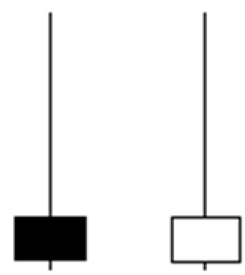
Recognition Criteria:

- 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.

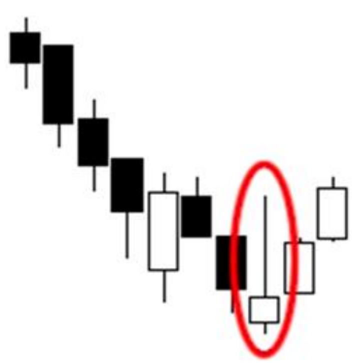
Inverted Hammer and Shooting Star

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.

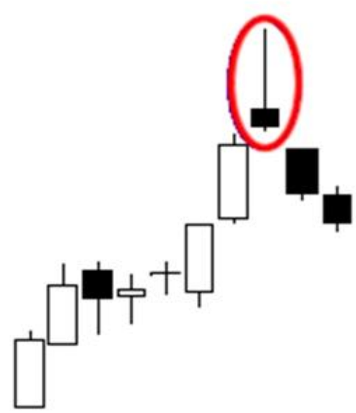
Inverted Hammer & Shooting Star



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 heck 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.

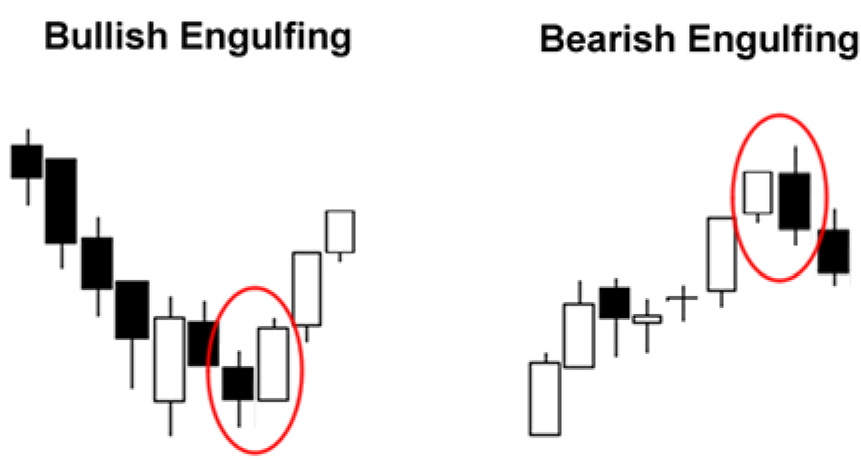
Since the sellers weren’t able to close the price any lower, this is a good indication that everybody who wants to sell has already sold. And if there are no more sellers, who is left? Buyers.

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. This is a definite bearish sign since there are no more buyers left because they’ve all been murdered.

Dual Candlestick Patterns

Engulfing Candles



The **bullish engulfing pattern** is a two candlestick pattern that signals a strong up move may be coming. It happens when a bearish candle is immediately followed by a larger bullish candle.

This second candle “engulfs” the bearish candle. This means buyers are flexing their muscles and that there could be a strong up move after a recent downtrend or a period of consolidation.

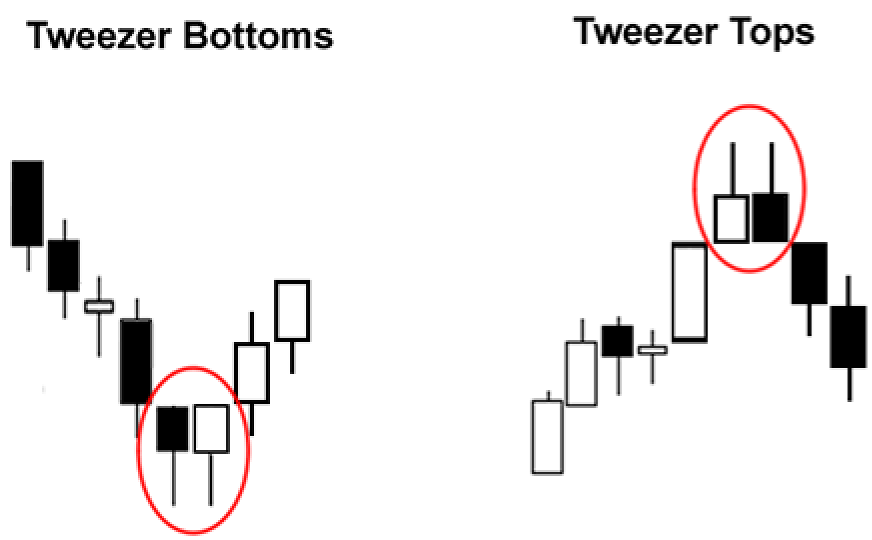
On the other hand, the **bearish engulfing pattern** is the opposite of the bullish pattern. This type of candlestick pattern occurs when the bullish candle is immediately followed by a bearish candle that completely “engulfs” it. This means that sellers overpowered the buyers and that a strong move down could happen.

Tweezer Bottoms and Tops

The tweezers are dual candlestick reversal patterns. This type of candlestick pattern are usually be spotted after an extended uptrend or downtrend, indicating that a reversal will soon occur.

Notice how the candlestick formation looks just like a pair of tweezers!

Amazing!

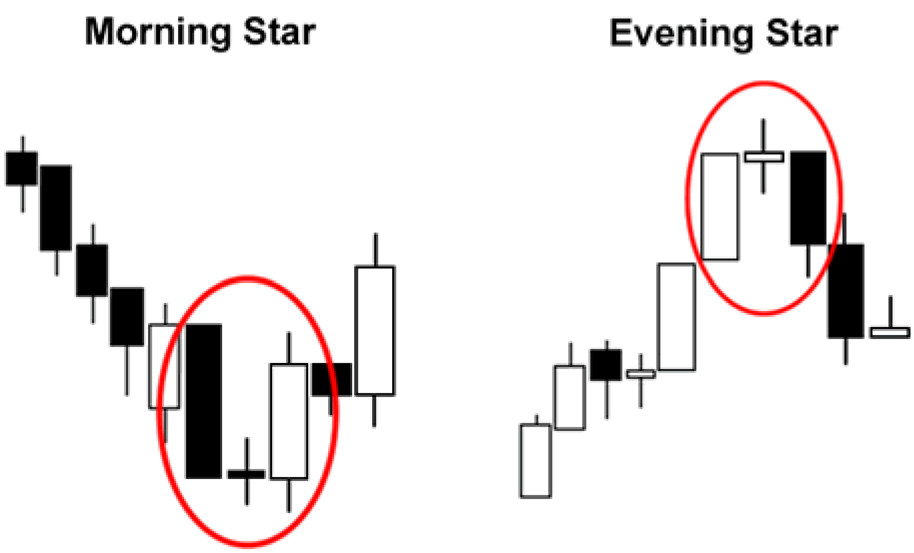


The most effective Tweezers have the following characteristics:

- The first candlestick is the same as the overall trend. If price is moving up, then the first candle should be bullish.
- The second candlestick is opposite the overall trend. If price is moving up, then the second candle should be bearish.
- The shadows of the candlesticks should be of equal length. Tweezer Tops should have the same highs, while Tweezer Bottoms should have the same lows.

Triple Candlestick Patterns

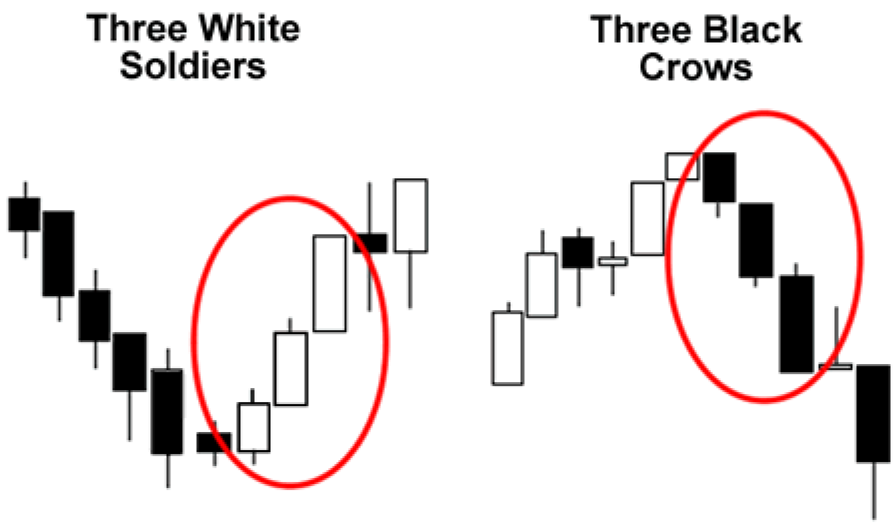
Evening and Morning Stars



The morning star and the evening star are triple candlestick patterns that you can usually find at the end of a trend. They are reversal patterns that can be recognized through three characteristics. We'll use the Evening Star Pattern on the right as an example of what you may see:

1. The first candlestick is a bullish candle, which is part of a recent uptrend.
2. The second candle has a small body, indicating that there could be some indecision in the market. This candle can be either bullish or bearish.
3. The third candlestick acts as a confirmation that a reversal is in place, as the candle closes beyond the midpoint of the first candle.

Three White Soldiers and Black Crows



The **three white soldiers** pattern is formed when three long bullish candles follow a downtrend, signaling a reversal has occurred. This type of triple candlestick pattern is considered as one of the most potent in-yo-face bullish signals, especially when it occurs after an extended downtrend and a short period of consolidation.

The first of the three soldiers is called the reversal candle. It either ends the downtrend or implies that the period of consolidation that followed the downtrend is over.

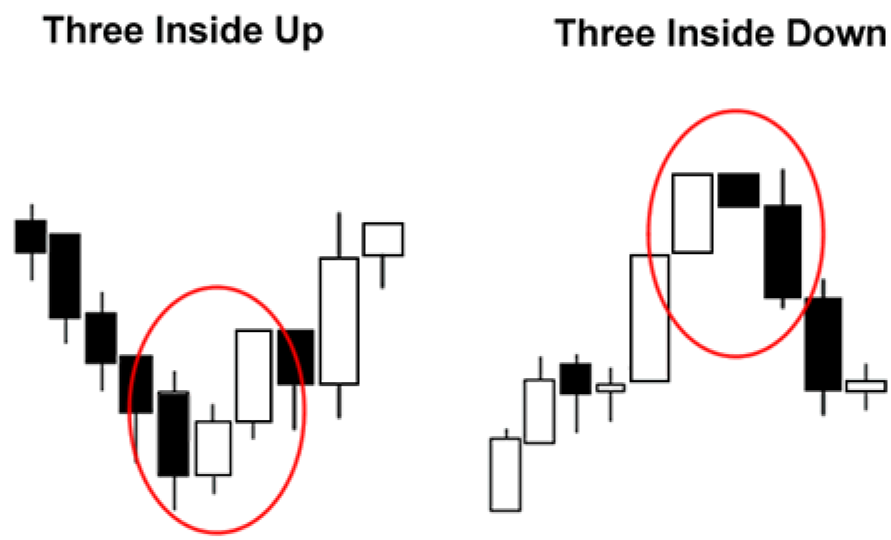
For the pattern to be considered valid, the second candlestick should be bigger than the previous candle's body. Also, the second candlestick should close near its high, leaving a small or non-existent upper wick.

For the three white soldiers pattern to be completed, the last candlestick should be at least the same size as the second candle and have a small or no shadow.

The **three black crows** candlestick pattern is just the opposite of the three white soldiers. It is formed when three bearish candles follow a strong uptrend, indicating that a reversal is in the works.

The second candle's body should be bigger than the first candle and should close at or very near its low. Finally, the third candle should be the same size or larger than the second candle's body with a very short or no lower shadow.

Three Inside Up and Down



The **three inside up** candlestick formation is a trend-reversal pattern that is found at the bottom of a downtrend. This triple candlestick pattern indicates that the downtrend is possibly over and that a new uptrend has started. For a valid three inside up candlestick formation, look for these properties:

1. The first candle should be found at the bottom of a downtrend and is characterized by a long bearish candlestick.
2. The second candle should at least make it up all the way up to the midpoint of the first candle.
3. The third candlestick needs to close above the first candle's high to confirm that buyers have overpowered the strength of the downtrend.

Conversely, the **three inside down** candlestick formation is found at the top of an uptrend. It means that the uptrend is possibly over and that a new downtrend has started. A three inside down candlestick formation needs to have the following characteristics:

1. The first candle should be found at the top of an uptrend and is characterized by a long bullish candlestick.
2. The second candle should make it up all the way down the midpoint of the first candle.
3. The third candlestick needs to close below the first candle's low to confirm that sellers have overpowered the strength of the uptrend.

Summary: Japanese Candlesticks

- 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.

There are many types of Japanese candlestick patterns, but they can be categorized into how many bars make up the candlestick pattern. There are single, dual, and triple candlestick formations. The most common types of Japanese candlestick patterns are the following:

Number of Bars	Japanese Candlestick Pattern
Single	Spinning Tops, Dojis, Marubozu, Inverted Hammer, Hanging Man, Shooting Star
Double	Bullish and Bearish Engulfing, Tweezer Tops and Bottoms
Triple	Morning and Evening Stars, Three Black Crows and Three White Soldiers, Three Inside Up and Down

Just refer to the Japanese Candlesticks Cheat Sheet for a quick reference on what these candlestick patterns mean.

Combine candlestick analysis with support and resistance levels for best results.

And finally, here are some words of wisdom.

Just because candlesticks hint at a reversal or continuation, it doesn’t mean it will happen for sure! You must always consider market conditions and what price action is telling you.

This is the forex market and nothing is set in stone!

Fibonacci Trading

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

Let us first start by introducing you to the Fib man himself…Leonardo Fibonacci.

No, Leonardo Fibonacci isn't some famous chef. Actually, he was a famous Italian mathematician, also known as a super duper uber ultra geek.

He had an "Aha!" moment when he 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: 0, 1, 1, 2, 3, 5, 8, 13, 21, 34, 55, 89, 144…

This series of numbers is derived by starting with 0 followed by 1 and then adding 0 + 1 to get 1, the third number. Then, adding the second and third number (1 + 1) to get 2, the fourth number, and so on.

After the first few numbers in the sequence, if you measure the ratio of any number to the succeeding higher number, you get .618. For example, 34 divided by 55 equals .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. With all those numbers, you could put an elephant to sleep. We'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. Besides, we've got a nice Fibonacci calculator that can magically calculate those levels for you. However, it's always good to be familiar with the basic theory behind the indicator so you'll have the knowledge to impress your date.

Traders use the Fibonacci retracement levels as potential **support and resistance areas**. 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 tend to become a self-fulfilling prophecy.

Traders use the Fibonacci extension levels as **profit taking levels**. Again, since so many traders are watching these levels to place buy and sell orders to take profits, this tool tends to work more often than not due to 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.

You got all that? Don't worry, we'll explain retracements, extensions, and most importantly, how to grab some pips using the Fibonacci tool in the following lessons.

How to Use Fibonacci Retracement to Enter a Forex Trade

The first thing you should know about the Fibonacci tool is that it works best when the forex market is trending.

The idea is to go long (or buy) on a retracement at a Fibonacci support level when the market is trending up, and to go short (or sell) on a retracement at a Fibonacci resistance level when the market is trending down.

Finding Fibonacci Retracement Levels

In order to find these Fibonacci retracement levels, you have to find the recent significant Swing Highs and Swings Lows. Then, for downtrends, click on the Swing High and drag the cursor to the most recent Swing Low.

For uptrends, do the opposite. Click on the Swing Low and drag the cursor to the most recent Swing High.

Got that? Now, let's take a look at some examples on how to apply Fibonacci retracements levels to the currency markets.

Uptrend

This is a daily chart of AUD/USD.

Here we plotted the Fibonacci retracement levels by clicking on the Swing Low at .6955 on April 20 and dragging the cursor to the Swing High at .8264 on June 3. Tada! The software magically shows you the retracement levels.

As you can see from the chart, the Fibonacci retracement levels were .7955 (23.6%), .7764 (38.2%), .7609 (50.0%), .7454 (61.8%), and .7263 (76.4%).

Now, the expectation is that if AUD/USD retraces from the recent high, it will find support at one of those Fibonacci retracement levels because traders will be placing buy orders at these levels as price pulls back.

Now, let's look at what happened after the Swing High occurred.

Price pulled back right through the 23.6% level and continued to shoot down over the next couple of weeks. It even tested the 38.2% level but was unable to close below it.

Later on, around July 14, the market resumed its upward move and eventually broke through the swing high. Clearly, buying at the 38.2% Fibonacci level would have been a profitable long term trade!

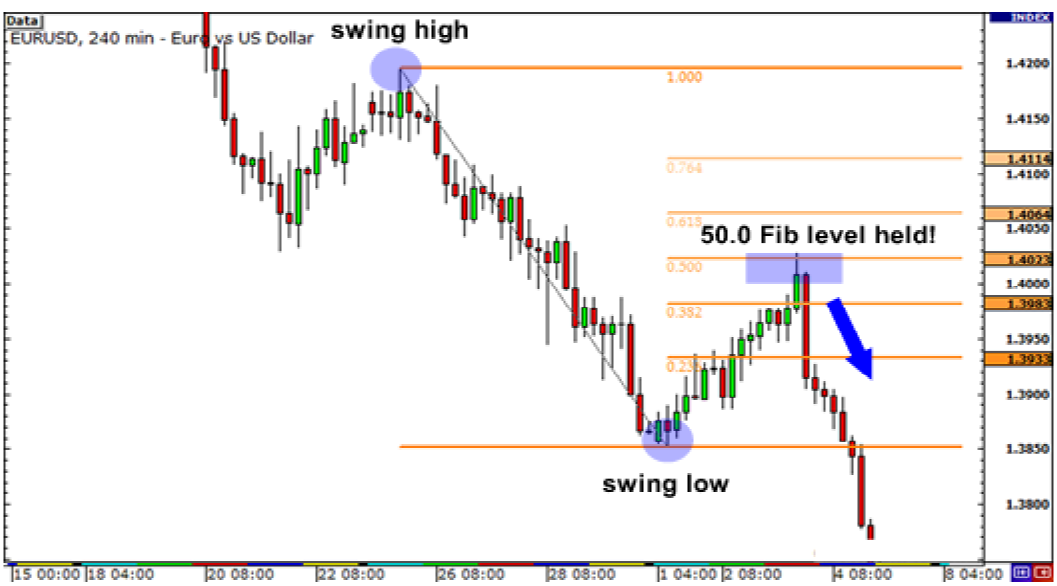
Downtrend

Now, let's see how we would use the Fibonacci retracement tool during a downtrend. Below is a 4-hour chart of EUR/USD.

As you can see, we found our Swing High at 1.4195 on January 25 and our Swing Low at 1.3854 a few days later on February 1. The retracement levels are 1.3933 (23.6%), 1.3983 (38.2%), 1.4023 (50.0%), 1.4064 (61.8%) and 1.4114 (76.4%).

The expectation for a downtrend is that if price retraces from this low, it could possibly encounter resistance at one of the Fibonacci levels because traders who want to play the downtrend at better prices may be ready with sell orders there.

Let's take a look at what happened next.



Yowza, isn't that a thing of beauty?!

The market did try to rally, stalled below the 38.2% level for a bit before testing the 50.0% level. If you had some orders either at the 38.2% or 50.0% levels, you would've made some mad pips on that trade.

In these two examples, we see that price *found* some temporary forex support or resistance at Fibonacci retracement levels. Because of all the people who use the Fibonacci tool, those levels become self-fulfilling support and resistance levels.

One thing you should take note of is that price won't always bounce from these levels. They should be looked at as *areas of interest*, or as Cyclopip likes to call them, "**KILL ZONES!**" We'll teach you more about that later on.

For now, there's something you should always remember about using the Fibonacci tool and it's that they are not always simple to use! If they were that simple, traders would always place their orders at Fibonacci retracement levels and the markets would trend forever.

In the next lesson, we'll show you what can happen when Fibonacci retracement levels fail.

Fibonacci Retracement is NOT Foolproof

Back in Grade 1, we said that support and resistance levels eventually break. Well, seeing as how Fibonacci levels are used to find support and resistance levels, this also applies to Fibonacci!

Fibonacci retracements do NOT always work! They are not foolproof. Let's go through an example when the Fibonacci retracement tool fails.

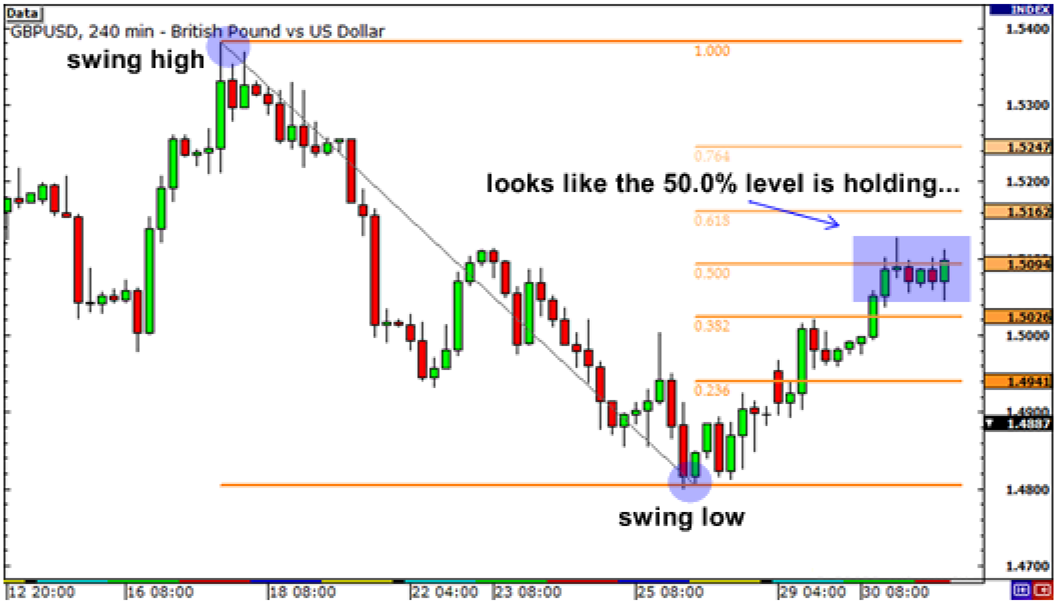
Below is a 4-hour chart of GBP/USD.

Here, you see that the pair has been in downtrend, so you decided to take out your Fibonacci retracement tool to help you spot a good entry point. You use the Swing High at 1.5383, with a swing low at 1.4799.

You see that the pair has been stalling at the 50.0% level for the past couple of candles.

You say to yourself, "Oh man, that 50.0% Fib level! It's holding baby! Time to short this sucka!"

You short at market and start day dreaming that you'll be driving down Rodeo Drive in your new Maserati with Scarlett Johansson (or if you're a lady trader, Ryan Gosling) in the passenger seat…



Now, if you really did put an order at that level, not only would your dreams go up in smoke, but your account would take a serious hit if you didn't manage your risk properly!

Take a look at what happened.

It turns out that that Swing Low was the bottom of the downtrend and market began to rally above the Swing High point.

What's the lesson here?

While Fibonacci retracement levels give you a higher probability of success, like other technical tools, they don't always work. You don't know if price will reverse to the 38.2% level before resuming the trend.

Sometimes it may hit 50.0% or the 61.8% levels before turning around. Heck, sometimes price will just ignore Mr. Fibonacci and blow past all the levels just like how Lebron James bullies his way through the lane with sheer force.

Remember, the market will not always resume its uptrend after finding temporary support or resistance, but instead continue to go past the recent Swing High or Low.

Another common problem in using the Fibonacci retracement tool is determining which Swing Low and Swing High to use.

People look at charts differently, look at different time frames, and have their own fundamental biases. It is likely that Stephen from Pipbuktu and the girl from Pipanema have different ideas of where the Swing High and Swing Low points should be.

The bottom line is that there is no absolute right way to do it, especially when the trend on the chart isn't so clear. Sometimes it becomes a guessing game.

That's why you need to hone your skills and combine the Fibonacci retracement tool with other tools in your forex toolbox to help give you a higher probability of success.

In the next lesson, we'll show you how to use the Fibonacci retracement tool in combination with other forms of support and resistance levels and candlesticks.

How to Use Fibonacci Retracement with Support and Resistance

Like we said in the previous section, using Fibonacci levels can be very subjective. However, there are ways that you can help tilt the odds in your favor.

While the Fibonacci retracement tool is extremely useful, it shouldn't be used all by its lonesome self.

It's kinda like comparing it to NBA superstar Kobe Bryant. Kobe is one of the greatest basketball players of all time, but even he couldn't win those titles by himself. He needed some backup.

Similarly, the Fibonacci retracement tool should be used in combination with other tools. In this section, let's take what you've learned so far and try to combine them to help us spot some sweet trade setups.

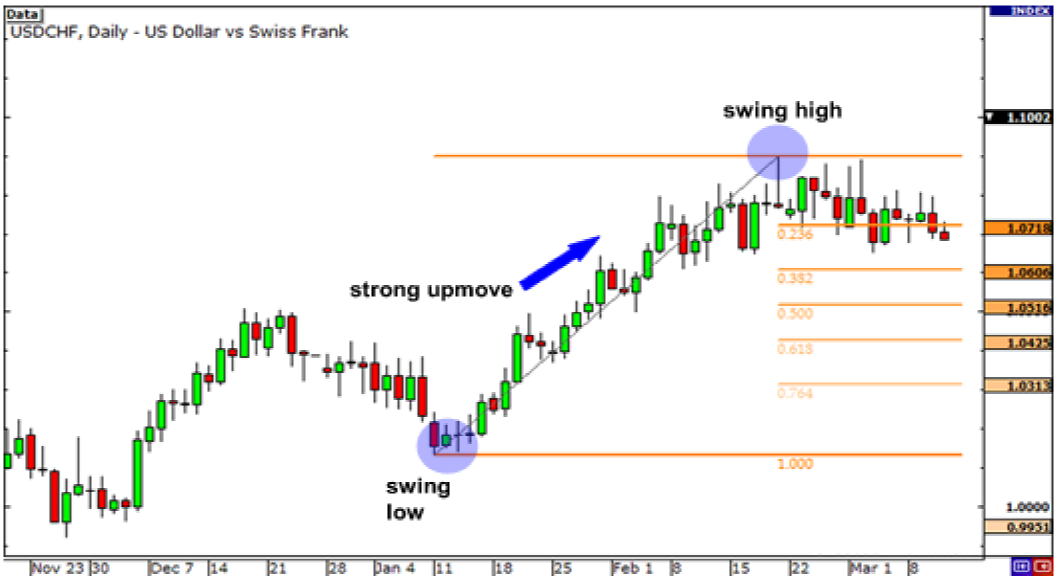
Are y'all ready? Let's get this pip show on the road!

Fibonacci Retracement + Support and Resistance

One of the best ways to use the Fibonacci retracement tool is to spot potential support and resistance levels and see if they line up with Fibonacci retracement levels.

If Fibonacci levels are already support and resistance levels, and you combine them with other price areas that a lot of other traders are watching, then the chances of price bouncing from those areas are much higher.

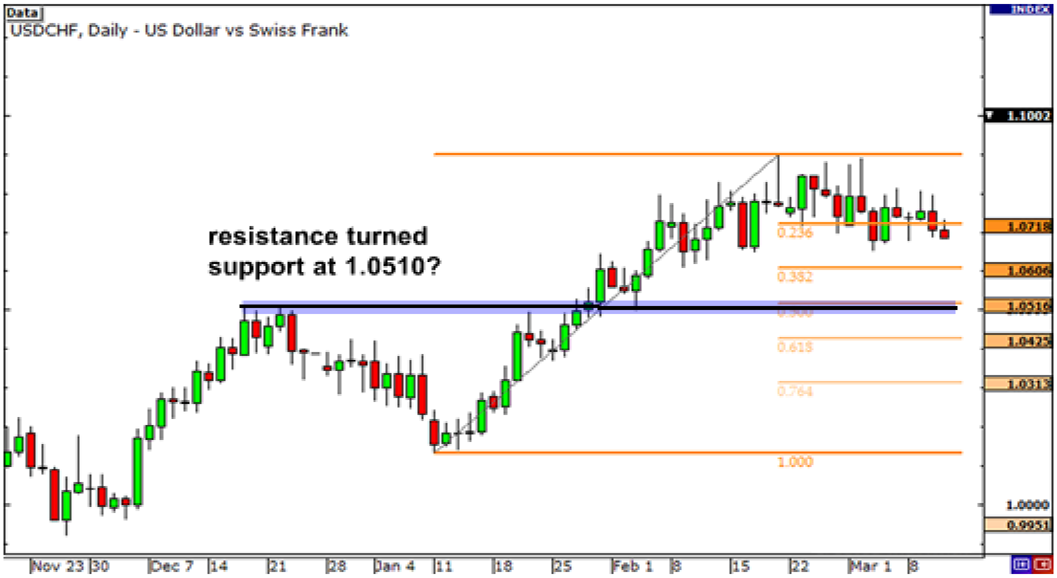
Let's look at an example of how you can combine support and resistance levels with Fibonacci levels. Below is a daily chart of USD/CHF.



As you can see, it's been on an uptrend recently. Look at all those green candles! You decide that you want to get in on this long USD/CHF bandwagon.

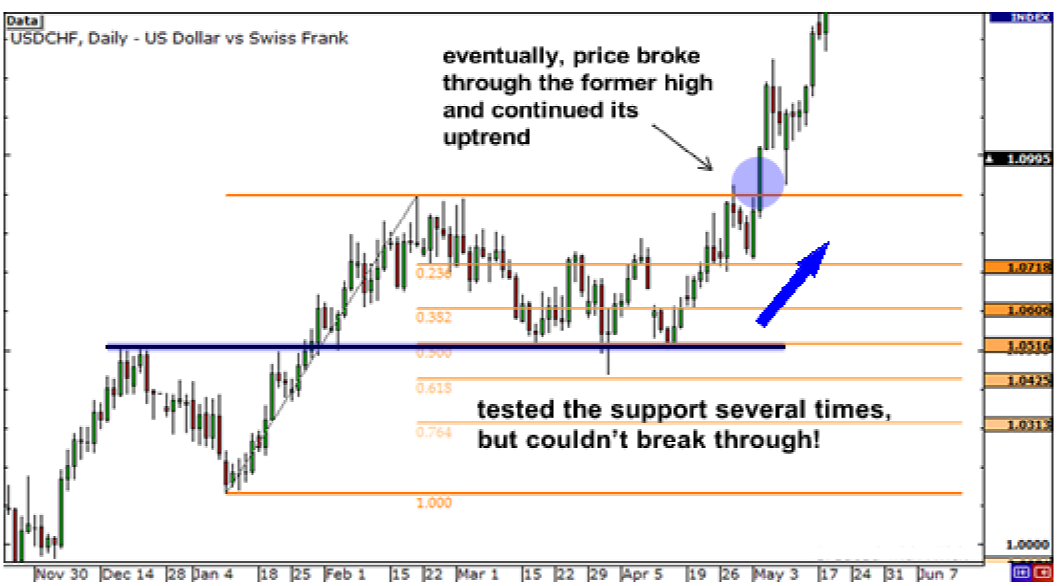
But the question is, "When do you enter?" You bust out the Fibonacci retracment tool, using the low at 1.0132 on January 11 for the Swing Low and the high at 1.0899 on February 19 for the Swing High.

Now your chart looks pretty sweet with all those Fibonacci retracement levels.



Now that we have a framework to increase our probability of finding solid entry, we can answer the question "Where should you enter?"

You look back a little bit and you see that the 1.0510 price was good resistance level in the past and it just happens to line up with the 50.0% Fibonacci retracement level. Now that it's broken, it could turn into support and be a good place to buy.



If you did set an order somewhere around the 50.0% Fib level, you'd be a pretty happy camper!

There would have been some pretty tense moments, especially on the second test of the support level on April 1. Price tried to pierce through the support level, but failed to close below it. Eventually, the pair broke past the Swing High and resumed its uptrend.

You can do the same setup on a downtrend as well. The point is you should look for price levels that seem to have been areas of interest in the past. If you think about it, there's a higher chance that price will bounce from these levels.

Why?

First, as we discussed in Grade 1, previous support or resistance levels would be good areas to buy or sell because other traders will also be eyeing these levels like a hawk.

Second, since we know that a lot of traders also use the Fibonacci retracement tool, they may be looking to jump in on these Fib levels themselves.

With traders looking at the same support and resistance levels, there's a good chance that there are a ton of orders at those price levels.

While there's no guarantee that price will bounce from those levels, at least you can be more confident about your trade. After all, there is strength in numbers!Remember that trading is all about **probabilities**. If you stick to those higher probability trades, then there's a better chance of coming out ahead in the long run.

How to Use Fibonacci Retracement with Trend Lines

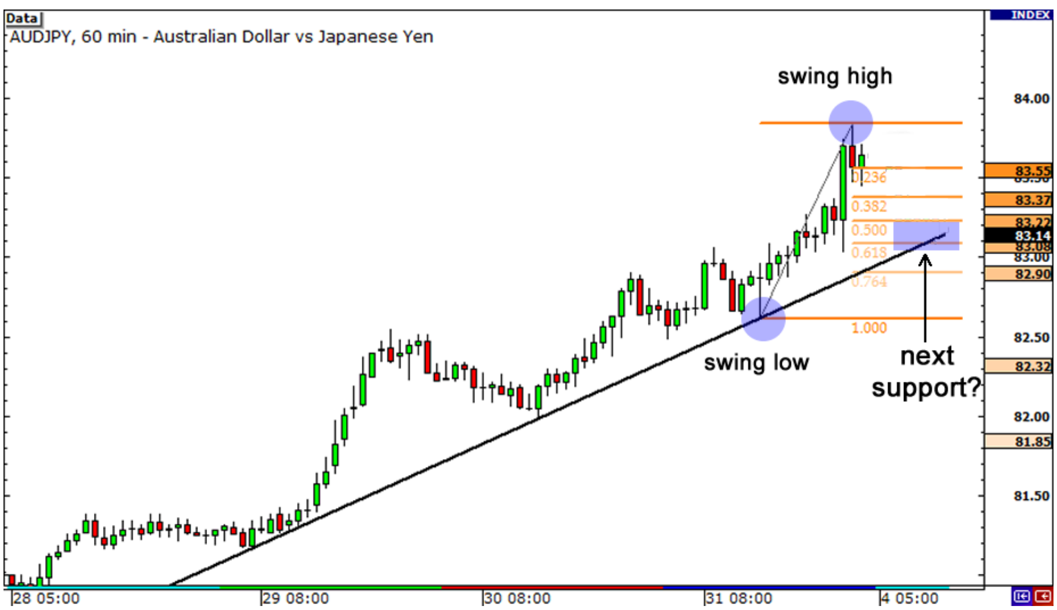
Another good tool to combine with the Fibonacci retracement tool is trend line analysis. After all, Fibonacci retracement levels work best when the market is trending, so this makes a lot of sense!

Remember that whenever a pair is in a downtrend or uptrend, traders use Fibonacci retracement levels as a way to get in on the trend. So why not look for levels where Fib levels line up right smack with the trend?

Here's a 1-hour chart of AUD/JPY. As you can see, price has been respecting a short term rising trend line over the past couple of days.

You think to yourself, "Hmm, that's a sweet uptrend right there. I wanna buy AUD/JPY, even if it's just for a short term trade. I think I'll buy once the pair hits the trend line again."

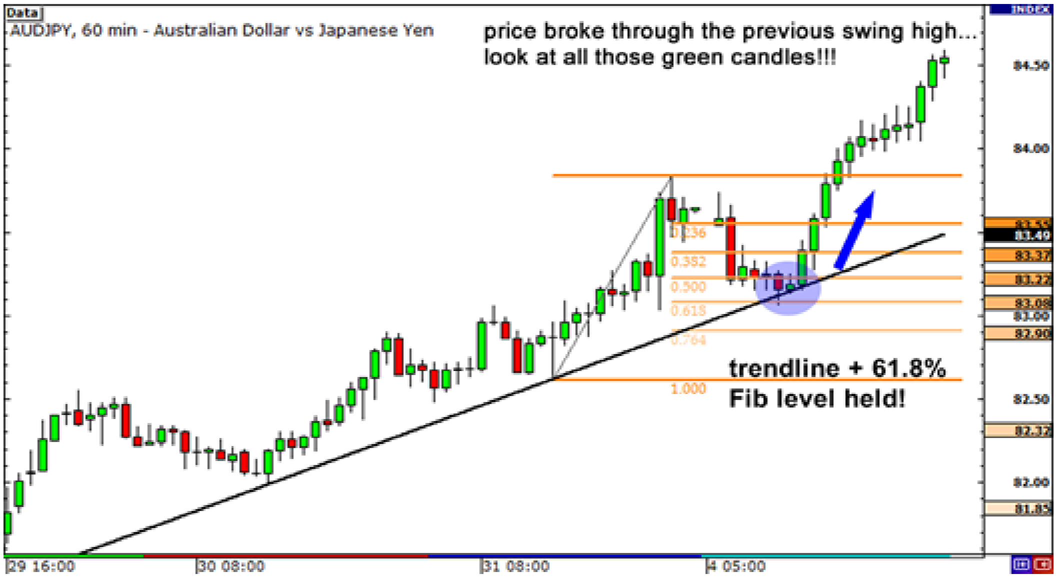
Before you do that though, why don't you reach for your forex toolbox and get that Fibonacci retracement tool out? Let's see if we can get a more exact entry price.



Here we plotted the Fibonacci retracement levels by using the Swing low at 82.61 and the Swing High at 83.84.

Notice how the 50.0% and 61.8% Fib levels are intersected by the rising trend line.

Could these levels serve as potential support levels? There's only one way to find out!



Guess what? The 61.8% Fibonacci retracement level held, as price bounced there before heading back up. If you had set some orders at that level, you would have had a perfect entry!

A couple of hours after touching the trend line, price zoomed up like Astro Boy on Red Bull, bursting through the Swing High.

Aren't you glad you've got this in your forex toolbox now?

As you can see, it does pay to make use of the Fibonacci retracement tool, even if you're planning to enter on a retest of the trend line. The combination of both a diagonal and a horizontal support or resistance level could mean that other traders are eying those levels as well.

Take note though, as with other drawing tools, drawing trend lines can also get pretty subjective.

You don't know exactly how other traders are drawing them, but you can count on one thing – that there's a trend!

If you see that a trend is developing, you should be looking for ways to go long to give you a better chance of a profitable trade. You can use the Fibonacci retracement tool to help you find potential entry points.

How to Use Fibonacci Retracement with Japanese Candlesticks

If you've been paying attention in class, you'd know by now that you can combine the Fibonacci retracement tool with support and resistance levels and trend lines to create a simple but super awesome trading strategy.

But we ain't done yet! In this lesson, we're going to teach you how to combine the Fibonacci retracement tool with your knowledge of Japanese candlestick patterns that you learned in Grade 2.

In combining the Fibonacci retracement tool with candlestick patterns, we are actually looking for exhaustive candlesticks. If you can tell when buying or selling pressure is exhausted, it can give you a clue of when price may continue trending.

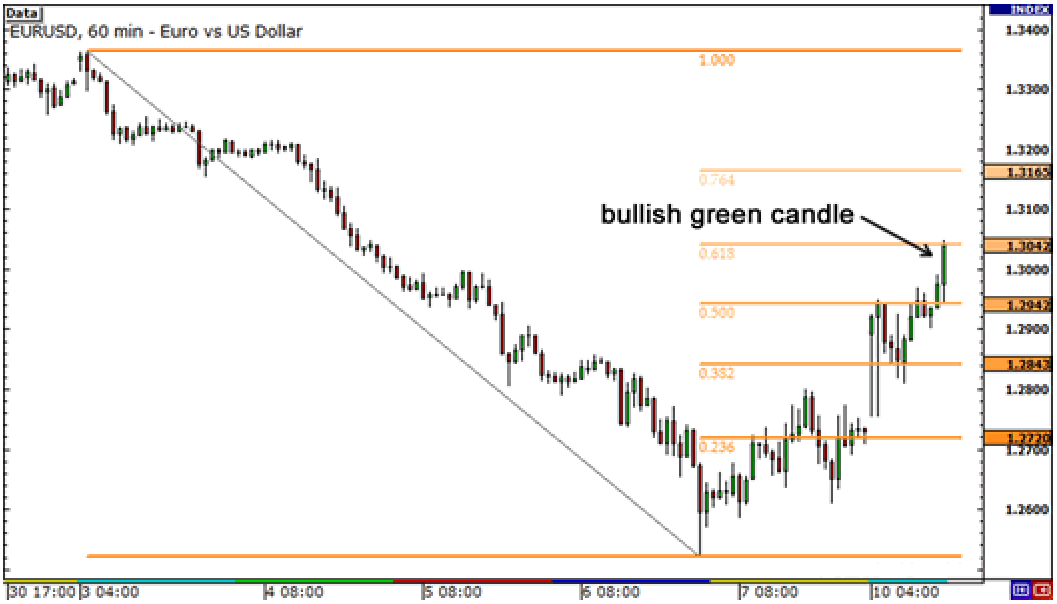
We here at BabyPips.com like to call them "Fibonacci Candlesticks," or "**Fib Sticks**" for short. Pretty catchy, eh? Let's take a look at an example to make this clearer.

Below is a 1-hour chart of EUR/USD.

The pair seems to have been in a downtrend the past week, but the move seems to have paused for a bit. Will there be a chance to get in on this downtrend? You know what this means. It's time to take the Fibonacci retracement tool and get to work!

As you can see from the chart, we've set our Swing High at 1.3364 on March 3, with the Swing Low at 1.2523 on March 6.

Since it's a Friday, you decided to just chill out, take an early day off, and decide when you wanna enter once you see the charts after the weekend.



Whoa! By the time you popped open your charts, you see that EUR/USD has shot up quite a bit from its Friday closing price.

While the 50.0% Fib level held for a bit, buyers eventually took the pair higher. You decide to wait and see whether the 61.8% Fib level holds. After all, the last candle was pretty bullish! Who knows, price just might keep shooting up!

Well, will you look at that? A long legged doji has formed right smack on the 61.8% Fibonacci retracement level. If you paid attention in Grade 2, you'd know that this is an "exhaustive candle." Has buying pressure died down? Is resistance at the Fibonacci retracement level holding? It's possible. Other traders were probably eyeing that Fib level as well.

Is it time to short? You can never know for sure (which is why risk management is so important), but the probability of a reversal looks pretty darn good!

If you had shorted right after that doji had formed, you could have made some serious profits. Right after the doji, price stalled for a bit before heading straight down. Take a look at all those red candles!

It seems that buyers were indeed pretty tired, which allowed sellers to jump back in and take control. Eventually, price went all the way back down to the Swing Low. That was a move of about 500 pips! That could've been your trade of the year!

Looking for "Fib Sticks" can be really useful, as they can signal whether a Fibonacci retracement level will hold.

If it seems that price is stalling on a Fib level, chances are that other traders may have put some orders at those levels. This would act as more confirmation that there is indeed some resistance or support at that price.

Another nice thing about Fib Sticks is that you don't need to place limit orders at the Fib levels. You may have some concerns whether the support or resistance will hold since we are looking at a "zone" and not necessarily specific levels.

This is where you can use your knowledge of candlestick formations.

You could wait for a Fib Stick to form right below or above a Fibonacci retracement level to give you more confirmation on whether you should put in an order.

If a Fib stick does form, you can just enter a trade at market price since you now have more confirmation that level could be holding.

How to Use Fibonacci Extensions to Know When to Take Profit

The next use of Fibonacci will be using them to find targets.

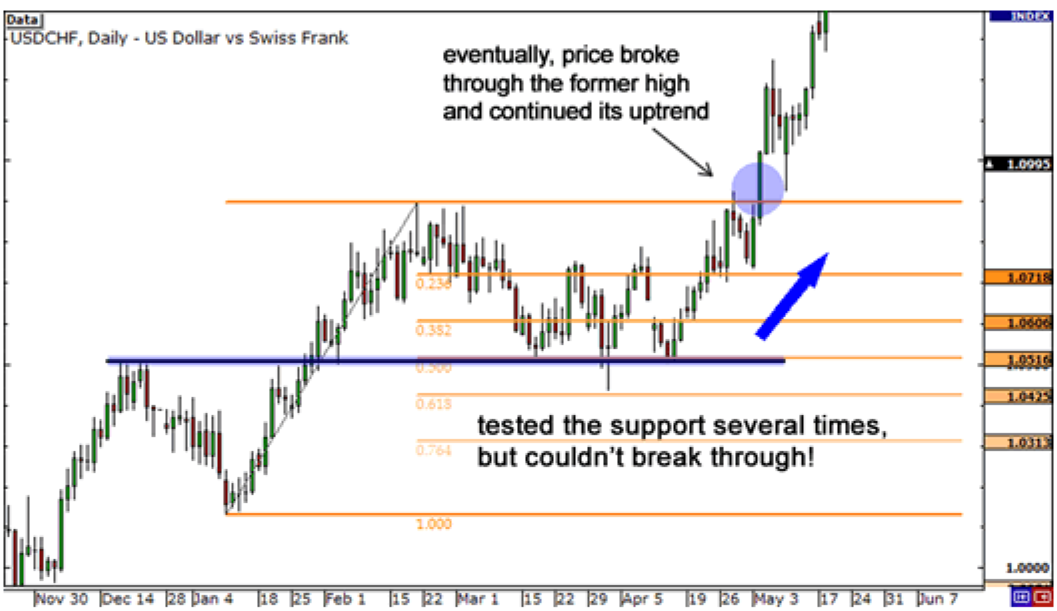
Gotta always keep in mind “Zombieland Rules of Survival #22" – When in doubt, know your way out! Let’s start with an example in an uptrend.

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 any of the retracement levels.

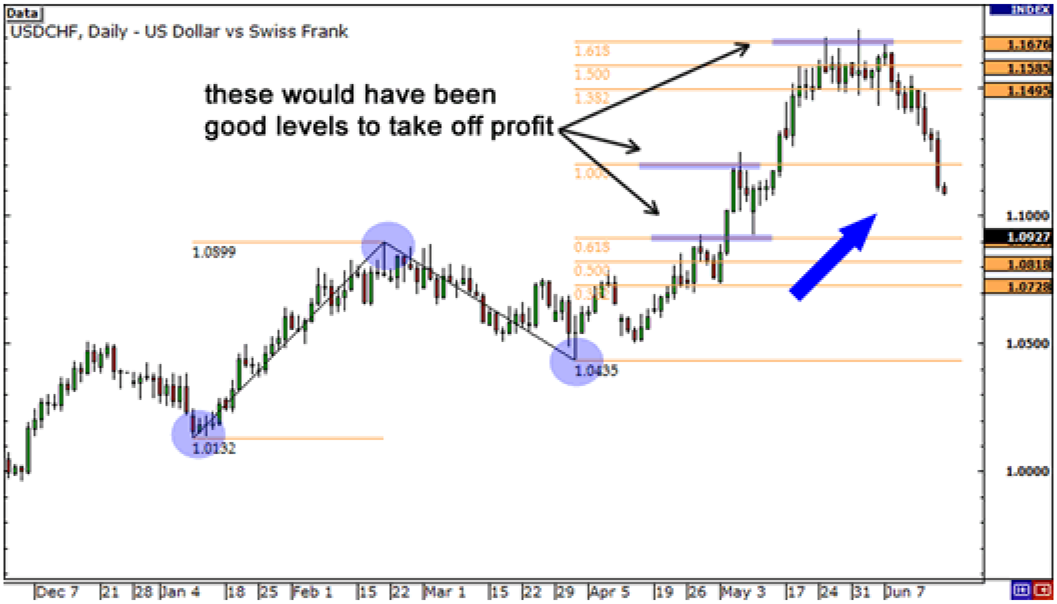
This will display each of the Price Extension Levels showing both the ratio and corresponding price levels. Pretty neat, huh?

Let’s go back to that example with the USD/CHF chart we showed you in the previous lesson.



The 50.0% Fib level held strongly as support and, after three tests, the pair finally resumed its uptrend. In the chart above, you can even see price rise above the previous Swing High.

Let’s pop on the Fibonacci extension tool to see where would have been a good place to take off some profits.



Here's a recap of what happened after the retracement Swing Low occurred:

- Price rallied all the way to the 61.8% level, which lined up closely with the previous Swing High.
- It fell back to the 38.2% level, where it found support
- Price then rallied and found resistance at the 100% level.
- A couple of days later, price rallied yet again before finding resistance at the 161.8% level.

As you can see from the example, the 61.8%, 100% and 161.8% levels all would have been good places to take off some profits.

Now, let's take a look at an example of using Fibonacci extension levels in a downtrend.

In a downtrend, the general idea is to take profits on a short trade at a Fibonacci extension level since the market often finds support at these levels.

Let's take another look at that downtrend on the 1-hour EUR/USD chart we showed you in the Fib Sticks lesson.

Here, we saw a doji form just under the 61.8% Fib level. Price then reversed as sellers jumped back in, and brought price all the way back down to the Swing Low.

Let's put up that Fib Extension tool to see where would have been some good places to take profits had we shorted at the 61.8% retracement level.

Here's what happened after price reversed from the Fibonacci retracement level:

- Price found support at the 38.2% level
- The 50.0% level held as initial support, then became an area of interest
- The 61.8% level also became an area of interest, before price shot down to test the previous Swing Low

- If you look ahead, you'll find out that the 100% extension level also acted as support

We could have taken off profits at the 38.2%, 50.0%, or 61.8% levels. All these levels acted as support, possibly because other traders were keeping an eye out for these levels for profit taking as well.

The examples illustrate that price finds at least some temporary support or resistance at the Fibonacci extension levels – not always, but often enough to correctly adjust your position to take profits and manage your risk.

Of course, there are some problems to deal with here.

First, there is no way to know which exact Fibonacci extension level will provide resistance. Any of these levels may or may not act as support or resistance.

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, but with a lot of practice, you'll make better decisions of picking Swing points.

You will have to use your discretion in using the Fibonacci extension tool. You will have to judge how much longer the trend will continue. Later on, we will teach you methods to help you determine the strength of a trend.

For now, let's move on to stop loss placement!

How to Use Fibonacci to Place Your Stop so You Lose Less Money

Probably just as important as knowing where to enter or take off profits is knowing where to place your stop loss.

You can't just enter a trade based on Fib levels without having a clue where to exit. Your account will just go up in flames and you will forever blame Fibonacci, cursing his name in Italian.

In this lesson, you'll learn a couple of techniques to set your stops when you decide to use them trusty Fib levels. These are simple ways to set your stop and the rationale behind each method.

The first method is to set your stop just past the next Fibonacci level.

If you were planning to enter at the 38.2% Fib level, then you would place your stop beyond the 50.0% level. If you felt like the 50.0% level would hold, then you'd put your stop past the 61.8% level and so on and so forth. Simple, right?

Let's take another look at that 4-hour EUR/USD chart we showed you back in the Fibonacci retracement lesson.

If you had shorted at the 50.0%, you could have placed your stop loss order just past the 61.8% Fib level.

The reasoning behind this method of setting stops is that you believed that the 50.0% level would hold as a resistance point. Therefore, if price were to rise beyond this point, your trade idea would be invalidated.

The problem with this method of setting stops is that it is entirely dependent on you having a perfect entry.

Setting a stop just past the next Fibonacci retracement level assumes that you are really confident that the support or resistance area will hold. And, as we pointed out earlier, using drawing tools isn't an exact science.

The market might shoot up, hit your stop, and eventually go in your direction. This is usually when we'd go to a corner, and start hitting our head on the wall.

We're just warning you that this might happen, sometimes a few times in a row, so make sure you limit your losses quickly and let your winners run with the trend. It might be best if you used this type of stop placement method for short term, intraday trades.

Now, if you want to be a little safer, another way to set your stops would be to place them past the recent Swing High or Swing Low.

This type of stop loss placement would give your trade more room to breathe and give you a better chance for the market to move in favor of your trade.

If the market price were to surpass the Swing High or Swing Low, it may indicate that a reversal of the trend is already in place. This means that your trade idea or setup is already invalidated and that you're too late to jump in.

Setting larger stop losses would probably be best used for longer term, swing-type trades, and you can also incorporate this into a "scaling in" method, which you will learn later on in this course.

Of course, with a larger stop, you also have to remember to adjust your position size accordingly.

If you tend to trade the same position size, you may incur large losses, especially if you enter at one of the earlier Fib levels.

This can also lead to some unfavorable reward-to-risk ratios, as you may have a wide stop that isn't proportional to your potential reward.

So which way is better?

The truth is, just like in combining the Fibonacci retracement tool with support and resistance, trend lines, and candlesticks to find a better entry, it would be best to use your knowledge of these tools to analyze the current environment to help you pick a good stop loss point.

As much as possible, you shouldn't rely solely on Fibonacci levels as support and resistance points as the basis for stop loss placement.

Remember, stop loss placement isn't a sure thing, but if you can tilt the odds in your favor by combining multiple tools, it could help give you a better exit point, more room for your trade to breathe, and possibly a better reward-to-risk ratio trade.

What Are Moving Averages?

A **moving average** is simply a way to smooth out price action over time. By "moving average", we mean that you are taking the average closing price of a currency pair for the last 'X' number of periods. On a chart, it would look like this:

Like every indicator, a moving average indicator is used to help us forecast future prices. By looking at the slope of the moving average, you can better determine the potential direction of market prices.

As we said, moving averages smooth out price action.

There are different types of moving averages and each of them has their own level of "smoothness".

Generally, the smoother the moving average, the slower it is to react to the price movement.

The choppier the moving average, the quicker it is to react to the price movement. To make a moving average smoother, you should get the average closing prices over a longer time period.

Now, you're probably thinking, "C'mon, let's get to the good stuff. How can I use this to trade?"

In this section, we first need to explain to you the two major types of moving averages:

1. Simple
2. Exponential

We'll also teach you how to calculate them and give the pros and cons of each. Just like in every other lesson in the BabyPips.com School of Pipsology, you need to know the basics first!

After you’ve got that on lockdown like Argentinian soccer player Lionel Messi’s ball-handling skills, we’ll teach you the different ways to use moving averages and how to incorporate them into your trading strategy.

By the end of this lesson, you’ll be just as smooth as Messi’s!

Are you ready?

If you are, give us a “Heck yeah!”

If not, go back and reread the intro.

Once you’re pumped and ready to go, head to the next page.

Simple Moving Average (SMA) Explained

A simple moving average (SMA) is the simplest type of moving average in forex analysis (DUH!). Basically, a simple moving average is calculated by adding up the last “X” period’s closing prices and then dividing that number by X.

Confused???

Don’t worry, we’ll make it crystal clear.

Calculating the Simple Moving Average (SMA)

If you plotted a 5 period simple moving average on a 1-hour chart, you would add up the closing prices for the last 5 hours, and then divide that number by 5. Voila! You have the average closing price over the last five hours! String those average prices together and you get a moving average!

If you were to plot a 5-period simple moving average on a 10-minute currency chart, you would add up the closing prices of the last 50 minutes and then divide that number by 5.

If you were to plot a 5 period simple moving average on a 30 minute chart, you would add up the closing prices of the last 150 minutes and then divide that number by 5.

If you were to plot the 5 period simple moving average on the 4 hr. chart… Okay, okay, we know, we know. You get the picture!

Most charting packages will do all the calculations for you. The reason we just bored you (yawn!) with a “how to” on calculating simple moving averages is because it’s important to understand so that you know how to edit and tweak the indicator.

Understanding how an indicator works means you can adjust and create different strategies as the market environment changes.

Now, as with almost any other forex indicator out there, moving averages operate with a delay. Because you are taking the averages of past price history, you are really only seeing the general path of the recent past and the general direction of “future” short term price action.

Disclaimer: Moving averages will not turn you into Ms. Cleo the psychic!

Here is an example of how moving averages smooth out the price action.

On chart above, we’ve plotted three different SMAs on the 1-hour chart of USD/CHF. As you can see, the longer the SMA period is, the more it lags behind the price.

Notice how the 62 SMA is farther away from the current price than the 30 and 5 SMAs.

This is because the 62 SMA adds up the closing prices of the last 62 periods and divides it by 62. The longer period you use for the SMA, the slower it is to react to the price movement.

The SMAs in this chart show you the overall sentiment of the market at this point in time. Here, we can see that the pair is trending.

Instead of just looking at the current price of the market, the moving averages give us a broader view, and we can now gauge the general direction of its future price. With the use of SMAs, we can tell whether a pair is trending up, trending down, or just ranging.

There is one problem with the simple moving average: they are susceptible to spikes. When this happens, this can give us false signals. We might think that a new currency trend may be developing but in reality, nothing changed.In the next lesson, we will show you what we mean, and also introduce you to another type of moving average to avoid this problem.

Exponential Moving Average (EMA) Explained

As we said in the previous lesson, simple moving averages can be distorted by spikes. We'll start with an example.

Let's say we plot a 5-period SMA on the daily chart of EUR/USD.

The closing prices for the last 5 days are as follows:

Day 1: 1.3172

Day 2: 1.3231

Day 3: 1.3164

Day 4: 1.3186

Day 5: 1.3293

The simple moving average would be calculated as follows:

(1.3172 + 1.3231 + 1.3164 + 1.3186 + 1.3293) / 5 = 1.3209

Simple enough, right?

Well what if there was a news report on Day 2 that causes the euro to drop across the board. This causes EUR/USD to plunge and close at 1.3000. Let's see what effect this would have on the 5 period SMA.

Day 1: 1.3172

Day 2: **1.3000**

Day 3: 1.3164

Day 4: 1.3186

Day 5: 1.3293

The simple moving average would be calculated as follows:

(1.3172 + **1.3000** + 1.3164 + 1.3186 + 1.3293) / 5 = **1.3163**

The result of the simple moving average would be a lot lower and it would give you the notion that the price was actually going down, when in reality, Day 2 was just a one-time event caused by the poor results of an economic report.

The point we're trying to make is that sometimes the simple moving average might be too simple. If only there was a way that you could filter out these spikes so that you wouldn't get the wrong idea. Hmm… Wait a minute… Yep, there is a way!

It's called the **Exponential Moving Average**!

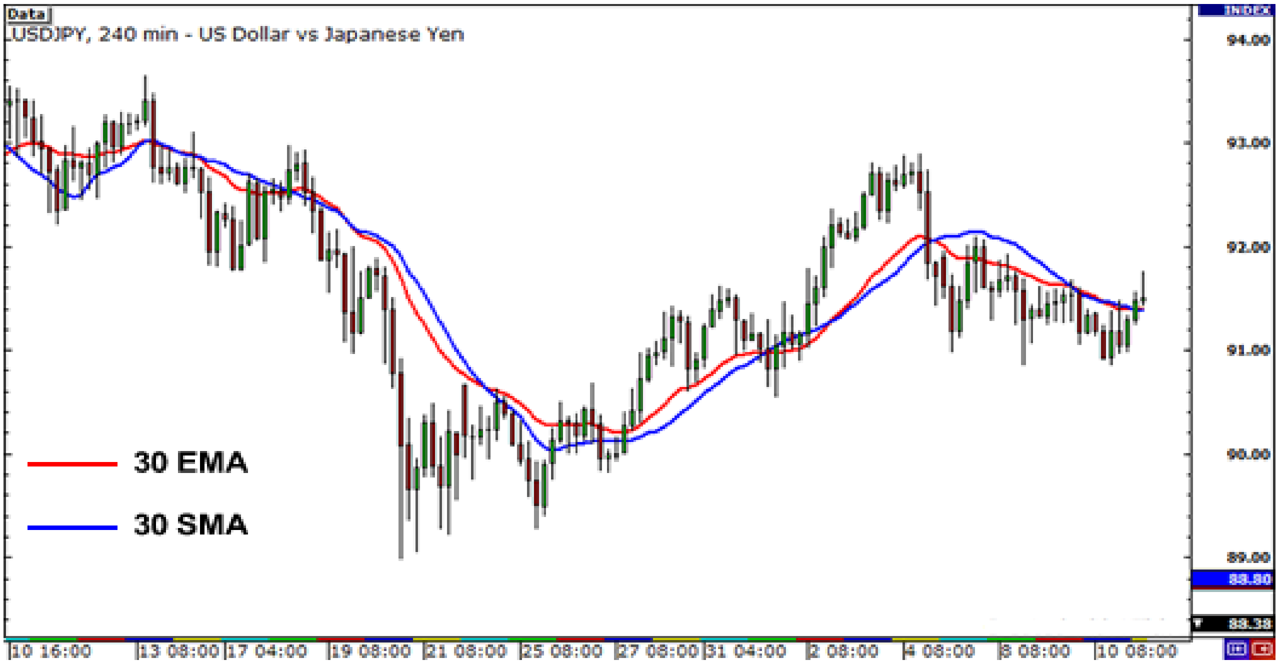
Exponential moving averages (EMA) give more weight to the most recent periods. In our example above, the EMA would put more weight on the prices of the most recent days, which would be Days 3, 4, and 5.

This would mean that the spike on Day 2 would be of lesser value and wouldn't have as big an effect on the moving average as it would if we had calculated for a simple moving average.

If you think about it, this makes a lot of sense because what this does is it puts more emphasis on what traders are doing recently.

Exponential Moving Average (EMA) and Simple Moving Average (SMA) Side By Side

Let's take a look at the 4-hour chart of USD/JPY to highlight how a simple moving average (SMA) and exponential moving average (EMA) would look side by side on a chart.



Notice how the red line (the 30 EMA) seems to be closer price than the blue line (the 30 SMA). This means that it more accurately represents recent price action. You can probably guess why this happens.

It's because the exponential moving average places more emphasis on what has been happening lately. When trading, it is far more important to see what traders are doing NOW rather what they were doing last week or last month.

Simple vs. Exponential Moving Averages

By now, you're probably asking yourself, which is better? The simple or the exponential moving average?

First, let's start with the exponential moving average. When you want a moving average that will respond to the price action rather quickly, then a short period EMA is the best way to go.

These can help you catch trends very early (more on this later), which will result in higher profit. In fact, the earlier you catch a trend, the longer you can ride it and rake in those profits (boo yeah!).

The downside to using the exponential moving average is that you might get faked out during consolidation periods (oh no!).

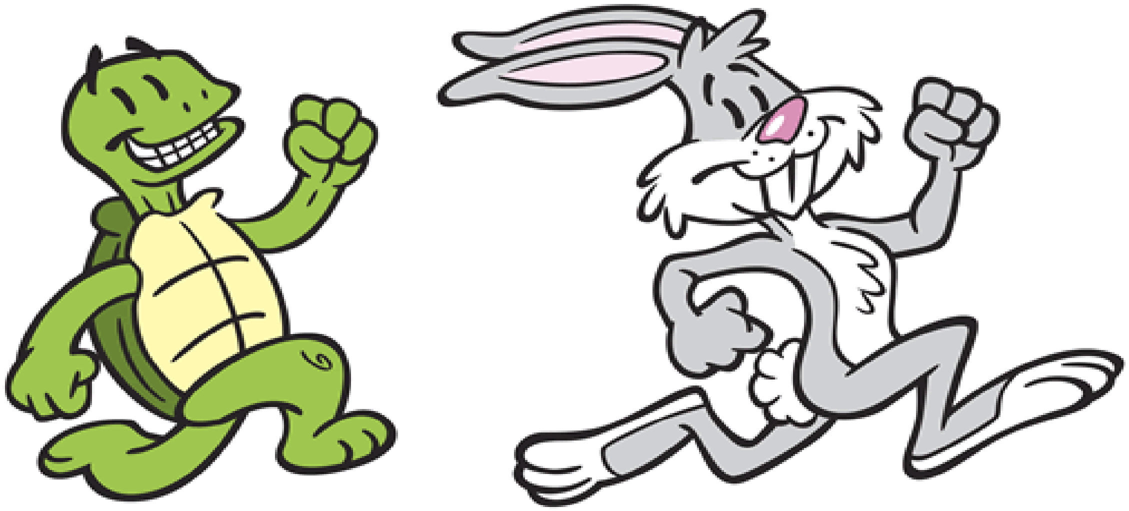
Because the moving average responds so quickly to the price, you might think a trend is forming when it could just be a price spike. This would be a case of the indicator being too fast for your own good.

With a simple moving average, the opposite is true. When you want a moving average that is smoother and slower to respond to price action, then a longer period SMA is the best way to go.

This would work well when looking at longer time frames, as it could give you an idea of the overall trend.

Although it is slow to respond to the price action, it could possibly save you from many fake outs. The downside is that it might delay you too long, and you might miss out on a good entry price or the trade altogether.

An easy analogy to remember the difference between the two is to think of a hare and a toirtoise.



SMA **EMA**

The tortoise is slow, like the SMA, so you might miss out on getting in on the trend early. However, it has a hard shell to protect itself, and similarly, using SMAs would help you avoid getting caught up in fakeouts.

On the other hand, the hare is quick, like the EMA. It helps you catch the beginning of the trend but you run the risk of getting sidetracked by fakeouts (or naps if you're a sleepy trader).

Below is a table to help you remember the pros and cons of each.

	SMA	**EMA**
Pros	Displays a smooth chart which eliminates most fakeouts.	Quick Moving and is good at showing recent price swings.
Cons	Slow moving, which may cause a a lag in buying and selling signals	More prone to cause fakeouts and give errant signals.

So which one is better?

It's really up to you to decide.

Many traders plot several different moving averages to give them both sides of the story. They might use a longer period simple moving average to find out what the overall trend is, and then use a shorter period exponential moving average to find a good time to enter a trade.

There are a number of trading strategies that are built around the use of moving averages. In the following lessons, we will teach you:

1. How to use moving averages to determine the trend
2. How to incorporate the crossover of moving averages into your trading system
3. How moving averages can be used as dynamic support and resistance

Time for recess! Go find a chart and start playing with some moving averages! Try out different types and try experimenting with different periods. In time, you will find out which moving averages work best for you.

How to Use Moving Averages to Find the Trend

One sweet way to use moving averages is to help you determine the trend.

The simplest way is to just plot a single moving average on the chart. When price action tends to stay above the moving average, it signals that price is in a general *uptrend*.

If price action tends to stay below the moving average, then it indicates that it is in a *downtrend*.

The problem with this is that it's too simplistic.

Let's say that USD/JPY has been in a downtrend, but a news report comes out causing it to surge higher.

You see that the price is now above the moving average. You think to yourself:

"Hmmm… It looks like this pair is about to shift direction. Time to buy this sucker!"

So you do just that. You buy a billion units cause you're confident that USD/JPY is going to go up.

Bammm! You get faked out! As it turns out, traders just reacted to the news but the trend continued and price kept heading lower!

What some traders do – and what we suggest you do as well – is that they plot a couple of moving averages on their charts instead of just one. This gives them a clearer signal of whether the pair is trending up or down depending on the order of the moving averages. Let us explain.

In an uptrend, the “faster” moving average should be above the “slower” moving average and for a downtrend, vice versa. For example, let’s say we have two MAs: the 10-period MA and the 20-period MA. On your chart, it would look like this:

Above is a daily chart of USD/JPY. Throughout the uptrend, the 10 SMA is above the 20 SMA. As you can see, you can use moving averages to help show whether a pair is trending up or down. Combining this with your knowledge on trend lines, this can help you decide whether to go long or short a currency.

You can also try putting more than two moving averages on your chart. Just as long as lines are in order (fastest to slowest in an uptrend, slowest to fastest in a downtrend), then you can tell whether the pair is in an uptrend or in a downtrend.

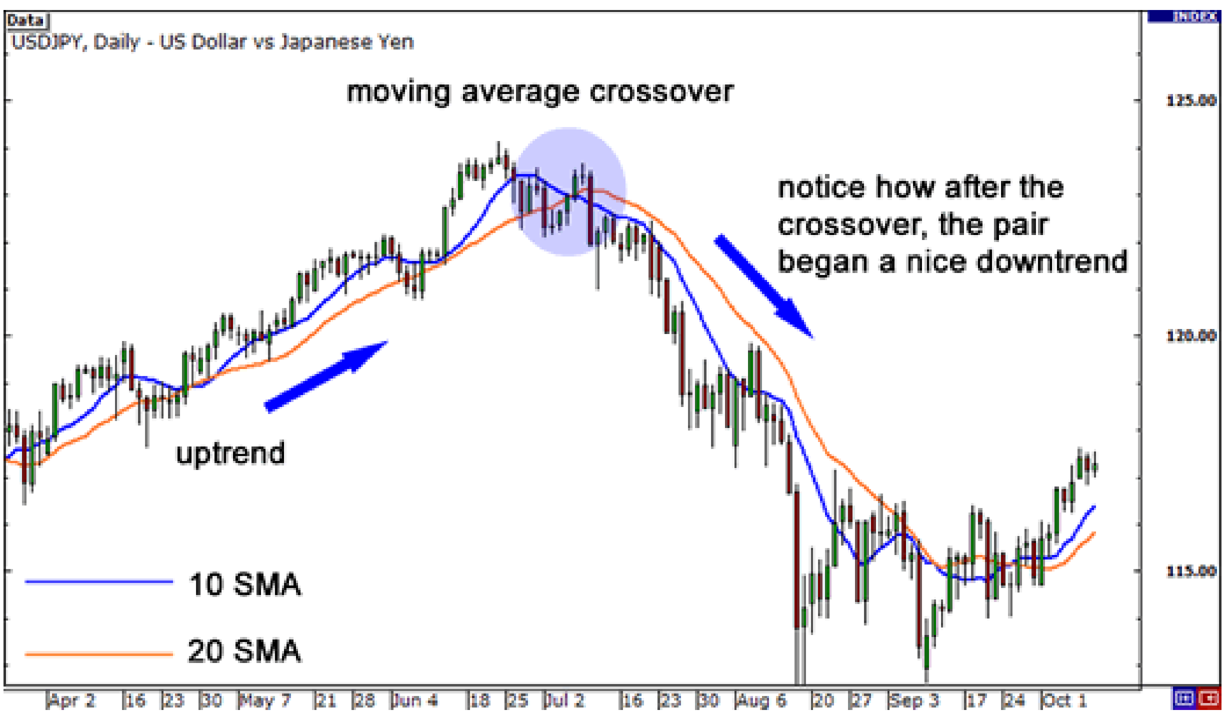
How to Use Moving Average Crossovers to Enter Trades

By now, you know how to determine the trend by plotting on some moving averages on your charts. You should also know that moving averages can help you determine when a trend is about to end and reverse.

All you have to do is plop on a couple of moving averages on your chart, and wait for a crossover. If the moving averages cross over one another, it could signal that the trend is about to change soon, thereby giving you the chance to get a better entry. By having a better entry, you have the chance to bag mo' pips!

If Allen Iverson made a living by having a killer crossover move, why can't you?

Let’s take another look at that daily chart of USD/JPY to help explain moving average crossover trading.



From around April to July, the pair was in a nice uptrend. It topped out at around 124.00, before slowly heading down. In the middle of July, we see that the 10 SMA crossed below the 20 SMA.

And what happened next?

A nice downtrend!

If you had shorted at the crossover of the moving averages you would have made yourself almost a thousand pips!

Of course, not every trade will be a thousand-pip winner, a hundred-pip winner, or even a 10-pip winner.

It could be a loser, which means you have to consider things like where to place your stop loss or when to take profits. You just can't jump in without a plan!

What some traders do is that they close out their position once a new crossover has been made or once price has moved against the position a predetermined amount of pips.

This is what Huck does in her HLHB system. She either exits when a new crossover has been made, but also has a 150-pip stop loss just in case.

The reason for this is you just don't know when the next crossover will be. You may end up hurting yourself if you wait too long!

One thing to take note of with a crossover system is that while they work beautifully in a volatile and/or trending environment, they don't work so well when price is ranging.

You will get hit with tons of crossover signals and you could find yourself getting stopped out multiple times before you catch a trend again.

How to Use Moving Averages as Dynamic Support and Resistance Levels

Another way to use moving averages is to use them as dynamic support and resistance levels.

We like to call it dynamic because it's not like your traditional horizontal support and resistance lines. They are *constantly changing* depending on recent price action.

There are many forex traders out there who look at these moving averages as key support or resistance. These traders will buy when price dips and tests the moving average or sell if price rises and touches the moving average.

Here's a look at the 15-minute chart of GBP/USD and pop on the 50 EMA. Let's see if it serves as dynamic support or resistance.

It looks like it held really well! Every time price approached 50 EMA and tested it, it acted as resistance and price bounced back down. Amazing, huh?

One thing you should keep in mind is that these are just like your normal support and resistance lines.

This means that price won't always bounce perfectly from the moving average. Sometimes it will go past it a little bit before heading back in the direction of the trend.

There are also times when price will blast past it altogether. What some forex traders do is that they pop on two moving averages, and only buy or sell once price is in the middle of the space between the two moving averages.

You could call this area "the zone."

Let's take another look at that 15-minute chart of GBP/USD, but this time let's use the 10 and 20 EMAs.

From the chart above, you see that price went slightly past the 10 EMA a few pips, but proceeded to drop afterwards.

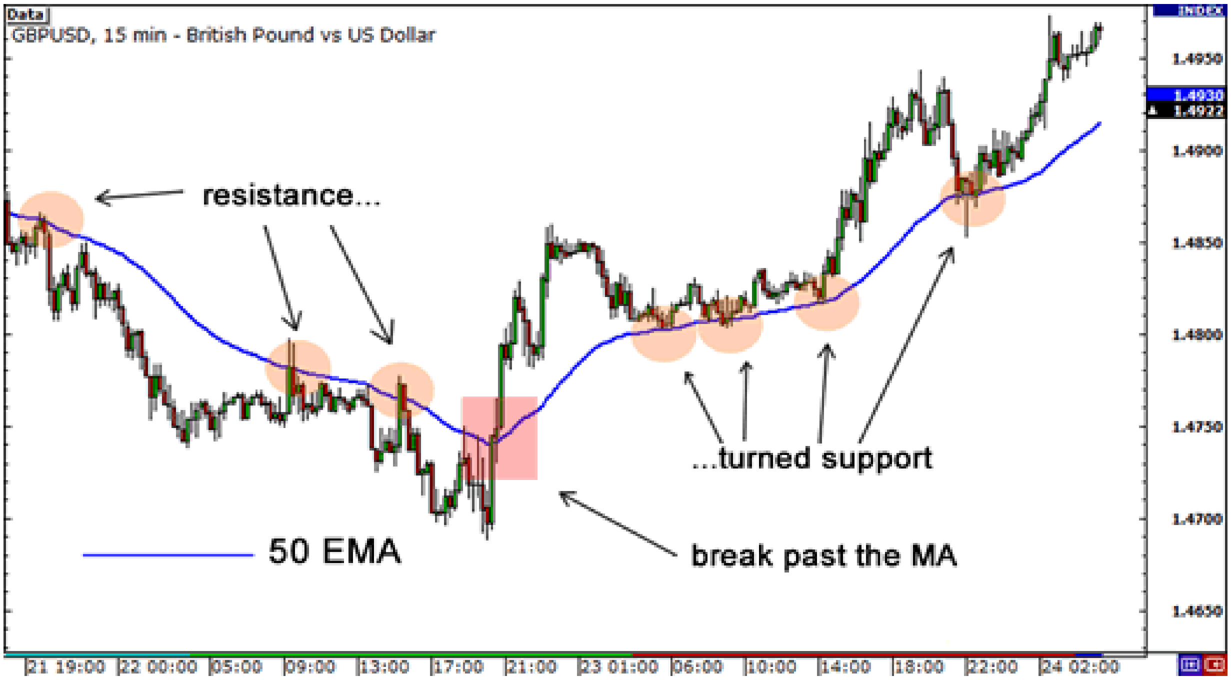
There are some traders who use intraday strategies just like this. The idea is that just like your horizontal support and resistance areas, these moving averages should be treated like zones or areas of interest.

The area between moving averages could therefore be looked upon as a zone of support or resistance.

Breaking through Dynamic Support and Resistance

Now you know that moving averages can potentially act as support and resistance. Combining a couple of them, you can have yourself a nice little zone. But you should also know that they can break, just like any support and resistance level!

Let's take another look at the 50 EMA on GBP/USD's 15-min chart.



In the chart above, we see that the 50 EMA held as a strong resistance level for a while as GBP/USD repeatedly bounced off it.

However, as we've highlighted with the red box, price finally broke through and shot up. Price then retraced and tested the 50 EMA again, which proved to be a strong support level.

So there you have it folks!

Moving averages can also act as dynamic support and resistance levels.

One nice thing about using moving averages is that they're always changing, which means that you can just leave it on your chart and don't have to keep looking back in time to spot potential support and resistance levels.

You know that the line most likely represent a moving area of interest. The only problem of course is figuring out which moving average to use!

Summary: Using Moving Averages

- There are many types of moving averages. The two most common types are a simple moving average and an exponential moving average.
- Simple moving averages are the simplest form of moving averages, but they are susceptible to spikes.
- Exponential moving averages put more weight to recent price, which means they place more emphasis on what traders are doing now.
- It is much more important to know what traders are doing now than to see what they did last week or last month.
- Simple moving averages are smoother than exponential moving averages.
- Longer period moving averages are smoother than shorter period moving averages.
- Using the exponential moving average can help you spot a trend faster, but is prone to many fake outs.
- Smooth moving averages are slower to respond to price action but will save you from spikes and fake outs. However, because of their slow reaction, they can delay you from taking a trade and may cause you to miss some good opportunities.
- You can use moving averages to help you define the trend, when to enter, and when the trend is coming to an end.
- Moving averages can be used as dynamic support and resistance levels.
- One of the best ways to use moving averages is to plot different types so that you can see both long-term movement and short term movement.

You got all of that? Why don't you open up your charting software and try popping up some moving averages.

Remember, using moving averages is simple. The hard part is determining which one to use!

That's why you should try them out and figure out which best fits your style of trading. Maybe you prefer a trend-following system. Or maybe you want use them as dynamic support and resistance.

Whatever you choose to do, make sure you read up and do some testing to see how it fits into your overall trading plan.

How to Use 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 ask.

Simple!

Let’s compare trading to building a house. You wouldn’t use a hammer on a screw, right? Nor would you use a buzz saw to drive in nails. There’s a proper tool for each situation.

Just like in trading, some trading tools and indicators are best used in particular environments or situations. So, the more tools you have, the better you can adapt to the ever-changing market environment.

Or if you want to focus on a few specific trading environments or tools, that’s cool too. It’s good to have a specialist when installing your electricity or plumbing in a house, just like it’s cool to be a Bollinger Band or Moving Average expert.

There are a million different ways to grab some pips!

For this lesson, as you learn about these indicators, think of each 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 plenty of options, right? You might even find one that you understand and comfortable enough to master on its own. Now, enough about tools already!

Let’s get started!

Bollinger Bands

Bollinger Bands, a chart indicator developed by John Bollinger, 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 price is quiet, the bands are close together. When price moves 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. 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.

What you just saw was a classic Bollinger Bounce. The reason these bounces occur is because Bollinger bands act like dynamic support and resistance levels.

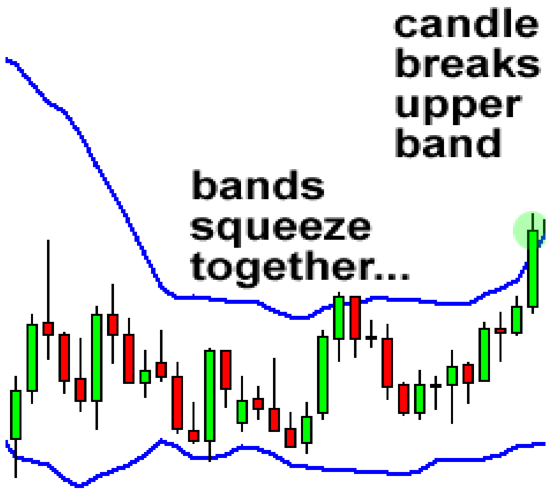
The longer the time frame you are in, the stronger these bands tend to be. Many traders have developed systems that thrive on these bounces and this strategy is best used when the market is **ranging** and there is no clear trend.

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 getting ready to happen.

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 price 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 again!

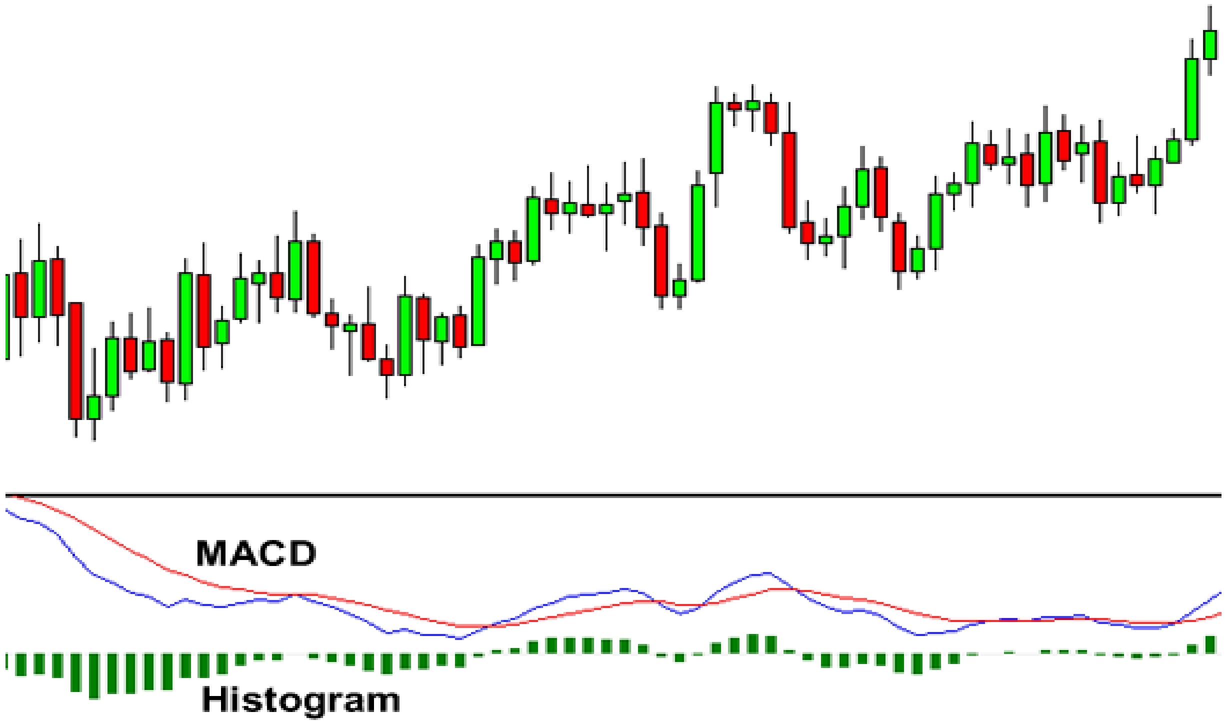
This is how a typical Bollinger Squeeze works.

This strategy is designed for you to catch a move as early as possible. Setups like these don't occur every day, but you can probably spot them a few times a week if you are looking at a 15-minute chart.

There are many other things you can do with Bollinger Bands, but these are the 2 most common strategies associated with them. It's time to put this in your trader's toolbox before we move on to the next indicator.

How to Use the MACD Indicator

MACD is an acronym for **M**oving **A**verage **C**onvergence **D**ivergence. This tool is used to identify moving averages that are indicating a new trend, whether it's bullish or bearish. After all, our top priority in trading is being able to find a trend, because that is where the most money is made.



With an MACD chart, you will usually see three numbers that are used for its settings.

- The first is the number of periods that is used to calculate the faster moving average.
- The second is the number of periods that is used in the slower moving average.
- And the third is the number of bars that is used to calculate the moving average of the difference between the faster and slower moving averages.

For example, if you were to see “12, 26, 9" as the MACD parameters (which is usually the default setting for most charting packages), this is how you would interpret it:

- The 12 represents the previous 12 bars of the faster moving average.
- The 26 represents the previous 26 bars of the slower moving average.
- The 9 represents the previous 9 bars of the difference between the two moving averages. This is plotted by vertical lines called a histogram (the green lines in the chart above).

There is a common misconception when it comes to the lines of the MACD. The two lines that are drawn are NOT moving averages of the price. Instead, they are the moving averages of the **DIFFERENCE** between two moving averages.

In our example above, the faster moving average is the moving average of the difference between the 12 and 26-period moving averages. The slower moving average plots the average of the previous MACD line. Once again, from our example above, this would be a 9-period moving average.

This means that we are taking the average of the last 9 periods of the faster MACD line and plotting it as our slower moving average. This smoothens out the original line even more, which gives us a more accurate line.

The histogram simply plots the difference between the fast and slow moving average. If you look at our original chart, you can see that, as the two moving averages separate, the histogram gets bigger.

This is called divergence because the faster moving average is “diverging” or moving away from the slower moving average.

As the moving averages get closer to each other, the histogram gets smaller. This is called convergence because the faster moving average is “converging” or getting closer to the slower moving average.

And that, my friend, is how you get the name, **M**oving **A**verage **C**onvergence **D**ivergence! Whew, we need to crack our knuckles after that one!

Ok, so now you know what MACD does. Now we’ll show you what MACD can do for YOU.

How to Trade Using MACD

Because there are two moving averages with different “speeds”, the faster one will obviously be quicker to react to price movement than the slower one.

When a new trend occurs, the fast line will react first and eventually cross the slower line. When this “crossover” occurs, and the fast line starts to “diverge” or move away from the slower line, it often indicates that a new trend has formed.

From the chart above, you can see that the fast line crossed under the slow line and correctly identified a new downtrend. Notice that when the lines crossed, the histogram temporarily disappears.

This is because the difference between the lines at the time of the cross is 0. As the downtrend begins and the fast line diverges away from the slow line, the histogram gets bigger, which is good indication of a strong trend.

Let's take a look at an example.

In EUR/USD's 1-hour chart above, the fast line crossed above the slow line while the histogram disappeared. This suggested that the brief downtrend would eventually reverse.

From then, EUR/USD began shooting up as it started a new uptrend. Imagine if you went long after the crossover, you would've gained almost 200 pips!

There is one drawback to MACD. Naturally, moving averages tend to lag behind price. After all, it's just an average of historical prices.

Since the MACD represents moving averages of **other** moving averages and is smoothed out by another moving average, you can imagine that there is quite a bit of lag. However, MACD is still one of the most favored tools by many traders.

How to Use Parabolic SAR

Up until now, we've looked at indicators that mainly focus on catching the beginning of new trends. 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 (**S**top **A**nd **R**eversal). A Parabolic SAR places dots, or points, on a chart that indicate potential reversals in price movement.

From the image 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.

How to Trade Using Parabolic SAR

The nice thing about the Parabolic SAR is that it is really simple to use. We mean REALLY simple.

Basically, when the dots are below the candles, it is a *buy* signal.

When the dots are above the candles, it is a *sell* signal.

Simple?

Yes, we thought so.

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.

Using Parabolic SAR to exit trades

You can also use Parabolic SAR to help you determine whether you should close your trade or not.

Check out how the Parabolic SAR worked as an exit signal in EUR/USD's daily chart above.

When EUR/USD started sliding down in late April, it seemed like it would just keep droppin' like it's hot. A trader who was able to short this pair has probably wondered how low it can go.

In early June, three dots formed at the bottom of the price, suggesting that the downtrend was over and that it was time to exit those shorts.

If you stubbornly decided to hold on to that trade thinking that EUR/USD would resume its drop, you would've probably erased all those winnings since the pair eventually climbed back near 1.3500.

How to Use Stochastic

The Stochastic is another indicator that helps us determine where a trend might be ending.

By definition, a Stochastic is an oscillator that measures overbought and oversold conditions in the market. The 2 lines are similar to the MACD lines in the sense that one line is faster than the other.

How to Trade Using the Stochastic

As we said earlier, the Stochastic tells us when the market is overbought or oversold. The Stochastic is scaled from 0 to 100.

When the Stochastic lines are above 80 (the red dotted line in the chart above), then it means the market is overbought. When the Stochastic lines are below 20 (the blue dotted line), then it means that the market is oversold.

As a rule of thumb, we buy when the market is oversold, and we sell when the market is overbought.

Looking at the chart above, you can see that the Stochastic has been showing overbought conditions for quite some time. Based on this information, can you guess where the price might go?

If you said the price would drop, then you are absolutely correct! Because the market was overbought for such a long period of time, a reversal was bound to happen.

That is the basics of the Stochastic. Many traders use the Stochastic in different ways, but the main purpose of the indicator is to show us where the market conditions could be overbought or oversold.

Over time, you will learn to use the Stochastic to fit your own personal trading style.

Okay, let's move on to RSI.

How to Use RSI (Relative Strength Index)

Relative Strength Index, or RSI, is similar to the stochastic in that it identifies overbought and oversold conditions in the market. It is also scaled from 0 to 100. Typically, readings below 30 indicate oversold, while readings over 70 indicate overbought.

How to Trade Using RSI

RSI can be used just like the stochastic. We can use it to pick potential tops and bottoms depending on whether the market is overbought or oversold.

Below is a 4-hour chart of EUR/USD.

EUR/USD had been dropping the week, falling about 400 pips over the course of two weeks.

On June 7, it was already trading below the 1.2000 handle. However, RSI dropped below 30, signalling that there might be no more sellers left in the market and that the move could be over. Price then reversed and headed back up over the next couple of weeks.

Determining the Trend using RSI

RSI is a very popular tool because it can also be used to confirm trend formations. If you think a trend is forming, take a quick look at the RSI and look at whether it is above or below 50.

If you are looking at a possible uptrend, then make sure the RSI is above 50. If you are looking at a possible downtrend, then make sure the RSI is below 50.

In the beginning of the chart above, we can see that a possible downtrend was forming. To avoid fake outs, we can wait for RSI to cross below 50 to confirm our trend. Sure enough, as RSI passes below 50, it is a good confirmation that a downtrend has actually formed.

How to Use ADX (Average Directional Index)

The Average Directional Index, or ADX for short, is another example of an oscillator. It fluctuates from 0 to 100, with readings below 20 indicating a weak trend and readings above 50 signaling a strong trend.

Unlike the stochastic, ADX doesn't determine whether the trend is bullish or bearish. Rather, it merely measures the strength of the current trend. Because of that, ADX is typically used to identify whether the market is ranging or starting a new trend.

Take a look at these neat charts we've pulled up:

In this first example, ADX lingered below 20 from late September until early December. As you can see from the chart, EUR/CHF was stuck inside a range during that time. Beginning in January though, ADX started to climb above 50, signaling that a strong trend could be waiting in the wings.

And would you look at that! EUR/CHF broke below the bottom of the range and went on a strong downtrend. Ooh, that'd be around 400 pips in the bag.

Book it, baby!

Now, let's look at this next example:

Just like in our first example, ADX hovered below 20 for quite a while. At that time, EUR/CHF was also ranging. Soon enough, ADX rose above 50 and EUR/CHF broke above the top of its range.

Tada!

A strong uptrend took place. That'd be 300 pips, signed, sealed, and delivered!

Looks simple enough, right?

If there's one problem with using ADX, it's that it doesn't exactly tell you whether it's a buy or a sell. What it does tell you is whether it'd be okay to jump in an ongoing trend or not.

Once ADX starts dropping below 50 again, it could mean that the uptrend or downtrend is starting to weaken and that it might be a good time to lock in profits.

How to Trade Using ADX

One way to trade using ADX is to wait for breakouts first before deciding to go long or short. ADX can be used as confirmation whether the pair could possibly continue in its current trend or not.

Another way is to combine ADX with another indicator, particularly one that identifies whether the pair is headed downwards or upwards.

ADX can also be used to determine when one should close a trade early.

For instance, when ADX starts to slide below 50, it indicates that the current trend is losing steam. From then, the pair could possibly move sideways, so you might want to lock in those pips before that happens.

Ichimoku Kinko Hyo

Yes, you're still in the right place. You're still in the School of Pipsology and not in some Japanese pop fan girl site (although Huck may disagree with the rest of the FX-Men on that). No, "Ichimoku Kinko Hyo" ain't Japanese for "May the pips be with you." but it can help you grab those pips nonetheless.

Ichimoku Kinko Hyo (IKH) is an indicator that gauges future price momentum and determines future areas of support and resistance. Now that's 3-in-1 for y'all! Also know that this indicator is mainly used on JPY pairs.

To add to your Japanese vocab, the word *ichimoku* translates to "a glance", *kinko* means "equilibrium", while *hyo* is Japanese for "chart." Putting that all together, the phrase *ichimoku kinko hyo* stands for "a glance at a chart in equilibrium." Huh, what does all that mean?

A chart might make things easier to explain…

Whoops. That didn't help. A few more lines and this'll resemble a seismograph.

Before you go off and call this gibberish, let's try to find out what each of the lines is for.

Kijun Sen (blue line): Also called standard line or base line, this is calculated by averaging the highest high and the lowest low for the past 26 periods.

Tenkan Sen (red line): This is also known as the turning line and is derived by averaging the highest high and the lowest low for the past nine periods.

Chikou Span (green line): This is called the lagging line. It is today's closing price plotted 26 periods behind.

Senkou Span (orange lines): The first Senkou line is calculated by averaging the Tenkan Sen and the Kijun Sen and plotted 26 periods ahead. The second Senkou line is determined by averaging the highest high and the lowest low for the past 52 periods and plotted 26 periods ahead.

Got it? Well, it's not really necessary for you to memorize how each of the lines is computed. What's more important is for you to know how to interpret these fancy lines.

How to Trade Using Ichimoku Kinyo Hyo

Let's take a look at the Senkou span first.

If the price is above the Senkou span, the top line serves as the first support level while the bottom line serves as the second support level.

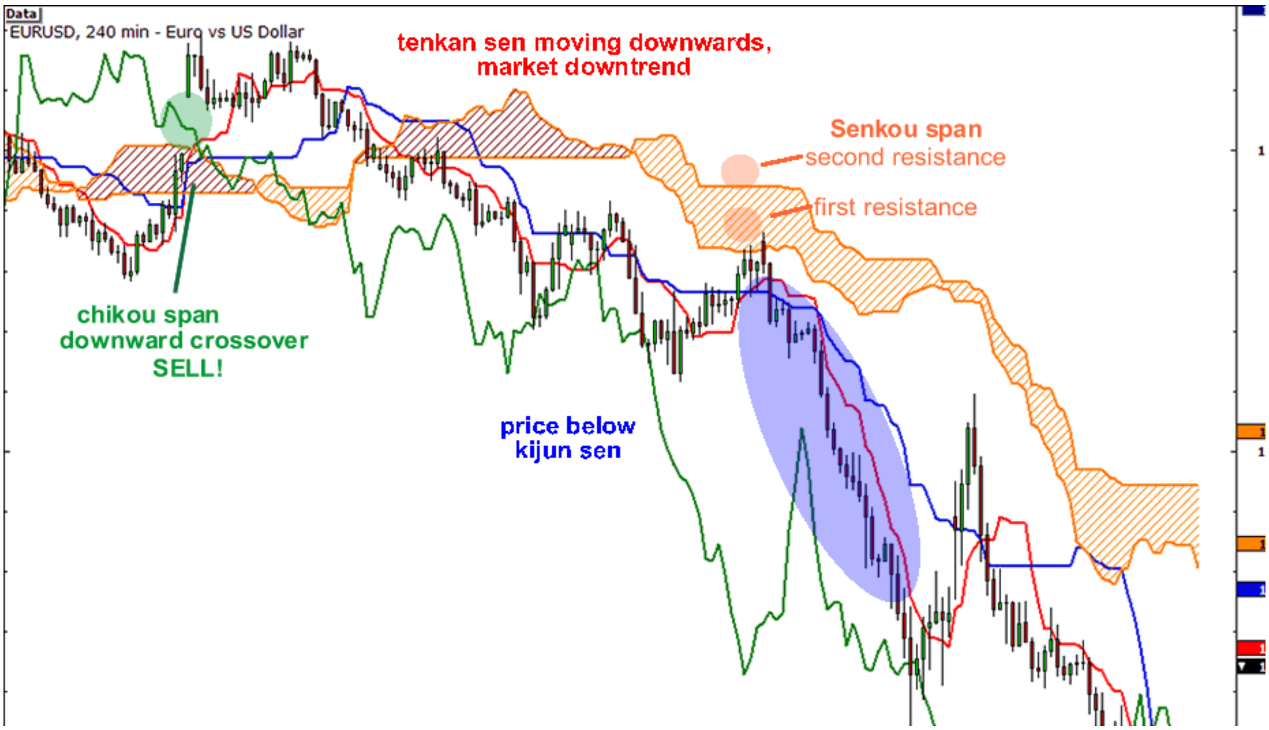
If the price is below the Senkou span, the bottom line forms the first resistance level while the top line is the second resistance level. Got it?

Meanwhile, the Kijun Sen acts as an indicator of future price movement. If the price is higher than the blue line, it could continue to climb higher. If the price is below the blue line, it could keep dropping.

The Tenkan Sen is an indicator of the market trend. If the red line is moving up or down, it indicates that the market is trending. If it moves horizontally, it signals that the market is ranging.

Lastly, if the Chikou Span or the green line crosses the price in the bottom-up direction, that's a buy signal. If the green line crosses the price from the top-down, that's a sell signal.

Here's that line-filled chart once more, this time with the trade signals:



It sure looks complicated at first but this baby's got support and resistance levels, crossovers, oscillators, and trend indicators all in one go! Amazing, right?

Okey dokey, we've already covered a smorgasbord of indicators. Let's see how we can put all of what you just learned together…

Trading with Multiple Chart Indicators

Now that you know how some of the most common chart indicators work, you're ready to get down and dirty with some examples. Better yet, let's combine some of these indicators and see how their trade signals pan out.

In a perfect world, we could take just one of these indicators and trade strictly by what that indicator told us. The problem is that we DON'T live in a perfect world, and each of these indicators has imperfections.

That is why many traders combine different indicators together so that they can “screen” each other. They might have 3 different indicators and they won’t trade unless all 3 indicators give them the same signal.

In this first example, we’ve got the Bollinger bands and the Stochastic on EUR/USD’s 4-hour chart. Since the market seems to be ranging or moving sideways, we’d better watch out for the Bollinger bounce.

Check out that those sell signals from the Bollinger bands and the Stochastic. EUR/USD climbed until the top of the band, which usually acts as a resistance level.

At the same time, the Stochastic reached the overbought area, suggesting that the price could drop down soon.

And what happened next?

EUR/USD fell by around 300 pips and you would’ve made a hefty profit if you took that short trade.

Later on, the price made contact with the bottom of the band, which usually serves as a support level. This means that the pair could bounce up from there. With the Stochastic in the oversold area, it means we should go long.

If you took that trade, you would have gotten around 400 pips! Not bad!

Here’s another example, with the RSI and the MACD this time.

When the RSI reached the overbought area and gave a sell signal, the MACD soon followed with a downward crossover, which is also a sell signal. And, as you can see, the price did move downhill from there.

Hooray for multiple indicators!

Later on, the RSI dipped to the oversold region and gave a buy signal. A few hours after, the MACD made an upward crossover, which is also a buy signal. From there, the price made a steady climb. More pips for us, yipee!

You probably noticed in this example that the RSI gives signals ahead of the MACD. Because of the various properties and magic formulas for the technical indicators, some really do give early signals while others are a bit delayed.

You'll learn more about this in sixth grade.

As you continue your journey as a trader, you will discover which indicators work best for you. We can tell you that we like using MACD, the Stochastic, and RSI, but you might have a different preference.

Every trader out there has tried to find the "magic combination" of indicators that will give them the right signals all the time, but the truth is that there is no such thing.

We urge you to study each indicator on its own until you know the tendencies of how it behaves relative to price movement, and then come up with your own combination that **you** understand and that fits your trading style.

Later on in the course, we will show you an example of a system that combines different indicators to give you an idea of how they can complement each other.

What is the Best Technical Indicator in Forex?

Now on to the good stuff: Just how profitable is each technical indicator on its own? After all, forex traders don't include these technical indicators just to make their charts look nicer. Traders are in the business of making money!

If these indicators generate signals that don't translate into a profitable bottom line over time, then they're simply not the way to go for your needs! In order to give y'all a comparison of the effectiveness of each technical indicator, we've decided to backtest each of the indicators on their own for the past 5 years.

Backtesting, the expertise of our resident forex robot Robopip, involves retroactively testing the parameters of the indicators against historical price action. You'll learn more about this in your future studies. For now, just take a look at the parameters we used for our backtest.

Indicator	Parameters	Rules
Bollinger Bands	(30,2,2)	Cover and go long when daily closing price crosses below lower band. Cover and go short when daily closing price crosses above upper band.
MACD	(12,26,9)	Cover and go long when MACD1 (fast) crosses above MACD2 (slow). Cover and go short when MACD1 crosses below MACD2.
Parabolic SAR	(.02,.02,.2)	Cover and go long when daily closing price crosses above ParSAR. Cover and go short when daily closing price crosses below ParSAR.
Stochastic	(14,3,3)	Cover and go long when Stoch % crosses above 20. Cover and go short when Stoch % crosses below 80.
RSI	(9)	Cover and go long when RSI crosses above 30. Cover and go short when RSI crosses below 70
Ichimoku Kinko Hyo	(9,26,52,1)	Cover and go long when conversion line crosses above baseline. Cover and go short when conversion line crosses below base line

Using these parameters, we tested each of the technical indicators on its own on the daily time frame of EUR/USD over the past 5 years. We are trading 1 lot (that's 100,000 units) at a time with no set stop losses or take profit points. We simply cover and switch position once a new signal appears. This means if we initially had a long position when the indicator told us to sell, we would cover and establish a new short position.

Also, we were assuming we were well capitalized (as suggested in our Leverage lesson) and started with an example balance of $100,000. Aside from the actual profit and loss of each strategy, we included total pips gained/lost and the max drawdown.

Again, let us just remind you that we **DO NOT SUGGEST** trading forex without any stop losses. This is just for illustrative purposes only! Moving on, here are the results of our backtest:

Strategy	Number of Trades	P/L in Pips	P/L in %	Max Drawdown
Buy And Hold	1	-3,416.66	-3.42	25.44
Bollinger Bands	20	-19,535.97	-19.54	37.99
MACD	110	3,937.67	3.94	27.55
Parabolic SAR	128	-9,746.29	-9.75	21.96
Stochastic	74	-20,716.40	-20.72	30.64
RSI	8	-18,716.69	-18.72	34.57
Ichimoku Kinko Hyo	53	30,341.22	30.34	19.51

The data showed that over the past 5-years, the indicator that performed the best on its own was the Ichimoku Kinko Hyo indicator. It generated a total profit of $30,341, or 30.35%. Over 5 years, that gives us an average of just over 6% per year!

Surprisingly, the rest of the technical indicators were a lot less profitable, with the Stochastic indicator showing a return of negative 20.72%. Furthermore, all of the indicators led to substantial drawdowns of between 20% to 30%. However, this does not mean that the Ichimoku Kinko Hyo indicator is the best or that technical indicators as a whole are useless. Rather, this just goes to show that they aren't that useful on their own.

Think of all those martial arts movies you watched growing up. Aside from The Rock and the People's Elbow, no one relied on just one move to beat all the bad guys. Each of them used a combination of moves to get the job done. Forex trading is similar. It is an art and as traders, we need to learn how to use and combine the tools at hand in order to come up with a system that works for us. This brings us to our next lesson: putting all these indicators together!

Summary: Popular Chart Indicators

Everything you learn about trading is like a tool that is being added to your forex trader's toolbox. Your tools will give you a better chance of making good trading decisions when you use the right tool at the right time.

Bollinger Bands

- Used to measure the market's volatility.
- They act like mini support and resistance levels.

Bollinger Bounce

- A strategy that relies on the notion that price tends to always return to the middle of the Bollinger bands.
- You buy when the price hits the lower Bollinger band.
- You sell when the price hits the upper Bollinger band.
- Best used in ranging markets.

Bollinger Squeeze

- A strategy that is used to catch breakouts early.
- When the Bollinger bands “squeeze”, it means that the market is very quiet, and a breakout is eminent. Once a breakout occurs, we enter a trade on whatever side the price makes its breakout.

MACD

- Used to catch trends early and can also help us spot trend reversals.
- It consists of 2 moving averages (1 fast, 1 slow) and vertical lines called a histogram, which measures the distance between the 2 moving averages.
- Contrary to what many people think, the moving average lines are NOT moving averages of the price. They are moving averages of other moving averages.
- MACD’s downfall is its lag because it uses so many moving averages.
- One way to use MACD is to wait for the fast line to “cross over” or “cross under” the slow line and enter the trade accordingly because it signals a new trend.

Parabolic SAR

- This indicator is made to spot trend reversals, hence the name Parabolic Stop And Reversal (SAR).
- This is the easiest indicator to interpret because it only gives bullish and bearish signals.
- When the dots are above the candles, it is a sell signal.
- When the dots are below the candles, it is a buy signal.
- These are best used in trending markets that consist of long rallies and downturns.

Stochastic

- Used to indicate overbought and oversold conditions.
- When the moving average lines are above 80, it means that the market is overbought and we should look to sell.
- When the moving average lines are below 20, it means that the market is oversold and we should look to buy.

Relative Strength Index (RSI)

- Similar to the stochastic in that it indicates overbought and oversold conditions.
- When RSI is above 70, it means that the market is overbought and we should look to sell.
- When RSI is below 30, it means that the market is oversold and we should look to buy.
- RSI can also be used to confirm trend formations. If you think a trend is forming, wait for RSI to go above or below 50 (depending on if you're looking at an uptrend or downtrend) before you enter a trade.

Average Directional Index (ADX)

- The ADX calculates the potential strength of a trend.
- It fluctuates from 0 to 100, with readings below 20 indicating a weak trend and readings above 50 signaling a strong trend.
- ADX can be used as confirmation whether the pair could possibly continue in its current trend or not.
- ADX can also be used to determine when one should close a trade early. For instance, when ADX starts to slide below 50, it indicates that the current trend is possibly losing steam.

Ichimoku Kinko Hyo

- Ichimoku Kinko Hyo (IKH) is an indicator that gauges future price momentum and determines future areas of support and resistance.
- *Ichimoku* translates to "a glance", *kinko* means "equilibrium", while *hyo* is Japanese for "chart". Putting that all together, the phrase ichimoku kinko hyo stands for "a glance at a chart in equilibrium."
- If the price is above the Senkou span, the top line serves as the first support level while the bottom line serves as the second support level. If the price is below the Senkou span, the bottom line forms the first resistance level while the top line is the second resistance level.
- The Kijun Sen acts as an indicator of future price movement. If the price is higher than the blue line, it could continue to climb higher. If the price is below the blue line, it could keep dropping.
- The Tenkan Sen is an indicator of the market trend. If the red line is moving up or down, it indicates that the market is trending. If it moves horizontally, it signals that the market is ranging.
- The Chikou Span is the lagging line. If the Chikou line crosses the price in the bottom-up direction, that's a buy signal. If the green line crosses the price from the top-down, that's a sell signal.

Each chart indicator has its imperfections. This is why forex traders combine many different indicators to "screen" each other. As you progress through your trading career, you will learn which indicators you like the best and can combine them in a way that fits **your** forex trading style.

Leading vs. Lagging Indicators

Where is that trend?

We've already covered a lot of tools that can help you analyze potential trending and range bound trade opportunities. Still doing great so far? Awesome! Let's move on.

In this lesson, we're going to streamline 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 which ones don't.

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

A **leading** indicator gives a 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 and 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 won't be.

When you use leading indicators, you will experience a lot of fakeouts. Leading indicators are notorious for giving bogus signals which could “mislead” you.

Get it? Leading indicators that “mislead” you?

Haha. 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. And that sucks.

It’s kinda like wearing bell-bottoms in the 1980s and thinking you’re so cool and hip with fashion….

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

1. Leading indicators or oscillators
2. Lagging, trend-following, or momentum 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.

How to Use Oscillators to Warn You of the End of a Trend

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!

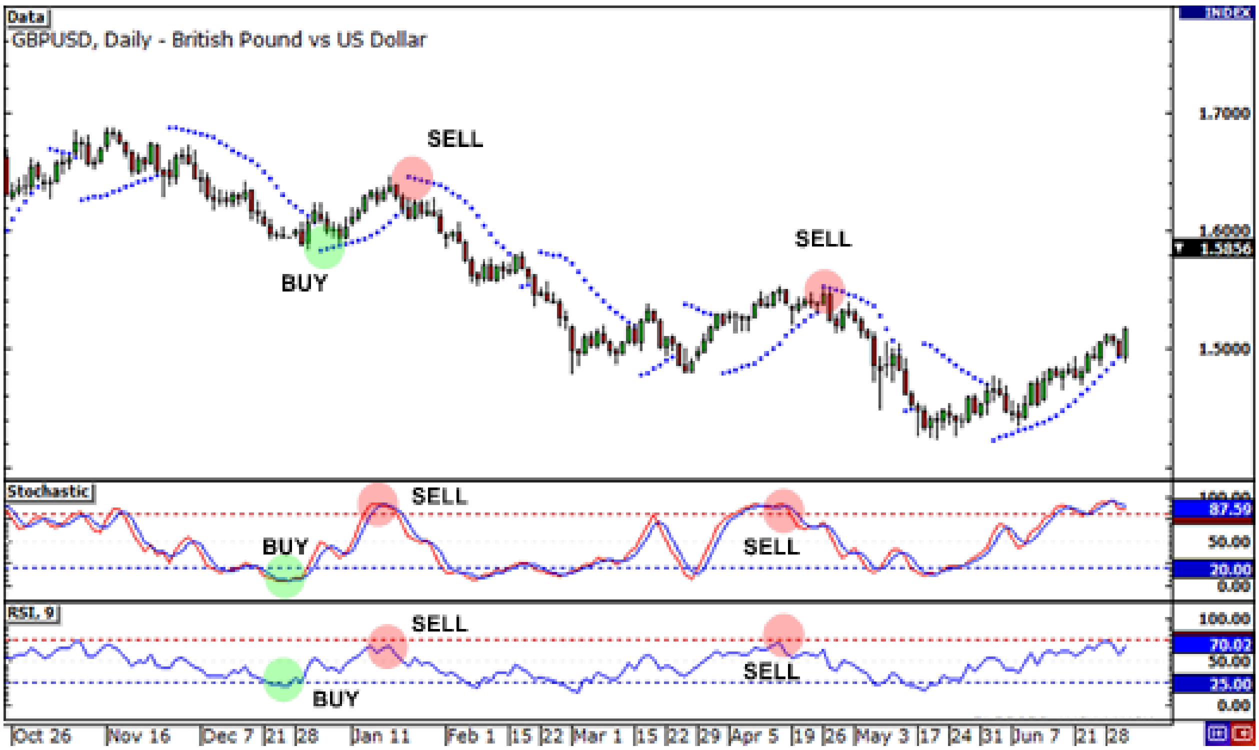
The Stochastic, Parabolic SAR, and Relative Strength Index (RSI) are all oscillators. Each of these indicators is designed to signal a possible reversal, where the previous trend has run its course and the price is ready to change direction.

Let's take a look at a couple of examples.

We've slapped on all three oscillators on GBP/USD's daily chart shown below. Remember when we discussed how to work the Stochastic, Parabolic SAR, and RSI?

If you don't, we're sending you back to fifth grade!

Anyway, as you can see on the chart, all three indicators gave buy signals towards the end of December. Taking that trade would've yielded around 400 pips in gains. Ka-ching!



Then, during the third week of January, the Stochastic, Parabolic SAR, and RSI all gave sell signals. And, judging from that long 3-month drop afterwards, you would've made a whole lot of pips if you took that short trade.

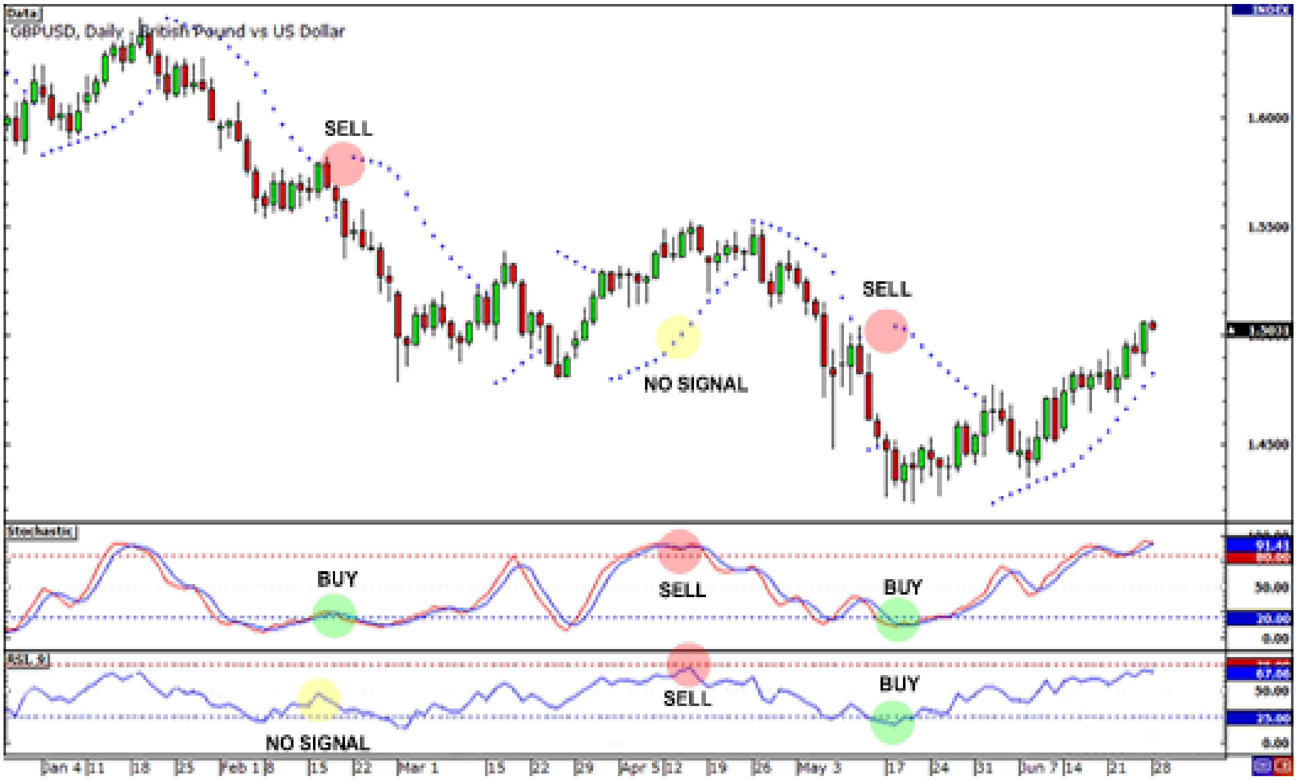
Around mid-April, all three oscillators gave another sell signal, after which the price made another sharp dive.

Now let's take a look at the same leading oscillators messing up, just so you know these signals aren't perfect.

In the chart below, you can see that the indicators could give conflicting signals.

For instance, the Parabolic SAR gave a sell signal in mid-February while the Stochastic showed the exact opposite signal. Which one should you follow?

Well, the RSI seems to be just as undecided as you are since it didn't give any buy or sell signals at that time.



Looking at the chart above, you can quickly see that there were a lot of false signals popping up.

During the second week of April, both the Stochastic and the RSI gave sell signals while the Parabolic SAR didn't give one. The price kept climbing from there and you could've lost a bunch of pips if you entered a short trade right away.

You would've had another loss around the middle of May if you acted on those buy signals from the Stochastic and RSI and simply ignored the sell signal from the Parabolic SAR.

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 the change from one closing price to the next.

Parabolic SAR has its own unique calculations that can further cause conflict.

That's the nature of oscillators. They assume that a particular price movement always results in the same reversal. Of course, that's hogwash.

While being aware of why a leading indicator may be wrong, 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.

How to Use Momentum Indicators to Confirm a Trend

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 GBP/USD's daily chart above, we've put on the 10 EMA (blue), 20 EMA (red), and the MACD.

Around October 15, the 10 EMA crossed above the 20 EMA, which is a bullish crossover.

Similarly, the MACD made an upward crossover and gave a buy signal.

If you jumped in on a long trade back then, you would've enjoyed that nice uptrend that followed.

Later on, both the moving averages and MACD gave a couple of sell signals.

And judging from the strong downtrends that occurred, taking those short trades would've given huge profits.

We can see those dollar signs flashing in your eyes!

Now let's look at another chart so you can see how these crossover signals can sometimes give false signals. We like to call them "fakeouts."

On March 15, the MACD made a bullish crossover while the moving averages gave no signal whatsoever.

If you acted on that buy signal from the MACD, you just suffered a fake out, buddy.

Similarly, the MACD's buy signal by the end of May wasn't accompanied by any moving average crossover. If you entered a long trade right then and there, you might've set yourself up for a loss since the price dipped a bit after that.

Bummer!

Summary: Leading and Lagging Indicators

Here's a quick recap of what we discussed in this lesson:

There are two types of indicators: **leading** and **lagging**.

1. A **leading** indicator or an oscillator gives a signal **before** the new trend or reversal occurs.
2. A **lagging** indicator or a momentum indicator gives a signal **after** the trend has started.

If you're able to identify the type of market you are trading in, you can pinpoint which indicators could give accurate signals and which ones are worthless at that time.

So, how do you figure out when to use oscillators or momentum indicators, or both?

That's another million dollar question! After all, we know they don't always work in tandem.

We'll give you a million dollars really soon…

Oh wait! We meant the million dollar answer!

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.

Besides…

You're not at it alone!

In the future sections, we're going to teach you how to correctly identify the forex market environment you are trading in to better use these indicators!

Chart Patterns Schmatterns

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 finish this lesson, you will be able to spot "explosions" on the charts before they even happen, potentially making you a lot of money in the process.

Chart patterns are like that funny feeling you get in your tummy right before you let a fart explode.

Don't you wish you had a chart to detect this explosion?

In this lesson, we will teach you basic chart patterns and formations. When correctly identified, it usually leads to an explosive breakout, so watch out!

Remember, our goal is to spot big movements before they happen so that we can ride them out and rake in the cash. After all, who doesn't want to have a pool of cash to swim in like Richie Rich?

Chart formations will greatly help us spot conditions where the market is ready to break out. They can also indicate whether the price will continue in its current direction or reverse so we'll also be devising some nifty trade strategies for these patterns.

Don't worry, we'll give you a neat little cheat sheet to help you remember all these cool patterns and strategies!

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

- Double Top and Double Bottom
- Head and Shoulders and Inverse Head and Shoulders
- Rising and Falling Wedges
- Bullish and Bearish Rectangles

- Bearish and Bullish Pennants
- Triangles (Symmetrical, Ascending, and Descending)

How to Trade Double Tops and Double Bottoms

Double Top

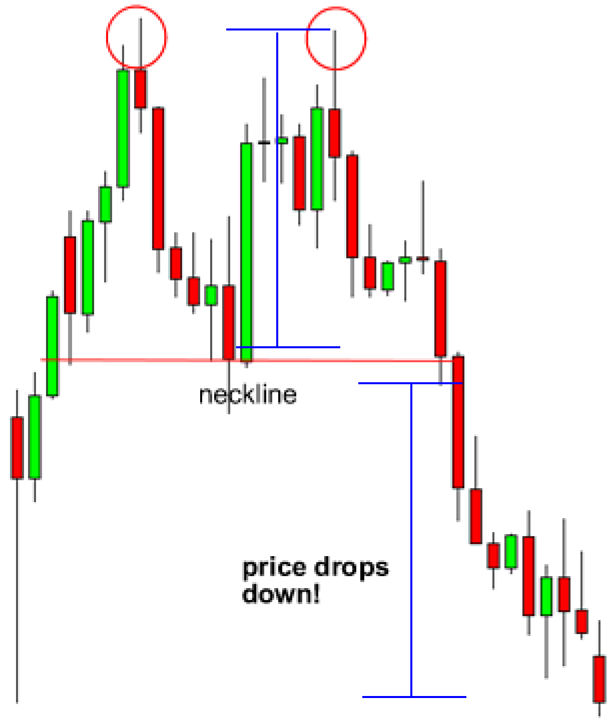
A double top is a reversal pattern that is formed after there is an extended move up. The “tops” are peaks which are formed when the price hits a certain level that can’t be broken.

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 second top was not able to break the high of the first 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 the double top, we would place our entry order below the neckline because we are anticipating a reversal of the uptrend.



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 that double tops are a trend reversal formation so you'll want to look for these after there is a strong uptrend.

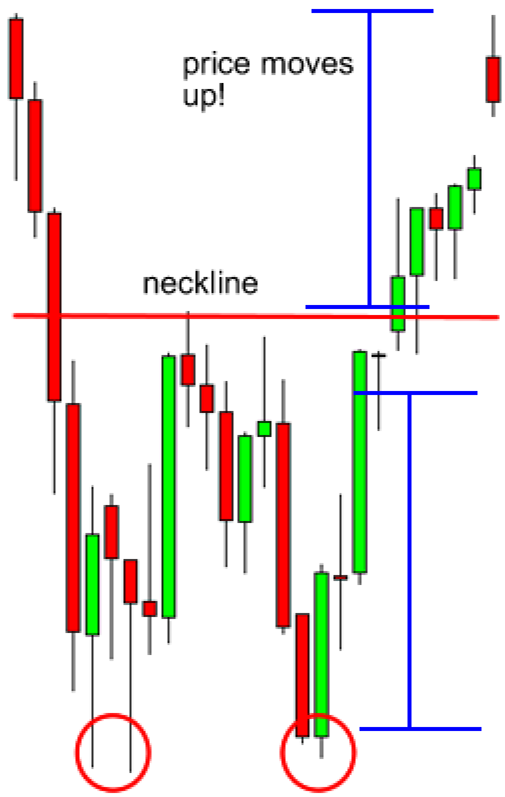
You'll also notice that the drop is approximately the same height as the double top formation. Keep that in mind because that'll be useful in setting profit targets.

Double Bottom

The double bottom is also a trend reversal formation, 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.

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 second bottom wasn’t able to significantly break the first bottom. This is a sign that the selling pressure is about finished, and that a reversal is about to occur.



Will you look at that!

The price broke the neckline and made a nice move up.

See how the price jumped by almost the same height as that of the double bottom formation?

Remember, just like double tops, double bottoms are also trend reversal formations. You'll want to look for these after a strong downtrend.

How to Trade the Head and Shoulders Pattern

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. Typically, when the slope is down, it produces a more reliable signal.

In this example, we can easily see the head and shoulders pattern.

The head is the second 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 put 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.

You can see that once the price goes below the neckline it makes a move that is at least the size of the distance between the head and 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!**"

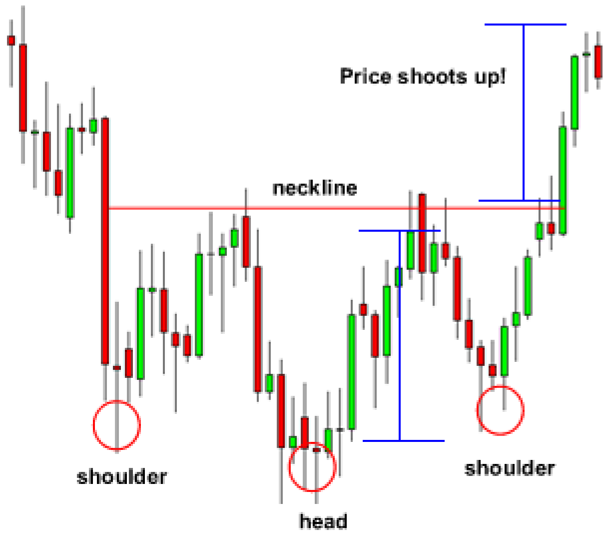
Inverse Head and Shoulders

The name speaks for itself. It is basically a head and shoulders formation, except this time it's upside down.

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.

If your target is hit, then be happy with your profits. However, there are trade management techniques 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.

How to Trade Wedge Chart Patterns

Wedges signal a pause in the current trend. When you encounter this formation, it signals that forex traders are still deciding where to take the pair next.

Wedges could serve as either continuation or reversal patterns.

Rising Wedge

A **rising wedge** is formed when price consolidates between upward sloping support and resistance lines.

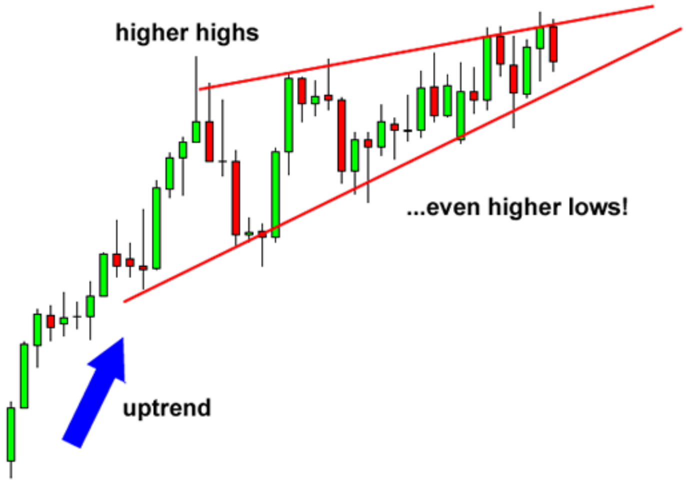
Here, the slope of the support line is steeper than that of the resistance. This indicates that higher lows are being formed faster than higher highs. This leads to a wedge-like formation, which is exactly where the chart pattern gets its name from!

With prices consolidating, we know that a big splash is coming, so we can expect a breakout to either the top or bottom.

If the rising wedge forms after an uptrend, it's usually a bearish reversal pattern.

On the other hand, if it forms during a downtrend, it could signal a continuation of the down move.

Either way, the important thing is that, when you spot this forex trading chart pattern, you're ready with your entry orders!



In this first example, a rising wedge formed at the end of an uptrend. Notice how price action is forming new highs, but at a much slower pace than when price makes higher lows.

See how price broke down to the downside? That means there are more forex traders desperate to be short than be long!

They pushed the price down to break the trend line, indicating that a downtrend may be in the cards.

Just like in the other forex trading chart patterns we discussed earlier, the price movement after the breakout is approximately the same magnitude as the height of the formation.

Now let's take a look at another example of a rising wedge formation. Only this time it acts as a bearish continuation signal.

As you can see, the price came from a downtrend before consolidating and sketching higher highs and even higher lows.

In this case, the price broke to the down side and the downtrend continued. That's why it's called a continuation signal yo!

See how the price made a nice move down that's the same height as the wedge?

What did we learn so far these Japanese candlestick chart patterns?

A rising wedge formed after an uptrend usually leads to a reversal (downtrend) while a rising wedge formed during a downtrend typically results in a continuation (downtrend).

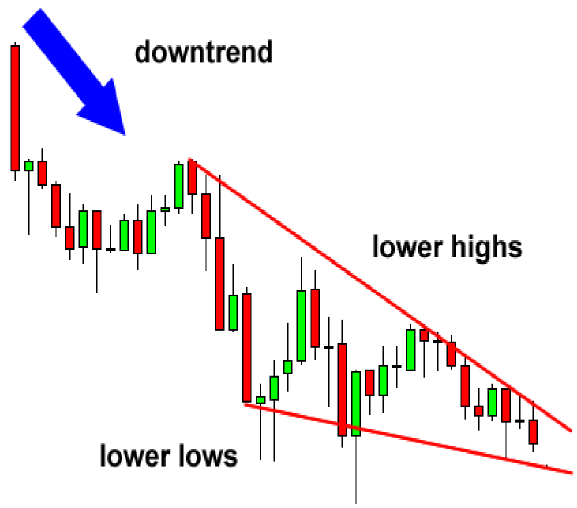
Simply put, a rising wedge leads to a downtrend, which means that it's a bearish chart pattern!

Falling Wedge

Just like the rising wedge, the **falling wedge** can either be a reversal or continuation signal.

As a reversal signal, it is formed at a bottom of a downtrend, indicating that an uptrend would come next.

As a continuation signal, it is formed during an uptrend, implying that the upward price action would resume. Unlike the rising wedge, the falling wedge is a bullish chart pattern.

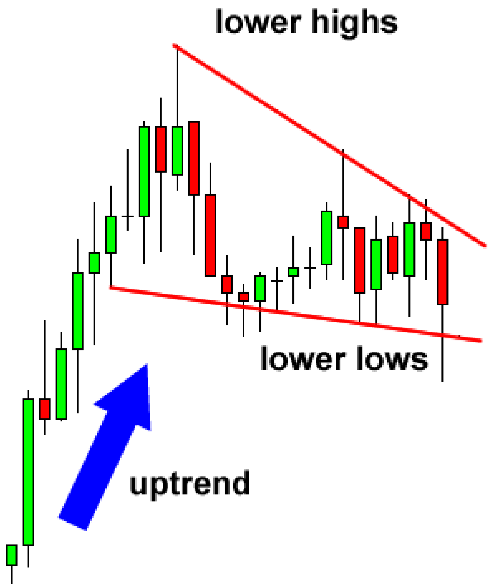


In this example, the falling wedge serves as a reversal signal. After a downtrend, the price made lower highs and lower lows.

Notice how the falling trend line connecting the highs is steeper than the trend line connecting the lows.

Upon breaking above the top of the wedge, the pair made a nice move upwards that's approximately equal to the height of the formation. In this case, the price rally went a few more pips beyond that target!

Let's take a look at an example where the falling wedge serves as a continuation signal. Like we mentioned earlier, when the falling wedge forms during an uptrend, it usually signals that the trend will resume later on.



In this case, the price consolidated for a bit after a strong rally. This could mean that buyers simply paused to catch their breath and probably recruited more people to join the bull camp.

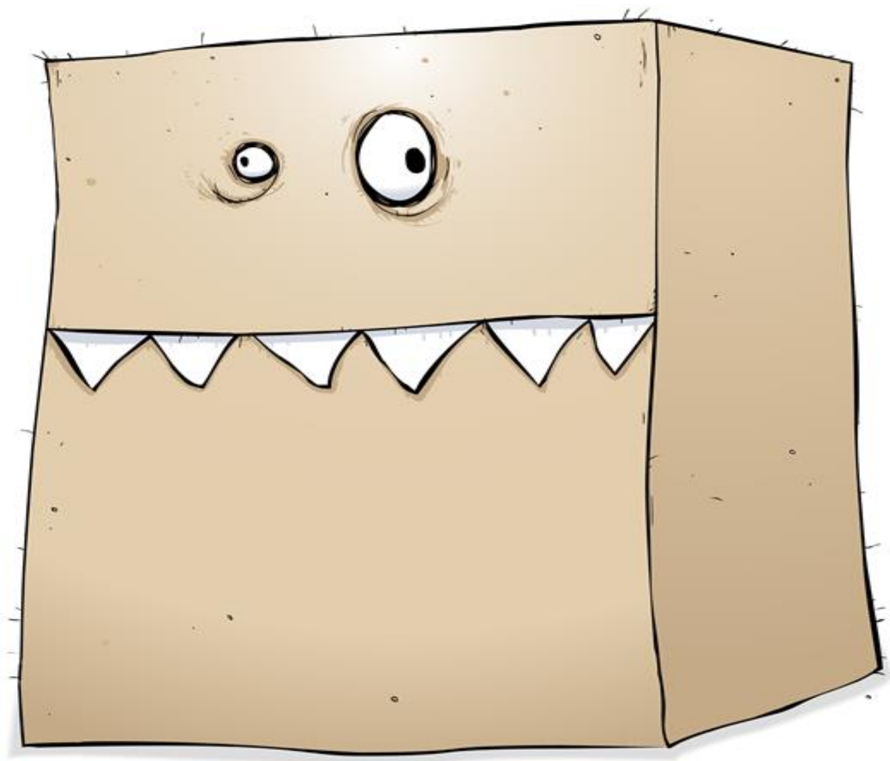
Hmm, it looks like the pair is revving up for a strong move. Which way would it go?

See how the price broke to the top side and went on to climb higher?

If we placed an entry order above that falling trend line connecting the pair’s highs, we would’ve been able to jump in on the strong uptrend and caught some pips! A good upside target would be the height of the wedge formation.

If you want to go for more pips, you can lock in some profits at the target by closing down a portion of your position, then letting the rest of your position ride.

How to Use Rectangle Chart Patterns to Trade Breakouts



A **rectangle** is a chart pattern formed when price is bounded by parallel support and resistance levels.

A rectangle exhibits a period of consolidation or indecision between buyers and sellers as they take turns throwing punches but neither has taken over.

The price will “test” the support and resistance levels several times before eventually breaking out. From there, the price could trend in the direction of the breakout, whether it is to the upside or downside.

In the example above, we can clearly see that the pair was bounded by two key price levels which are parallel to one another. We just have to wait until one of these levels breaks and go along for the ride!

Remember, when you spot a rectangle: **THINK OUTSIDE THE BOX!**

Bearish Rectangle

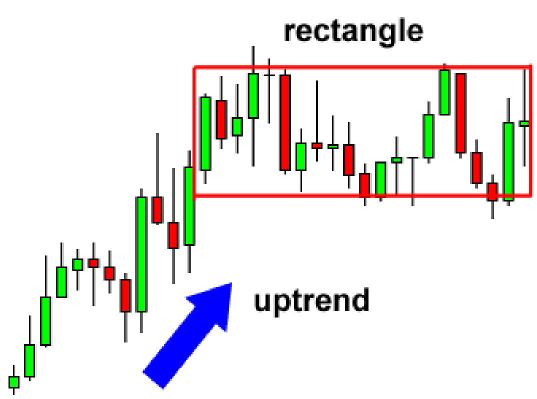
A **bearish rectangle** is formed when the price consolidates for a while during a downtrend. This happens because sellers probably need to pause and catch their breath before taking the pair any lower.

In this example, price broke the bottom of the rectangle chart pattern and continued to shoot down. If we had a short order just below the support level, we would have made a nice profit on this trade.

Here's a tip: Once the pair falls below the support, it tends to make a move that is about the size of the rectangle pattern. In the example above, the pair moved beyond the target so there would have been a chance to catch more pips!

Bullish Rectangle

Here's another example of a rectangle, this time, a **bullish rectangle** chart pattern. After an uptrend, the price paused to consolidate for a bit. Can you guess where the price is headed next?



If you answered up, then you're right! Check out that nice upside breakout right there!

Notice how the price moved all the way up after breaking above the top of the rectangle pattern. If we had a long order on top of the resistance level, we would've caught some pips on the trade!

Just like in the bearish rectangle pattern example, once the pair breaks, it will usually make a move that's AT LEAST the size of its previous range.

How to Trade Bearish and Bullish Pennants

Bearish Pennants

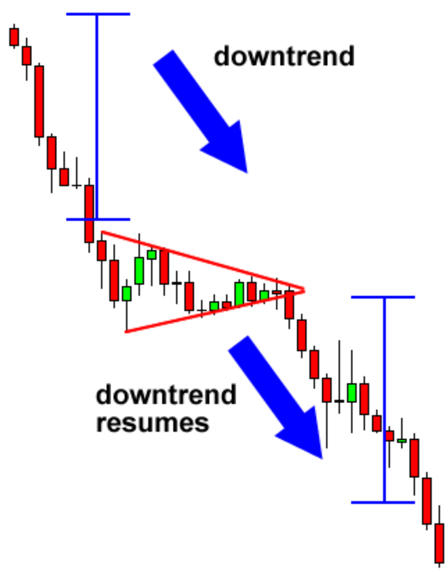
Similar to rectangles, pennants are continuation chart patterns formed after strong moves.

After a big upward or downward move, buyers or sellers usually pause to catch their breath before taking the pair further in the same direction. Because of this, the price usually consolidates and forms a tiny symmetrical triangle, which is called a pennant.

While the price is still consolidating, more buyers or sellers usually decide to jump in on the strong move, forcing the price to bust out of the pennant formation.

A **bearish pennant** is formed during a steep, almost vertical, downtrend. After that sharp drop in price, some sellers close their positions while other sellers decide to join the trend, making the price consolidate for a bit.

As soon as enough sellers jump in, the price breaks below the bottom of the pennant and continues to move down.

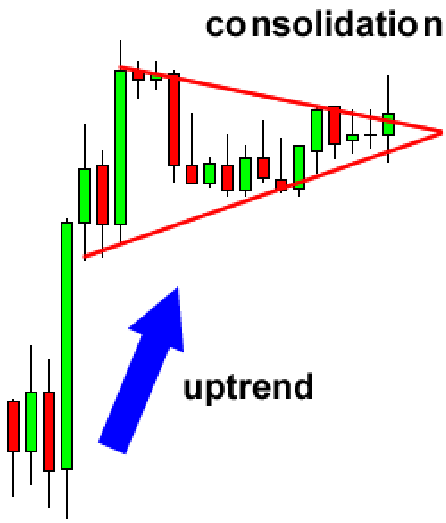


As you can see, the drop resumed after the price made a breakout to the bottom. To trade this chart pattern, we'd put a short order at the bottom of the pennant with a stop loss above the pennant. That way, we'd be out of the trade right away in case the breakdown was a fake out.

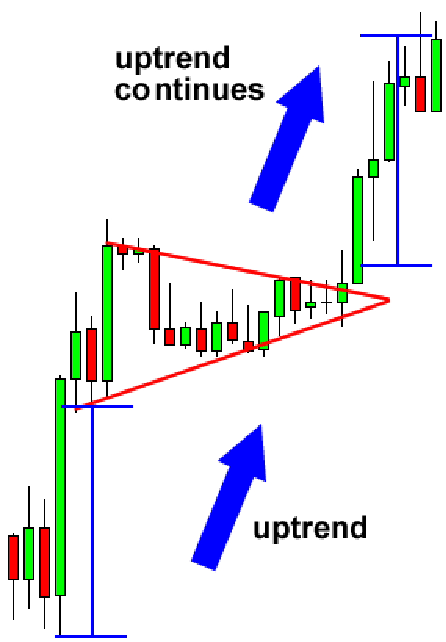
Unlike the other chart patterns wherein the size of the next move is approximately the height of the formation, pennants signal much stronger moves. Usually, the *height* of the earlier move (also known as the mast) is used to estimate the size of the breakout move.

Bullish Pennant

Bullish pennants, just like its name suggests, signals that bulls are about to go a-chargin' again. This means that the sharp climb in price would resume after that brief period of consolidation, when bulls gather enough energy to take the price higher again.



In this example, the price made a sharp vertical climb before taking a breather. I can hear the bulls stomping and revving up for another run!



Just like we predicted, the price made another strong move upwards after the breakout. To play this, we'd place our long order above the pennant and our stop below the bottom of the pennant to avoid fake outs.

Like we discussed earlier, the size of the breakout move is around the height of the mast (or the size of the earlier move). You see, pennants may be small in size but they could signal huge price moves so don't underestimate 'em!

How to Trade Triangle Chart Patterns

Symmetrical Triangle

A **symmetrical triangle** is a chart formation 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's 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 were a battle between the buyers and sellers, then this would be a draw.

This is also a type of consolidation.

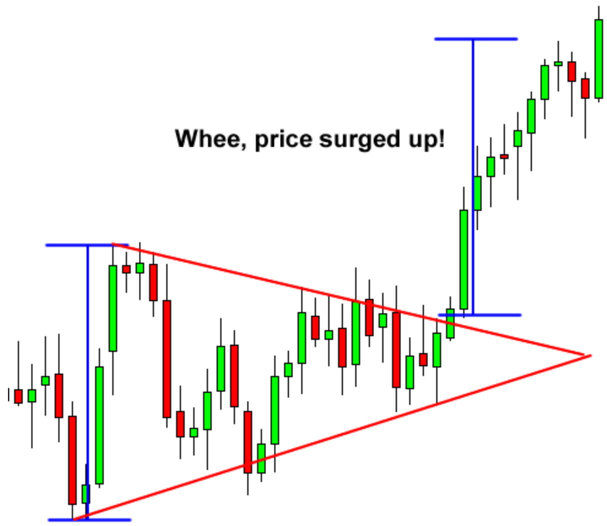
In the chart above, we can see that neither the buyers nor the sellers could push the price in their direction. When this happens we get lower highs and higher lows.

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 **most likely** break out. Eventually, one side of the market will give in.

So how can we take advantage of this?

Simple.

We can place entry orders above the slope of the lower highs and below the slope of the higher lows. Since we already know that the price is going to break out, we can just hitch a ride in whatever direction the market moves.



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 Triangle

This type of triangle chart pattern 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 our 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 you should not be obsessed with which direction the price goes, but you should be ready for 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 lost the battle and the price proceeded to dive! You can see that the drop was approximately the same distance as the height of the triangle formation.

If we set our short order below the bottom of the triangle, we could’ve caught some pips off that dive.

Descending Triangle

As you probably guessed, descending triangles are the exact opposite of ascending triangles (we knew you were smart!). In descending triangle chart patterns, 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 do say MOST, the price will eventually break the support line and continue to fall.

However, in some cases the support line will be 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 ended up breaking above the top of the triangle pattern. After the upside breakout, it proceeded to surge higher, by around the same vertical distance as the height of the triangle.

Placing an entry order above the top of the triangle and going for a target as high as the height of the formation would've yielded nice profits.

Know the 3 Main Groups of Chart Patterns

That's a whole lot of chart patterns we just taught you right there. We're pretty tired so it's time for us to take off and leave it to you from here…

Just playin'! We ain't leaving you till you're ready!

In this section, we'll discuss a bit more how to use these chart patterns to your advantage.

It's not enough to just know how the tools work, we've got to learn how to use them. And with all these new weapons in your arsenal, we'd better get those profits fired up!

Let's summarize the chart patterns we just learned and categorize them according to the signals they give.

Reversal Chart Patterns

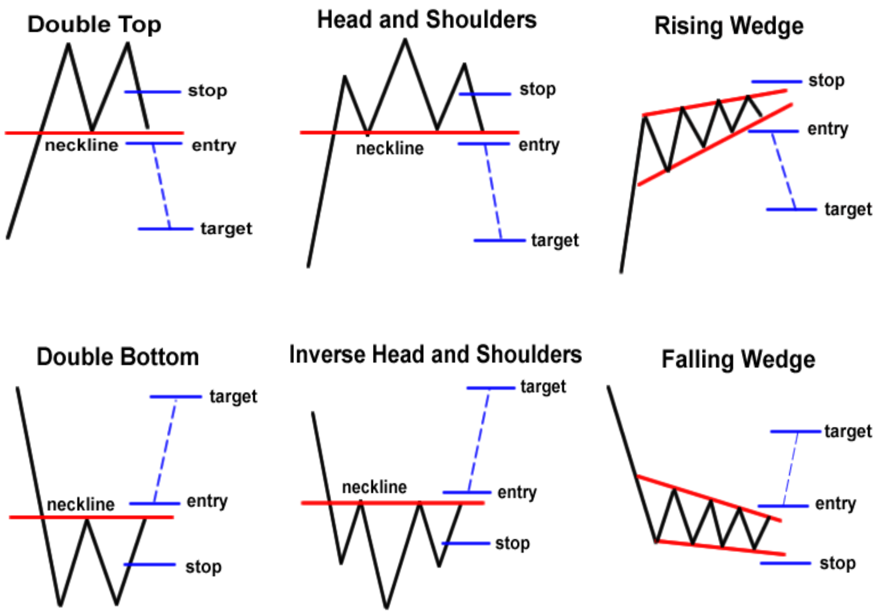
Reversal patterns are those chart formations that signal that the ongoing trend is about to change course.

If a reversal chart pattern forms during an uptrend, it hints that the trend will reverse and that the price will head down soon. Conversely, if a reversal chart pattern is seen during a downtrend, it suggests that the price will move up later on.

In this lesson, we covered six chart patterns that give reversal signals. Can you name all six of them?

1. Double Top
2. Double Bottom
3. Head and Shoulders
4. Inverse Head and Shoulders
5. Rising Wedge
6. Falling Wedge

If you got all six right, brownie points for you!



To trade these chart patterns, simply place an order beyond the neckline and in the direction of the new trend. Then go for a target that's almost the same as the height of the formation.

For instance, if you see a double bottom, place a long order at the top of the formation's neckline and go for a target that's just as high as the distance from the bottoms to the neckline.

In the interest of proper risk management, don't forget to place your stops! A reasonable stop loss can be set around the middle of the chart formation.

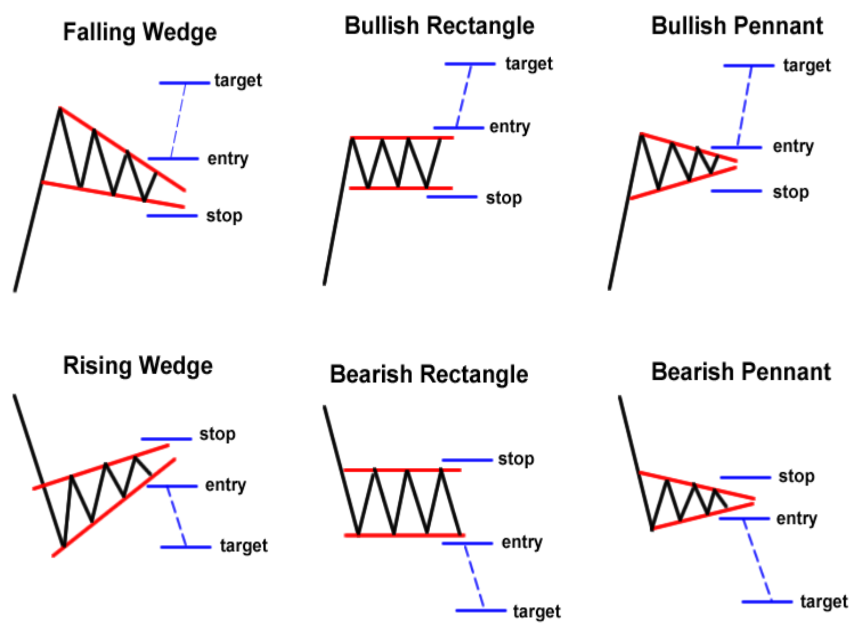
For example, you can measure the distance of the double bottoms from the neckline, divide that by two, and use that as the size of your stop.

Continuation Chart Patterns

Continuation chart patterns are those chart formations that signal that the ongoing trend will resume.

Usually, these are also known as consolidation patterns because they show how buyers or sellers take a quick break before moving further in the same direction as the prior trend.

We've covered several continuation chart patterns, namely the wedges, rectangles, and pennants. Note that wedges can be considered either reversal or continuation patterns depending on the trend on which they form.



To trade these patterns, simply place an order above or below the formation (following the direction of the ongoing trend, of course). Then go for a target that's at least the size of the chart pattern for wedges and rectangles.

For pennants, you can aim higher and target the height of the pennant's mast.

For continuation patterns, stops are usually placed above or below the actual chart formation.

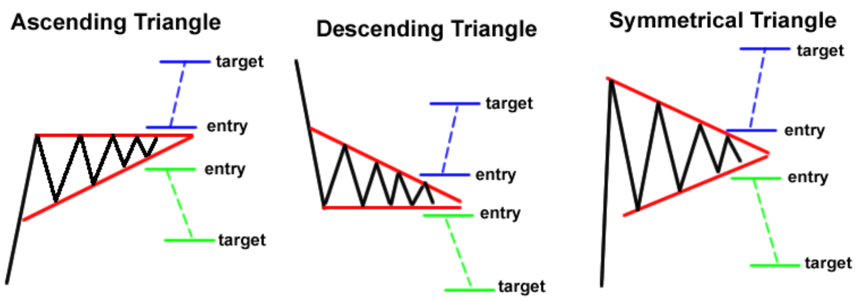
For example, when trading a bearish rectangle, place your stop a few pips above the top or resistance of the rectangle.

Bilateral Chart Patterns

Bilateral chart patterns are a bit more tricky because these signal that the price can move either way.

Huh, what kind of a signal is that?!

This is where triangle formations fall in. Remember when we discussed that the price could break either to the topside or downside with triangles?



To play these chart patterns, you should consider both scenarios (upside or downside breakout) and place one order on top of the formation and another at the bottom of the formation.

If one order gets triggered, you can cancel the other one. Either way, you'd be part of the action.

Double the possibilities, double the fun!

The only problem is that you could catch a false break if you set your entry orders too close to the top or bottom of the formation.

So be careful and don't forget to place your stops too!

Forex Chart Patterns Cheat Sheet

Like we promised, here's a neat little cheat sheet to help you remember all those forex chart patterns and what they are signaling.

We've listed the basic forex chart patterns, when they are formed, what type of signal they give, and what the next likely price move may be. Check it out!

Chart Pattern	Forms During	Type of Signal	Next Move
Double Top	Uptrend	Reversal	Down
Double Bottom	Downtrend	Reversal	Up
Head and Shoulders	Uptrend	Reversal	Down
Inverse Head and Shoulders	Downtrend	Reversal	Up
Rising Wedge	Downtrend	Continuation	Down
Rising Wedge	Uptrend	Reversal	Down
Falling Wedge	Uptrend	Continuation	Up
Falling Wedge	Downtrend	Reversal	Up
Bearish Rectangle	Downtrend	Continuation	Down
Bullish Rectangle	Uptrend	Continuation	Up
Bearish Pennant	Downtrend	Continuation	Down
Bullish Pennant	Uptrend	Continuation	Up

You also might want to add this page to your bookmarks in case you need to double-check those chart patterns' signals before you risk your hard-earned cash on a trade. You never know when you're gonna need to cheat, hah! Bookmark this thing yo!

And as you probably noticed, we didn't include the triangle formations (symmetrical, ascending, and descending) in this cheat sheet. That's because these chart patterns can form either in an uptrend or downtrend, and can signal either a continuation or reversal. Confusing I know, but that's where practice and experience comes in!

Like we mentioned, it's tough to tell where the forex market will breakout or reverse. So what's important is that you prepare well and have your entry/exit orders ready so that you can be part of the action either way!

Forex Pivot Points

Are you all excited? It's your last year in junior high before you head off to high school!

Professional forex traders and market makers use **pivot points** to identify potential 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.

The reason why pivot points are so enticing?

It's because they are **OBJECTIVE**.

Unlike some of the other indicators that we've taught you about already, there's no discretion involved.

In many ways, forex pivot points are very similar to Fibonacci levels. Because so many people are looking at those levels, they almost become self-fulfilling.

The major difference between the two is that with Fibonacci, there is still some subjectivity involved in picking Swing Highs and Swing Lows. With pivot points, forex traders typically use the same method for calculating them.

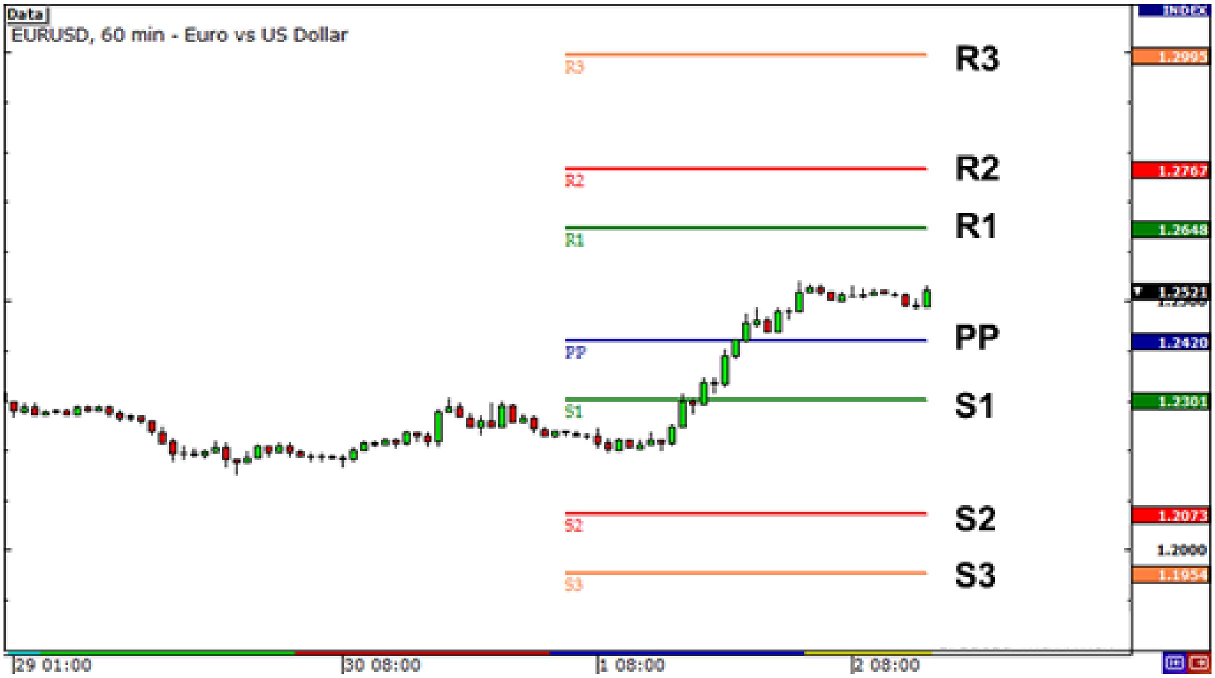
Many traders keep an eye on these levels and you should too.

Pivot points are especially useful to short-term traders who are looking to take advantage of small price movements. Just like normal support and resistance levels, forex traders can choose to trade the *bounce* or the *break* of these levels.

Range-bound traders use pivot points to identify reversal points. They see pivot points as areas where they can place their buy or sell orders.

Breakout forex 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:



As you can see here, horizontal support and resistance levels are placed on your chart. And look – they're marked out nicely for you! How convenient is that?!

Pivot Point Lingo

Here's quick rundown on what those acronyms mean:

PP stands for Pivot Point.

S stands for Support.

R stands for Resistance.

But don't get too caught up in thinking "S1 has to be support" or "R1 has to be resistance." We'll explain why later.

In the following lessons, you will learn how to calculate forex pivot points, the different types of pivot points and most importantly, how you can add pivot points to your forex trading toolbox!

How to Calculate Pivot Points

The first thing you're going to learn is how to calculate pivot point levels.

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 forex 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 resistance (R1) = (2 x PP) – Low

First support (S1) = (2 x PP) – High

Second level of support and resistance:

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

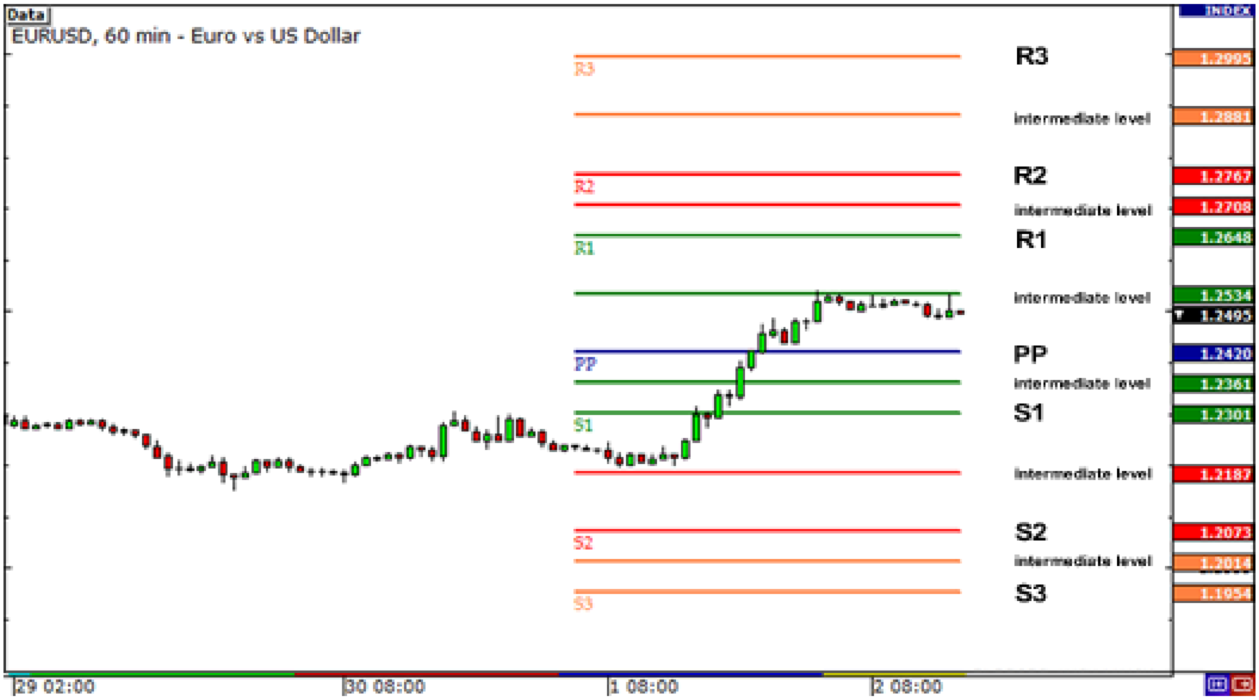
Second support (S2) = PP – (High – Low)

Third level of support and resistance:

Third resistance (R3) = High + 2(PP – Low)

Third support (S3) = Low – 2(High – PP)

Keep in mind that some forex charting software plot intermediate levels or mid-point levels. These are basically *mini levels* between the main pivot point and support and resistance levels.



If you hated algebra, have no fear because you don't have to perform these calculations yourself. Most charting softwares will automatically do this for you. Just make sure you configure your settings so that it uses the correct closing time and price.

We here at BabyPips.com also have our very own Pivot Point Calculator!

The awesome part is, just like everything on the website, it's FREE!

The forex pivot point calculator can come in handy, especially if you want to do a little back testing to see how pivot point levels have held up in the past. Remember, one of the advantages of using pivot points is that it is objective, so it's very easy to test how price reacted to them.

Next up, we'll teach you the various ways in which you can incorporate pivot points into your forex trading strategy.

How to use Pivot Points for Range Trading

The simplest way to use pivot point levels in your forex trading is to use them just like your regular support and resistance levels. Just like good ole support and resistance, price will test the levels repeatedly.

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

If you see that a pivot level is holding, this could give you some good trading opportunities.

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

If price was nearing a support level, you would buy and put your stop just below the level.

See? Just like your regular support and resistance! Nothing hard about that!

Let's take a look at an example so you can visualize this. Here's a 15-minute chart of GBP/USD.

In the chart above, you see that price is testing the S1 support level. If you think it will hold, what you can do is buy at market and then put a stop loss order past the next support level.

If you're conservative, you can set a wide stop just below S2. If price reaches past S2, chances are it won't be coming back up, as both S1 and S2 could become resistance levels.

If you're a little more aggressive and confident that support at S1 would hold, you can set your stop just below S1.

As for your take profit points, you could target PP or R1, which could also provide some sort of resistance. Let's see what happened if you bought at market.

And bam! Looks like S1 held as support! What's more, if you had targeted PP as your take profit point, you would have hit your PT! Woohoo! Ice cream and pizza for you!

Of course, it ain't always that simple. You shouldn't rely only on the pivot point levels. You should note whether pivot point levels line up with former support and resistance levels.

You can also incorporate candlestick analysis and other types of indicators to help give you more confirmation.

For example, if you see that a doji has formed over S1, or that the stochastic is indicating oversold conditions, then the odds are higher that S1 will hold as support.

Also, most of the time, trading normally takes place between the first support and resistance levels. Occasionally, price will test the second levels and every once in a while, the third levels will be tested.

Lastly, you should also fully understand that sometimes, price will just break through all the levels like how Rafael Nadal breezes through the competition at the French Open.

What will you do when that happens? Continue to hold onto your trade and be a sucker and watch your account dwindle away? Or will you take advantage and get back some pips?

In the next lesson, we'll teach you how to take advantage when these levels break down.

How to use Pivot Points to Trade Breakouts

Just like your normal support and resistance levels, pivot point levels won't hold forever.

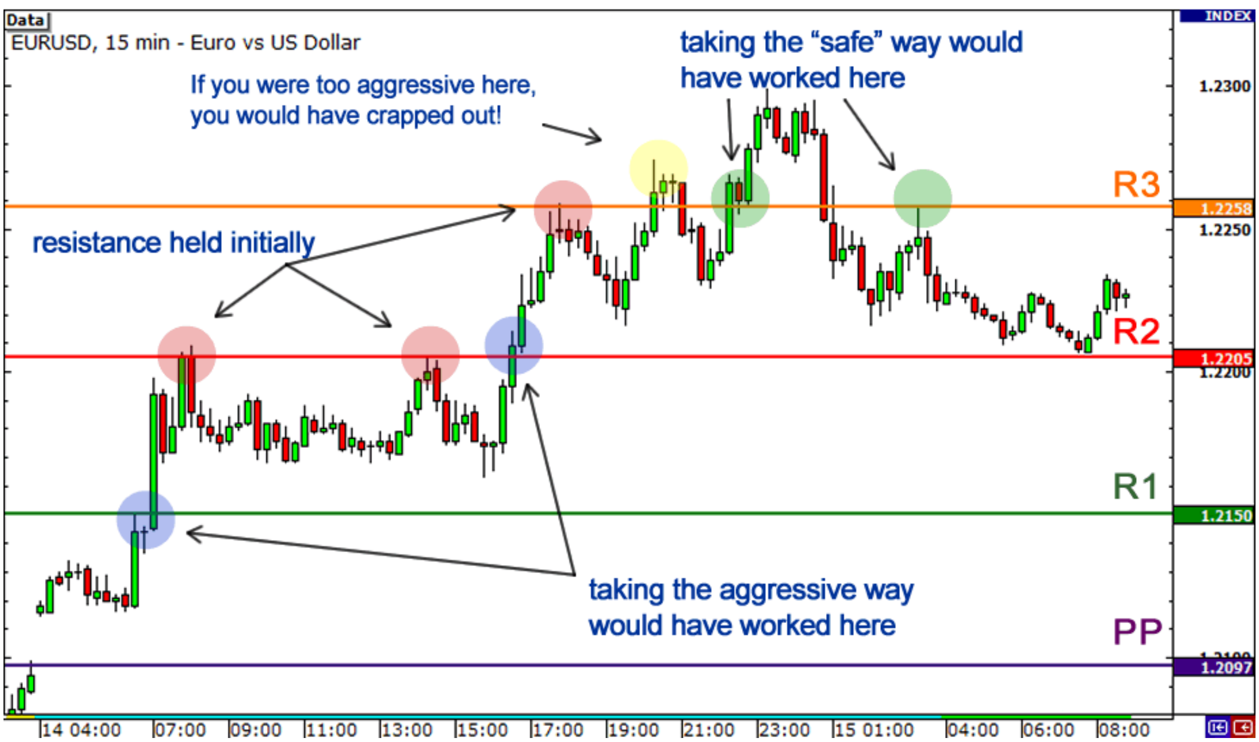
Using pivot points for range trading will work, but not all the time. In those times that these levels fail to hold, you should have some tools ready in your forex toolbox to take advantage of the situation!

As we showed you earlier, there are two main ways to trade breakouts: the *aggressive* way or the *safe* way.

Either method will work just fine. Just always remember that if you take the safe way, which means waiting for a retest of support or resistance, you may miss out on the initial move.

Using Pivot Points to Trade Potential Breakouts

Let's take a look at a chart to see potential breakout trades using pivot points. Below is a 15-minute chart of EUR/USD.



Here we see EUR/USD made a strong rally throughout the day. We see that EUR/USD opened by gapping up above the pivot point. Price made a strong move up, before pausing slightly at R1.

Eventually, resistance broke and the pair jumped up by 50 pips!

If you had taken the aggressive method, you would have caught the initial move and been celebrating like you just won the World Cup.

On the other hand, if you had taken the safe way and waited for a retest, you would have been one sad little trader. The price did not retest after breaking R1. In fact, the same thing happened for both R1 and R2!

Notice how EUR/USD bulls tried to make a run for R3 as well.

However, if you had taken the aggressive method, you would have gotten caught up in a fake out as the price failed to sustain the initial break. If your stop was too tight, then you would have gotten stopped out.

Later on though, you'll see that the price eventually broke through. Notice how there was also a retest of the broken resistance line.

Also, observe how when the pair reversed later in the day and broke down past R3. There was an opportunity to take a short on the retest of resistance-turned support – turned resistance (read that again if you have to!).

Remember that, when support levels break, they usually turn into resistance levels.

This concept of "**role reversal**" also applies for broken resistance levels which become support levels. These would have been good opportunities to take the "I think I'll play it safe" method.

Where do you place stops and pick targets with breakouts?

One of the difficult things about taking breakout trades is picking a spot to place your stop. Unlike range trading where you are looking for breaks of pivot point support and resistance levels, you are looking for strong fast moves.

Once a level breaks, in theory, that level will likely become "support-turned-resistance" or "resistance-turned-support." Again, this is called a *role reversal*…since the roles have been reversed.

If you were going long and price broke R1, you could place your stop just below R1.

Let's go back to that EUR/USD chart to see where you could place your stops.

As for setting targets, you would typically aim for the next pivot point support or resistance level as your take profit point. It's very rare that price will break past all the pivot point levels, unless a big economic event or surprise news comes out.

Let's go back to that EUR/USD chart to see where you would put those stops and take profit.

In this example, once you saw price break R1, you would have set your stop just below R1. If you believed that price would continue to rise, you could keep your position and move your stop manually to see if move would continue. You'd have to watch carefully and adjust accordingly. You'll learn more about this in later lessons.

As with any method or indicator, you have to be aware of the risks with taking breakout trades.

First of all, you have no idea whether or not the move will continue. You might enter thinking that price will continue to rise, but instead you catch a top or bottom, which means that you've been faked out!

Second, you won't be sure if it's a true breakout, or just wild moves caused by the release of important news. Spikes in volatility are a common occurrence during news events, so be sure to keep up with breaking news and be aware of what's on the forex calendar for the day or week.

Lastly, just like in range trading, it would be best to pop on other key support and resistance levels. You might be thinking that R1 is breaking, but you failed to notice a strong resistance level just past R1. Price may break past R1, test the resistance and just fall back down.

You should make use of your forex knowledge of support and resistance, candlestick patterns, and momentum indicators to help you give stronger signals as to whether the break is for real or not.

How to Use Pivot Points to Measure Market Sentiment

There is one other way to incorporate pivot points into your forex trading strategy, and that's to use it to gauge **market sentiment**.

What this means is that you can tell whether traders are more inclined to buy or sell the pair. All you would need to do is to keep an eye on the pivot point. You could treat it like the 50 yard line of a football field. Depending on which side the ball (in this case, price) is on, you can tell whether buyers or sellers have the upper hand.

If the price breaks through the pivot point to the top, it's a sign that traders are bullish on the pair and you should start buying the pair like it's a Krispy Kreme donut. Here's an example of what happened when the price stayed above the pivot point.

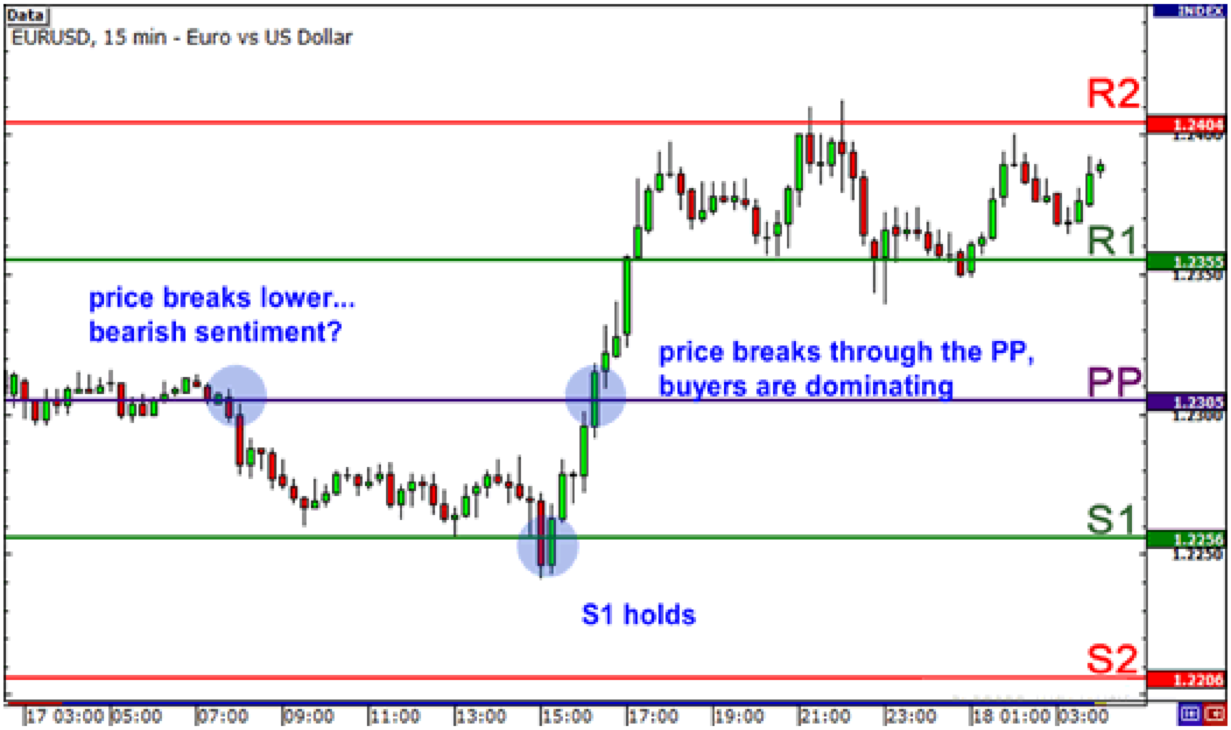
In this example, we see that EUR/USD gapped up and opened above the pivot point. The price then rose higher and higher, breaking through all the resistance levels.

Now, if price breaks through the pivot point to the bottom, then you should start selling the pair like it's Enron stock. The price being below the pivot point would signal bearish sentiment and that sellers could have the upper hand for the trading session.

Let's take a look at a chart of GBP/USD.

In the chart above, we see that the price tested the pivot point, which held as a resistance level. Next thing you know, the pair keeps going lower and lower. If you had taken the clue that price remained below the pivot point and sold the pair, you would have made some nice moolah. GBP/USD dropped almost 300 pips!

Of course, it doesn't always work out like this. There are times when you think that forex traders are bearish on a pair, only to see that the pair reverses and breaks through to the top!



In this example, if you saw price breaking lower from the pivot point and sold, you would have had a sad, sad day. Later on during the European session, EUR/USD popped higher, eventually breaking through the pivot point. What's more, the pair stayed above the pivot point, showing how buyers were rockin' away.

The lesson here?

Traders are fickle!

How forex traders feel about a currency can shift dramatically day to day, even session to session. This is why you cannot simply buy when price is above the pivot point or sell when it is below it.

Instead, if you choose to use pivot point analysis in this way, you should combine it with other indicators to help you determine overall market sentiment.

Know the 3 Other Types of Pivot Points

While we suggest that you stick to the standard method of calculating pivot points, you should know that there are other ways to calculate for pivot points. In this lesson, we will talk about these other methods, as well as give you the formulas on how to calculate for these levels.

Woodie Pivot Point

R2 = PP + High – Low

R1 = (2 X PP) – Low

PP = (H + L + 2C) / 4

S1 = (2 X PP) – High

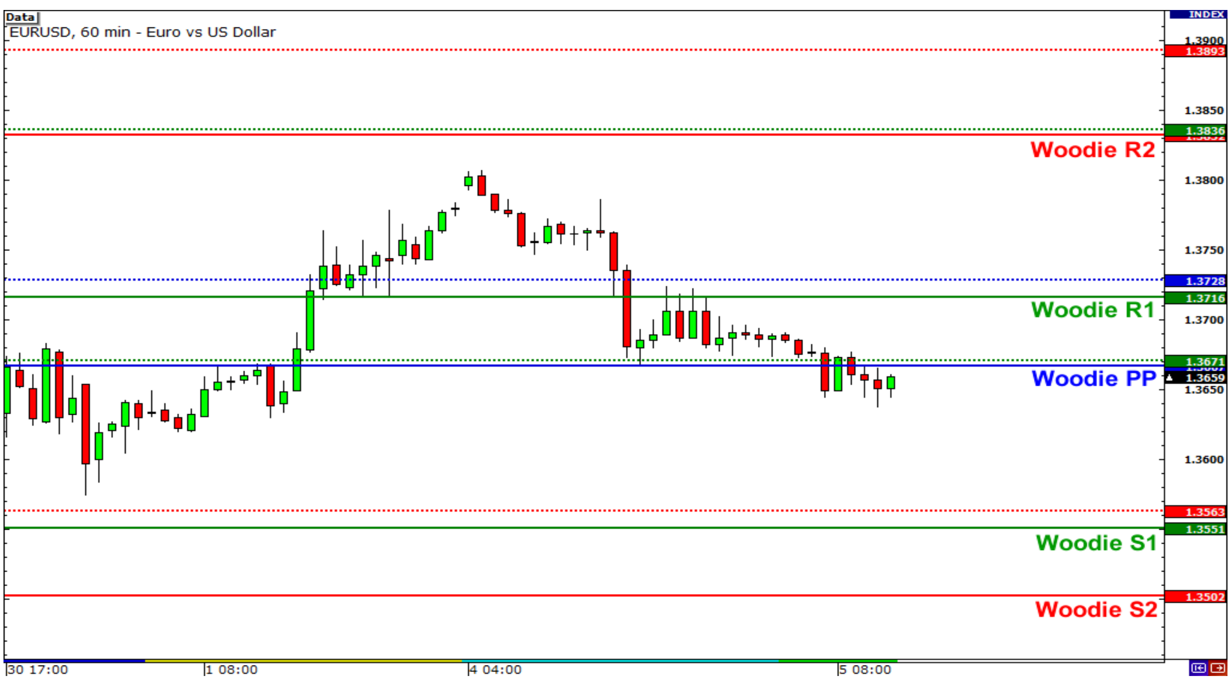
S2 = PP – High + Low

C – Closing Price, H – High, L – Low

In the formulas above, you'll notice that the pivot point calculation is very different from the standard method.

Also, in order the calculate for the corresponding support and resistance levels, you would use the difference between the previous day's high and low, otherwise known as the range.

Here's a chart example of the Woodie pivot point calculation applied on EURUSD. The Woodie pivot point, support levels, and resistance levels are the solid lines while the dotted lines represent the levels calculated through the standard method.



Because they have different formulas, levels obtained through the Woodie calculations are very different from those gotten through the standard method.

Some traders prefer to use the Woodie formulas because they give more weight to the closing price of the previous period. Others prefer the standard formulas because many traders make use of those, which could make them self-fulfilling.

In any case, since resistance turns into support (and vice versa), if you choose to use the Woodie formulas, you should keep an eye on these levels as they could become areas of interest. Whatever floats your boat!

Camarilla Pivot Point

R4 = C + ((H-L) x 1.5000)

R3 = C + ((H-L) x 1.2500)

R2 = C + ((H-L) x 1.1666)

R1 = C + ((H-L) x 1.0833)

PP = (H + L + C) / 3

S1 = C – ((H-L) x 1.0833)

S2 = C – ((H-L) x 1.1666)

S3 = C – ((H-L) x 1.2500)

S4 = C – ((H-L) x 1.5000)

C – Closing Price, H – High, L – Low

The Camarilla formulas are similar to the Woodie formula. They also use the previous day's close and range to calculate the support and resistance levels.

The only difference is that you should calculate for 8 major levels (4 resistance and 4 support), and each of these levels should be multiplied by a multiplier.

The main concept of Camarilla pivot points is that it is based on the idea that price has a natural tendency to revert back to the mean (sound familiar?), or in this case, the previous day's close.

The idea is that you should buy or sell when price reaches either the third support or resistance level. However, if price were to burst through S4 or R4, it would mean that the intraday trend is strong, and it's about time you jump on that bandwagon!

Check out how the Camarilla calculation gives different levels (solid lines) compared to the standard method's levels (dotted lines)!

As you can see from the chart above, **more emphasis is given to the closing price as opposed to the pivot point**. Because of this, it's possible that resistance levels could be below the pivot point or support levels could be above it.

See how all the support and resistance levels are above the Camarilla pivot point?

Fibonacci Pivot Point

R3 = PP + ((High – Low) x 1.000)

R2 = PP + ((High – Low) x .618)

R1 = PP + ((High – Low) x .382)

PP = (H + L + C) / 3

S1 = PP – ((High – Low) x .382)

S2 = PP – ((High – Low) x .618)

S3 = PP – ((High – Low) x 1.000)

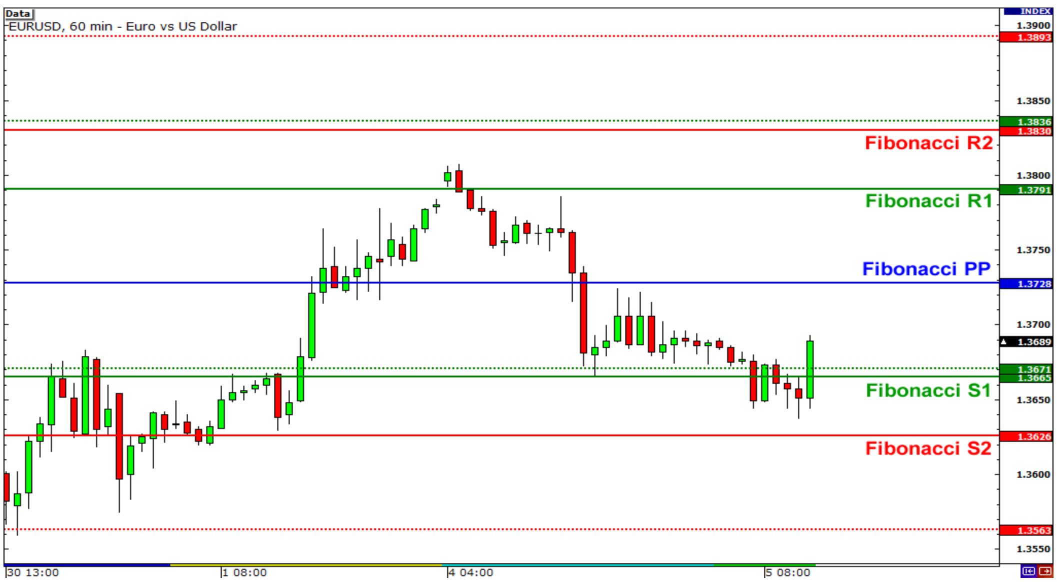
C – Closing Price, H – High, L – Low

Fibonacci pivot point levels are determined by first calculating the pivot point like you would the standard method.

Next, multiply the previous day's range with its corresponding Fibonacci level. Most traders use the 38.2%, 61.8% and 100% retracements in their calculations.

Finally, add or subtract the figures you get to the pivot point and voila, you've got your Fibonacci pivot point levels!

Look at the chart below to see how the levels calculated through the Fibonacci method (solid lines) differ from those calculated through the standard method (dotted lines).



The logic behind this is that many traders like using the Fibonacci ratios. People use it for retracement levels, moving averages, etc.

Why not use it for pivot points as well?

Remember that both Fibonacci and pivot points levels are used to find support and resistance. With so many traders looking at these levels, they can actually become self-fulfilling.

Which pivot point method is best?

The truth is, just like all the variations of all the other indicators that you've learned so far, there is no single best method. It really all depends on how you combine your knowledge of pivot points with all the other tools in your forex trading toolbox.

Just know that most charting software that do automatic calculations normally use the standard method in calculating for the pivot point levels.

But now that you know how to calculate for these levels on your own, you can give them all a swing and see which one works best for you. Pivot away!

Summary: Pivot Points

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

- Pivot points are a technique used by forex traders to help determine potential support and resistance areas.
- There are four main ways to calculate for pivot points: Standard, Woodie, Camarilla, and Fibonacci.
- Pivots can be extremely useful in forex since many currency pairs usually fluctuate between these levels. Most of the time, price ranges between R1 and S1.
- Pivot points can be used by range, breakout, and trend traders.
- Range-bound forex traders will enter a buy order near identified levels of support and a sell order when the pair nears resistance.
- Pivot points also allow breakout forex traders to identify key levels that need to be broken for a move to qualify as a strong momentum move.
- Sentiment (or trend) forex traders use pivot points to help determine the bullishness or bearishness of a currency pair.
- 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.
- Using pivot point analysis alone is not always enough. Learn to use pivot points along with other technical analysis tools such as candlestick patterns, MACD crossover, moving averages crossovers, the stochastic, RSI, etc. The greater the confirmation, the greater your probability of a successful trade!

Elliott Wave Theory

Back in the old school days of the 1920-30s, there was this mad genius and professional accountant named Ralph Nelson Elliott.

By analyzing closely 75 years worth of stock data, Elliott discovered that stock markets, thought to behave in a somewhat chaotic manner, actually didn't.

When he hit 66 years old, he finally gathered enough evidence (and confidence) to share his discovery with the world.

He published his theory in the book entitled *The Wave Principle*.

According to him, the market traded in repetitive cycles, which he pointed out were the emotions of investors caused by outside influences (ahem, CNBC, Bloomberg, ESPN) or the predominant psychology of the masses at the time.

Elliott explained that the upward and downward swings in price caused by the collective psychology always showed up in the same repetitive patterns.

He called these upward and downward swings "waves".

He believes that, if you can correctly identify the repeating patterns in prices, you can predict where price will go (or not go) next.

This is what makes Elliott waves so appealing to traders. It gives them a way to identify precise points where price is most likely to reverse. In other words, Elliott came up with a system that enables traders to catch tops and bottoms.

So, amidst all the chaos in prices, Elliott found order. Awesome, huh?

Of course, like all mad geniuses, he needed to claim this observation and so he came up with a super original name: **The Elliott Wave Theory**.

But before we delve into the Elliott waves, you need to first understand what **fractals** are.

Fractals

Basically, fractals are structures that can be split into parts, each of which is a very similar copy of the whole. Mathematicians like to call this property “self-similarity”.

You don’t need to go far to find examples of fractals. They can found all over nature!

A sea shell is a fractal. A snow flake is a fractal. A cloud is a fractal. Heck, a lightning bolt is a fractal.

So why are fractals important?

One important quality of Elliott waves is that they are fractals. Much like sea shells and snow flakes, Elliott waves could be further subdivided into smaller Elliot waves.

Ready to be an Elliottician now? Read on!

Impulse Waves

Mr. Elliott showed that a trending market moves in what he calls a 5-3 wave pattern.

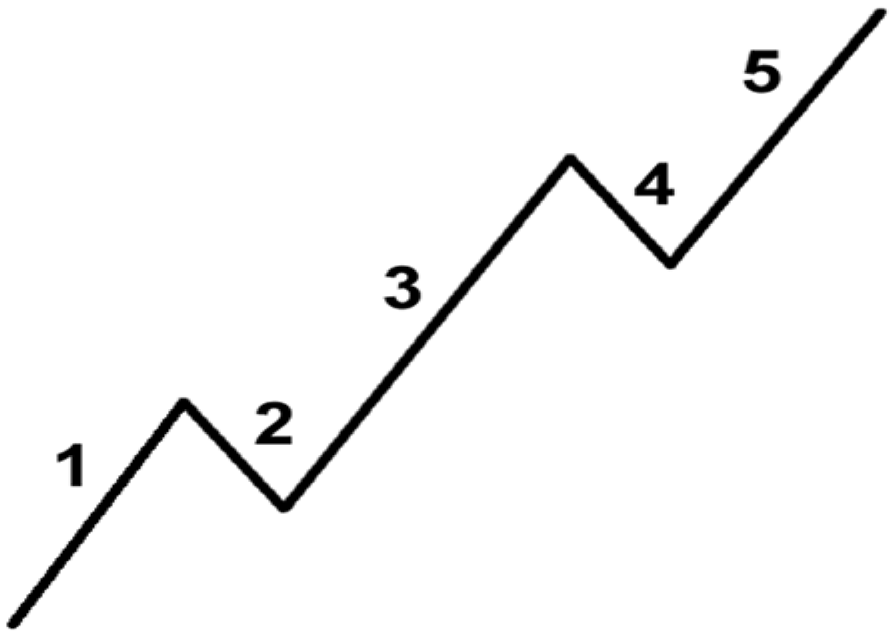
The first 5-wave pattern is called **impulse waves**.

The last 3-wave pattern is called **corrective waves**.

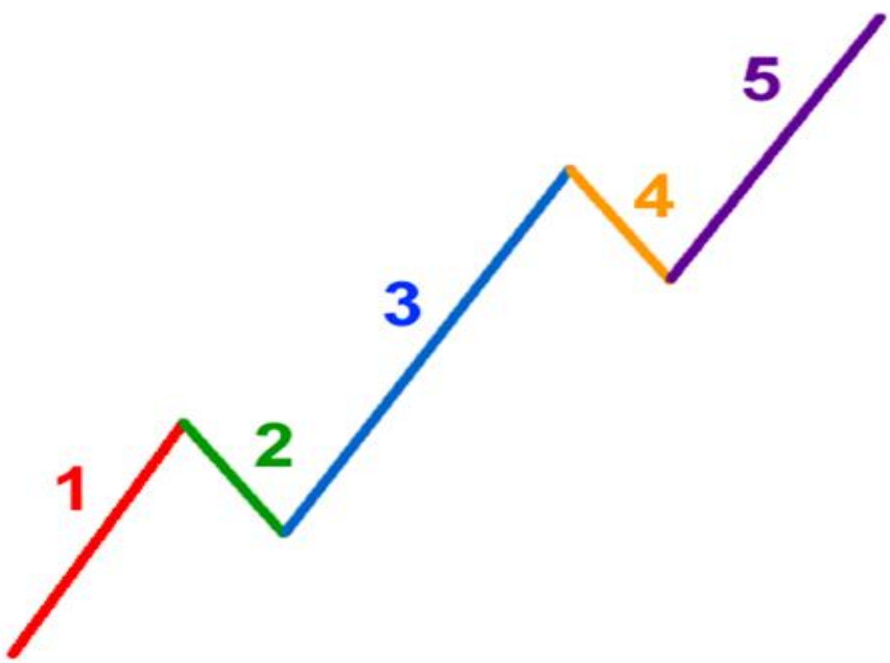
In this pattern, Waves 1, 3, 5 are **motive**, meaning they go along with the overall trend, while Waves 2 and 4 are **corrective**.

Do not confuse Waves 2 and 4 with the ABC corrective pattern (discussed in the next section) though!

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 magnifico! It’s so pretty! We like colors, so we’ve color-coded each wave along with its wave count.

Here is a short description of what happens during each wave.

We’re going to use stocks for our example since stocks are 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

Traders 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. Traders and investors 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.

Extended Impulse Waves

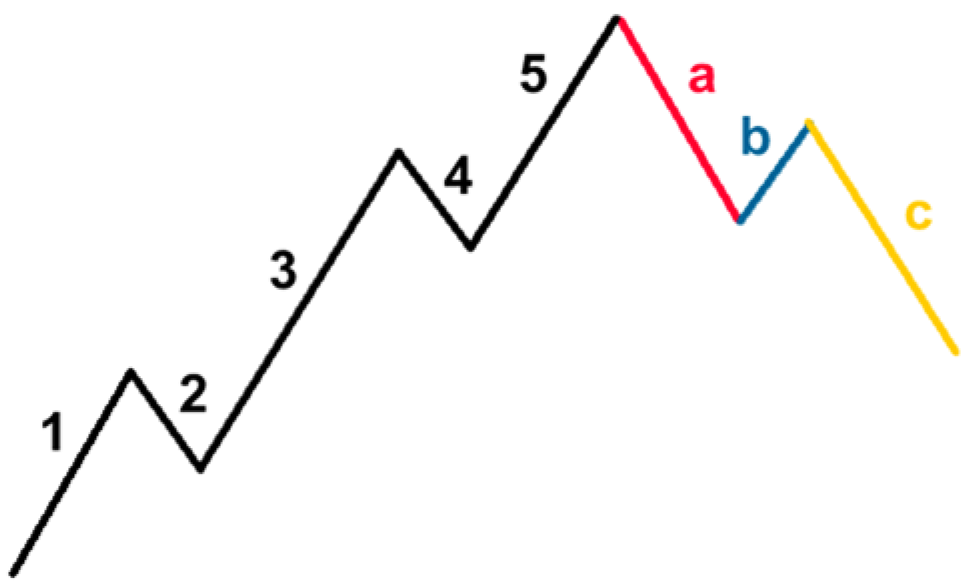
One thing that you also need to know about the Elliott Wave Theory is that one of the three impulse waves (1, 3, or 5) will always be “extended”. Simply put, there will always be one wave that is longer than the other two, regardless of degree.

According to Elliott, it is usually the fifth wave which is extended. As time went by, this old school style of wave labeling has changed because more and more people started labeling the third wave as the extended one.

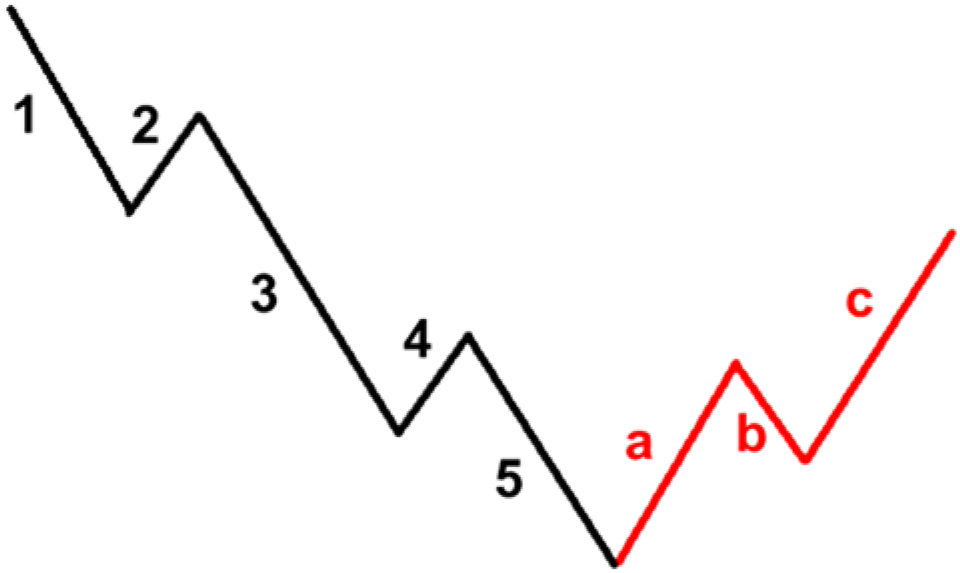
Check out this forum thread for more Elliott Wave diagrams.

Corrective Waves

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 a smokin’ hot corrective 3-wave pattern!



Just because we’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:



Types of Corrective Wave Patterns

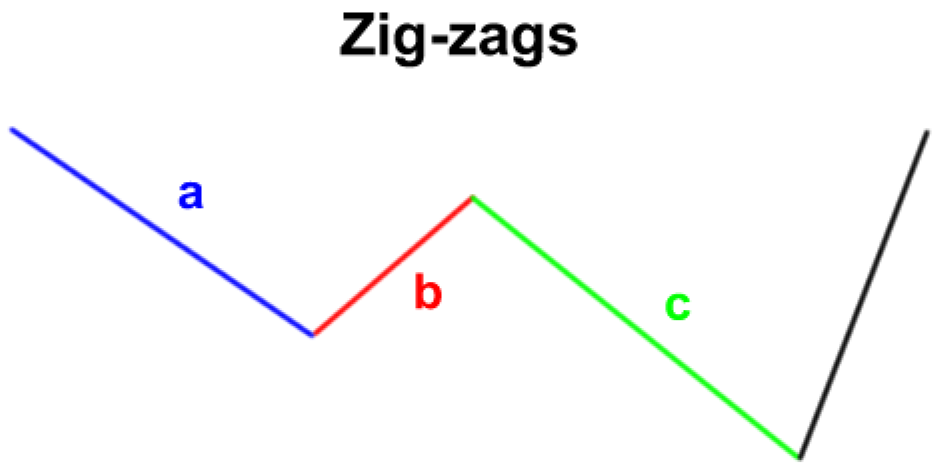
According to Elliott, there are 21 corrective ABC patterns ranging from simple to complex.

“Uh 21? I can’t memorize all of that! The basics of the Elliott Wave Theory are already mind-blowing!”

Take it easy, young padawan. The great thing about Elliott Wave is you don’t have to be above the legal drinking age to trade it! You don’t have to get a fake ID or memorize all 21 types of corrective ABC patterns because they are just made up of three very simple easy-to-understand formations.

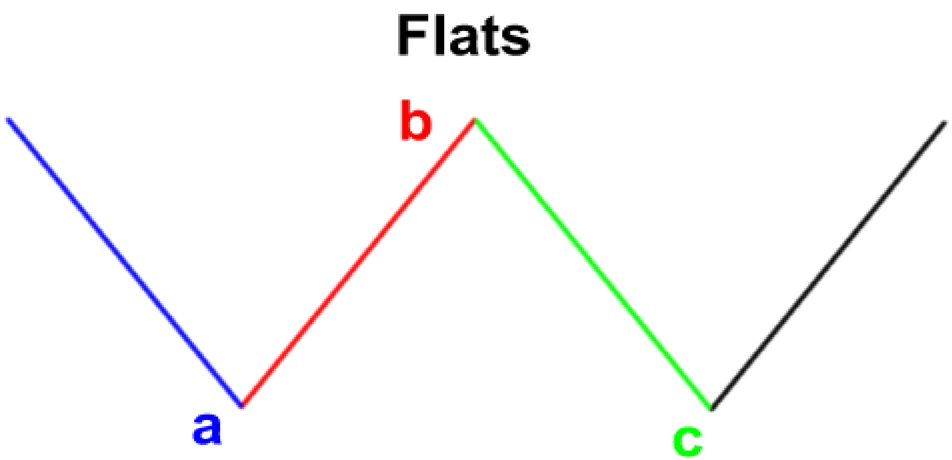
Let’s take a look at these three formations. The examples below apply to uptrends, but you can just invert them if you’re dealing with a downtrend.

The Zig-Zag Formation



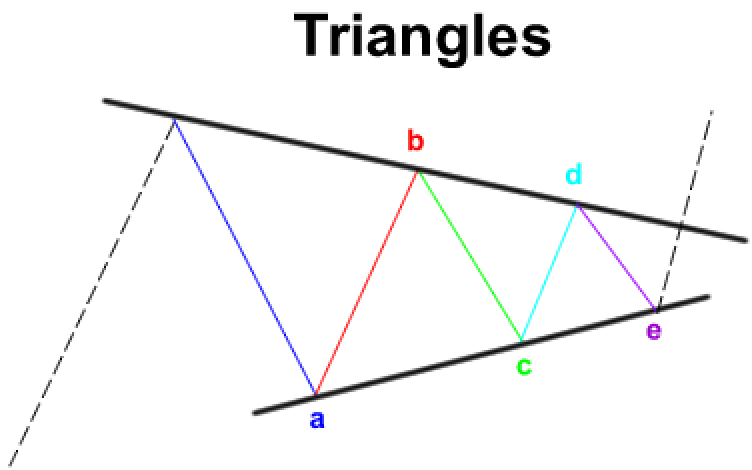
Zig-zag formations are very steep moves in price that goes against the predominant trend. Wave B is typically shortest in length compared to Waves A and C. These zig-zag patterns can happen twice or even thrice in a correction (2 to 3 zig-zag patterns linked together). Like with all waves, each of the waves in zig-zag patterns could be broken up into 5-wave patterns.

The Flat Formation



Flat formations are simple sideways corrective waves. In flats, the lengths of the waves are **GENERALLY** equal in length, with wave B reversing wave A's move and wave C undoing wave B's move. We say generally because wave B can sometimes go beyond the beginning of wave A.

The Triangle Formation

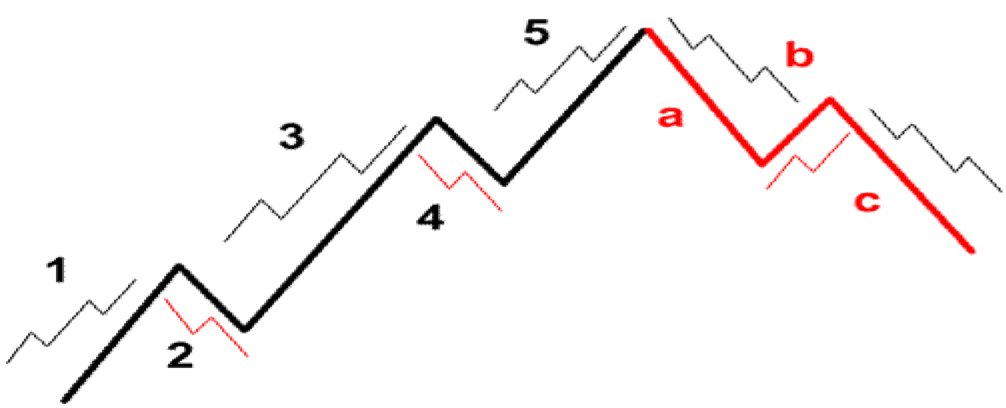


Triangle formations are corrective patterns that are bound by either converging or diverging trend lines. Triangles are made up of 5-waves that move against the trend in a sideways fashion. These triangles can be symmetrical, descending, ascending, or expanding.

Drop by our forums if you want to see the bullish and bearish versions of these Elliott Wave patterns.

Elliott Waves Within an Elliott Wave

Like we mentioned earlier, Elliott waves are fractals. Each 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 Waves 1, 3, and 5 are made up of a smaller 5-wave impulse pattern while Waves 2 and 4 are made up of smaller 3-wave corrective pattern?

Always remember that each wave is comprised of smaller wave patterns. This pattern repeats itself…

FOREVER!

To make it easy to label these waves, the Elliott Wave Theory has assigned a series of categories to the waves in order of the largest to the smallest. They are:

- **Grand Supercycle** (multi-century)
- **Supercycle** (about 40–70 years)
- **Cycle** (one year to several years)
- **Primary** (a few months to a couple of years)
- **Intermediate** (weeks to months)
- **Minor** (weeks)
- **Minute** (days)
- **Minuette** (hours)
- **Sub-Minuette** (minutes)

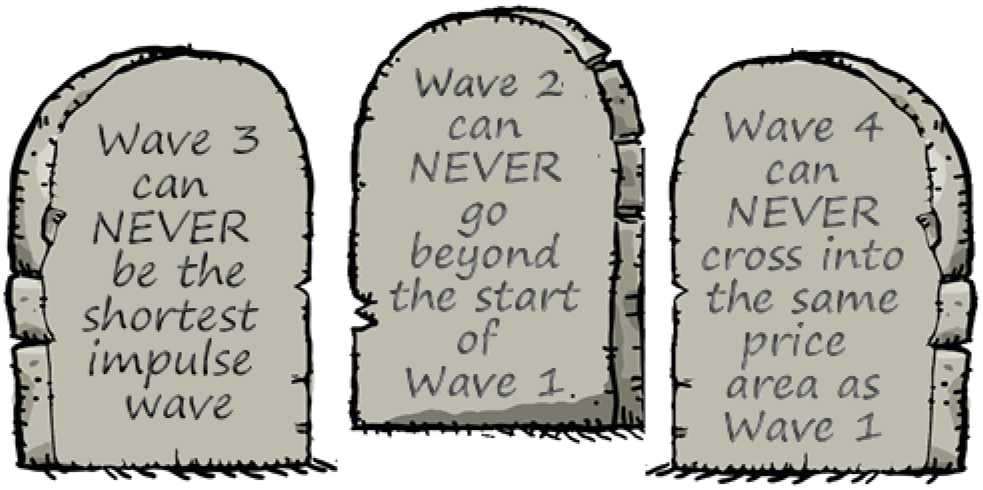
A Grand Supercycle is made up of Supercycle waves which is made up of Cycle waves which is made up Primary waves, which is made up of Intermediate waves which is made up of Minor waves which is made up of Minute waves which is made up of Minuette waves which is made up of Sub-Minuette waves. Did you get all that?

Okay, to make things much clearer, let's see how an Elliott Wave looks in real life.

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

Besides, we're not going to let you go at it alone! In the following sections, we'll give you some tips on how to correctly and easily identify waves as well as teach you how to trade using Elliott Waves. Surf's up!

3 Cardinal Rules of the Elliott Wave Theory



As you may have guessed, the key in using the Elliott Wave Theory in trading is all about being able to correctly identify waves.

By developing the right eye in recognizing what wave the market is in, you will be able to find out which side of the market to trade on, long or short.

There are three cardinal “cannot-be-broken” rules in labeling waves. So, before you jump right in to applying the Elliott Wave Theory to your trading, you must take note of the rules below.

Failing to label waves correctly can prove disastrous to your account.

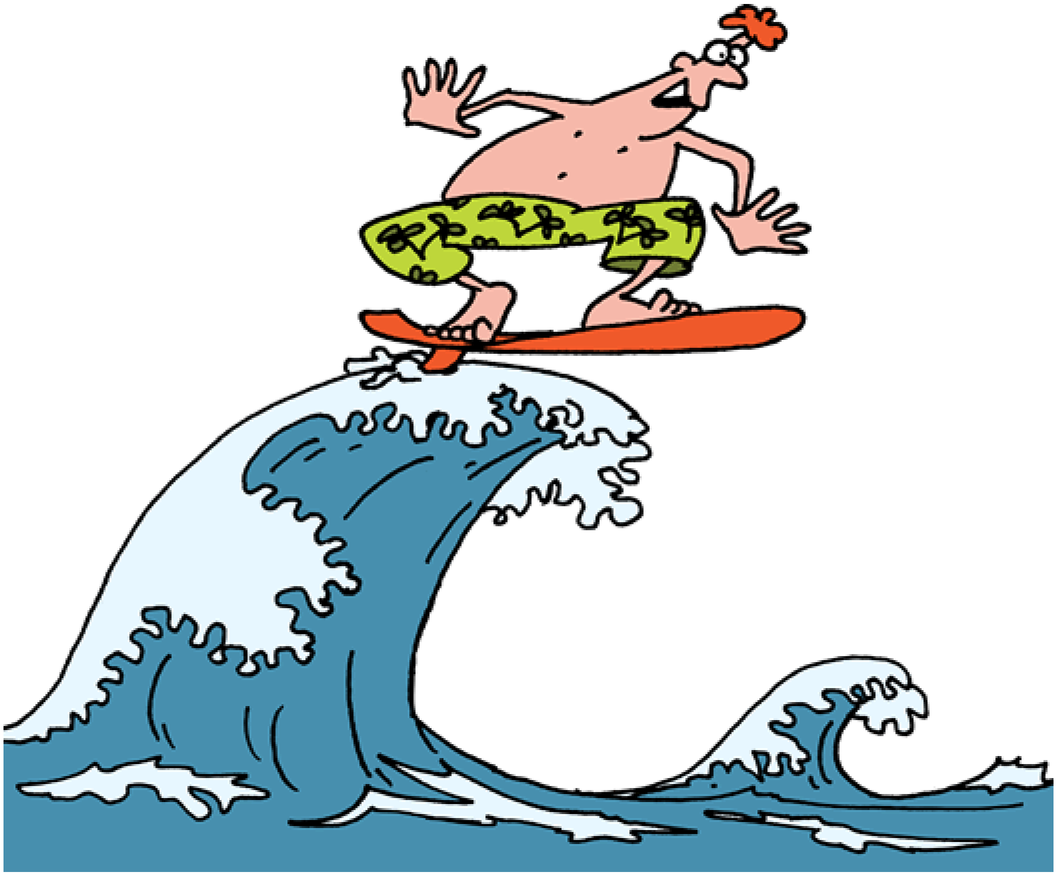
3 Cardinal Rules of the Elliott Wave Theory

- Rule Number 1: Wave 3 can NEVER be the shortest impulse wave
- Rule Number 2: Wave 2 can NEVER go beyond the start of Wave 1
- Rule Number 3: Wave 4 can NEVER cross in the same price area as Wave 1

Then, there are the guidelines that help you in correctly labeling waves. Unlike the three cardinal rules, these guidelines can be broken. Here they are:

- Conversely, sometimes, Wave 5 does not move beyond the end of wave 3. This is called truncation.
- Wave 5, more often than not, goes beyond or “breaks through” the trend line drawn off Wave 3 parallel to a trend line connecting the start of Waves 3 and 5.
- Wave 3 tends to be very long, sharp, and extended.
- Waves 2 and 4 frequently bounce off Fibonacci retracement levels.

How to Trade Forex Using Elliott Waves



This is probably what you all have been waiting for – drumroll please – using the Elliott Wave Theory in forex trading! In this section, we will look at some setups and apply our knowledge of Elliott Wave to determine entry, stop loss, and exit points. Let's get it on!

Hypothetical, will-most-probably-be-right scenario:

Let's say you wanted to begin your wave count. You see that price seems to have bottomed out and has began a new move upwards. Using your knowledge of Elliott Wave, you label this move up as Wave 1 and the retracement as Wave 2.

In order to find a good entry point, you head back to the School of Pipsology to find out which of the three cardinal rules and guidelines you could apply. Here's what you found out:

- Rule Number 2: Wave 2 can NEVER go beyond the start of Wave 1
- Waves 2 and 4 frequently bounce off Fibonacci retracement levels

So, using your superior Elliott Waving trading skillz, you decide to pop the Fibonacci tool to see if price is at a Fib level. Holy mama! Price is just chillin' like ice cream fillin' around the 50% level. Hmm, this could be the start of Wave 3, which is a very strong buy signal.

Since you're a smart forex trader, you also take your stop into consideration.

Cardinal rule number 2 states that Wave 2 can never go beyond the start of Wave 1 so you set your stop below the former lows.

If price retraces more than 100% of Wave 1, then your wave count is wrong.

Let's see what happens next…

Your Elliott Wave analysis paid off and you caught a huge upward move! You go to Vegas (or Macau), blow all your forex profits on roulette, and end right back where you started. Lucky for you we have another hypothetical scenario where you can earn imaginary money again…

Scenario 2:

This time, let's use your knowledge on corrective waves patterns to grab those pips.

You begin counting the waves on a downtrend and you notice that the ABC corrective waves are moving sideways. Hmm, is this a flat formation in the works? This means that price may just begin a new impulse wave once Wave C ends.

Trusting your Elliott Wave skills, you go ahead and sell at market in hopes of catching a new impulse wave.

You place your stop just a couple of pips above the start of Wave 4 just in case your wave count is wrong.

Because we like happy endings, your trade idea works out and nets you a couple thousand pips on this day, which is not always the case.

You have also learned your lesson this time around so you skip Vegas and decide to use your profits to grow your forex trading capital instead.

Summary: Elliott Wave Theory

- Elliott Waves are **fractals**. Each wave can be split into parts, each of which is a very similar copy of the whole. Mathematicians like to call this property “self-similarity”.
- A trending market moves in a 5-3 wave pattern.
- The first 5-wave pattern is called **impulse** wave.
- One of the three impulse waves (1, 3, or 5) will always be extended. Wave 3 is usually the extended one.
- The second 3-wave pattern is called **corrective** wave. Letters A, B, and C are used instead of numbers to track the correction.
- Waves 1, 3 and 5, are made up of a smaller 5-wave impulse pattern while Waves 2 and 4 are made up of smaller 3-wave corrective pattern.
- There are 21 types of corrective patterns but they are just made up of three very simple, easy-to-understand formations.
- The three fundamental corrective wave patterns are **zig-zags**, **flats**, and **triangles**.

There are three cardinal rules in Elliott Wave Theory when labeling waves:

- Rule Number 1: Wave 3 can NEVER be the shortest impulse wave
- Rule Number 2: Wave 2 can NEVER go beyond the start of Wave 1
- Rule Number 3: Wave 4 can NEVER cross in the same price area as Wave 1

If you look hard enough at a chart, you’ll see that the market really does move in waves.

Because the forex market never moves in text book perfect fashion, it will take many, many hours of practice analyzing waves before you start to get comfortable with Elliott waves. Stay diligent and never give up!

Harmonic Price Patterns in the Forex Market

Now that you've got the basic chart patterns down, it's time to move on and add some more advanced tools to your forex trading arsenal.

In this lesson, we'll be looking at harmonic price patterns. These bad boys may be a little harder to grasp but once you spot these setups, it can lead to some very nice profits!

The whole idea of these patterns is that they help people spot possible retracements of recent trends. In fact, we'll make use of other tools we've already covered – the Fibonacci retracement and extensions!

Combining these wonderful tools to spot these harmonic price patterns, we'll be able to distinguish possible areas for a continuation of the overall trend.

In this lesson, we're going to discuss the following Harmonic Price Patterns:

- ABCD Pattern
- Three-Drive Pattern
- Gartley Pattern
- Crab Pattern
- Bat Pattern
- Butterfly Pattern

Phew! That's quite a lot to cover!

But don't you worry… Once you get the hang of things, it'll be as easy as 1-2-3!

We'll start off with the more basic ABCD and three-drive patterns before moving on to Gartley and the animals.

After learning about them, we'll take a look at the tools you need in order to trade these patterns successfully in the forex market.

For all these harmonic price patterns, the point is to wait for the entire pattern to complete before taking any short or long trades. You'll see what we're talking about later on so let's get started!

The ABCD and the Three-Drive

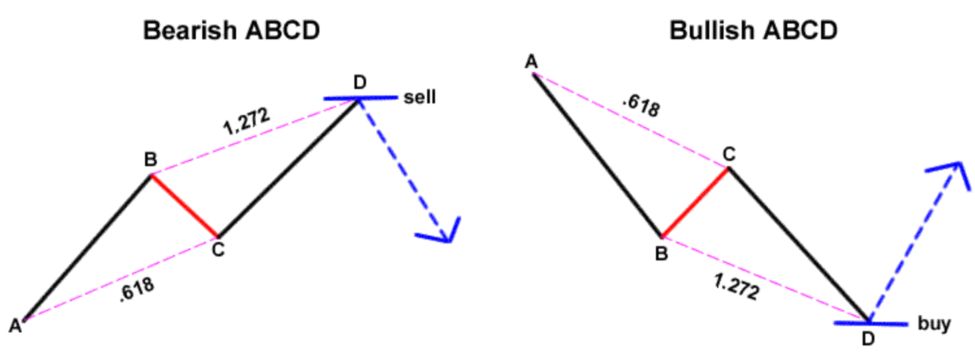
The ABCD

Let's start this lesson with the simplest harmonic pattern. So what could be more basic than the good old ABC's? We'll just pop in another letter at the end (because we're cool like that), and we've got the ABCD chart pattern! That was easy!

To spot this chart pattern, all you need are ultra-sharp hawk eyes and the handy-dandy Fibonacci tool.

For both the bullish and bearish versions of the ABCD chart pattern, the lines AB and CD are known as the **legs** while BC is called the **correction** or **retracement**. If you use the Fibonacci retracement tool on leg AB, the retracement BC should reach until the 0.618 level. Next, the line CD should be the 1.272 Fibonacci extension of BC.

Simple, right? All you have to do is wait for the entire pattern to complete (reach point D) before taking any short or long positions.



Oh, but if you want to be extra strict about it, here are a couple more rules for a valid ABCD pattern:

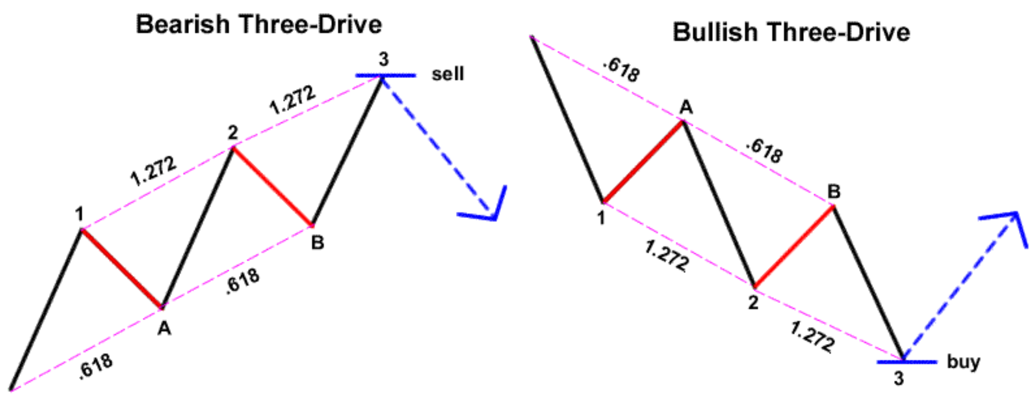
- The length of line AB should be equal to the length of line CD.

- The time it takes for the price to go from A to B should be equal to the time it takes for the price to move from C to D.

Three-Drive

The three-drive pattern is a lot like the ABCD pattern except that it has three legs (now known as drives) and two corrections or retracements. Easy as pie! In fact, this three-drive pattern is the ancestor of the Elliott Wave pattern.

As usual, you'll need your hawk eyes, the Fibonacci tool, and a smidge of patience on this one.



As you can see from the charts above, point A should be the 61.8% retracement of drive 1. Similarly, point B should be the 0.618 retracement of drive 2. Then, drive 2 should be the 1.272 extension of correction A and drive 3 should be the 1.272 extension of correction B.

By the time the whole three-drive pattern is complete, that's when you can pull the trigger on your long or short trade. Typically, when the price reaches point B, you can already set your short or long orders at the 1.272 extension so that you won't miss out!

But first, it'd be better to check if these rules also hold true:

- The time it takes the price to complete drive 2 should be equal to the time it takes to complete drive 3.
- Also, the time to complete retracements A and B should be equal.

Here's a forum thread discussing the ABCD pattern and a trade setup with the three-drive pattern.

Trading The Gartley Pattern

Once upon a time, there was this insanely smart trader dude named Harold McKinley Gartley.

He had a stock market advisory service in the mid-1930s with a huge following. This service was one of the first to apply scientific and statistical methods to analyze the stock market behavior.

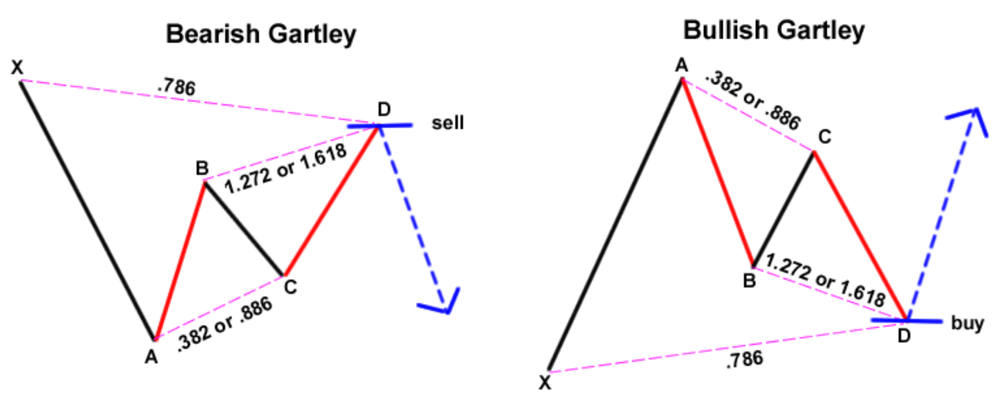
According to Gartley, he was finally able to solve two of the biggest problems of traders: what and when to buy.

Soon enough, traders realized that these patterns could also be applied to other markets. Since then, various books, trading software, and other patterns (discussed below) have been made based on the Gartleys.

Gartley a.k.a. "222" Pattern

The Gartley "222" pattern is named for the page number it is found on in H.M. Gartleys book, *Profits in the Stock Market*. Gartleys are patterns that include the basic ABCD pattern we've already talked about, but are preceded by a significant high or low.

Now, these patterns normally form when a correction of the overall trend is taking place and look like 'M' (or 'W' for bearish patterns). These patterns are used to help traders find good entry points to jump in on the overall trend.



A Gartley forms when the price action has been going on a recent uptrend (or downtrend) but has started to show signs of a correction.

What makes the Gartley such a nice setup when it forms is the reversal points are a Fibonacci retracement and Fibonacci extension level. This gives a stronger indication that the pair may actually reverse.

This pattern can be hard to spot and once you do, it can get confusing when you pop up all those Fibonacci tools. The key to avoiding all the confusion is to take things one step at a time.

In any case, the pattern contains a bullish or bearish ABCD pattern, but is preceded by a point (X) that is beyond point D. The "perfect" Gartley pattern has the following characteristics:

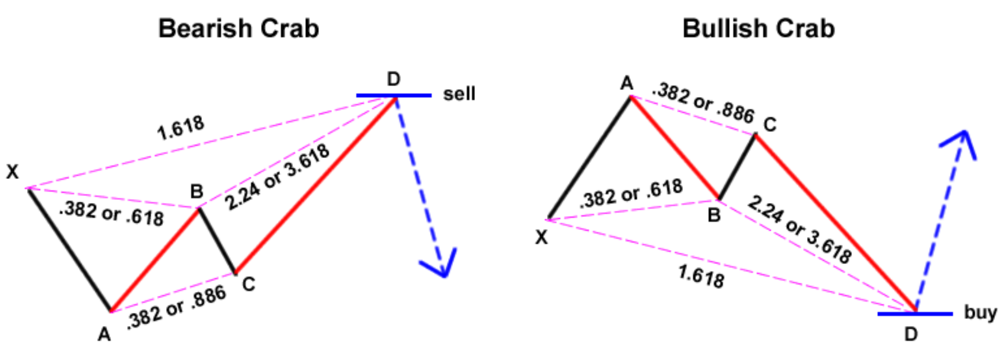
1. Move AB should be the .618 retracement of move XA.
2. Move BC should be either .382 or .886 retracement of move AB.
3. If the retracement of move BC is .382 of move AB, then CD should be 1.272 of move BC. Consquently, if move BC is .886 of move AB, then CD should extend 1.618 of move BC.
4. Move CD should be .786 retracement of move XA

Gartley Mutants: The Animals

As time went by, the popularity of the Gartley pattern grew and people eventually came up with their own variations.

For some odd reason, the discoverers of these variations decided to name them after animals (Maybe they were part of PETA?).Without further ado, here comes the animal pack…

The Crab



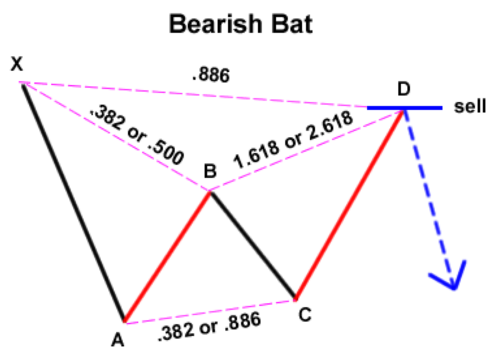
In 2000, Scott Carney, a firm believer in harmonic price patterns, discovered the “Crab”.

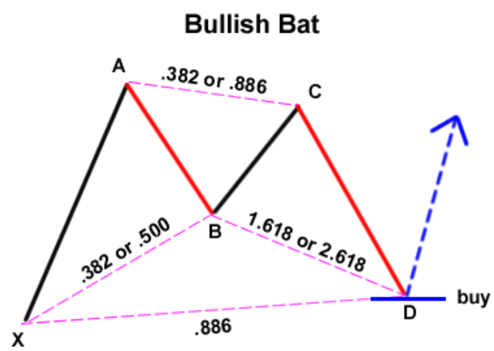
According to him, this is the most accurate among all the harmonic patterns because of how extreme the Potential Reversal Zone (sometimes called “price better reverse or imma gonna lose my shirt” point) from move XA.

This pattern has a high reward-to-risk ratio because you can put a very tight stop loss. The “perfect” crab pattern must have the following aspects:

1. Move AB should be the .382 or .618 retracement of move XA.
2. Move BC can be either .382 or .886 retracement of move AB.
3. If the retracement of move BC is .382 of move AB, then CD should be 2.24 of move BC. Consquently, if move BC is .886 of move AB, then CD should be 3.618 extension of move BC.
4. CD should be 1.618 extension of move XA.

The Bat

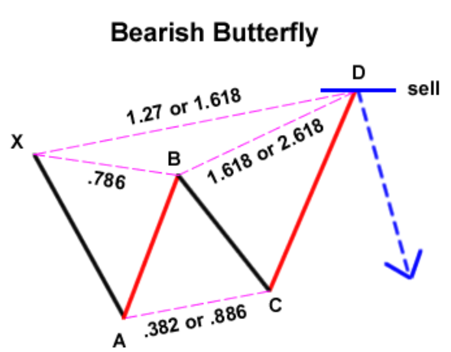


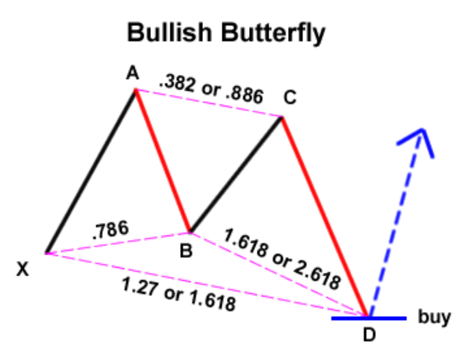


Come 2001, Scott Carney founded another Harmonic Price Pattern called the "Bat." The Bat is defined by the .886 retracement of move XA as Potential Reversal Zone. The Bat pattern has the following qualities:

1. Move AB should be the .382 or .500 retracement of move XA.
2. Move BC can be either .382 or .886 retracement of move AB.
3. If the retracement of move BC is .382 of move AB, then CD should be 1.618 extension of move BC. Consquently, if move BC is .886 of move AB, then CD should be 2.618 extension of move BC.
4. CD should be .886 retracement of move XA.

The Butterfly





Then, there is the Butterfly pattern. Like Muhammad Ali, if you spot this setup, you'll surely be swinging for some knockout-sized pips!

Created by Bryce Gilmore, the perfect Butterfly pattern is defined by the .786 retracement of move AB with respect to move XA. The Butterfly contains these specific characteristics:

1. Move AB should be the .786 retracement of move XA.
2. Move BC can be either .382 or .886 retracement of move AB.
3. If the retracement of move BC is .382 of move AB, then CD should be 1.618 extension of move BC. Consquently, if move BC is .886 of move AB, then CD should extend 2.618 of move BC.
4. CD should be 1.27 or 1.618 extension of move XA.

3 Steps in Trading Harmonic Price Patterns

As you may have guessed, profiting off **Harmonic Price Patterns** is all about being able to spot those "perfect" patterns and buying or selling on their completion.

There are three basic steps in spotting Harmonic Price Patterns:

- Step 1: Locate a potential Harmonic Price Pattern
- Step 2: Measure the potential Harmonic Price Pattern
- Step 3: Buy or sell on the completion of the Harmonic Price Pattern

By following these three basic steps, you can find high probability setups that will help you grab those oh-so-lovely pips.

Let's see this process in action!

Step 1: Locate a potential Harmonic Price Pattern

Oh wow, that looks like a potential Harmonic Price Pattern! At this point in time, we're not exactly sure what kind of pattern that is. It LOOKS like a three-drive, but it could be a Bat or a Crab…

Heck, it could even be a Moose! In any case, let's label those reversal points.

Step 2: Measure the potential Harmonic Price Pattern

Using the Fibonacci tool, a pen, and a piece of paper, let's list down our observations.

1. Move BC is .618 retracement of move AB.
2. Move CD is 1.272 extension of move BC.
3. The length of AB is roughly equal to the length of CD.

This pattern qualifies for a bullish ABCD pattern, which is a strong buy signal.

Step 3: Buy or sell on the completion of the Harmonic Price Pattern

Once the pattern is complete, all you have to do is respond appropriately with a buy or sell order.

In this case, you should buy at point D, which is the 1.272 Fibonacci extension of move CB, and put your stop loss a couple of pips below your entry price.

Is it really that easy?

Not exactly.

The problem with harmonic price patterns is that they are so perfect that they are so difficult to spot, kind of like a diamond in the rough.

Check out this excellent forum thread discussing Gartley setups.

More than knowing the steps, you need to have hawk-like eyes to spot potential harmonic price patterns and a lot of patience to avoid jumping the gun and entering before the pattern is completed.

Summary: Harmonic Price Patterns

Harmonic price patterns enable us to distinguish possible areas for a continuation of the overall trend.

There are six harmonic price patterns:

- The ABCD Pattern
- The Three-Drive Pattern
- The Gartley Pattern
- The Crab Pattern
- The Bat Pattern
- The Butterfly Pattern

The three basic steps in spotting harmonic price patterns are the following

- Step 1: Locate a potential harmonic price pattern
- Step 2: Measure the potential harmonic price pattern
- Step 3: Buy or sell on the completion of the harmonic price pattern

Again, harmonic price patterns are so perfect that they are very difficult to spot.

More than knowing the steps, you need to have hawk-like eyes to spot potential harmonic price patterns and a lot of patience to avoid jumping the gun and entering before the pattern is completed.

With enough practice and experience, trading using harmonic price patterns can yield a lot of pips!

Trading Divergences

What if there was a low risk way to sell near the top or buy near the bottom of a trend?

What if you were already in a long position and you could know ahead of time the perfect place to exit instead of watching your unrealized gains, a.k.a your potential Aston Martin down payment, vanish before your eyes because your trade reverses direction?

What if you believe a currency pair will continue to fall but would like to short at a better price or a less risky entry?

Well guess what? There is a way! It's called **divergence trading**.

In a nutshell, divergence can be seen by comparing price action and the movement of an indicator. It doesn't really matter what indicator you use. You can use RSI, MACD, the stochastic, CCI, etc.

The great thing about divergences is that you can use them as a leading indicator, and after some practice it's not too difficult to spot.

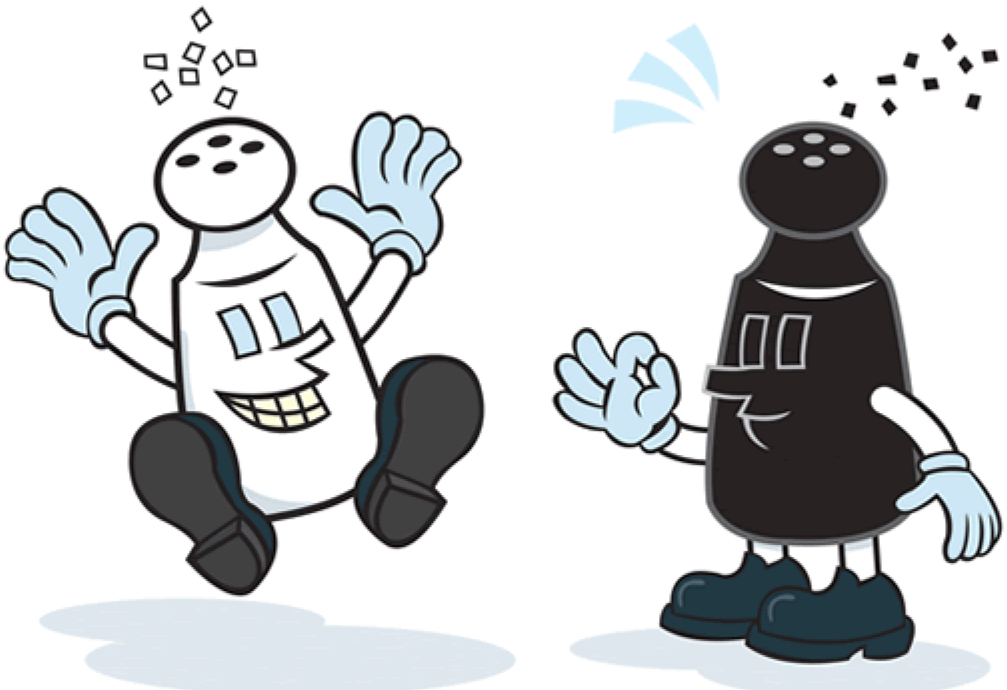
When traded properly, you can be consistently profitable with divergences. The best thing about divergences is that you're usually buying near the bottom or selling near the top. This makes the risk on your trades are very small relative to your potential reward.

Cha-ching!

Trading Divergences

Just think "higher highs" and "lower lows".

Price and momentum normally move hand in hand like Hansel and Gretel, Ryu and Ken, Batman and Robin, Jay Z and Beyonce, Serena and Venus Williams, salt and pepper…You get the point.



If price is making **higher highs**, the oscillator should also be making **higher highs**. If price is making **lower lows**, the oscillator should also be making **lower lows**.

If they are NOT, that means price and the oscillator are diverging from each other. And that's why it's called "divergence."

Divergence trading is an awesome tool to have in your toolbox because divergences signal to you that something fishy is going on and that you should pay closer attention.

Using divergence trading can be useful in spotting a weakening trend or reversal in momentum. Sometimes you can even use it as a signal for a trend to continue!

There are **TWO** types of divergence:

1. Regular
2. Hidden

In this grade, we will teach you how to spot these divergences and how to trade them. We'll even have a sweet surprise for you at the end.

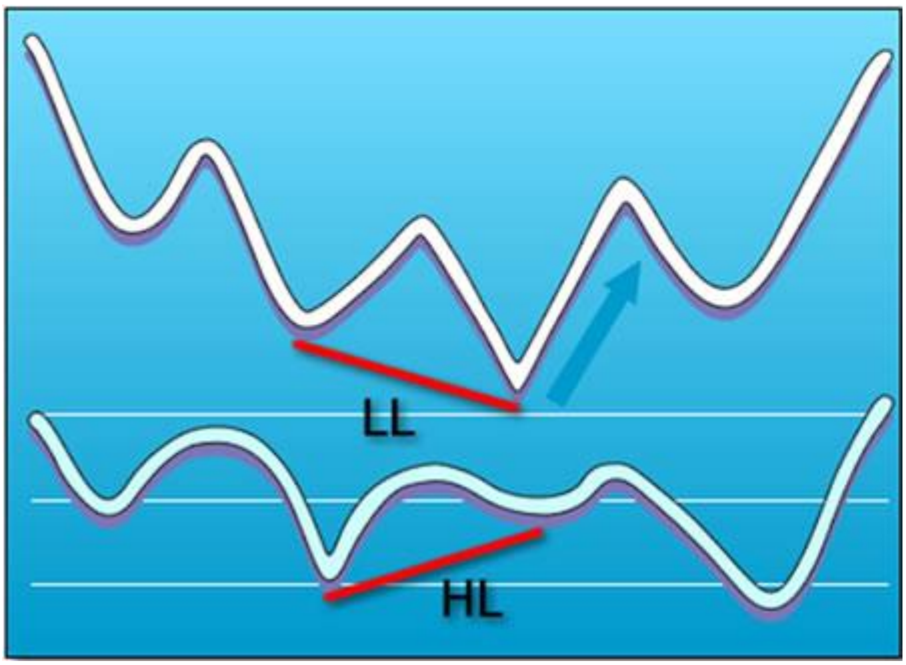
Regular Divergence

A regular divergence is used as a possible sign for a trend reversal.

If price is making lower lows (LL), but the oscillator is making higher lows (HL), this is considered to be regular bullish divergence.

This normally occurs at the end of a down trend. After establishing a second bottom, if the oscillator fails to make a new low, it is likely that the price will rise, as price and momentum are normally expected to move in line with each other.

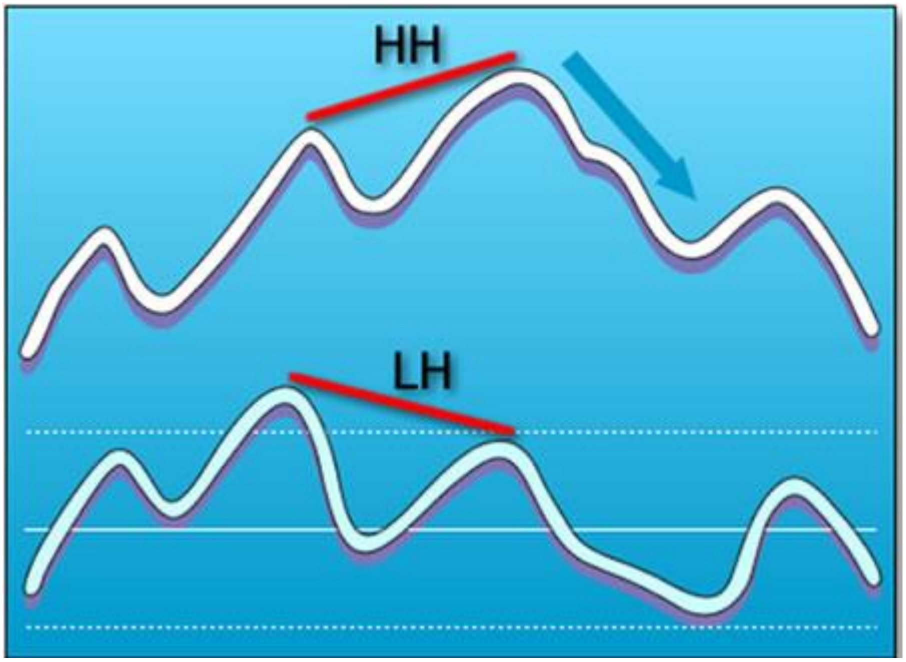
Below is an image that portrays regular bullish divergence.



Now, if the price is making a higher high (HH), but the oscillator is lower high (LH), then you have regular bearish divergence.

This type of divergence can be found in an uptrend. After price makes that second high, if the oscillator makes a lower high, then you can probably expect price to reverse and drop.

In the image below, we see that price reverses after making the second top.



As you can see from the images above, the regular divergence is best used when trying to pick tops and bottoms. You are looking for an area where price will stop and reverse.

The oscillators signal to us that momentum is starting to shift and even though price has made a higher high (or lower low), chances are that it won't be sustained.

See the regular bearish divergence at work through this GBP/USD trade handpicked by Pipcrawler!

Did you get all of that? Pretty simple eh?

Now that you've got a hold on regular divergence, it's time to move and learn about the second type of divergence – hidden divergence.

Don't worry, it's not super concealed like the Chamber of Secrets and it's not that tough to spot. The reason it's called "hidden" is because it's hiding inside the current trend.

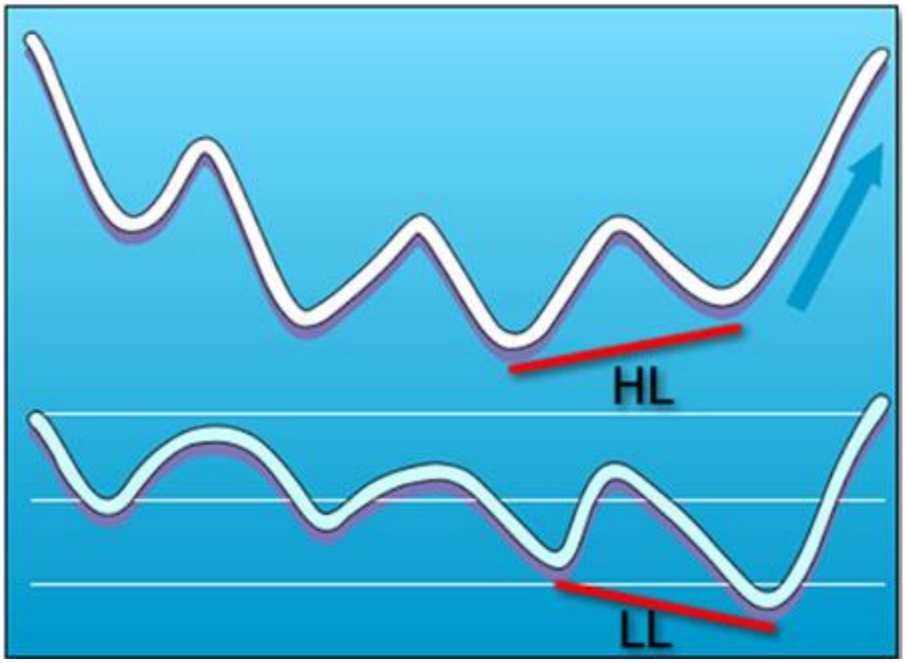
We'll explain more in the next section. Read on!

Hidden Divergence

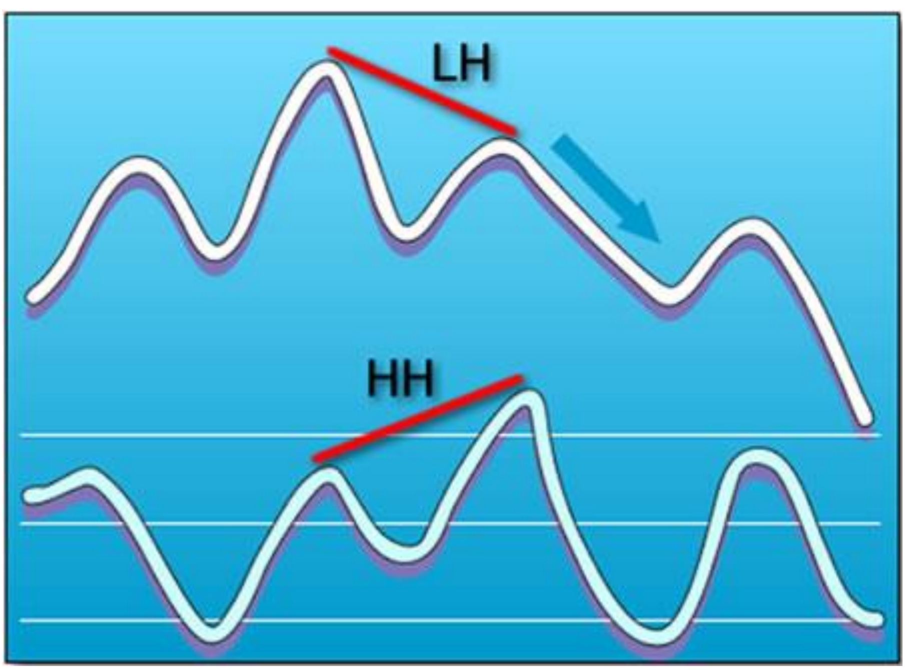
Divergences not only signal a potential trend reversal; they can also be used as a possible sign for a trend continuation. Always remember, the trend is your friend, so whenever you can get a signal that the trend will continue, then good for you!

Hidden bullish divergence happens when price is making a higher low (HL), but the oscillator is showing a lower low (LL).

This can be seen when the pair is in an uptrend. Once price makes a higher low, look and see if the oscillator does the same. If it doesn't and makes a lower low, then we've got some hidden divergence in our hands.



Lastly, we've got hidden bearish divergence. This occurs when price makes a lower high (LH), but the oscillator is making a higher high (HH). By now you've probably guessed that this occurs in a downtrend. When you see hidden bearish divergence, chances are that the pair will continue to shoot lower and continue the downtrend.



Let's recap what you've learned so far about hidden divergence.

If you're a trend follower, then you should dedicate some time to spot some hidden divergence.

If you do happen to spot it, it can help you jump in the trend early.

Sounds good, yes?

Okay, now you know about both regular and hidden divergence.

We hope you got it all down pat. Keep in mind that regular divergences are possible signals for trend reversals while hidden divergences signal trend continuation.

In the next lesson we'll show you some real-world examples of when divergences existed and how you could have traded them.

How To Trade Divergences

Now it's time to put those Jedi divergence mind tricks to work and force the markets to give you some pips!

Here we'll show you some examples of when there was divergence between price and oscillator movements.

First up, let's take a look at regular divergence. Below is a daily chart of USD/CHF.

We can see from the falling trend line that USD/CHF has been in a downtrend. However, there are signs that the downtrend will be coming to an end.

While price has registered lower lows, the stochastic (our indicator of choice) is showing a higher low.

Something smells fishy here. Is the reversal coming to an end? Is it time to buy this sucker?

If you had answered yes to that last question, then you would have found yourself in the middle of the Caribbean, soaking up margaritas, as you would have been knee deep in your pip winnings!

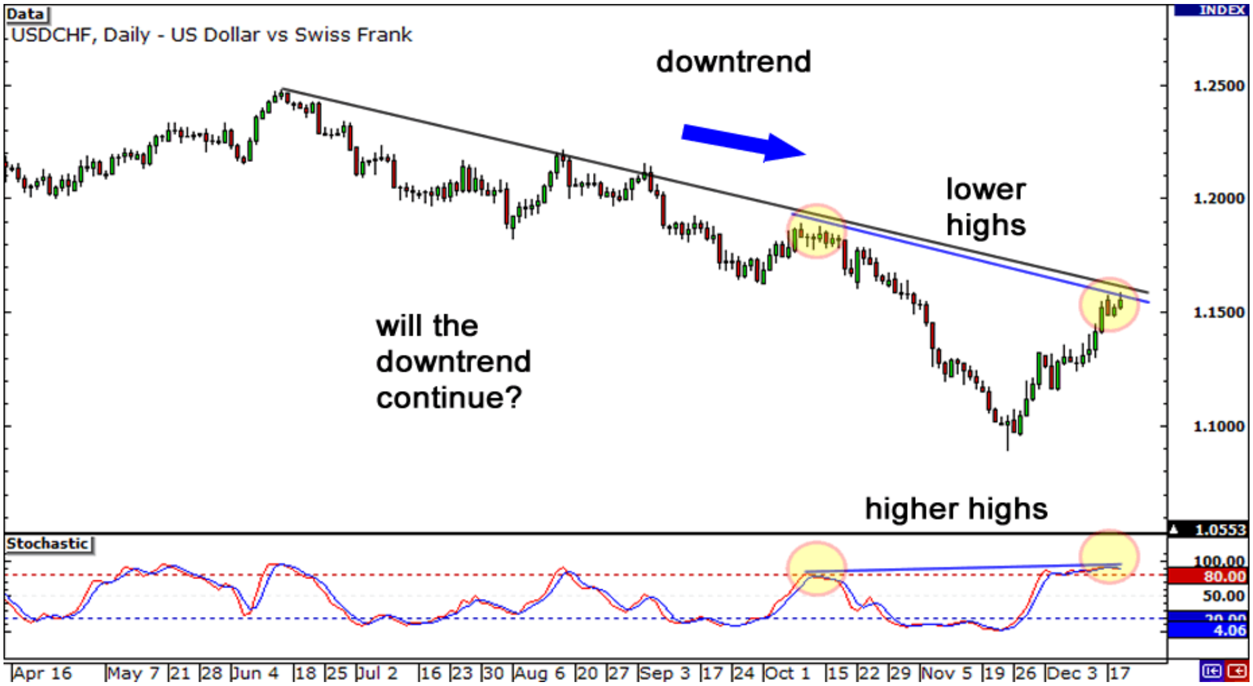
It turns out that the divergence between the stochastic and price action was a good signal to buy. Price broke through the falling trend line and formed a new uptrend. If you had bought near the bottom, you could have made more than a thousand pips, as the pair continued to shoot even higher in the following months.

Now can you see why it rocks to get in on the trend early?!

Before we move on, did you notice the tweezer bottoms that formed on the second low?

Keep an eye out for other clues that a reversal is in place. This will give you more confirmation that a trend is coming to an end, giving you even more reason to believe in the power of divergences!

Next, let's take a look at an example of some hidden divergence. Once again, let's hop on to the daily chart of USD/CHF.



Here we see that the pair has been in a downtrend. Notice how price has formed a lower high but the stochastic is printing higher highs.

According to our notes, this is hidden bearish divergence! Hmmm, what should we do? Time to get back in the trend?

Well, if you ain't sure, you can sit back and watch on the sidelines first.

If you decided to sit that one out, you might be as bald as Professor Xavier because you pulled out all your hair.

Why?

Well the trend continued!

Price bounced from the trend line and eventually dropped almost 2,000 pips!

Imagine if you had spotted the divergence and seen that as a potential signal for a continuation of the trend?

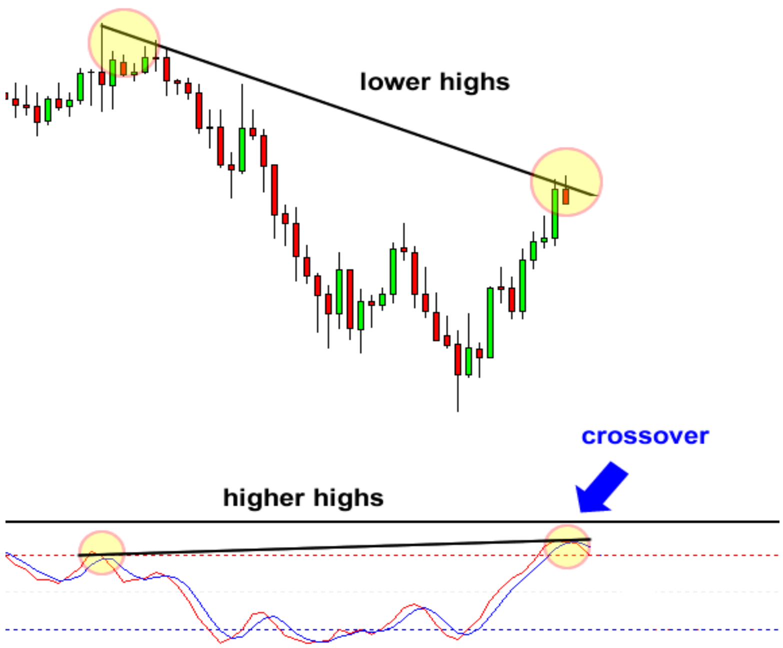
Not only would you be sipping those margaritas in the Caribbean, you'd have your own pimpin' yacht to boot!

How to Avoid Entering Too Early When Trading Divergences

While using divergences is a great tool to have in your trading toolbox, there are times when you might enter too early because you didn't wait for more confirmation. Below are a couple of tricks that you can make use of so that you have more confirmation that the divergence will work out in your favor.

Wait for an indicator crossover.

This ain't so much a trick as it is a rule. Just wait for a crossover of the momentum indicator. This would indicate a potential shift in momentum from buying to selling or vice versa. The main reasoning behind this is that you are waiting for top or bottom and these can't be formed unless a crossover is made!



In the chart above, the pair showed lower highs while the stochastic already made higher highs. Now that's a bearish divergence there and it sure is tempting to short right away.

But, you know what they say, patience is a virtue. It'd be better to wait for the stochastic to make a downward crossover as confirmation that the pair is indeed headed down.

A couple of candles later, the stochastic did make that crossover. Playing that bearish divergence would've been pip-tastic!

What's the main point here? Just be patient! Don't try to jump the gun because you don't quite know when momentum will shift! If you aren't patient, you might just get burned as one side keeps dominating!

Wait for indicator to move out of overbought/oversold territory.

Another trick would be to wait for momentum highs and lows to hit overbought and oversold conditions, and wait for the indicator to move out of these conditions.

The reason for doing this is similar to that of waiting for a crossover – you really don't have any idea when momentum will begin to shift.

Let's say you're looking at a chart and you notice that the stochastic has formed a new low while price hasn't.

You may think that it's time to buy because the indicator is showing oversold conditions and divergence has formed. However, selling pressure may remain strong and price continues to fall and make a new low.

You would have been pretty bummed out as trend didn't continue. In fact, a new downtrend is probably in place as the pair is now forming lower highs. And if you were stubborn, you might have missed out on this down move too.

If you had waited patiently for more confirmation that the divergence had formed, then you could have avoided losing and realized that a new trend was developing.

Draw trend lines on the momentum indicators themselves.

This might sound a little ridiculous since you would normally draw trend lines only on price action. But this is a nifty lil' trick that we wanna share with you. After all, it doesn't hurt to have another weapon in the holster right? You never know when you might use it!

This trick can be particularly useful especially when looking for reversals or breaks from a trend. When you see that price is respecting a trend line, try drawing a similar trend line on your indicator.

You may notice that the indicator will also respect the trend line. If you see both price action and the momentum indicator break their respective trend lines, it could signal a shift in power from buyers to sellers (or vice versa) and that the trend could be changing. Oh yeah! Break it down like a Michael Jackson video!

9 Rules for Trading Divergences

Before you head out there and start looking for potential divergences, here are nine cool rules for trading divergences.

Learn 'em, memorize 'em (or keep coming back here), apply 'em to help you make better trading decisions. Ignore them and go broke.

1. Make sure your glasses are clean

In order for divergence to exist, price must have either formed one of the following:

- Higher high than the previous high
- Lower low than the previous low

- Double top
- Double bottom

Don't even bother looking at an indicator unless ONE of these four price scenarios have occurred. If not, you ain't trading a divergence, buddy. You're just imagining things. Immediately go see your optometrist and get some new glasses.

2. Draw lines on successive tops and bottoms

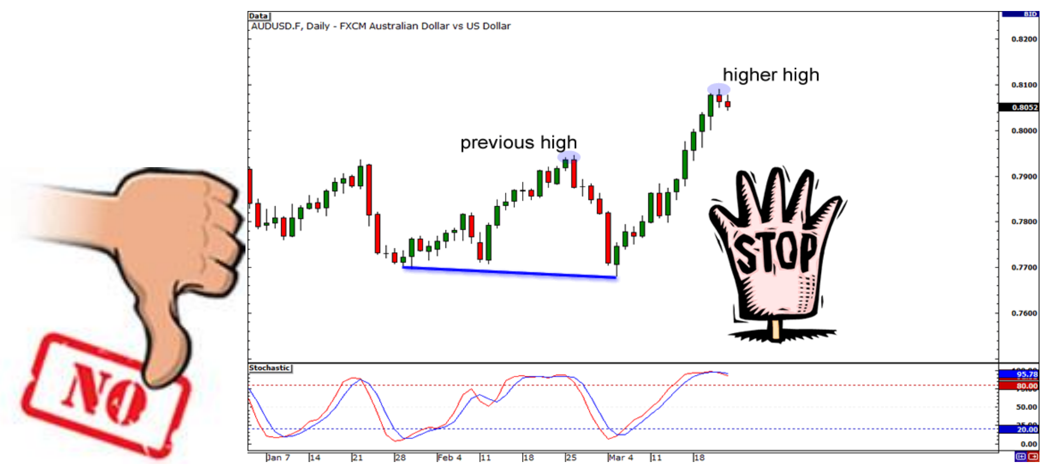
Okay now that you got some action (recent price action that is), look at it. Remember, you'll only see one of four things: a higher high, a flat high, a lower low, or a flat low.

Now draw a line backward from that high or low to the previous high or low. It HAS to be on successive major tops/bottom. If you see any little bumps or dips between the two major highs/lows, do what you do when your significant other shouts at you – ignore it.

3. Do Tha Right Thang – Connect TOPS and BOTTOMS only

Once you see two swing highs are established, you connect the TOPS. If two lows are made, you connect the BOTTOMS.

Don't make the mistake of trying to draw a line at the bottom when you see two higher highs. It sounds dumb but really, peeps regularly get confused.



4. Eyes on the Price

So you've connected either two tops or two bottoms with a trend line. Now look at your preferred indicator and compare it to price action. Whichever indicator you use, remember you are comparing its TOPS or BOTTOMS. Some indicators such as MACD or Stochastic have multiple lines all up on each other like teenagers with raging hormones. Don't worry about what these kids are doing.

5. Be Fly like Pip Diddy

If you draw a line connecting two highs on price, you MUST draw a line connecting the two highs on the indicator as well. Ditto for lows also. If you draw a line connecting two lows on price, you MUST draw a line connecting two lows on the indicator. They have to match!

6. Keep in Line

The highs or lows you identify on the indicator MUST be the ones that line up VERTICALLY with the price highs or lows. It's just like picking out what to wear to the club – you gotta be fly and matchin' yo!

7. Ridin' the slopes

Divergence only exists if the SLOPE of the line connecting the indicator tops/bottoms DIFFERS from the SLOPE of the line connection price tops/bottoms. The slope must either be: Ascending (rising) Descending (falling) Flat (flat)

8. If the ship has sailed, catch the next one

If you spot divergence but the price has already reversed and moved in one direction for some time, the divergence should be considered played out. You missed the boat this time. All you can do now is wait for another swing high/low to form and start your divergence search over.

9. Take a step back

Divergence signals tend to be more accurate on the longer time frames. You get less false signals. This means fewer trades but if you structure your trade well, then your profit potential can be huge. Divergences on shorter time frames will occur more frequently but are less reliable.

We advise only look for divergences on 1-hour charts or longer. Other traders use 15-minute charts or even faster. On those time frames, there's just too much noise for our taste so we just stay away.

So there you have it kiddos – 9 rules you MUST follow if you want to seriously consider trading using divergences. Trust us, you don't wanna be ignoring these rules.

Follow these rules, and you will dramatically increase the chances of a divergence setup leading to a profitable trade.

Now go scan the charts and see if you can spot some divergences that happened in the past as a great way to begin getting your divergence skills up to par!

Divergence Cheat Sheet

Let's review!

There are two types of divergences:

1. Regular divergence
2. Hidden divergence

Each type of divergence will contain either a bullish bias or a bearish bias.

Since you've all be studying hard and not been cutting class, we've decided to help y'all out (cause we're nice like that) by giving you a cheat sheet to help you spot regular and hidden divergences quickly.

Type	Bias	Price	Oscillator	Description	Example
Regular	Bullish	Lower Low	Higher Low	Indicates underlying strength. Bears are exhausted.Warning of possible trend direction change from downtrend to uptrend.	
	Bearish	Higher High	Lower High	Indicates underlying weakness. Bulls are exhausted.Warning of possible trend direction change from uptrend to downtrend.	
Hidden	Bullish	Higher Low	Lower Low	Indicates underlying strength. Good entry or re-entry. Occurs during retracements in an uptrend. Nice to see during price retest of previous lows. “Buy the dips”	
	Bearish	Lower High	Higher High	Indicates underlying weakness. Found during retracements in a downtrend. Nice to see during price retests of previous highs. “Sell the rallies”	

Whew! That’s quite a lot to remember, isn’t it? We’ll give you two options:

1. You can write this all down in your palm and look back on it while trading. If you’re the type who gets sweaty palms when you’re nervous, we wouldn’t recommend this.
2. You can simply bookmark this page and just revisit it when you mix up those higher lows, lower highs, lower lows, and higher highs. You don’t want to make a wild guess while coming up with a trade, do you?

Summary: Divergences

Please keep in mind that we use divergence as an indicator, not a signal to enter a trade!

It wouldn't be smart to trade based solely on divergences since too many false signals are given. It's not 100% foolproof, but when used as a *setup condition* and combined with additional confirmation tools, your trades have a high probability of winning with relatively low risk.

There are a bunch of ways to take advantage of those divergences.

One way is to look at trend lines or candlestick formations to confirm whether a reversal or continuation is in order.

Another way is to make use of momentum tricks by watching out for an actual crossover or waiting for the oscillator to move out of the overbought/oversold region. You can also try drawing trend lines on the oscillator too.

With these nifty tricks, you can guard yourself against false signals and filter out those that'll be very profitable.

On the flip side, it is just as dangerous trade against this indicator.

If you're unsure about which direction to trade, chill out on the sidelines.

Remember that taking no position is a trading decision in itself and it's better to hold on to your hard-earned cash than bleed Benjamins on a shaky trade idea.

Divergences don't appear that often, but when they do appear, it'd behoove you to pay attention.

Regular divergences can help you collect a big chunk of profit because you're able to get in right when the trend changes.

Hidden divergences can help you ride a trade longer resulting in bigger-than-expected profits by keeping you on the correct side of a trend.

The trick is to train your eye to spot divergences when they appear AND choose the proper divergences to trade.

Just because you see a divergence, it doesn't necessarily mean you should automatically jump in with a position. Cherry pick your setups and you'll do well.

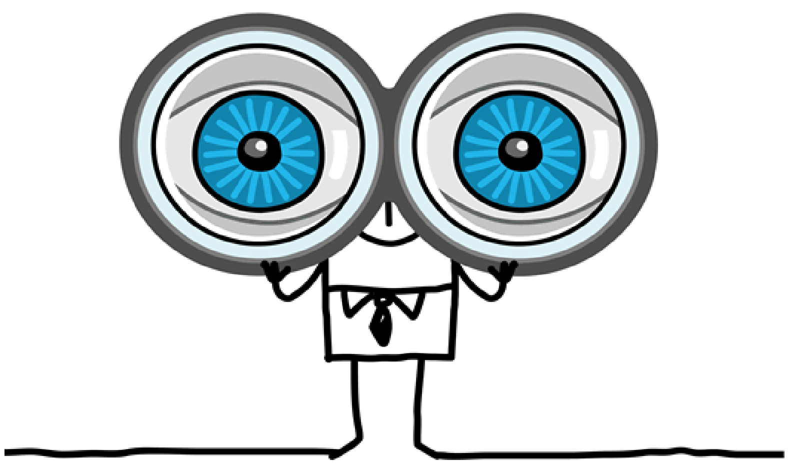
For more discussions on divergences, visit any of the following forum threads:

- Questions on Stochastic Oscillator / Divergence
- Divergence Trading: Avoiding False Signals
- Hidden Divergence and Regular Divergence

Know Your Trading Environment

When two people go to war, the foolish man always rushes blindly into battle without a plan, much like a starving man at his favorite buffet spot.

The wise man, on the other hand, will always get a situation report first to know the surrounding conditions that could affect how the battle plays out.



Like in warfare, we must also get a situation report on trading environment. This means we need to know what kind of market environment we are actually in. Some forex traders cry saying that their system sucks.

Sometimes the system does in fact…suck. Other times, the system is potentially profitable, but it is being utilized in the wrong trading environment.

Seasoned forex traders try to figure out the appropriate strategy for the current market environment they are trading in.

Is it time to bust out those Fibs and look for retracements? Or are ranges holding?

Just as the coach comes up with different plays for particular situations or opponents, you should also be able to decide which strategy to use depending on trading environment.

By knowing what market environment we are trading in, we can choose a trend-based strategy in a trending market or a range-bound strategy in a ranging market.

Are you worried about not getting to use your beastly range-bound strategy? How about your Bring-Home-Da-Bacon trend-based system?

Have no fear!

The forex market provides many trending and ranging opportunities across different time frames wherein these strategies can be implemented.

By knowing which strategies are appropriate, you will find it easier to figure out which indicators to pull out from your forex toolbox.

For instance, Fibs and trend lines are useful in trending markets while pivot points, support and resistance levels are helpful when the market is ranging.

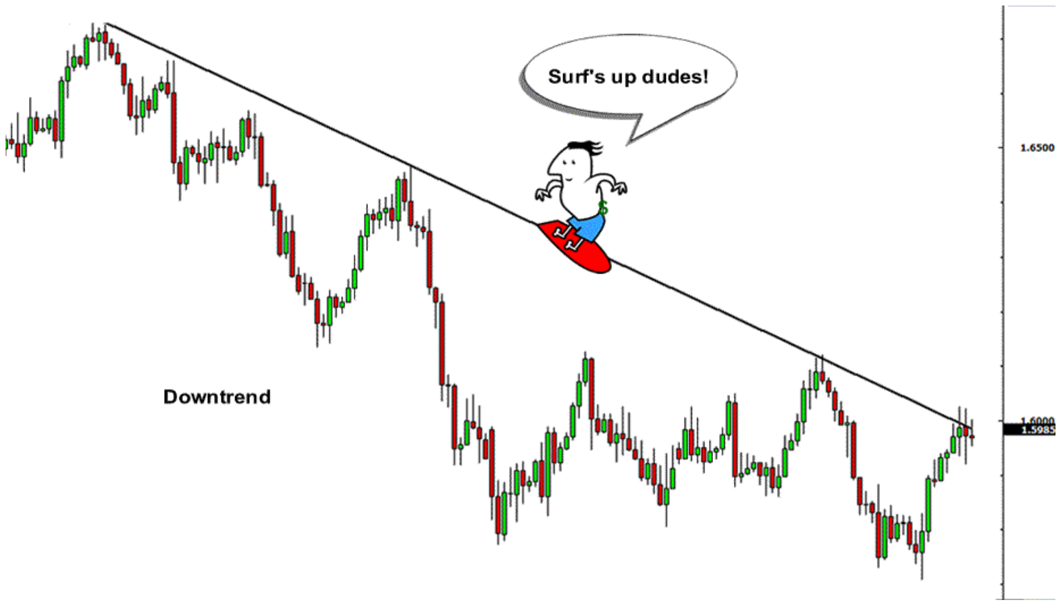
Before spotting those opportunities, you have to be able to determine the trading environment. The state of the market can be classified into three scenarios:

- Trending up
- Trending down
- Ranging

What is a Trending Market?

A **trending** market is one in which price is generally moving in one direction.

Sure, price may go against the trend every now and then, but looking at the longer time frames would show that those were just retracements.



Trends are usually noted by “higher highs” and “higher lows” in an **uptrend** and “lower highs” and “lower lows” in a **downtrend**.

When trading a trend-based strategy, traders usually pick the major currencies as well as any other currency utilizing the dollar because these pairs tend to trend and be more liquid than other pairs.

Liquidity is important in trend-based strategies. The more liquid a currency pair, the more movement (a. k. a. **volatility**) we can expect.

Check out Huck’s EUR/USD win from following the trend.

The more movement a currency exhibits, the more opportunities there are for price to move strongly in one direction as opposed to bouncing around within small ranges.

Other than eyeballing price action, you can also make use of technical tools you have learned in previous sections to determine whether a currency pair is trending or not.

ADX in a Trending Market

A way to determine if the market is trending is through the use of the Average Directional Index indicator or ADX for short.

Developed by J. Welles Wilder, this indicator uses values ranging from 0-100 to determine if price is moving strongly in one direction, i.e. trending, or simply ranging.

Values more than 25 usually indicate that price is trending or is already in a strong trend.

The higher the number is, the stronger the trend.

However, the ADX is a lagging indicator which means that it doesn't necessarily predict the future. It also is a non-directional indicator, which means it will report a positive figure whether price is trending up or down.

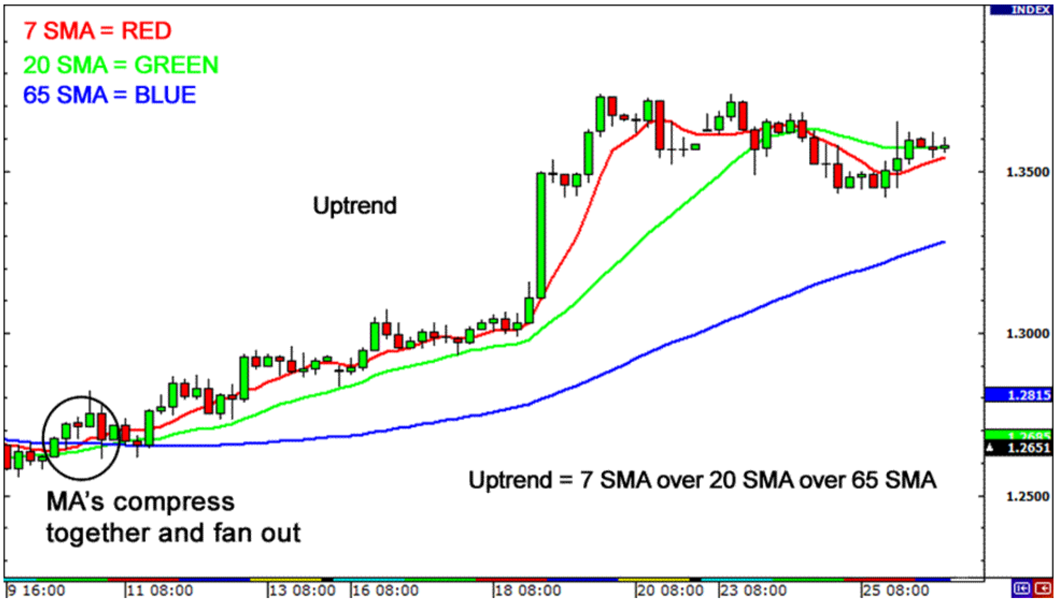
Take a look at this example. Price is clearly trending downwards even though ADX is greater than 25.

Moving Averages in a Trending Market

If you're not a fan of the ADX, you can also make use of simple moving averages. Check this out!

Place a 7 period, a 20 period, and a 65 period Simple Moving Average on your chart. Then, wait until the three SMA's compress together and begin to fan out.

If the 7 period SMA fans out on top of the 20 period SMA, and the 20 SMA on top of the 65 SMA, then price is trending up.



On the other hand, if the 7 period SMA fans out below the 20 period SMA, and the 20 SMA is below the 65 SMA, then price is trending down.

Bollinger Bands in a Trending Market

One tool that is often used for range-bound strategies can also be helpful in trend discovery. We're talking about Bollinger bands or just Bands.

One thing you should know about trends is that they are actually quite rare. Contrary to what you might think, prices really range 70-80 percent of the time. In other words, it is the norm for price to range.

So, if prices deviate from the “norm” then they must be in a trend right? What is one of the best technical tools we have mentioned in the previous grades that measure deviation?

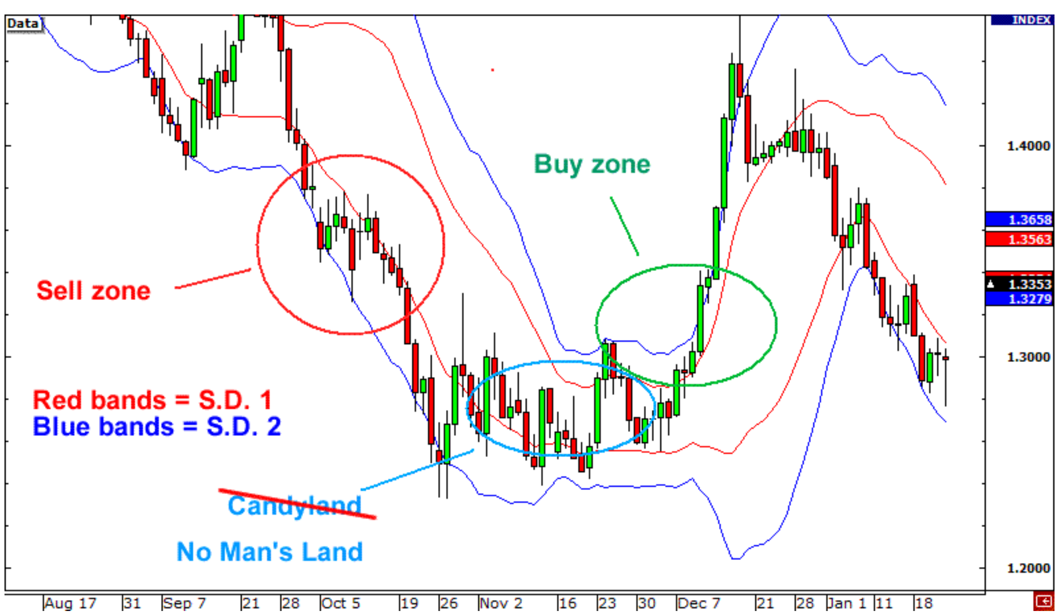
If you said a ruler, we give you mad props for effort.

If you said Bollinger bands, we’ll give you cyber milk and cookies! Here, take some.

Bollinger bands actually contain the standard deviation formula. But don’t worry about being a nerd and figuring out what that is.

Here’s how we can use Bollinger bands to determine the trend! Prepare for the craziness.

Place Bollinger bands with a standard deviation of 1 and another set of bands with a standard deviation of 2. You will see three set of price zones: the sell zone, the buy zone, and the “No-man’s Land.”



The **sell zone** is the area between the two bottom bands of the standard deviation 1 (SD 1) and standard deviation 2 (SD 2) bands. Bear in mind that price has to close within the bands in order to be considered in the sell zone.

The **buy zone** is the area between the two top bands of the SD 1 and SD 2 bands. Like the sell zone, price has to close within the two bands in order to be considered in the buy zone.

The area in between the standard deviation 1 bands is an area in which the market struggles to find direction. Price will close within this area if price is really in **"No-Man's Land".** Price direction is pretty much up for grabs.

The Bollinger bands make it easier to confirm a trend visually.

Downtrends can be confirmed when price is in the sell zone.

Uptrends can be confirmed when price is in the buy zone.

What is a Range-Bound Market?

A **range-bound** market is one in which price bounces in between a specific high price and low price. The high price acts as a major resistance level in which price can't seem to break through.

Likewise, the low price acts as major support level in which price can't seem to break as well. Market movement could be classified as horizontal or sideways.

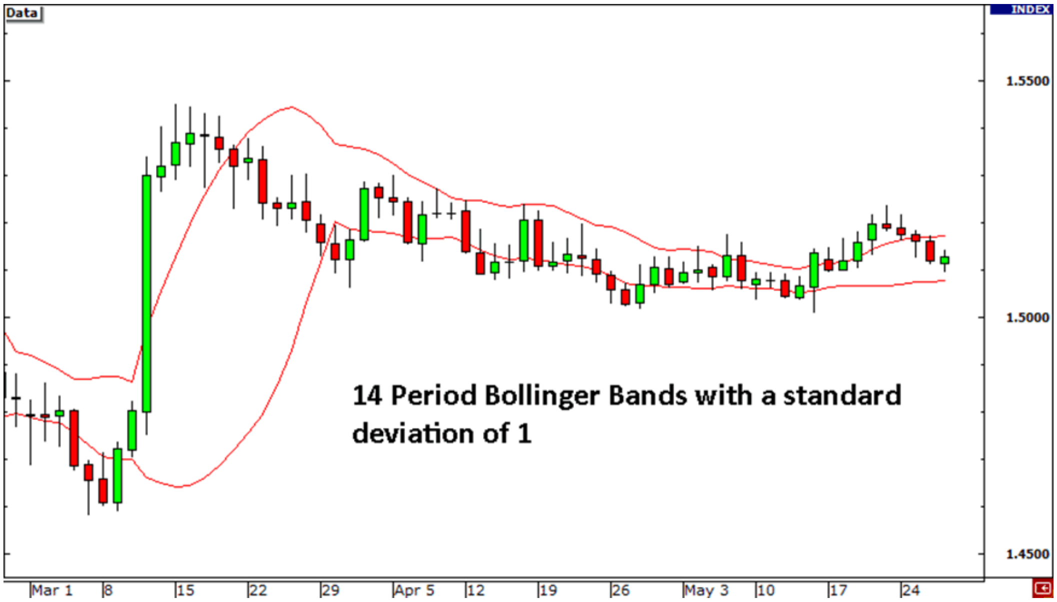
ADX in a Ranging Market

One way to determine if the market is ranging is to use the same ADX that we discussed earlier. A market is said to be ranging when the ADX is below 25. Remember, as the value of the ADX diminishes, the weaker trend is.

Bollinger Bands in a Ranging Market

In essence, Bollinger bands contract when there is less volatility in the market and expand when there is more volatility. Because of that, Bollinger bands provide a good tool for breakout strategies.

When the bands are thin and contracted, volatility is low and there should be little movement of price in one direction. However, when bands start to expand, volatility is increasing and more movement of price in one direction is likely.

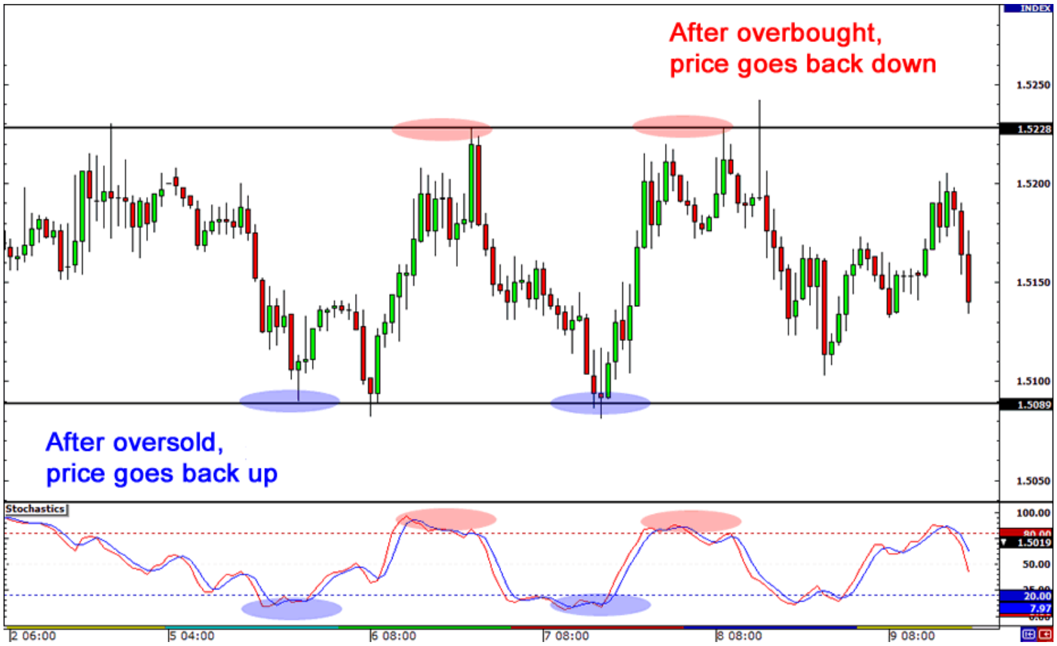


Generally, range trading environments will contain somewhat narrow bands compared to wide bands and form horizontally. In this case, we can see that the Bollinger bands are contracted, as price is just moving within a tight range.

The basic idea of a range-bound strategy is that a currency pair has a high and low price that it normally trades between.

By buying near the low price, the forex trader is hoping to take profit around the high price. By selling near the high price, the trader is hoping to take profit around the low price. Popular tools to use are channels such as the one shown above and Bollinger bands.

Using oscillators, like Stochastic or RSI, will help increase the odds of you finding a turning point in a range as they can identify potentially oversold and overbought conditions. Here’s an example using GBP/USD.



Bonus tip: The best pairs for trading range-bound strategies are currency crosses. By crosses, we mean those pairs that do not include the USD as one of the currencies in the pair.

One of the most well-known pair for trading ranges is the EUR/CHF. The similar growth rates shared by the European Union and Switzerland pretty much keep the exchange rate of the EUR/CHF stable.

Conclusion

Whether you're trading a pair that's in a trending or ranging environment, you should take comfort in knowing that you can profit whatever the case may be.

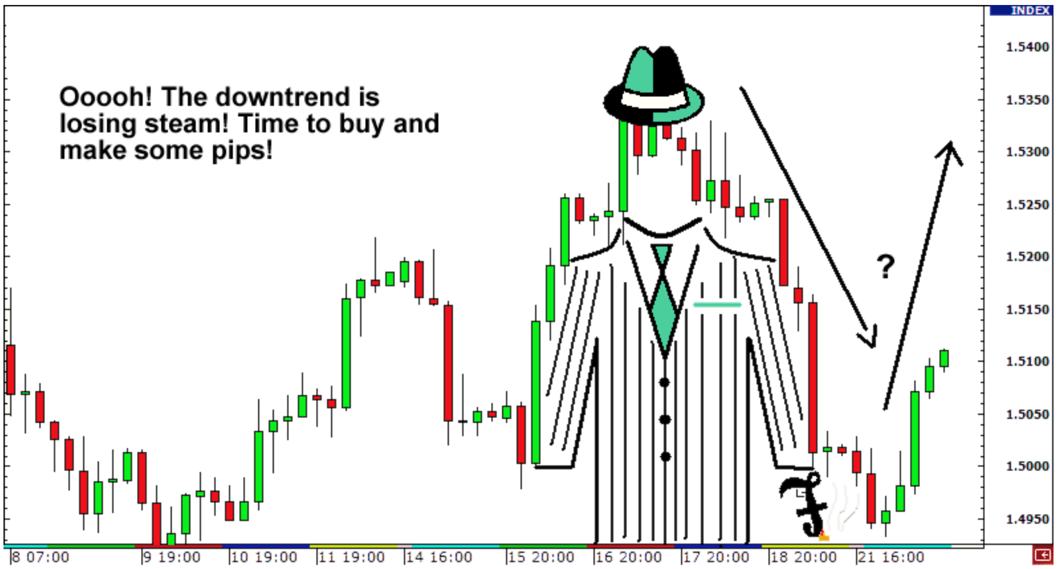
Find out how you can pick tops and bottoms in both trending and ranging market environments.

By knowing what a trending environment and a ranging environment are and what they look like, you'll be able to employ a specific strategy for each.

As the old wise man in Central Park says, "Only a fool dips his cookies in habanero salsa!"

Retracement or Reversal?

Have you ever been in this situation before?



It looks as though price action may be rallying and a buy trade is in order.

WRONG!

You've been hit by the "Smooth Retracement!"

Nobody likes to be hit the "Smooth Retracement" but, sadly, it does happen.

Why?

In the above example, the forex trader failed to recognize the difference between a retracement and a reversal. Instead of being patient and riding the overall downtrend, the trader believed that a reversal was in motion and set a long entry. Whoops, there goes his money!

Check out how Happy Pip got fooled by the “Smooth Retracement” in one of her AUD/USD trades.

In this lesson, you will learn the characteristics of retracements and reversals, how to recognize them, and how to protect yourself from false signals.

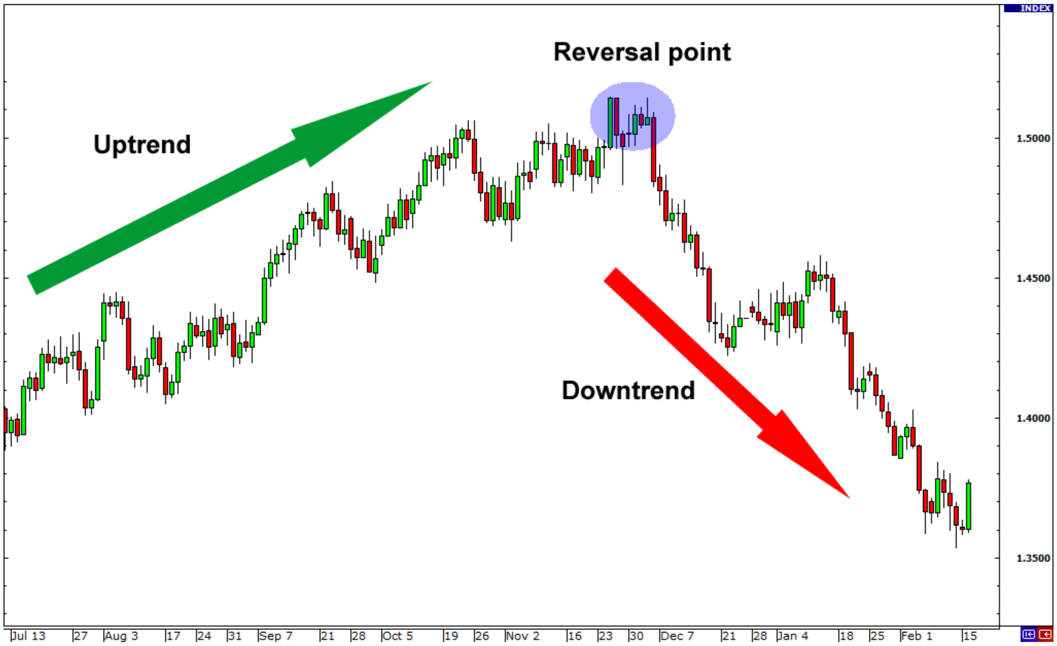
What are Retracements?

A retracement is defined as a temporary price movement against the established trend. Another way to look at it is an area of price movement that moves against the trend but returns to continue the trend.

Easy enough? Let’s move on…

What are Reversals?

Reversals are defined as a change in the overall trend of price. When an uptrend switches to a downtrend, a reversal occurs. When a downtrend switches to an uptrend, a reversal also occurs. Using the same example as above, here’s how a reversal looks like.



What Should You Do?

When faced with a possible retracement or reversal, you have three options:

1. If in a position, you could **hold** onto your position. This could lead to losses if the retracement turns out to be a longer term reversal.
2. You could **close your position** and **re-enter** if the price starts moving with the overall trend again. Of course there could be a missed trade opportunity if price sharply moves on one-direction. Money is also wasted on spreads if you decide to re-enter.
3. You could **close permanently**. This could result in a loss (if price went against you) or a huge profit (if you closed at a top or bottom) depending on the structure of your trade and what happens after.

Because reversals can happen at any time, choosing the best option isn't always easy. This is why using trailing stop loss points can be a great risk management technique when trading with the trend. You can employ it to protect your profits and make sure that you will always walk away with some pips in the event that a long-term reversal happens.

How to Identify Reversals

Properly distinguishing between retracements and reversals can reduce the number of losing trades and even set you up with some winning trades.

Classifying a price movement as a retracement or a reversal is very important. It's up there with paying taxes *cough*.

There are several key differences in distinguishing a temporary price change retracement from a long-term trend reversal. Here they are:

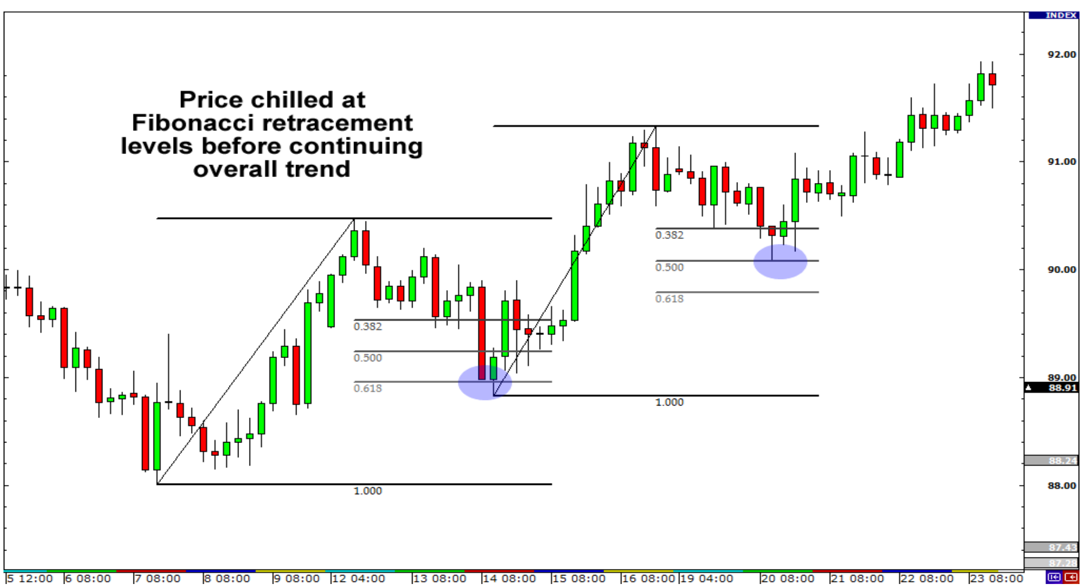
Retracements	Reversals
Usually occurs after huge price movements.	Can occur at anytime.
Short-term, short-lived reversal.	Long-term price movement
Fundamentals (i.e., the macroeconomic environment) don't change.	Fundamentals DO change, which is usually the catalyst for the long-term reversal.
In an uptrend, buying interest is present, making it likely for price to rally. In a downtrend, selling interest is present, making it likely for price to decline.	In an uptrend, there is very little buying interest forcing the price to fall lower. In a downtrend, there is very little selling interest forcing the price to rise further.

Identifying Retracements

A popular way to identify retracements is to use Fibonacci levels.

For the most part, price retracements hang around the 38.2%, 50.0% and 61.8% Fibonacci retracement levels before continuing the overall trend.

If price goes beyond these levels, it may signal that a reversal is happening. Notice how we didn't say will. As you may have figured out by now, technical analysis isn't an exact science, which means nothing certain… especially in forex markets.

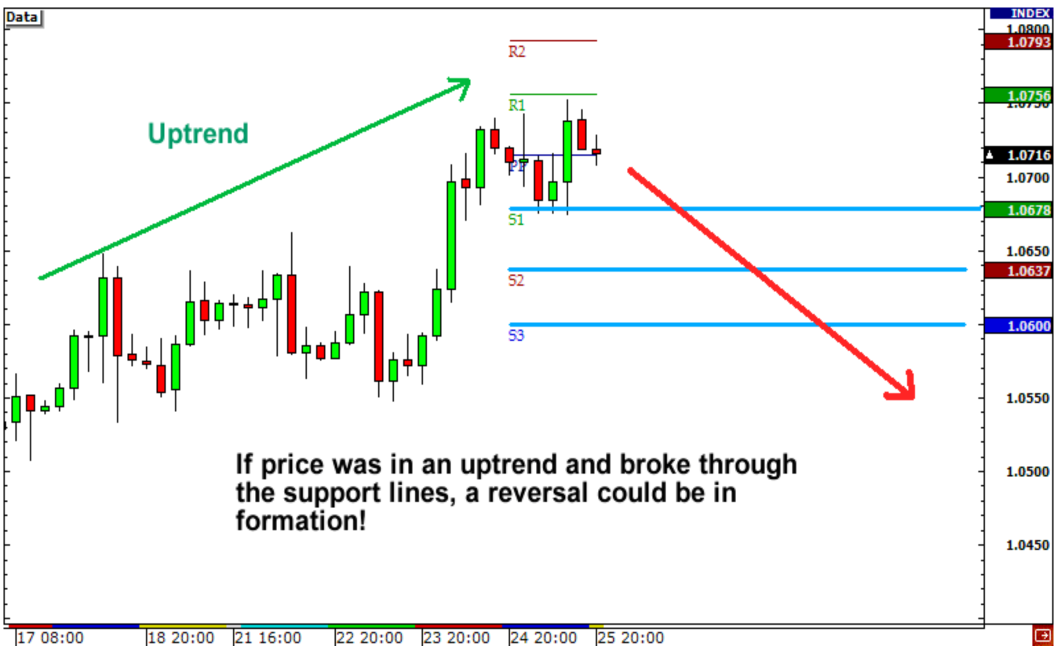


In this case, price took a breather and rested at the 61.8% Fibonacci retracement level before resuming the uptrend. After a while, it pulled back again and settled at the 50% retracement level before heading higher.

Another way to see if price is staging a reversal is to use pivot points.

In an uptrend, traders will look at the lower support points (S1, S2, S3) and wait for it to break. In a downtrend, forex traders will look at the higher resistance points (R1, R2, R3) and wait for it to break.

If broken, a reversal could be in the making! For more information or another refresher, check out the Pivot Points Lesson!



The last method is to use trend lines. When a major trend line is broken, a reversal may be in effect.

By using this technical tool in conjunction with candlestick chart patterns discussed earlier, a forex trader may be able to get a high probability of a reversal.

While these methods can identify reversals, they aren't the only way. At the end of the day, nothing can substitute for practice and experience.

With enough screen time, you can find a method that suits your forex trading personality in identifying retracements and reversals.

Protect Yo Self From Reversals

Whenever Happy Pip goes swimming at the beach or the pool, she always wears her hot pink rubber ducky floaters. Whenever she trades retracements, she uses stop loss points.

Pink rubber ducky floaters are **life savers**. Stop loss points are **capital savers**.

As we said before, reversals can happen at any time. Retracements can turn into reversals without warning.

This makes using trailing stops in trending markets very important. With trailing stop loss points, you can effectively prevent yourself from exiting a position too early during a retracement and exit a reversal in a pinch.

Conclusion

You don't have to be shot down by the "Smooth Retracement". You don't have to lose all those pips. And you most certainly don't need to wear pink arm floaties (although if pink's your favorite color, it's okay – we don't judge).

Just know how to distinguish retracements from reversals. This is part of growing up as a trader. Having the ability to do so will effectively reduce your losses and prevent winners from turning into losers.

With lots of practice and experience, you'll find yourself being able to trade accordingly to retracements and exit with a profit more times than not.

May we also suggest further reading for this topic? These forum threads might be able to help you out:

- How do I know if a trend is losing strength?
- Best indicator for gauging the strength of any current trend
- Trend channels and price action

How to Trade Breakouts

What are breakouts and how can I take advantage of them?

Unlike the breakouts you might have had as a teenager, a breakout in the trading world is a little different!

A breakout occurs when the price “breaks out” (get it?) of some kind of consolidation or trading range.

A breakout can also occur when a specific price level is breached such as support and resistance levels, pivot points, Fibonacci levels, etc.

With breakout trades, the goal is to enter the market right when the price makes a breakout and then continue to ride the trade until volatility dies down.

Volatility, Not Volume

You’ll notice that unlike trading stocks or futures, there is no way for you to see the volume of trades made in the forex market.

With stock or future trades, volume is essential for making good breakout trades so not having this data available in the forex leaves us at a disadvantage.

Because of this disadvantage, we have to rely not only on good risk management, but also on certain criteria in order to position ourselves for a good potential breakout.

If there is large price movement within a short amount of time then volatility would be considered high.

On the other hand, if there is relatively little movement in a short period of time then volatility would be considered low.

While it’s tempting to get in the market when it is moving faster than a speeding bullet, you will often find yourself more stressed and anxious; making bad decisions as your money goes in and then goes right back out.

This high volatility is what attracts a lot of forex traders, but it’s this same volatility that kills a lot of them as well.

The goal here is to use volatility to your advantage.

Rather than following the herd and trying to jump in when the market is super volatile, it would be better to look for currency pairs with volatility that is very low.

This way, you can position yourself and be ready for when a breakout occurs and volatility skyrockets!

How to Measure Volatility

Volatility is something that we can use when looking for good breakout trade opportunities.

Volatility measures the overall price fluctuations over a certain time and this information can be used to detect potential breakouts.

There are a few indicators that can help you gauge a pair's current volatility. Using these indicators can help you tremendously when looking for breakout opportunities.

1. Moving Average

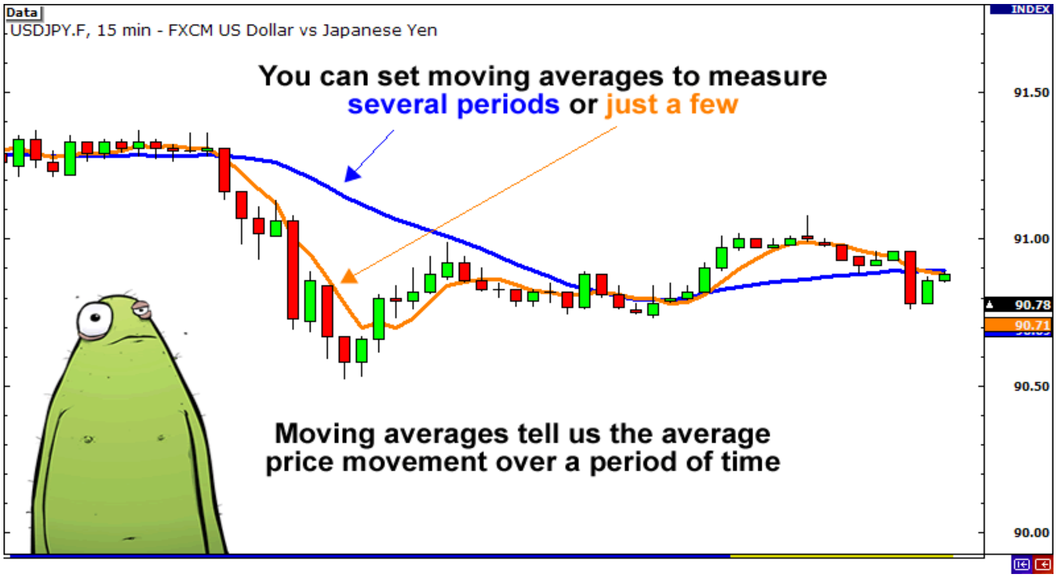
Moving averages are probably the most common indicator used by forex traders and although it is a simple tool, it provides invaluable data.

Simply put, moving averages measures the average movement of the market for an X amount of time, where X is whatever you want it to be.

For example, if you applied a 20 SMA to a daily chart, it would show you the average movement for the past 20 days.

There are other types of moving averages such as exponential and weighted, but for the purpose of this lesson we won't go too much in detail on them.

For more information on moving averages or if you just need to refresh yourself on them, check out our lesson on moving averages.



2. Bollinger Bands

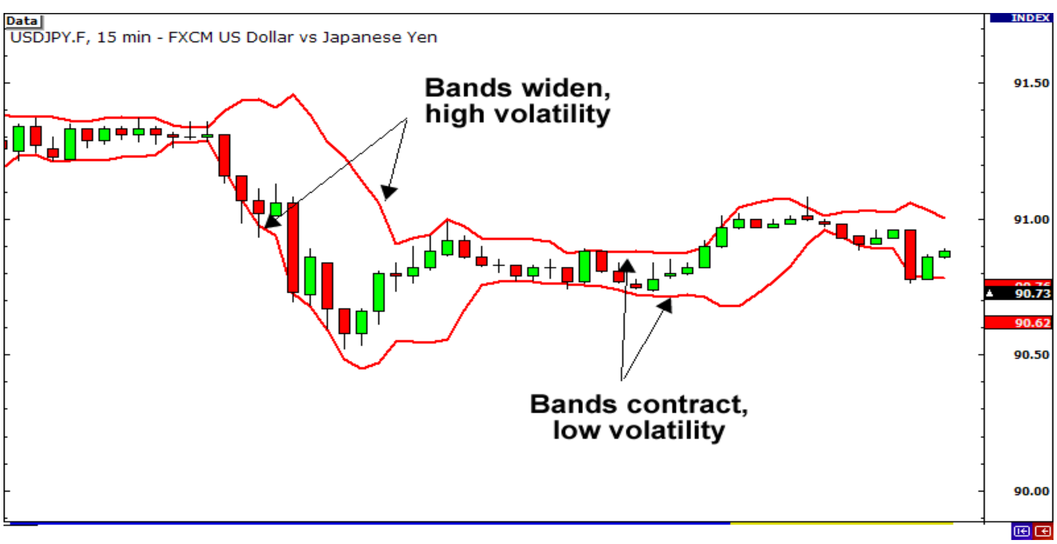
Bollinger bands are excellent tools for measuring volatility because that is exactly what it was designed to do.

Bollinger bands are basically 2 lines that are plotted 2 standard deviations above and below a moving average for an X amount of time, where X is whatever you want it to be.

So if we set it at 20, we would have a 20 SMA and two other lines. One line would be plotted +2 standard deviations above it and the other line would be plotted -2 standard deviations below.

When the bands contract, it tells us that volatility is low.

When the bands widen, it tells us that volatility is high.

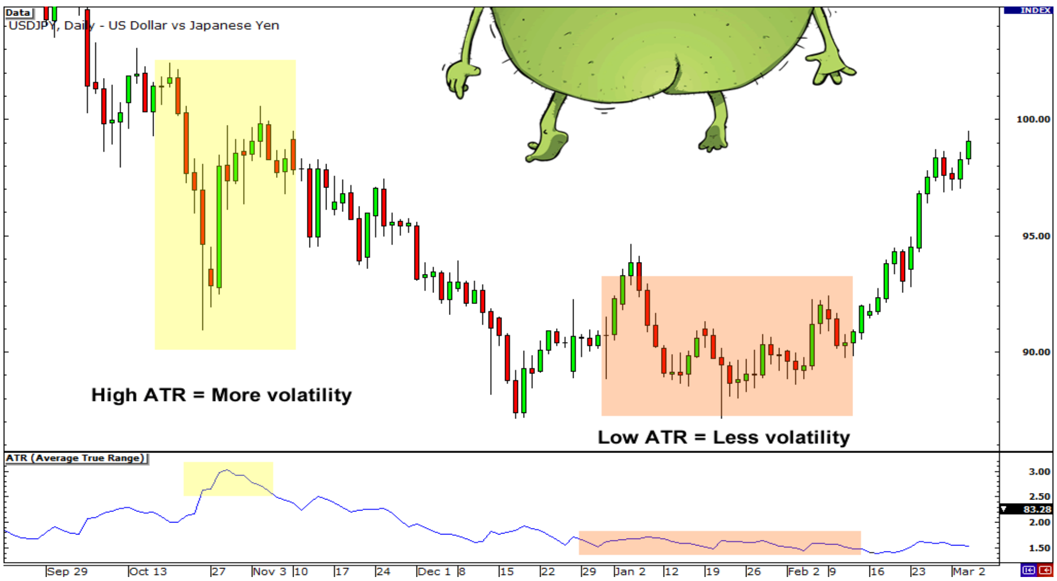


3. Average True Range (ATR)

Last on the list is the ATR.

The ATR is an excellent tool for measuring volatility because it tells us the average trading range of the market for X amount of time, where X is whatever you want it to be.

So if you set ATR to 20 on a daily chart, it would show you the average trading range for the past 20 days.



When ATR is falling, it is an indication that volatility is decreasing. When ATR is rising, it is an indication that volatility has been on the rise.

Types of Breakouts

When trading breakouts in forex, it is important to realize that there are two main types:

1. Continuation breakouts
2. Reversal breakouts

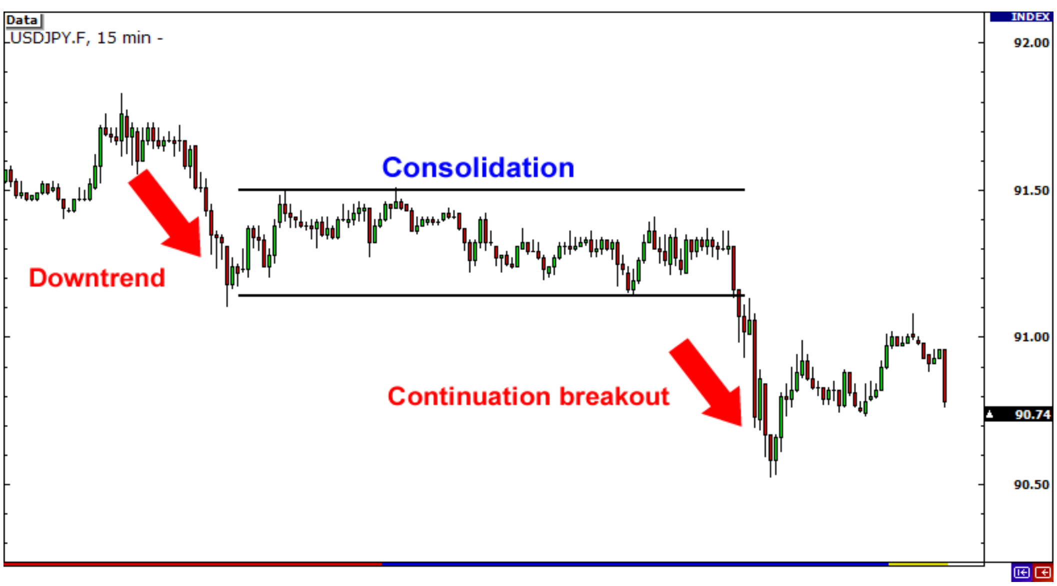
Knowing what type of breakout you are seeing will help you make sense of what is actually happening in the big picture of the market.

Breakouts are significant because they indicate a change in the supply and demand of the currency pair you are trading. This change in sentiment can cause extensive moves that provide excellent opportunities for you to grab some pips.

Continuation Breakouts

Sometimes when there is an extensive move in one direction the market will often take a breather. This occurs when buyers and sellers pause to see what they should do next. As a result, you will see a period of range-bound movement called consolidation.

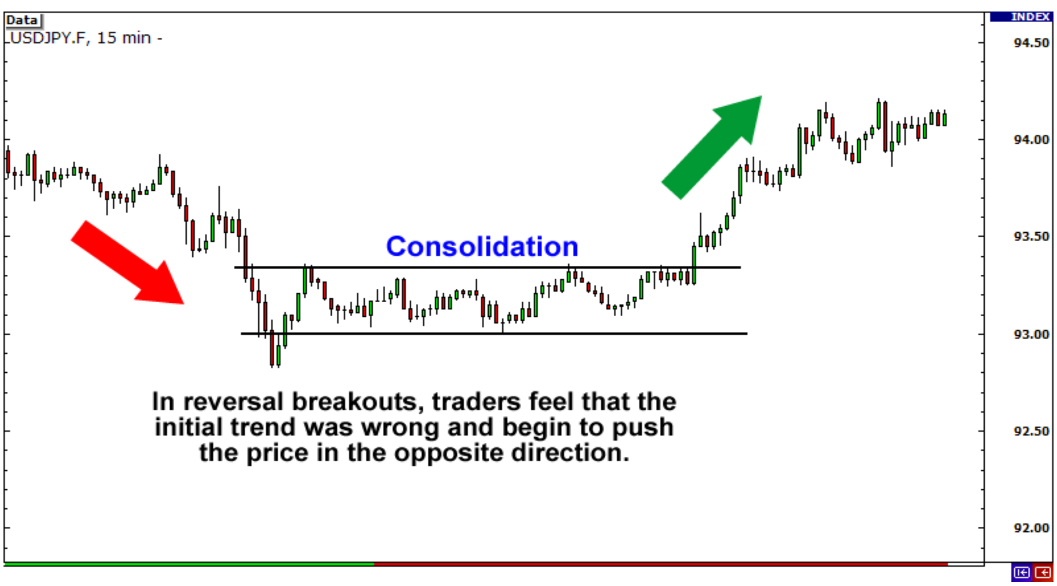
If traders decide that the initial trend was the right decision, and continue to push the price in the same direction, the result is a continuation breakout. Just think of it as a “continuation” of the initial trend…. You’re so smart!



Reversal Breakouts

Reversal breakouts start off the same way as continuation breakouts in the fact that after a long trend, there tends to be a pause or consolidation.

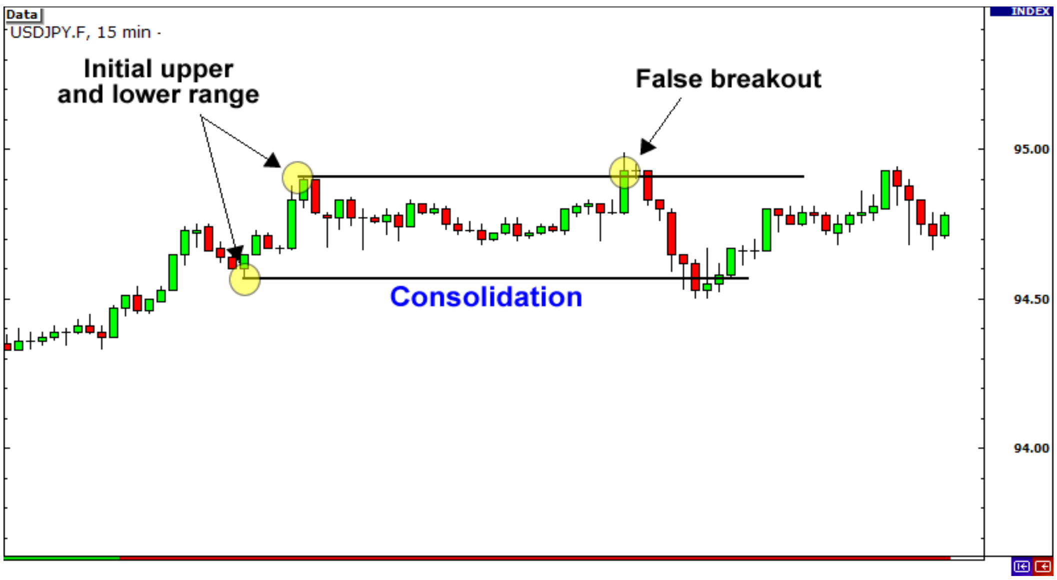
The only difference is that after this consolidation, forex traders decide that the trend is exhausted and push the price in the opposite or “reverse” direction. As a result, you have what is called a “reversal breakout”. You catch on quick!



False Breakouts

Now we know by now you are super excited to start trading breakouts (please tell us you haven't already started trading!) but you also have to be careful. Just like Lionel Messi can fake out defenders, the market can fake you out as well produce false breakouts.

False breakouts occur when the price breaks past a certain level (support, resistance, triangle, trend line, etc.) but doesn't continue to accelerate in that direction. Instead, what you might've seen was a short spike followed by the price moving back into its trading range.



A good way to enter on a breakout is to wait until the price retraces back to the original breakout level and then wait to see if it bounces back to create a new high or low (depending on which direction you are trading).

Another way to combat fake outs is by not taking the first breakout you see. By waiting to see if the price will continue to move in your intended direction, you give yourself a better chance of taking a profitable trade. The downside to this is that you may miss out on some trades in which the price moves quickly without any hesitation.

How to Trade Breakouts Using Trend Lines, Channels and Triangles

Just like breakouts on your face, the nice thing about breakout trading in forex is that opportunities are pretty easy to spot with the naked eye! Unlike the former, you don't even have to look in the mirror!

Once you start getting used to the signs of breakouts, you'll be able to spot good potential trades fairly quickly.

Chart Patterns

By now you should be accustomed to looking at charts and recognizing familiar patterns that indicate a reversal breakout. Here are just a few:

- Double Top/Bottom
- Head and Shoulders
- Triple Top/Bottom

In addition to chart patterns there are several tools and indicators you can use to supplement your case for a reversal breakout.

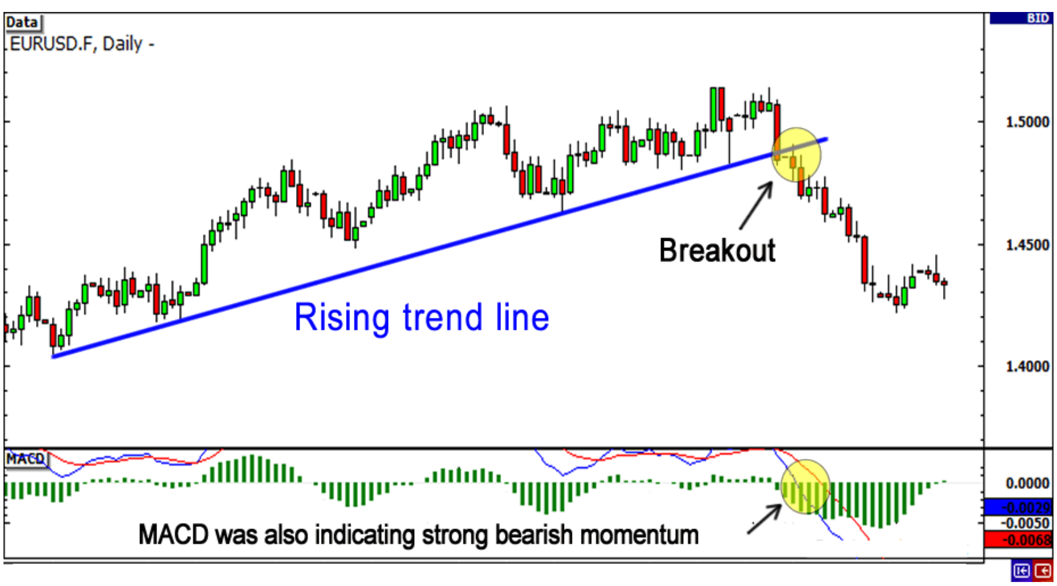
Trend Lines

The first way to spot a possible breakout is to draw trend lines on a chart. To draw a trend line you simply look at a chart and draw a line that goes with the current trend.

When drawing trend lines it is best if you can connect at least two tops or bottoms together. The more tops or bottoms that connect, the stronger the trend line.

So how can you use trend lines to your advantage? When the price approaches your trend line, only two things can happen. The price could either bounce off the trend line and continue the trend OR price could breakout through the trend line and cause a reversal. We want to take advantage of that breakout!

Looking at the price is not enough however. This is where using one or more of the indicators mentioned earlier in this lesson could help you tremendously.



Notice that as EUR/USD broke the trend line MACD was showing bearish momentum. Using this information we can safely say that the breakout will continue to push the euro down and as traders, we should short this pair.

Channels

Another way to spot breakout opportunities is to draw trend channels. Drawing trend channels are almost the same as drawing trend lines except that after you draw a trend line you have to add the other side.

Channels are useful because you can spot breakouts on either direction of the trend. The approach is similar to how we approach trend lines in that we wait for the price to reach one of the channel lines and look at the indicators to help us make our decision.

Notice that the MACD was showing strong bearish momentum as EUR/USD broke below the lower line of the trend channel. This would've been a good sign to go short!

Triangles

The third way you can spot breakout opportunities is by looking for triangles. Triangles are formed when the market price starts off volatile and begins to consolidate into a tight range. Our goal is to position ourselves when the market consolidates so that we can capture a move when a breakout occurs.

There are 3 types of triangles:

1. Ascending triangle
2. Descending triangle
3. Symmetrical triangle

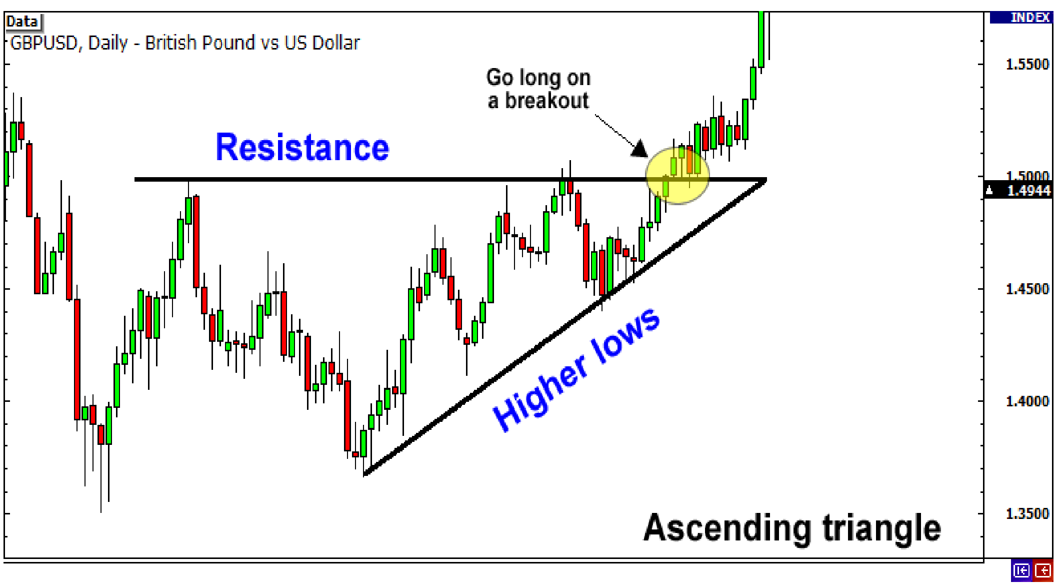
Ascending Triangles

Ascending triangles form when there is a resistance level and the market price continues to make higher lows. This is a sign that the bulls are slowly starting to gain momentum over the bears.

The story behind an ascending triangle is that each time the price reaches a certain high, there are several traders who are convinced about selling at that level, resulting in the price dropping back down.

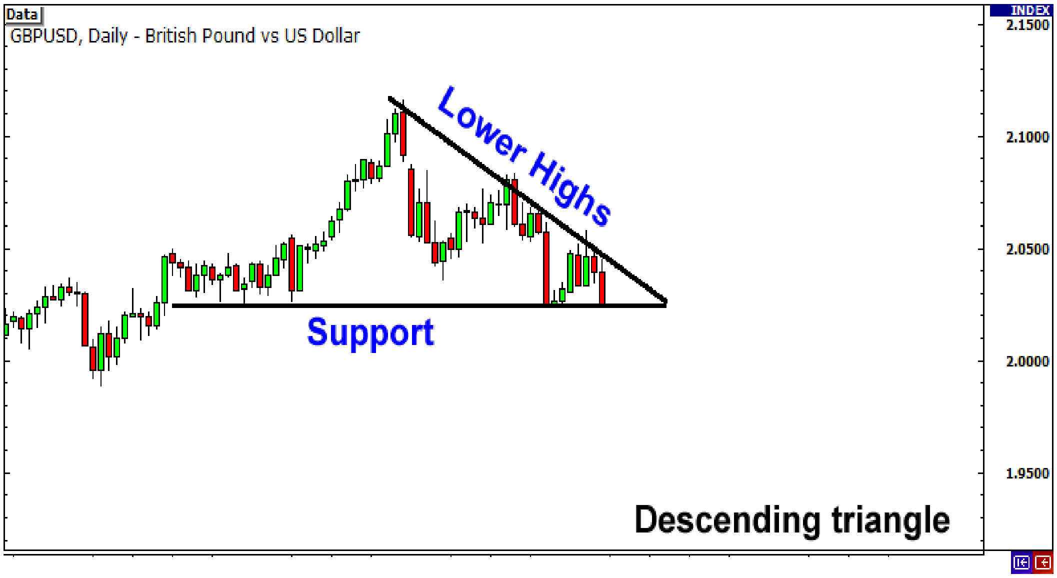
On the other side, there are several traders who believe the price should be higher, and as the price begins to drop, buy higher than its previous low. The result is a struggle between the bulls and bears which ultimately converges into an ultimate showdown…

What we are looking for is a breakout to the upside since ascending triangles are generally bullish signals. When we see a breach of the resistance level the proper decision would be to go long.

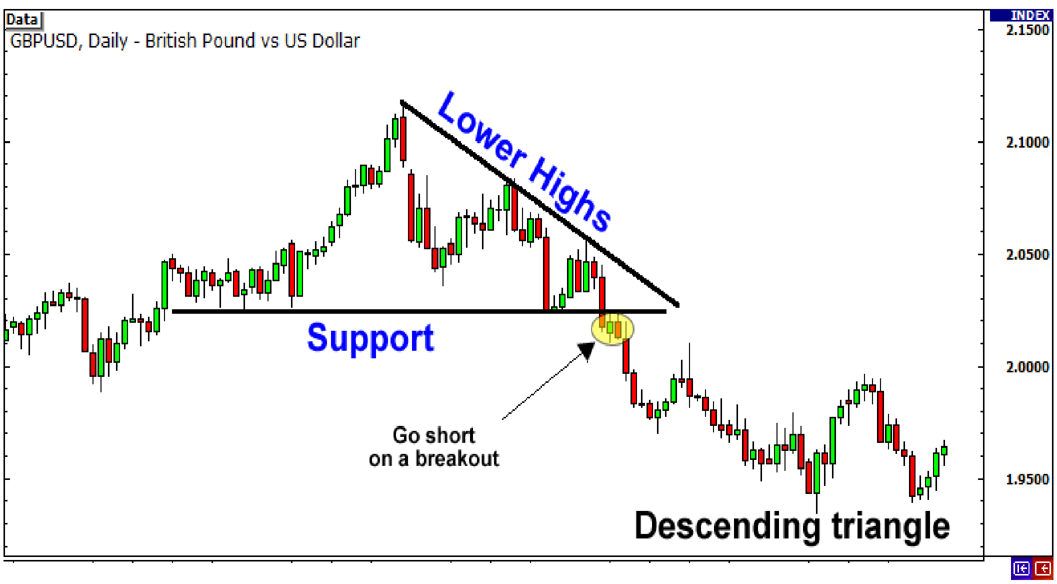


Descending Triangles

Descending triangles are basically the opposite of ascending triangles. Sellers are continuing to put pressure on the buyers, and as a result, we start to see lower highs met by a strong support level.

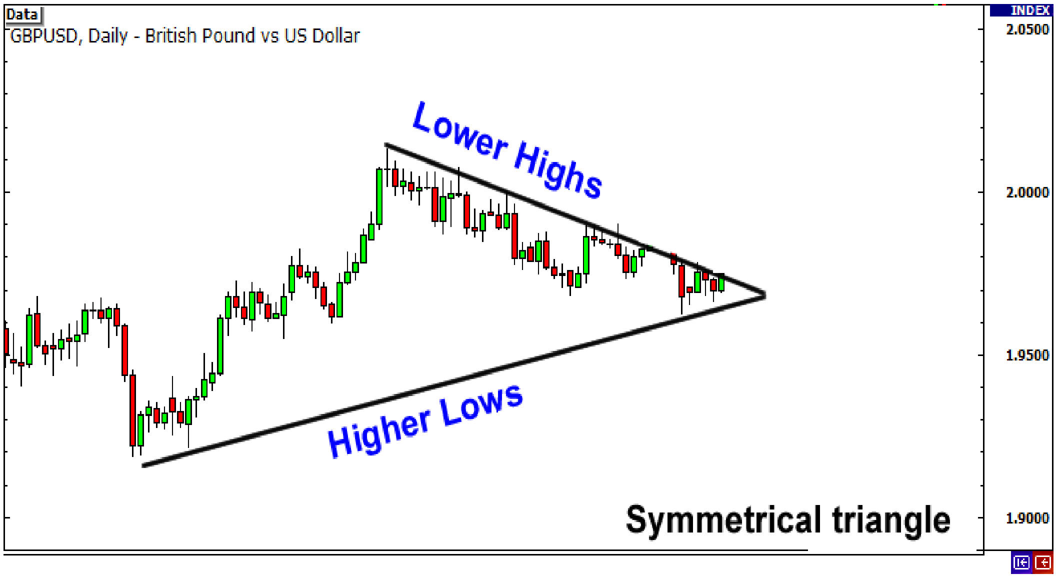


Descending triangles are generally bearish signals. To take advantage of this, our goal is to position ourselves to go short if the price should breakout below the support level.

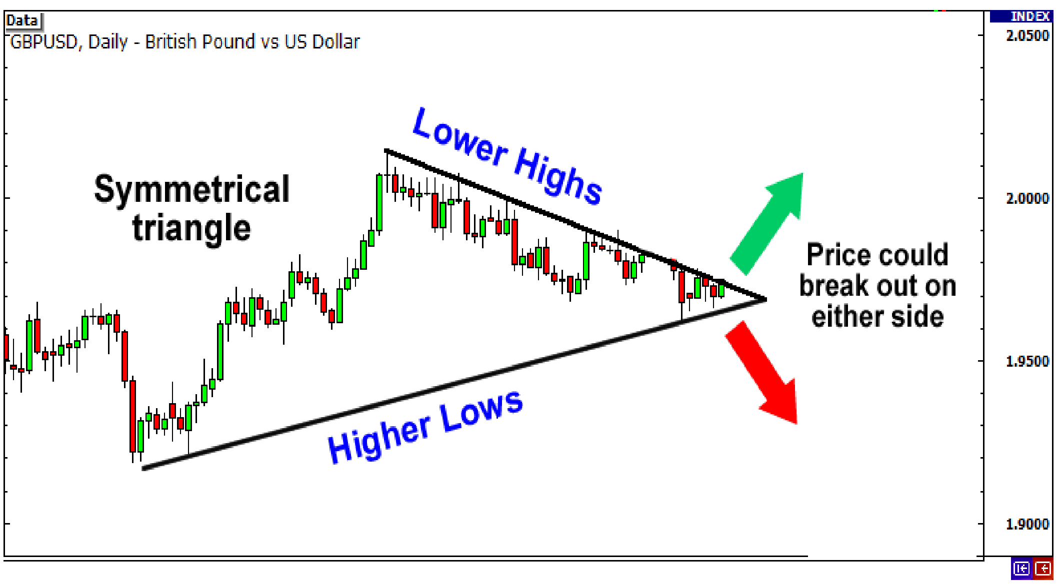


Symmetrical Triangles

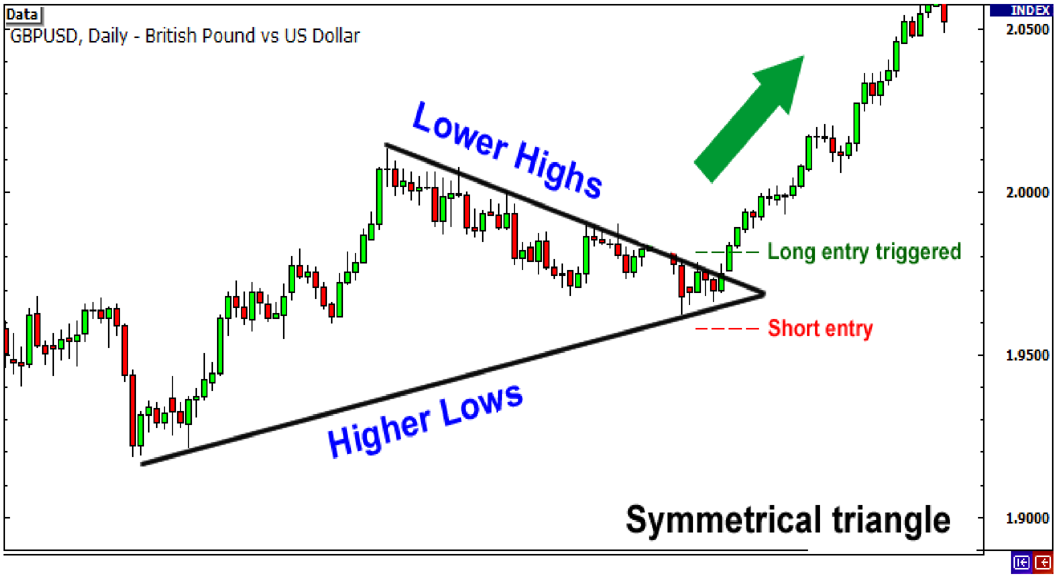
The third type of triangle is the symmetrical triangle. Rather than having a horizontal support or resistance level, both the bulls and the bears create higher lows and lower highs and form an apex somewhere in the middle.



Unlike the ascending and descending triangles which are generally bullish and bearish signals, symmetrical triangles have NO directional bias. You must be ready to trade a breakout on either side!



In the case of the symmetrical triangle, you want to position yourself to be ready for both an upside or downside breakout. A perfect time to use the one-cancels-the-other (OCO) order! Don't remember what an OCO order is? Go review your types of orders!



In this scenario, GBP/USD broke out on the upside and our long entry was triggered.

Breaking down the Triangle Breakouts

To help you memorize the different types of triangle breakouts, just think of facial breakouts.

Ascending triangles usually breakout to the upside. So when you think of ascending triangles, think of breaking out on your forehead.

Descending triangles usually breakout to the downside. So when you think of descending triangles, think of breaking out on your chin.

Symmetrical triangles can break either to the upside or the downside. So when you think of symmetrical triangles, think of breaking out on both your chin and forehead.

Here’s a quick and disgusting memory tickler:

Ascending triangle = Forehead breakout

Descending triangle = Chin breakout

Symmetrical triangle = Forehead OR chin breakout

EWWWW!!!!

Gross eh? But we bet you’ll remember it!

How to Measure the Strength of a Breakout

As you learned earlier, when a trend moves for an extended period of time and it starts to consolidate, one of two things could happen:

1. The price could continue in the same direction (continuation breakout)
2. The price could reverse in the opposite direction (reversal breakout)

Wouldn’t it be nice if there was a way to know to confirm a breakout? If only there was a way to avoid fake outs…

Hmmm…

You guessed it…. THERE IS A WAY!

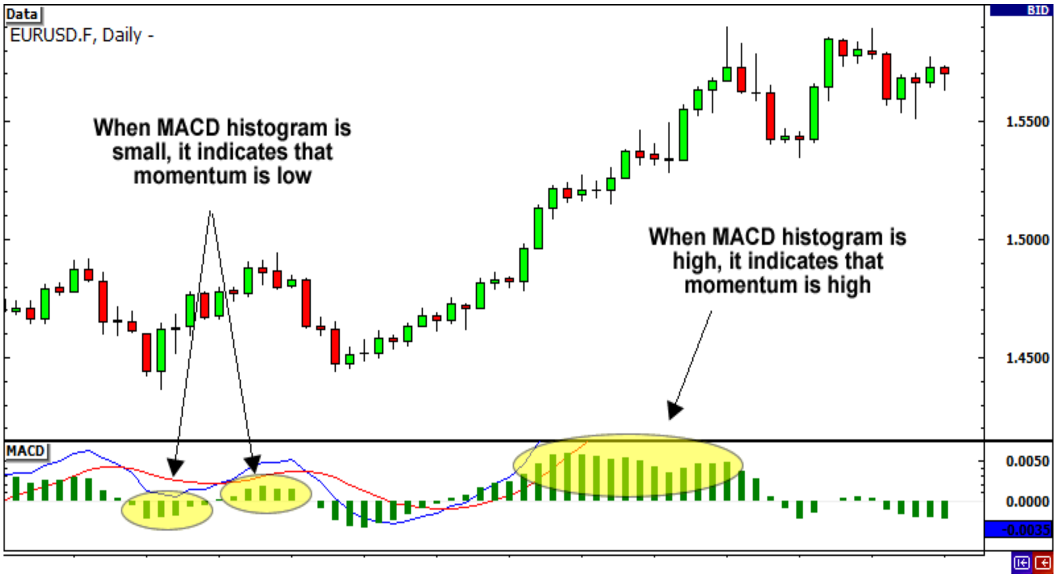
In fact, there are a couple of ways to tell whether or not a trend seems to be nearing its demise and a reversal breakout is in order.

Moving Average Convergence/Divergence (MACD)

By now you should have a good foundation of the MACD indicator. If you don’t, you might want to check out our lesson on MACD.

MACD is one of the most common indicators used by forex traders and for good reason. It is simple yet dependable and can help you find momentum, and in this case, the *lack* of momentum!

MACD can be displayed in several ways but one of the “sexiest” ways is to look at it as a **histogram**. What this histogram does is actually show the difference between the slow and fast MACD line. When the histogram gets bigger, it means momentum is getting stronger. When the histogram gets smaller, it means momentum is getting weaker.



So how can we use this when trying to spot a trend reversal? Glad you asked!

Remember that trading signal we talked about earlier called divergences and how it occurs when the price and indicators move in the opposite direction? Since MACD shows us momentum it would make sense that momentum would increase as the market makes a trend. However, if MACD begins to decrease even when the trend is continuing, you can deduce that momentum is decreasing and this trend could be close to an end.

You can see from the picture that as price was moving higher, MACD was getting smaller. This meant that even as the price was still trending, momentum was beginning to fade out. From this information, we can conclude that a trend reversal is highly likely.

Relative Strength Index (RSI)

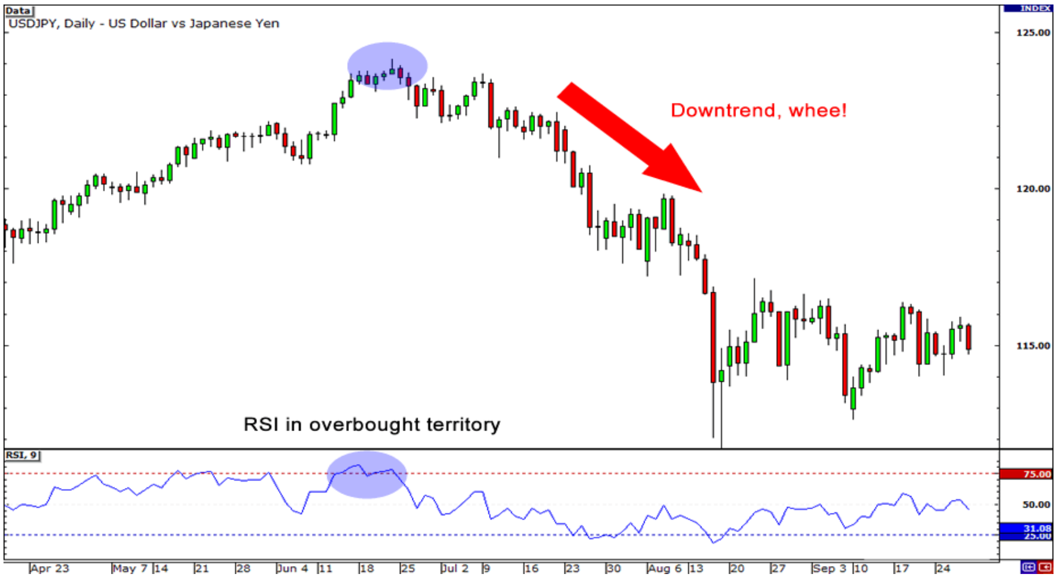
RSI is another momentum indicator that is useful for confirming reversal breakouts. Basically, this indicator tells us the changes between higher and lower closing prices for a given period of time. We won't go into too much detail about it but if you would like to know more check out our lesson on RSI.

RSI can be used in a similar way to MACD in that it also produces divergences. By spotting these divergences, you can find possible trend reversals.

However, RSI is also good for seeing how long a trend has been overbought or oversold. A common indication of whether a market is overbought is if the RSI is above 70. On the flipside, a common indication of whether a market is oversold is if the RSI is below 30.

Because trends are movements in the same direction for an extended period of time, you will often see RSI move into overbought/oversold territory, depending on the direction of the trend.

If a trend has produced oversold or overbought readings for an extended period of time and begins to move back within the range of the RSI, it is a good indication that the trend may be reversing.



In the same example as before, the RSI showed that the market was overbought for a billion days (ok not that long). Once RSI moved back below 70, it was good indication that the trend was about to reverse.

How to Detect Fakeouts

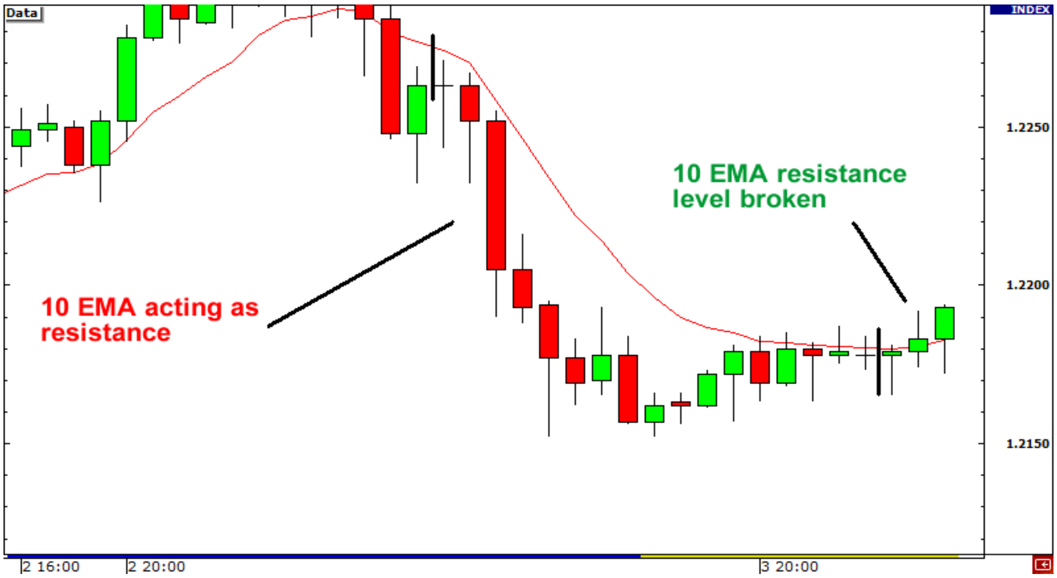
Breakouts are popular among forex traders.

It makes sense right?

When price finally "breaks" out of that support or resistance level, one would expect price to keep moving in the same direction of the break. There must have been enough momentum building up in order for price to have broken out of the level, right?

It's time to hop aboard that train. It's all smooth sailing now. All you have to do is just wait for it…

Yes, wait for it…



Wait for it… Just a few more moments… To see price inch one direction… Then suddenly move miles in the opposite direction!

Huh?!? What the heck?! What happened to "the bread and butter and the end of world hunger" strategy?

End of story: You are left eating ketchup packets and crackers like Tom Hanks in The Terminal.

Support and Resistance Levels Are Tricky

One thing you should remember to note about support and resistance levels is that they are *areas* in which a predictable price response can be expected.

Support Levels

Support levels are areas where buying pressure is just enough to overcome selling pressure and halt or reverse a downtrend.

A strong support level is more likely to hold up even if price breaks the support level and it provides traders a good *buying* opportunity.

Resistance Levels

Resistance levels are just like support levels but work in the opposite way. They tend to halt or even reverse uptrends.

Resistance levels are areas in which selling pressure is just enough to overcome buying pressure and force price back down.

Strong resistance levels are more like to hold up even if price breaks the resistance level and it provides traders a good selling opportunity.

In the next section, we will dive deeper into fakeouts and discuss why we should trade them and how to profit off them.

It's not enough learning about breakout strategies because there will be times that breakouts fail. We have to know what to do in case of fakeouts.

This is part of your Jedi forex training. To be a Jedi master, you must be able to master fakeouts.

Are you up for it?

Fade the Breakout

Fade the breakout you say? Was that just a typo? Did you mean to say, "trade the breakout"?

Nope!

Fading breakouts simply means trading in the opposite direction of the breakout.

Fading breakouts = trading false breakouts.

You would fade a breakout if you believe that a breakout from a support or resistance level is false and unable to keep moving in the same direction.

In cases in which the support or resistance level broken is significant, fading breakouts may prove to be smarter than trading the breakout.

Keep in mind that fading breakouts is a great *short-term* strategy. Breakouts tend to fail at the first few attempts but may succeed eventually.

REPEAT: Fading breakouts is a great short-term strategy. It is NOT a great one to use for longer term traders.

By learning trade false breakouts, also known as fakeouts, you can avoid getting whipsawed.

Trading breakouts appeal to many forex traders. Why?

Support and resistance levels are supposed to be price floors and ceilings. If these levels are broken, one would expect for price to continue in the same direction as the breakage.

If a support level is broken, that means that the general price movement is downwards and people are more likely to sell than buy.

Conversely, if a resistance level is broken, then the crowd believes that price is more likely to rally even higher and will tend to buy rather than sell.

Independent retail forex traders have greedy mentalities. They believe in trading in the direction of the breakout. They believe in huge gains on huge moves. Catch the big fish, forget the small fries.

In a perfect world, this would be true. But the world is not perfect. Frogs and princesses do not live happily ever after. What does in fact happen is that most breakouts FAIL.

Breakouts fail simply because the smart minority has to make money off the majority. Don't feel so bad. The smart minority tends to be comprised of the big players with huge accounts and buy/sell orders.

In order to sell something, there must be a buyer. However, if everyone wants to buy above a resistance level or sell below a support level, the market maker has to take the other side of the equation. And let us warn you: the market maker ain't no fool.

Retail traders like to trade breakouts.

The smart minority, the institutional, more seasoned traders, prefer to fade breakouts.

The smarter forex traders take advantage of the collective thinking of the crowd or inexperienced traders and win at their expense. That is why trading alongside the more experienced forex traders could be very profitable as well.

Which would you rather be part of: the smart minority that fades breakouts or the losing majority that gets caught in false breakouts?

How to Trade Fakeouts

In order to fade breakouts, you need to know where potential fakeouts can occur.

Potential fakeouts are usually found at support and resistance levels created through trend lines, chart patterns, or previous daily highs or lows.

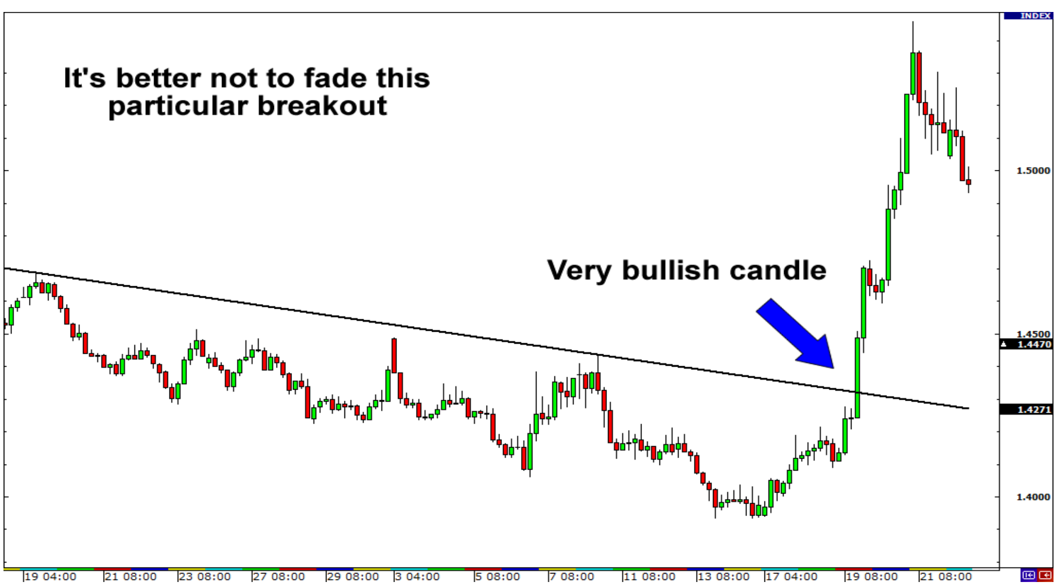
Trend lines

In fading breakouts, always remember that there should be SPACE between the trend line and price.

If there is a gap between the trend line and price, it means price is heading more in the direction of the trend and away from the trend line. Like in the example below, having space between the trend line and price allows price to retrace back towards the trend line, perhaps even breaking it, and provide fading opportunities.

The SPEED of price movement is also very important.

If price is inching like a caterpillar towards the trend line, a false breakout may be likely. However, a fast price movement towards the trend line could prove to be a successful breakout. With a high price movement speed, momentum can carry price past the trend line and beyond. In this situation, it is better to step back from fading the breakout.



How do we fade trend line breaks?

It's very simple actually. Just enter when price pops back inside.

This will allow you to take the safe route and avoid jumping the gun. You don't want sell above or below a trend line only to find out later that the breakout was real!

Using the first chart example, let's point out possible entry points by zooming in a little.

Chart Patterns

Chart patterns are physical groupings of price you can actually see with your own eyes. They are an important part of technical analysis and also help you in your decision-making process.

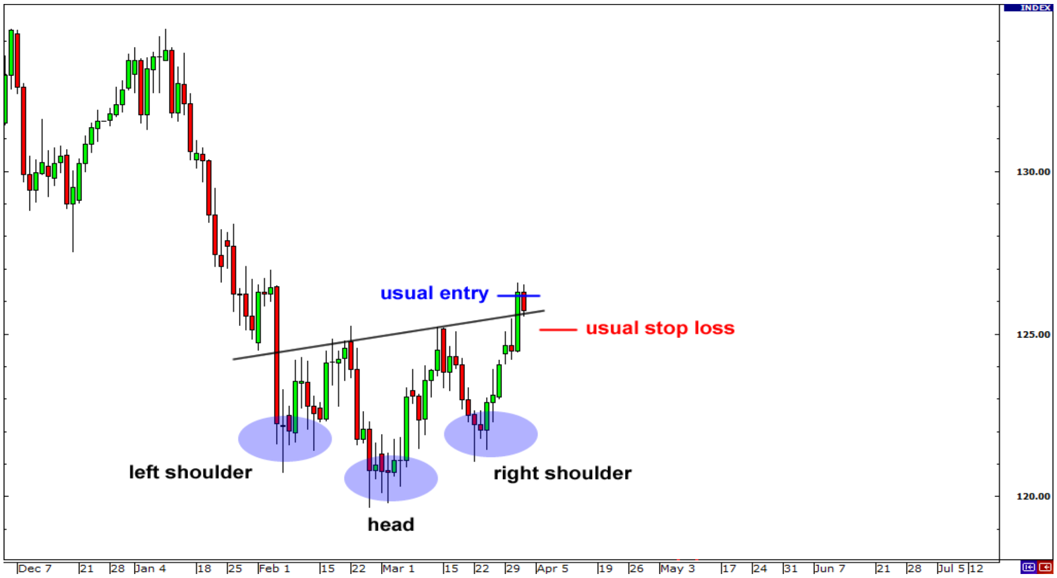
Two common patterns where false breakouts tend to occur are:

- Head and Shoulders
- Double Top/Bottom

The **head and shoulders** chart pattern is actually one of the hardest patterns for new traders to spot. However, with time and experience, this pattern can become an instrumental part of your trading arsenal.

The head and shoulders pattern is considered a reversal. If formed at the end of an uptrend, it could signal a bearish reversal. Conversely, if it is formed the end of a downtrend, it could signal a bullish reversal. Head and shoulders are known for generating false breakouts and creating perfect opportunities for fading breakouts.

False breakouts are common with this pattern because many traders who have noticed this formation usually put their stop loss very near the neckline.



When the pattern experiences a false breakout, prices will usually rebound. Traders who have sold the downside breakout or who have bought the upside breakout will have their stops triggered when prices move against their positions. This usually is caused by the institutional traders who want to scrape money from the hands of individual traders.

In a head and shoulders pattern, you can assume that the first break tends to be false.

You can fade the breakout with a limit order back in the neckline and just put your stop above the high of the fake out candle.

You could place your target a little below the high of the second shoulder or a little above the low of the second shoulder of the inverse pattern.

The next pattern is the **double top** or the **double bottom**.

Traders just love these patterns! Why you ask? Well it is because they're the easiest to spot!

When price breaks below the neckline, it signals a possible trend reversal. Because of this, plenty of traders place their entry orders very near the neckline in case of a reversal.

The problem with these chart patterns is that countless traders know them and place orders at similar positions. This leaves the institutional traders open to scrape money from the commoner's hands.

Similar to the head and shoulders pattern, you can place your order once price goes back in to catch the bounce. You can set your stops just beyond the fake out candle.

What kind of market should I fade breakouts?

The best results tend to occur in a **range-bound market**. However, you cannot ignore market sentiment, major news events, common sense, and other types of market analysis.

Financial markets spend a lot time bouncing back and forth between a range of prices and do not deviate much from these highs and lows.

Ranges are bound by a support level and a resistance level, and buyers and sellers continually push prices up and down within those levels. Fading the breakouts in these range-bound environments can prove to be very profitable. However, at some point, one side is eventually going to take over and a new trending stage will form.

Summary: Trading Breakouts and Fakeouts

Trading Breakouts

With breakout trades, the goal is to enter the market right when the price makes a breakout and then continue to ride the trade until volatility dies down.

Breakouts are significant because they indicate a change in the supply and demand of the currency pair you are trading.

You'll notice that unlike trading stocks or futures, there is no way for you to see the volume of trades made in the forex. Because of this, we need to rely on volatility.

Volatility measures the overall price fluctuations over a certain time and this information can be used to detect potential breakouts.

There are a few indicators that can help you gauge a pair's current volatility. Using these indicators can help you tremendously when looking for breakout opportunities.

- Moving Averages
- Bollinger Bands
- Average True Range (ATR)

There are two types of breakouts:

- Continuation
- Reversal

To spot breakouts, you can look at:

- Chart Patterns
- Trend lines

- Channels
- Triangles

You can measure the strength of a breakout using the following:

- Moving Average Convergence/Divergence (MACD)
- RSI

Finally, breakouts usually work best and FOR REAL with some kind of economic event or news catalyst. Always be sure to check the forex calendar and news before figuring out whether or not a breakout trade is the right play for the situation.

Trading Fakeouts

Institutional traders like to fade breakouts. So we must like to fade breakouts also.

Are you going to follow the crowd, or are you going to follow the money?

Think, act, eat, sleep, and watch the same movies as these guys do. If we can trade in the same way the institutional players do, success is just a glimpse away.

Fading breakouts simply means trading in the opposite direction as the breakout. You would fade a breakout if you believe that a breakout from a support or resistance level is false and unable to keep moving in the same direction.

In cases in which the support or resistance level broken is significant, fading breakouts may prove to be smarter than trading the breakout.

Potential fake outs are usually found at support and resistance levels created through **trend lines**, **chart patterns**, or **previous daily highs** or **lows**.

The best results tend to occur in a **range-bound market**. However, you cannot ignore market sentiment, common sense, and other types of market analysis.

Financial markets spend a lot time bouncing back and forth between a range of prices and do not deviate much from these highs and lows.

Finally, the odds of a fake out are higher when there is no major economic event or news catalyst to shift forex traders’ sentiment in the direction of the break.

What is Fundamental Analysis?

Along your travels, you've undoubtedly come across Gulliver, Frodo, and the topic of fundamental analysis.

Wait a minute…

We've already given you a teaser about fundamental analysis during Kindergarten! Now let's get to the nitty-gritty!
What is it exactly and will I need to use it? Well, fundamental analysis is the study of fundamentals! That was easy, wasn't it? Ha! Gotcha!

There's really more to it than that. Soooo much more.

Whenever you hear people mention fundamentals, they're really talking about the economic fundamentals of a currency's host country or economy.

Economic fundamentals cover a vast collection of information – whether in the form of economic, political or environmental reports, data, announcements or events.

Fundamental analysis is the use and study of these factors to forecast future price movements of currencies.

It is the study of what's going on in the world and around us, economically and financially speaking, and it tends to focus on how macroeconomic elements (such as the growth of the economy, inflation, unemployment) affect whatever we're trading.

Fundamental Data and Its Many Forms

In particular, fundamental analysis provides insight into how price action "should" or may react to a certain economic event.

Fundamental data takes shape in many different forms.

It can appear as a report released by the Fed on U.S. existing home sales. It can also exist in the possibility that the European Central Bank will change its monetary policy.
The release of this data to the public often changes the economic landscape (or better yet, the economic mindset), creating a reaction from investors and speculators.

There are even instances when no specific report has been released, but the anticipation of such a report happening is another example of fundamentals.

Speculations of interest rate hikes can be "priced in" hours or even days before the actual interest rate statement.

In fact, currency pairs have been known to sometimes move 100 pips just moments before major economic news, making for a profitable time to trade for the brave.

That's why many forex traders are often on their toes prior to certain economic releases and you should be too!

Generally, economic indicators make up a large portion of data used in fundamental analysis. Like a fire alarm sounding when it detects smoke or feels heat, economic indicators provide some insight into how well a country's economy is doing.

While it's important to know the numerical value of an indicator, equally as important is the market's anticipation and prediction of that value.

Understanding the resulting impact of the actual figure in relation to the forecasted figure is the most important part. These factors all need consideration when deciding to trade.

Phew!

Don't worry. It's simpler than it sounds and you won't need to know rocket science to figure it all out.

Fundamental analysis is a valuable tool in estimating the **future conditions of an economy**, but not so much for **predicting currency price direction**.
This type of analysis has a lot of gray areas because fundamental information in the form of reports releases or monetary policy change announcements is vaguer than actual technical indicators.

Analysis of economic releases and reports of fundamental data usually go something like this:

"An interest rate increase of that percentage MAY cause the euro to go up."

"The U.S. dollar SHOULD go down with an indicator value in that range."

"Consumer confidence dipped 2% since the last report."

Here's an Economic Report, Now What?

The market has a tendency to react based on how people feel. These feelings can be based on their reaction to economic reports, based on their assessment of current market conditions.

And you guessed it – there are tons of people, all with different feelings and ideas.

You're probably thinking "Geez, there's a lot of uncertainty in fundamental analysis!"

You're actually very right.

There's no way of knowing 100% where a currency pair will go because of some new fundamental data.

That's not saying that fundamental analysis should be dismissed.

Not at all.

Because of the sheer volume of fundamental data available, most people simply have a hard time putting it all together.

They understand a specific report, but can't factor it into the broader economic picture. This simply takes time and a deeper understanding of the data.

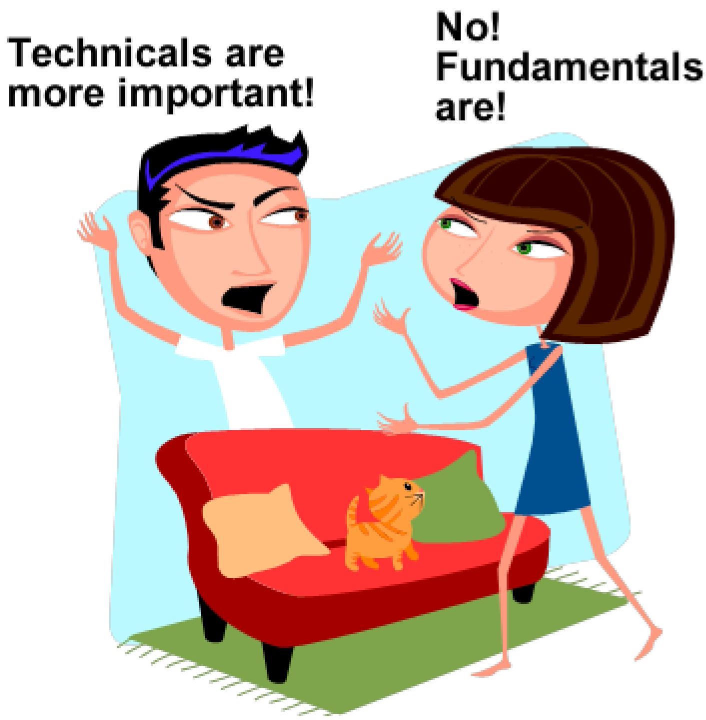
Also, since most fundamental data are reported only for a single currency, fundamental data for the other currency in the pair would also be needed and would then have to be compared to get an accurate picture.

If you're too busy to go through a bajillion news reports and economic data, don't fret. Our resident economic guru, Bloomberg, got your back covered! Make sure you read up on his regular economic analysis on his forexfactory.
As we mentioned from the get-go, it's all about pairing a strong currency with a weak one.

At this point, you're probably still waiting for the answer to "Will I ever need to use fundamental analysis to become a successful forex trader?"

We totally understand that there are purists on both sides.

Technical analysis seems to be the preferred methodology of short-term forex traders, with price action as their main focus.
Intermediate or medium traders and some long-term traders like to focus on fundamental analysis too because it helps with currency valuation.



We like to be a little crazy by saying you should use BOTH!
Technically-focused strategies are blown to bits when a key fundamental event occurs. In the same respect, pure fundamental traders miss out on the short term opportunities that pattern formations and technical levels bring.

A mix of technical and fundamental analysis covers all angles. You're aware of the scheduled economic releases and events, but you can also identify and use the various technical tools and patterns that market players focus on.

I have a couple of trade examples for you showing how the perfect blend of fundamental and technical analysis results in huge profits.
There's your answer!

Happy?!

In this lesson, we'll discuss the major fundamental factors that affect currencies. These are interest rates, monetary policies, and market-moving economic reports.

Why Interest Rates Matter for Forex Traders

Simply put, interest rates make the forex world go ’round! In other words, the forex market is ruled by interest rates.

A currency’s interest rate is probably the biggest factor in determining the perceived value of a currency. So knowing how a country’s central bank sets its monetary policy, such as interest rate decisions, is a crucial thing to wrap your head around.

One of the biggest influences on a central bank’s interest rate decision is price stability, or “inflation”.

Inflation is a steady increase in the prices of goods and services.

Inflation is the reason why your parents or your parents’ parents paid a nickel for a soda pop in the 1920’s, but now people pay twenty times more for the same product.

It’s generally accepted that moderate inflation comes with economic growth.

However, too much inflation can harm an economy and that’s why central banks are always keeping a watchful eye on inflation-related economic indicators, such as the CPI and PCE.

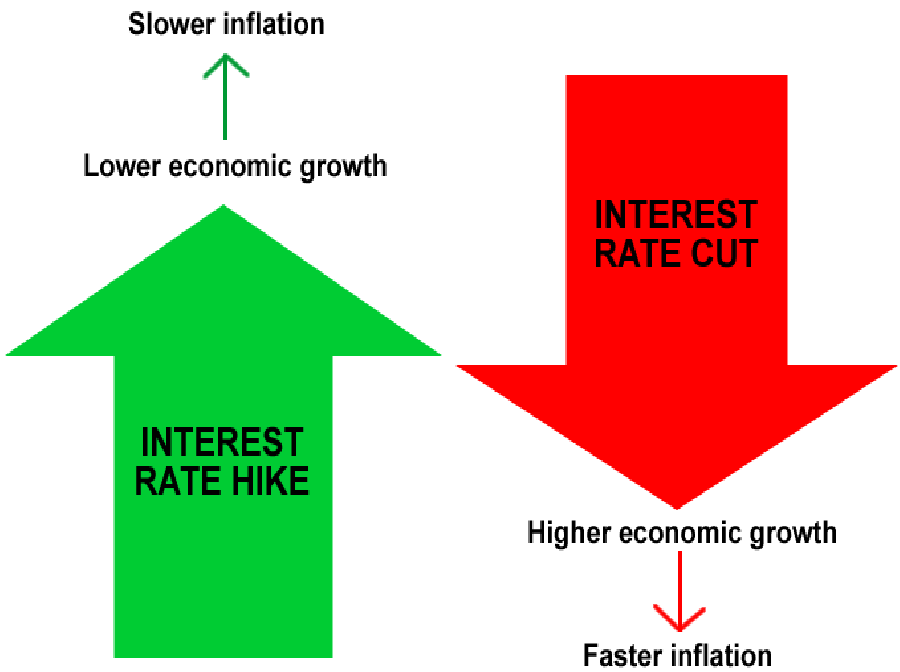
Country	Central Bank
Australia	Reserve Bank of Australia (RBA)
Canada	Bank of Canada (BOC)
European Union	European Central Bank (ECB)
Japan	Bank of Japan (BOJ)
New Zealand	Reserve Bank of New Zealand (RBNZ)
Switzerland	Swiss National Bank (SNB)
United Kingdom	Bank of England (BOE)
United States	Federal Reserve (Fed)

In an effort to keep inflation at a comfortable level, central banks will mostly likely increase interest rates, resulting in lower overall growth and slower inflation.

This occurs because setting high interest rates normally forces consumers and businesses to borrow less and save more, putting a damper on economic activity. Loans just become more expensive while sitting on cash becomes more attractive.

On the other hand, when interest rates are decreasing, consumers and businesses are more inclined to borrow (because banks ease lending requirements), boosting retail and capital spending, thus helping the economy to grow.

Yippee!



What does this have to do with the forex market?
Well, currencies rely on interest rates because these dictate the flow of global capital into and out of a country. They're what investors use to determine if they'll invest in a country or go elsewhere.

For instance, if you had your choice between a savings account offering 1% interest and another offering .25%, which would you choose?

Neither, you say?

Yea, we're inclined to go the same route – keep the money under the mattress, ya know what we mean? – but that's not an option.

Ha! You would pick the 1%, right?

We hope so… because 1 is bigger than 0.25. Currencies work the same way!

The higher a country's interest rate, the more likely its currency will strengthen. Currencies surrounded by lower interest rates are more likely to weaken over the longer term.

Pretty simple stuff.

The main point to be learned here is that domestic interest rates directly affect how global market players feel about a currency's value relative to another.

Interest Rate Expectations

Markets are ever-changing with the anticipation of different events and situations. Interest rates do the same thing – they change – but they definitely don't change as often.

Most forex traders don't spend their time focused on current interest rates because the market has already "priced" them into the currency price. What is more important is where interest rates are **EXPECTED** to go.

It's also important to know that interest rates tend to shift in line with monetary policy, or more specifically, with the end of monetary cycles.

If rates have been going lower and lower over a period a time, it's almost inevitable that the opposite will happen.

Rates will have to increase at some point.

And you can count on the speculators to try to figure out when that will happen and by how much.

The market will tell them; it's the nature of the beast. A shift in expectations is a signal that a shift in speculation will start, gaining more momentum as the interest rate change nears.

While interest rates change with the gradual shift of monetary policy, market sentiment can also change rather suddenly from just a single report.

This causes interest rates to change in a more drastic fashion or even in the opposite direction as originally anticipated.

So you better watch out!

Interest Rate Differentials

Pick a pair, any pair.

Many forex traders use a technique of comparing one currency's interest rate to another currency's interest rate as the starting point for deciding whether a currency may weaken or strengthen.

The difference between the two interest rates, known as the "interest rate differential," is the key value to keep an eye on. This spread can help you identify shifts in currencies that might not be obvious.

An interest rate differential that increases helps to reinforce the higher-yielding currency, while a narrowing differential is positive for the lower-yielding currency.

Instances where the interest rates of the two countries move in opposite directions often produce some of the market's largest swing.

An interest rate increase in one currency combined with the interest rate decrease of the other currency is a perfect equation for sharp swings!

Nominal vs. Real Interest Rates

When people talk about interest rates, they are either referring to the nominal interest rate or the real interest rate.

What's the difference?

The nominal interest rate doesn't always tell the entire story. The nominal interest rate is the rate of interest before adjustments for inflation.

real interest rate = nominal interest rate – expected inflation

The nominal rate is usually the stated or base rate that you see (e.g., the yield on a bond).
Markets, on the other hand, don't focus on this rate, but rather on the real interest rate.

If you had a bond that carried a nominal yield of 6%, but inflation was at an annual rate of 5%, the bond's real yield would be 1%.

Boohoo!

That's a huge difference so always remember to distinguish between the two.

How Monetary Policy Affects the Forex Market

As we mentioned earlier, national governments and their corresponding central banking authorities formulate monetary policy to achieve certain economic mandates or goals.

Central banks and monetary policy go hand-in-hand, so you can't talk about one without talking about the other.

While some of these mandates and goals are very similar between the world's central bank, each have their own unique set of goals brought on by their distinctive economies.

Ultimately, monetary policy boils down to promoting and maintaining price stability and economic growth.

To achieve their goals, central banks use monetary policy mainly to control the following:

- the interest rates tied to the cost of money,
- the rise in inflation,
- the money supply,
- reserve requirements over banks,
- and discount window lending to commercial banks

Types of Monetary Policy

Monetary policy can be referred to in a couple different ways. **Contractionary** or **restrictive monetary policy** takes place if it *reduces* the size of the money supply. It can also occur with the raising of interest rates.
The idea here is to slow economic growth with the high interest rates. Borrowing money becomes harder and more expensive, which reduces spending and investment by both consumers and businesses.

Expansionary monetary policy, on the other hand, *expands* or increases the money supply, or decreases the interest rate. The cost of borrowing money goes down in hopes that spending and investment will go up.

Accommodative monetary policy aims to create economic growth by lowering the interest rate, whereas tight monetary policy is set to reduce inflation or restrain economic growth by raising interest rates.

Finally, **neutral monetary policy** intends to neither create growth nor fight inflation.
The important thing to remember about inflation is that central banks usually have an inflation target in mind, say 2%.

They might not come out and say it specifically, but their monetary policies all operate and focus on reaching this comfort zone.

They know that some inflation is a good thing, but out-of-control inflation can remove the confidence people have in their economy, their job, and ultimately, their money.

By having target inflation levels, central banks help market participants better understand how they (the central bankers) will deal with the current economic landscape.

Let's take a look at an example.

Back in January of 2010, inflation in the U.K. shot up to 3.5% from 2.9% in just one month. With a target inflation rate of 2%, the new 3.5% rate was well above the Bank of England's comfort zone.

Mervyn King, the governor of the BOE, followed up the report by reassuring people that temporary factors caused the sudden jump, and that the current inflation rate would fall in the near term with minimal action from the BOE.
Whether or not his statements turned out to be true is not the point here. We just want to show that the market is in a better place when it knows why the central bank does or doesn't do something in relation to its target interest rate.

Simply put, traders like stability.

Central banks like stability.

Economies like stability. Knowing that inflation targets exist will help a trader to understand why a central bank does what it does.

Round and Round with Monetary Policy Cycles

For those of you that follow the U.S. dollar and economy (and that should be all of you!), remember a few years back when the Fed increased interest rates by 10% out of the blue?

It was the craziest thing to come out of the Fed ever, and the financial world was in an uproar!

Wait, you don't remember this happening?

It was all over the media.

Petroleum prices went through the roof and milk was priced like gold.

You must have been sleeping!

Oh wait, we were just pulling your leg!

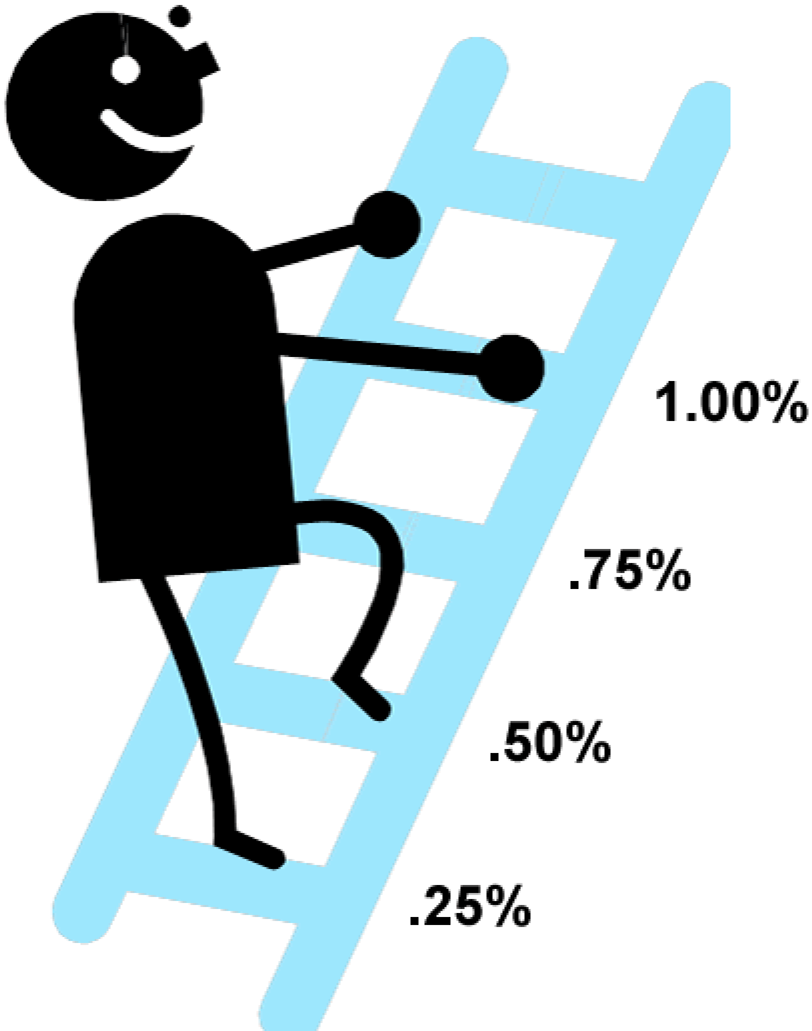
We just wanted to make sure you were still awake. Monetary policy would never dramatically change like that.

Most policy changes are made in small, incremental adjustments because the bigwigs at the central banks would have utter chaos on their hands if interest rates changed radically.

Just the idea of something like that happening would disrupt not only the individual trader, but the economy as a whole.

That's why we normally see interest rate changes of .25% to 1% at a time. Again, remember that central banks want price stability, not shock and awe.

Part of this stability comes with the amount of time needed to make these interest rate changes happen. It can take several months to even several years.



Just like forex traders who collect and study data to make their next move, central bankers do a similar job, but they have to focus their decision-making with the entire economy in mind, not just a single trade.

Interest rate hikes can be like stepping on the brakes while interest rate cuts can be like hitting the accelerator, but bear in mind that consumers and business react a little more slowly to these changes.

This lag time between the change in monetary policy and the actual effect on the economy can take one to two years.

Hawkish and Dovish Central Banks

We just learned that currency prices are affected a great deal by changes in a country's interest rates. We now know that interest rates are ultimately affected by a central bank's view on the economy and price stability, which influence monetary policy.

Central banks operate like most other businesses in that they have a leader, a president or a chairman. It's that individual's role to be the voice of that central bank, conveying to the market which direction monetary policy is headed. And much like when Jeff Bezos or Mark Zuckerberg steps to the microphone, everyone listens.

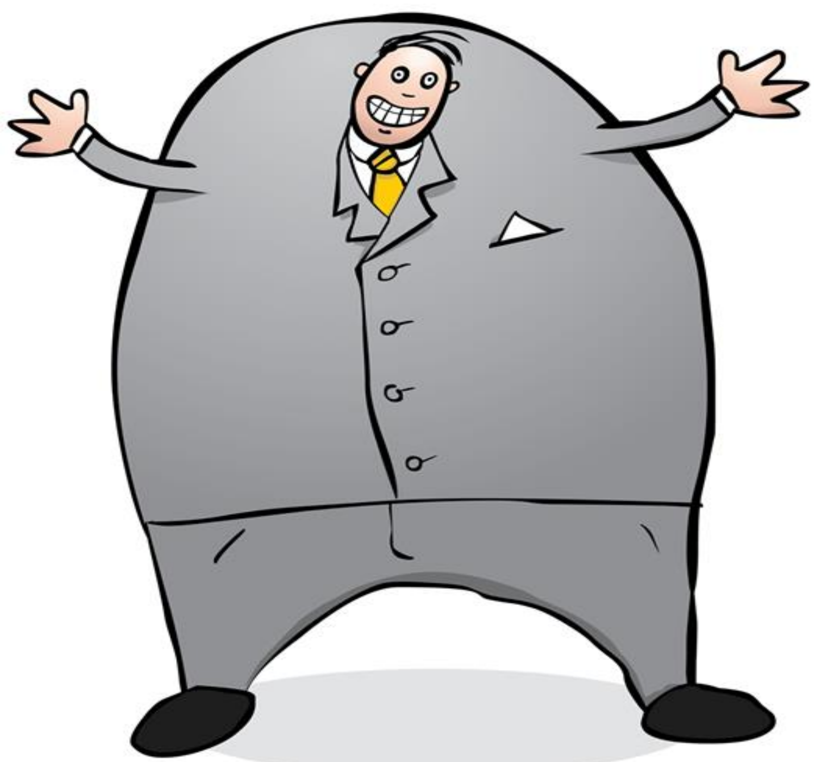
So by using the Pythagorean Theorem (where $a^2 + b^2 = c^2$), wouldn't it make sense to keep an eye on what those guys at the central banks are saying?

Using the Complex conjugate root theorem, the answer is yes!

Yes, it's important to know what's coming down the road regarding potential monetary policy changes. And lucky for you, central banks are getting better at communicating with the market.

Whether you actually understand what they're saying, well that's a different story.

So, the next time Janet Yellen or Mario Draghi are giving speeches, keep your ears open. Better yet, use the trusty BabyPips.com Economic Calendar to prepare yourself before the actual speech.



While the central bank chairman isn't the only one making monetary policy decisions for a country or economy, what he or she has to say is only not ignored, but revered like the gospel.

Okay, maybe that was a bit dramatic, but you get the point.

Not all central bank officials carry the same weight.

Central bank speeches have a way of inciting a market response, so watch for quick movement following an announcement.

Speeches can include anything from changes (increases, decreases or holds) to current interest rates, to discussions about economic growth measurements and outlook, to monetary policy announcements outlining current and future changes.

But don't despair if you can't tune in to the live event. As soon as the speech or announcement hits the airwaves, news agencies from all over make the information available to the public.

Forex analysts and traders alike take the news and try to dissect the overall tone and language of the announcement, taking special care to do this when interest rate changes or economic growth information are involved.

Much like how the market reacts to the release of other economic reports or indicators, forex traders react more to central bank activity and interest rate changes when they don't fall in line with current market expectation.

It's getting easier to foresee how a monetary policy will develop over time, due to an increasing transparency by central banks.

Yet there's always a possibility that central bankers will change their outlook in greater or lesser magnitude than expected. It's during these times that marketing volatility is high and care should be taken with existing and new trade positions.

Hawkish vs. Dovish Central Banks

Yes, you're in the right place.

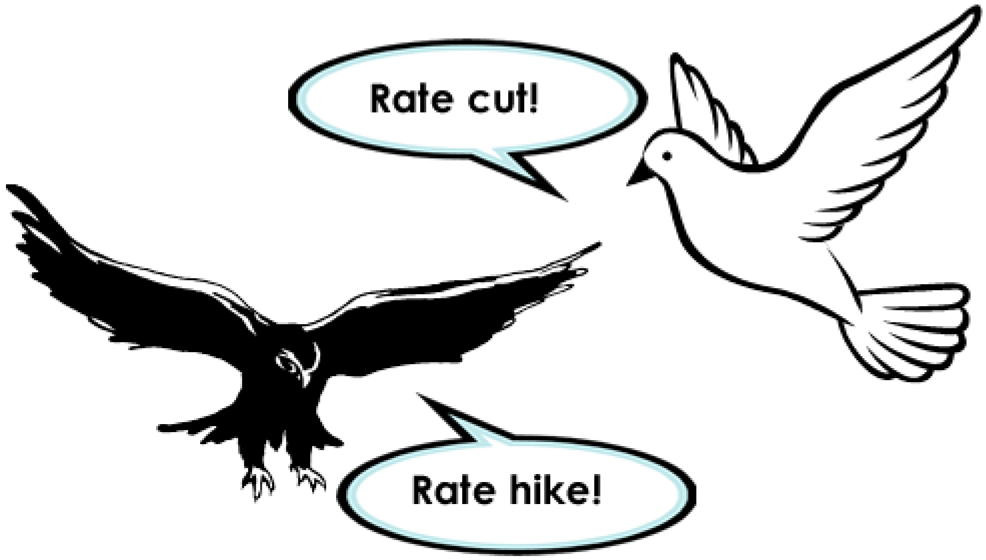
Tonight's match puts the L.A. Hawks up against the N.Y. Doves.

You're in for a treat. Wait, what?!

Whoops sorry, wrong subject.

We really just meant hawks versus doves, central bank hawks versus central bank doves that is. Central bankers can be viewed as either **hawkish** or **dovish**, depending on how they approach certain economic situations.
Central bankers are described as "hawkish" when they are in support of the raising of interest rates to fight inflation, even to the detriment of economic growth and employment.

For example, "The Bank of England suggests the existence of a threat of high inflation." The Bank of England could be described as being hawkish if they made an official statement leaning towards the increasing of interest rates to reduce high inflation.
Dovish central bankers, on the other hand, generally favor economic growth and employment over tightening interest rates. They also tend to have a more non-aggressive stance or viewpoint regarding a specific economic event or action.



And the winner is…. It's a tie!
Well, sort of.

You'll find many a banker "on the fence", exhibiting both hawkish and dovish tendencies. However, true colors tend to shine when extreme market conditions occur.

Fundamental Factors That Affect Currency Values

There are several fundamental factors that help shape the long term strength or weakness of the major currencies and will affect you as a forex trader. We've included what we think are the most important for your reading pleasure:

Economic Growth and Outlook

We start easy with the economy and outlook held by consumers, businesses and the governments. It's easy to understand that when consumers perceive a strong economy, they feel happy and safe, and they spend money. Companies willingly take this money and say, "Hey, we're making money! Wonderful! Now… uh, what do we do with all this money?"

Companies with money spend money. And all this creates some healthy tax revenue for the government. They jump on board and also start spending money. Now everybody is spending, and this tends to have a positive effect on the economy.

Weak economies, on the other hand, are usually accompanied by consumers who aren't spending, businesses who aren't making any money and aren't spending, so the government is the only one still spending. But you get the idea. Both positive and negative economic outlooks can have a direct effect on the currency markets.

Capital Flows

Globalization, technology advances and the internet have all contributed to the ease of investing your money virtually anywhere in the world, regardless of where you call home. You're only a few clicks of the mouse away (or a phone call for you folks living in the Jurassic era of the

2000's) from investing in the New York or London Stock exchange, trading the Nikkei or Hang Seng index, or from opening a forex account to trade U.S. dollars, euros, yen, and even exotic currencies.

Capital flows measure the amount of money flowing into and out of a country or economy because of capital investment purchasing and selling. The important thing you want to keep track of is capital flow balance, which can be positive or negative.

When a country has a positive capital flow balance, foreign investments coming into the country are greater than investments heading out of the country. A negative capital flow balance is the direct opposite. Investments leaving the country for some foreign destination are greater than investments coming in.

With more investment coming into a country, demand increases for that country's currency as foreign investors have to sell their currency in order to buy the local currency. This demand causes the currency to increase in value.

Simple supply and demand.

And you guessed it, if supply is high for a currency (or demand is weak), the currency tends to lose value. When foreign investments make an about-face, and domestic investors also wants to switch teams and leave, and then you have an abundance of the local currency as everybody is selling and buying the currency of whatever foreign country or economy they're investing in.

Foreign capital love nothing more than a country with high interest rates and strong economic growth. If a country also has a growing domestic financial market, even better! A booming stock market, high interest rates… What's not to love?! Foreign investment comes streaming in. And again, as demand for the local currency increases, so does its value.

Trade Flows & Trade Balance

We're living in a global marketplace. Countries sell their own goods to countries that want them (exporting), while at the same time buying goods they want from other countries (importing). Have a look around your house. Most of the stuff (electronics, clothing, doggie toys) lying around are probably made outside of the country you live in.

Every time you buy something, you have to give up some of your hard-earned cash.

Whoever you buy your widget from has to do the same thing.

U.S. importers exchange money with Chinese exporters when they buy goods. And Chinese imports exchange money with European exporters when they buy goods.

All this buying and selling is accompanied by the exchange of money, which in turn changes the flow of currency into and out of a country.

Trade balance (or balance of trade or net exports) measures the ratio of exports to imports for a given economy. It demonstrates the demand of that country's good and services, and ultimately it's currency as well. If exports are higher than imports, a trade surplus exists and the trade balance is positive. If imports are higher than exports, a trade deficit exists, and the trade balance is negative.
So:

Exports > Imports = Trade Surplus = Positive (+) Trade Balance

Imports > Exports = Trade Deficit = Negative (-) Trade Balance

Trade deficits have the prospect of pushing a currency price down compared to other currencies. Net importers first have to sell their currency in order to buy the currency of the foreign merchant who's selling the goods they want. When there's a trade deficit, the local currency is being sold to buy foreign goods. Because of that, the currency of a country with a trade deficit is less in demand compared to the currency of a country with a trade surplus.

Net exporters, countries that export more than they import, see their currency being bought more by countries interested in buying the exported goods. It is in more demand, helping their currency to gain value. It's all due to the demand of the currency. Currencies in higher demand tend to be valued higher than those in less demand.

It's similar to pop stars. Because she's more in demand, Taylor Swift gets paid more than Pink. Same thing with Justin Bieber versus Vanilla Ice.

The Government: Present and Future

The years 2009 and 2010 have definitely been the years where more eyes were glaringly watching their respective country's governments, wondering about the financial difficulties being faced, and hoping for some sort of fiscal responsibility that would end the woes felt in our wallets. Instability in the current government or changes to the current administration can have a direct bearing on that country's economy and even neighboring nations. And any impact to an economy will most likely affect exchange rates.

Where to Find Forex News and Market Data

A quick Yahoogleing (that's Yahoo, Google, plus Bing) search of "forex + news" or "forex + data" returns a measly 30 million results combined.

30 MILLION! That's right! No wonder you're here to get some education! There's just way too much information to try to process and way too many things to confuse any newbie forex trader. That's some insane information overload if we've ever seen it.

But information is king when it comes to making successful trades.

Currency price moves because of all of this information: economic reports, a new central bank chairperson, and interest rate changes.

News moves fundamentals and fundamentals move currency pairs!
It's your goal to make successful trades and that becomes a lot easier when you know why price is moving that way it is. Successful forex traders weren't born successful; they were taught or they learned.

Successful forex traders don't have mystical powers (well, except for Pipcrawler, but he's more weird than he is mystical) and they can't see the future.

What they can do is see through the blur that is forex news and data, pick what's important to traders at the moment, and make the right trading decisions.

Where to Find Forex News and Market Data

Market news and data are available through a multitude of sources.

The internet is the obvious winner in our book, as it provides a wealth of options, at the speed of light, directly to your screen, with access from almost anywhere in the world. But don't forget about print media and the good old tube sitting in your living room or kitchen.

Individual forex traders will be amazed at the sheer number of currency-specific websites, services, and TV programming available to them. Most of them are free of charge, while you may have to pay for some of the others. Let's go over our favorites to help you get started.

Traditional Financial News Sources
While there are tons of financial news resources out there, we advise you to stick with the big names.

These guys provide around-the-clock coverage of the markets, with daily updates on the big news that you need to be aware of, such as central bank announcements, economic report releases and analysis, etc. Many of these big players also have institutional contacts that provide explanations about the current events of the day to the viewing public.

- Reuters
- The Wall Street Journal
- Bloomberg
- MarketWatch.com

Real-time Feeds

If you're looking for more immediate access to the movements in the currency market, don't forget about that 80-inch flat screen TV in your bathroom!

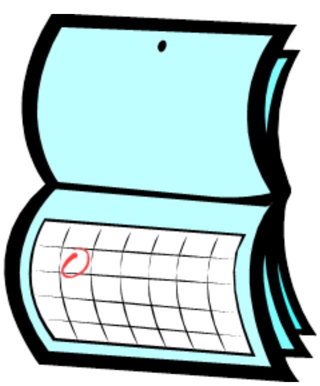
Financial TV networks exist 24 hours a day, seven days a week to provide you up-to-the-minute action on all of the world's financial markets.

In the U.S., the top dogs are (in random order), Bloomberg TV, Fox Business, CNBC, MSNBC, and even CNN. You could even throw a little BBC in there.

Another option for real-time data comes from your forex trading platform.

Many forex brokers include live newsfeeds directly in their software to give you easy and immediate access to events and news of the currency market. Check your broker for availability of such features not all brokers features are created equally.

Economic Calendars



Wouldn't it be great if you could look at the current month and know exactly when the Fed is making an interest rate announcement, what rate is forecasted, what rate actually occurs , and what type of impact this change has on the currency market? It's all possible with an economic calendar.

The good ones let you look at different months and years, let you sort by currency, and let you assign your local time zone. 3:00 pm where you're sitting isn't necessarily 3:00 pm where we're sitting, so make use of the time zone feature so that you're ready for the next calendar event!

Yes, economic events and data reports take place more frequently than most people can keep up with. This data has the potential to move markets in the short term and accelerate the movement of currency pairs you might be watching.

Lucky for you, most economic news that's important to forex traders is scheduled several months in advance.

So which calendar do we recommend?

We look no further than our very own BabyPips.com forex economic calendar to provide all that goodness!
If you don't like ours (which we highly doubt), a simple Yahoogleing search will offer up a nice collection for you to examine.

Market Information Tips

Keep in mind the timeliness of the reports you read. A lot of this stuff has already occurred and the market has already adjusted prices to take the report into account.

If the market has already made its move, you might have to adjust your thinking and current strategy. Keep tabs on just how old this news is or you'll find yourself "yesterday's news."

You also have to be able to determine whether the news you're dealing with is fact or fiction, rumor or opinion.

Economic data rumors do exist, and they can occur minutes to several hours before a scheduled release of data. The rumors help to produce some short-term trader action, and they can sometimes also have a lasting effect on market sentiment.

Institutional traders are also often rumored to be behind large moves, but it's hard to know the truth with a decentralized market like spot forex. There's never a simple way of verifying the truth.

Your job as a forex trader is to create a good trading plan and quickly react to such news about rumors, after they've been proven true or false. Having a well-rounded risk management plan in this case could save you some moolah!

And the final tip: **Know who is reporting the news.**

Are we talking analysts or economists, economist or the owner of the newest forex blog on the block? Maybe a central bank analyst?

The more reading and watching you do of forex news and media, the more finance and currency professionals you'll be exposed to.

Are they offering merely an opinion or a stated fact based on recently released data?

The more you know about the "Who", the better off you will be in understanding how accurate the news is. Those who report the news often have their own agenda and have their own strengths and weaknesses.

Get to know the people that "know", so YOU "know". Can you dig it?

Market Expectations to News and Their Impact on Currencies

There's no one "All in" or "Bet the Farm" formula for success when it comes to predicting how the market will react to data reports or market events or even why it reacts the way it does.

You can draw on the fact that there's usually an initial response, which is usually short-lived, but full of action.

Later on comes the second reaction, where forex traders have had some time to reflect on the implications of the news or report on the current market.

It's at this point when the market decides if the news release went along with or against the existing expectation, and if it reacted accordingly.

Was the outcome of the report expected or not? And what does the initial response of the market tell us about the bigger picture?

Answering those questions gives us place to start interpreting the ensuing price action.

Consensus Market Expectations

A consensus expectation, or just consensus, is the relative agreement on upcoming economic or news forecasts. Economic forecasts are made by various leading economists from banks, financial institutions and other securities related entities.

Your favorite news personality gets into the mix by surveying her in-house economist and collection of financial sound "players" in the market.

All the forecasts get pooled together and averaged out, and it's these averages that appear on charts and calendars designating the level of expectation for that report or event.

The consensus becomes ground zero; the incoming, or actual data is compared against this baseline number. Incoming data normally gets identified in the following manner:

- **"As expected"** – the reported data was close to or at the consensus forecast.
- **"Better-than-expected"**– the reported data was better than the consensus forecast.
- **"Worse-than-expected"** – the reported data was worse than the consensus forecast.

Whether or not incoming data meets consensus is an important evaluation for determining price action. Just as important is the determination of how much better or worse the actual data is to the consensus forecast. Larger degrees of inaccuracy increase the chance and extent to which the price may change once the report is out.

However, let's remember that forex traders are smart, and can be ahead of the curve. Well the good ones, anyway.

Many forex traders have already "priced in" consensus expectations into their trading and into the market well before the report is scheduled, let alone released.

As the name implies, pricing in refers to traders having a view on the outcome of an event and placing bets on it before the news comes out.

The more likely a report is to shift the price, the sooner traders will price in consensus expectations. How can you tell if this is the case with the current market?

Well, that's a tough one.

You can't always tell, so you have to take it upon yourself to stay on top of what the market commentary is saying and what price action is doing before a report gets released. This will give you an idea as to how much the market has priced in.

A lot can happen before a report is released, so keep your eyes and ears peeled. Market sentiment can improve or get worse just before a release, so be aware that price can react with or against the trend.
There is always the possibility that a data report totally misses expectations, so don't bet the farm away on the expectations of others. When the miss occurs, you'll be sure to see price movement occur.

Help yourself out for such an event by anticipating it (and other possible outcomes) to happen.

Play the "what if" game.

Ask yourself, "What if A happens? What if B happens? How will traders react or change their bets?"

You could even be more specific.

What if the report comes in under expectation by half a percent? How many pips down will price move? What would need to happen with this report that could cause a 40 pip drop? Anything?

Come up with your different scenarios and be prepared to react to the market's reaction. Being proactive in this manner will keep you ahead of the game.

What the Heck? They Revised the Data? Now what?

Too many questions… in that title.

But that's right, economic data can and will get revised.

That's just how economic reports roll!

Let's take the monthly Non-Farm Payroll employment numbers (NFP) as an example. As stated, this report comes out monthly, usually included with it are revisions of the previous month's numbers.
We'll assume that the U.S. economy is in a slump and January's NFP figure decreases by 50,000, which is the number of jobs lost. It's now February, and NFP is expected to decrease by another 35,000.

But the incoming NFP actually decreases by only 12,000, which is totally unexpected. Also, January's revised data, which appears in the February report, was revised upwards to show only a 20,000 decrease.

Non-Farm Payrolls			
	Actual	Forecast	Previous
January	-50,000	-30,000	-80,000
February	-12,000	-35,000	-20,000

Better than expected Feb NFP

Upward revision in Jan NFP

As a trader you have to be aware of situations like this when data is revised.
Not having known that January data was revised, you might have a negative reaction to an additional 12,000 jobs lost in February. That's still two months of decreases in employment, which ain't good.

However, taking into account the upwardly revised NFP figure for January and the better than expected February NFP reading, the market might see the start of a turning point.

The state of employment now looks totally different when you look at incoming data **AND** last month's revised data.
Be sure not only to determine if revised data exists, but also note the scale of the revision. Bigger revisions carry more weight when analyzing the current data releases.

Revisions can help to affirm a possibly trend change or no change at all, so be aware of what's been released.

What is a Currency Cross Pair?

Back in the ancient days, if someone wanted to change currencies, they would first have to convert their currencies into U.S. dollars, and only then could they convert their dollars into the currency they desired.

For example, if a person wanted to change their U.K. sterling into Japanese yen, they would first have to convert their sterling into U.S. dollars, and then convert these dollars into yen.

With the invention of currency crosses, individuals can now bypass the process of converting their currencies into US dollars and simply convert it directly into their desired currency. Some examples of crosses include: GBP/JPY, EUR/JPY, EUR/CHF, and EUR/GBP.

Calculating Currency Cross Rates

Warning: This part is a little boring…unless you like numbers. It's not difficult but it can be kind of dry. The good news is that this section really isn't necessary anymore since most broker platforms already calculate cross rates for you.

However, if you are the type that likes to know how everything works, then this section is for you! And besides, it's always good to know how things work right? In this section, we will show you how to calculate the bid (buying price) and ask (selling price) of a currency cross.

Let's say we want to find the bid/ask price for GBP/JPY. The first thing we would do is look at the bid/ask price for both GBP/USD and USD/JPY.

Why these 2 pairs?

Because both of them have the **U.S. dollar** as their common denominator.
These 2 pairs are called the "**legs**" of GBP/JPY because they are the U.S. dollar pairs associated with it.
Now let's say we find the following bid/ask prices:

GBP/USD: 1.5630 (bid) / 1.5635 (ask)

USD/JPY: 89.38 (bid) / 89.43 (ask)

To calculate the bid price for GBP/JPY, you simply multiply the bid prices for GBP/USD and USD/JPY.

If you got 139.70, good job! Your calculator is working properly, yipee!

To get the ask price for GBP/JPY, just multiply the ask prices for GBP/USD and USD/JPY and we get 139.82. Easy as pie!

Why Trade Currency Crosses?

Over 90% of the transactions in the forex market involve the U.S. dollar. This is because the U.S. dollar is the reserve currency in the world. You may be asking yourself, "Why the U.S. dollar and not the sterling, or euro?"

Most agricultural and industrial commodities such as oil are priced in U.S. dollars. If a country needs to purchase oil or other agricultural goods, it would first have to change its currency into U.S. dollars before being able to buy the goods. This is why many countries keep a reserve of U.S. dollars on hand. They can make purchases much faster with Greenbacks already in their pocket.

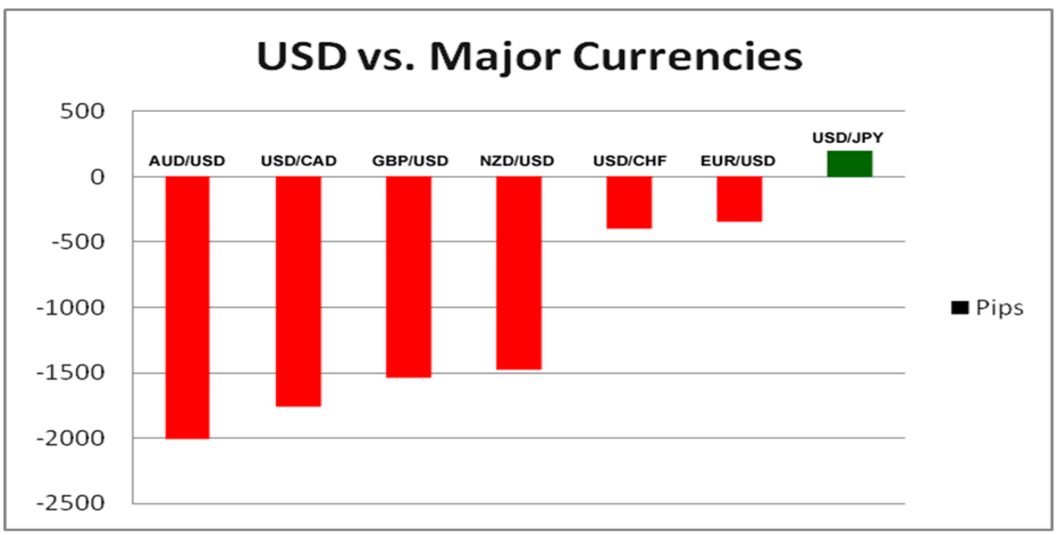
Countries such as China, Japan, and Australia are examples of heavy importers of oil, and as a result, they keep huge reserves of U.S. dollars in their central banks. In fact, China has almost a **trillion U.S. dollars** in its reserve stockpile!
So what does this all have to do with trading currency crosses? Well since most of the world is glued to the U.S. dollar, a majority of trading speculation will be based on one question:

"Is the U.S. dollar weak or strong today?"
This one question will affect many of the most liquid currency pairs:

The majors: GBP/USD, EUR/USD, USD/CHF, USD/JPY

The commodity pairs: AUD/USD, USD/CAD, NZD/USD

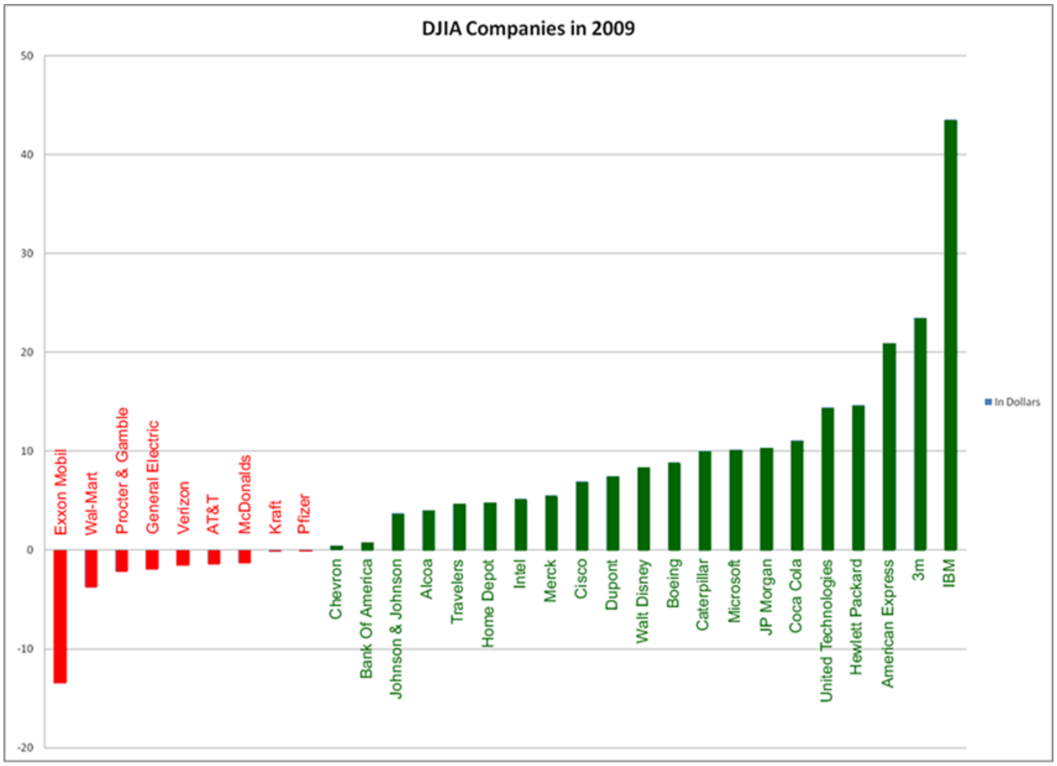
Notice that all of these pairs are tied to the U.S. dollar. This doesn't give a trader many options when most of their trading decisions are based on this one speculation.



In 2009, the Dollar was negative across the board.
Notice how the Dollar move was universal in almost every major currency pair.

You can see that by trading any of the 7 most popular currencies, you are basically taking either an anti-U.S. dollar or pro-U.S. dollar stance. This one speculation affects these pairs in almost the same way across the board.

Conversely in the stock market, traders have multiple companies to choose from and are not bound to one major speculation idea.



Although the DJIA was up over 1400 points in 2009, 9 of the 30 companies that make up the index were still negative

With stocks, you can see that even though the overall market was positive, there are still plenty of other trading opportunities. There isn't just one kind of speculation that affects the entire basket of stocks.

Currency Crosses Provide More Trading Opportunities

Instead of just looking at the seven "major" dollar-based pairs, currency crosses provide more currency pairs for you to find profitable opportunities!

By trading currency crosses, you give yourself more options for trading opportunities because these currencies are not bound to the U.S. dollar, thus possibly having different price movement behaviors. So while the majority of the markets will only trade on anti-U.S. dollar or pro-U.S. dollar sentiments, you can find new opportunities in currency crosses.

For example, all the dollar-based pairs might be trading sideways or in some uglier fashion where it would be smart to just sit on the sidelines and wait for better trade setups, but if you knew to switch your charts to look at currency crosses, you might just find trading opportunities galore!

Be different! The majority of traders just trade the majors. Now you can be part of the minority that trade currency crosses.

Currency Crosses Are Trend-y

Since a majority of the forex market will deal with the U.S. dollar, you can imagine that many of the news reports will cause U.S. dollar-based currency pairs to spike. The US has the largest economy in the world, and as a result, speculators react strongly to U.S. news reports, even if it doesn't cause a huge fundamental shift in the long run.

What this means for your charts is that you will see several “spikes” even if there is a trend emerging. This can make it harder to spot trend or range indications.

The day to day economic activities of the U.S. can keep U.S. dollar based currencies such as EUR/USD (above) from making smooth trends.

Conversely, we can see that during the same date range, cross currency EUR/JPY made a much, much smoother ride to the top. This was probably due to less spikes that came from U.S. data. So as you can see, both charts showed the euro rise during the same time period, but the one without the U.S. dollar (EUR/JPY) made for a much easier trade.

Our resident currency cross monster Cyclopip caught a hundred pips by riding EUR/JPY's trend. Check out how caught that move!
If you are a trend following kinda dude, then currency crosses may be easier to trade than the major pairs. It will be easier for you to spot the trend and be more confident in your entry points because you know that these technical levels hold more than they do for the majors.

In the next section, we'll discuss how playing with currency crosses can also allow you to take advantage of the interest rate differentials. Now that's like a cherry on top of a sundae!

Trade Interest Rate Differentials

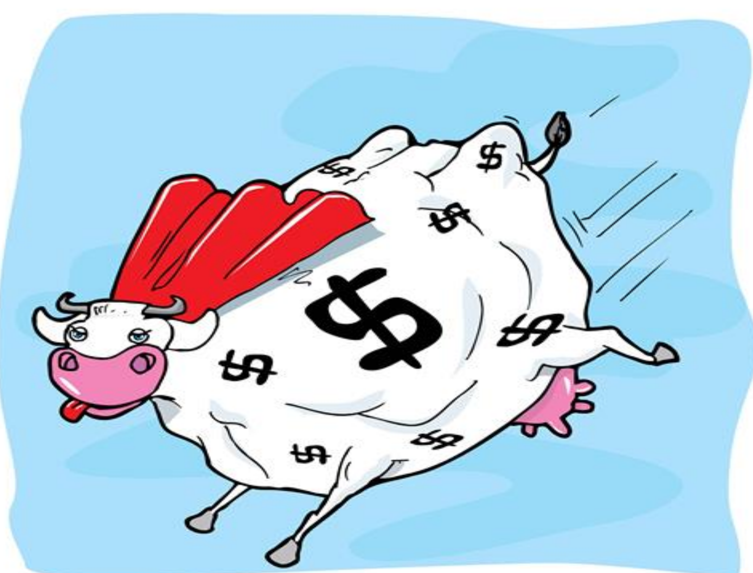
By selling currencies whose country has a lower interest rate against currencies whose country has a higher interest rate, you can profit from the **interest rate differential** (known as a carry trade) as well as price appreciation.
That's like being able to get a frosted cupcake with sprinkles on top! That talks to you! Imagine how delicious that would taste!

Currency crosses offer many pairs with high interest rate differentials that are prime for these types of trades.

For example, take a look at the nice uptrend on AUD/JPY. If you had a long position on this pair, you would've made a hefty profit.

On top of that, the interest rate differential between AUD and JPY was huge. From 2002 to 2007, the Reserve Bank of Australia had raised rates to 6.25% while the BOJ kept their rates at 0%.
That means you made profits off your long position AND the interest rate differential on that trade!

Now that'd be an awesome cash cow right there!



Later on in college (if your brain hasn't exploded with all this forex knowledge by then), we'll teach you more about carry trade. We'll teach you which ones will work and which ones won't. We'll even teach you about a lil' something called risk aversion. But that's for a later lesson.

Be Careful Trading Obscure Currency Crosses

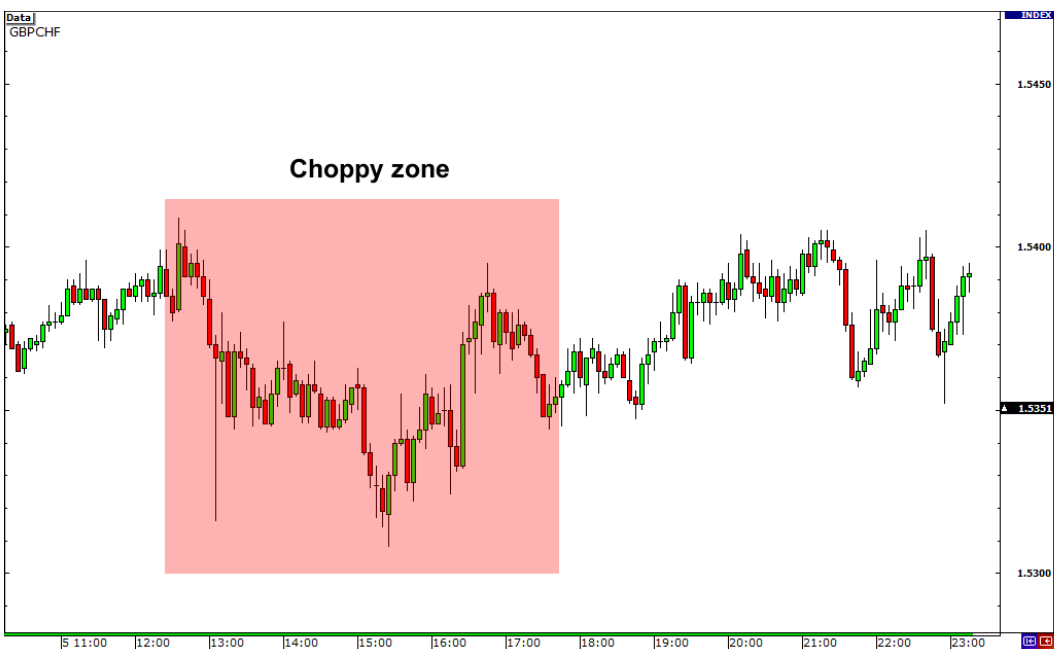
While the euro and yen crosses are the most liquid crosses, more currency crosses exist that don't even include the U.S. dollar, euro, or the yen! We'll call these the "Obscure Currency Crosses"!

If we were in school – come to think of it, we actually are in school! – the major pairs would be the jocks while the obscure currency crosses would be the eccentric emo kids or hipsters.

That's because most forex traders would rather hang out with the cool crowd than the obscure crosses!
We're talking about really weird combinations like **AUD/CHF**, **AUD/NZD**, **CAD/CHF**, and **GBP/CHF**. That's why we call them obscure crosses (duh!).
Trading in these pairs can be more difficult and riskier than trading euro or yen currency crosses. Since very few forex traders trade them, transaction volume is much lower resulting in lower **liquidity**.
Due to the illiquid markets for these crosses, their prices can become quite **volatile**, so being stopped out on **whipsaws** can become a common occurrence.
Check out these screenshots of AUD/CHF and GBP/CHF:

You don't want to get stopped out by those nasty spikes, do you? That's why most forex traders usually put wider stops when trading these pairs.

But judging from the choppy movement of obscure crosses, it would really be tough to catch a good trade on these pairs.



See what we mean?

Also, since these currency cross pairs aren't traded too much by forex traders, the spreads on these pairs can be pretty big.

If you want to trade these currency crosses, just be ready for some wild price swings and be willing to pay the price of the massive spread!

How to Trade Fundamentals With Currency Crosses

If strong economic data comes out of Australia, you might want to look at buying the AUD. Your first reaction might be to buy **AUD/USD**.
But what if at the same time, recent data also show the United States experiencing strong economic growth? Price action of AUD/USD may be flat.

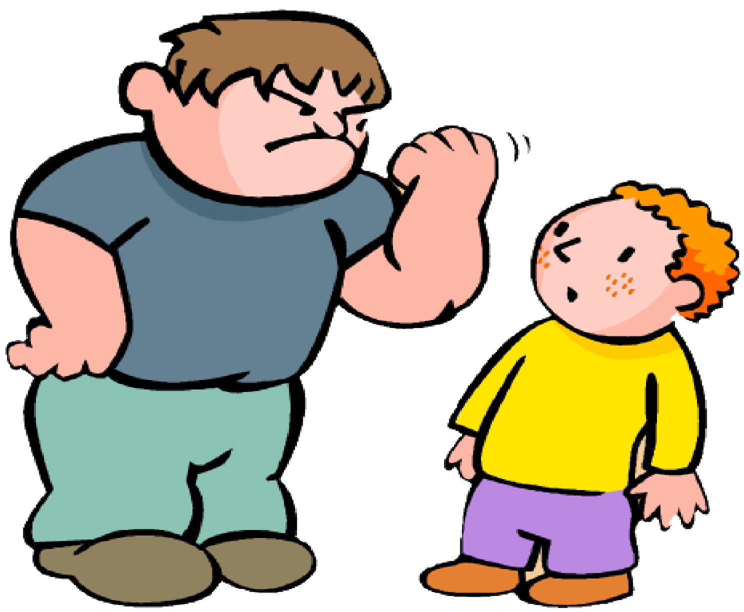
One option that you have is to match the AUD against the currency of an economy that isn't doing so well…. Hmmmm… what could you do?

Ah! Thank the forex gods for currency crosses!

Let's say you did some analysis, checked the economic calendar and you notice that the Japanese economy isn't doing so good right now.

What do you do?

Of course, like any self-respecting bully, you jump all over this opportunity and go long **AUD/JPY**!



There's nothing wrong with being a bully, at least not here at the School of Pipsology.
It's your job as a forex trader to take advantage of certain opportunities so that you can put some silver dollars into your piggy bank.

Because of currency crosses, you now have the opportunity to match the currency of the best performing economy against that of the weakest economy without having to deal with the U.S. dollar.

How to Trade a Synthetic Currency Pair and Why You Probably Shouldn't

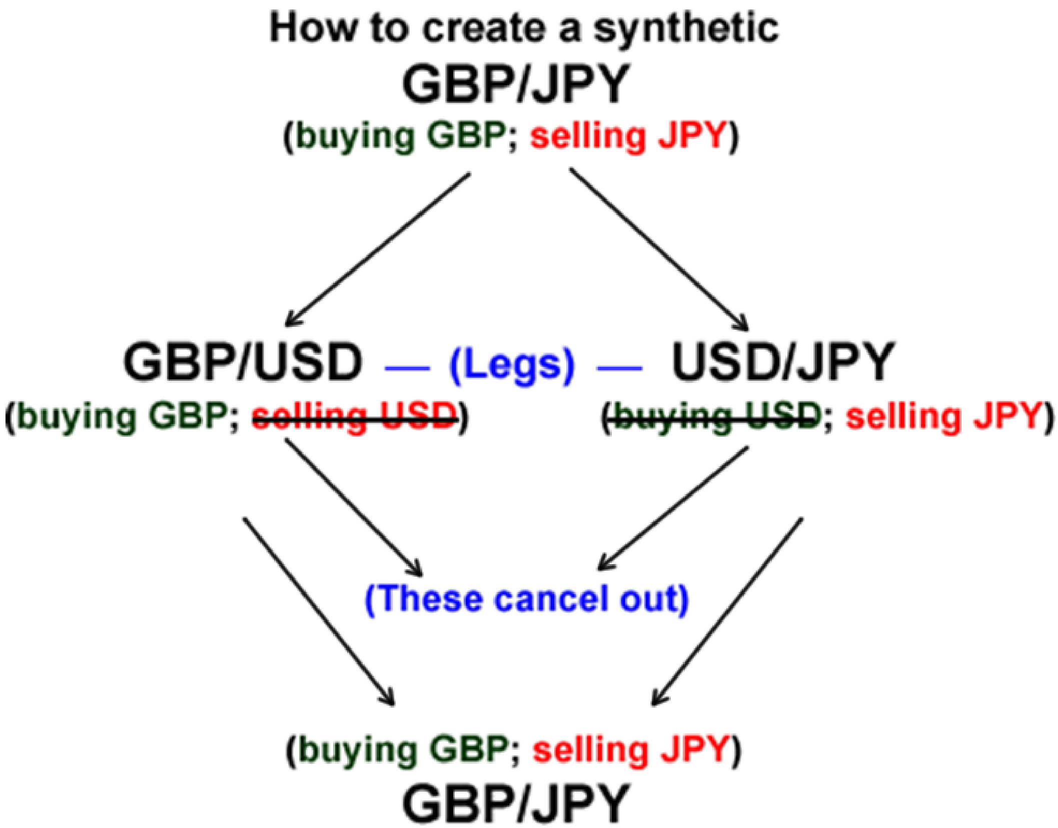
Sometimes institutional forex traders can't trade certain currency crosses because they trade in such high volume that there isn't enough liquidity to execute their order.

In order to execute their desired trade, they have to create a "**synthetic pair**".

How to Create a Synthetic Currency Pair

Let's say that an institutional forex trader wants to buy GBP/JPY but can't because there isn't enough liquidity. To execute this trade, they would have to buy both GBP/USD and USD/JPY (earlier in this lesson, we learned that these pairs are called its legs).

They are able to do this because there is plenty of liquidity in GBP/USD and USD/JPY which means they can make large orders.



If you're a retail forex trader, and you wanted to pretend to trade like an institutional trader, then you could technically trade synthetic currency pairs as well. But it wouldn't be too smart.

Ever since the great Al Gore "invented the internet," technology has improved to the point now that even weird currency crosses like GBP/NZD or CHF/JPY can now be traded on your forex broker's platform. Aside from having access to a larger "menu" of currency pairs to trade, the spreads would be tighter on the crosses compared to the synthetic pair you'd create.

And let's not forgot about margin use! Creating a synthetic currency pair requires you to open two separate positions and each position requires its own margin. This locks up unnecessary capital in your trading account when you can simply trade the cross-currency and save on margin.

So unless you're trading yards (forex slang term for one BILLION units), forget synthetic currency pairs and stick to currency crosses. You will be savings yourself some pips (thanks to a tighter spread) as well as freeing up your capital so you can take on more trades.

Trading the Euro and Yen Crosses

After the U.S. dollar, the euro and yen are the most traded currencies. And like the U.S. dollar, the euro and yen are also held as reserve currencies by different countries. So this makes the euro and yen crosses the most liquid outside of the U.S. dollar-based "majors."

Trading the Euro Crosses

The most popular EUR crosses are **EUR/JPY**, **EUR/GBP**, and **EUR/CHF**.
News that affects the euro or Swiss franc will be felt more in EUR crosses than EUR/USD or USD/CHF.

U.K. news will greatly affect EUR/GBP.
Oddly enough, U.S. news plays a part in the movement of the EUR crosses. U.S. news makes strong moves in GBP/USD and USD/CHF. This not only affects the price of the GBP and CHF against the USD, but it could also affect the GBP and CHF against the EUR.
A big move higher in the USD will tend to see a higher EUR/CHF and EUR/GBP and the same goes for the opposite direction.

Confused? Ok ok…let's break this down.

Let's say that the U.S. shows positive economic data causing the USD to rise. This means that GBP/USD would fall, driving the price of the GBP down. At the same time USD/CHF would rise, also driving the price of the CHF down.

The drop in GBP price would then cause EUR/GBP to rise (since traders are selling off their GBP).

The drop in CHF price would also cause EUR/CHF to rise (since traders are selling off their CHF).

Conversely, this would also work in the opposite direction if the U.S. showed negative economic data.

Trading the Yen Crosses

The JPY is one of the more popular cross currencies and it is basically traded against all of the other major currencies.

EUR/JPY has the highest volume of the JPY crosses according to the latest Triennial Central Bank Survey from the Bank for International Settlements.
GBP/JPY, **AUD/JPY**, and **NZD/JPY** are attractive carry trade currencies because they offer the highest interest rate differentials against the JPY.
When trading JPY currency cross pairs, you should always keep an eye out on the USD/JPY. When key levels are broken or resisted on this pair, it tends to spill over into the JPY cross pairs.

For example, if USD/JPY breaks out above a key resistance area, it means that traders are selling off their JPY. This could prompt the selling of the JPY against other currencies. Therefore you could expect to see EUR/JPY, GBP/JPY, and other JPY crosses to rise as well.

The CAD/JPY

Over recent years, this currency cross has become very popular, becoming highly correlated with the price of oil.

Canada is second largest owner of oil reserves and has benefited with the rise of oil prices.
On the other hand, Japan is heavily reliant on the importing of oil. In fact, over **99%** of Japan's crude oil is imported as it has almost no native oil reserves.
These two factors have caused an 87% positive correlation between the price of oil and CAD/JPY.

How to Use Currency Crosses to Trade the Majors

Even if you don't ever want to trade the currency crosses and simply stick to trading the majors, you can use crosses to help you make better forex trading decisions.

Here's an example…

Currency crosses can provide clues about the *relative* strength of each major currency pair.
Let's say you see a buy signal for EUR/USD and GBP/USD but you can only take one trade.

Which one do you take?

Simply looking at your crystal ball and guessing isn't likely to result in the right answer.

To find the right answer, you would look at EUR/GBP cross.
If EUR/GBP is trending downward, this indicates that the pound is relatively stronger than the euro at the moment.

So the right answer would be to buy GBP/USD instead of EUR/USD due to the pound's relative strength against the euro.

Since the euro is weaker, relative to the pound, if it proves to strengthen against the U.S. dollar, it is likely to strengthen LESS than the pound.

If the U.S. dollar weakens across the board, GBP/USD you would make more pips since it would rally higher than EUR/USD.

So GBP/USD is the better trade.

You can do this relative strength analysis on any of the major currency pairs.

Know Which Currency Cross to Use

Let's say you're bearish on the U.S. dollar. How will you trade?

- Can't decide whether to buy EUR/USD or sell USD/CHF? Look at **EUR/CHF**.
- Can't decide whether to buy USD/CHF or USD/JPY? Look at **CHF/JPY**.
- Can't decide whether to buy EUR/USD or sell USD/JPY? Look at **EUR/JPY**.
- Can't decide whether to buy GBP/USD or sell USD/CHF? **Look at GBP/CHF**.
- Can't decide whether to buy GBP/USD or sell USD/JPY? **Look at GBP/JPY**.

So always remember, looking at currency cross pairs could give you an idea of the relative strength of a particular currency.

How Cross Currency Pairs Affect Dollar Pairs

Let's pretend the Fed announces they will raise interest rates. The market quickly starts buying the U.S. dollar across all major currencies….EUR/USD and GBP/USD fall while USD/CHF and USD/JPY rise.

You were short EUR/USD and were pleased to see price move in your favor making you some pips, but right before you were about to break out the cigar, you notice your friend who was long USD/JPY made a lot more pips than you.

You're like "What's up with that yo?"

You compare the charts of EUR/USD and USD/JPY and see that USD/JPY made the bigger move. It broke through a major technical resistance level and shot up 200 pips while EUR/USD barely shot down 100 pips and failed to break a major support level.

You're thinking to yourself, "If the U.S. dollar was being bought across the board, then how come my EUR/USD trade looks so weak compared to my friend's USD/JPY trade?"

This is due to the currency crosses! In this particular example, **EUR/JPY**.
When USD/JPY broke through its major resistance level, the combination of stop losses being hit and breakout traders jumping on the bandwagon pushed it even higher.

Since buying more USD/JPY weakens the yen, this would cause EUR/JPY (and possibly other yen-based pairs) to break through its major resistance level, once again hitting stops and attracting breakout traders, pushing EUR/JPY even higher.

This causes the euro to strengthen and slows down the descent of your EUR/USD trade. The EUR/JPY cross buying acts a “parachute” and this is why EUR/USD didn’t move as much or as fast as the USD/JPY.

So even if you only trade the major currencies, cross currency pairs still have an effect on your trades!

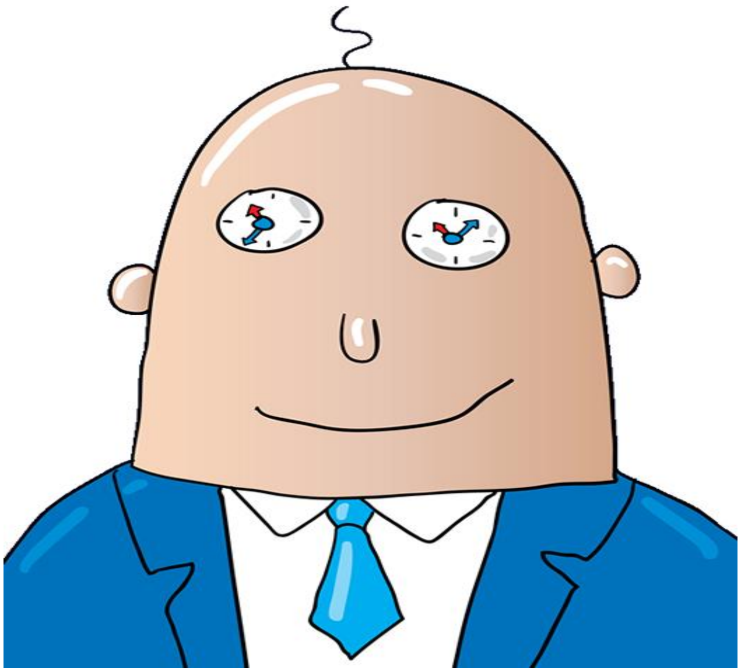
Summary: Currency Crosses

As you can see, there are many, many trade opportunities presenting themselves in the forex market other than figuring out what the Greenback will do any given day – and now you know how to find them! Here are a couple of things to remember:

- Crosses give forex traders more pairs to trade, which means more trading opportunities.
- We normally see cleaner trends and ranges on currency crosses than we do on majors.
- You can take advantage of interest rate differentials by trading currency crosses.
- Do your due diligence and analysis and match the strong currencies against the weak ones.
- If the pair you are looking to trade isn’t available with your broker, don’t worry. You know how to create a synthetic pair by simultaneously going long or short two major pairs to create one currency cross.
- The most popular euro crosses are the EUR/JPY, EUR/GBP, and EUR/CHF.
- GBP/JPY, AUD/JPY, and NZD/JPY are attractive carry trade currencies because they offer the highest interest rate differentials against the JPY.
- When trading obscure currency crosses, watch out for wild price swings and wider spreads.
- Even if you wanna stick to the majors, you can make use of currency crosses to help you decide between which pairs to trade as crosses can signal which currency is stronger.
- Don’t forget that moves in currency cross pairs can have an effect on the majors.
- Last tip; please be conscientious of the pip value of the cross you are trading. Some crosses will have a higher or lower pip value than the majors. This information is good to know for your risk analysis.

- So, on the days you may not see any opportunities in the major pairs, or if you want to avoid the volatility of a US news event, check out some the currency crosses. You may never know what you may find!

Trading Multiple Time Frames In Forex



What the heck is multiple time frame analysis?

Multi-time frame ana… WHAT?! Chill out young padawan, it ain't as complicated as it sounds! You're almost done with high school – now's not the time to get senioritis, although you probably got that way back in Grade 12. Ha!

Multiple time frame analysis is simply the process of looking at the same pair and the same price, *but on different time frames*.
Remember, a pair exists on several time frames – the **daily**, the **hourly**, the **15-minute**, heck, even the **1-minute**!
This means that different forex traders can have their different opinions on how a pair is trading and both can be completely correct.

John may see that EUR/USD is on a downtrend on the 4-hour chart. However, Jane trades on the 5-minute chart and sees that the pair just ranging up and down. And they could both be correct!

As you can see, this poses a problem. Trades sometimes get confused when they look at the 4-hour, see that a sell signal, then they hop on the 1-hour and see price slowly moving up.

What are you supposed to do?

Stick with one time frame, take the signal and completely ignore the other time frame?

Flip a coin to decide whether you should buy or sell?

Luckily for you, we here at BabyPips.com aren't about to let you graduate without knowing how to use multiple time frame analysis to your advantage.

First, we'll try to help you determine which time frame you should focus on. Each forex trader should trade a specific time frame that fits his or her own personality (more on this later).

Secondly, we'll also teach you how to look at different time frames of the same currency pair to help you make better, more educated trading decisions.

What Time Frame Should I Trade?

One of the reasons newbie forex traders don't do as well as they should is because they're usually trading the wrong time frame for their personality.

New forex traders will want to get rich quick so they'll start trading small time frames like the 1-minute or 5-minute charts. Then they end up getting frustrated when they trade because the time frame doesn't fit their personality.

For some forex traders, they feel most comfortable trading the 1-hour charts.
This time frame is longer, but not too long, and trade signals are fewer, but not too few. Trading on this time frame helps give more time to analyze the market and not feel so rushed.

On the other hand, we have a friend who could never, ever, trade in a 1-hour time frame.
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 forex traders trade on a 1-hour chart because he thinks it's too fast! He trades only daily, weekly, and monthly charts.

Okay, so you're probably asking what the right time frame is for you.

Well buddy, if you had been paying attention, it depends on your personality. You have to feel comfortable with the time frame 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. That's natural.

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 time frame.

We started with the 15-minute chart.

Then the 5-minute chart.

Then we tried the 1-hour chart, the daily chart, and the 4-hour chart.

This is natural for all new forex traders until you find your comfort zone and why we suggest that you **DEMO** trade using different time frames to see which fits your personality the best.

What Time Frame Is Best for Trading?

Well, just like everything in life, it all depends on YOU.

Time Frame	Description	Advantages	Disadvantages

Do you like to take things slowly, take your time on each trade? Maybe you're suited for trading longer time frames.

Or perhaps you like the excitement, quick, fast paced action? Perhaps you should take look at the 5-min charts.

In the table below, we've highlighted some of the basic time frames and the differences between each.

Time Frame	Desciption	Advantage	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 the markets intradayFewer transactions mean less times to pay the spreadMore time to think through each trade	Large swingsUsually 1 or 2 two goods a year so PATIENCE is required.Bigger account needed to ride longer term swings Frequent losing months
Short-term (Swing)	Short-term traders use hourly time frames and hold trades for several hours to a week.	More opportunities for tradesLess chance of losing monthsLess 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 15-minute. Trades are held intraday and exited by market close.	Lots of trading opportunitiesLess chance of losing monthsNo overnight risk	Transaction costs will be much higher (more spreads to pay)Mentally more difficult due to the need to change biases frequentlyProfits are limited by needing to exit at the end of the day.

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You also have to consider the amount of capital you have to trade.

Shorter time frames allow you to make better use of margin and have tighter stop losses.

Larger time frames require bigger stops, thus a bigger account, so you can handle the market swings without facing a margin call.

The most important thing to remember is that whatever time frame you choose to trade, it should naturally fit your personality.

If you feel a little uptight like your undies are loose or your pants are little too short, then maybe it’s just not the right fit.

This is why we suggest demo trading on several time frames for a while to find your comfort zone. This will help you determine the best fit for you to make the best trading decisions you can.

When you finally decide on your preferred time frame, that’s when the fun begins. This is when you start looking at multiple time frames to help you analyze the market.

Why You Should Look at Multiple Time Frames When Trading Forex

Before we explain how to do multiple time frame analysis for your forex trading, we feel that it's necessary to point out why you should actually flip through the different time frames.

After all, isn't it hard enough analyzing just one chart as a forex trader?

You've got a billion indicators on, you've gotta read up on economic news, you've got basketball practice, a Call of Duty session, a hot date at McDonald's…

Well, let's play a game called "Long or Short" to show why you should be paying attention and putting in the extra effort to look at different time frames.

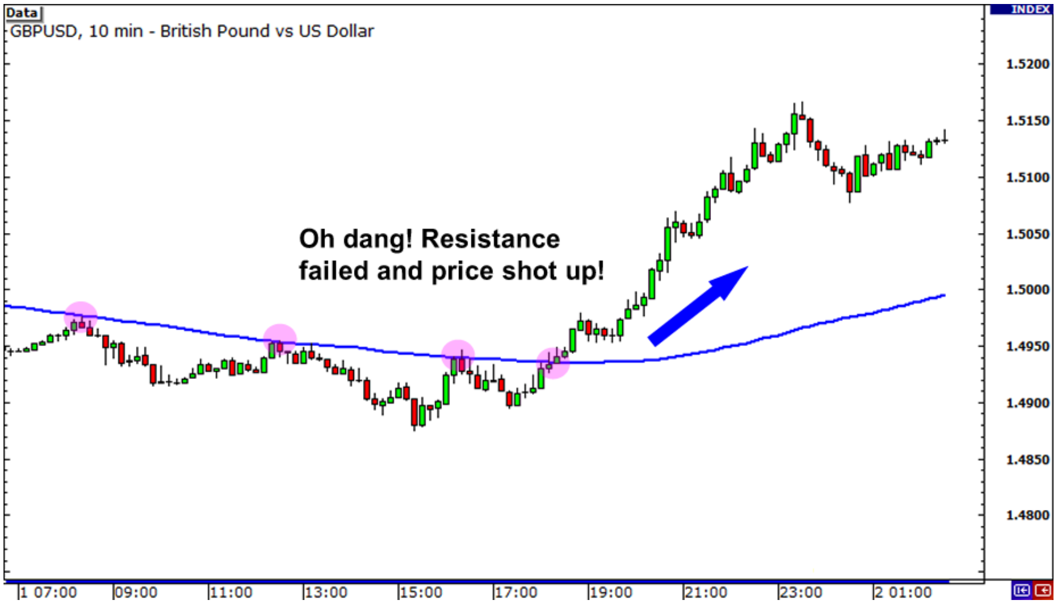
The rules of the game are easy. You look at a chart and you decide whether to go long or short. Easy, right? Okay, ready?

Let's take a look at the 10 minute chart of GBP/USD on July 1, 2010 (7/01/2010) at 8:00 am GMT. We've got the 200 simple moving average on, which appears to be holding as resistance.
With price testing the resistance and forming a doji, it seems like a good time to short right?
We'll take that as a yes.

But dang, look what happens next!

The pair closed above resistance and rose another 200 pips!

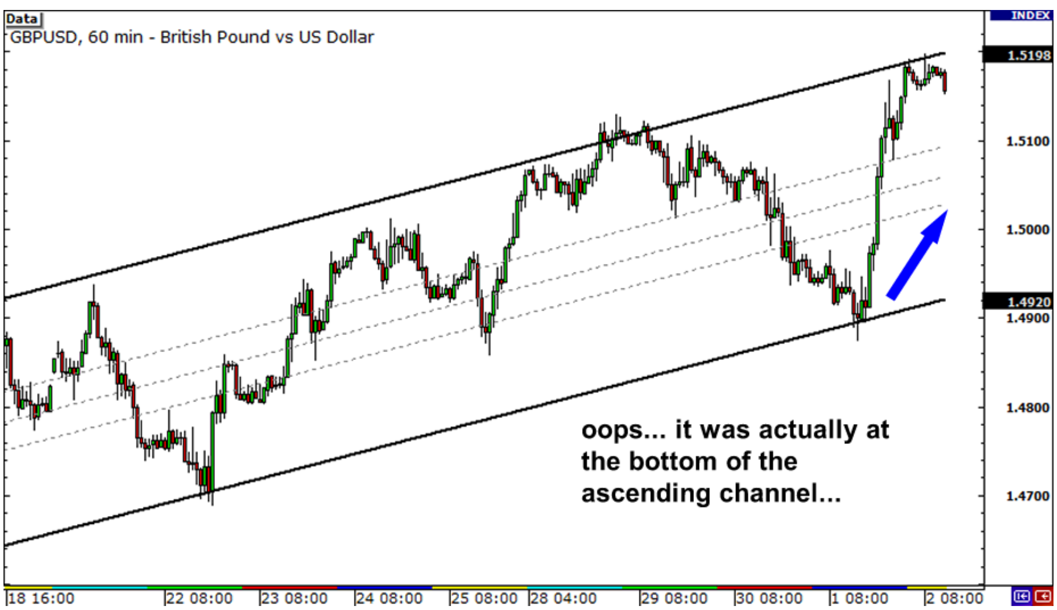
Ouch! Oh well, too bad!



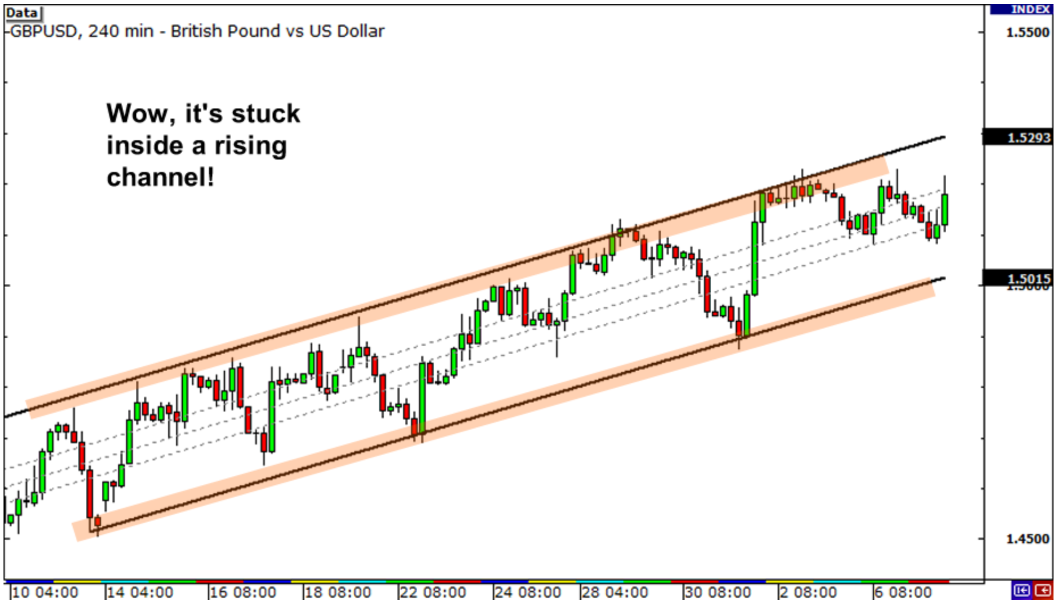
What the hell happened? Hmm, let's hop on to the 1-hour chart to see what happened…

If you had been looking at the one hour chart, you would have noticed that the pair was actually at the bottom of the ascending channel.

What's more, a doji had formed right smack on the support line! A clear buy signal!



The ascending channel would have been even clearer on the 4-hour chart.



If you had looked at this chart first, would you still have been so quick to go short when you were trading on the 10-minute chart?

All of the charts were showing the same price data. They were just different time frames of that same data.

Check out another example of multiple time frame analysis in our forums.
Do you see now the importance of looking at multiple time frames?

We used to just trade off the 15-minute charts and that was it.

We could never understand why when everything looked good the market would suddenly stall or reverse. It never crossed our minds to take a look at a larger time frame to see what was happening.

When the market did stall or reverse on the 15-minute chart, it was often because it had hit support or resistance on a larger time frame.

It took a couple hundred negative pips to learn that the larger the time frame, the more likely an important support or resistance levels would hold.

Trading using multiple time frames has probably kept us out of more losing trades than any other one thing alone. It will allow you to stay in a trade longer because you're able to identify where you are relative to the **big picture**.
Most beginners look at only one time frame. They grab a single time frame, apply their indicators and ignore other time frames.

The problem is that a new trend, coming from another time frame, often hurts forex traders who don't look at the big picture.

How to Do Multiple Time Frame Analysis to Find Better Entry and Exit Points

No, we aren't about to break out into song like the Glee cast.

Here at BabyPips.com, we've got our version of a mash-up, which we like to call the "Time Frame Mash-up".

This is where multiple time frame analysis comes in to play.

This is where we'll teach you how to not only lock in on your preferred trading time frame, but zoom in and out of charts so that you can knock a winner out of the park.

You ready? You sure you can hack this? You've basically got a semester left of BabyPips.com High School of Pipsology?

You don't wanna quit now do you?

Didn't think so!

First of all, take a broad look at what's happening.

Don't try to get your face closer to the market, but push yourself further away.

You have to remember, a trend on a longer time frame has had more time to develop, which means that it will take a bigger market move for the pair to change course. Also, support and resistance levels are more significant on longer time frames.

Start off by selecting your preferred time frame and then go up to the next higher time frame.

There you can make a strategic decision to go long or short based on whether the market is **ranging or trending**. You would then return to your preferred time frame (or even lower!) to make tactical decisions about **where to enter and exit** (place stop and profit target).

Just so you know, this is probably one of the best uses of multiple time frame analysis – you can zoom in to help you find better entry and exit points. By adding the dimension of time to your analysis, you can obtain an edge over the other tunnel vision traders who trade off on only one time frame.

Did you get all of that? Well, if you didn't, no worries – we're gonna go through an example now to help make things a little clearer.

How to Perform Multiple Time Frame Analysis

Let's say that Cinderella, who gets bored all day cleaning up after her evil step sisters, decides that she wants to trade forex.

After some demo trading, she realizes that she likes trading the EUR/USD pair the most, and feels most comfortable looking at the 1-hour chart. She thinks that the 15-minute charts are too fast while the 4-hour take too long – after all, she needs her beauty sleep.

The first thing that Cinderella does is move up to check out the 4-hour chart of EUR/USD. This will help her determine the overall trend.

She sees that the pair is clearly in an uptrend.

This signals to Cinderella that she should ONLY be looking for BUY signals. After all, the trend is her friend, right? She doesn't want to get caught in the wrong direction and lose her slipper.

Now, she zooms back to her preferred time frame, the 1-hour, to help her spot an entry point. She also decides to pop on the stochastic indicator.

Once she goes back down to the 1-hour chart, Cinderella sees that a doji candlestick has formed and the stochastic has just crossed over out of oversold conditions!

But Cinderella still isn't quite sure – she wants to make sure she has a really good entry point, so she scales down to the 15-minute chart to help her find an even better entry and to give her more confirmation.

So now Cinderella is locking her eyes in on the 15-minute chart, and she sees that the trend line seems to be holding pretty strongly. Not only that, but stochastic are showing oversold conditions on the 15-minute time frame as well!

She figures that this could be a good time to enter and buy. Let's see what happens next.

As it turns out, the uptrend continues, and EUR/USD continues to rise up the charts.

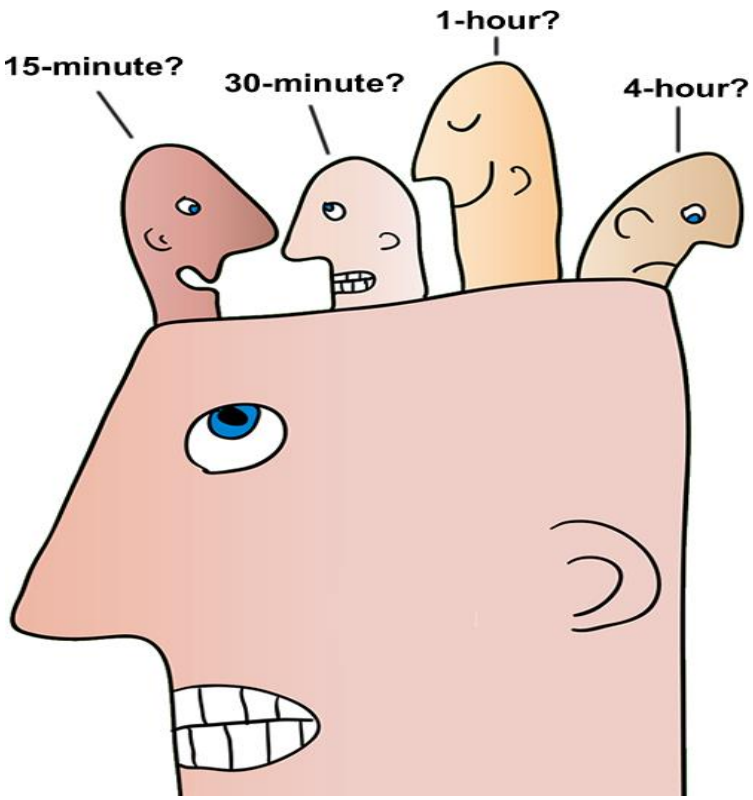
Cinderella would have entered just above 1.2800 and if she had kept the trade open for a couple of weeks, she would have made 400 pips! She could have bought another pair of glass slippers!

There is obviously a limit to how many time frames you can study. You don't want a screen full of charts telling you different things.

Use at least two, but not more than three time frames because adding more will just confuse the geewillikers out of you and you'll suffer from analysis paralysis, then proceed to go crazy.

Is there a wrong way to do multiple time frame analysis, you ask? Some of our forex friends have been nice enough to give their two cents on this matter through this on multiple time frame analysis. At the end of the day, it really is all about finding what works best for you

Trading With Three Time Frames



Here at the BabyPips.com School of Pipsology, we like using three time frames. We feel that this gives us the most flexibility, as we can decipher the long, medium and short term trends.

The largest time frame we consider our **main trend** – this shows us the big picture of the pair we wanna trade.
The next time frame down is what we normally look at, and it signals to us the medium term buy or selling **bias**.
The smallest time frame shows the short term trend and helps us find really good **entry and exit points**.

You can use any time frame you like as long as there is enough time difference between them to see a difference in their movement.

You might use:

- 1-minute, 5-minute, and 30-minute
- 5-minute, 30-minute, and 4-hour
- 15-minute, 1-hour, and 4-hour
- 1-hour, 4-hour, and daily
- 4-hour, daily, and weekly and so on.

When you're trying to decide how much time in between charts, just make sure there is enough difference for the smaller time frame to move back and forth without every move reflecting in the larger time frame.

If the time frames are too close, you won't be able to tell the difference, which would be pretty useless.

Summary: Multiple Time Frame Analysis

So now you're done! Now you can add multiple time frame analysis to your forex trading tool box! Here are a few tips you should remember:

- You have to decide what the correct time frame is for YOU. This comes from trying different time frames out through different market environments, recording your results, and analyzing those results to find what works for you.
- Once you've found your preferred time frame, go up to the next higher time frame. Then make a strategic decision to go long or short based on the direction of the trend. Then return to your preferred time frame (or lower) to make tactical decisions about where to enter and exit (place stop and profit target).
- Adding the dimension of time to your analysis gives you an edge over the other tunnel vision forex traders who only trade off on only one time frame.
- Make it a habit to look at multiple time frames when trading.
- Make sure you practice! You don't wanna get caught up in the heat of trading not knowing where the time frame button is! Make sure you know how to shift quickly between them. Heck, you should even practice having chart containing multiple time frames up at the same time!
- Choose a set of time frames that you are going to watch, and only concentrate on those time frames. Learn all you can about how the market works during those time frames.
- Don't look at too many time frames, you'll be overloaded with too much information and your brain will explode. And you'll end up with a messy desk since there will be blood splattered everywhere. Stick to two or three time frames. Any more than that is overkill.
- We can't repeat this enough: **Get a bird's eye view**. Using multiple time frames resolves contradictions between indicators and time frames. Always begin your market analysis by stepping back from the markets and looking at the big picture.

Don't believe us? Find out what other traders have to say about finding the best time frame to trade.

Commitment of Traders Report

The COT Report: What, Where, When, Why, and How

The Commodity Futures Trading Commission, or CFTC, publishes the Commitment of Traders report (COT) every Friday, around 2:30 pm EST.

Because the COT measures the net long and short positions taken by speculative traders and commercial traders, it is a great resource to gauge how heavily these market players are positioned in the market.

Later on, we'll let you meet these market players. These are the hedgers, large speculators, and retail traders. Just like players in a team sport, each group has its unique characteristics and roles. By watching the behavior of these players, you'll be able to foresee incoming changes in market sentiment.
You're probably asking yourself, "Why the heck do I need to use data from the FX futures market?"

"Doesn't the spot forex market have a report that measures how currency traders are positioned?"

"I'm a spot forex trader! Activity in the futures market doesn't involve me."

Remember, since spot forex is traded over-the-counter (OTC), transactions do not pass through a centralized exchange like the Chicago Mercantile Exchange.
So what's the closest thing we can get our hands on to see the state of the market and how the big players are moving their money?

Yep, you got it…

The Commitment of Traders report from the futures market.

Before going into using the Commitment of Traders report in your trading strategy, you have to first know WHERE to go to get the COT report and HOW to read it.

How to Find the COT Report

Step 1:

Open up the address below in your web browser. (http://www.cftc.gov/marketreports/commitmentsoftraders/index.htm)

Step 2:

Once the page has loaded, scroll down a couple of pages to the “**Current Legacy Report**” and click on “**Short Format**” under “**Futures Only**” on the “**Chicago Mercantile Exchange**” row to access the most recent COT report.

	Futures Only		Futures-and-Options-Combined	
Chicago Board of Trade	Long Format	Short Format	Long Format	Short Format
Chicago Mercantile Exchange	Long Format	Short Format	Long Format	Short Format
Chicago Board Options Exchange	Long Format	Short Format	Long Format	Short Format
Chicago Climate Futures Exchange	Long Format	Short Format	Long Format	Short Format
Kansas City Board of Trade	Long Format	Short Format	Long Format	Short Format

Step 3:

It may seem a little intimidating at first because it looks like a big giant gobbled-up block of text but with a little bit of effort, you can find exactly what you’re looking for. Just press CTRL+F (or whatever the find function is of your browser) and type in the currency you want to find.

To find the British Pound Sterling, or GBP, for example, just search up “Pound Sterling” and you’ll be taken directly to a section that looks something like this:

```
BRITISH POUND STERLING - CHICAGO MERCANTILE EXCHANGE                  Code-096742
FUTURES ONLY POSITIONS AS OF 03/16/10                          |
---------------------------------------------------------------| NONREPORTABLE
      NON-COMMERCIAL        |  COMMERCIAL      |     TOTAL     |   POSITIONS
--------------------------|-----------------|-----------------|----------------
  LONG   | SHORT   |SPREADS |  LONG   | SHORT  |  LONG   | SHORT  |  LONG   | SHORT
-------------------------------------------------------------------------------
(CONTRACTS OF GBP 62,500)                          OPEN INTEREST:      121,551
COMMITMENTS
  11,731   75,718      158   94,765   14,211  106,654   90,087   14,897   31,464

CHANGES FROM 03/09/10 (CHANGE IN OPEN INTEREST:     -27,011)
   1,314    1,828   -1,315  -24,446  -24,496  -24,447  -23,983   -2,564   -3,028

PERCENT OF OPEN INTEREST FOR EACH CATEGORY OF TRADERS
     9.7     62.3      0.1     78.0     11.7     87.7     74.1     12.3     25.9

NUMBER OF TRADERS IN EACH CATEGORY (TOTAL TRADERS:       81)
      12       41        3       13       18       27       60
```

Yowza! What the heck is this?! Don't worry. We'll explain each category below.

- **Commercial:** These are the big businesses that use currency futures to hedge and protect themselves from too much exchange rate fluctuation.
- **Non-Commercial**: This is a mixture of individual traders, hedge funds, and financial institutions. For the most part, these are traders who looking to trade for speculative gains. In other words, these are traders just like you who are in it for the Benjamins!
- **Long:** That's the number of long contracts reported to the CFTC.
- **Short:** That's the number of short contracts reported to the CFTC.
- **Open interest**: This column represents the number of contracts out there that have not been exercised or delivered.
- **Number of traders:** This is the total number of traders who are required to report positions to the CFTC.
- **Reportable positions:** The number of options and futures positions that are required to be reported according to CFTC regulations.
- **Non-reportable positions**: The number of open interest positions that do not meet the reportable requirements of the CFTC like retail traders.

If you want to access all available historical data, you can view it here.
You can see a lot of things in the COT report but you don't have to memorize all of it.

As a budding trader, you'll only be focusing on answering the basic question:

"Wat da dilly on da market yo?!"

Translation: "**What's the market feeling this week?**"

Understanding the COT Report

In order to understand the futures market, first you need to know the people making the shots and those who are warming up the bench. These players could be categorized into three basic groups:

1. Commercial traders (Hedgers)
2. Non-commercial traders (Large Speculators)
3. Retail traders (Small Speculators)

Don't Skip the Commercial – The Hedgers

Hedgers or commercial traders are those who want to protect themselves against unexpected price movements. Agricultural producers or farmers who want to hedge (minimize) their risk in changing commodity prices are part of this group.

Banks or corporations who are looking to protect themselves against sudden price changes in currencies or other assets are also considered commercial traders.

A key characteristic of hedgers is that they are ***most bullish at market bottoms*** and ***most bearish at market tops***.
What the hedgehog does this mean?

Here's a real life example to illustrate:

There is a virus outbreak in the U.S. that turns people into zombies. Zombies run amok doing malicious things like grabbing strangers' iPhones to download fart apps.

It's total mayhem as people become disoriented and helpless without their beloved iPhones. This must be stopped now before the nation crumbles into oblivion!

Guns and bullets apparently don't work on the zombies. The only way to exterminate them is by chopping their heads off.

Apple sees a "market need" and decides to build a private Samurai army to protect vulnerable iPhone users.

It needs to import samurai swords from Japan. Tim Cook, the CEO of Apple, contacts a Japanese samurai swordsmith who demands to be paid in Japanese yen when he finishes the swords after three months.

Apple also knows that, if the USD/JPY falls, it will end up paying more yen for the swords.

In order to protect itself, or rather, hedge against currency risk, the firm buys JPY futures.

If USD/JPY falls after three months, the firm's gain on the futures contract would offset the increased cost on its transaction with the Japanese sword smith.

On the other hand, if USD/JPY rises after three months, the firm's loss on the futures contract would be offset by the decrease in cost of its payment for the samurai swords.

In It to Win It – The Large Speculators

In contrast to hedgers, who are not interested in making profits from trading activities, speculators are in it for the money and have no interest in owning the underlying asset!

Many speculators are known as hardcore trend followers since they buy when the market is on an uptrend and sell when the market is on a downtrend. They keep adding to their position until the price movement reverses.

Large speculators are also big players in the futures market since they hold huge accounts.

As a result, their trading activities can cause the market to move dramatically. They usually follow moving averages and hold their positions until the trend changes.

Cannon fodders – The Small Speculators

Small speculators, on the other hand, own smaller retail accounts. These comprise of hedge funds and individual traders.

They are known to be anti-trend and are usually on the **wrong side of the market**. Because of that, they are typically less successful than hedgers and commercial traders.
However, when they do follow the trend, they tend to be highly concentrated at market tops or bottoms.

How to Use the COT Report for Trading

Since the COT report comes out weekly, its usefulness as a market sentiment indicator would be more suitable for longer-term trades.

The question you may be asking now is this:

How the heck do you turn all that "big giant gobbled-up block of text" into a sentiment-based indicator that will help you grab some pips?!

One way to use the COT report in your trading is to find **extreme net long or net short positions**.
Finding these positions may signal that a market reversal is just around the corner because if everyone is long a currency, who is left to buy?

No one.

And if everyone is short a currency, who is left to sell?

What's that?

Pretty quiet…

Yeah, that's right. NO ONE.

One analogy to keep in mind is to imagine driving down a road and hitting a dead end. What happens if you hit that dead end? You can't keep going since there's no more road ahead. The only thing to do is to turn back.

Let's take a look at this chart of the EUR/USD from **TimingCharts**:

On the top half, we've got the price action of EUR/USD going on. At the same time, on the bottom half, we've got data on the long and short positions of EUR futures, divided into three categories:

- Commercial traders (blue)
- Large Non-commercial (green)
- Small non-commercial (red)

Ignore the commercial positions for now, since those are mainly for hedging while small retail traders aren't relevant.

Let's take a look at what happened mid-way through 2008. As you can see, EUR/USD made a steady decline from July to September. As the value of the net short positions of non-commercial traders (the green line) dropped, so did EUR/USD. In the middle of September, net short positions hit an extreme of 45,650. Soon after, investors started to buy back EUR futures. Meanwhile, EUR/USD rose sharply from about 1.2400 to a high near 1.4700!

Over the next year, the net value of EUR futures position gradually turned positive. As expected, EUR/USD eventually followed suit, even hitting a new high around 1.5100. In early October 2009, EUR futures net long positions hit an extreme of 51,000 before reversing. Shortly after, EUR/USD began to decline as well.

Holy Guacamole! Just by using the COT as an indicator, you could have caught two crazy moves from October 2008 to January 2009 and November 2009 to March 2010.

The first was in mid-September 2009. If you had seen that speculative traders' short positions were at extreme levels, you could have bought EUR/USD at around 1.2300. This would have resulted in almost a 2,000-pip gain in a matter of a few months!

Now, if you had also seen that net long positions were at an extreme in November 2009, you would have had sold EUR/USD and you could have grabbed about 1,500 pips!

With those two moves, by **using the COT report as a market sentiment reversal indicator**, you could have grabbed a total of 3,500 pips. Pretty nifty, eh?

How to Pick Tops and Bottoms With the COT Report

As you would've guessed, ideal places to go long and short are those times when sentiment is at an *extreme*.
If you noticed from the previous example, the speculators (green line) and commercials (blue line) gave opposite signals. While hedgers buy when the market is bottoming, speculators sell as the price moves down.

Here's that COT report chart again:

Hedgers are bearish when the market moves to the top while speculators are bullish when the price is climbing.

As a result, **speculative positioning indicates trend direction** while **commercial positioning could signal reversals**.
If hedgers keep increasing their long positions while speculators increase their short positions, a market bottom could be in sight.

If hedgers keep adding more short positions while speculators keep adding more long positions, a market top could occur.

Of course, it's difficult to determine the exact point where a sentiment extreme will occur so it might be best to do nothing until signs of an actual reversal are seen.

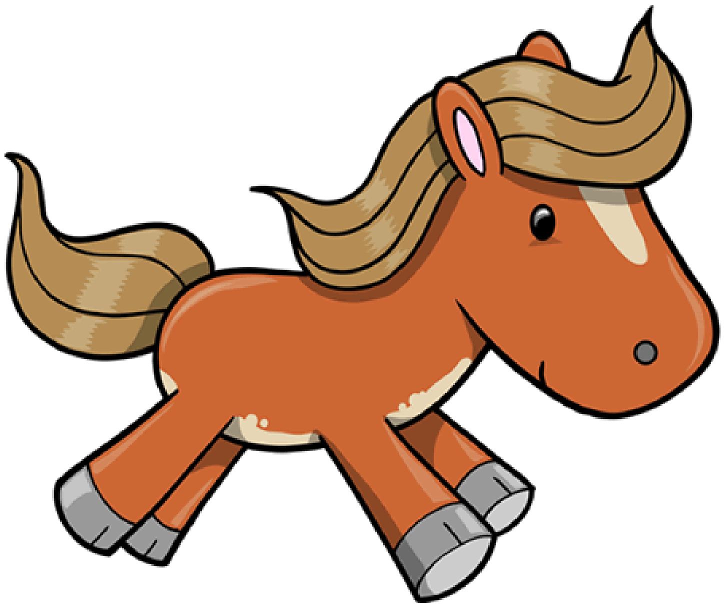
We could say that speculators, because they follow the trend, catch most of the move BUT are wrong on turning points.

Commercial traders, on the other hand, miss most of the trend EXCEPT when price reverses.

Until a sentiment extreme occurs, it would be best to go with the speculators.

The basic rule is this: every market top or bottom is accompanied by a sentiment extreme, but not every sentiment extreme results in a market top or bottom.

How to Create Your Own COT Trading Indicator



Having your very own COT indicator is like having your own pony.

Using the COT report can be quite useful as a tool for spotting potential reversals in the market.

There's one problem though, we cannot simply look at the absolute figures printed on the COT report and say, "Aha, it looks like the market has hit an extreme… I will short and buy myself 10,000,000 pairs of socks with my easy profits."

Determining extremes can be difficult because the net long and short positions are not all relevant. What may have been an extreme level five years ago may no longer be an extreme level this year. How do you deal with this problem?

What you want to do is create an index that will help you gauge whether the markets are at extreme levels. Below is a step-by-step process on how to create this index.

A. Decide how long of a period we want to cover. The more values we input into the index, the less sentiment extreme signals we will receive, but the more reliable it will be. Having less input values will result in more signals, although it might lead to more false positives.
B. Calculate the difference between the positions of large speculators and commercial traders for each week.

The formula for calculating this difference is:

Difference = Net position of Large Speculators – Net position of Commercials

Take note that if large speculators are extremely long, this would imply that commercial traders are extremely short. This would result in a positive figure.

On the other hand, if large speculators are extremely short, that would mean that commercial traders are most likely extremely long; this would result in a negative figure.

1. Rank these results in ascending order, from most negative to most positive.

2. Assign a value of 100 to the largest number and 0 to the smallest figure.
And now we have a COT indicator! This is very similar to the RSI and stochastic indicators that we've discussed in earlier lessons.

Once we have assigned values to each of the calculated differences, we should be alerted whenever new data inputted into the index shows an extreme: 0 or 100. This would indicate that the difference between the positions of the two groups is largest, and that a reversal may be imminent.

Remember, we are interested in knowing whether the trend is going to continue or if it is going to end. If the COT report reveals that the markets are at extreme levels, it would help pinpoint those tops and bottoms that we all love so much.

We dug around the forums and found this little gold nugget for you. Apparently you can download the COT indicator if you're trading on an MT4 platform and you can find the link in our COT data to indicator forum thread!

How to Interpret the COT Report

Now that we know how to determine sentiment extremes, what's next? Recall that not every sentiment extreme results in a market top or bottom so we'll need a more accurate indicator. Calculating the percentage of speculative positions that are long or short would be a better gauge to see whether the market is topping or bottoming out. The equation to calculate for the %-long and %-short is indicated below:

$$\%\ \text{long} = \frac{\#\ \text{of long contracts}}{\#\ \text{of long contracts} + \#\ \text{of short contracts}}$$

$$\%\ \text{short} = \frac{\#\ \text{of short contracts}}{\#\ \text{of long contracts} + \#\ \text{of short contracts}}$$

To illustrate this better, let's go back a few years and see what happened with Canadian dollar futures. Going through the COT reports released on the week ending August 22, 2008, speculators were net short 28,085 contracts. On March 20, 2009, they were net short 23,950 contracts.

From this information alone, you would say that there is a higher probability of a market bottom in August since there were more speculators that were short in that period. But hold on a minute there… You didn't think it would be THAT easy right?

A closer look would show that 66,726 contracts were short while 38,641 contracts were long. Out of all the speculative positions in **August** (66,726 / (38,641 + 66,726)), **63.3%** were short positions.

On the other hand, there were just 8,715 long contracts and 32,665 short contracts in **March**. This means that (32,655 / (8,715 + 32,665)) **78.9%** of the speculative positions were short positions during that period. What does this mean?
There is a higher chance that a bottom will occur when 78.9% of all speculative positions are short as opposed to just 63.3%. As you can see on the chart below, the bottom in fact did not occur around August 2008, when the Canadian dollar was worth roughly around 94 U.S. cents.

The Canadian dollar continued to fall over the next few months. By the time March came around and the %-short ratio hit 78.9%, the Canadian dollar had hit a bottom around 77 U.S. cents. Then what happened? It started to steadily rise!

A market bottom? Yep, you got it.

Summary: Market Sentiment

Did those thousand-pip moves excite you?

Before we start betting the farm based on our analysis of the COT report, remember that those were just specific cases of when the COT report signalled a perfect market reversal.

The best thing to do would be to back test and look at reasons why a reversal took place.

Was the economy booming?

Or was it in the middle of a recession?

Remember, the COT report measures the sentiment of traders during a specific period of time. Like every other tool in your toolbox, using the COT report as an indicator does not always correlate to market reversals. So take the time to study this report and get your own feel of what works and what doesn't.

Also, before we bring this lesson to an end, always keep in mind that market prices aren't driven by solely COT reports, stochastic, Fibonacci levels, etc.
The markets are driven by the millions of people reacting to economic analysis, fundamental reports, politics, Godzilla attacks, UFO sightings, Lady Gaga concerts – life in general! It is how you use these tools that will help you be prepared to what lies ahead.

In conclusion…

- As forex traders, it is our job to gauge what the market is feeling.
- One way to gauge market sentiment extremes is through the Commitment of Traders Report.
- By understanding the activities of the three groups of traders (commercial traders, non-commercial, retail traders), we can find ourselves in better positions to fish for tops and bottoms.
- Remember, every market top or bottom is accompanied by a sentiment extreme, but not every sentiment extreme results in a market top or bottom.

News Makes the Forex Market Move

It's not enough to only know technical analysis when you trade. It's just as important to know what makes the forex market move.

Just like in the great Star Wars world, behind the trend lines, double tops, and head and shoulder patterns, there is a fundamental force behind these movements. This force is called the **news**!
To understand the importance of the news, imagine this scenario (purely fictional of course!)

Let's say, on your nightly news, there is a report that the biggest software company that you have stock with just filed bankruptcy.

What's the first thing you would do? How would your perception of this company change? How do you think other people's perceptions of this company would change?

The obvious reaction would be that you would immediately sell off your shares. In fact, this is probably what just about everyone else who had any stake in that company would do.

The fact is that news affects the way we perceive and act on our trading decisions. It's no different when it comes to trading currencies.

There is, however, a distinct difference with how news is handled in the stock market and the forex market.

Let's go back to our example above and imagine that you heard that same report of the big software company filing bankruptcy, but let's say you heard the report a day before it was actually announced in the news.

Naturally you would sell off all your shares, and as a result of you hearing the news a day earlier, you would make (save) more money than everyone else who heard it on their nightly news.

Sounds good for you right? Unfortunately this little trick is called **INSIDER TRADING**, and it would have you thrown in jail.
Martha Stewart did it and now she has a nice mug-shot to go along with her magazine covers.

In the stock market, when you hear news before everyone else it is illegal. In the forex market, it's called ***FAIR GAME***!
The earlier you hear or see the news, the better it is for your trading, and there is absolutely no penalty for it!

Add on some technology and the power of instant communication, and what you have is the latest and greatest (or not so greatest) news at the tip of your fingers.

This is great… Uhmmm… "news" for retail traders because it allows U.S. to react fairly quickly to the market's speculations.

Big traders, small traders, husky traders, or skinny traders all have to depend on the same news to make the market move because if there wasn't any news, the market would hardly move at all!

The news is important to the forex market because it's the news that makes it move. Regardless of the technicals, news is the fuel that keeps the forex market going!

Be Careful Trading the News

Why trade the news?

The simple answer to that question is "To make more money!"

But in all seriousness, as we learned in the previous section, news is a very important part to the forex market because it has the potential to make it move!

When news comes out, especially important news that everyone is watching, you can almost expect to see some major movement. Your goal as a forex trader is to get on the right side of the move, but the fact that you know the market will most likely move somewhere makes it an opportunity definitely worth looking at.

Dangers of Trading the News

As with any trading strategy, there are always possible dangers that you should be aware of.

Here are some of those dangers:

Because the forex market is very volatile during important news events, **many dealers widen the spread during these times**. This increases trading costs and could hurt your bottom line.
You could also get "locked out" which means that your trade could be executed at the right time but may not show up in your trading station for a few minutes. This is bad for you because you won't be able to make any adjustments if the trade moves against you!

Imagine thinking you didn't get triggered, so you try to enter at market… then you realize that your original ordered got triggered! You'd be risking twice as much now!

You could also experience **SLIPPAGE**.
Slippage occurs when you wish to enter the market at a certain price, but due to the extreme volatility during these events, you actually get filled at a far different price.

Big market moves made by news events often don't move in one direction. Often times the market may start off flying in one direction, only to be whipsawed back in the other direction. Trying to find the right direction can sometimes be a headache!

Profitable as it may be, trading the news isn't as easy as beating Pipcrawler at Call of Duty. It will take tons of practice, practice and you guessed it… more practice!

Most importantly, you must **ALWAYS** have a plan in place. In the following lessons, we'll give you some tips on how to trade news reports.

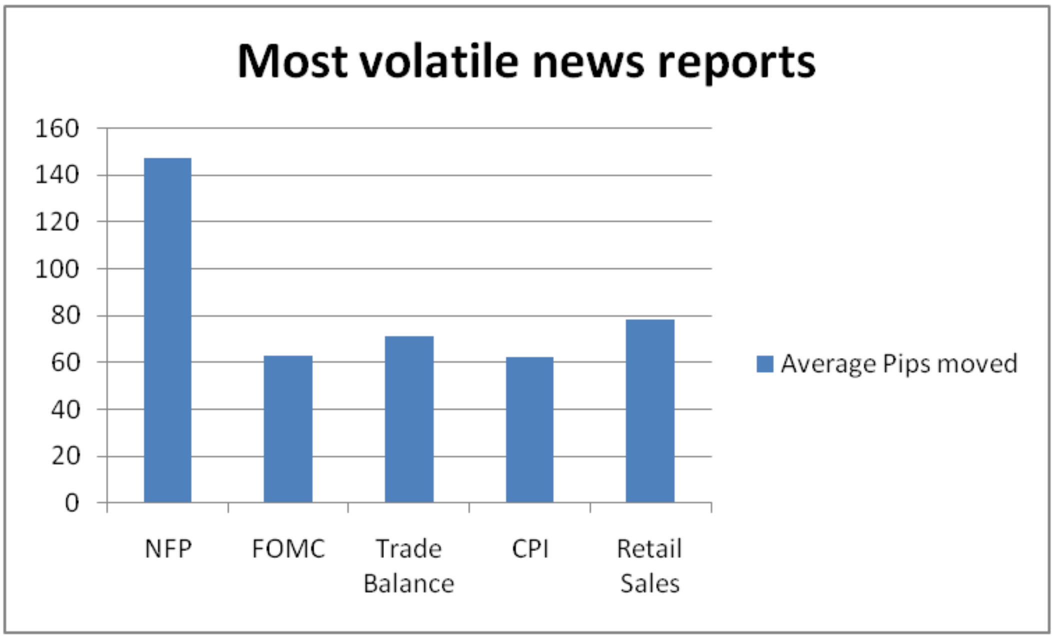
Which News Releases Should I Trade?

Before we even look at strategies for trading news events, we have to look at which news events are even worth trading.

Remember that we are trading the news because of its ability to increase volatility in the short term, so naturally we would like to only trade news that has the best forex market moving potential.

While the markets react to most economic news from various countries, the biggest movers and most watched news comes from the **U.S**. The reason is that the U.S. has the largest economy in the world and the U.S. Dollar is the world's reserve currency. This means that the U.S. Dollar is a participant in about 90% of all forex transactions, which makes U.S. news and data important to watch.

With that said, let's take a look at some of the most volatile news for the U.S.



In addition to inflation reports and central bank talks, you should also pay attention to **geo-political news** such as war, natural disasters, political unrest, and elections. Although these may not have as big an impact as the other news, it's still worth paying attention to them.
When our economic guru Forex Gump is in a good mood, he usually releases an article on upcoming news reports that you can play and with trade strategies to boot! Check out some of his articles of this sort:

Also, keep an eye on moves in the **stock market**. There are times where sentiment in the equity markets will be the precursor to major moves in the forex market.
Now that we know which news events make the most moves, our next step is to determine which currency pairs are worth trading.

Because news can bring increased volatility in the forex market (and more trading opportunities), it is important that we trade currencies that are liquid. Liquid currency pairs give us a reassurance that our orders will be executed smoothly and without any "hiccups".

1. EUR/USD
2. GBP/USD
3. USD/JPY
4. USD/CHF
5. USD/CAD
6. AUD/USD

Did you notice anything here?

That's right! These are all **major currency pairs**!
Remember, because they have the most liquidity, majors pairs usually have the tightest spreads. Since spreads *widen* when news reports come out, it makes sense to stick with those pairs that have the tightest spreads to begin with.
Now that we know which news events and currency pairs to trade, let's take a look at some approaches to trading the news.

2 Ways to Trade the News

There are two main ways to trade the news:

a) Having a ***directional bias***
b) Having a ***non-directional bias***

Directional Bias

Having directional bias means that you expect the market to move a certain direction once the news report is released. When looking for a trade opportunity in a certain direction, it is good to know what it is about news reports that will cause the market to move.

Consensus vs. Actual Number

Several days or even weeks before a news report comes out, there are analysts that will come up with some kind of forecast on what numbers will be released. As we talked about in a previous lesson, this number will be different among various analysts, but in general there will be a common number that a majority of them agree on. This number is called a **consensus**.
When a news report is released, the number that is given is called the **actual** number.

"Buy the rumors, sell on the news."

This is a common phrase used in the forex market because often times it seems that when a news report is released, the movement doesn't match what the report would lead you to believe.

For example, let's say that the U.S. unemployment rate is expected to increase. Imagine that last month the unemployment rate was at 8.8% and the consensus for this upcoming report is 9.0%.

With a consensus at 9.0%, it means that all the big market players are anticipating a weaker U.S. economy, and as a result, a weaker dollar.

So with this anticipation, big market players aren't going to wait until the report is actually released to start acting on taking a position. They will go ahead and start selling off their dollars for other currencies before the actual number is released.

Now let's say that the actual unemployment rate is released and as expected, it reports 9.0%.

As a retail trader, you see this and think "Okay, this is bad news for the U.S. It's time to short the dollar!"

However, when you go to your trading platform to start selling the dollar, you see that the markets aren't exactly moving in the direction you thought it would. It's actually moving up! What the heck! Whyyyyyy??

This is because the big players have already adjusted their positions way before the news report even came out and may now be taking profits after the run up to the news event.

Now let's revisit this example, but this time, imagine that the actual report released an unemployment rate of 8.0%. The market players thought the unemployment rate would rise to 9.0% because of the consensus, but instead the report showed that the rate actually decreased, showing strength for the dollar.

What you would see on your charts would be a huge dollar rally across the board because the big market players didn't expect this to happen. Now that the report is released and it says something totally different from what they had anticipated, they are all trying to adjust their positions as fast as possible.

This would also happen if the actual report released an unemployment rate of 10.0%. The only difference would be that instead of the dollar rallying, it would drop like a rock!

Since the market consensus was 9.0% but the actual report showed a bigger 10.0% unemployment rate, the big players would sell off more of their dollars because the U.S. looks a lot weaker now than when the forecasts were first released.

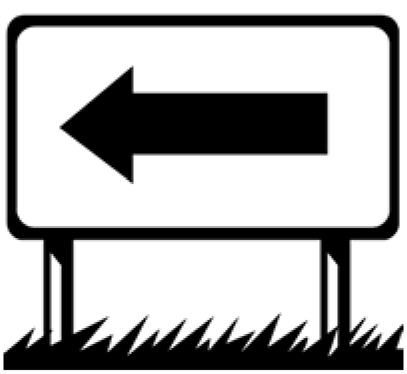
It's important to **keep track of the market consensus and the actual numbers**, you can better gauge which news reports will actually cause the market to move and in what direction.

Non-directional Bias

A more common news trading strategy is the **non-directional bias** approach. This method disregards a directional bias and simply plays on the fact that a big news report will create a big move. It doesn't matter which way the forex market moves. We just want to be there when it does!

What this means is that once the market moves in either direction, you have a plan in place to enter that trade. You don't have any bias as to whether price will go up or down, hence the name *non-directional bias*.

How to Trade the News With a Directional Bias



Let's now see how to trade the news with a directional bias in a trading scenario. Let's go back to our example of the U.S. unemployment rate report. Earlier, we gave examples of what could happen if the report came in light with expectations, or slightly better. Let's say there was a surprising drop. What effect could this have on the dollar? One thing that could happen is that the dollar falls. What??? Isn't the dollar supposed to rise if the unemployment rate is dropping?

There could be a couple reasons why the dollar could still fall even though there are more people with jobs.

The first reason could be that the long-term and overall trend of the U.S. economy is still in a downward spiral. Remember that there are several fundamental factors that play into an economy's strength or weakness. Although the unemployment rate dropped, it might not be a big enough catalyst for the big traders to start changing their perception of the dollar.

The second reason could be the reason for the unemployment rate drop. Perhaps it's right after Thanksgiving during the holiday rush. During this time, many companies normally hire seasonal employees to keep up with the influx of Christmas shoppers. This increase in jobs may cause a short term drop in the unemployment rate, but it's not at all indicative of the long term outlook on the U.S. economy.
A better way to get a more accurate measure of the unemployment situation would be to look at the number from last year and compare it to this year. This would allow you to see if the job market actually improved or not.

The important thing to remember is to always take a step back and look at the overall picture before making any quick decisions.
Now that you have that information in your head, it's time to see how we can trade the news with a directional bias.

Let's stick with our unemployment rate example to keep it simple. The first thing you would want to do before the report comes out is take a look at the trend of the unemployment rate to see if it has been increasing or decreasing. By looking at what has been happening in the past, you can prepare yourself for what might happen in the future.

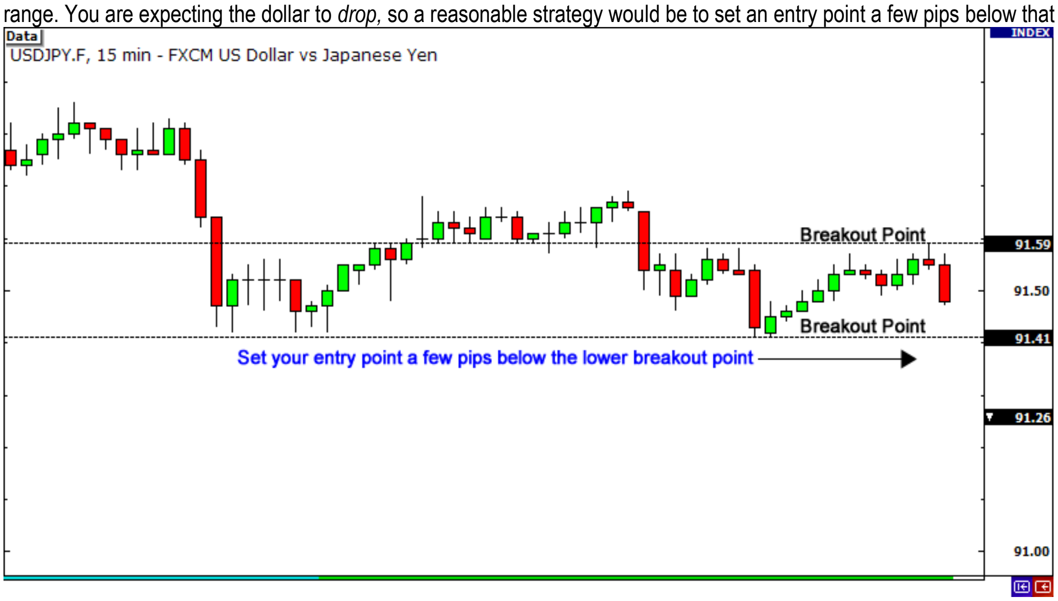
Imagine that the unemployment rate has been steadily increasing. Six months ago it was at 1% and last month it topped out at 3%. You could now say with some confidence that jobs are decreasing and that there is a good possibility the unemployment rate will continue to rise.

Since you are expecting the unemployment rate to rise, you can now start preparing to go short on the dollar. This is your directional bias. Particularly, you feel like you could short USD/JPY.

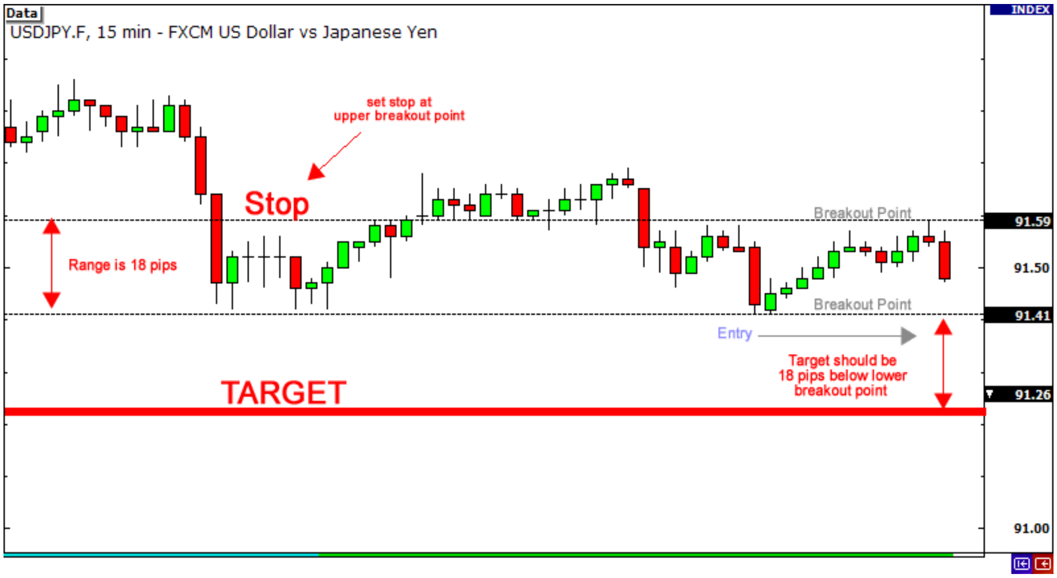
Just before the unemployment rate is about to be announced, you could look at the price movement of USD/JPY at least 20 minutes prior and find the range of movement. Take note of the high and low that is made. This will become your **breakout points**.

*Note: The smaller the range the larger the tendency there is for a volatile move!

Since you have a bearish outlook on the dollar (your directional bias), you would pay particular attention to the lower breakout point of that range. You are expecting the dollar to *drop,* so a reasonable strategy would be to set an entry point a few pips below that level.



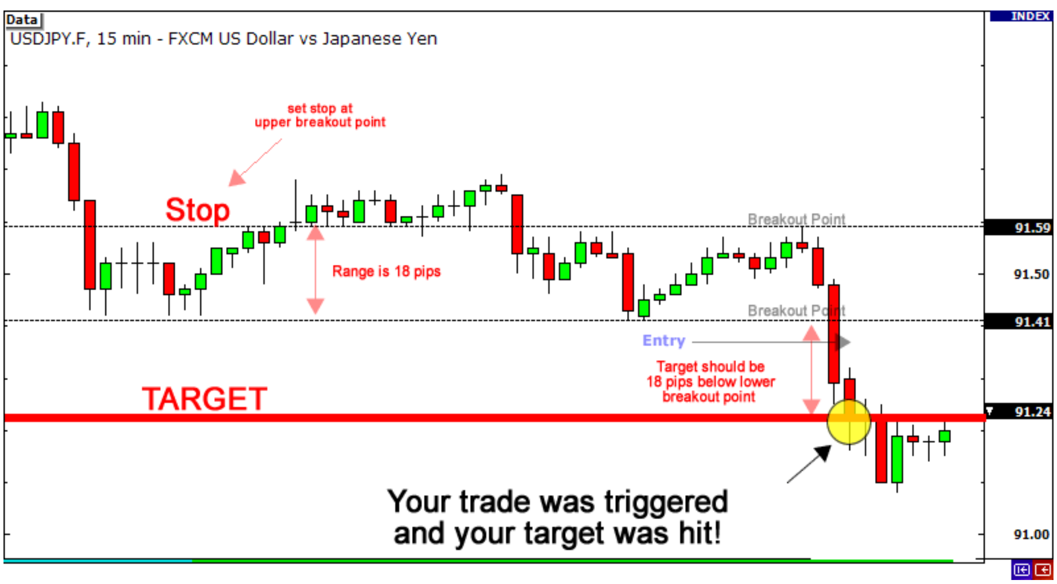
You could then set a stop just at the upper breakout point and set your limit for the same amount of pips as the breakout point range.



One of two things could happen at this point.

1. If the unemployment rate drops then the dollar could rise. This would cause USD/JPY to rise and your trade would most likely not trigger. No harm no foul!
2. Or if the news is as you expected and the unemployment rate rises, the dollar could drop (assuming the entire fundamental outlook on the dollar is already bearish).

This is good for you because you already set up a trade that was bearish on the dollar and now all you have to do is watch your trade unfold.



Later on, you see that your target gets hit. You just grabbed yourself a handful of pips! Booyeah!

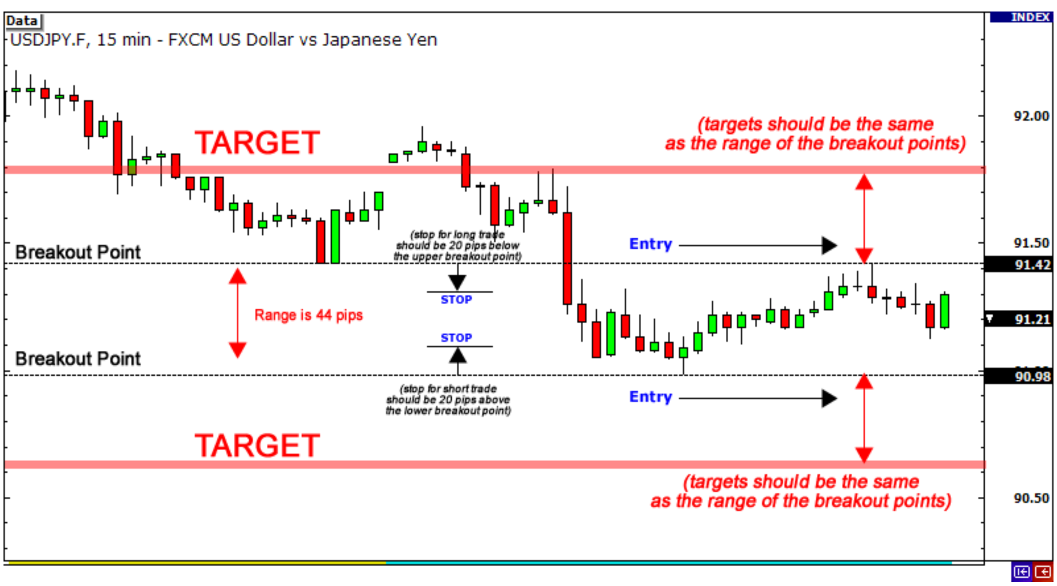
The key to having a directional bias is that you must truly **understand the concepts behind the news report** that you plan to trade.
If you don't understand what **effect** it can have on particular currencies, then you might get caught up in some bad setups. Luckily for you, we've got Pip Diddy and Forex Gump to help explain what effect each report can have on the forex market.

How to Trade the News Using the Straddle Trade Strategy

The first thing to consider is **which news reports to trade**. Earlier in this lesson we discussed the biggest moving news releases. Ideally you would want to only trade those reports because there is a high probability the market will make a big move after their release.
The next thing you should do is take a **look at the range at least 20 minutes *before* the actual news release**. The high of that range will be your upper breakout point, and the low of that range will be your lower breakout point. Note that the smaller the range is the more likely it is you will see a big move from the news report.
The **breakout points** will be your entry levels. This is where you want to set your orders. Your stops should be placed approximately **20 pips below and above the breakout points**, and your initial targets should be about the same as the range of the breakout levels.

Straddle Trade

This is known as a **straddle trade** – you are looking to play BOTH sides of the trades, whichever trade it moves.



Now that you're prepared to enter the market in either direction, all you have to do is wait for the news to come out. Sometimes you may get triggered in one direction only to find that you get stopped out because the price quickly reverses in the other direction. However, your other entry will get triggered and if that trade wins, you should recoup your initial losses and come out with a small profit.

A best case scenario would be that only one of your trades gets triggered and the price continues to move in your favor so that you don't incur any losses. Either way, if done correctly you should still end up positive for the day.

One thing that makes a non-directional bias approach attractive is that it eliminates any emotions – you just want to profit when the move happens. This allows you take advantage of more trading opportunities, because you will be triggered either way.

There are many more strategies for trading the news, but the concepts mentioned in this lesson should always be part of your routine whenever you are working out an approach to taking advantage of news report movements.

Summary: Trading the News

There you have it! Now you know how to trade the news! Just keep these things in mind when trading:

- When you have a **directional bias**, you are expecting price to move a certain direction, and you've got your orders in already.
- It is always good to understand the **underlying reasons** why the market moves in a certain direction when news is released.
- When you have a **non-directional bias**, you don't care which way price heads. You just want to get triggered.
- Setups for the non-directional bias are also called **straddle trades**.

That's pretty much it…

Is it really that easy???

HECK NO!!!

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 trading.

Like in any other trading method, your success depends on your preparation.

This will take time and practice. Do your homework and study the economic indicators to understand why they are important.

Remember, nothing worth having comes easy, so stick with it and you'll find that trading the news will be very rewarding once you get the hang of it!

What is Carry Trade?

Did you know there is a trading system that can make money if price stayed exactly the same for long periods of time?

Well there is and it's one the most popular ways of making money by many of the biggest and baddest money manager mamajamas in the financial universe!

It's called the "**Carry Trade**".

What is a Carry Trade?

A carry trade involves borrowing or selling a financial instrument with a low interest rate, then using it to purchase a financial instrument with a higher interest rate.

While you are paying the low interest rate on the financial instrument you borrowed/sold, you are collecting higher interest on the financial instrument you purchased. Thus your profit is the money you collect from the interest rate differential.

For example:

Let's say you go to a bank and borrow $10,000. Their lending fee is 1% of the $10,000 every year.

With that borrowed money, you turn around and purchase a $10,000 bond that pays 5% a year.

What's your profit?

Anyone?

You got it! It's 4% a year! **The difference between interest rates!**
By now you're probably thinking, "That doesn't sound as exciting or profitable as catching swings in the market."

However, when you apply it to the spot forex market, with its higher leverage and daily interest payments, sitting back and watching your account grow daily can get pretty sexy.

To give you an idea, a 3% interest rate differential becomes 60% annual interest a year on an account that is 20 times leveraged!

In this section, we will discuss how carry trades work, when they will work, and when they will NOT work.

We will also tackle **risk aversion** (WTH is that?!? Don't worry, like we said, we'll be talking more about it later).

What is a Currency Carry Trade?

In the forex market, currencies are traded in **pairs** (for example, if you buy USD/CHF, you are actually buying the U.S. dollar and selling Swiss francs at the same time).
Just like the example in the previous, you pay interest on the currency position you sell, and collect interest on the currency position you buy.

What makes the carry trade special in the spot forex market is that interest payments happen every trading day based on your position. Technically, all positions are closed at the end of the day in the spot forex market. You just don't see it happen if you hold a position to the next day.

Brokers close and reopen your position, and then they debit/credit you the overnight interest rate difference between the two currencies. This is the cost of "**carrying**" (also known as "**rolling over**") a position to the next day.
The amount of leverage available from forex brokers has made the carry trade very popular in the spot forex market. Most forex trading is margin based, meaning you only have to put up a small amount of the position and you broker will put up the rest. Many brokers ask as little as 1% or 2% of a position. What a deal, eh?

Let's take a look at a **generic** example to show how awesome this can be.
For this example we'll take a look at Joe the Newbie Forex Trader.

It's Joe's birthday and his grandparents, being the sweet and generous people they are, give him $10,000. Schweeeet!

Instead of going out and blowing his birthday present on video games and posters of bubble gum pop stars, he decides to save it for a rainy day. Joe goes to the local bank to open up a savings account and the bank manager tells him, "Joe, your savings account will pay 1% a year on your account balance. Isn't that fantastic?"

Joe pauses and thinks to himself, "At 1%, my $10,000 will earn me $100 in a year."

"Man, that sucks!"

Joe, being the smart guy he is, has been studying BabyPips.com's School of Pipsology and knows of a better way to invest his money.

So, Joe kindly responds to the bank manager, "Thank you sir, but I think I'll invest my money somewhere else."

Joe has been demo trading several systems (including the carry trade) for over a year, so he has a pretty good understanding of how forex trading works. He opens up a real account, deposits his $10,000 birthday gift, and puts his plan into action.

Joe finds a currency pair whose interest rate differential is +5% a year and he purchases $100,000 worth of that pair. Since his broker only requires a 1% deposit of the position, they hold $1,000 in margin (100:1 leverage). So, Joe now controls $100,000 worth of a currency pair that is receiving 5% a year in interest.

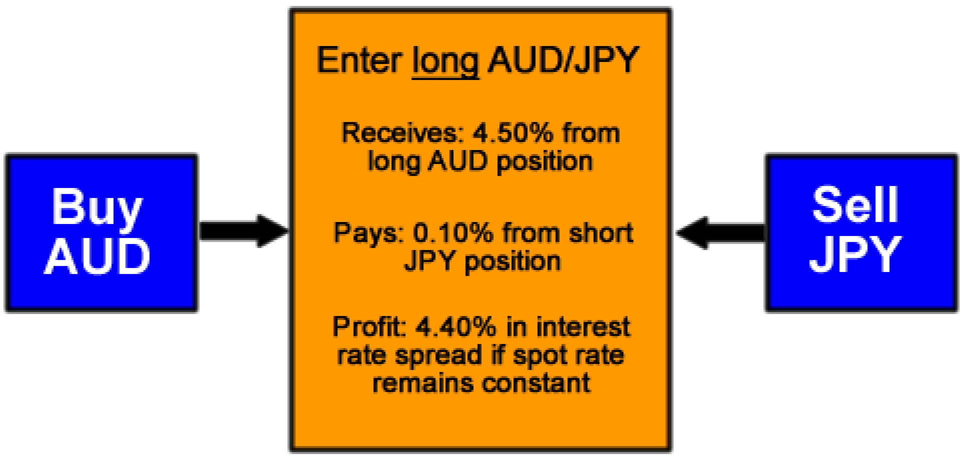
What will happen to Joe's account if he does nothing for a year?

Well, here are 3 possibilities. Let's take a look at each one:

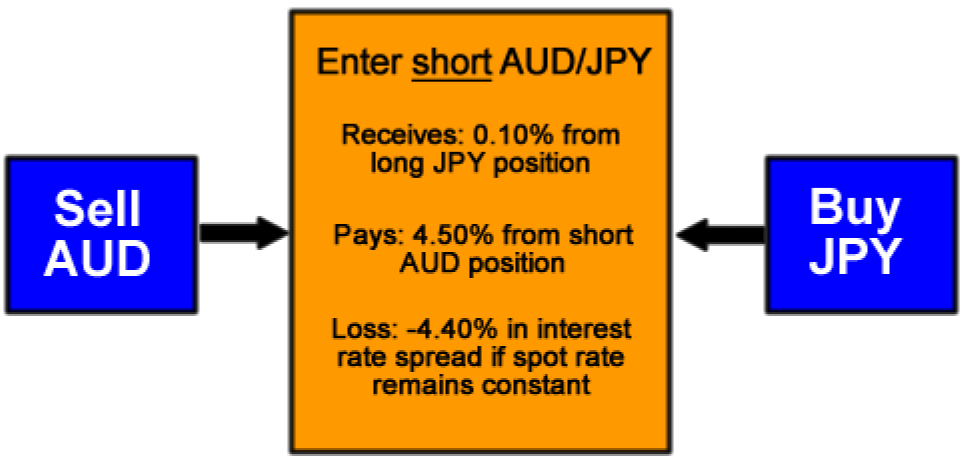
1. **Currency position loses value.** The currency pair Joe buys drops like a rock in value. If the loss brings the account down to the amount set aside for margin, then the position is closed and all that's left in the account is the margin – $1000.
2. **The pair ends up at the same exchange rate at the end of the year.** In this case, Joe did not gain or lose any value on his position, but he collected 5% interest on the $100,000 position. That means on interest alone, Joe made $5,000 off of his $10,000 account. That's a 50% gain! Sweet!
3. **Currency position gains value.** Joe's pair shoots up like a rocket! So, not only does Joe collect at least $5,000 in interest on his position, but he also takes home any gains! That would be a nice present to himself for his next birthday!

Because of 100:1 leverage, Joe has the potential to earn around 50% a year from his initial $10,000.

Here is an example of a currency pair that offers a 4.40% differential rate based on interest rates as of September 2010:



If you **buy** AUD/JPY and held it for a year, you earn a "positive carry" of +4.40%.
Of course, if you **sell** AUD/JPY, it works the opposite way:



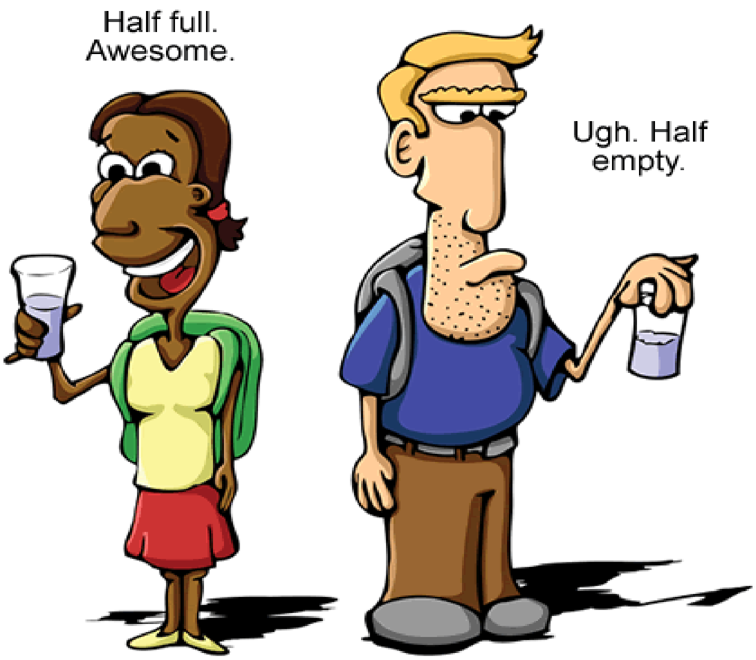
If you sold AUD/JPY and held it for a year, you would earn a "**negative carry**" of -4.40%.

Again, this is a generic example of how the carry trade works.

Any questions on the concept? No? We knew you could catch on quick!

Now it's time to move on to the most important part of this lesson: Carry Trade Risk.

Know When Carry Trades Work and When They Don't



When Do Carry Trades Work?

Carry trades work best when investors ***feel*** risky and **optimistic** enough to buy high-yielding currencies and sell lower yielding currencies. It's kinda like an optimist who sees the glass half full. While the current situation might not be ideal, he is hopeful that things will get better. The same goes for carry trade. Economic conditions may not be good, but the outlook of the buying currency does need to be positive.

If the outlook of a country's economy looks as good as Angelina Jolie or Brad Pitt, then chances are that that country's central bank will have to raise interest rates in order to control inflation.

This is good for carry trade because a higher interest rate means a bigger interest rate differential.

When Do Carry Trades NOT Work?

On the other hand, if a country's economic prospects aren't looking too good, then nobody will be prepared to take on the currency if they think the central bank will have to lower interest rates to help their economy.

To put it simply, carry trades work best when investors have ***low risk aversion***.

Carry trades do not work well when risk aversion is HIGH (i.e. selling higher-yielding currencies and buying back lower-yielding currencies). When risk aversion is high, investors are less likely to take risky ventures.

Let's put this into perspective.

Let's say economic conditions are tough, and the country is currently undergoing a recession. What do you think your next door neighbor would do with his money?

Your neighbor would probably choose a low-paying yet safe investment than put it somewhere else. It doesn't matter if the return is low as long as the investment is a "sure thing."

This makes sense because this allows your neighbor to have a fall back plan in the event that things go bad, e.g. he loses his job. In forex jargon, your neighbor is said to have a high level of ***risk aversion***.
The psychology of big investors isn't that much different from your next door neighbor. When economic conditions are uncertain, investors tend to put their investments in safe haven currencies that offer low interest rates like the U.S. dollar and the Japanese yen.

If you want a specific example, check out Forex Gump's Piponomics article on how risk aversion led to the unwinding of carry trade.
This is the polar opposite of carry trade. This inflow of capital towards safe assets causes currencies with low interest to appreciate against those with high interest.

Carry Trade Criteria and Risk

Carry Trade Criteria

It's pretty simple to find a suitable pair to do a carry trade. Look for two things:

1. Find a high interest differential.
2. Find a pair that has been stable or in an uptrend in favor of the higher-yielding currency. This gives you the ability to stay in the trade **AS LONG AS POSSIBLE** and profit off the interest rate differential.

Pretty simple, huh? Let's take a real life example of the carry trade in action:

This is a weekly chart of AUD/JPY. Up until recently, the Bank of Japan has maintained a "Zero Interest Rate Policy" (currently, the interest rate stands at 0.10%).

With the Reserve Bank of Australia touting one of the higher interest rates among the major currencies (4.50% in the chart example), many traders have flocked to this pair (one of the factors creating a nice little uptrend in the pair).

From the start of 2009 to early 2010, this pair moved from a price of 55.50 to 88.00 – that's 3,250 pips!

If you couple that with interest payments from the interest rate differential of the two currencies, this pair has been a nice long term play for many investors and traders able to weather the volatile up and down movements of the currency market.

Of course, economic and political factors are changing the world daily. Interest rates and interest rate differentials between currencies may change as well, bringing popular carry trades (such as the yen carry trade) out of favor with investors.

Carry Trade Risk

Because you are a very smart trader, you already know what the first question you should ask before entering a trade is right?

"What is my risk?"

Correct! Before entering a trade you must **ALWAYS** assess your max risk and whether or not it is acceptable according to your risk management rules.

In the example at the start of the lesson with Joe the Newbie Forex Trader, his maximum risk would have been $9,000. His position would be automatically closed out once his losses hit $9,000.

Eh?

That doesn't sound very good, does it?

Remember, this is the worst possible scenario and Joe is a newbie, so he hasn't fully appreciated the value of stop losses.

When doing a carry trade, you can still limit your losses like a regular directional trade.

For instance, if Joe decided that he wanted to limit his risk to $1,000, he could set a stop order to close his position at whatever the price level would be for that $1,000 loss. He would still keep any interest payments he received while holding onto the position.

Summary: Carry Trade

While you are paying the low interest rate on the financial instrument you borrowed/sold, you are collecting higher interest on the financial instrument you purchased. Your profit is the money you collect from the **interest rate differential**.
This is another way to make money in the forex market without having to buy low and sell high, which can be pretty tough to do day after day.

Carry trades work best when investors ***feel*** like taking on risk. Current economic conditions need not be good, but the outlook does need to be positive.
If a country's economic prospects aren't looking too good, then nobody will be prepared to take on the risk. To put it simply, carry trades work best when investors have ***low risk aversion***.
Carry trades do not work well when risk aversion is high.

When risk aversion is high, investors are less likely to buy higher-yielding currencies or likely to reduce their positions in higher-yielding currencies.

When economic conditions are uncertain, investors tend to put their investments in safe haven currencies, which tend to offer low interest rates like the U.S. dollar and the Japanese yen.

It's pretty simple to find a suitable pair to do a carry trade. Look for two things:

1. Find a high interest differential.
2. Find a pair that has been stable or in an uptrend in favor of the higher-yielding currency. This gives you the ability to stay in the trade **AS LONG AS POSSIBLE** and profit off the interest rate differential.

Always remember that economic and political factors are changing the world daily. Interest rates and interest rate differentials between currencies may change as well, bringing popular carry trades (such as the yen carry trade) out of favor with investors. So when doing a carry trade, you should still limit your losses like a regular directional trade.

When properly applied, the carry trade can add significant income to your account, along with your directional trading strategies.

What is the US Dollar Index?

If you've traded stocks, you're probably familiar with all the indices available such as the Dow Jones Industrial Average (DJIA), NASDAQ Composite Index, Russell 2000, S&P 500, Wilshire 5000, and the Nimbus 2001. Oh wait, that last one is actually Harry Potter's broomstick.
Well if U.S. stocks have an index, the U.S. dollar can't be outdone. For currency traders, we have the **U.S. Dollar Index (USDX)**.
The U.S. Dollar Index consists of a geometric weighted average of a basket of foreign currencies against the dollar.

Say whutttt!?! Okay before you fall asleep after that super geeky definition, let's break it down.

It's very similar to how the stock indices work in that it provides a general indication of the value of a basket of securities. Of course, the "securities" we're talking about here are other major world currencies.

The US Dollar Index Currency Basket

The U.S. Dollar Index consists of six foreign currencies. They are the:

- Euro (EUR)
- Yen (JPY)
- Pound (GBP)
- Canadian dollar (CAD)
- Krona (SEK)
- Franc (CHF)

Here's a trick question. If the index is made up of 6 currencies, how many countries are included?

If you answered "6", you're wrong.

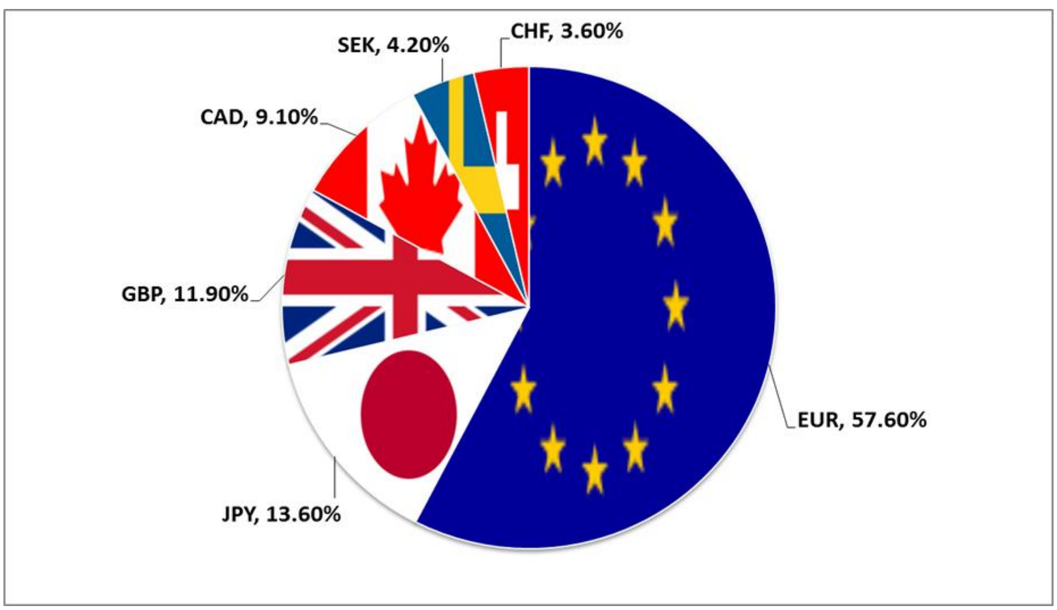
If you answered "24", you're a genius!

There are 24 countries total, because there are 19 members of the European Union that have adopted the euro as their sole currency, plus the other five countries (Japan, Great Britain, Canada, Sweden, and Switzerland) and their accompanying currencies.

It's obvious that 24 countries make up a small portion of the world but many other currencies follow the U.S. Dollar index very closely. This makes the USDX a pretty good tool for measuring the U.S. dollar's global strength.

US Dollar Index Components

Now that we know what the basket of currencies is composed of, let's get back to that *"geometric weighted average"* part. Because not every country is the same size, it's only fair that each is given appropriate weights when calculating the U.S. dollar index. Check out the current weights:



With its 19 countries, euros make up a big chunk of the U.S. Dollar Index. The next highest is the Japanese yen, which would make sense since Japan has one of the biggest economies in the world. The other four make up less than 30 percent of the USDX.

Here's something interesting: When the euro falls, which way does the U.S. Dollar Index move?

The euro makes up such a huge portion of the U.S. Dollar Index, we might as well call this index the "Anti-Euro Index". Because the USDX is so heavily influenced by the euro, people have looked for a more "balanced" dollar index. More on that later though. First, let's go to the charts!

How to Read the US Dollar Index

Just like any currency pair, the US Dollar Index (USDX) even has its own chart. Holler at the U.S. Dollar Index:

First, notice that the index is calculated 24 hours a day, five days a week. Also, the US Dollar Index (USDX) measures the dollar's general value relative to a base of 100.000. Huh?!?

Okay. For example, the current reading says 86.212. This means that the dollar has fallen 13.79% since the start of the index. (86.212 – 100.000).

If the reading was 120.650, it means the dollar's value has risen 20.65% since the start of the index. (120.650 – 100.00)

The start of the US Dollar Index is March 1973. This is when the world's biggest nations met in Washington D.C. and all agreed to allow their currencies to float freely against each. The start of the index is also known as the "base period".

The U.S. Dollar Index Formula

This is strictly for the grown and geeky. Here is the formula to calculating USDX:

USDX = 50.14348112 × EUR/USD^(-0.576) × USD/JPY^(0.136) × GBP/USD^(-0.119) × USD/CAD^(0.091) × USD/SEK^(0.042) × USD/CHF^(0.036)

Got that? Good! Now you can get a wedgie from the school bully.

We're kidding!

Queen Cleopiptra usually includes the U.S. dollar index in her Chartology articles so if you're planning to watch USDX, you should also find out what our resident chartologist has to say.

Trade-Weighted Dollar Index

There is also another kind of dollar index used by the Federal Reserve. It is called the "**trade-weighted U.S. dollar index**".
The Fed wanted to create an index that could more accurately reflect the dollar's value against foreign currencies based on how competitive U.S. goods are compared to goods from other countries. It was formed in 1998 in order to keep up-to-date with U.S. trade.

The Trade-Weighted U.S. Dollar Index

Here is the current weighting (in percentage) of the index:

Country	Weight(%)
Euro zone	16.22
China	20.81
Canada	12.618
Mexico	11.67
Japan	7.552
United Kingdom	3.393
Korea	3.8
Taiwan	2.381
Singapore	1.889
Brazil	2.204
Malaysia	1.467
Hong Kong	1.269
India	1.958
Switzerland	1.634
Thailand	1.408
Australia	1.415
Russia	1.202
Israel	1.034
Sweden	0.734
Indonesia	1.063
Saudi Arabia	1.071
Chile	0.876
Philippines	0.553
Colombia	0.664
Argentina	0.63
Venezuela	0.485
Total	100

*Weights as of October 21, 2013

The main difference between the USDX and the trade-weighted U.S. dollar index is the basket of currencies used and their relative weights.

The trade weighted index includes countries from all over the world, including some developing countries. Given how global trade is developing, this index is probably a better reflection of the dollar's value across the globe.

The weights are based on annual trade data.

Weights for the broad index can be found at http://www.federalreserve.gov/releases/H10/Weights.
If you'd like to see historical data, check out http://www.federalreserve.gov/releases/h10/Summary/.

How to Use the USDX for Forex Trading

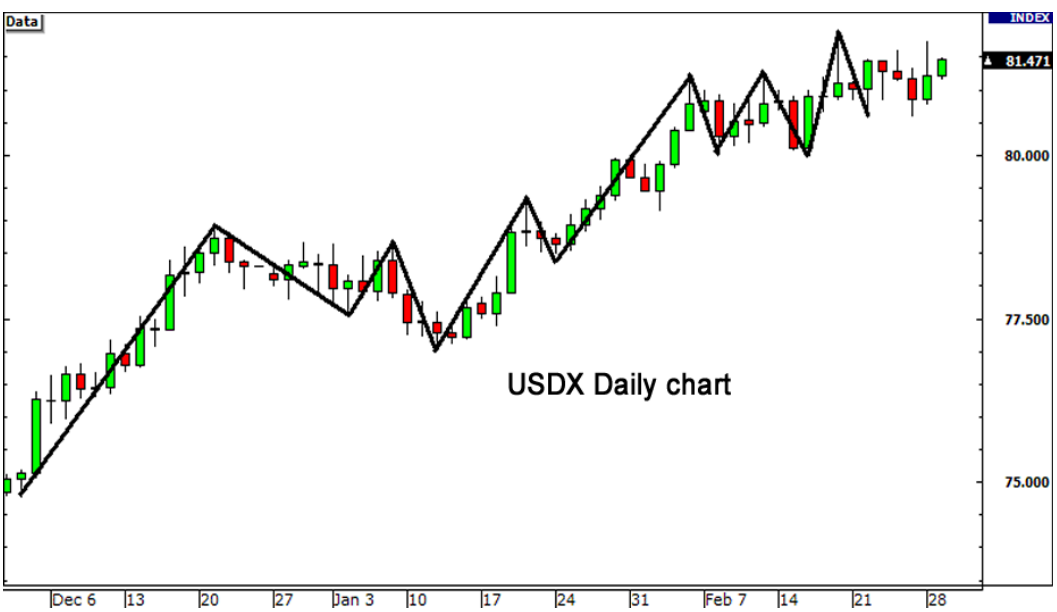
I bet you're wondering, "How do I use this USDX in my trading arsenal?"

Well, hold your trigger finger and you'll soon find out! We all know that most of the widely traded currency pairs include the U.S. dollar. If you don't know, some that include the U.S. dollar are EUR/USD, GBP/USD, USD/CHF, USD/JPY, and USD/CAD.

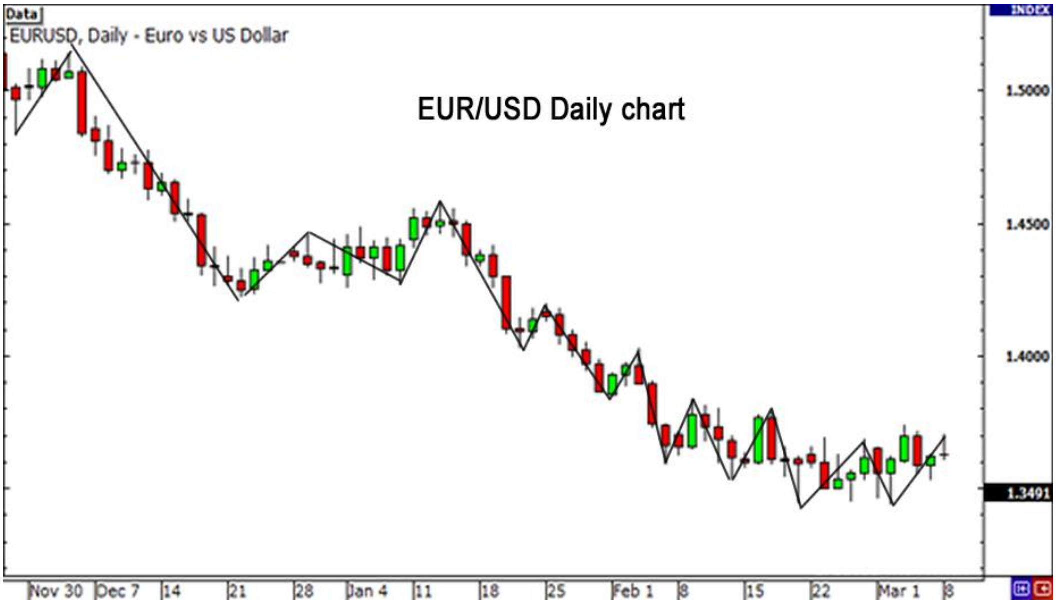
What does this mean? If you trade any of these pairs, the USDX can be the next best thing to sliced bread (or hamburger on a bun… or chocolate ice cream).

If you don't, the USDX will still give you an idea of the relative strength of the U.S. dollar around the world. In fact, when the market outlook for the U.S. dollar is unclear, more often times than not, the USDX provides a better picture.

In the wide world of forex, the USDX can be used as an indicator of the U.S. dollar's strength.
Because the USDX is comprised of more than 50% by the euro zone, EUR/USD is quite inversely related. Check it:



Next, take a look at a chart of EUR/USD.



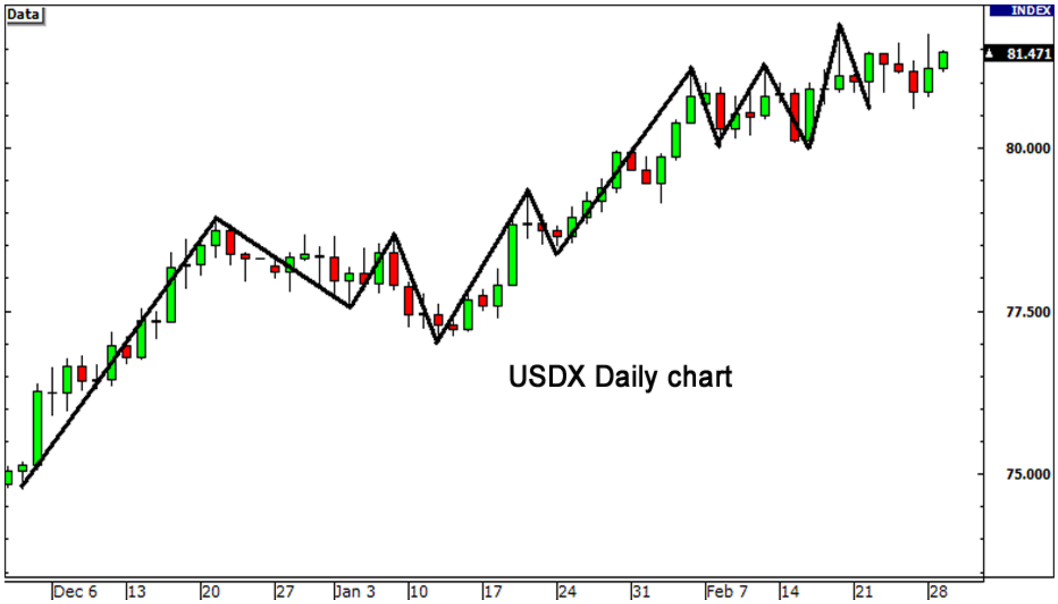
It's like a mirror image! If one goes up, the other most likely goes down. Will you look at that? It seems like the trend lines almost inversely match up perfectly. This could be a big help to those big on trading EUR/USD.

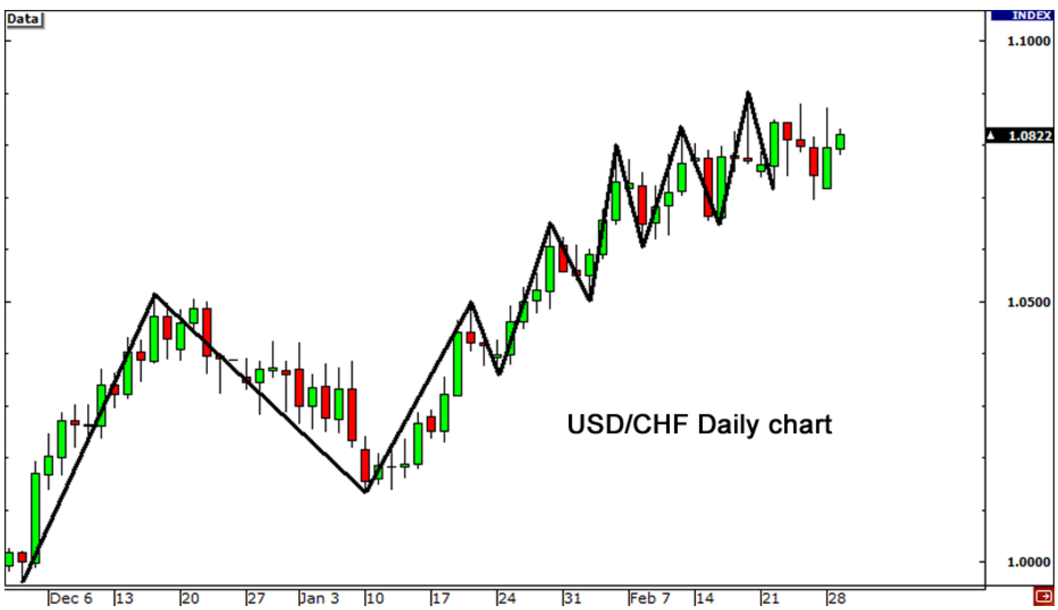
If the USDX makes significant movements, you can almost surely expect currency traders to react to the movement accordingly. Both the USDX and forex traders react to each other. Breakouts in spot USD pairs will almost certainly move the USDX in similar breakout fashion.

To sum it all up, forex traders use the USDX as a key indicator for the direction of the USD.

Always keep in mind the position of the USD in the pair you are trading.

For example, if the USDX is strengthening and rising, and you are trading EUR/USD, a strong USD will show a downtrend on the EUR/USD chart. If you are trading a pair in which the USD is the based currency, such as the USD/CHF, a rise in the USDX will most likely show a rise in USD/CHF charts like the one shown below.





Here are two little tips you should always remember:

If USD is the base currency (USD/XXX), then the USDX and the currency pair should move the same direction.

If USD is the quote currency (XXX/USD), then the USDX and the currency pair should move in opposite directions.

The Dollar Smile Theory

Ever wonder why the dollar strengthens both in times of tough luck and when the economy is booming like a Beyoncé single? Well, so does everybody else. In fact, this really smart dude over at Morgan Stanley came up with a theory to explain this phenomenon.
Stephen Jen, a former currency strategist and economist, came up with a theory and named it the "Dollar Smile Theory." His theory depicts three main scenarios directing the behavior of the U.S. dollar. Here's a simple illustration:

Scenario 1: The first part of the smile shows the U.S. dollar benefiting from risk aversion, which causes investors to flee to "safe-haven" currencies like the dollar and the yen. Since investors think that the global economic situation is shaky, they are hesitant to pursue risky assets and would rather buy up the less risky U.S. dollar regardless of the condition of the U.S. economy.

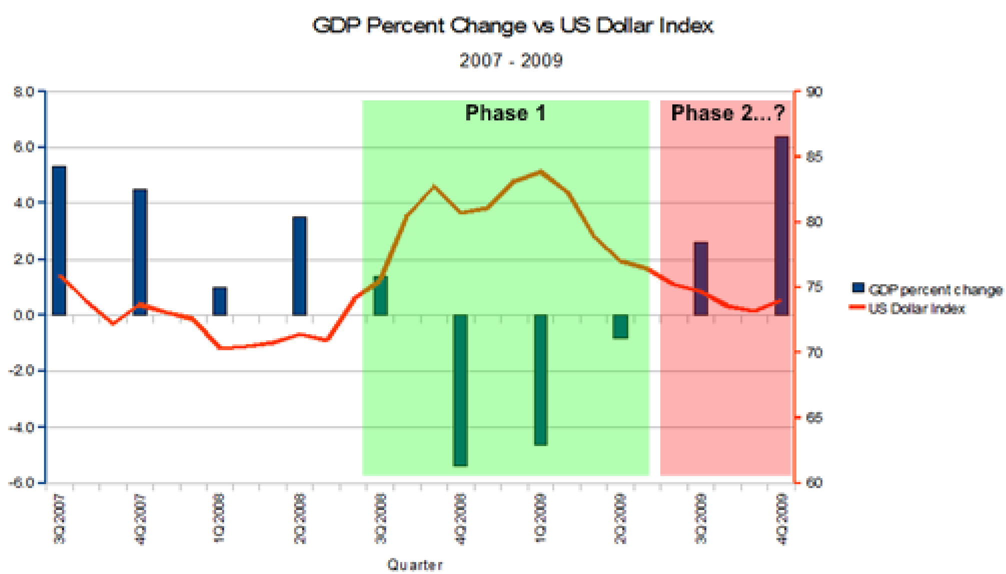
Scenario 2: Dollar drops to new low. The bottom part of the smile reflects the lackluster performance of the Greenback as the U.S. economy grapples with weak fundamentals.
The possibility of interest rate cuts also weighs the U.S. dollar down.

This leads to the market shying away from the dollar. The motto for USD becomes "Sell! Sell! Sell!"

Scenario 3: Dollar appreciates due to economic growth. Lastly, a smile begins to form as the U.S. economy sees the light at the end of the tunnel. As optimism picks up and signs of economic recovery appear, sentiment towards the dollar begins to pick up. In other words, the greenback begins to appreciate as the U.S. economy enjoys stronger GDP growth and expectations of interest rate hikes increase.

This theory appears to have been in play when the 2007 financial crisis began. Remember when the dollar got a huge boost at the peak of the global recession? That's phase 1.

When the market eventually bottomed out in March 2009, investors suddenly switched back to the higher yielding currencies, making the dollar the winner of the "Worst Currency" award for 2009.



So will the Dollar Smile Theory hold true?

Only time will tell.

In any case, this is an important theory to keep in mind. Remember, all economies are cyclical.

The key part is determining which part of the cycle the economy is in.

How Gold Affects AUD/USD and USD/CHF

Before we detail the relationship between the com-dolls and gold, let's first note that the U.S. dollar and gold don't quite mesh very well.

Usually, when the dollar moves up, the gold falls and vice-versa.

The traditional logic here is that during times of economic unrest, investors tend to dump the greenback in favor of gold.

Unlike other assets, gold maintains its intrinsic value or rather, its natural shine!

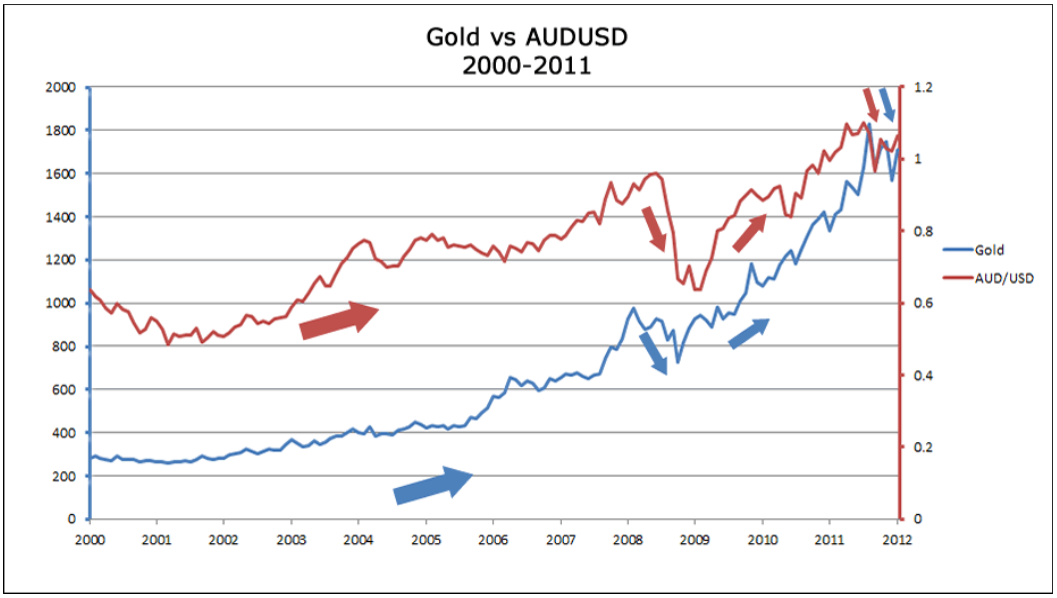
Gold and AUD/USD

Nowadays, the inverse relationship between the Greenback and gold still remains although the dynamics behind it have somewhat changed.

Because of the dollar's safe haven appeal, whenever there is economic trouble in the U.S. or across the globe, investors more often than not run back to the Greenback.

The reverse happens when there are signs of growth.

Take a look at this awesome chart:

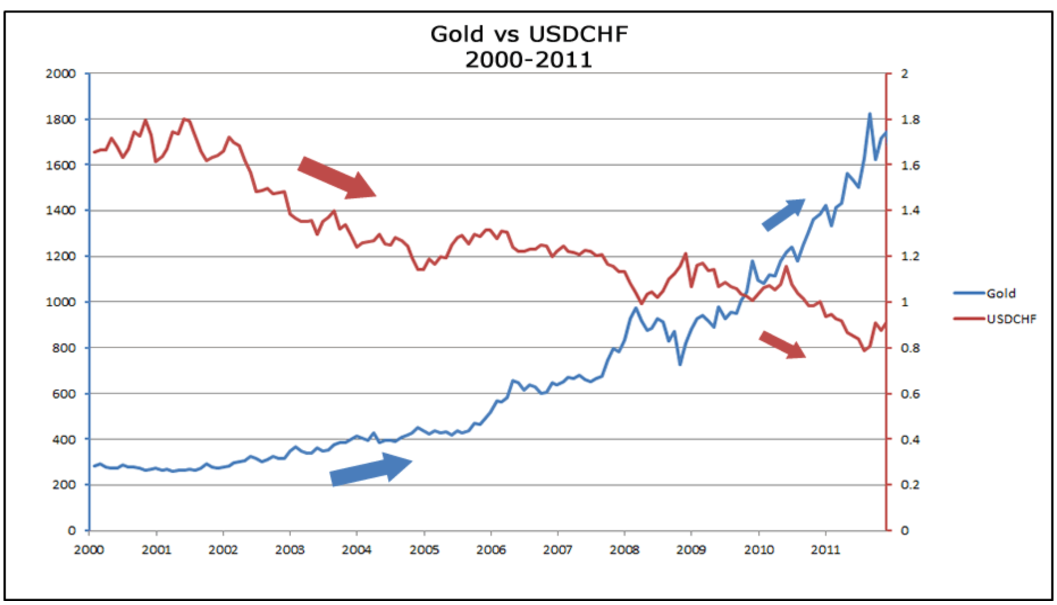


Currently, [Australia]() is the third biggest gold-digger… we mean, gold producer in the world, sailing out about $5 billion worth of the yellow treasure every year!

Gold has a **positive correlation** with AUD/USD.
When gold goes up, AUD/USD goes up. When gold goes down, AUD/USD goes down.

Historically, AUD/USD has had a whopping 80% correlation to the price of gold!

Not convinced? Here's another one:



Gold and USD/CHF

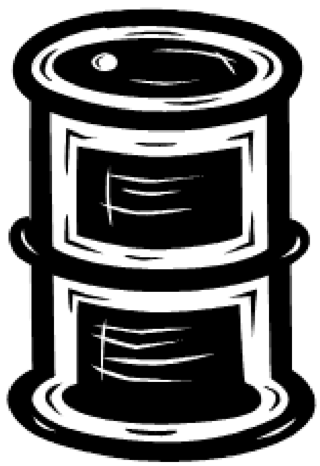
Across the seven seas, Switzerland's currency, the Swiss franc, also has a strong link with gold. Using the dollar as base currency, the USD/CHF usually climbs when the price of gold slides.
Conversely, the pair dips when the price of gold goes up. Unlike the Australian dollar, the reason why the Swiss franc moves along with gold is because more than 25% of Switzerland's money is backed by gold reserves.

Gold has a **negative correlation** with USD/CHF.
When gold goes up, USD/CHF goes down. When gold goes down, USD/CHF goes up.

Isn't that awesome?

The relationship between gold and major currencies is just ONE of the many that we will tackle. Keep reading!

How Oil Affects USD/CAD



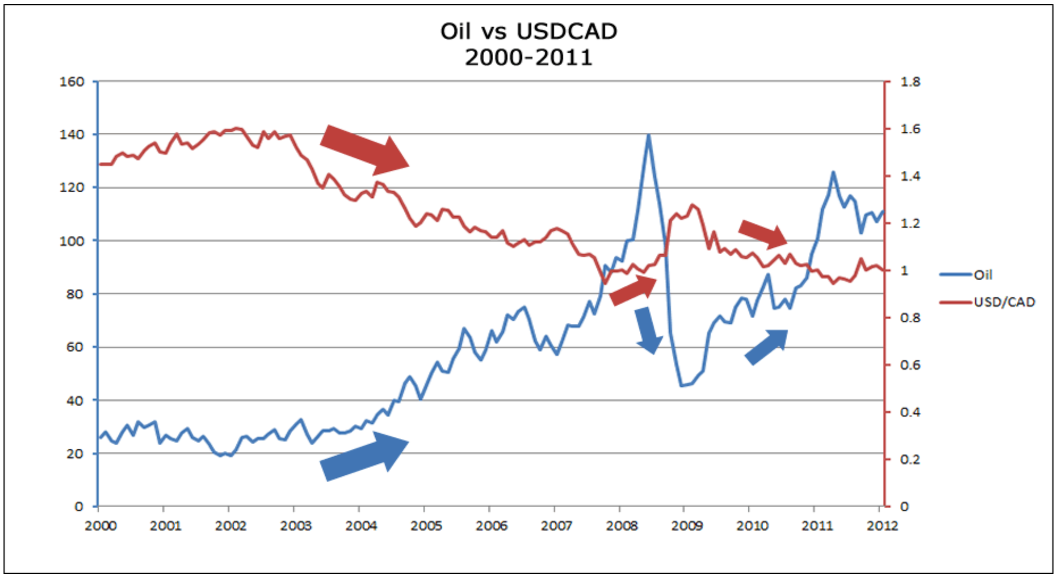
Now, let me talk about the other kind of gold… the black one.

As you may know, crude oil is often referred to as the "black gold" or as we here at BabyPips.com like to call it, "black crack."
One can live without gold, but if you're a crack addict, you can't live without crack.

Oil is the drug that runs through the veins of the global economy as it is a major source of energy.

Canada, one of the top oil producers in the world, exports around 2 million barrels of oil a day to the United States. This makes it the largest supplier of oil to the U.S.!
This means that Canada is United States' main black crack dealer!

Because of the volume involved, it creates a huge amount of demand for Canadian dollars.



Also, take note that Canada's economy is dependent on exports, with about 85% of its exports going to its big brother down south, the U.S. Because of this, USD/CAD can be greatly affected by how U.S. consumers react to changes in oil prices.

If U.S. demand rises, manufacturers will need to order more oil to keep up with demand. This can lead to a rise in oil prices, which might lead to a fall in USD/CAD.

If U.S. demand falls, manufacturers may decide to chill out since they don't need to make more goods. Demand in oil might fall, which could hurt demand for the CAD.

Oil has a **negative correlation** with USD/CAD.
When oil goes up, USD/CAD goes down. When oi goes down, USD/CAD goes up.

So, the next time you gas up your car and see that oil prices are rising, you can use this information to your advantage! It may be a clue for you to go short on USD/CAD!

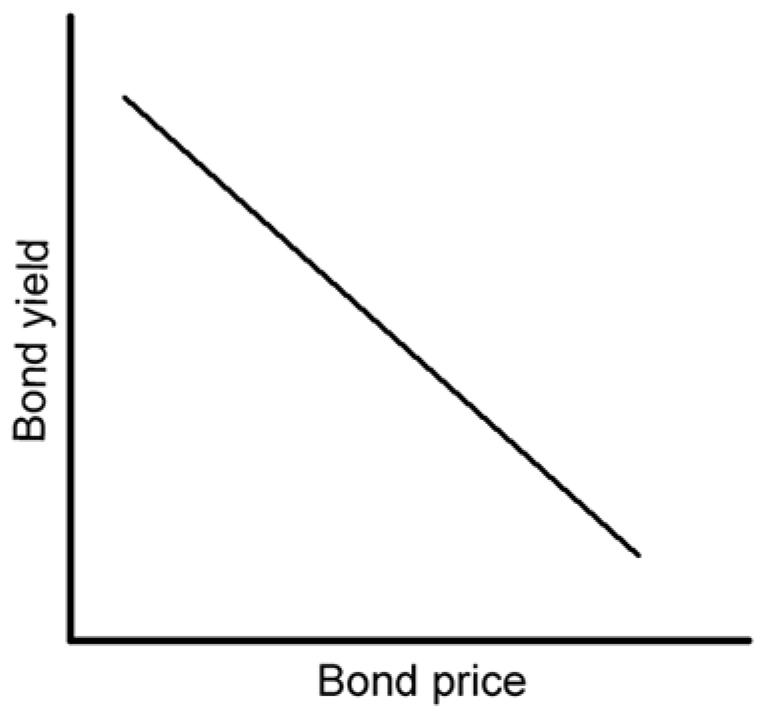
Some forex brokers allow you to trade gold, oil, and other commodities. There, you can readily pull up their charts using their platforms. You can also monitor the prices of gold on Bloomberg. You can likewise check the prices of oil on Bloomberg as well.

How Bond Yields Affect Currency Movements

A bond is an "IOU" issued by an entity when it needs to borrow money. These entities, such as governments, municipalities, or multinational companies, need a lot of funds in order to operate so they often need to borrow from banks or individuals like you. When you own a government bond, in effect, the government has borrowed money from you.

You might be wondering, "Isn't that the same as owning stocks?"

One major difference is that bonds typically have a defined term to maturity, wherein the owner gets paid back the money he loaned, known as the **principal**, at a predetermined set date. Also, when an investor purchases a bond from a company, he gets paid at a specified rate of return, also known as the **bond yield**, at certain time intervals. These periodical interest payments are commonly known as **coupon payments**.
Bond yield refers to the rate of return or interest paid to the bondholder while the bond price is the amount of money the bondholder pays for the bond.
Now, bond prices and bond yields are *inversely correlated*. When bond prices rise, bond yields fall and vice-versa. Here's a simple illustration to help you remember:



Wait a minute… What does this have to do with the currency market?!

Always keep in mind that inter-market relationships govern currency price action.

In this case, **bond yields actually serve as an excellent indicator of the strength of a nation's stock market, which increases demand of the nation's currency.**

For example, U.S. bond yields gauge the performance of the U.S. stock market, thereby reflecting the demand for the U.S. dollar.

Let's look at one scenario: Demand for bonds usually increases when investors are concerned about the safety of their stock investments. This flight to safety drives bond prices higher and, by virtue of their inverse relationship, pushes bond yields down.

As more and more investors move away from stocks and other high-risk investments, increased demand for "less-risky instruments" such as U.S. bonds and the safe-haven U.S. dollar pushes their prices higher.

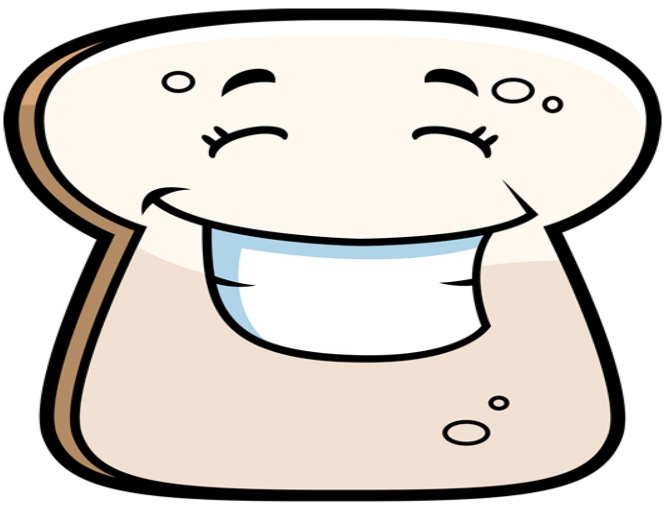
Another reason to be aware of **government bond yields is that they act as an indicator of the overall direction of the country's interest rates and expectations**.

For example, in the U.S., you would focus on the 10-year Treasury note. A rising yield is dollar bullish. A falling yield is dollar bearish.

It's important to know the underlying dynamic on why a bond's yield is rising or falling. It can be based on **interest rate expectations** or it can be based on market uncertainty and a "**flight to safety**" to less-risky bonds.
After understanding how rising bond yields usually cause a nation's currency to appreciate, you're probably itching to find out how this can be applied to forex trading. Patience, young padawan!

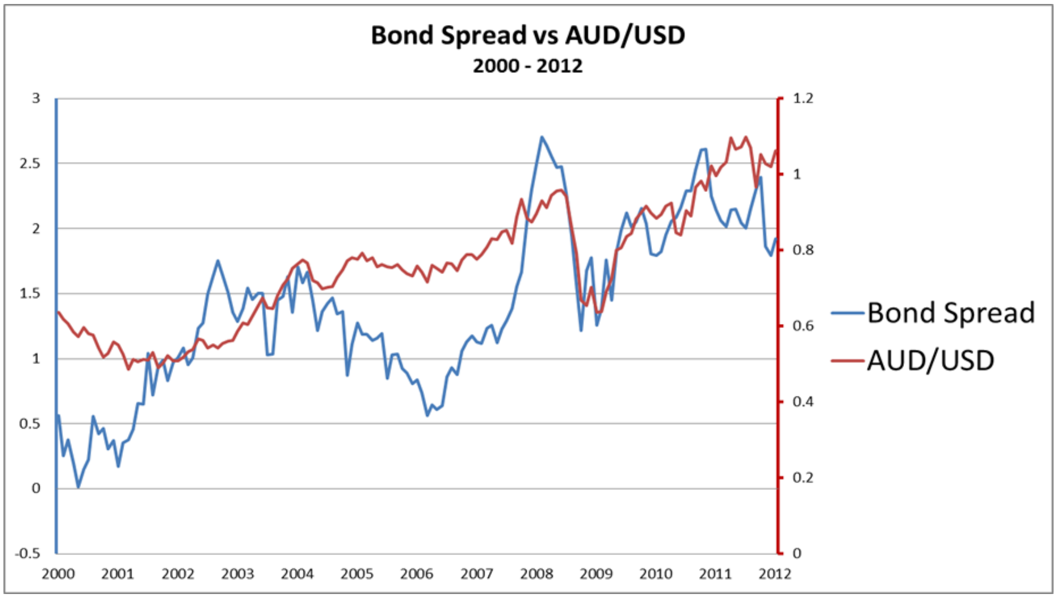
Recall that one of our goals in currency trading (aside from catching plenty of pips!), is to pair up a strong currency with a weak one by first comparing their respective economies. How can we use their bond yields to do that?

How Bond Spreads Between Two Countries Affect Their Exchange Rate


Spread some bonds all over me!

The **bond spread** represents the difference between two countries' bond yields.
These differences give rise to carry trade, which we discussed in a previous lesson.
By monitoring bond spreads and expectations for interest rate changes, you will have an idea where currency pairs are headed.

Here's what we mean:



As the bond spread between two economies widens, the currency of the country with the higher bond yield appreciates against the other currency of the country with the lower bond yield.
You can observe this phenomenon by looking at the graph of AUD/USD price action and the bond spread between Australian and U.S. 10-year government bonds from January 2000 to January 2012.

Notice that when the bond spread rose from 0.50% to 1.00% from 2002 to 2004, AUD/USD rose almost 50%, rising from .5000 to 0.7000.

The same happened in 2007, when the bond differential rose from 1.00% to 2.50%, AUD/USD rose from .7000 to just above .9000. That's 2,000 pips!

Once the recession of 2008 came along and all the major central banks started to cut their interest rates, AUD/USD plunged from the .9000 handle back down to 0.7000.

So what happened here?

One factor that is probably in play here is that traders are taking advantage of carry trades.

When bond spreads were *increasing* between the Aussie bonds and U.S. Treasuries, traders load up on their long AUD/USD positions.
Why?

To take advantage of carry trade!

However, once the Reserve Bank of Australia started cutting rates and bond spreads began to tighten, traders reacted by unwinding their long AUD/USD positions, as they were no longer as profitable.

How Fixed Income Securities Affect Currency Movements

A quick recap: So far, we've discussed how differences in rates of return can serve as an indicator of currency price movement.

As the bond spread or interest rate differential between two economies increases, the currency with the higher bond yield or interest rate generally appreciates against the other.

Much like bonds, **fixed income securities** are investments that offer a fixed payment at regular time intervals.
Economies that offer higher returns on their fixed income securities should attract more investments.
This would then make their local currency more **attractive** than those of other economies offering lower returns on their fixed income market.
For instance, let's consider gilts and Euribors (we're talking about U.K. bonds and European securities here!).

If Euribors are offering a lower rate of return compared to gilts, investors would be discouraged from putting their money in euro zone's fixed income market and would rather place their money in higher-yielding assets. Because of that, the EUR could weaken against other currencies, particularly the GBP.

This phenomenon applies to virtually any fixed income market and for any currency.

You can compare the yields on the fixed income securities of Brazil to the fixed income market of Russia and use the differentials to predict the behavior of the real and the ruble.

Or you can look at the fixed income yields of Irish securities in comparison to those in Korea… Well, you get the picture.

If you want to try your hand at these correlations, data on government and corporate bonds can be found on these two websites:

- Bloomberg
- Trading Economics

You can also check out the government website of a particular country to find out the current bond yields. Those are pretty accurate. They are the government. You can trust them.

In fact, most countries offer bonds but you might want to stick to those whose currencies are part of the majors.

Here are some of the popular bonds from around the globe and their cool nicknames:

Economy	Bonds Offered
United States	U.S. Treasury bonds, Yankee bonds
United Kingdom	Gilts, Bulldog bonds
Japan	Japanese bonds, Samurai bonds
Euro zone	Euro zone bonds, Euribors
Germany	Bunds
Switzerland	Swiss bonds
Canada	Canadian Bonds
Australia	Australian Bonds, kangaroo bonds, Matilda bonds
New Zealand	New Zealand bonds, Kiwi bonds
Spain	Matador bonds

Some countries also offer bonds with varying terms to maturity so just make sure you are comparing bonds with the same term to maturity (such as 5-year gilts to 5-year Euribors), otherwise your analysis would be off.

And we wouldn't want that, would we?

Forex and Global Equity Markets

Did you know that equity markets can also be used to help gauge currency movement? In a way, you can use the equity indices as some kind of a forex crystal ball.

Based on what you see on the television, what you hear on the radio, and what you read in the newspaper, it seems that the stock (equity) market is the most closely covered financial market. It's definitely exciting to trade since you can buy the companies that make the products you can't live without.


One thing to remember is that in order to purchase stocks from a particular country, you must first have the local currency.

To invest in stocks in the Japan, a European investor must first exchange his euros (EUR) into Japanese yen (JPY).

This increased demand for JPY causes the value of the JPY to appreciate. On the other hand, selling euros increases its supply, which drives the euro's value lower.

When the outlook for a certain stock market is looking good, international money flows in. On the other hand, when the stock market is struggling, international investors take their money out and look for a better place to park their funds.

Even though you may not trade stocks, as a forex trader, you should still pay attention to the stock markets in major countries.

If the stock market in one country starts performing better than the stock market in another country, you should be aware that money will probably be moving from the country with the weaker stock market to the country with the stronger stock market.

This could lead to a rise in value of the currency for the country with the stronger stock market, while the value of the currency could depreciate for the country with the weaker stock market.

The general idea is: **strong stock market, strong currency; weak stock market, weak currency.**
If you bought the currency from the country with the stronger stock market and sold the currency from the country with the weaker stock market, you can potentially make some nice dough.

Not too familiar with the major global equity indices? It's your lucky day! Here they are!

Stock Index	Description
Dow	The Dow Jones Industrial Average (or Dow for short), is considered to be one of the premier stock indexes in the U.S. It measures how well the top 30 publicly owned companies are trading. Despite the name, barely any of the companies have anything to do with industrial production and are instead representative of some of the biggest companies in America. It is closely watched by investors around the world and is highly indicative of market sentiment, thus making it sensitive to both local and foreign economic and political events. The companies that are part of the Dow are so large that you probably deal with at least one of them every day. Imagine life without AT&T, McDonalds, Pfizer or Intel? Yes – these companies are all listed in the Dow!
S&P500	The Standard & Poor 500, more commonly known as the S&P 500, is a weighted index of the stock prices of the 500 largest American companies. It is considered a bellwether for the American economy and is used to predict its direction. After the Dow Jones Industrial Average, it is the most traded index in the U.S. Some mutual funds, exchange-traded funds, and other funds such as pension funds, are designed to track the performance of the S&P 500 index. Hundreds of billions of U.S. dollars have been invested in this fashion.
NASDAQ	NASDAQ stands for National Association of Securities Dealers Automated Quotations. It refers to the largest electronic screen-based equity securities trading market in the U.S., comprising of approximately 3,700 companies and corporations. It also boasts of having the largest trading volume among the world's stock markets.
Nikkei	The Nikkei, similar to the Dow Jones Industrial Average, is the most widely quoted average of the Japanese stock market. It is a price-weighted average of the top 225 companies and is supposed to be reflective of the overall market.The Nikkei includes companies like Toyota, Japan Airlines, and Fuji film.
Dax	The DAX is short for the Deutscher Aktien Index (you're probably better off remembering just DAX). It is the stock market index in Germany that consists of the top 30 blue chip companies that are traded on the Frankfurt Stock Exchange.

With Germany being the largest economy in the euro zone, the DAX is normally the most closely watched index within the whole euro zone. Some companies that are part of the DAX are Adidas, BMW, and Deutsche Bank.

DJ EURO STOXX 50

The Dow Jones Euro Stoxx 50 index is the euro zone's leading blue-chip index. It comprises over 50 top-sector stocks from 12 euro zone countries. It was created by Stoxx Ltd., which is a joint venture of Deutsche Boerse AG, Dow Jones & Company and SIX Swiss Exchange.

FTSE

The FTSE (pronounced "footsie") index tracks the performance of the most highly capitalized UK companies listed on the London Stock Exchange. There are several versions of this index, such as the FTSE 100 or FTSE 250, depending on the number of companies included in the index.

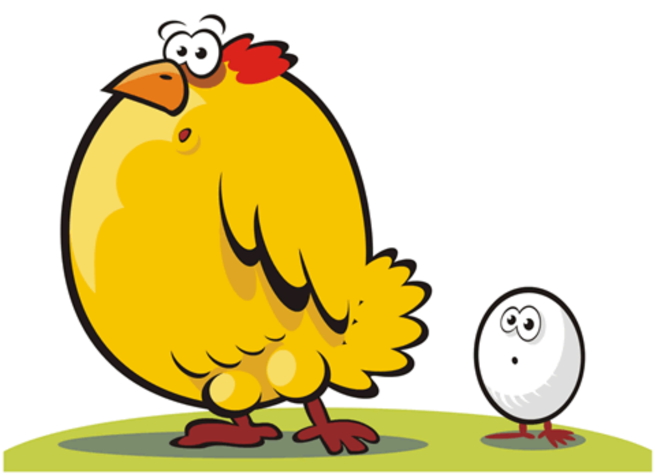
Hang Seng

The Hang Seng index is a stock market index in Hong Kong. By recording and monitoring the daily price changes of the stocks included in the index, it tracks the overall performance of the Hong Kong stock market.
This index is currently compiled by the HSI Services Limited, which is a subsidiary of Hang Seng Bank.

The Relationship Between Stocks and Forex

One issue with using global equity markets to make forex trading decisions is figuring out which leads which.

It's like answering that age old question, "Which came first, the chicken or the egg?" or "Who's yo daddy?!"



Are the equity markets calling the shots? Or is it the forex market that wears the pants in the relationship?

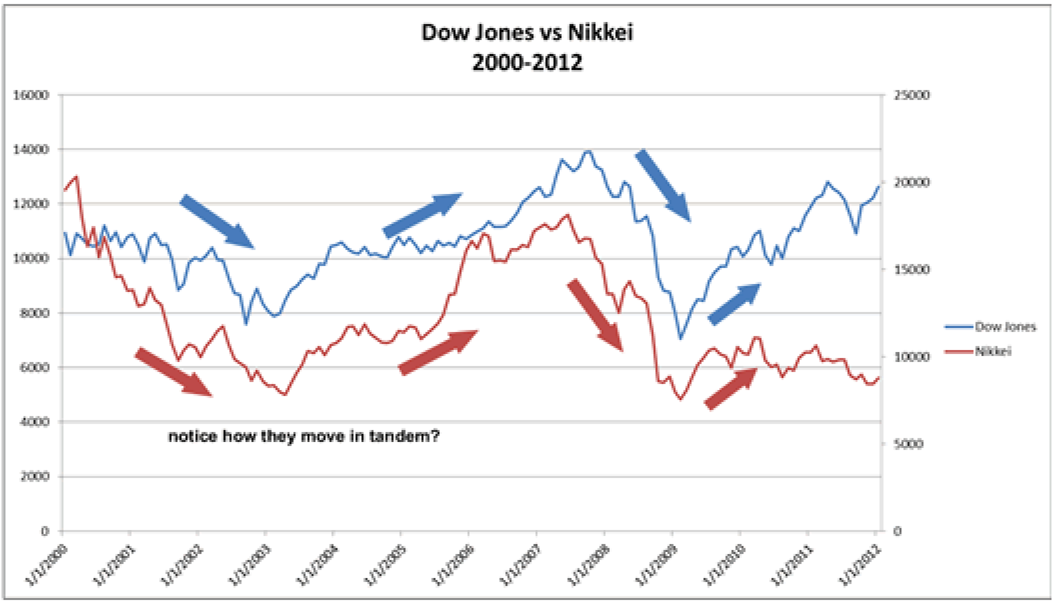
The basic idea is that, when a domestic equity market rises, confidence in that specific country grows as well, leading to an inflow of funds from foreign investors. This tends to create a demand for the domestic currency, causing it to rally versus other foreign currencies.

On the flip side, when a domestic equity market performs terribly, confidence falters, causing investors to convert their invested funds back into their own local currencies.

For the past couple of years, however, this principle holds contrary for the U.S. and Japan.

Any upbeat economic figures in the U.S. and Japan more often than not weigh down on their respective currencies, the dollar and yen.

First, let's take a look at the correlation between the Dow Jones Industrial Average and the Nikkei to see how stock markets all over the globe perform relative to each other.



Since the turn of the century, the Dow Jones Industrial Average and the Nikkei 225, the Japanese stock index, have been moving together like lovers on Valentine's Day, falling and rising at the same time. Also notice that sometimes one index leads, rallying or dropping first before being followed by the other index. You could say that stock markets in the world generally move in the same direction.

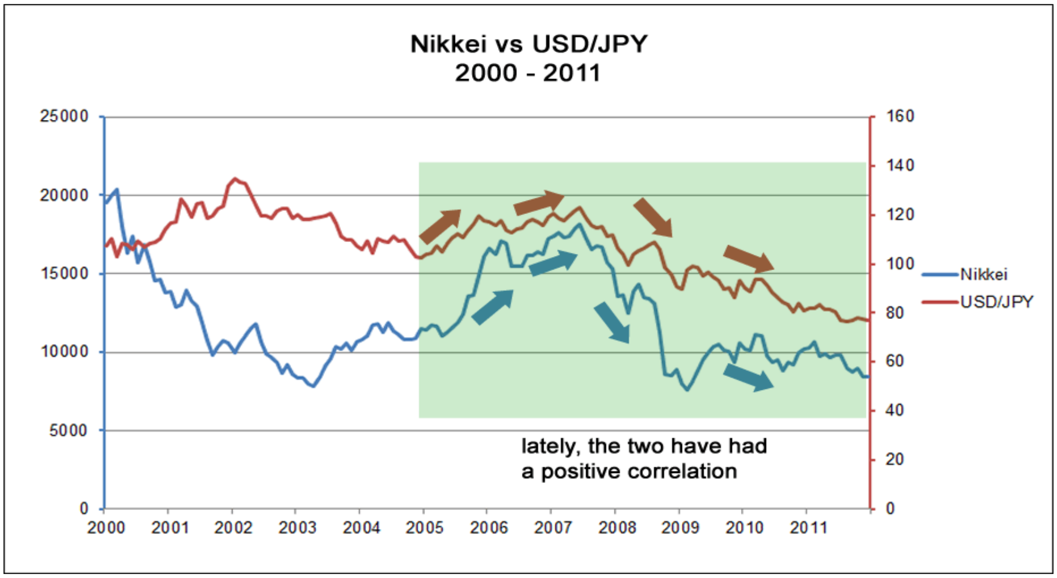
How the Stock Market Affects the Forex Market

Nikkei and USD/JPY

Before the global economic recession that started in 2007, when most economies suffered consecutive quarters of negative GDP growth, the Nikkei and the USD/JPY were inversely correlated.

Investors believed that the performance of the Japanese stock market reflected the status of the country, so a rally in the Nikkei led to a strengthening of the yen.

The opposite also held true. Whenever the Nikkei would drop, USD/JPY would rise as well.



When the financial crisis hit, however, the relationships just went crazy like Lindsay Lohan.

The Nikkei and USD/JPY, which used to move oppositely, now move in the same direction.

Amazing isn't it?

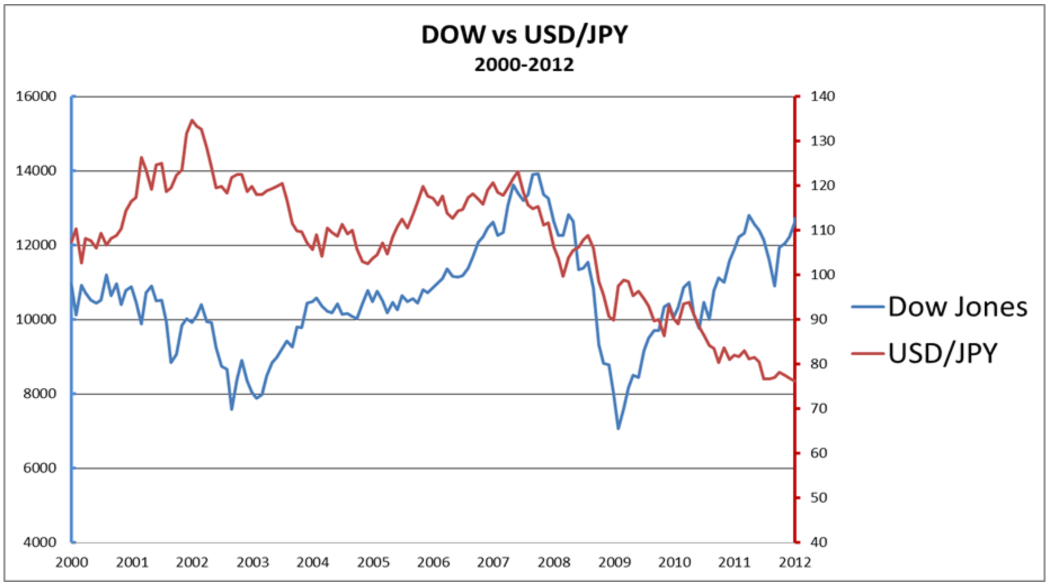
Who would've thought that stocks would have something to do with the foreign exchange market?

Well, we did, and now you know too!

Correlation Between USD/JPY and Dow

Let's take a look at the correlation between the USD/JPY and the Dow. Based on what you read earlier, you might assume that the USD/JPY and Dow would be highly correlated.

However, a look at the chart below would tell you that it isn't quite the case. While the correlation is positive, it isn't as strong.



Take a look at the Dow (blue line).

It peaked at 14,000 late in 2007 before dropping like a hot potato in 2008. At the same time, USD/JPY (orange line) also fell, but not as sharply as the Dow.

This serves as a reminder that we should always take into account fundamentals, technicals, and market sentiment, so always read up!

Don't take correlations for granted because they aren't a sure fire thing!

How to Use EUR/JPY as a Leading Indicator for Stocks

As we said earlier, in order for someone to invest in a particular stock market, one would need the local currency in order to purchase stocks.

You can imagine what the effect of stock markets like the DAX (that's the German stock market), have on currencies.

In theory, whenever the DAX rises, we can probably expect the euro to rise as well, as investors need to get a hand on some euros.

While the correlation is imperfect, statistics show that it still holds pretty accurately.

We here at BabyPips.com did a little research of our own and found out that **EUR/JPY seems to be highly correlated with stock markets across the globe**.

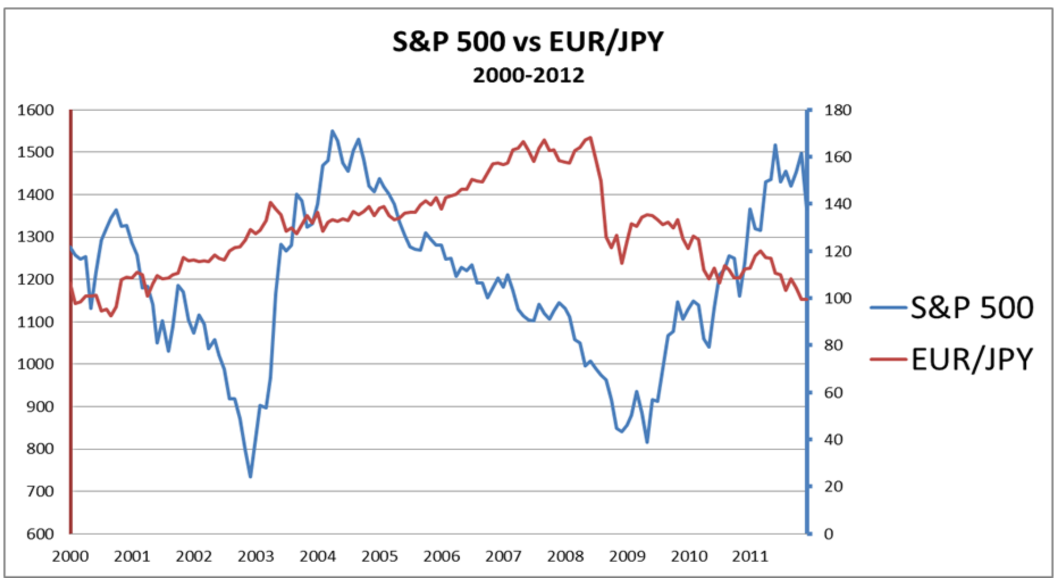
You should know that the yen, along with the U.S. dollar, are considered to be safe havens amongst the major currencies.

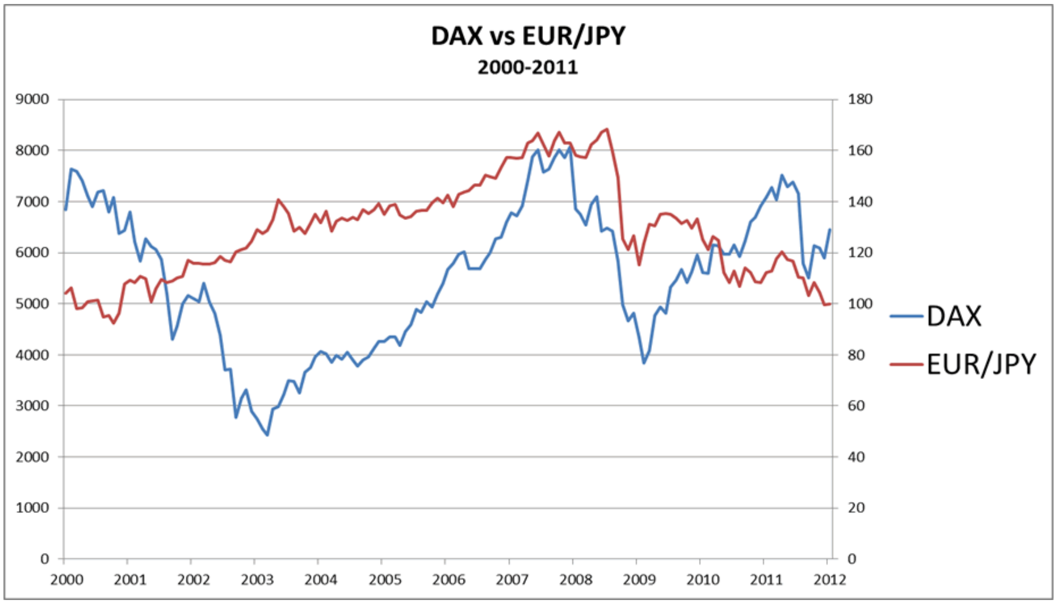
Whenever confidence in the global economy is down and traders are fearful, we typically see traders take their money out of the stock markets, which leads to a drop in the values of the DAX and S&P500.

With money flowing out of these markets, we usually see EUR/JPY fall as traders run for cover.

On the flip side, when the sun is bright and risk appetite is rampant, investors pour their money into stock markets, which in turns leads to a rise in the EUR/JPY.

Take a look at charts below to see the correlation between the EUR/JPY and the DAX and S&P500.





The correlation seems to have held well this past decade, as EUR/JPY and both indexes rose steadily together, until 2008, when we were hit with the financial crisis. In late 2007, EUR/JPY had hit its peak, and so did the stock indexes.

If you want to see the raw data for yourself, check out Yahoo! Finance
This a great place to start digging and doing your own research.

The site offers historical price data for almost all currency pairs and equity markets.

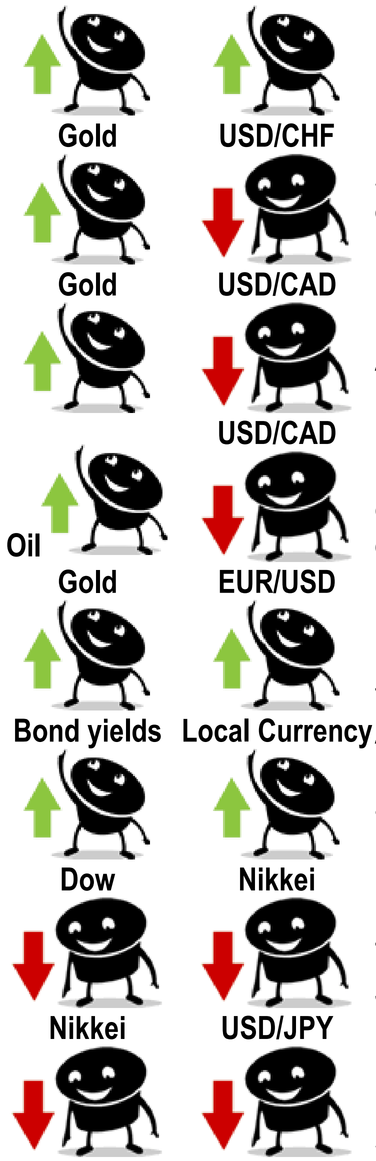
You can compare historical prices and come up with your own barometers of risk.

Intermarket Analysis Cheat Sheet

That's a lot of intermarket correlations to remember so let's do a quick recap. The price action of currencies is often driven by their relationship with commodities, bonds, and stock indices.

Here's a neat one-page cheat sheet for you to bookmark and make it easy for you!

If	Then	Why
Gold 	USD 	During times of economic unrest, investors tend to dump the dollar in favor of gold. Unlike other assets, gold maintains its intrinsic value.
Gold 	AUD/USD 	Australia is the third biggest gold producer in the world, sailing out about $5 billion worth a year.
Gold	NZD/USD	New Zealand (rank 25) is also a large producer of gold.



25% of Switzerland’s reserves are backed by gold. As gold prices goes up, the pair moves down (CHF is bought).

Canada is the 5th largest producer of gold in the world. As gold price goes up, the pair tends to move down (CAD is bought).

Canada is one of the top oil producers in the world. It exports around 2 million barrels of oil a day to the U.S. As oil prices goes up, the pair moves down.

Since both gold and euro are considered “anti-dollars,” if the price of gold goes up, EUR/USD may go up as well.

An economy that offer higher returns on its bonds attract more investments. This makes its local currency more attractive than that of another economy offering lower returns on its bonds.

The performance of the U.S. economy is closely tied with Japan.

Investors consider the yen as a safe-haven and tend to seek it during periods of economic distress.

The Forex Trader's Guide to Major Economies

Today we're going to take a trip around the world, but it ain't gonna take 80 days.

If you're fast enough to keep up, we can probably get around in just 80 seconds!

…Not!

In any case, we'll make sure you learn about the nitty-gritty of each major economy and what makes its engine go.

For each country that we will be touring, we'll start off with a quick peek at the important **facts and figures**, followed by an **overview of its economy**.
Once that's out of the way, we'll visit the **country's central bank** to find out some of their secrets. In this section, we will explore the powerful **monetary policy tools** central banks employ to control the country's economy.
Hopefully, we'll stumble into the room where they keep their printing plates and we can sneak out the back door and sell it on the black market.

We're kidding – we're here to teach you how to trade forex the legal way.

After that, we'll discuss the **important characteristics** that differentiate that country's local currency from all the rest, as well as hard-hitting **economic indicators** for that country.
To keep the trip interesting, we'll be dishing some **trivia** every now and **trading tactics** that will prove useful later on when you go off on your pip-catching adventure!
And as we promised, this very exclusive field trip is covered by your scholarship. No need for travel visas and no need to buy a travel fanny.
Although if you're paranoid like Huck, then go right ahead.

Let's get this show on the road!

United States of America

The United States of America is comprised of 50 states and a federal district. Majority of the country could be found in North America, but the United States also has some territories in the Pacific.

Since its independence from the U.K. on the Fourth of July back in 1776, the U.S. has become an economic superpower not just in the West but also in the whole world.

Being the world's **largest economy**, the U.S. plays a serious role in the global market. Just about any economic development in the U.S., such as a rise or fall in consumer spending or an affair by its President that is made public, could create quite a hefty impact on economies all over the world!

United States: Facts, Figures, and Features

- **Neighbors:** Canada, Mexico, Puerto Rico, Cuba
- **Size:** 3,794,101 square miles
- **Population:** 309,349,689
- **Density:** 87.4 people per square mile
- **Capital City:** Washington, D.C.
- **Head of Government:** President Barack Obama
- **Famous Actors:** Sandra Bullock, Will Smith, Johnny Depp, Halle Berry
- **Currency:** U.S. Dollar (USD)
- **Main Imports:** Industrial supplies (crude oil, etc.), capital goods (computers, telecom equipments, automobile parts, office machines, electric power machinery), consumer goods (automobile, clothing, medicines, furniture, toys), and agricultural products
- **Main Exports:** Capital goods (transistors, aircraft, automobile parts, computers, telecom equipment), industrial supplies (organic chemicals), consumer goods (automobiles, medicines), agricultural products (soybeans, fruit, corn) , Barbies, Xbox consoles, and Apple iPods
- **Import Partners:** China (19%), Canada (14.1%), Mexico (12%), Japan (6.4%), Germany (4.7%)
- **Export Partners:** Canada (18.9%), Mexico (14%), China (7.2%), and Japan (4.5%)
- **Time Zones:** GMT -10, GMT -9, GMT -8, GMT -7, GMT -6, GMT -5
- **Website:** http://www.usa.gov

Economic Overview

The U.S. is widely considered to be the richest country in the world, producing about $16.24 trillion in output in 2012. It ranked 13th in 2012 in terms of per capita income – that's just the country's total income divided by its population – of about $51,700 in a year.

The U.S.'s main industries are aircrafts, automobiles, transistors, telecom equipments, and other industrial materials. Although it might seem that the US economy is heavily oriented towards the manufacturing physical goods, 70% of its output actually comes from the services sector!

Speaking of trade, one key element of the U.S. economy is that the country is notorious for running huge trade deficits (i.e., the total value of goods flowing in to the country is more than the total value of those going out).

The U.S. is also home to the New York Stock Exchange, which is the largest stock exchange in the world. It is also home to the world's largest bond market, with a market capitalization of over $31 trillion and over $822 billion in bonds traded daily on average.

Being the top economy in the world in today's globalized market, any domestic event affecting the U.S. also has the potential to affect markets around the world… Yes, even the foreign exchange market!

Monetary & Fiscal Policy

The Federal Reserve Board, more commonly called the *Fed*, is the U.S.'s main governing body when it comes to setting and implementing monetary policy.
Monetary policy is just the way the Fed controls the availability and supply of money in the economy and what makes the Fed special from other central banks is that its objectives are based on a longer-term effects of its monetary policy.
The Fed has two main objectives. The first one is keeping the prices of consumer goods and services stable and the second one is making sure that there is sustainable economic growth.

In other words, the Fed just wants to make sure that yo' Benjies doesn't lose value and yo' momma and poppa have jobs!

Within the Fed is the Federal Open Market Committee (FOMC). Currently led by Fed Governor Janet Yellen, the FOMC is tasked to make sound and rational decisions on monetary policy.
The FOMC has two main weapons to use in its battle against inflation and achieve its long-term objectives: open market operations and the Fed's Funds Rate.

The Fed's first line of defense, its open market operations, is the buying or selling of government financial instruments like securities, notes and bonds.
The Feds Funds Rate, its stronger, more obvious double-barreled shotgun, is the interest rate the Fed offers other commercial banks.

Now, the one accountable for fiscal policy decisions is the U.S. Treasury. Fiscal policy is the use of government spending or tax collection to influence the direction of the economy.

To encourage business activity, the U.S. Treasury, for instance, could choose to lower taxes and to allot more budget on capital infrastructures like highways, schools, broadband, secret military ninja bases, etc. On the other hand, if inflation starts to get out of hand, it could increase tax rates and cut spending.

Getting to Know the USD

Did you know that the nickname "Buck" for the U.S. dollar originated from buckskin, which was a common medium of exchange when the early American settlers traded with the Indians?

Even after paper currency replaced buckskin in the barter system, people still refer to the medium of exchange as bucks! Check out these forex-related properties of the buck:

Liquidity is my thing!

A ginormous amount of currency transactions every day involves the USD. Commodities like gold and crude oil are also denominated in dollars. During the Asian session alone, the dollar takes up around 93% of all the currency transactions!

To put this in perspective, take the New York Stock Exchange and the U.S. bond market for example. The value of the companies listed in the NYSE amounts to $28.5 trillion, about 78% of the size of the world's $36.6 trillion stock market.

Similarly, of the $82.2 trillion value of the global bond market, the U.S. takes up $31.2 trillion. Every single transaction there, in some way, involves the USD. How's THAT for liquidity?

The Fed and the U.S. government believe I should remain strong

Over the past few decades, the Fed and the U.S. Treasury have kept a “strong dollar” policy. They believe that monetary and fiscal policy should be geared towards a strong exchange rate of the USD, as it would benefit the U.S. and the rest of the world.

The currencies of many emerging countries rely on me to determine their value

How often have you heard the phrase, the dollar is the world’s reserve currency? Well, the reason behind this is that some countries actually peg their currencies against the dollar!
When a country does this, the government agrees to buy or sell their currency at a fixed priced versus the dollar. While the government can increase and decrease the supply of money, they are still subject to having the equivalent amount of dollars in reserve.

This process magnifies the importance of the dollar around the world, because this means that some economies are entirely dependent on the dollar!

If the dollar’s value were to stage a massive fall, it would produce a wide-reaching negative effect in all the other countries that are pegged their currency on the dollar.

Important Economic Indicators for the USD

Non-farm employment change (NFP) – The NFP employment report measures the change in the number of employed people in the prior month.
GDP – The Gross Domestic Product (GDP) report is the measure of the country’s total value of all final goods and services.

Retail Sales – The headline retail sales report measures the monthly change in the total value of sales at a retail level. The core version of the report, on the other hand, excludes vehicle sales.
Consumer Price Index (CPI) – The CPI measures the change in the prices of a fixed basket of goods and services. The core account excludes food and energy prices because of their volatile nature.
Personal Consumption Expenditure – This is very similar to the CPI report as it measures the price changes of US consumer goods. The reason why you should look at this report is because this is the one that the Fed looks at when making decisions regarding monetary policy. And we all want to be in cahoots with the experts right?
University of Michigan Consumer Sentiment – Every month, the University of Michigan releases its consumer sentiment report. This index measures the attitude consumers have towards the economy. The more confident consumers are about economic conditions, the more likely they are to spend.

What Moves the USD?

The Gold Rush

Whenever the dollar is at risk of losing its value due to inflation, investors turn to gold for safety. Unlike most financial assets, gold maintains its intrinsic value. Gold is gold is gold – it’s the same everywhere! So when gold prices are rising, it could be a sign that the dollar is losing its appeal.

Economic Developments in the U.S.

Fundamentally, positive economic developments in the U.S. attract more participants to invest in the U.S. An investor would of course need to have some dollars to be able to transact in the U.S. So as the demand for U.S. investments increases, the demand for the greenback rises as well.

Capital Inflows and Outflows

With respect to Japan and London, the U.S. probably has the deepest and most advanced financial markets. This provides the many kings, sultans, billionaires, and heirs around the world many types of investments which they can choose from.

In order to invest in these American assets, investors would first need to convert whatever currency they are holding in to U.S. dollars. The capital inflows and outflows from the U.S. financial markets can have a significant effect on the value of the dollar.

Economic Developments Around the World

Since the USD takes up about majority daily currency transactions, just about any major development in the world (i.e. strong GDP growth in Australia, a stock market crash in Beijing, or a Godzilla attack in Tokyo) affects its short term valuation.

Bond Yield Differentials

With investors always looking for the best deal for their money, it is important to keep track of the differences in the yields of bonds of the U.S. and other foreign countries.

If investors see that bond yields are rising in foreign countries while yields in the U.S. are staying steady or going lower, investors will move their funds out of U.S. bonds (selling their dollars in the process) and begin purchasing foreign bonds.

Rumors on the Interest Rate Grapevine

Market participants pay attention to interest rates trends, and you should too.
If the Fed is expected to raise interest rates, this means that demand for dollar-denominated financial assets (like Treasuries) could rise, which would be bullish for the dollar.

If the Fed is expected to cut interest rates, it could lessen demand for these assets and we could see investors move their funds away from the dollar.

Since Fed officials usually drop hints about the central bank's future interest rate moves, traders are all ears during policymakers' speeches.

Trading the USD

USD as the Base Currency

USD/XXX is traded in amounts denominated in USD. Standard lot sizes are 100,000 USD and mini lot sizes are 10,000 USD.

The pip value, which is denominated in XXX, is calculated by dividing 1 pip of the USD/XXX, which would be 0.0001 or 0.01 depending on the pair being talked about, by the USD/XXX current rate.

Profit and loss are denominated in XXX. For one standard lot position size, each pip movement is worth 10 XXX. For one mini lot position size, each pip movement is worth 1 XXX. For example, if one pip is equal to 0.0001 and the current exchange rate of USD/XXX is 1.4000, one pip of one standard lot would equate to 14 USD.

Margin calculations are based in US dollars. With a leverage of 100:1, 1,000 USD is needed to trade 100,000 USD/CAD.

USD as the Quote Currency

XXX/USD is traded in amounts denominated in XXX. Standard lot sizes are 100,000 XXX and mini lot sizes are 10,000 XXX.

The pip value, which is denominated in US dollars, is calculated by dividing 1 pip of the XXX/USD (0.0001 or 0.01 depending on the pair) by the XXX/USD's current rate.

Profit and loss are denominated in U.S. dollars. For one standard lot position size, each pip movement is worth 10 USD. For one mini lot position size, each pip movement is worth 1 USD.

Margin calculations are based in US dollars. For example, if the current XXX/USD rate is 0.8900 and the leverage is 100:1, 890 USD is needed in available margin to be able to trade on standard lot of 100,000 XXX. However, the as the XXX/USD rate increases, a larger available margin in USD is required. Conversely, the lower the XXX/USD rate is, the less required available margin is needed.

USD Trading Tactics

Now let's put all these things we just learned and come up with some trade tactics for the USD.

Looking at differences in U.S. economic developments and economic data from other major economic is a good way to start off trading the USD. For example, a jump in the US retail sales and ugly results on UK's employment situation report would be give you a reason to sell the GBP/USD.

The U.S. dollar index or USDX, which tracks the performance of the USD versus a fixed basket of currencies, is also a great barometer of the strength of the USD. By regularly looking at the U.S. dollar index, you can find some clues on where the USD is headed.
A USDX that is trending upwards could provide you the additional confirmation you need to take a short position on the EUR/USD.

Talks of a Fed funds rate hike, which signals the possibility of higher returns on US assets, encourage traders to buy up the USD. Well, don't get left behind!

Taking note of the Fed's monetary policy outlook, which is usually part of Fed officials' speeches, could yield some clues about the direction of the USD.

Hawkish remarks could serve as signals to go long on the USD/JPY while dovish comments could serve as reasons to short the USD/JPY.

To stay updated on the economic developments in the United States, make sure you read Pip Diddy's U.S. economic commentary every day!

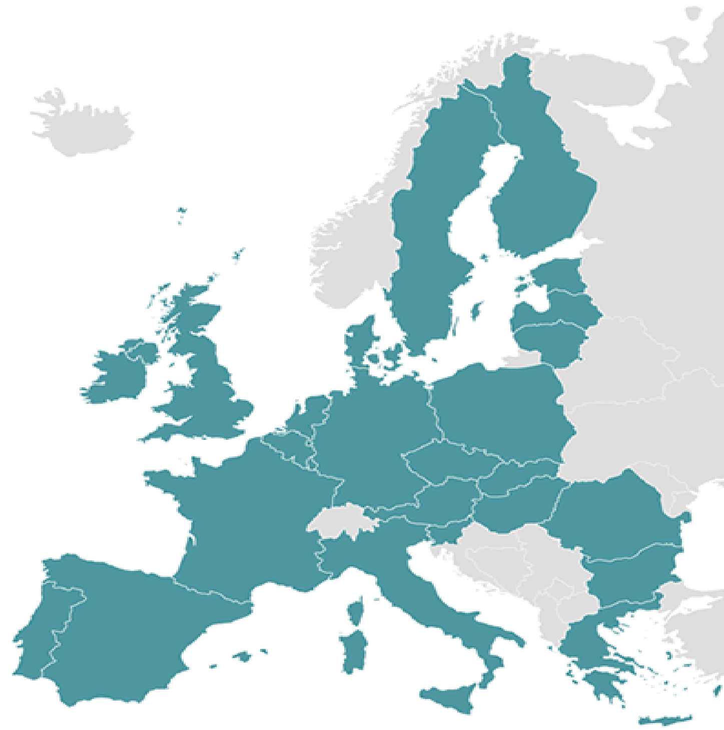
Euro Zone

The European Union (EU) is a brotherhood of 28-member states which started from a tiny gang of six neighboring states in 1951. By the magical powers of the Treaty of Maastricht, it then grew into a large economic and political bloc, making it the largest economic region in the world. Talk about playing a huge role in international trade and global economic affairs!

Among these EU member states, eighteen countries adopted the euro (EUR) as their common currency. These nations comprise the euro zone, which is also called the European Monetary Union (EMU) or Euroland.

Members of this elite club are: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain.

Aside from adopting a common currency, these nations also share the same monetary policy set by the European Central Bank (ECB).



Euro zone: Facts, Figures, and Features

- **Member Nations:** Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain
- **Size:** 1,691,658 square miles
- **Population:** 505,665,73
- **Density:** 300.9 people per square mile
- **Head of European Commission:** Jose Manuel Barroso
- **Head of European Parliament:** Martin Schulz
- **Head of European Council:** Herman Van Rompuy
- **Currency:** Euro (EUR)
- **Main Imports:** Machinery, vehicles, aircraft, plastics, crude oil, chemicals, textiles, metals
- **Main Exports:** Machinery, motor vehicles, aircraft, plastics, pharmaceuticals and other chemicals, Antonio Banderas, Penelope Cruz, Jean-Claude "The Muscles from Brussels" van Damme
- **Imports partners:** China 15.89%, U.S. 11.97%, Russia 11.22%, Norway 6.13%, Switzerland 5.14%
- **Exports partners:** U.S. 19.07%, Russia 8.03%, Switzerland 7.49%, China 6%, Turkey 4.14%
- **Time Zones:** GMT, GMT+1, GMT+2
- **Website:** http://www.europa.eu

Economic Overview

The euro zone, which comprises more than half of the nations in the EU, ranks as the largest economy with a GDP of $18.45 trillion in 2011. Being a services-oriented economy, services account for a whopping 70% of its GDP!

On top of that, the euro zone takes pride in being the second most attractive investment market for domestic and international investors.

As an economic union, the euro zone has a standardized system of laws, particularly for trade. The size of their entire economy makes the euro zone a major player in the international trade arena.

Because the individual countries are grouped as one entity, it enables them to facilitate trade easier, mostly with its number one trade partner, the U.S.

This active participation in international trade also has a significant impact on the role of the EUR as a reserve currency.

This is because countries who transact with the euro zone need to have a significant amount of reserve currencies in order to reduce exchange rate risk and minimize transaction costs.

Monetary & Fiscal Policy

The European Central Bank (ECB) acts as the governing body for the monetary policy of the EU. Led by the current ECB President Mario Andretti… errr, we mean Mario Draghi, the Executive Board also consists of the ECB Vice President and four other policymakers.
Along with the top guns from the national central banks within the euro zone, they make up the ECB Governing Council who vote on monetary policy changes.

The main objective of the ECB is to maintain price stability in the entire region – quite a tall order! To achieve this goal, the euro zone signed the Maastricht Treaty which applied a certain set of criteria for the member nations. Here are some of the requirements:

- The nation's inflation rate must not exceed the average inflation of the three best performing (lowest inflation rates) states by more than 1.5%.
- Their long-term interest rates must not exceed the average rates of these low-inflation states by more than 2%.
- Exchange rates must stay within the range of the exchange rate mechanism for at least a couple of years.
- Their government deficit must be less than 3% of their GDP.

If a nation fails to meet these conditions, they are penalized with a hefty fine. Yikes!

The ECB also makes use of their minimum bid rate and open market operations as their monetary policy tools. The ECB minimum bid rate or repo rate is the rate of return the central bank offers to the central banks of its member states. They make use of this rate to control inflation.

Open market operations, on the other hand, are used to manage interest rates, control liquidity, and establish monetary policy stance. Such operations are conducted through buying or selling of government securities in the market.

In order to increase liquidity, the ECB buys securities and pays with euros, which then get circulated. Conversely, to mop up excess liquidity, the ECB sells securities in exchange for euros.

Other than making use of those monetary policy tools, the ECB can also opt to intervene in the foreign exchange market to further cap inflation. Because of this, traders pay close attention to comments from the Governing Council members since these could impact the EUR.

Getting to Know the euro

Aside from being dubbed the anti-dollar, the euro is also nicknamed “fiber.” Some say that this nickname was derived from the Trans-Atlantic fiber optic, which was used for communication, while some argue that it was from the paper used to print European banknotes way back then! Here are some of the other characteristics of the euro.

They call me the Anti-Dollar!

With the euro popularly known as the anti-dollar, EUR/USD is the most actively traded currency pair. As such, it is also the most liquid of the major pairs and offers the lowest pip spread.

I’m busy during the London session…

The euro is most active during 8:00 am GMT, at the beginning of the London session. It often has little movement during the latter half of the U.S. session, around 5:00 pm GMT.

…and I’ve had a few relationships.

EUR/USD is often linked to the movement of capital markets, such as bonds and equities. It is negatively correlated to the movement of the S&P 500, which represents the performance of the U.S. stock market.

This correlation was thrown out of sync after the 2007 financial crisis though. Now, EUR/USD has a slightly positive correlatoin with the S&P 500.

EUR/USD is also negatively correlated to USD/CHF, reflecting how the Swiss Franc moves in almost perfect tandem with the euro.

Important Economic Indicators for the euro

Gross Domestic Product – Gross domestic product is the central measure of economic growth in the region. Since Germany is the largest economy in the euro zone, its GDP tends to move the euro the most.
Employment Change – The euro is also sensitive to changes in employment, particularly in the euro zone’s largest economies like Germany and France.

German Industrial Production – This measures the change in volume of output from Germany’s manufacturing, mining, and quarrying industries. Because of this, it reflects the short-term strength of German industrial activity.
German IFO Business Climate Survey – This is one of the country’s key business surveys. Conducted monthly, this takes into the account the current business situation of Germany as well as expectations for future conditions.
Budget Deficits – Recall that one of the criterias in the Maastricht Treaty requires that euro zone economies keep their debt-to-GDP ratio below 60% and their deficit less than 3% of its annual GDP. Failure to achieve these targets could result to fiscal instability in the euro zone.
Consumer Price Index – Since one of the goals of the ECB is to maintain price stability, they keep an eye on inflation indicators such as the CPI. If the annual CPI deviates from the central bank target, the ECB could make use of its monetary policy tools to keep inflation in check.

What Moves the EUR?

Euro zone Fundamentals

Reports of strong economic performance by the euro zone as a whole, or by its member nations, can boost the euro higher. For instance, better than expected GDP reports from Germany or France could encourage traders to be bullish on the euro.

Uncle Sam’s Groovy Moves

Sudden changes in market sentiment, buoyed mostly by U.S. economic data, tend to have a huge impact on EUR/USD.

Being considered the anti-dollar, the euro is also swayed by talks of reserve diversification away from the U.S. dollar. Euro as the new reserve currency, anyone?

Differences in Rates of Return

Bond spread between 10-year U.S. government bonds and 10-year Bunds (German bonds) usually indicate the direction of EUR/USD.

If the difference between the yields of the U.S. bonds and Bunds widens, EUR/USD moves in favor of the currency with the higher yield.

Similar to bond yields, interest rate differentials also serve as an excellent indicator for the EUR/USD movement. For instance, traders usually compare the Euribor futures rate with the Eurodollar futures rate.

Just to clear things up: “Euribor” is an acronym that stands for Euro interbank offer rate, which is the rate Euro zone banks use for inter-bank transactions, while Eurodollars are deposits denominated in U.S. dollars.

Trading EUR/USD

EUR/USD is traded in amounts denominated in euros. Standard lot sizes are 100,000 EUR and mini lot sizes are 10,000 EUR.

The pip value, which is denominated in U.S. dollars, is calculated by dividing 1 pip of EUR/USD (that’s 0.0001) by EUR/USD’s rate.

Profit and loss are denominated in U.S. dollars. For one standard lot position size, each pip movement is worth 10 USD. For one mini lot position size, each pip movement is worth 1 USD.

Margin calculations are based in US dollars. For instance, if the current EUR/USD rate is 1.4000 and the leverage is 100:1, it will take $1,400.00 USD in available margin to be able to trade one standard lot position of 100,000 EUR.

As EUR/USD’s rate increases, a larger available margin in U.S. dollars is required. The lower EUR/USD’s rate, the lower the required available margin in U.S. dollars.

EUR/USD Trading Tactics

Pro-euro moves, which typically take place upon the release of strong economic figures from the euro zone, create opportunities for long EUR/USD trades.

Anti-euro moves, which usually occur when weak euro zone economic reports are released, provide basis for a short EUR/USD trade.

Since EUR/USD usually acts as a measure of traders’ view on the U.S. dollar, sensing the direction of the U.S. dollar could create some trade strategies for EUR/USD.

For instance, if traders are expected to buy the dollar if the U.S. retail sales report prints better-than-expected results, you could look for an opportunity to short EUR/USD.

Aside from waiting for EUR/USD pair to retest or break significant support and resistance levels, taking a trade based on retracements also works for this pair.

EUR/USD is highly susceptible to retracements, which means that setting short or long orders at significant Fibonacci levels could yield some pips. By catching retracements, one may be able to enter the trade at a better price than just simply jumping in the direction of the price movement.

If you're a bit more adventurous, there are other euro pairs, such as EUR/JPY, EUR/CHF, and EUR/GBP, that you can check out! Each EUR cross has cool and unique characteristics too.

For instance, EUR/JPY, which is more volatile than EUR/USD, tends to be more active during the Asian and London sessions.

EUR/GBP and EUR/CHF tend to be range-bound most of the time. The latter is more prone to large spikes though due to lower level of liquidity.

United Kingdom

The United Kingdom is a land of many accents as it is actually composed of four countries – England, Northern Ireland, Scotland, and Wales.

Headed by the Queen, the U.K. is considered a constitutional monarchy, but is governed through a parliamentary system that is based in England's capital of London.

The U.K. is also part of the European Union. However, the U.K. has refused to join the euro zone and is adamant about using the pound as its currency. Unfortunately, this means that having a Schengen visa won't let you travel through the U.K., you have to get a separate visa!

United Kingdom: Facts, Figures, and Features

- **Neighbors:** Ireland, Germany, France
- **Size:** 94,060 square miles
- **Population:** 64,100,000 (22nd)
- **Density:** 661.9 people per square mile
- **Capital City:** London (population 8,308,000)
- **Head of State:** Queen Elizabeth II
- **Head of Government Prime Minister:** David Cameron
- **Currency:** British Pound (GBP) or sterling
- **Main Imports:** Manufactured goods,machinery, fuels, foodstuff
- **Main Exports:** Manufactured goods, fuels, chemicals, tobacco, David Beckham, Simon Cowell
- **Imports Partners:** Germany 12.6%, China 8%, Netherlands 7.5%, France 5.4%, U.S. 6.5%, Norway 4%, Belgium 4.4%
- **Exports Partners:** Germany 11.3%, U.S. 10.5%, Netherlands 8.8%, France, 7.4%, Ireland 6.2%, Belgium 5.1%
- **Time Zone:** GMT
- **Website:** http://number10.gov.uk

Economic Overview

The U.K. is the world's seventh largest economy and the third largest in Europe after Germany and France. As far as history shows us, they're a force to reckon with. After all, it is Britain that started the Industrial Revolution.

The U.K. also had the world's largest empire back in the day. So for the past 300 years or so, the U.K. has been a relevant world power. Now that's what you call consistency!

In terms of trade, England is a net importer of goods with a consistent trade deficit. Its largest trading partner is the euro zone, more specifically Germany, which shouldn't come as a surprise because Germany is a stone's throw away across the English Channel.

Trade activity with the euro zone accounts for over half of the UK's trading activity. The U.S., on an individual basis, still remains the U.K.'s largest trading partner.

Not only do the British have cool accents and hotties like Kate Beckinsale, it is also home to arguably the oldest major financial center in the world. We're talking about London, boys and girls! Having a financial hub like London amplifies England's place in world trade.

Monetary & Fiscal Policy

Now here's a little bit of trivia for all of you: The oldest central bank in the world is the Bank of England (BOE).
Back in the day, when England was on the verge of economic expansion, government leaders realized that they needed an entity to help facilitate international trade. Enter the Bank of England. In 1694, the BOE was founded to help facilitate trade and growth for England.

Today, the BOE's main monetary policy objective is that of maintaining price stability while at the same time, fostering growth and employment.

As it is, the BOE is aiming for a target inflation rate of 2.0%, which is measured by the consumer price index (CPI). In order to meet this target, the BOE has been granted the magical power to change interest rates to levels that they believe will allow them to meet this target.

The group within the BOE that is in charge of determining interest rates is the Monetary Policy Committee (MPC).

The MPC holds monthly meetings, which are closely followed for announcements on changes in monetary policy, including changes in the interest rate. Like all other things British, interest rates have a different name in England. In England, the interest rate is called the bank repo rate.

The main policy tools used by the BOE's Monetary Policy Committee are bank repo rate and open market operations.

The bank repo rate is the rate set by the BOE for its own operations in the market to help meet the MPC's inflation target. Whenever the MPC changes this rate, it affects the rates commercial banks set for their savers and borrowers. This in turn will also affect spending and output in the economy, and eventually costs and prices.

Like other central banks, if the BOE raises the repo rate, they are aiming to curb inflation. On the other hand, if they lower the rate, they are aiming to stimulate growth in the economy.

When the BOE engages in open market operations, the BOE buys and sells GBP denominated treasuries and securities to control the supply of money. This is an alternative method to increase liquidity in the financial markets.

If the BOE feels that there is a need to stimulate the economy, they will "print more money" and inject this into money supply through the purchases of the government and corporate securities.

On the other hand, if the BOE feels like the economy has had enough candy, they will sell more securities, effectively "taking back" money from the economy.

Getting to Know the GBP

The GBP must be pretty popular kid since it has a lot of cool nicknames. Aside from being called the Sterling and the Pound, GBP pairs have awesome nicknames such as Cable (GBP/USD) and Guppy (GBP/JPY). Impressive, huh?

I like to bust a move…

GBP/USD is one of the most liquid currency pairs in the forex market. How come? Remember, London has long been a major financial center in the world. With major business transactions taking place every day, lots of moolah goes in and out of London.

Still, the GBPUSD only accounts for 14% of daily global trades, making it just the third most active pair traded. This is probably the reason why spreads on the GBP/USD tend to be a pip or two more than that of the EUR/USD and the USD/JPY.

… and traders like me because I've got some nice curves.

With so many big time corporations being based in London, there are many highly attractive investments to be found in the U.K. market.

Couple this with having some of the higher interest rates (usually) amongst the major currencies, investors may find British securities to be more attractive. In order to get their hands on these assets, investors would first need to purchase some GBP.

I'm nimble during the London session…

GBP/USD trading volume is the highest during the European session, with potential for strong moves during the New York session when key U.K. and U.S. data is released.

The Asian session doesn't normally provide much movement as European traders are still in bed while U.S. traders have just finished their day.

… but be careful 'cause I can get kinda rowdy!

The GBP pairs are very prone to volatile moves because of its lower level of liquidity compared to that of the EUR.

With liquidity growing thin at certain times in the market, the GBP can get caught in one direction, especially if there are large buy or sell orders in that direction. Compared to other currency pairs, GBP pairs tend to react more strongly to surprise economic data releases.

Important Economic Indicators for the GBP

Consumer Price Index (CPI) – The BOE looks at this account as a measure of inflation. It measures the change in prices of consumer goods.
Unemployment Rate – This is the measure of how many unemployed people there are in the UK economy. Analysts look at this account carefully because it could be a leading indicator of future spending. How come? Well, if a person has no job, he has no money. Without any money, nobody would be able to afford tea time!
Gross Domestic Product (GDP) – This figure reflects the state of the UK economy. It indicates whether the economy is growing and booming, or if it is stuck in the English Channel and drowning.
Purchasing Managers Index (PMI) – This index surveys business managers and asks them their view of the current economic landscape. Scores above 50.0 indicate improving conditions which may lead to expansion, while scores below 50.0 hint at possible contraction.
Gfk Consumer Confidence report -This report gauges consumers' confidence about current and future economic conditions. The more confident consumers are regarding the state of the UK economy, the more likely that they will be willing to spend.

What Moves the GBP

Changes in Monetary Policy

Many investors look at the pound for higher yielding assets and for carry trade. Changes in the MPC's interest rate alter sentiment towards the pound as it affects the yield of British securities.

In addition, changes in the bank repo rate also reveal the BOE's outlook on the economy.

If the BOE officials feel that the economy is hurting, they will either expand quantitative easing measures or cut interest rates, which will signal to the public that the economy is unstable.

If the BOE feels that economy's rise may lead to inflationary pressures down the road, they may cut back on quantitative easing or hike interest rates.

Developments in the euro zone and US

Like other currency pairs, GBP/USD is also heavily affected by developments in the euro zone and U.S. U.S. economic data directly affect investors and traders sentiment in the market. Good or bad data from the U.S. can either send market participants running to the GBP on increased risk appetite, or looking for safety in the USD on account of risk aversion.

The Spill Over Effect

The euro zone accounts for a majority of the U.K.'s trade relations. Because of this, you should also keep your binoculars ready to see any developments over in the mainland (Remember, the U.K. is an island!). Any bad news or poor economic performance could potentially lead to bearish sentiment towards the GBP.

Driven by Risk Sentiment

Albeit small, the GBP benefits from the fact that it boats a higher interest rate amongst other major currencies. When traders are in search of greater yields, they will look to the U.K. because of the potential of getting a higher return on their investments. When traders want to unwind their high-yielding investments and look for USD-dearest, they will start selling off the GBP.

Trading GBP/USD

GBP/USD is traded in amounts denominated in GBP. Standard lot sizes are 100,000 GBP and mini lot sizes are 10,000 GBP.

The pip value, which is denominated in U.S. dollars, is calculated by dividing 1 pip of GBP/USD (for GBP/USD, this is 0.0001) by GBPUSD's spot rate.

Profit and loss are denominated in U.S. dollars. For one standard lot position size, each pip movement is worth 10 USD. For one mini lot position size, each pip movement is worth 1 USD.

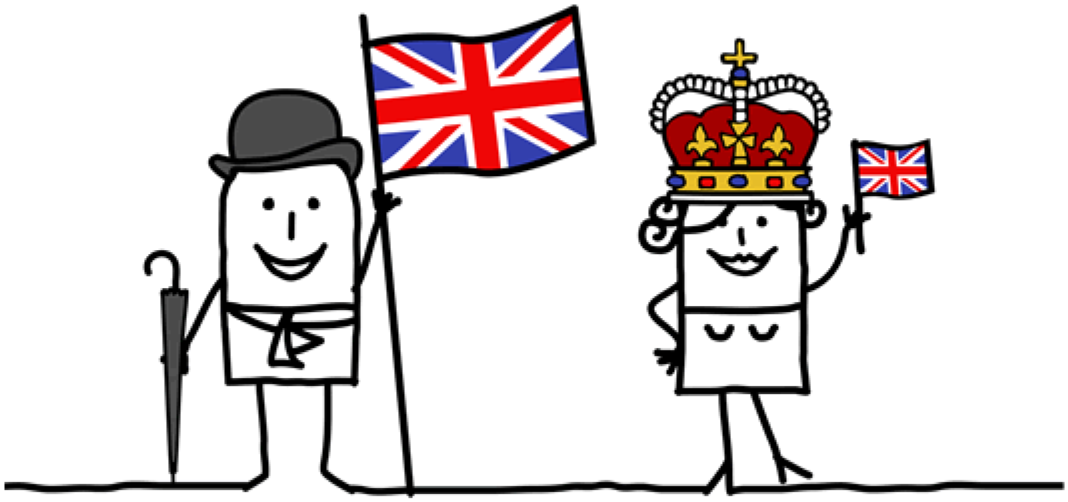
Margin calculations are based in U.S. dollars. For example, if the current GBP/USD rate is 1.5000 and the leverage is 100:1, 1,500 USD is needed in available margin to be able to trade one standard lot of 100,000 GBP. Take note, a higher GBP/USD sport rate requires more USD in available margin, while a lower rate would need less USD for margin.

GBP/USD Trade Tactics

One way to trade GBP pairs is to take note of when key reports come out. GBP pairs tend to react more strongly to economic reports.

For example, if U.K. GDP figures were to come in much better than expected, it could lead to massive rally in the GBP. Even if you were to enter late, you could still grab a bunch of pips because GBP pairs really move a lot.

Be careful though – GBP/USD and GBP/JPY pairs are the most volatile among the majors. In fact, GBPUSD moves around 160 pips per day on average. Because the GBP is so volatile, you might want to set wider stop loss orders to withstand all the strong moves in the market.



Japan

Konichiwa! Located in East Asia, Japan is an archipelago of 6,852 islands, although a majority of its land mass is accounted for by the 4 largest islands.

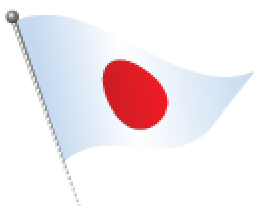
Despite being a relatively small country, Japan's capital, Tokyo, is home to 36 million hard working citizens, making it the largest metropolitan area in the globe.

Also, even though Japan is densely populated, the Japanese have one of the highest standards of living, while also having the highest life expectancy in the world.

Japan is also one of the most advanced and tech-friendly countries in the world. Can you imagine a world without the karaoke, the Gameboy or a Prius? That's right – didn't think so.

Also, did you know that the Japanese characters that make up Japan's name mean sun-origin, and that Japan is often referred to as the "Land of the Rising Sun"?

Japan: Facts, Figures, and Features



- **Neighbors:** Russia, Korea, China
- **Size:** 145,925 square miles
- **Population:** 126,659,683 (10th)
- **Density:** 873.1 people per square mile
- **Capital City:** Tokyo (population 13,189,000)
- **Head of State:** Emperor Akihito
- **Head of Government:** Prime Minister Yoshihiko Noda
- **Currency:** Japanese Yen (JPY)
- **Main Imports:** Petroleum, liquid natural gas, clothing, semiconductors, coal, audio and visual apparatus
- **Main Exports:** Motor vehicles, semiconductors, iron and steel products, auto parts, Suzuki Ichiro, Sony PlayStation, Samurai swords, Mr. Miyagi
- **Imports Partners:** China 21.3%, U.S. 8.8%, Australia 6.4%, Saudi Arabia 6.2%, UAE 5%, South Korea 4.6%, Qatar 4%
- **Exports Partners:** China 18.1%, U.S. 17.8%, South Korea 7.7%, Thailand 5.5%, Hong Kong 5.1%
- **Time Zone:** GMT +09
- **Website:** http://kantei.go.jp

Economic Overview

Aside from being the video game capital of the world, Japan's economy is ranked as the third largest as of 2011.

Since the end of World War II, Japan has been on a rampage, experiencing rapid economic growth, despite the fact that the country is mountainous and volcanic. Because of the laws of nature, this limits the growth of natural resources in Japan.

In order to make up for this lack of resources, the Japanese economy has become very export dependent, with exports amounting to more than $697 billion in 2013! Not only does it make up 14% of the country's output, it's also the sixth largest in the world!

Recently, Japan has been riding the cocktails of China's massive growth. With Japan being the nearest major economy, Chinese demand has led to massive shopping sprees of Japanese products.

Not only does Japan have great food (how can you beat tempura and sushi?!), it is also home to one of the world's biggest financial centers – Tokyo!

As you see in the movies, Japanese businessmen mean serious business! With so much money flowing in and out of Tokyo every day, traders and investors can use Japan as a proxy for what's happening in the Far East.

Monetary & Fiscal Policy

While the Bank of Japan (BOJ) has been around since the late 1800s, only recently did the BOJ gain independence from the Ministry of Finance (MoF). It was only in 1998 that the Japanese government passed laws giving the BOJ control over monetary policy.
Take note that the Ministry of Finance still remains in charge of foreign exchange policy, which has led to tension and continuous differences between the two.

Normally, the government and the central bank are independent of each other – one should not have any influence over other. This is not the case for Japan. Even though the BOJ has gained independence from the government, there is a question of who really "wears the pants".

The MoF has kept a watchful eye on the BOJ, pressuring it to pass policies that would help the yen hit the MoF's foreign exchange targets. Similar to other central banks, the BOJ's main objective is that of price stability. The ninja bankers at the BOJ make use of open market operations and interest rates changes to meet their goals.

One thing you should know about the BOJ is that for a very, very long time, they have kept rates at low levels, with the current rate sitting between 0.00% to 0.10%. Because the rate is already so low, the central bank cannot decrease the rate to stimulate growth or create liquidity.

For instance, in its efforts to fight deflation, the BOJ has whipped out its shurikens and has flooded the markets with money through unorthodox quantitative easing measures.

Quantitative easing measures are moves made by central banks in order to increase liquidity and money supply through the purchase of government securities.

This is sometimes called "printing money", because the central bank literally creates new money from thin air in order to buy back their government securities. In theory, the increase in the money supply would lead to an increase in lending and spending.

Over the years, Japan has created liquidity in the markets by flooding the economy with various programs that let the BOJ buy or sell Japanese government bonds and bills.

Getting to Know the JPY

The yen is so hardcore that it didn't want to be named anything else. It came into the foreign exchange market called the yen and up to now, it is still called the yen. The yen is the yen is the yen. It is also tied in currency crosses, especially against the EUR, GBP, and AUD.

Traders love me like the Japanese love their sushi.

After the USD and the EUR, the JPY is the most heavily traded currency, with USD/JPY also ranking as the 2nd most traded currency pair. Because of the role that Japan plays in international trade, there is need for the JPY in order to complete international transactions.

Are you ready for the Asian Sensation?

When investors think of Asia, they subconsciously think of Japan. With Tokyo being one of the world's major financial centers, Japan is often representative of what's happening in Asia.

Japan is normally a major trading partner of other Asian powers. If business is doing well in Asia, this is normally reflected by the Nikkei, the major stock exchange in Tokyo.

I'm always on the go…

With Japanese reports coming out during the Asian session, it is only natural that the yen trading is active during the Asian session (0:00 GMT).

The yen can also be active in other sessions depending on what economic data is released. This should be expected – it is part of Japanese culture, they do business around the clock!

…but I'm all for cheap thrills!

With many investors looking for the most bang for their buck, some have resorted to carry trade. With the JPY having the lowest interest rate amongst the majors, it is normally used in carry trade as a funding source.

The Japanese tend to think alike.

Japanese asset managers tend to make the same investment decisions. This leads to highly correlated positions, which means that it is likely to see trends develop.

I'm prone to breakouts…

One characteristic of yen pairs is their tendency to consolidate for quite some time, then break out in direction, then consolidate once again, then break out once again! Keep your eyes and ears ready because you never know when this might happen!

…and I have a love-hate relationship with China

With China emerging as a major power in the world, its influence on the JPY will continue to grow. If signs point to further growth in the Chinese economy, it may affect demand for the JPY.

How so?

As we've said, China is one of Japan's major trading partners. Naturally, as Chinese businesses boom, they will need to order more from Japan. This in turn would increase demand for the JPY, causing it to appreciate.

Important Economic Indicators for the JPY

Gross Domestic Product – This measures the economic activity of Japan. It indicates whether the economy is red hot like lava from Mt. Fuji, or if it's in the process of harakiri.
Tankan Surveys – These reports survey managers from a broad range of industries, questioning them on their views of the economy. Rising sentiment (scores above 0.0) indicate that Japanese businessmen expect business activity to pick up. Scores below 0.0 suggest otherwise.
Trade Balance – The Japanese economy is heavily export dependent. Falling export numbers could lead to a decline in economic activity.
Unemployment Rate – This measures the rate of unemployment in Japan. High unemployment could lead to a decline in consumer spending – how would they be able to afford their video games and anime??
Consumer Price Index (CPI) – In the past, the Bank of Japan has shown that they are not afraid to make moves to fight off deflation. If trends show that prices of samurai swords and shurikens continue to fall, it may lead to some surprise moves by the BOJ.
Core Machinery Orders – A large chunk of Japan's exports are comprised of machinery orders. The rise or fall in core machinery orders could reflect the current status of Japanese trade.

What Moves the JPY

Investment Moves

Due to its low interest rates, the JPY has been considered as a good funding source for investments in other countries. This means that if traders and investors are scared, they will begin to unwind their positions in higher yielding assets. Once traders start unwinding these riskier positions (carry trades), they have to cover their short JPY trades by buying back the currency.

The BOJ effect

This doesn't refer to those announced, scheduled effects. I'm talking about currency intervention! The BOJ and MoF keep special attention to the FX markets. With the Japanese economy being very export dependent, the value of the yen plays a key role in trade.

The BOJ doesn't want the JPY to appreciate too much because it would make Japanese exports relatively more expensive. By keeping the value of the JPY lower, they can stimulate demand for Japanese products, which in turn, would benefit the economy.

Trading USD/JPY

USD/JPY is traded in amounts denominated by the base currency, the US Dollar. Standard lot sizes are 100,000 units of USD and mini lot sizes are 10,000 units. Many brokers now offer customizable lot sizes to as low as 1 unit.

The change in the pair's value is denominated by the counter currency, the Japanese yen. Take note, for yen pairs it is the 0.01 decimal place. So, a change in value of USD/JPY from 95.00 to 95.01 is a move of 1 pip.

As with any currency pair, the change in value is denominated by the counter currency. The profit and loss is calculated in Japanese yen and then converted to the currency your account is based in. For one standard lot position size, each pip movement is worth 1,000 JPY. For one mini lot position size, each pip movement is worth 100 JPY. For example, if the current exchange rate of USD/JPY is 95.00 and you want to trade one standard lot, then one pip would equate to 10.52 USD (see our Pips and Pipettes lesson on how to calculate pip values).
Margin calculations are based in U.S. dollars. For instance, with a leverage of 100:1, 1,000 USD is what is needed to be set aside in your account to trade 100,000 USD/JPY.

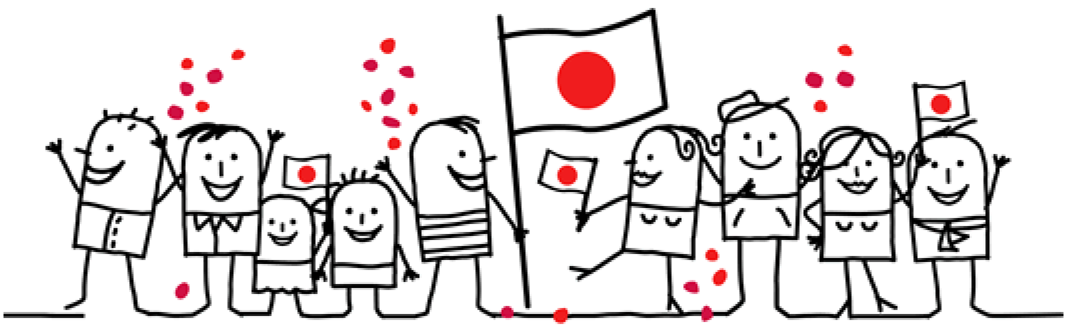
USD/JPY Trading Tactics

USD/JPY tends to follow short to medium term trends, which could last a few days. If you are maintaining a swing trade, that is holding a trade for more than a day, you can try to enter on retracements.

Once price begins to consolidate, you can close your position, and wait for another trend to develop. Take note that when price breaks out, it is likely that you will see a sustained move as traders jump back in on the trend.

Another tip to remember is that Japanese industrial companies normally set their orders at round figures, like 100.00 or 90.50. You should keep track of whenever price are near these figures, as they can serve as short-term support and resistance levels.

Finally, you should also keep an eye out other yen pairs like EUR/JPY and GBP/JPY. If you see that one of these crosses is about to break a key technical level, it could unleash a fury of JPY buying or selling that will have a massive effect across the board.



Canada

Oh Canada… Uncle Sam's friendly, environment-loving, French-influenced, semi-frozen buddy up north. It is a place known to have created some of the most amazing things in the world, such as basketball, baseball, maple syrup, and Smarties.

Canada, whose geographical area takes up most of North America, extends from the Atlantic Ocean all the way to the east to the Pacific Ocean. It is composed of ten provinces and three territories, and is considered as one of the world's most developed countries.

In terms of land mass, Canada is numero dos in the world right after Russia! Given its sheer size and contributions to the world, you can just imagine how Canada and its domestic currency, the Canadian dollar, are important to forex trading.

Canada: Facts, Figures, and Features

- **Neighbors**: United States of America
- **Size:** 3,854,085 square miles
- **Population:** 35,427,524
- **Density:** 8.3 people per square mile
- **Capital City:** Ottawa
- **Head of State:** Queen Elizabeth II, represented by Governor-General David Lloyd Johnston
- **Prime Minister:** Stephen Harper
- **Currency:** Canadian dollar (CAD)
- **Main Imports**: machinery and equipment, motor vehicles and parts, electronics, crude oil, chemicals, electricity, durable consumer goods
- **Main Exports:** Justin Bieber, motor vehicles and parts, industrial machinery, aircraft, telecommunications equipment, electronics, chemicals, plastics, fertilizers, wood pulp, timber, crude petroleum, natural gas, electricity, aluminium, Steve Nash, Sidney Crosby
- **Imports Partners:** U.S. 50.6%, China 11%, Mexico 5.5%
- **Exports Partners:** U.S. 74.5%, China 4.3%, UK 4.1%
- **Time Zones:** GMT -8, GMT -7, GMT -6, GMT -5, GMT -4
- **Website:** http://www.canada.gc.ca/home.html

Economic Overview

Canada is considered as a resource-based country, which basically means that most of the economic growth it experienced early on came from the utilization and export of its own natural resources.

According to the IMF, Canada's economy is the tenth largest in the world, making it part of the world's G8. It ranks as the seventh biggest producer of gold and the seventh largest producer of black crack (oil).

Despite its robust industrial and manufacturing industry, much of Canada's GDP actually comes from its service sector. Its advanced services sector employs three out of every four working Canadians and account for about 70% of the country's GDP. Next time you meet a Canadian, go ahead and make a bet with him that he works in the services industry. More often than not, you'll win!

Canada's economy really got going in January of 1989, when the Free Trade Agreement came into effect. The agreement basically removed all the tariffs (that is the tax imposed on trade) between the US and Canada. In effect, Canada now exports over 70% of its goods to the US.

Monetary & Fiscal Policy

The Bank of Canada (BOC) is the main governing body when it comes to determining the country's monetary policy. Decisions on the monetary policy are made by Governing Council, which is made up of the bank's governor, the senior deputy and four other deputy governors. Unlike most other central banks, the BOC doesn't have a set time to make changes on its policies. The council meets every single working day and can alter monetary policy to their liking at any time.

The bank's basic mandate is similar to other central banks in that they aim to make sure that the Canadian dollar's value is stable and that the country's inflation rate is within their 1-3% target. The BOC does this through open market operations and constant adjustment of the bank rate.

The BOC implements its open market operations by using a method called the Large Value Transfer System (LVTS). The LVTS enables commercial banks all over Canada to borrow and lend money to each other so that they could go about their daily operations. Now, the interest rate charged on these transactions is called the bank rate. By altering the bank rate, the BOC can basically control the flow of money in the economy.

To illustrate this, let's say the bank rate is set at 2.00%. In one of its meetings, the BOC realizes that the CAD is losing value much faster than expected, which is causing businesses to increase the prices of goods they sell and the services they offer. The BOC then decides to raise the bank rate to 2.50%.

By hiking the bank rate, the interest needed to be paid to lenders increases, in turn, reduces the likelihood of banks, businesses and consumers of taking additional debt. Now, since there is less money in the pockets of consumers, the chance of them spending is decreased, preventing any further inflation. What business in their right mind would increase prices when nobody is buying, right?

Getting to Know the CAD

You might be wondering why the CAD is nicknamed after Canada's national bird, the Loonie… Well, that's because that's the engraved design on Canada's coins! Check out these other cool properties of the Loonie:

The Black Crack and Me

Historically, the price of black crack has been highly correlated with the USD/CAD. The general rule is that whenever oil prices start climbing, the CAD usually follows. If the price of oil is projected to increase over the next couple of years, then you'd want to go sell the USD/CAD!

My work hours are short…

The USD/CAD has been known to move in tight ranges for the most part of the day. It is only when U.S. traders are eating their Cheerios during the overlap of the European trading session and the US trading session that the pair begins to move.

…unlike my B.F.F., the USD…

A key factor to look at when trading the USD/CAD is that its direction is closely tied to the U.S. economy. Remember, more than being close neighbors, the U.S. and Canada engage in heavy trade with each other. When the U.S. economy experiences robust growth, the Canadian economy is usually just right behind it! So whenever you decide to trade the CAD, take some time off to see how well (or poorly) the U.S. is doing.

…but I'm still feisty during the US session.

The CAD usually doesn't start moving until the U.S. trading session, around 1:00 pm GMT. The CAD offers little movement during the Asian trading session and the morning European trading session.

Important Economic Indicators for the CAD

Consumer Price Index (CPI) – Similar to other central banks, the Bank of Canada's objective is to make sure that inflation does not get out of hand. Since the consumer price index tracks the increase (or decrease) in the prices of consumer goods and services, the report is closely watched by currency traders.
Gross Domestic Product (GDP) – The GDP is the broadest measure of Canada's economic activity. It reveals whether the country is growing or not.
Trade Balance – Just like other commodity-based countries, Canada's economy is highly susceptible to changes in its export and import activities.
Ivey Purchasing Mangers' Index (PMI) – The PMI is a survey designed to see whether businesses are optimistic or pessimistic about the economy. A reading above base line 50.0 means that conditions in the business sector is growing while a reading below 50.0 indicates otherwise.

What Moves the CAD?

U.S. Economic Data

U.S. economic data usually prints roughly at the same time as Canadian data. On the one hand, the negative data from the US coupled with positive data from Canada could lead to a massive drop in the USD/CAD's value. On the other hand, positive U.S. data and poor Canadian data could send the USD/CAD soaring high!

Mergers and Acquisitions

Because of the proximity between the U.S. and Canada, company mergers and acquisitions happen quite often. These cause a huge amount of money to flow between the two countries, which create a significant effect on the foreign exchange market.

For example, in order for a U.S. company to buy out a Canadian company, it must first exchange it's U.S. dollars to Canadian dollars to complete the transaction. Imagine the amount of money that flows through the foreign exchange market just to seal the deal!

Trading the USD/CAD

USD/CAD is traded in amounts denominated in USD. Standard lot sizes are 100,000 USD and mini lot sizes are 10,000 USD.

The pip value, which is denominated in Canadian dollars, is calculated by dividing 1 pip of USD/CAD (that's 0.0001) by USD/CAD's current rate.

Profit and loss are denominated in Canadian dollars. For one standard lot position size, each pip movement is worth 10 CAD. For one mini lot position size, each pip movement is worth 1 CAD. For example, if the current exchange rate of USD/CAD is 1.1000 and you want to trade one standard lot, then one pip would equate to 9.90 USD.

Margin calculations are based in US dollars. With a leverage of 100:1, 1,000 USD is needed to trade 100,000 USD/CAD.

USD/CAD Trading Tactics

Since USD/CAD is only active during the U.S. trading session, the pair is highly susceptible to fake outs during the other two trading sessions. This means that a break in a significant support level in the USD/CAD during the morning European trading session would, more often than not, simply be a fake out.

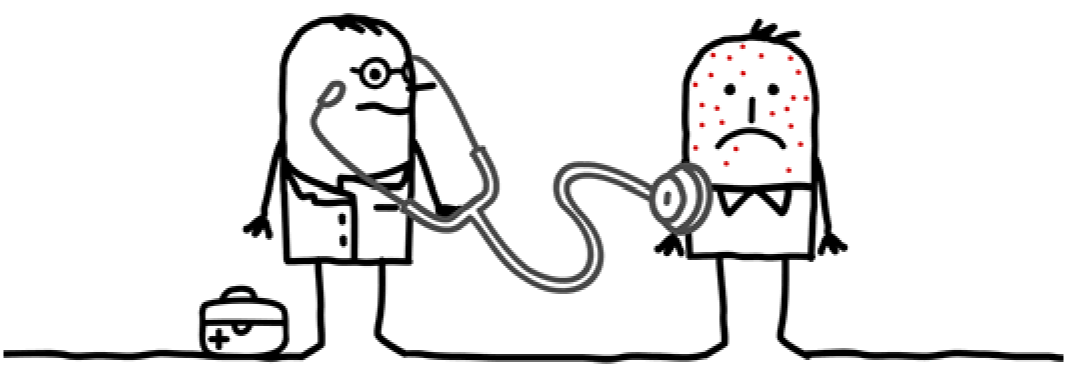
Watching the differences in the results of economic data between the U.S. and Canada is also a great practice to determine where the USD/CAD is headed. Because both and US and Canadian data are released just a few hours or minutes apart, variances in results tend to result in exaggerated one directional moves.

For instance, negative US data coupled with positive Canadian data would be a good reason to sell USD/CAD.

Lastly, beyond looking at economic data, spending some time to analyze oil price behavior would help a lot in trading the CAD.

Since Canada is considered as one of the world's major black crack producers, changes in its price create quite a hefty impact in the CAD's value. In fact, since 1988, the exchange rate of USD/CAD and the price of oil have been inversely correlated by as much as 68%.

How can you use this to your advantage? Well, if you notice that over time that oil prices at your local gasoline station are rising, it could give you the additional confirmation you need to short the USD/CAD.



Australia

Officially known as the Commonwealth of Australia, Australia could be found somewhere in the Southern Hemisphere, just southeast of Asia.

Considered as the world's biggest island, Australia is the only country on earth that governs an entire continent!

Before the coming of settlers from Europe in 1788, Aboriginal people inhabited most of the country.

Since then, people from all over the world have migrated to Australia, which has made it one of the most culturally diverse countries in the world. Now, Australia is home to people from 200 different countries.

Lastly, and probably most importantly, Australia is known for producing the meanest and most hardcore actors of all time like Mel Gibson, the Braveheart; Hugh Jackman, the Wolverine; and the legendary Heath Ledger, the Joker!

To add to that, they also have mech-kangaroos, battle tank armadillos, and bomber pelicans. You can see how the rest of the world really had no choice but to name an entire continent after them.

Australia: Facts, Figures, and Features

- **Neighbors:** New Zealand, Papua New Guinea, Indonesia
- **Size:** 2,969,907 square miles
- **Density:** 7.3 people per square mile
- **Capital City:** Canberra (population 358,222)
- **Head of State:** Queen Elizabeth II
- **Head of Government:** Prime Minister Tony Abbott
- **Currency:** Australia dollar (AUD)
- **Main Imports:** Machinery and transportation, electrical and telecommunications equipment; crude oil and petroleum products
- **Main Exports:** Ores and metals; wool, food and live animals; fuels, transport machinery and equipment, Hugh Jackman, Nicole Kidman, Heath Ledger
- **Import Partners:** China 18.4%, U.S. 11.7%, Japan 7.9%, Singapore 6%, Germany 4.6%, Thailand 4.2%, South Korea 4.1%
- **Export Partners:** China 29.5%, Japan 19.3%, South Korea 8%, India 4.9%
- **Time Zone:** GMT +10

- **Website:** http://www.australia.gov.au

Economic Overview

Compared to G7 nations, Australia's overall economy is relatively small. According to the World Bank, however, on a per person basis, its GDP is even higher than the U.K., Germany and even the U.S.!

In the past fifteen years or so, Australia's economy has grown an average of 3.6% annually, well above the 2.5% world norm. No wonder it ranked third overall in the Legatum Institute's 2011 Prosperity Index!

Australia's economy is highly service oriented, with over 70% of its GDP coming from industries such as finance, education, and tourism.

Despite having a very robust export industry and stellar growth, Australia has been notoriously famous for consistently having a high current account deficit. This means that Australia is using up more resources from other economies to satisfy its own domestic consumption.

Monetary & Fiscal Policy

The Reserve Bank of Australia (RBA) is the main governing body of Australia when it comes to monetary and fiscal policy. The RBA's aim is three-fold:

1. Keep exchange rates stable
2. Ensure growth
3. Maintain full employment

In order to do this, the bank believes that the country's annual inflation rate must be kept within 2-3%. By keeping a tight rein on inflation, the value of their domestic currency is secured, which will eventually lead to sustainable economic growth.

How does the RBA make sure inflation is controlled? Two ways: adjusting the cash rate and conducting open market operations.

The cash rate is the interest rate charged by lending banks on overnight loans to other financial institutions.

Open market operations, on the other hand, is the way the RBA controls money supply through the buying and selling of government loans or other financial assets. With the exception of January, the RBA meets monthly to discuss what changes it will make to monetary policy.

To make this easier to swallow, take this simple example. Let's say that inflation in Australia is increasing much faster than what the bank wants. In order to suppress the high inflation rate, the bank decides to raise the cash rate, which will effectively increase the cost of borrowing by…. uh, borrowers.

Naturally, this move will tone down lending, lessening the overall money in circulation. And basic supply and demand tells us that the scarcer something is, the more valuable it is!

Getting to Know the AUD

Even though they've got their seasons mixed up, the Australians are always up bright and early to play. Well, this is mostly because the Australian market is the first to open every week! Just like the people inhabiting the place, Australia's local currency, the AUD, is called the Aussie.

I'm called a commodity dollar for a reason…

One important characteristic of the AUD is that it has a high positive correlation with gold prices. The reason behind this is that Australia is the third biggest gold-digger… errr, gold producer in the world. As a result, whenever the price of gold rises or falls, the AUD goes along for the ride.

… and I'm one of the best candidates for carry trade.

Among the major currencies, the AUD has been known for having the a high interest rate. This makes it a favorite for carry trade. Carry trade is the practice of buying a currency with a high interest rate in exchange for a currency with a lower interest rate.

I'm only awake a couple of hours a day…

Most of the AUD's movement happens during the Asian trading session, the time when economic data from Australia is released.

… but bad weather is one of my worst enemies!

Given the commodity based economy of Australia, unfavorable weather conditions tend to put a serious strain on Australia's growth, which leads to a sell-off in the AUD.

How severely do weather conditions affect the AUD?

Well, let's just say that during the Australian drought of 2002, AUD/USD fell to .4770 – that is almost half its current exchange rate!

Important Economic Indicators for Australia

Consumer Price Index – Because the RBA's primary goal is controlling inflation, the CPI, which measures the overall change in price of consumer goods and services, is closely watched by the bank.
Balance of Trade – Australia has an extremely robust trade sector so currency traders and bank officials alike tend to watch changes in the country's export and import levels.
Gross Domestic Product – This measures how well Australia's economy is doing. Positive readings indicate economic growth while negative readings mean economic contraction.
Unemployment Rate – The unemployment rate tracks how many people in Australia's labor force are out of work. The number of people employed, or rather, unemployed in this cause, has a high correlation with economic activity. A person without a job means he has less money available for spending.

What Moves the AUD

Economic and Interest Rate Outlook

The AUD is greatly affected by macroeconomic factors such as monetary policy rhetoric, interest rates and domestic economic data.

In trading the AUD, always pay special attention to the interest rate outlook. Comments made by officials from the RBA regarding interest rates, for instance, could create a hefty impact on the AUD.

China's Economy

For the better part of the last decade, China has been on a roll, posting some massive growth figures. In order to create finished goods, China sources a lot of its raw materials like coal and iron ore, from Australia.

For China to buy raw materials from Australia, it must first need to exchange its local currency for the AUD. This means that increased demand for Chinese goods tend to prop up the AUD's value.

Likewise, a decline in demand for Chinese products could lead to a fall in the AUD's value.

New Zealand Data

To a lesser extent, data from New Zealand influences the AUD's price action. Take note that New Zealand's economy is very similar to Australia, which makes their currency positively correlated.

In fact, the relationship of the two countries is sometimes described as "Trans-Tasman" to show how closely tied their economies are and to indicate the existence of the Tasman Sea sitting right between them.

With that said, it is important to be aware of important upcoming data from New Zealand as it could indirectly cause the AUD to move.

Trading AUD/USD

AUD/USD is traded in amounts denominated in AUD. Standard lot sizes are 100,000 AUD and mini lot sizes are 10,000 AUD.

The pip value, which is denominated in U.S. dollars, is calculated by dividing 1 pip of AUD/USD (that's 0.0001) by the AUD/USD's current rate.

Profit and loss are denominated in U.S. dollars. For one standard lot position size, each pip movement is worth 10 USD. For one mini lot position size, each pip movement is worth 1 USD.

Margin calculations are based in U.S. dollars. For example, if the current AUD/USD rate is 0.9000 and the leverage is 100:1, 900 USD is needed in available margin to be able to trade on standard lot of 100,000 AUD. However, as AUD/USD rises, a larger available margin in USD is required. Conversely, the lower AUD/USD rate is, the less required available margin is needed.

AUD/USD Trading Tactics

Since the AUD is one of the best candidates for carry trade, which is the buying of a currency with high interest rates and the selling of a currency with low interest rates, AUD/USD is highly affected by crosses.

How can you use this to your advantage?

Well, if you see a break of a significant technical support level in AUD/JPY, that could be a good sign to sell AUD/USD!

Another thing to consider when trading AUDUSD is data coming out from New Zealand. Because of Australia's nearness and trade relations with New Zealand, positive economic data from New Zealand usually helps push the AUD's value up.

This means that better-than-expected New Zealand economic reports could be seen as a good signal to buy the AUD. Conversely, poor economic data from New Zealand could be a reason to sell the AUD.

Lastly, take some time to look at how commodity-prices, especially gold are doing. More often than not, the price of gold leads the AUD.

This means that whenever the gold rises in value, AUD/USD could rally soon after! Of course, when the value of gold falls, the AUD also tends follows suit.

New Zealand

If you've seen the Lord of the Rings, then you probably know that Middle Earth is located somewhere along the hills of New Zealand.

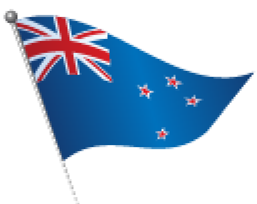
More than being home to Frodo Baggins and his hobbit friends, New Zealand is also one of Australia's next-door neighbors in Oceania, the Southern region of the Pacific Ocean.

The country is made up of two main islands, the North Island and the South Island, and several smaller islands.

Famous for hosting a larger population of sheep than people, New Zealand is home to about four million residents. To put that into perspective, New York alone had a population of 8.4 million people in 2011.

New Zealand is also known as Aotearoa, which means "Land of the Long White Cloud" in Maori, one of the major languages in the country.

New Zealand: Facts, Figures, and Features



- **Neighbors:** Australia, Fiji, Tonga
- **Size:** 104,483 square miles
- **Population:** 4,537,081 (123rd)
- **Density:** 42.7 people per square mile
- **Capital City:** Wellington (city population 179,466)
- **Head of State:** Queen Elizabeth II
- **Head of Government:** Prime Minister John Key
- **Currency:** New Zealand dollar (NZD)
- **Main Imports:** machinery and equipment, vehicles and aircraft, petroleum, electronics, textiles, plastics
- **Main Exports:** Russell Crowe, Ores and metals; wool, food and live animals; fuels, transport machinery and equipment
- **Import Partners:** China 16.4%, Australia 15.2%, US 9,3%, Japan 6.5%, Singapore 4.8%, Germany 4.4%
- **Export Partners:** Australia 21.1%, China 15%, US 9%, Japan 7%
- **Time Zone:** GMT +12
- **Website:** http://www.newzealand.govt.nz

Economic Overview

With its teeny-tiny population, New Zealand's economy is also relatively small. Its GDP, which is valued at 123 billion USD in 2011, ranks 65th among the world economies. But don't underestimate New Zealand… This country makes up for its size by being a strong player in trade!

Their economic activity is largely dependent on trade, mostly with the Land Down Under (Australia), the Land of the Rising Sun (Japan), and Uncle Sam (U.S.). It is an export-driven economy, with its main exports such as ores, metals, and wool comprising a third of its GDP. It also exports much of its cattle and dairy products. Angus beef sound familiar to you?

Its primary industries are agriculture and tourism, and they only have small manufacturing and technology sectors. Because of that, its imports from other countries comprise mostly of heavy machinery, equipment, vehicles, and electronic products.

Since the country has removed many barriers to foreign investment, the World Bank has praised New Zealand for being one of the most business-friendly countries in the world, second to Singapore.

Monetary & Fiscal Policy

The Reserve Bank of New Zealand (RBNZ) is in charge of the monetary and fiscal policy of the nation. Currently headed by Governor Alan Bollard, the RBNZ holds monetary policy meetings eight times a year. The RBNZ is tasked with maintaining price stability, setting interest rates, and monitoring output and exchange rates.
To achieve price stability, the RBNZ must ensure that annual inflation meets the 1.5% central bank target… otherwise the government has the right to kick the RBNZ Governor out of office (We're not kidding).

The RBNZ has the following tools in its monetary policy arsenal:

The official cash rate (OCR), which affects short-term interest rates, is set by the RBNZ Governor. By lending 25 basis points above this rate and borrowing at 25 basis points below the OCR to commercial banks, the central bank is able to control the interest rates offered to individuals and businesses.

Open market operations are used to meet the cash target or the amount of reserves parked in commercial banks. By forecasting the cash target daily, the RBNZ is able to calculate how much money to inject in the economy in order to meet the target.

Getting to Know the NZD

The New Zealand dollar is nicknamed "Kiwi."It's a bird! It's a plane! No, wait, it's really a bird. The Kiwi also happens to be the national symbol for New Zealand… but let's focus on the Kiwi as a currency and its interesting characteristics.

Show me the commodities!

Since New Zealand's economy is mostly dependent on its exports of commodities and agricultural products, the overall economic performance of the region is linked to commodity prices.

If commodity prices rise, then the amount of money paid for New Zealand's exports also rises, which then makes a larger contribution to the country's GDP. Since a higher GDP reflects a strong economic performance, it could lead to an appreciation of the Kiwi.

Conversely, falling commodity prices result to lower monetary value of exports, making a smaller contribution to GDP. A lower GDP could then cause the Kiwi to depreciate.

I move hand-in-hand with the AUD

Since Australia is New Zealand's number one trade partner, the economic performance of Australia has a huge impact on New Zealand's.

For instance, when the Australian economy does well, Australian firms pump up their importing activities and guess who benefits from that? New Zealand, of course!

…and, just like the AUD, I enjoy carry trades!

Just like Australia, New Zealand enjoys higher interest rates compared to other major economies, such as the U.S., the U.K., or Japan.

Interest rate differentials between economies often serve as indicators of money flows. Since investors prefer to receive higher returns, they'd sell lower-yielding investments in exchange for higher-yielding assets or currencies. In other words, the higher the interest rate, the more money flows in.

I'd like more migration, please.

Because New Zealand's population is less than half the number of people living in New York, an increase in migration into the country has a huge effect on the economy. This is because as the population grows, the demand for goods and overall consumption increases.

Oh, I'm weather-sensitive too.

New Zealand's economy is also largely driven by its agricultural industry, which means that severe weather conditions such as droughts have a huge negative impact on their entire economy. Those heat waves are also prevalent in Australia, which is more frequented by forest fires, costing close to 1% of its GDP in damages. This doesn't do the NZD any good…

Important Economic Indicators for the NZD

Gross Domestic Product – Just like any other nation, the gross domestic product (GDP) serves as an economic report card for New Zealand. By serving as a gauge of overall economic performance for the New Zealand, it influences the demand for the NZD.
Consumer Price Index (CPI) – The consumer price index measures the change in price levels. As a measure of inflation, it is closely watched by the RBNZ in determining changes in monetary policy. They're supposed to maintain price stability, remember?
Balance of Trade – Since New Zealand is an export-driven economy, traders often take a look at their trade balance to gauge the international demand for New Zealand's products.

What Moves the NZD?

Economic Growth

Positive GDP growth reflects the strong economic standing of New Zealand, boosting demand for its currency. Negative GDP growth highlights the poor economic performance of the country, dampening demand for the NZD.

Surge in Exports

Higher demand for New Zealand's products often results to a higher GDP, which then boosts the NZD. In contrast, lower exports make a smaller contribution to GDP, causing the NZD's value to fall.

Rising Commodity Prices

Increasing commodity prices causes the monetary value of New Zealand's exports to rise, pushing its GDP higher. Falling commodity prices, on the other hand, cause the monetary value of exports to fall, dragging its GDP down.

Trading NZD/USD

Since the counter currency is the US Dollar, the changes in value are measured in Greenbacks.
On a 100,000 unit NZD/USD position, each pip movement is worth $10 USD while on a 10,000 NZD/USD position size, each pip movement is worth $1 USD.

Margin calculations are based in US dollars. For instance, if the current NZDUSD rate is 0.7000 and leverage is 100:1, 700 USD in available margin is required for a 100,000 NZD position. A 10,000 NZD position requires 70 USD in available margin.

You see, because of the Kiwi's relatively low value against the U.S. dollar, it requires the least amount of available margin among the other majors. That means it's cheaper to trade the Kiwi!

NZD/USD Trade Tactics

Strong economic reports from New Zealand result to an appreciation of the NZD so if there's a good chance that an economic release could beat the consensus, it could be a sign to go long NZD/USD.

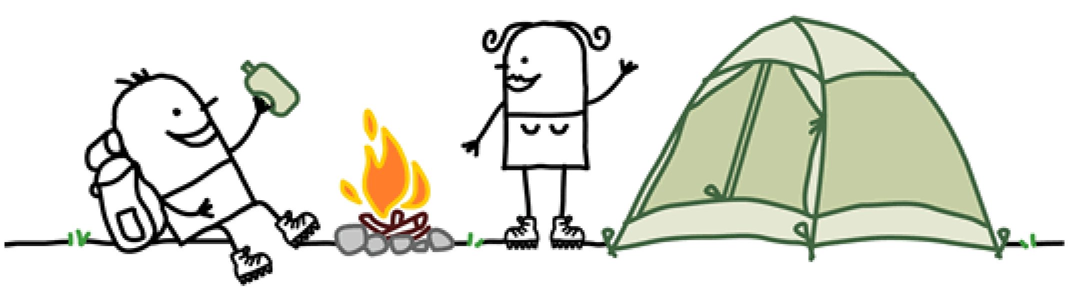
Weak economic reports, on the other hand, push the NZD down. If an upcoming report is likely to come in weaker than expected, it could be a chance to short NZD/USD.

Aside from watching economic reports, taking note of commodity price behavior could also serve as an influence on NZD/USD price action.

In recent history, commodity prices tend to surge when demand for riskier assets is also strong. During these times, investors place their money in higher-yielding assets such as gold and other commodities and sell the lower-yielding U.S. dollar. As a result, the commodity-based Kiwi gains strongly against the safe-haven US.. dollar.

On the other hand, when risk aversion forces investors to flee back to the safe-havens, the NZD edges lower against the USD.

Just like the AUD, the NZD is also a good candidate for carry trade. Since carry trades involve buying of a currency with high interest rates and selling of a currency with low interest rates, New Zealand's relatively high interest rate provides support for the NZD.



Switzerland

Switzerland was founded in 1291 and is located in the middle of western Europe and shares much of its history and culture with Germany, Austria, Italy, and France.

Although being right smack in the middle of Europe, Switzerland is not part of the European Union. While there were talks between the EU and Switzerland in the mid 1990s, the Swiss public rejected the proposal to be part of EU. Since then, Switzerland has maintained its economic independence.

Switzerland is considered to be a small country, but let us tell you that it is PACKED! It has a population of about 7.78 million, with around 477 people per square mile.

Switzerland is also known for its neutrality as it has refrained from participating in either of the two World Wars.

Switzerland: Facts, Figures, and Features

- **Neighbors:** Germany, France, Italy, Austria
- **Size:** 15,940 square miles
- **Population:** 7,954,700
- **Density:** 477.4 people per square mile
- **Capital City:** Bern
- **President of the Swiss Confederation:** Didier Burkhalter
- **Currency:** Swiss Franc (CHF)
- **Main Imports:** Machinery and transport equipments, medicinal and pharmaceutical products, other chemicals, manufactured goods
- **Main Exports:** Chemicals, clocks and watches, food, instruments, jewelry, machinery, pharmaceuticals, precious metals, textiles, Rolex, Roger Federer
- **Imports Partners:** Germany 26.19%, Italy 10.46%, France 8.4%, United States 6.08%, China 5.75%, Austria 4.4%
- **Exports Partners:** Germany 18.5%, United States 11.61%, Italy 7.61%, France 6.96%, United Kingdom 5.67%
- **Time Zones:** GMT + 1
- **Website:** http://www.switzerland.com/en.cfm/home

Economic Overview

Switzerland is one of the richest countries in the world in terms of per capita income (that's total GDP divided by the country's population).

In 2010, it produced $529.9 billion in total output. As small as it is, on a per person basis, it boasts of a GDP of $46,815, which is seventh highest in the world.

Its main trading partners are Germany, the U.S., France, Italy, Austria, Russia, and the U.K. Like Japan, Switzerland is also highly dependent on its exports, which make up about $308.3 billion or 58.2% of its GDP.

Switzerland's main industries are machinery, chemicals, textiles, precision instruments and watches. Don't laugh at that last one – it actually comprises a decent chunk of Switzerland's output! Anyway, it's time to move on!

Monetary & Fiscal Policy

The Swiss National Bank (SNB), which is presently chaired by Mr. Thomas Jordan, conducts the nation's monetary policy by influencing the country's monetary and credit conditions.
The Governing Board, which is responsible for determining the bank's policies, consists of 3 members – the Chairman, Vice Chairman, and a third member. That's right – only three people are part of the board!

Unlike most central banks, the SNB sets a target range for its desired interest rate (also called Libor) rather than a fixed figure for three months.

On top of its purpose to control the country's money supply and influence interest rates, the SNB has a more on-hand role in keeping the CHF's valuation stable.

An excessively strong CHF could cause inflation to spike and could also undermine the country's exports. With Switzerland's strong reliance on their exports, the SNB, favors a weaker CHF and does not hesitate to intervene in the forex markets to weaken it.

One of the major monetary policies of the SNB is inflation targeting. The bank's inflation target, which is monitored in the CPI, is below 2% a year.

The bank will then attempt to influence the country's actual inflation rate through open market operations and by adjusting the Libor rate.

Speaking of open market operations, the bank influences the Libor rate through short term repurchase (repo) transactions. A repo transaction involves selling of a particular security for cash and agreeing to repurchase the same security at a later date.

If the interest rate in the open market rises over the SNB's desired band, the central bank will supply the other banks with more liquidity through repo operations at lower repo rates.

On the other hand, the SNB can reduce liquidity by increasing the repo rate, eventually increasing the Libor rate as well.

On the fiscal side, one attractive fiscal policy that Switzerland has is that they have some of the lowest tax rates among developed nations. In fact, it is often referred to as a "tax haven" nation.

Corporate tax rates in Switzerland run from 8.5% to 10.0%. This, in addition to its bank secrecy laws, make Switzerland one of the most business-friendly nations in the world.

Getting to Know the CHF

Not too long ago, France, Belgium, and Luxembourg also termed their currencies as francs… until they adopted the cooler euro, that is. At present, Switzerland is the only one using the franc as its currency, the Swiss Franc (CHF).

Among financial geeks, the Swiss Franc is known as the "Swissy".

Thanks to Switzerland's neutrality…

Switzerland is considered to be politically neutral due to its bank secrecy laws, giving the CHF a "safe haven" status as well. Usually, during times of economic uncertainty, investors move their funds into Switzerland, causing the CHF to gain in value.

I'm still stuck in the bling-bling era!

Not only do the Swiss refuse to join the "cool kids" of the EU, but they are also the only country that still adheres to a gold standard.

About 25% of the country's money is backed with gold reserves, giving the CHF an 80% correlation with the price of gold. This means that whenever the price of gold rises, the CHF could stand to benefit as well.

Important Economic Indicators for the CHF

GDP – The Gross Domestic Product (GDP) is the measure of the country's total value of all final goods and services. The report gauges the change in the economy's total output from the previous period.
Retail sales – The headline retail sales report measures the monthly change in the total value of sales at a retail level.
Consumer Price Index (CPI) – The CPI measures the change in the prices of a basket of goods and services. The CPI is followed closely by the SNB, as it uses the report to help in its inflation analysis.
Balance of Trade – The balance of trade measures the total difference in value between exported and imported goods in the country. Switzerland has a very robust export industry so traders often use the country's trade balance to measure how well the economy is faring.

What Moves the CHF

Price of Gold

As mentioned earlier, the CHF has an 80% correlation with the price of gold, as 25% of Switzerland's cash is backed with gold reserves. When gold prices go up, the CHF usually goes up as well. Conversely, when gold prices slide, the CHF likewise declines.

Developments in the Euro Zone and the U.S.

Since Switzerland is an export-dependent country, it is vastly affected by the economic development of its major trading partners in the euro zone and the U.S. Switzerland's major export partners in the euro zone are Germany (21.2%), France (8.2%), Italy (7.9%), and Austria (4.5%).

The U.S., meanwhile, takes about 8.7% of Switzerland's exports. Poor economic performance in any of these countries could mean less business for Switzerland.

Sortin' Out the Rough Edges

Political tension in its neighbors in Europe, particularly in the euro zone, could cause traders to seek the safety of the Swissy.

Remember that the euro zone is a brood of 16 states with the ECB directing and implementing a set of monetary policies for the entire group.

Given that the economies of the member-countries grow at different paces, ECB policies sometimes go against what a single nation needs at that specific time.

The X-factor

USD/CHF is also affected by the cross exchange rates like EUR/CHF. A jump in the EUR's valuation due to a hike in the ECB's interest rate, for example, could spill the Swissy's weakness onto other currency pairs like USD/CHF.

Merger and Acquisition (M&A) Activities

Switzerland's main industry is banking and finance. Merger and acquisition (M&A) activities, or simply the buying and selling of firms, are very common.

How can this affect the spot prices of the CHF?

For example, if a foreign firm wishes to acquire a business in Switzerland, it will have to pay for it using CHF. On the other hand, if a Swiss bank, for example, wishes to purchase a US firm, it will then have to dump its CHF for the USD.

Trading USD/CHF

USD/CHF is traded in the amounts denominated in USD. Standard lots sizes are $100,000 while mini lot sizes are $10,000.

The pip value, which is denominated in CHF, is calculated by dividing 1 pip (0.0001) by USD/CHF's rate.

Profit and loss are denominated in Swiss francs. For one standard lot position size, each pip fluctuation is valued at 10 CHF. For one mini lot position size, each pip fluctuation is worth 1 CHF. To illustrate, if the prevailing market rate of USD/CHF is 1.0600 and you want to trade one standard lot, then one pip would be equivalent to 9.4340 USD.

Margin calculations are typically in USD. At 100:1 leverage, you need $1,000 to control 100,000 units of USD/CHF.

USD/CHF Trading Tactics

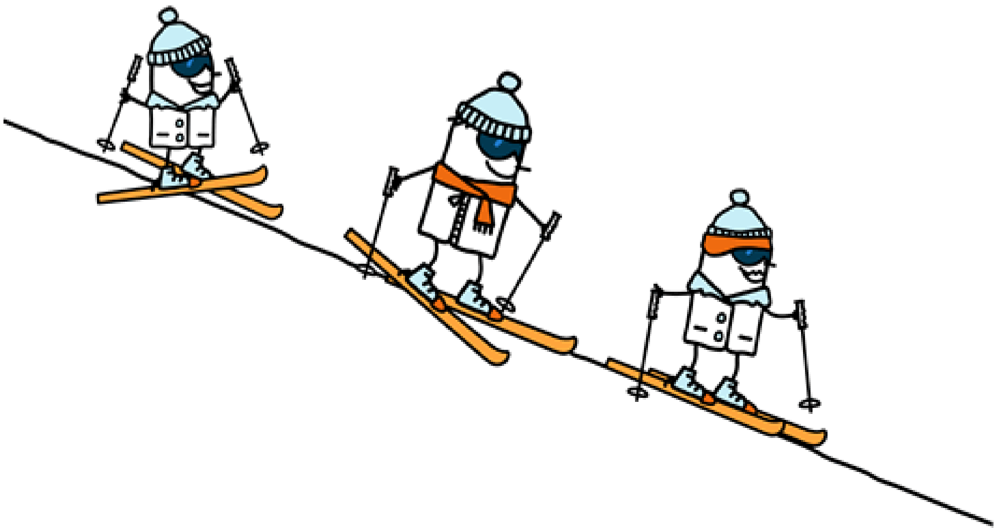
The Swissy pairs (USD/CHF and EUR/CHF) are usually active during the European trading session only. Both currency pairs tend to be range-bound most of the time. Given this, they are mostly susceptible to sudden spikes and breakouts.

As we mentioned earlier, the SNB is very much keen on monitoring the valuation of the Swissy. It is notoriously known to intervene in the forex market to weaken the CHF especially when it reaches some historical key levels.

For example, if USD/CHF falls back to its yearly low due to an increase in risk appetite, the SNB could just be lurking around to push the pair back higher.

You could also trade the Swissy by monitoring the economic fundamentals of its major trading partner, the euro zone. Any economic or political tension in the euro zone could lead investors back to the safety of the Swissy.

Given this, currency crosses like EUR/CHF could also be used to trade, for example, the USD/CHF. A rate hike by the ECB which boosts EUR/CHF could also spill over on USD/CHF.



China

Welcome to the grown-ups' table, China!

If all you know about China is that it has the world's largest population and Great Wall, then you need to read up, playa!

China was first recognized as a unified country back in 221 BC, ruled by the Qin dynasty. No, big, fat pandas weren't kung fu masters back then; at least we don't' think so. Since that time, we've seen many dynasties rise and fall until the People's Republic of China was establish in 1945.

It wasn't until recently though, that China emerged as a legitimate world power. It boasts world class cities, Olympic gold medalists, and delicious dimsum. Not only is it the birthplace of Yao Ming, it even became the third nation to send a man to space.

From sports, to space travel, to economic might, China is slowly crawling its way up the leader boards!

China: Facts, Figures, and Features

- **Neighbors:** Korea, Mongolia, India, Japan, Russia
- **Size:** 3,705,407 square miles
- **Population:** 1,350,695,000
- **Density:** 373 per square mile
- **Capital City:** Beijing (population: 11,716,000)
- **Head of Government:** Xi Jinping
- **Currency:** Chinese Renminbi / Yuan (CNY)
- **Main Imports:** petroleum, copper, iron, steel, machinery, plastics, medical equipment, organic chemicals
- **Main Exports:** rice, apparel, clothing, office machines, electronic goods, machinery, steel, Yao Ming, Jackie Chan, Apple iPads, Cherry cars
- **Imports Partners:** South Korea 9.4%, Japan 8.3%, Taiwan 8%, United States 7.8%, Australia 5%, Germany 4.8%
- **Exports Partners:** Hong Kong 17.4%, United States 16.7%, Japan 6.8%, South Korea 4.1%
- **Time Zone:** GMT+8, GMT+7, GMT +6, GMT +5, GMT+4
- **Website:** http://english.gov.cn/

Economic Overview

In late 2009, China overtook Japan as the world's second largest economy and as of 2011, China's GDP stands at a massive 7 trillion USD.

It wasn't always this way though. For the longest time, China's economy was secluded from the rest of the world. It was only during the formalization of the modern government, the People's Republic of China, that China started opening its door to the rest of the world.

China hit a humungous growth spurt in the 1990s and 2000s, as the nation posted ridiculous double digit growth. This put its booming economy at the forefront of emerging market growth.

Interestingly, the growth has been spurred on by the agriculture and industrial industries, which account for more than 60% of the total GDP.

Export trade has also played a major factor, with the undervalued yuan helping make Chinese goods more attractive in international markets.

Over the past year though, there have been fears that the Chinese economy may overheat. To counter this, the Chinese government has implemented various monetary and fiscal policies to ease the transition to more sustainable growth levels.

Monetary & Fiscal Policy

The People's Bank of China (PBoC), which is located in Beijing, is in charge of China's monetary policies. Aside from controlling interest rates and reserve ratio requirements, the PBoC is also tasked with regulating financial institutions in mainland China.
Now here's a little piece of trivia for you: Did you know that the PBoC currently holds the most financial assets among all the public financial institutions in existence? It is currently holding over $1.3 TRILLION USD worth of Treasury bills, and not to mention all the other bonds from other countries that's on its balance sheet!

This shouldn't be too surprising considering how China managed to trump most nations in terms of economic performance!

Another interesting factoid about the PBoC is that its interest rates used to be divisible by 9 instead of 25 a few years back. This was because the Chinese based their rate system on the abacus, which was set in multiplies of 9. Can you imagine reading about a 0.18% hike in benchmark rates?

Recently, however, the PBoC decided to let go of this traditional practice and adopt the convention of hiking or cutting interest rates by 0.25% increments. In fact, the PBoC is pretty notorious for making aggressive interest rate changes depending on how the Chinese economy is faring.

Aside from the interest rate, the PBoC also has the ability to adjust the reserve ratio requirement (RRR) for banks in its monetary policy arsenal. You see, the RRR refers to the amount of cash Chinese banks are required to hold in their vaults. By varying the ratio, the PBoC is able to control how much money is in circulation and keep inflation within their target levels.

Getting to Know the CNY

The yuan is the primary unit of Chinese modern currency or renminbi. If you're constantly getting confused between yuan and renminbi just as Dr. molar often mistakes sugar for salt when making his morning coffee, all you have to remember is that the term renminbi is the official name of China's currency while yuan refers to the actual units.
Although China is in the midst of reforming its exchange rate policies, the yuan still remains pegged to the U.S. dollar. This means that if the U.S. dollar rises or falls in value, the yuan follows accordingly. As such, CNY isn't one of the commonly traded currencies in the forex market.

One problem with this peg is that it has caused tension between China and the United States, who has come close to naming China a currency manipulator. Because the yuan is undervalued, haters claim that it gives China an unfair trade advantage and has be the main driver of Chinese growth.

To China's credit though, it has been gradually loosening the yuan's peg in recent years. They've done so by slowing introducing CNY-denominated bonds in Hong Kong. Word on the street is that big financial players can't wait to start changing their cash to yuans and investing in CNY-denominated assets.

Important Economic Indicators for the CNY

GDP – This figure acts as China's economic report card because it reflects how much their economy expanded or contracted (but it's the former in recent history, and nearly at double digits too!) for the period. This is typically reported on a quarterly basis compared to the same quarter in the previous year.
CPI – The PBoC keeps a close eye on the Chinese CPI report because it reflects how much price levels have changed over a particular period of time. If the annual CPI reading exceeds or falls below the Chinese government's target levels, the PBoC could wield its monetary policy tools in its next rate decision.
Trade Balance – A huge chunk of China's economy is comprised of international trade, which means that the trade balance is typically considered a leading indicator of growth.
PBoC Interest Rate Decision – As we mentioned earlier, PBoC is notorious for making aggressive monetary policy changes whenever they feel that the Chinese economy is overheating or if it needs more stimulus.

Trading the Chinese Economic Reports

Even though the yuan isn't a commonly traded currency, that doesn't mean you can't make any pips off those Chinese economic releases!

Because China's economy is so ginormous, its economic events will most likely impact those nations that they are closely associated with. One of these is Australia. China is Australia's largest trading partner, with the two nations exchanging nearly a hundred billion dollars' worth of products each year.

With that, Chinese economic data releases tend to impact the Australian dollar the most among the major currency pairs. Strong economic data from China typically indicates that the Chinese demand for Australian commodities could increase while weak Chinese data could hint at a downturn in trade with Australia.

Of course, since China is currently the world's second largest economy next to Uncle Sam, its economic standing also has a huge effect on risk sentiment. This means that a slowdown in China could reduce traders' appetite for risk and higher-yielding currencies as they worry about the potential impact of this slump on the global economy. On the other hand, an economic boom in China could be positive for risk as market participants see this as a sign of further growth for the global economy.

Trade Tactics

If you watch the Australian dollar just like our comdoll queen Happy Pip, then you should definitely mark your calendars for Chinese economic releases and PBoC statements.
More often than not, better than expected economic figures from China lead to an AUD/USD or AUD/JPY rally while weaker than expected results usually trigger an Aussie selloff. PBoC rate decisions are a little more tricky as these depend on prevailing market sentiment, so it's best to do your homework and read up on Gump's economic analysis articles to be in the loop!

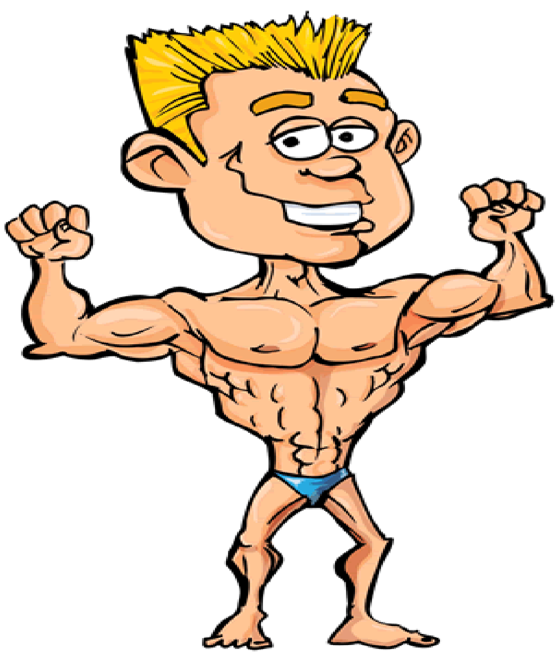
What is a Trading Plan?

Now that you're about half way through college, here's one piece of advice you should always remember.

Be your own trader.

In other words: **Don't follow someone else's trading advice blindly!** Just because someone may be doing well with their method, it doesn't mean it will work for you.

We're all in different situations in life, and we all have different market views, thought processes, risk tolerance levels, and market experience. Have your own personalized forex trading plan and update it as you learn from the market.



With rock solid discipline, your trading could look like this.
Developing a Trading Plan and sticking to it are the two main ingredients of **trading discipline**. But trading discipline isn't enough. Even solid trading discipline isn't enough.

It has to be **rock solid** discipline.

We repeat: **rock solid**.

Like Zac Efron's abs.

Plastic solid discipline won't do. Nor will discipline made from straws and sticks. We don't want to be little piggies.

We want to be successful traders!

And having **rock solid trading discipline** is the most important characteristic of successful traders.

A **trading plan** defines what is supposed to be done, why, when, and how. It covers your trader personality, personal expectations, risk management rules, and trading system(s).

When followed to, a trading plan will help limit trading mistakes and minimize your losses. After all, "**If you fail to plan, then you've already planned to fail.**"

A trading plan removes any bad decision making in the heat of the moment. Your emotions can consume you when money is on the line, causing you to make irrational decisions. You don't want that to happen.

The best way to prevent it from happening is to *minimize* (notice we did not say eliminate) thinking by having a plan for every potential market action. With the right forex trading plan, every action is spelled out, so that in the heat of the moment you don't have to make any rash decisions. You just simply stick to your trading plan.

The Difference Between a Trading Plan and a Trading System

Before we continue, we have to quickly distinguish the difference between a trading plan and a trading system.

A trading system describes how you will enter and exit trades.

A trading system is part of your trading plan but is just one of several important parts, i.e., analysis, executions, risk management, etc. Since market conditions are always changing, a good trader will usually have two or more trading systems in his or her trading plan.

Trading systems will be covered more in-depth later on in the lesson, but we thought that it was important to point out the difference between the two upfront to avoid any confusion.

Why Do Forex Traders Need A Trading Plan?

A trading plan will make trading simpler than it would be if you traded without one.

Think of when you use a GPS device. You enter where you want to go. It then figures out where you currently are and then shows you how to get to where you want to go. You're able to constantly check on your GPS to see if you're still on the right track. When you make a wrong turn, it knows to make adjustments, and it points you back in the right direction.

A trading plan is your trading GPS. It will show you where you currently are as a trader and help you get to your destination: **consistent profitability**.

Traveling without a GPS wouldn't be smart idea. You wouldn't know how to get to your destination and it's highly likely that you'll drive around lost like a chicken with its head chopped off. You're probably thinking that one could use an ancient object called "maps" instead, but we have no clue what that is. Please don't make such absurd suggestions again.

Trading without a trading plan would be the same thing as driving without a GPS–a bad idea. You're trying to get to this Promised Land called "Consistent Profits," but since you have no way of knowing whether you're headed in the right direction, you'll most likely end up blowing out your account.

With a trading plan, you're able to know if you're headed in the right direction. You'll have a framework to measure your trading performance. And just like a GPS, you're able to monitor this continually.
This allows you trade with less emotion and stress.

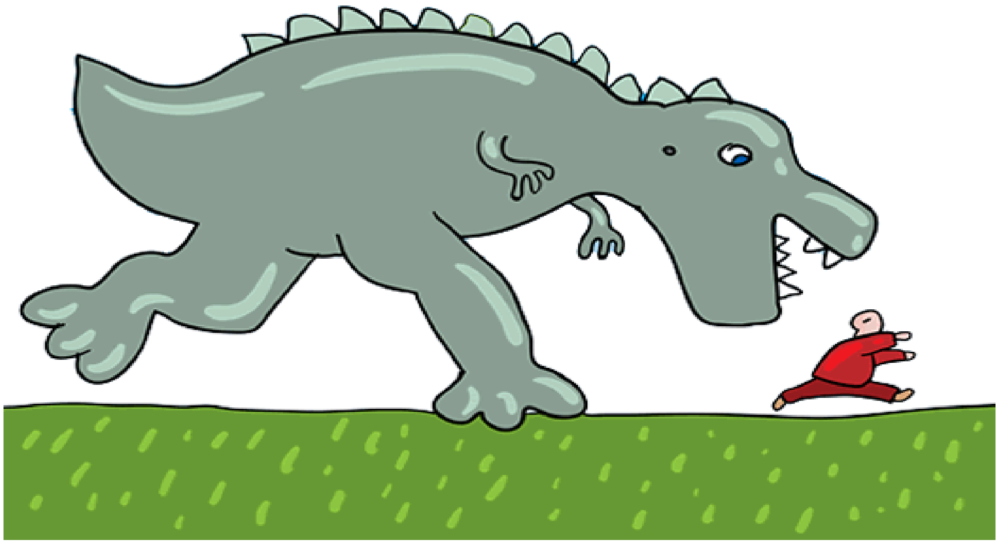
Without a trading plan, this would be nearly impossible. Instead, you'd be a "**cowboy trader**", shooting from the hip, trading by the seat of your pants, relying on your gut, guesses or signals from strangers. That ain't trading – that's gambling!
Whenever you trade, you'll probably end up a nervous, emotional wreck, crying yourself to sleep as your rollercoaster account balance grinds at your psyche. (Okay pretty drastic, but we think you get the picture).

Just as you use a GPS to both figure out the route to be taken and to judge the progress that has been made, your trading plan defines how you'll become consistently profitable and tells you if you're on track.

Most importantly, if you suck at trading (and you certainly will in the beginning), you will know it is down to one of only two reasons: either **there's a problem in your trading plan** or **you are not sticking to your trading plan**.
If you're trading without a plan, it's impossible to know what you're doing right from wrong. You have no way to evaluate your results, so you'll never know how to stop sucking.

We can't emphasize this enough…

"**If you fail to plan, then you've already planned to fail.**"
Obviously, a trading plan doesn't guarantee success, but a good plan that is followed will help you stay in the forex game longer than traders who don't having a trading plan.



SURVIVAL is better than failure and it should be your first goal as a newbie trader.

Remember, 90% of new traders don't make it. You want to be part of that special "10%" that does make it.

You're probably thinking, "Ba humbug! Trading plan, schmading plan. I can be part of that 10% without a stinkin' trading plan!"

It may be tempting to trade by the seat of your pants, but if you don't develop clearly defined trading plans and be disciplined enough to follow them consistently, you'll have much difficulty making consistent money as a trader.

Don't take any chances. Have a trading plan.

Why Trading Discipline is the Key to Consistent Profitability

What's wrong with deviating from your forex trading plan if you make a profit anyway?

Making an occasional winning trade, even when you throw your trading plan out the window, may provide short-term pleasure, but entering trades haphazardly can adversely influence your ability to maintain discipline in the long term.

Trading is a marathon, not a sprint!

When you stop following your trading plan, you become rewarded for lacking discipline and you may start believing that abandoning a trading plan is no big deal.

An unjustified reward may increase your tendency to abandon trading plans in the future. You may be prone to think “I was rewarded once, maybe I will be rewarded again. I'll take a chance.” But the positive outcomes of undisciplined trading are usually short-lived, and a lack of discipline ultimately produces the long-term trading losses.

It's important to distinguish **justified** wins from **unjustified** wins.
A **justified win** is when you create a very detailed trading plan and FOLLOW the plan. A win that results from following a trading plan is justified and reinforces discipline.
An **unjustified win** occurs when you make a plan but don't follow it or if you have no plan at all. You might be rewarded, but the outcome occurred by chance.
You might as well flip a coin or hang a printed copy of your charts on the wall and throw darts at it to help you make trading decisions. The win is unjustified and can reinforce undisciplined trading.

Maintaining discipline is vital for consistent and profitable trading. **Trading is a matter of getting the law of averages to work in your favor.** You trade proven forex trading strategies, over and over, so that across a series of trades, the strategies work enough to produce an overall profit. It's like making shot after shot on the basketball court so as to accumulate a winning number of points. The more shots you take, the more likely you will amass points. Just look at Kobe Bryant or Kevin Durant.

The winning player is the person who first develops the skill to make the shot consistently, so that at every possible opportunity, the ball is likely to go through the basket. They've developed the skill to learn how to shoot the ball the same way every single time. Consistency is crucial!

It's the same for trading. One must trade consistently, following a specific trading plan on each and every single trade. If you trade one approach this time, and a different approach at another time, your performance will more than likely be haphazard.

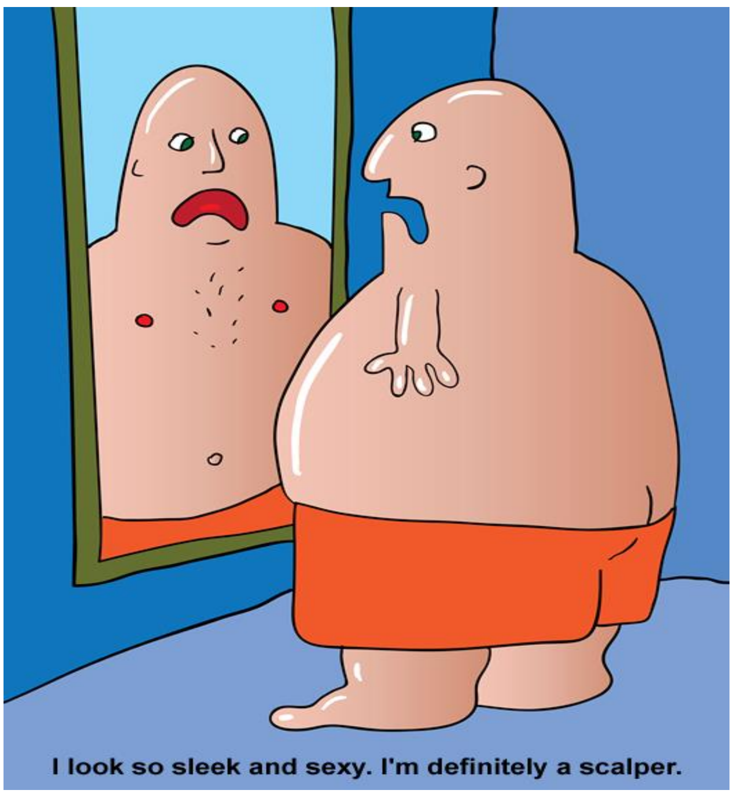
We can't stress this enough…

You have to allow the law of averages to work in your favor, so that across a series of trades, you will make an overall profit.
If you follow the plan sometimes and abandon it at other times, you throw off the probabilities, and you will most likely end up losing overall.

With trading discipline comes profitability.
Don’t let unjustified wins interfere with your ability to maintain discipline. Follow your own trading plan, and cement in the mindset that if you follow your plan, you will end up more profitable in the long run.

Now that we’re done explaining how important a trading plan is (can we stress this enough?), it’s time for you to learn what should go inside a good trading plan.

How To Find A Trading Style That Suits Your Personality



The first step in building a trading plan is to realistically take a holistic view of yourself.

The foundation of your trading plan starts with your self-reflection because you will be the only one using it. This self-reflection will reveal your trader profile, which is basically who you are as a trader.

Who you are as a trader will define what kind of method suits you. Strategies, systems, and methods which aren’t compatible with your profile and personality will drastically lower your chances of success.

While most traders want to immediately jump into creating or finding trading systems and strategies, they won't know which ones match their personality and unique situation if they don't spend some time on self-reflection first.
Before you think about clicking the Buy or Sell button on your trading platform, there are some questions you should ask yourself so that you can better form your trading plan. While you're at it, you should write down these answers. Writing down your answers will help remind you of what you're going to do and help make sure you stick to the plan.

Now are you ready for some Q&A?

In the following sections, we'll go through some questions that should make clearer what your trading profile is, and how it will shape your trading plan.

What is Your Motivation to Be a Forex Trader?

Is it to become filthy rich? Is it for the thrill? Is it because you want to do something challenging and exciting? Is it because the girl you like trades currencies and you want to impress her?

It is important to know what your true motivation is, or whether you should even be trading at all. **Forex traders who aren't serious or committed to the craft will be quickly eliminated by the market.**
For example, seeking thrills and seeking consistent profits don't go together. You might enjoy the thrill of putting on a humungous "I'm betting the farm" position, but believe us, you won't be smiling once your trade blows up in your face.

If thrills are what you seek, go to a casino, jump out of a plane or try driving an F1 racing car.

Better yet, if you want a real thrill, drive an F1 racing car out of a plane and land in a casino. Now that's a real thrill! And you might even lose less money than if you were trading.

What have you determined to be your goal(s) for trading?

This can be expressed monetarily using a profit goal (either in currency or percent return) per unit of time. For example, you might choose a goal like making $4,223,834,145.53 per month, or achieving a 529% return every week.

This doesn't necessarily have anything to do with money. Like "My goal for trading is be able to buy them new Space Jam Jordan 11s so I can impress my lady crush and she can fall in love with me and we can live happily ever after."

Or "My goal is to have enough money to have plastic surgery so that I can look like Halle Berry and have everyone eating out of my hands."

Okay.

We lied.

Everything has to do with money.

Whatever you decide, just make sure it's specific and measurable. Set trading goals that will help you develop as a trader.
It can't be vague like "I want to be rich".

Changing it to "I want to be super rich." does not count.

Be specific!

"I want to make 1% every week."

"I want to be winning 50% of the time by the end of this year."

"I want to double my account in six months."

"I don't want to make any trading mistakes for the day."

By making your goals specific and measurable, not only will you know what you really want, but you'll be able to monitor your progress and see whether you are improving or not.

What Is Your Risk Capital? How Much Money Can You Afford To Lose?

You need to determine if you can even afford to trade.

Forex trading should only be done with **risk capital**.
Risk capital is money that you can lose.
This is the kind of money that if you lost, you wouldn't lose your home, car, spouse, limbs, electricity, etc.

Don't risk what you can't afford to lose!
If you're playing with money that you need to pay the bills, it will have a huge negative impact on your ability to make objective trading decisions.

Imagine how stressed you'll be while your trade is open knowing you might not be able to put on the food on the table if you get stopped out.

Every time a pip goes against you, you'll be thinking, "There goes tomorrow's lunch!"

You don't want to end up starving, homeless, and broke now do you?

Unless you do.

In that case, go ahead and risk all your hard-earned money in forex.

Don’t be stupid!

If you can’t afford to make dough in the kitchen, then you can’t afford to make dough in the forex market.

Don’t start trading forex with real money until you’ve accumulated enough risk capital. Until then…

Stick to demo until you really know what you are getting into!

Later on, we’ll teach you all about risk management and how you should manage your risk capital.

How Much Time Can You Dedicate To Forex Trading?

You need to seriously consider how much trading will affect your current lifestyle.

How much time each day/week/month (whichever is most appropriate) can you dedicate to the various requirements of forex trading and managing a trading system?
Your time availability will determine your trading style.
The shorter the timeframe you are trading, the more time you need in front of the charts.

If you’re a **day trader**, since you’re entering and exiting trades throughout the day, you need to be glued to the screen the whole time.

The longer the timeframe you trade, the less you have to watch the market. You can simply check your trade from time to time.

Don't forget about distractions!

When you say you can trade currencies for 8 hours a day, does that mean 8 hours of your undivided attention staring at charts and analyzing economic data releases? OR does that mean 8 hours of staring at charts, analyzing economic data release while cooking your Honeybun some breakfast, juggling knives, playing with your kids, watching Justin Bieber on YouTube, following Lady Gaga on Twitter, stalking someone on Facebook, and saving the world from the forces of evil?

Because if you were an **scalper**, you'd probably missed a lot of entries and exits, and end up instead scalping your own head due to your many losses or missed winning opportunities.
You also need to dedicate time to developing AND tweaking your trading system. Trading your system will require you stare at charts looking for possible entries. Once you're in a trade, you then need to manage it.

After you exit, you need time to review your trade and look for ways to improve. And then you need time to write everything you felt and did in your trading journal.

How much time you'll need to accomplish all of this will depend on your trading system.

Naturally, your forex trading system needs to factor in how much time you can dedicate.

This is all assuming you only have ONE trading system.

You should repeat this process for every trading system you wish to trade.

Whatever "operating hours" you decide, just make sure you're able to commit to it consistently.

Which Kind Of Returns Do You Expect To Make From Forex Trading?

Ahhh. Of course, anybody who's interested in trading certainly has ambitions of raking in some dough. It make sense – trading involves risk, and we expect to be compensated for those risks.

There's no doubt that every currency trader expects to make profit.

The question that you should ask yourself though is this:

What kind of returns do you expect to make?

Your answer to this question will play a huge role in determining what kind of trading style you will implement, what currency pairs and times you will trade, and most importantly, the risks involved in achieving your goals.

Let's look at an example to help explain this better. Let's say there are two forex traders, Bruce and Mike. Bruce is looking to score 10% a year while Mike is a little more ambitious – he wants to DOUBLE his account and make 100% returns

As you can imagine, a trader like Mike, who is looking to double his account, is in a very different situation.

It is very likely that Mike will have to take a lot more trades and/or risk more than Bruce. He will have to expose himself to more potential losses if he ever wants to achieve his goal of 100% returns.

Traders will also have to take into consideration drawdowns. A drawdown is normally calculated as the distance from the highest value of your account to next lowest point. (We'll explain this a little bit more in a following lesson. For now, pay attention in class!)
Each forex trader must decide how big of a drawdown he or she can accept in order to hit their profit target goals.

On the one hand, there are forex traders who are risk averse and would rather have small drawdowns. The tradeoff is that this will also limit potential reward.

On the other hand, there are forex traders who are comfortable with large drawdowns, just as long as their system also yields huge returns.

You will also have to take into consideration how much time you can dedicate to trading. If you can't dedicate a significant amount of time working on your system, reading up on the markets and learning new trading techniques, recording/reviewing your journal, then we can guarantee you that you will have a difficult time hitting your goals.

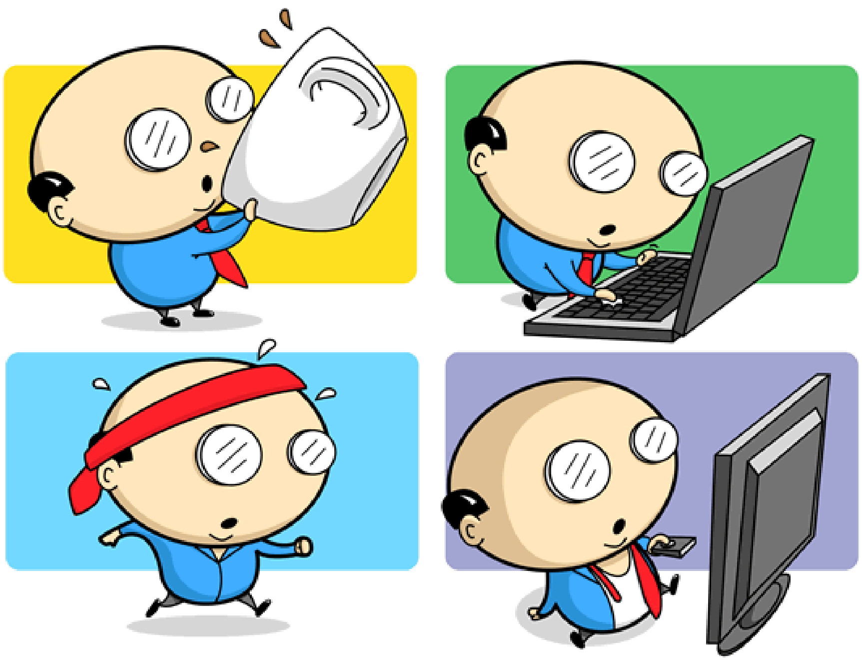
If you can't make this time commitment, you may have to readjust your expectations as to how much you can make your account grow. We highly suggest that you check out Pipwcrawler's thread about setting newbie expectations

In the end, just know that success depends on YOU.

Do you have the discipline to grind it out consistently to tweak your skills and gain the experience needed to navigate the markets?

If you don't, then expect inconsistent returns, if any at all, over the long term.

What Is Your Daily Pre-Trading Routine?



What activities will you do BEFORE you start trading?

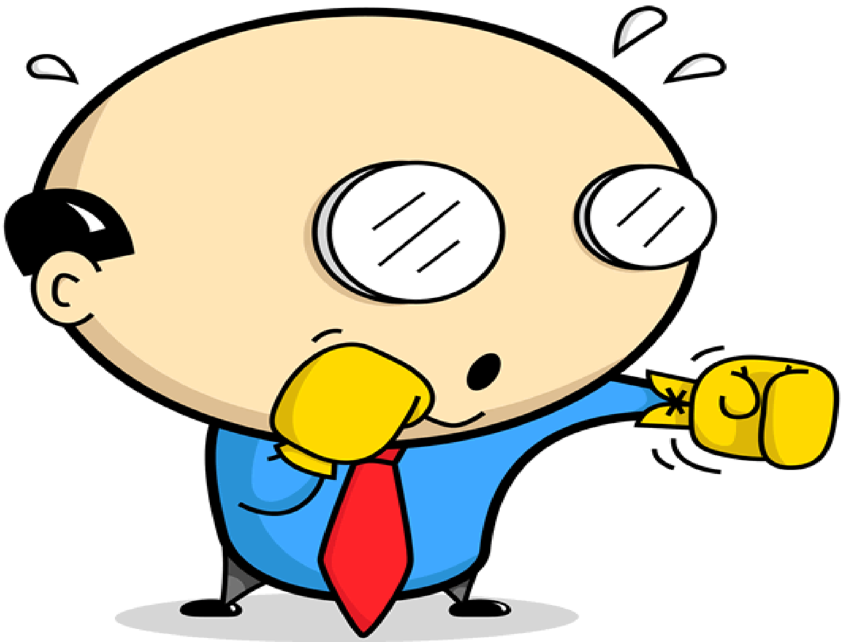
We don't mean showering and brushing your teeth (although you should always take a shower and brush your teeth. You don't wanna smell like Pipcrawler now do you?)

Your forex trading routine should help you accomplish the following tasks:

- Reviewing any open positions and making any necessary adjustments
- Reviewing yesterday's trades
- Getting yourself "up to speed" on the market
- Identifying any upcoming news that could cause volatility
- Being ready to trade when the next trading session opens

Now you will want to review the overall market news. This can be done online through sites such as Bloomberg, or through television (CNBC, Bloomberg TV, BBC). Determine what the overall market sentiment is for the day, review yesterday's trades and how the previous trading session finished, and maybe identify key market areas like support and resistance.
Now it's time to start trading your system!

Your pre-market routine will be critical to your success as a trader. It will help you plan your day so that you are not spending time during market hours scrambling trying to figure out what news or data will be coming out, and what to do if the market does something you didn't expect.



Let's go Mr. Market! I'm ready for you!

You want to start your forex trading session feeling calm, relaxed, and prepared for whatever the market throws at you.

Keep up-to-date with both the fundamentals and technicals affecting the forex market.

A forex trader in the dark is a forex trader in the red.

What Forex Trading Software, Hardware, And Other Tools Will You Use?

What “toys” will you use for your forex trading profession?

Write down the hardware, software, data feeds, and internet access that will comprise your forex “trading desk.”

Don’t forget backups! Make sure you have a backup plan for everything just in case your main tools fail while you’re in a trade. What if your computer crashes and doesn’t boot back up? What if your internet connection goes down? What if your electricity goes out? (Laptop and pocket WiFi. Bam!)

Finally, don’t get suckered by all the razzle-dazzle currency trading vendors (cough *scammers!* cough) try to lure you with. Do you really need that $5,000 chart pattern recognition software that displays in 3D IMAX? Didn’t think so. Save your money and use it for capital instead.

What forex broker/platform will you use?

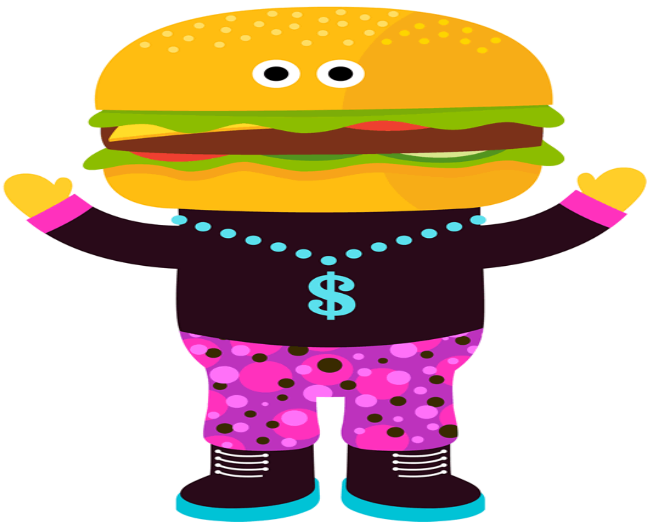
Where will you execute your trades? It’s not like you can call the bank and say, “I want go long EUR/USD.” Okay fine, you could have done this in the past, but we’re living in the 21st century now – time to get up to speed and use those online platforms!

But it isn’t that simple. Make sure you know the ins and outs of broker you choose from executing orders to depositing and withdraw money (hopefully profits, right?).

Stick With Your Trading Plan

A forex trading plan is only effective if it’s followed. You have to stick to it. It sounds simple to do. It is really just common sense but most traders still can’t do it. Why, oh, why?

Trader incompatibility. A trading plan should be a personalized plan for you, a plan that fits your own goals, risk tolerances, and individual lifestyle. You must develop each component on an individual basis, never losing sight of the fact that it must be custom tailored to YOU and YOUR needs.
Not your girlfriend’s. Not your boyfriend’s. Not your basketball coach’s. Not even Ronald, your weirdo best friend whose head is shaped like a hamburger who likes to wear pink polka dot pants and is an aspiring rapper.



Yo my homie! My trading plizan is da bizomb!

Your trading plan must be made based on reality, not on hope. If you're simply trying to copy somebody else's trading plan or yours is based on false assumptions, then you will not be compatible with it and will have trouble following it.

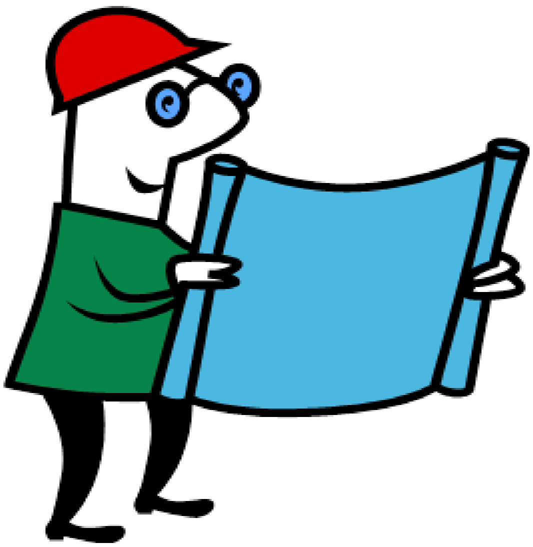
Solution: **Be honest with yourself. Then revise your trading plan.**
Trading plans are intended to be long-term. Many forex traders give up on their trading plan, or often more specifically, the trading system in the trading plan, after suffering a string of losses rather than sticking it out through the inevitable rough times.

Solution: **Be patient!**
No discipline: Trading according to a plan requires sticking to it through thick and thin. That takes discipline. Rock solid discipline. Forex traders lacking discipline do not stick to their trading plans. You need to be disciplined. Rock solid. Does it sound like we're beating a dead horse? Well, good.

Solution: **Stay disciplined!**
Self-destructive behavior: Some forex traders have deeply ingrained psychological issues that will sabotage them. This can be resolved with hard work on one's self, but the trader must be self-aware of such issues first. You can't figure out a solution if you don't know the root problem.

Solution: **Look in the mirror. Hopefully you don't turn to stone.**
If you're personally having trouble sticking to your trading plan, most likely it's one of the reasons above. If it is, refer to the solution below it.

Summary: Developing a Trading Plan



The difference between making money and losing money can be as simple as trading with a plan or trading without one. A trading plan is an organized approach to executing a trading system that you've developed based on your market analysis and outlook while factoring in risk management and personal psychology.

No matter how good your trading plan is, it won't work if you don't follow it.

Forex traders who follow a disciplined approach are the ones who survive year after year after year. They can even have more losing trades than winning ones and still be profitable because they follow a disciplined approach.

Here is a summary of what the key benefits are:

- Trading that is simpler with a plan than it is without one.
- Reduced stress which means better health.
- Ability to gauge your performance, identify problems, and make corrections.
- A trading plan helps to prevent many psychological issues from taking root.
- A trading plan that is adhered to strictly will reduce the number of bad trades.
- A trading plan will help prevent irrational behavior in the heat of the moment.
- A trading plan enables you to control the only thing you can control… yourself!
- A trading plan will instill a large measure of discipline into your trading. Gamblers lack both discipline and a trading plan.
- A plan will enable you to trade outside your comfort zone. How many times have you let a loss run and cut a profit short because it was the comfortable thing to do? A plan, executed with discipline, will help to prevent this from happening.
- A plan is your GPS which will enable you to get from wherever you are now to wherever you want to be: consistent profitability.
- Your trading plan is designed in such a way that if you do take a "wrong turn," you will know about it very quickly and have the opportunity to correct the problem before losses spiral out of control.

One last thing before you head of to your next class…

Always remember that the trading plan is a **work in progress**.
As things change, the trading plan must change, too. Assess your trading plan and processes periodically, especially when you have changes in your financial or life situation. Also, as your research leads to changes in your trading system or methods, be sure to reflect those adjustments in your forex trading plan.

As Pipcrawler always says, **"Adapt and survive!"**
Remember, the main purpose of the trading plan is to keep you on task, and to operate in an effective and efficient manner to make good trading decisions. It is, however, only as good as you make it, and it is completely useless if it is not applied in practice.

Know The Different Types Of Trading Styles

Each forex trader is unique

There are over 8 billion people in the world (including space aliens disguised as humans) and not one person is exactly the same as another. Even identical twins will have different fingerprints.

Everyone has their own look, personality, talents, and pizza topping preferences (we like pepperoni and potato chips). We all like different things and are unique in our own way.

I am Zoltran. I am unique trader. Look into my eyes!

Trading is the same way. Our unique personalities will lead us to trade differently from one another. Some may be aggressive, "type A" personality traders while others may be more relax, "type B" personality traders. Some may like taking small wins all the time, while others don't mind losing a bit in order to make those huge gains when they do win.

The point is that no two traders are alike. Even if a group of people were to trade the same system rules, each person's end results would most likely be different from everyone else.

Is that a bad thing? Not at all!

Our uniqueness is what makes the world go round, so it's important to know your lifestyle and personality to help identify trading strengths and weaknesses. Trying to force a trade that doesn't match your personality will result in frustration and can hinder you from making consistent profits.

This lesson will take you through a variety of trading styles so that you can identify which one may match you the best.

Your Most Important Investment As A Forex Trader

A common mistake by many new traders is that they think they can make money… fast! While it's true you can make money in a short amount of time, it doesn't mean you will end up profitable in the long run.

A typical scenario is that a new trader reads a little bit about trading forex, finds a system online that claims to make money quickly, and then jumps right into trading because he feels like he's got enough of a background to make millions of dollars.

Unfortunately after the "honeymoon" period is over and the excitement settles down, this new trader now realizes that trading isn't as easy as he thought. The system doesn't seem to be working like it claimed it would and he has no idea why the market is doing what it's doing.

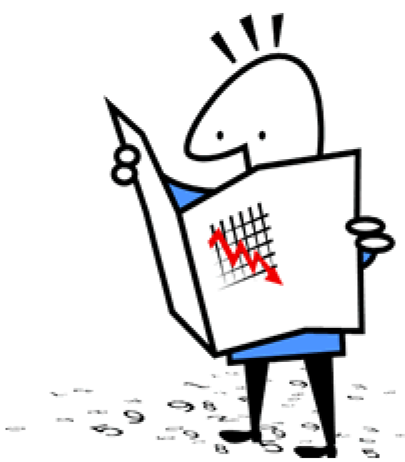
The most important thing you can invest in as a forex trader is your **TIME**! Every single trading day is a learning experience and if you stop learning, then you will never become a truly successful trader.
Take into account how much time it will take you to learn the basics. Then consider how much time it will take in your daily routine to read charts, news reports, record your trades, and be in the markets.

For someone who can dedicate a "full-time" job mentality to forex trading, then this is no problem. However, if you're like most people, you may have a job, school work, tuba lessons, World of Warcraft dailies, so you cannot exactly dedicate your entire day to trading.

This doesn't mean that you can't trade, but it should give you some realistic expectations when it comes to determining your trading style. You probably can't be a scalper or day trader, but maybe longer term trades will work better for your schedule.

Each day requires your time to analyze the market. Because news makes the market move, it's important to consider the economic developments going on around the world and to make it part of your daily routine.

Some things to consider in your market analysis:



- **Forex Market Developments** – Look at what the "talk of the town" is in the forex world. See what the analysts are buzzing about and how the currencies reacted.
- **News Releases** – Know what news reports are coming out each day and how they affect the markets. The more important the news report, the more movement you can expect to see in its currency. Make sure you check out our wicked-sick Forex Calendar

- **Market Prices of Other Commodities** – The price of oil or U.S. Treasury yields can affect the way currencies move so it's important to find out why these things are rising or falling and keep that in mind when trading currencies.
- **Current Events** – Check out many news websites and get to know what is happening across the globe. Events such as major elections, military conflicts, and political scandals can all affect currency movements or global risk sentiment

Finally, after going through your daily economic analysis, you have to look at the charts. Charts will give you insights into key support and resistance levels, trends, and possible price points in which to enter the market.

Scalping

Scalping is like those high action thriller movies that keep you on the edge of your seat. It's fast paced, exciting, and mind-rattling all at once. These types of trades are usually only held onto for a few seconds to a few minutes at the most! The main objective for forex scalpers is to grab very small amounts of pips as many times as they can throughout the busiest times of the day.

Because scalpers basically have to be glued to the charts, it is best suited for those who can spend several hours of undivided attention to their trading.

It requires intense focus and quick thinking to be successful. Check out this post by our regular psychologist, Dr. Pipslow, on how to to work on your concentration skills.
It is not for those looking to make big wins all the time, but rather for those who like raking in small profits over the long run to make an overall profit.

You might be a forex scalper if:

- You like fast trading and excitement
- You don't mind being focused on your charts for several hours at a time
- You are an impatient person who doesn't like to wait for long trades
- You can think fast and change bias, or direction, quickly
- You have fast fingers (put those Starcraft 2 skills to work!)
- You are a surgeon!

You might NOT be a forex scalper if:

- You easily get stressed in fast moving environments
- You can't commit several hours of undivided attention to your charts
- You'd rather make fewer trades with higher profit gains
- You like taking your time to analyze the overall picture of the market

Some things to consider if you decide to scalp:

Trade only the most liquid pairs

Pairs such as the EUR/USD, GBP/USD, USD/CHF, and USD/JPY offer the tightest spreads because they tend to have the highest trading volume. You want your spreads to be as tight as possible since you will be entering the market frequently.

Trade only during the busiest times of the day

The most liquid times of the day are during the session overlaps. This is from 2:00 am to 4:00 am and from 8:00 am to 12:00 noon Eastern Time (EST).

Make sure to account for the spread

Because you enter the market frequently, spreads will be a big factor in your overall profit. Be sure your targets are at least *double your spread* so that you can account for the times the market moves against you.

Try focusing on one pair first

Scalping is very intense and if you can put all your energy in one pair, you'll have a better chance at being successful. If you start to get accustomed to the pace of things, then you can start by adding on another pair and see how it works for you.

Make sure you follow good money management

This goes for any type of trading, but since you are making so many trades within a day it is especially important that you are sticking to risk management practices.

Major news reports can throw you off

Because of slippage and high volatility, trading around highly anticipated news reports can be very dangerous. It sucks when you unexpectedly see price jump in the opposite direction of your trade because of a news report!

Day Trading

Day trading is another short term trading style, but unlike scalping, you are typically only taking one trade a day and closing it out when the day is over. These traders like picking a side at the beginning of the day, acting on their bias, and then finishing the day with either a profit or a loss. They DON'T like holding their trades overnight.

Day trading are suited for forex traders that have enough time throughout the day to analyze, execute and monitor a trade. If you think scalping is too fast but swing trading is a bit slow for your taste, then day trading might be for you.

You might be a forex day trader if:

- You like beginning and ending a trade within one day.
- You have time to analyze the markets at the beginning of the day and can monitor it throughout the day.
- You like to know whether or not you win or lose at the end of the day.

You might NOT be a forex day trader if:

- You like longer or shorter term trading.
- You don't have time to analyze the markets and monitor it throughout the day.
- You have a day job.

Some things to consider if you decide to day trade:

Stay informed on the latest fundamentals events to help you choose a direction

You will want to keep yourself up-to-date on the latest economic news so that you can make your trading decisions at the beginning of the day.

Do you have time to monitor your trade?

If you have a full time job, consider how you will manage your time between your work and trading. Basically….don't get fired from your job because you are always looking at your charts!

Types of Day Trading

Trend trading

Trend trading is when you look at a longer time frame chart and determine an overall trend. Once the overall trend is established, you move to a smaller time frame chart and look for trading opportunities in the direction of that trend. Using indicators on the shorter time frame chart will give you an idea of when to time your entries. For an example of this style of trading, visit Pip Surfer's blog as he trades his world-renowned Cowabunga System.

First determine what the overall trend is by looking at a longer time frame. You can use indicators to help you confirm the trend.

Once you determine the overall trend, you can then move to a smaller timeframe and look for entries in the same direction. Remember this? It's called Multi-time Frame Analysis!

Countertrend trading

Counter trend day trading is similar to trend trading except that once you determine your overall trend, you look for trades in the opposite direction. The idea here is to find the end of a trend and get in early when the trend reverses. This is a little more risky but can have huge payoffs.

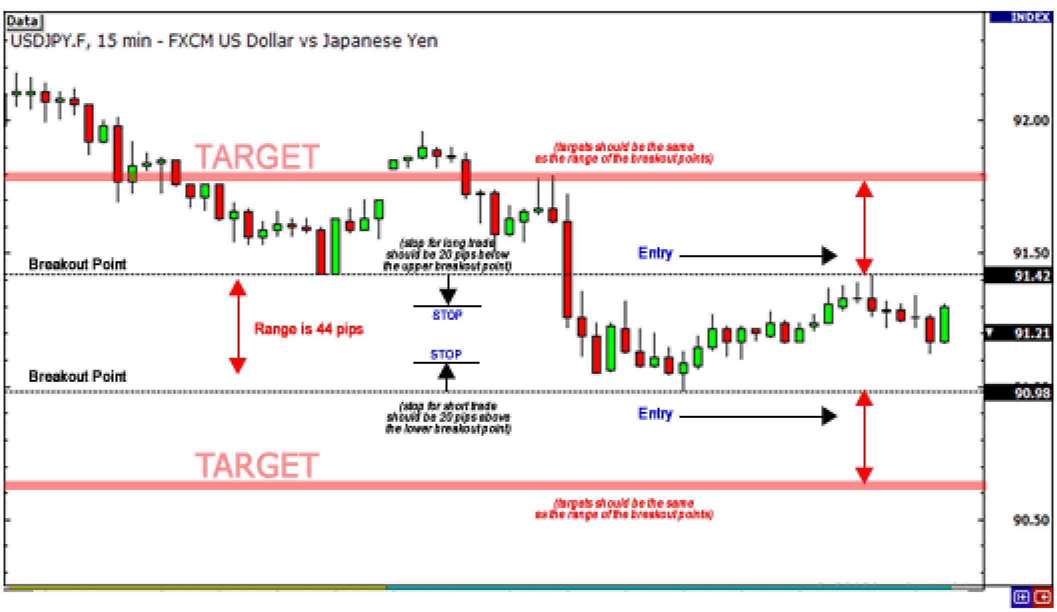
In this example we see that there was a long and exhausted downtrend on the 4hr chart. This gives us. an indication that the market may be ready for a reversal.

Since our thinking is “counter-trend”, we would look for trades in the opposite direction of the overall trend on a smaller timeframe such as a 15 minute chart.

Remember that going opposite of the trend is very risky, but if timed correctly, can have huge rewards!

Breakout trading

Breakout day trading is when you look at the range a pair has made during certain hours of the day and then placing trades on either side, hoping to catch a breakout in either direction. This is particularly effective when a pair has been a tight range because it is usually an indication that the pair is about to make a big move. Your goal here is to set yourself up so that when the move takes place you are ready to catch the wave!



In breakout trading, you determine a range where support and resistance have been holding strongly. Once you do, you can set entry points above and below your breakout levels. As a rule of thumb you want to target the same amount of pips that makes up your determined range. Make sure you check out our "**Trading Breakouts**" lesson so you get this down pat!

Swing Trading

Swing trading is a longer term trading style that requires patience to hold your trades for several days at a time.

It is ideal for those who can't monitor their charts throughout the day but can dedicate a couple of hours analyzing the market every night.

This is probably best suited for those who have full-time jobs or school, but have enough free time to stay up-to-date with what is going on in the global economies.

Forex swing trading attempts to identify medium term trends and enter only when there seems to be a high probability of winning.

Because trades last much longer than one day, larger stop losses are required to weather volatility, and a forex trader must adapt that to their money management plan.

You will most likely see trades go against you during the holding time since there can be many fluctuations of the price during the shorter time frames.

It is important that you are able to remain calm during these times and trust in your analysis.

Since trades usually have larger targets, spreads won't have as much of an impact to your overall profits. As a result, trading pairs with larger spreads and lower liquidity is acceptable.

You might want to be a forex swing trader if:

- You don't mind holding your trades for several days.
- You are willing to take fewer trades, but more careful to make sure your trades are very good setups.
- You don't mind having large stop losses.
- You are patient.
- You are able to remain calm when trades move against you.

You might NOT want to be a forex swing trader if:

- You like fast paced, action-packed trading.
- You are impatient and like to know whether you are right or wrong immediately.
- You get sweaty and anxious when trades go against you.
- You can't spend a couple of hours every day to analyze the markets.

- You can't give up your World of Warcraft raiding sessions.

If you have a full time job but enjoy trading on the side, then swing trading might be more your style!

Position Trading

Position trading is the longest term trading and can have trades that last for several months to several years!
This kind of forex trading is reserved for the ultra-patient traders, and requires a good understanding of the fundamentals.

Because position trading is held for so long, fundamental themes will be the predominant focus when analyzing the markets.

Fundamentals dictate the long term trends of currency pairs and it is important that you understand how economic data affects your countries and its future outlook.

Because of the lengthy holding time of your trades, your stop losses will be very large.

You must make sure you are well capitalized or you will most likely get margin called.
Forex position trading also requires thick skin because it is almost guaranteed that your trades will go against you at one point or another.

These won't just be little retracements either.
You may experience huge swings and you must be ready and have absolute trust in your analysis in order to remain calm during these times.

You might be a forex position trader if:

- You are an independent thinker. You have to be able to ignore popular opinion and make your own educated guesses as to where the market is going.
- You have a great understanding of fundamentals and have good foresight into how they affect your currency pair in the long run.
- You have thick skin and can weather any retracements you face.
- You have enough capital to withstand several hundred pips if the market goes against you
- You don't mind waiting for your grand reward. Long term forex trading can net you several hundred to several thousands of pips. If you get excited being up 50 pips and already want to exit your trade, consider moving to a shorter term trading style.
- You are extremely patient and calm.

You might NOT be a forex position trader if:

- You easily get swayed by popular opinions on the markets.
- You don't have a good understanding of how fundamentals affect the markets in the long run.
- You aren't patient. Even if you are somewhat patient, this still might not be the trading style for you. You have to be the ultimate zen master when it comes to being this kind of patient!
- You don't have enough starting capital.
- You don't like it when the market goes against you.
- You like seeing your results fast. You may not mind waiting a few days, but several months or even years is just too long for you to wait.

What Type Of Forex Trader Are You?

There are four main types of forex traders:

1. The Scalper
2. The Day Trader
3. The Swing Trader
4. The Position Trader

Scalpers hold onto for a few seconds to a few minutes at the most. Their main objective is to grab very small amounts of pips as many times as they can throughout the busiest times of the day.

Day traders usually pick side at the beginning of the day, acting on their bias, and then finishing the day with either a profit or a loss. These kinds of traders do not hold their trades overnight.

Swing traders are for those people that like to hold on to trades for several days at a time. These types of traders can't monitor their charts throughout the day so they dedicate a couple hours analyzing the market every night to make sound trading decisions.

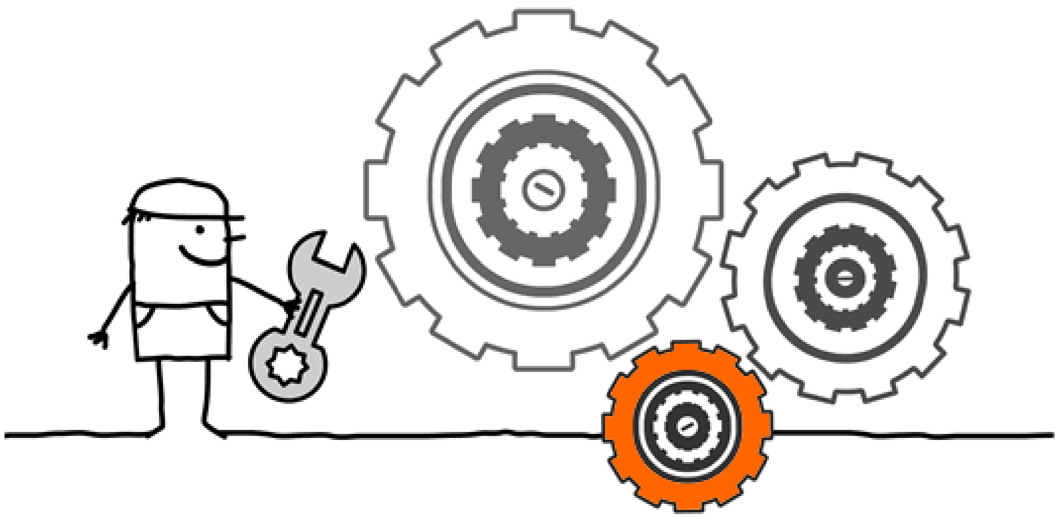
Position traders are those that have trades that last for several weeks, months, or even years. These traders know that fundamental themes will be the predominant factor when analyzing the markets and therefore make their trading decisions based on them.

No matter what style you choose, you have to make sure that it is truly you.

Always changing your forex trading style can lead to trouble and is a sure fire way to the doghouse.

But if you try scalping and you realize after a week that it's too fast or too draining, then be flexible enough to switch it up.

How To Create A Mechanical Trading System



So far, we've taught you how to develop your trading plan. We've also discussed how important it is for you to discover which type of forex trader you are.

Next, we're gonna teach you how to add some meat to your thin trading plan frame by showing you **how to create a forex trading system**. More specifically, we're gonna teach you all about forex *mechanical* trading systems.

Mechanical trading systems are systems that generates trade signals for a trader to take. They are called mechanical because a trader will take the trade regardless of what is happening in the markets.

In theory, this should eliminate all biases and emotions in your trading, because you are supposed to follow the rules of your system **NO MATTER WHAT**.

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 systems 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 forex traders lack the discipline to follow the rules that go along with the system.

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

The third truth is that creating mechanical trading systems isn't 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 forex mechanical trading system that is right for you. At the end of the lesson, we will give you an example of a system that one of the FX-Men uses just so we can show you how awesome we are! (Insert evil laugh here.)

Goals of your mechanical trading system

We know you're saying, "DUH, the 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 forex trader.

When developing your mechanical trading system, you want to achieve two very important goals:

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

If you can accomplish those two goals with your trading system, you have a much better chance of being successful.

The hard part about those goals is that they contradict each other.

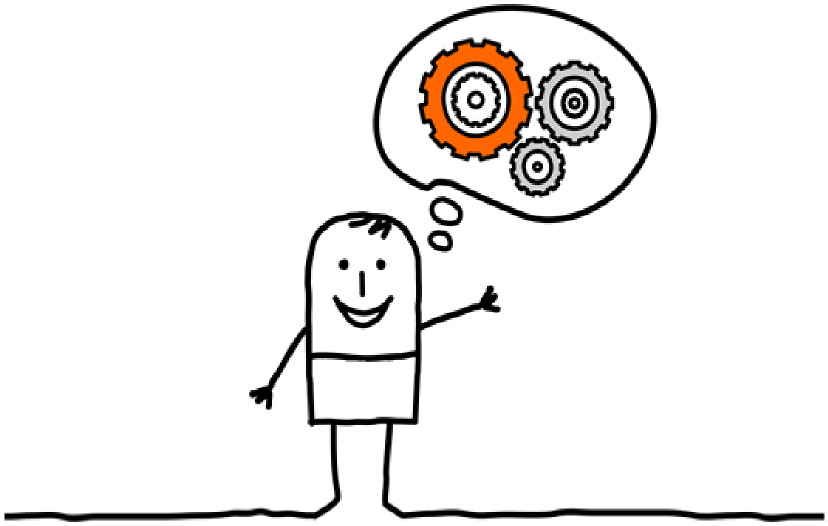
If you have a system who's primary goals is to catch trends early, then you will probably get faked out many times.

On the other hand, if you have a mechanical trading system that focuses on avoiding 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 mechanical trading 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.

If you have no idea where to start, drop by Free Forex Trading Systems thread forums. Tons of forex traders post their ideas for trading systems, so you may find one or two that you can use when you build your own mechanical trading system.

Design Your Trading System in 6 Steps



The main focus of this article is to guide you through the process of developing your own forex trading 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 forex trading 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 forex 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, 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 two 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 forex 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 Pipsurfer really likes MACD, Stochastic, 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 forex trading 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 he or she could potentially lose BEFORE thinking about how much he or she 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.

One of the forex traders believes that it is best to wait until a candle closes before entering. He has been in many situations where he will be in the middle of a candle and all of the indicators match up, only to find that by the close of the candle, the trade has totally reversed on him!

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 trading 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 yeah, did we mention you should ALWAYS stick to your rules?

How to Test Your Forex Trading 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 us, it is very 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 forex trading system and feel comfortable taking trades with no hesitation.

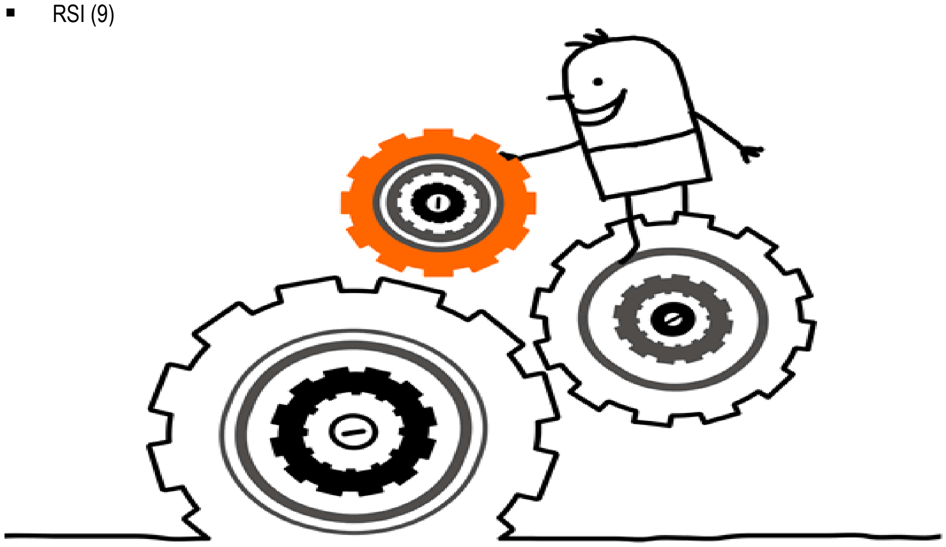
YOU'VE MADE IT!

Build Your Trading System in 6 Steps

In this section we'll give you a rough picture 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 own forex trading system.

Trading Setup

- Trade on daily chart (swing trading)
- 5 SMA applied to the close
- 10 SMA applied to the close
- Stochastic (14,3,3)
- RSI (9)



Trading Rules

Entry Rules

Enter **long** if:

- The 5 SMA crosses above the 10 SMA 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 SMA crosses below the 10 SMA 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 SMA crosses the 10 SMA in the opposite direction of your trade OR if RSI crosses back to 50
- Exit when trade hits stop loss of 100 pips

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

The "So Easy It's Ridiculous" Trading System

As you can see, we have all the components of a good forex 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 simple moving averages to help us identify a new trend as early as possible.
The Stochastic 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 100 pips on each trade. Usually, the higher the time frame, 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 time frame.

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's an example of a long trade setup:

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 some decent pips! 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.

Here's an example of a short entry order for the "So Easy It's Ridiculous" system.

We can see that our criteria is met, as there was a moving average crossover, the Stochastic was showing downward momentum and not yet in oversold territory, and RSI was less than 50.
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.

Boo yeah baby! As it turns out, the trend was pretty strong and pair dropped almost 800 pips before another crossover was made! Now isn't that ridiculously easy?

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 forex 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 headache.

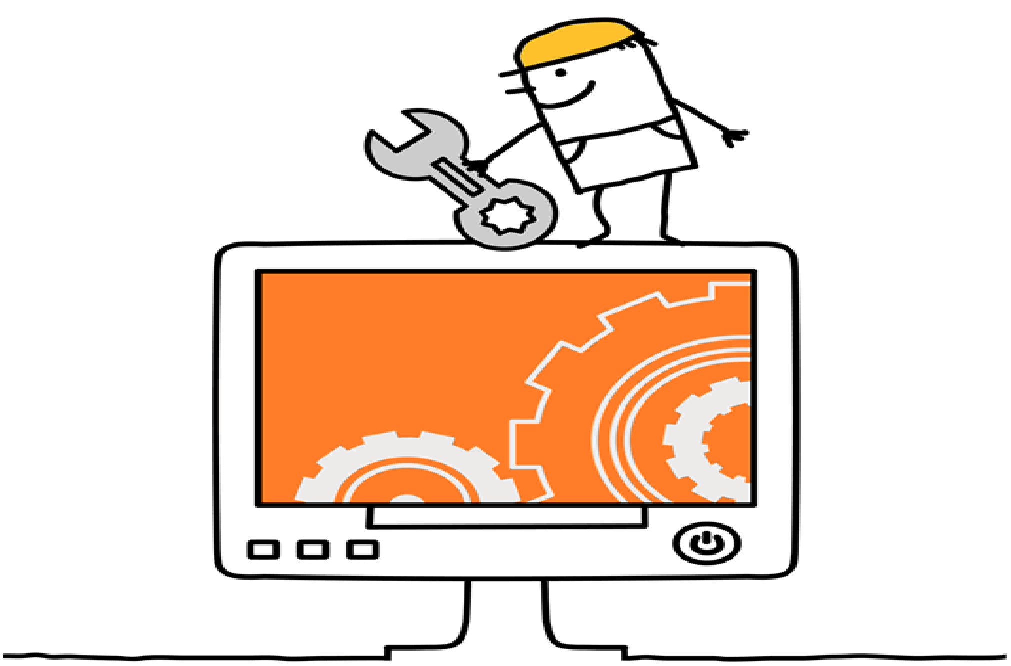
The most important thing is **discipline**. We can't stress it enough. Well, yes we can.

YOU MUST ALWAYS STICK TO YOUR TRADING SYSTEM RULES!

If you have tested your forex 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: Creating Your Own Mechanical Trading System



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

Your mechanical trading system should attempt to accomplish 2 goals:

1. Be able to identify a trend as early as possible.
2. Be able to find ways to avoid whipsaws (confirm your trend).

If it is profitable, then you trade your forex 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 backtesting.

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 mechanical forex trading system:

1. Find your time frame.
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 forex trading system rules down and ALWAYS stick to those rules!

There are 3 phases to testing your system:

1. 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. This is called backtesting.
2. 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.
3. 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!

Okay now legal stuff our lawyers asked us to add:

HYPOTHETICAL PERFORMANCE RESULTS HAVE MANY INHERENT LIMITATIONS, SOME OF WHICH ARE DESCRIBED BELOW. NO REPRESENTATION IS BEING MADE THAT ANY ACCOUNT WILL OR IS LIKELY TO ACHIEVE PROFITS OR LOSSES SIMILAR TO THOSE SHOWN. IN FACT, THERE ARE FREQUENTLY SHARP DIFFERENCES BETWEEN HYPOTHETICAL PERFORMANCE RESULTS AND THE ACTUAL RESULTS SUBSEQUENTLY ACHIEVED BY ANY PARTICULAR TRADING PROGRAM. ONE OF THE LIMITATIONS OF HYPOTHETICAL PERFORMANCE RESULTS IS THAT THEY ARE GENERALLY PREPARED WITH THE BENEFIT OF HINDSIGHT. IN ADDITION, HYPOTHETICAL TRADING DOES NOT INVOLVE FINANCIAL RISK, AND NO HYPOTHETICAL TRADING RECORD CAN COMPLETELY ACCOUNT FOR THE IMPACT OF FINANCIAL RISK IN ACTUAL TRADING. FOR EXAMPLE, THE ABILITY TO WITHSTAND LOSSES OR ADHERE TO A PARTICULAR FOREX TRADING PROGRAM IN SPITE OF TRADING LOSSES ARE MATERIAL POINTS WHICH CAN ALSO ADVERSELY AFFECT ACTUAL TRADING RESULTS. THERE ARE NUMEROUS OTHER FACTORS RELATED TO THE MARKETS IN GENERAL OR TO THE IMPLEMENTATION OF ANY SPECIFIC TRADING PROGRAM WHICH CANNOT BE FULLY ACCOUNTED FOR IN THE PREPARATION OF HYPOTHETICAL PERFORMANCE RESULTS AND ALL OF WHICH CAN ADVERSELY AFFECT ACTUAL TRADING RESULTS.

Why You Need A Forex Trading Journal

Journaling?!?

Isn’t that only for silly high school girls who write about their silly crushes on silly high school boys?

Heck ya!

Ok, not really… high school girls keep DIARIES.

Forex traders keep trading **JOURNALS**.
Two entirely different things! Get it right! Geez!

Keeping a trading journal is actually a crucial task in any performance or goal-oriented endeavor. The key is to have some way to measure, track, and stay focused on improving your performance.

World-class athletes do it to keep track of what helps them to be better, faster, and stronger on the field or court. Scientists do it in the process of finding their next greatest discovery. And forex traders do it to help get them duckets!

What “getting them duckets” means in simple terms is to become disciplined, consistent, and most importantly, profitable.

A disciplined trader is a profitable trader and keeping a trading journal is the first step to building your discipline.
This might sound simple or easy but we assure you that to actually get started can be very difficult. In fact, many forex traders give up after a while and rely on the logs that the forex broker provides.

The logs or transaction history from your forex broker gives information that is, at best, marginally useful as it doesn’t tell you much of **WHY** you entered and exited the trade.

That information provides **NO** help to your next trade.
Zero. Zilch. Nein. Nada.

A forex trading journal isn’t just about writing in the prices of your entry and exit and the time you executed the trade. The trading journal is also about refining your methods and mastering your own psychology.

To be even more specific, it is about your **individual emotional psychology before, during, and after the trade.**
For example, your trading method says to buy USD/JPY.

But your gut feeling tells you that the trade is **NOT** going to work…
So you remind yourself, "I don't think this trade is going to work. BUT I have to follow my trading plan so I'll take it."

During the middle of your trade, the price comes 3 pips away from your stop loss and you're thinking, "OMG. This trade isn't looking so good. I knew it! Why didn't I listen to myself? I'm such an idiot! I'm about to lose here! I'll just exit now."

You then decide to close your trade.

A few moments later the price shoots to your original profit target. Had you stayed in the trade you would have made a gazillion pips.

This is why you should write a trading journal. This is a classic case that probably happens to too many traders.

We fail to stay in the trade, we fail to trade the plan and most importantly, we fail to distance our emotions from our trading!
If you keep trading like that and you don't keep a trading journal, the balance on your trading account will become a big fat ZERO before you realize what you're doing wrong.

5 Reasons To Keep A Forex Trading Journal

Okay, enough with the doom and gloom. Let's just say that most expert traders keep a trading journal and review their trades consistently.

And you know what most expert forex traders are? Even though some won't admit it…

They are **BALLERS**! They got the money. They got the cars. They got the clothes. They got the ice.
We might be exaggerating, but only by a little bit.

Besides helping you in your journey to baller status, there are other personal benefits to journaling…

- Defining yourself and your situation in life
- Keeping progress of your goals you've set in your Trading Plan
- Clarifying your weaknesses and strengths in your ability to perform and handle pressure
- Providing a way to self-coach and improve on your own

That last bullet point is probably the most crucial as most every new visitor that comes through BabyPips.com doesn't walk down the path of your average Wall Street trader.

Not everyone gets their Master's degree or PhD in mathematics, computer science, financial engineering, or whatever, then moves on to a big financial institution or a proprietary trading firm.

We're all "average Joes" learning from home or where ever we can find an internet connection. This means we learn how to trade ALL from scratch and develop our own methods.

Thankfully, because of the internet and forex trading forums, we can learn and connect with other like-minded individuals, both new and experienced, to shorten that learning curve. Even so, most of us lack access to that crucial asset to learning any task or skill quickly and efficiently: a coach or mentor.

A coach or mentor is there to guide you every step of the way, pointing out your mistakes, recognizing the things that went well, and keeping you disciplined and accountable for your performance. A mentor of any caliber is hard to come by for most new traders, so we have to the next best thing: mentoring yourself with a trading journal.

A **well-kept, detailed** forex trading journal can be almost as good as having a coach watching you over your shoulder and helping you learn those lessons. Heck, keeping a journal may seem boring and time-consuming, but a forex trader can often learn more from reviewing their own trades, than from reading a book or even attending a seminar.

Over time, your journal will grow with you and, if you keep detailed records on everything about your forex trading (from psychological issues, the market environment, system tweaks, etc), it will help you recognize important lessons like:

- What news event should be avoided
- How much more or less you need to risk per trade
- When you should start trading and stop playing online mini-golf

Also, how disciplined you are with your trading journal will be a great predictor of your overall forex trading success down the road.

5 Things You Must Have In Your Trading Journal

The answer to that question is simple…Everything!!!

You record everything you feel and do before the trade, during the trade, and after the trade has been completed.

Trading is a performance skill, regardless of your trading style or method.
Your outcome is determined by how well you analyze the market environment, your ability to create a plan or trading method, how well you execute that plan, and luck.

There are many variables that lead to success, so you have to write down everything to determine your weak and strong points.

For traders, that means recording:

- **Who you are and your motivations for forex trading.** To find the right trading method for you, you have to know who you are, your lifestyle considerations, and why you do the things you do.
- **Market views and philosophy.** This is how you understand and frame the markets, and how you make the decisions to act and manage the risk to your account.
- **Observations of the market.** Each day is different in the market, but that doesn't mean there are certain "tendencies" or "behaviors" that you can take advantage of. With careful and consistent observation, you can find these "tendencies" and create or adjust your strategies to them. Also, if the environment changes, you'll be on top of the situation and change with it!
- **Trading mistakes and missed opportunities.** Mistakes and missed opportunities are just as detrimental to your success as the market going against your trade. Closing trades too early, not taking legit setups, entering the wrong entry levels or positions sizes, etc. should be recorded in your journal so that you avoid the same mistakes in the future.
- **Performance statistics.** Many aspects of your forex trading performance can be quantified into hard data. This gives you a realistic, no BS picture of how you're doing. Like Shakira's hips, the numbers don't lie. And sometimes a shot of reality can give you the kick in the butt you need to kick up your game!

Truth be told, this sounds like a lot. So to make it easier for you to get started, here are what we feel are the bare minimum. Our "must-have" elements of a trading journal.

Before we reveal our list, we just want to point that this is what we believe should be included in a trading plan.

We simply provide this list so you can have a better idea of what to include in your own plan, but you don't necessarily have to follow it exactly.

All right, here are our 5 “must-have” elements of a forex trading journal:

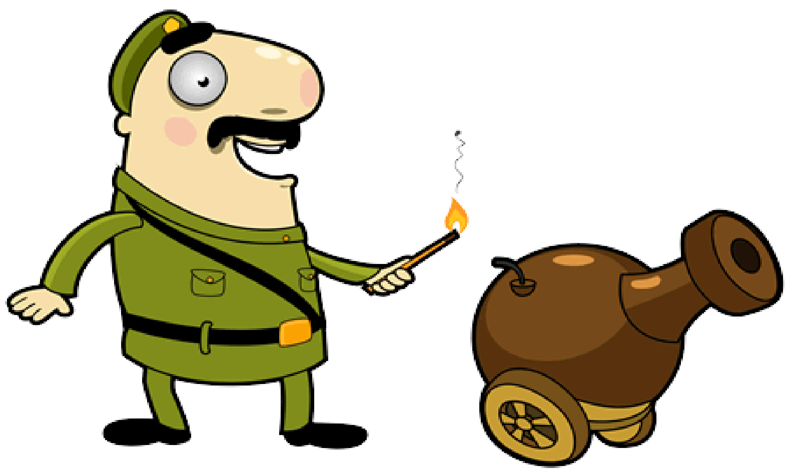
1. Potential trading area
2. Entry trigger
3. Position size
4. Trade management rules
5. Trade retrospective

Again, It’s up to you.

It’s your trading journal.

Just like your custom World of Warcraft character, you should customize your trading journal as you see fit.
Remember, you are the one who’s going to benefit from writing a forex trading journal. So write down what you think you would benefit the most from!

Potential Trading Area



You need to have a valid reason for every trade you enter. This is also known as logic or rationale. You are not a caveman. Nor are you a gambler, right?

Why are you looking at this area to enter? This area is determined by whatever setup detection method you have written in your Trading Plan.
An example might be the crossover of two moving averages or price hitting resistance on a Fibonacci retracement level.
Your **potential trading area** stands between current price and your entry trigger.
We strongly suggest you take a screenshot of your chart showing this area. Try to make a habit of taking screenshots of your charts.

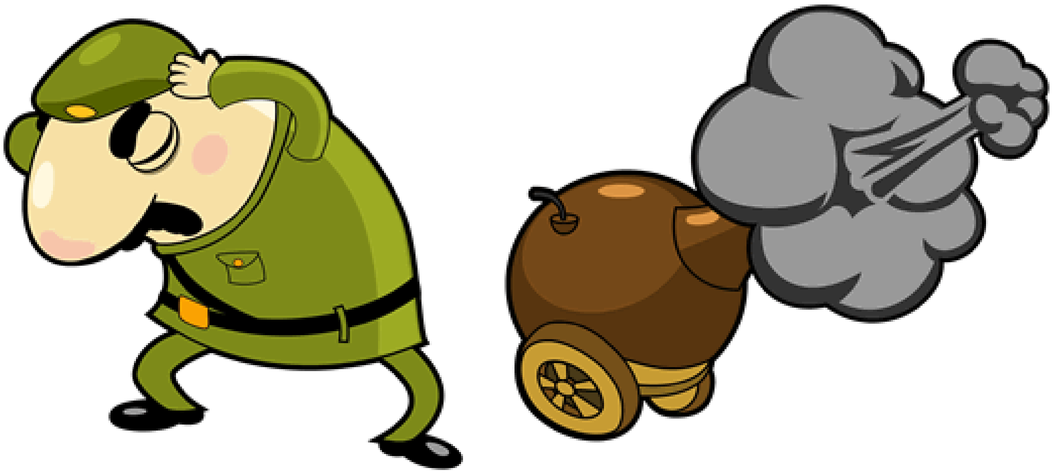
When it’s time to review your trades later, having the ability to see what happened visually will help train your eyes to see possible opportunities or traps to avoid on your charts in real-time.

This will help you remember the reason why you entered the trade, or make you realize some things that you may have overlooked.

The potential trade area is where you believe you will have an edge that you trade with a high probability of success, and that reward/risk ratio is in your favor. You must determine, for yourself, how you want to meet this requirement.
When you sat down in your chair in front of your screen, you were “ready” to trade. The potential trading area is where you “aim.”

This will keep you from entering a trade without a plan and shooting from the hip.

Entry Trigger



The entry trigger tells you when to "fire!"

Your entry trigger tells you that once you're in the potential trade area, when to actually enter the trade.
This is your specific entry technique. Now that you've decided on where you're looking to enter a trade, now you have to decide how to actually enter the trade.

Do you just blindly enter? If you want to cross the street, do you simply just start walking across? Only if you want to possibly get ran over. Of course, you look both ways first to make sure it's "safe". This same approach is also practical with trading. You want to make sure it is "safe" to enter the market (i.e. a high probability trade setup).

The entry technique will help keep you out of trades that aren't behaving the way you would expect in your potential trade area.

Let's pretend your potential trade area is where bearish divergence is present. Do you just automatically short? Or do you wait for price to trade near a significant resistance level first? Maybe even wait for an exhaustion reversal candlestick like a shooting star to form?
Instead of waiting….you short now, and then watch price climb higher and get stopped out.

Just because you find a good area to trade doesn't mean you should just jump right in. A good entry technique provides that solid confirmation to help keep you out of losing trades.

Again, make a screenshot of your chart and label where your entry trigger is.

Don't forget that you must **combine a good entry trigger with a good potential trade area**. A moving average crossover may be a popular entry technique but if you don't factor in the area in which you're thinking of entering, you will probably be whipsawed to death.
Using an entry trigger as a "stand-alone" technique is a recipe for disaster. Make sure you're aware of your "surroundings" as well. Don't bring a knife to a gun fight. Or for you kids out there, don't bring a tennis racquet to your baseball game.

Position Sizing

This is the easy one. You must decide, based on your risk management rules in your forex trading plan, what your **position size** will be. This allows you to know your maximum risk.
How much are you willing to risk per trade?

1%?

2%?

5%?

10%?!

20%?!!!!

Or are you going to **bet the farm?!!!!!**

Yeah that's right. Do it. Bet the farm.

No silly!
Don't bet the farm!

Haven't you been paying attention?

You want to become a trader, not a gambler!

And unless you're really a farmer, you probably don't even own a farm anyway.

Position sizing is important because it helps your account stay healthy and ready for the next opportunity.

It important to take note of how big or small you are trading. By keeping track of position size in your journal, you can see whether you are comfortable trading large position sizes, or if you prefer smaller lot sizes while using wider stops.

Luckily for you, the FX-Men have decided to give you guys a gift – in our Tools section, we have a Position Size Calculator to help you do the math and find the right number of units you should be trading! Sweet eh?

Trade Management Rules

You need to have a game plan in place BEFORE you even consider getting in the trade. **That game plan tells you how you will manage this trade, whether it goes for you or against you.**

Entering a trade is the easy part, it's exiting a trade where you'll determine whether you make or lose money.

Two traders, Tom and Jerry, could take the same trade but have two totally different outcomes. Tom will make money on the trade because he properly managed his trade and planned an exit for different scenarios.

Even if he loses, he will know when to stop the bleeding and get out with a smaller loss. Jerry on the other hand, does not have a plan in place. He does not know what he is going to do if price goes drastically against him, eventually wiping out his account.

It's critical to determine how you will manage the trade BEFORE you enter the trade.

You do NOT want to be making critical decisions in the heat of battle.

When you enter a trade, you should have already decided how you will react to every possible outcome.

EVERY.
POSSIBLE.

OUTCOME.

Try and figure out all the possible variations that could occur and decide BEFOREHAND what you will do. You want to be a cold-hearted, emotionless execution robot when in a trade.

You want to be like Spock but without his human side. You want to be a Vulcan trader.

All decisions are made BEFORE a trade. You are proactive. This means you are not yet in the trade! When deciding to enter a trade, you simply refer to what you wrote here. This eliminates any seat-of-the-pants decision making.

If you do take the trade, you already know where your initial stop loss will is placed, where your profit target(s) are, if you will trail your stop, where you might get out of your trade early, etc.
Pretend you're Keanu Reeves. If you were to be given a pop quiz at any point in time during the trade, and are asked, "What if price does this or that? Or if price goes here or there?" You should be able to answer in a snap without thinking, for every single trade, every single time.
You must have your trade management rules fully planned out ahead of time, BEFORE the trade is initiated.

You NEVER EVER want to be thinking "What do the hell do I do now?"' when in a trade.

The time to decide such things is always, always, always BEFORE you ever enter a trade yo. Word?

Trade Retrospective

Retrospective means to take a look back at events that already have taken place.
Once you've finished trading, it might be tempting to call up yo homies to hit up happy hour, kick back shots of Patrón, and splurge on bottles of Dom Pérignon, but it's crucial that you review how your trade went, win or lose.

You want to look back over the whole process to understand what you did right and wrong. Here are some questions to ask yourself:

How well did your trade work out?

- Was the position size sufficient to match the risk and reward scenarios, or was it too large? Too small?
- Could you have entered at a better level?
- What tools might you have used to improve your entry timing?
- Were you patient enough or did you rush in thinking you'd never have a chance again?
- Was your take profit realistic or a pie in the sky?
- Did the market pay any respect to your choice of take-profit levels, such as stopping short of it, or did prices blow right through it?
- Did the market pay any respect to your choice of stop-loss levels, such as stopping short of it, or did prices blow right through it?
- What news or event catalysts caused the market to move the way it did?

Use the answers to refine your position size, entry level, and order placement going forward.

How well did you manage the trade after it was open?

- Were you able to effectively monitor the market while your trade was active? If so, how? If not, why not? The answers to these questions will reveal a lot about how much time and dedication you're able to devote to your trading.
- Did you modify your trade plan along the way?
- Did you adjust your stop loss order to protect profits?
- Did you take partial profit at all?
- Did you close out your trade based on your trading plan, or did the market surprise you somehow?

Based on your answers, you'll learn what role your emotions may have played and how disciplined a trader you are.

While you may want to vent your thoughts, emotions, and feeling to yo homies, it's better to write them down here. You are probably boring them to death anyway. They don't want to hear your whining.

What can you improve and what specific steps will you take for improvement?

This is your opportunity for trader self-improvement.

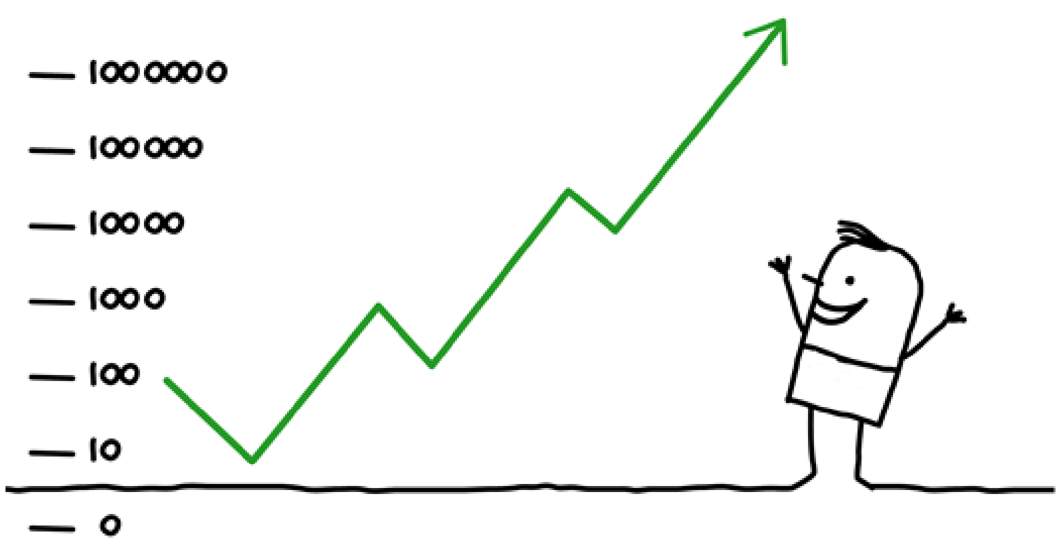
Do not just write vague confessions like “I need to hold my winners longer” or “I need to cut my losses quicker” or “I need to be more disciplined”. These are totally *useless* by themselves.
Identify SPECIFIC steps that you will take to improve. How will hold your winners longer? Will you work on choosing better profit target? Will you learn how to not freak out at the first sign of your unrealized profits falling?

There are no right or wrong answers in this review process; just be as honest with yourself as you can be. And be specific. Otherwise, you won’t improve as a forex trader.

Did you execute your trade according to your trading plan?
DO NOT TAKE THIS QUESTION LIGHTLY.

If you are not routinely executing trades according to your plan, then you either have a serious problem with self-discipline or there is a problem with your Trading Plan. Either way, you have a BIG problem that needs to be fixed yesterday!

Trading Journal Statistics



While your bottom line (total profit or loss) can easily tell you your overall trading performance, keeping statistics is a great way to find out what part of your forex trading system, plans, or processes are keeping you from running like a fine tuned race car instead of a junkyard clunker.

Your “performance stats” help you determine what’s working, what’s not working, and what to improve on. Here are some of the statistics to keep, at a minimum, to track your system vitals.

- **Net Profit:** This is your total gain minus losses and expenses. These expenses include cost of equipment, commissions, and other costs. Basically, this is how much your account is up or down at any given time minus to costs to trade.
- **Win percentage:** That’s the total number of wins divided by the total number of trades. What percent of the time do you win trades?
- **Loss percentage:** That’s the total number of losses divided by the total number of trades. What percent of the time do you lose trades?
- **Largest winning trade:** Will be removed from your “average win” calculation. This is not necessary to do, but if you do have an abnormally large win in relation to your other wins, then taking it out will provide a more accurate look and expectations to your stats.
- **Largest losing trade:** Will be removed from your “average loss” calculation. This is not necessary to do, but if you do have an abnormally large loss in relation to your other losses, then taking it out will provide a more accurate look and expectations to your stats.
- **Average trade gain:** This is computed by dividing the total gain from all your winning trades divided by the number of winning trades.
- **Average trade loss:** That’s your total loss from all your losing trades divided by the total number of losing trades.
- **Payoff ratio per trade:** That’s your average winning trade minus your average losing trade.
- **Average holding time:** Divide your total holding time for all your trades by the number of trades.
- **P/L of long/short only trades:** This stat helps determine what types of trades or trading environments you perform well in.
- **Largest # of consecutive losses:** This stat helps in determining your max draw down, or the worse possible scenario you have experienced so far.
- **Average # of consecutive losses:** This stat helps in determining your average drawdown and controlling your potential max risk.
- **Largest trading account percent of drawdown:** This is the amount your account equity has gone down after your longest string of losses.
- **Tracking feelings and mistakes.** How well you execute your trading plans can be quantified, as well as your mental state when you trade.

Keeping track of how you feel will help you avoid trading during those frustrating times–like when you wake up right after a news event (that you forgot about), and it pushes the markets fast, so you try to chase it.

But then your computer crashes, you lose power, and your dog goes running out of the house into oncoming traffic. By the time you get back online you see the market has moved 100 pips in the direction you wanted to buy. Don’t you hate it when that happens? You’re probably not in a good mood by then, so trading for the rest of the day may be a bad idea.

- **Expectancy:** In simple terms, expectancy is the average amount you can expect to win (or lose) per trade.

This can be computed by multiplying the loss percentage by the average loss and subtracting it from the win percentage times the average win. This stat helps you determine the correct position size and how profitable your trading method is.

Ideally, you should be keeping track of these statistics so that you can compare and analyze your performance over a set period of time.

For example, at the end of the year, Huck releases her year-end trading review. After going through her trades, she could see that she was actually unknowingly taking trades against the trend! Knowing this, she can adjust her trading so that she can avoid going against the trend and this will hopefully lead to better trading performance.

The goal of collecting and calculating these stats should be to find ways to maximize your expectancy (pips or dollars gained per trade), set the correct position size per trade, and determine the trading conditions best suited for YOU!

Reviewing Your Trading Journal

After a good number of trades, you will have collected a lot of fancy-schmancy data and observations on the market and yourself…how do you analyze it all??

Again, it's pretty simple:

1. Find what works and keep doing it
2. Find out what doesn't work and stop doing it.

And finding what works and doesn't work is all about keen observation and asking the right questions. Refine your analysis of your trading results by breaking them down to smaller categories, such as day of the week or specific currency pairs.
Here's a sample of the types of questions you should be asking yourself when you review your journal:

- Which chart patterns or technical indicators work out best for you? Which do not?
- How can you adjust your indicators to get you in trades earlier, or help you avoid whipsaws and fakeouts?
- Are you closing winning trades too early? Is it that you need to adjust your profit targets or are you afraid of losing your unrealized gains?
- Do you hold onto losing trades longer than you should? How can you improve your stop-loss processes?
- How often do you follow your trading plans? Of the ones you do follow, have you been profitable?
- What trade setup did you miss, or not take, and why? Was it a legitimate signal or setup according to my method or system?
- What could you have done differently to make prevent/reduce this loss or maximize your gain?
- Are you winning more on trades with multiple lots or single lots?
- What kind of market environments have you been doing well in? Trending or ranging?

- Were most of your wins or losses biased towards certain currency pairs?
- Which news events have brought on the kind of volatility you were looking to trade or avoid?
- Which trading sessions have been the most favorable to your trading style?
- Are you losing trades concentrated on certain days of the week, such as Mondays and Fridays?

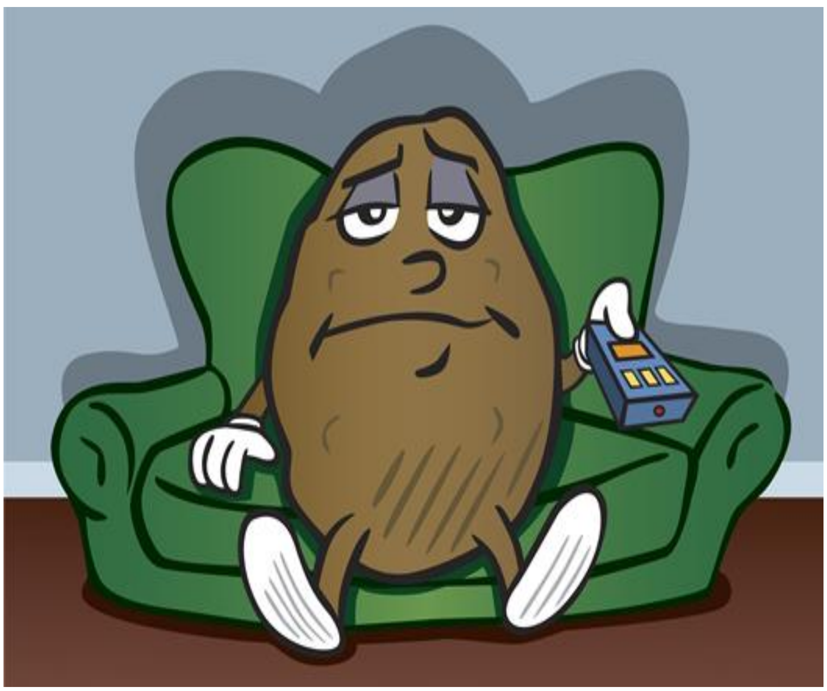
Questions like these can help you quickly filter out the actions that have kept you from making some pips.

In the beginning, the idea is to get to the point where you have figured out what works for you and to only do those things.

Once you have figured out those right things, the next step is to consistently practice those actions that work until it becomes a habit.

Finally, persistent journaling will help keep you on top of your performance and help you recognize when the markets change–and yes the markets are always changing.

Keeping A Trading Journal Is Hard But It's Worth It



Couch Piptato

Keeping a trading journal is hard.

But so is losing all your trading capital, failing as a forex trader, giving up, never to return to forex trading ever again.

And reminiscing about the good 'ol simpler days of being happy that N'Sync was performing in town.
Which would you rather choose?

Entering trades in a journal forces you to view the trades in black and white, rather than simply relying on your memory, which for most humans, is a stretch.

More importantly, a trading journal allows a trader to step back and view their trades as a **group of trades**, and not as individual and ultimately random transactions.
Boy, this sounds like a lot of work, doesn't it?

Heck ya it is, but doesn't anything worth achieving require work?!?

Keeping a trading journal is the equivalent of an athlete's practice.

It's not uncommon for a professional athlete to spend far more time practicing or training for an event than actually participating in it.
According to Tim Grover, Michael Jordan's personal physical trainer:

"Michael would go for 40 or 50 points one night, and the next morning he was right back at it in practice. He just couldn't take a day off. His mental toughness was unbelievable, but the reason was that he was so physically ready every day. He used to have a saying, 'I practice so hard because that makes the games easy for me.'"

John Wooden, winner of a record 10 NCAA Men's Basketball Championships, and known as one the greatest minds basketball has ever known, ran a very strict and disciplined two hour practice, 5 days a week, in preparation for a 40-minute basketball game.
You know who much time that is? That's 10 hours (or 600 minutes) of practice for 40 minutes of the real thing.

Practice makes perfect

And that's not all! Not only did he stress meticulous and deliberate practice, he kept a LOG of how every practice went. Coach Wooden would refer to his practice logs if his team had a problem he couldn't solve.
For example, if his current team was shooting poorly, he would research his old practice logs to determine how he improved shooting. Even in the days of no computers or iPads, Coach Wooden understood the importance of strict record keeping!

While the act of journaling really isn't that hard, it does take consistent time and effort. It is definitely a time-intensive process.

MeetPips.com: Online Forex Trading Journal

If your journal is a hurriedly, scribbled paragraph per day, the odds are good that it lacks the specifics you need to accurately assess what you're doing well and what needs improvement.

Luckily for you, we've created a place that has made it easier for you to keep track of your trading and do a lot of the calculations for you…

MeetPips.com – the coolest online trading journal in the world!
Not only are you able to easily create a trading journal on MeetPips.com, you will be joining an online trade journaling community for forex traders who wish to become more disciplined and consistently profitable.

Based on our experience, it's difficult to maintain a journal manually, especially with lots of trades. It's also difficult to constantly calculate and recalculate performance statistics.

MeetPips.com allows you to enter you trades into your very own online journal. Your trades are then calculated and out spits all sorts of statistics and fancy-schmancy graphs for you to review and analyze.

You're able to learn specifically how each of their strategies are performing and which aren't.

Again, one of the keys to enhancing your trading performance is to know what area is working at any given time and what should be abandoned.

You can then go about making your own decisions on how you can tweak these areas into a personalized trading plan for you, a plan that fits your own goals, risk tolerances, and individual lifestyle.

MeetPips.com also allows you to read other user's trading journals and see how they trade (although there is an option to keep your trade journal private).

A public trade journal also motivates traders to stick to their rules better because they can't hide their mistakes and or make excuses.

Having access to other traders allows you to avoid mistakes like "I wish I had known what I know now because I feel that these things would have saved me time and money."

You're also able to look at other traders' journals and possibly "borrow" some of their ideas to incorporate into your own trading strategies.

Ultimately, you must develop your own plan, based on your own trading style, based on your personality, based on…YOU. YOU. And YOU. (What up, Soulja Boy?)
It takes time and effort at the beginning to get a trading journal, but you'll find that after a while it will become habit and you'll actually enjoy the work you put into it. Learning to write will build discipline and when you reflect on your entries after a week of trading you will learn a lot about yourself and your trading psychology.

This is something that no mentor or forex school can teach you. You have to experience it yourself. Only by this experience can you be a successful trader

Summary: Keeping a Trade Journal

There are three elements for sustained successful trading:

1. Having and executing a good trading PLAN.

2. Having a good trading system as part of that plan.
3. Review and improve your trading performance and plans.

Every forex trader should maintain a journal that focuses on these elements.

Your trade journal is a log of all trading activity. This journal's objective is to monitor both the performance of your trading system AND your ability to execute it with consistency (follow your trading plan).

Poor trading systems are less frequently the cause of poor trading performance than the inability of the trader to properly apply them. That's following the Trading Plan. Your trading journal is intended to make sure you do just that.

A trading journal provides any serious trader who wishes to make money a tool to help them evaluate themselves objectively.

Journals are only as good as what is written in them. If one fails to accurately track trades, it becomes hard to judge trading performance.

Start to maintain a trade journal. These both should be ongoing efforts, not just a one-off for the sake of completing an assignment. Be thorough and honest. Do not short-change YOURSELF by failing to put in entries or through incompleteness.

Learning to write and maintain a trading journal will build discipline in you. Not only that, when you reflect on your entries after a month of trading, we guarantee you will learn a lot about yourself and your trading psychology.

You'll clearly see what you're good at, what you suck at, and what the best way it is for YOU to trade. This is something that no mentor, no book, no video, no seminar can teach you. You have to experience it yourself. Only through this experience will you become a successful trader.

To build the skill of trading, you must have the will to maintain a trading journal.

Here's some final advice to keeping a helpful trading journal:

- **Always begin the journal before the trade, and end it after the trade.**
- Write down everything. Don't leave anything out. Be honest. If you decided to play Call of Duty while you were in a trade and forgot to exit your trade, write that down, and explain why.
- Pay very close attention to your emotions. Then make sure you write them down.
- Make sure the journal includes observations about you and your trading and about the forex market. We've found that trading journals are usually skewed toward self-analysis and include little in the way of market observation. Take a screenshot of intraday charts of each day's action and write comments on them. Make note of patterns that you are watching for. After a couple of months, you will start to see the patterns emerging in real time. The trading journal is a learning tool and a great mechanism for training your eye to see the setups you want to be trading.
- Nothing is too silly to record inside your journal. Write it down. Write down whether you missed a trade because you were watching the latest episode of Game of Thrones, or playing Call of Duty or you were busy talking to your sweetheart. Write it all down!

Introduction to MetaTrader 4

Congratulations! If you've made your way to this lesson, it means that you're now ready to open a demo or live MT4 trading account. And because BabyPips.com is the bee's knees, we're here to guide you through it.

First, you should know that MetaTrader 4 (MT4) is simply a trading platform used by tons of traders and brokers. Traders use it to view real-time currency prices, open or adjust orders, get technical and fundamental analysis, and open Youtube videos. We're half kidding about the last part. Meanwhile, brokers use the MT4 platform to reach a broader audience.

What's good about the MT4 platform is that it offers boatloads of currency pairs and indicators that you can choose from. Not only that, but its customizable charts are so newbie-friendly that any six-year old kid can spot breakout patterns from it.

Mechanical traders can also plug in their EAs in the MT4 platform. This makes it easy for them to track trade opportunities.

The MT4 platform can't be accessed through a website though. You have to install the platform on your computer or your phone before you can gain access to your trades and currency prices.

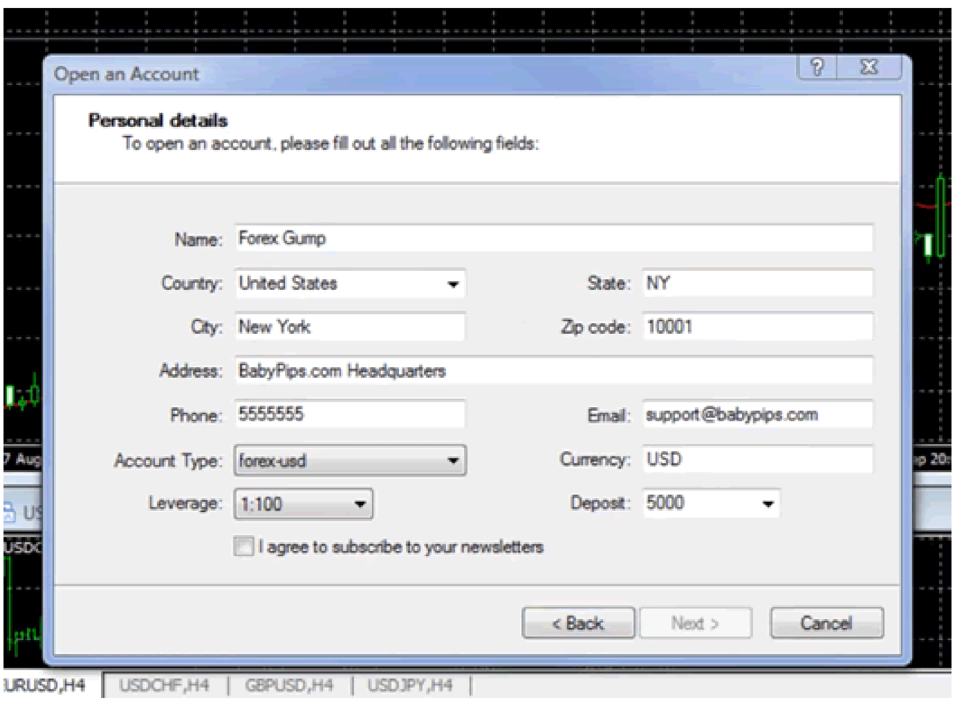
Want to open your account now? Here's how:

Step-by-step instructions:

Step 1: Setting up your account

a) Download and install MT4.exe

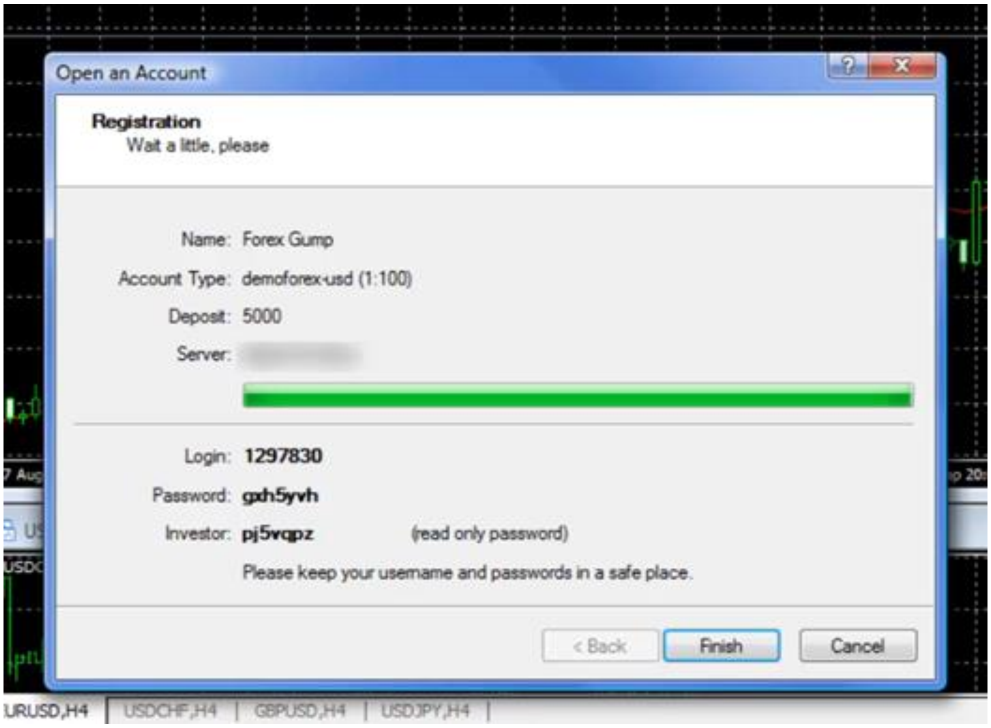
b) Carefully fill in the account details.



Step 2: Record your account details

a) Record and keep a copy of your account login information before exiting the registration process.

b) With MT4, you are able to create and access multiple accounts without exiting the program. Please pay attention to which account you are using before placing trades and orders.



As much as we'd like you to go forth and make live pips, we HIGHLY ENCOURAGE you to try demo trading first. This way you'll get the feel of the platform without putting any of your hard earned capital at risk. Besides, unlike in live trading, you can always add to your capital or open a new one if you blow out your account or if your demo account expires.

MT4 Basics: How to Set Orders

Now that you've set up your MT4 account, it's time to learn how to use it!

We know, we know. With so many tabs, windows, and buttons, the MT4 platform can look a little bit intimidating if it's your first time using it. But don't worry, it won't bite! Besides, we'll be holding your hand through the entire process and go nice and slow.

We'll start with the basics – setting orders. By the time you're done with this lesson, you'll know how to:

1. Buy or sell via market execution
2. Buy or sell via pending order
3. Modify a trade after it has been entered

Are you ready? Great! Let's begin!

Entering a Trade via Market Execution

Click the New Order button. You'll find it in the standard toolbar.

- A dialogue box should appear. From the drop-down list, select the currency pair you want to trade.
- Next, select Market Execution in the Order Type drop-down list.

- Enter the size of the position you want to open. Keep in mind that volume, which indicates the size of your position, is expressed in terms of standard lot sizes. Remember, one standard lot is worth 100,000 units. Hence, if you wish to buy 5,000 units of a certain currency pair, you would enter “0.05” in the volume field.
- If you have any remarks or notes you would like to include about your trade, you can do so in the comment field. This is optional.
- Finally, determine whether to BUY or SELL the currency pair. A dialogue box will appear to confirm that your trade has been executed.

You may have noticed that when you choose to buy or sell a pair at market, the stop loss and take profit fields may be disabled. Don’t worry! These options have only been disabled to help you get in on a trade as fast as possible when price is already moving. You can still specify your exit levels by modifying the trade AFTER it has been entered. We’ll teach you all about editing existing orders later on.

Entering a Trade via Pending Order

1. Click the New Order button.
2. From the drop-down list, select the currency pair you want to trade.
3. Next, select Pending Order in the Order Type drop-down list.
4. Determine whether you want to BUY or SELL the pair in the Order Type drop-down list.

You will be presented with 4 options:

Buy Limit – if you plan on going long at a level lower than market price

Sell Limit – if you plan on going short at a level higher than market price

Buy Stop – if you plan on going long at a level higher than market price

Sell Stop – if you plan on going short at a level lower than market price

5. After you have selected the type of order, punch in the price at which you wish to enter the market.
6. Then, enter the size of the position you want to open in the volume field.
7. Fill in the stop loss and take profit fields.
8. You’ll notice that by using a Pending Order, you also have the option to set an expiry date on your order.
9. Once you’ve filled everything out, click the Place button to enter your trade. A dialogue box will appear to confirm that your trade has been executed.

Modifying Trades

Click on the trade tab. There, you will find all of your trades, including their entry prices, position sizes, stop losses, and profit targets.

To add/modify stop loss or profit target:

1. Right-click on the trade that you want to modify and select the “Modify or Delete Order” option.
2. Next, fill in the Stop Loss and Take Profit fields with your desired levels. When you’re done, hit the Modify button.
3. A dialogue box should appear to confirm that your trade adjustments have been executed.

To close an open trade:

1. Right-click the trade you wish to close and click the “Close Order” option.
2. If you want to close your entire position, select the yellow button below the Buy and Sell options.
3. After hitting close, your profit balance should change and reflect the profit or loss you made on your recently closed trade.

MT4 Basics: How to Install an EA

Now that you've had a little bit of practice with the indicator tools that the MT4 platform provides, it's time for you to move on to the next stage of your MT4 training: how to install an expert advisor.

An expert advisor, otherwise known in the forex world as an "EA," is basically a program that you install onto the platform that will automatically follow a trader's instructions once a certain criteria has been met. In a sense, you can call it "automated trading" as you don't even have to be touching your mouse and keyboard for orders to be entered.
The advantage of using an EA is that if you already have a mechanical system in place, you can create an EA to replicate the actions required once your system gives you a signal. This is particularly useful if you like trading multiple pairs or if you just don't have the time to to be in front of your computer to trade.

But before we get to the part on how to install an EA, be WARNED that there are many people out there offering EA programs that may not perform as advertised. They will tell you that their EA system has made them thousands of pips without them having to do a thing. We're not saying it's impossible, but unless they show you account statements that are audited by a highly reputable, third-party accounting firm, take it with a grain of salt.

DO NOT be fooled by their flashy advertising and promises of higher returns!

What would be best is if YOU create the EA yourself. We won't lie – it ain't particularly easy and you may have to spend some time figuring it out, but hey, if it was easy, then everyone would do it right?

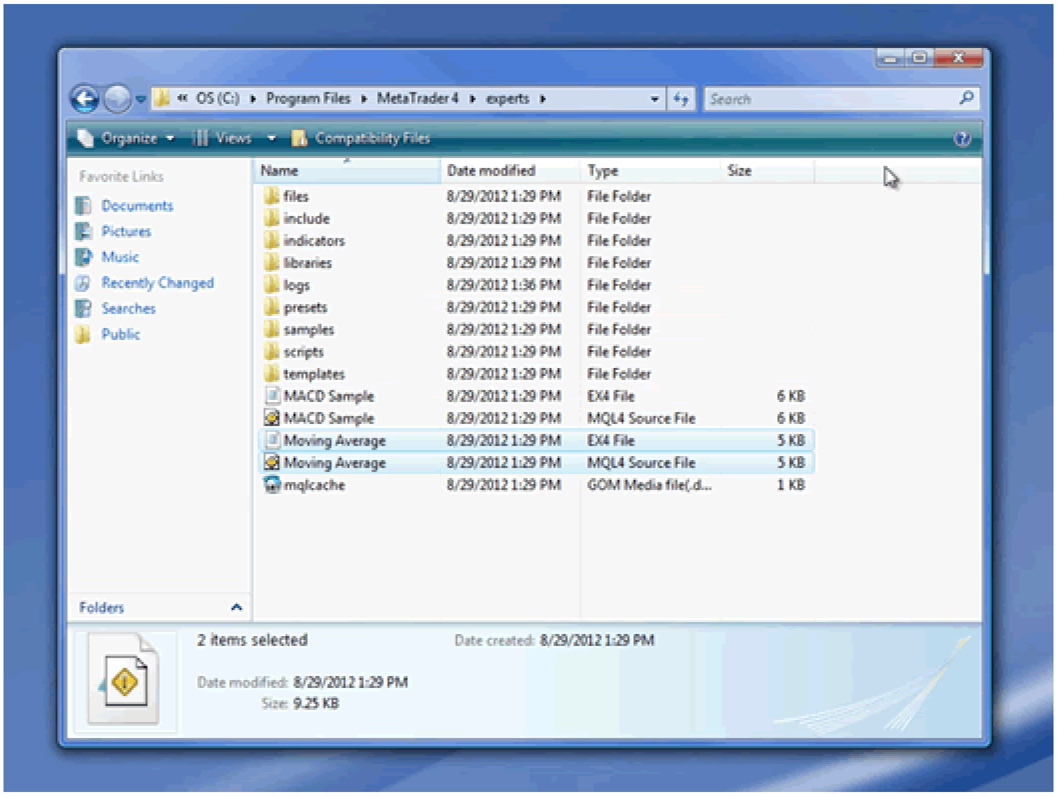
We highly encourage you to learn and understand all aspects of whatever Expert Advisor that you plan to use. If the EA is centered around moving averages, make sure you know if it uses simplified or exponential moving averages and how many bars it covers. If it uses Stochastic, make sure you know what settings are used to generate the signals. Remember, this is your hard-earned money that you're entrusting to a computer program here.

Once you know the ins and the outs of the EA, then you can start loading it on the terminal!

Step-by-step instructions:

Step 1: Transferring files

1. Create or download an EA. Keep note of the location of where you saved it.
2. Select and copy the EA file you wish to install.
3. Look for the MetaTrader4 folder. This is normally located in the **C:** drive.
4. Paste the files into the **Experts** folder. A pop-up requesting admin permission may appear; if so, just click **Continue**.

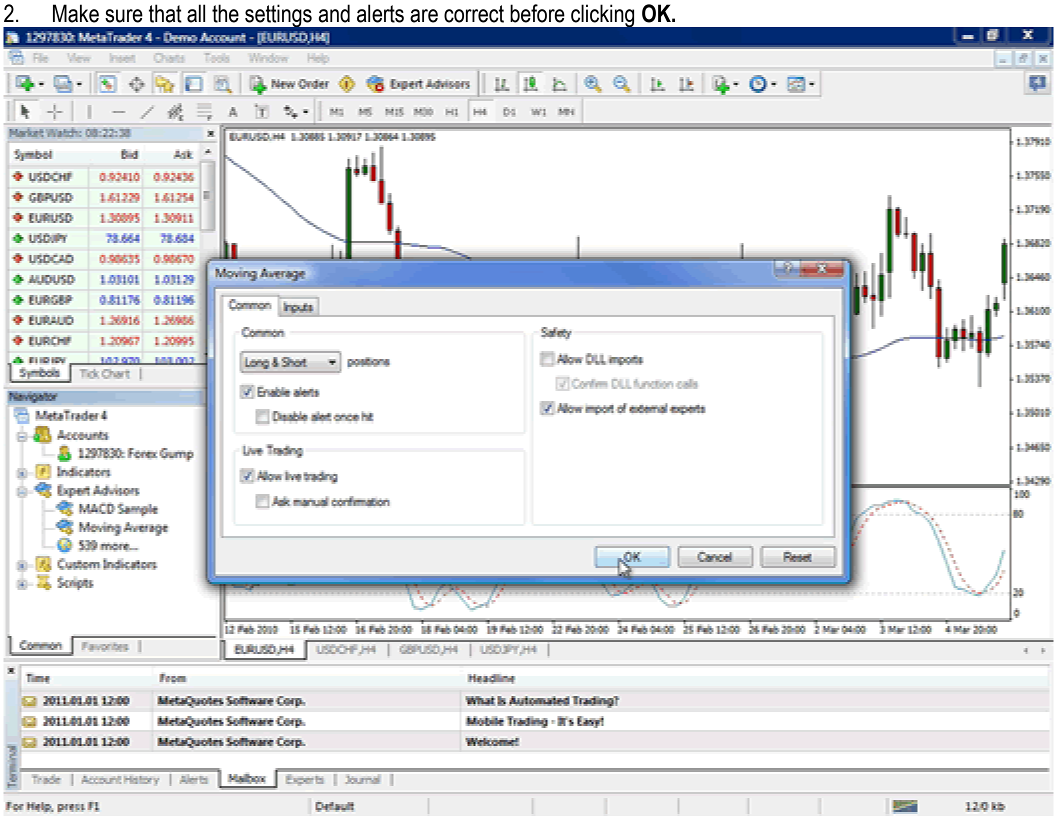


Step 2: Installing the EA on the MT4 platform

1. Launch your MT4 platform.
2. Look for the **Expert Advisors** section under the **Navigator** pane at the left side of the platform. Click on the **Plus** sign and the available EAs should be listed there.
3. Click on the EA you want to install and drag it onto one of the charts on your platform.

Step 3: Adjusting the settings

1. A pop-up box will appear showing the settings of your EA.
2. Make sure that all the settings and alerts are correct before clicking **OK.**



Once again, let us remind you that you shouldn't just use an EA blindly. Test it out on demo first and understand everything there is to know about it before committing your capital to it!

MT4 Basics: How to Use Indicators

Not all trading platforms are created equal. Heck, even MT4 platforms aren't all the same!

They come with different sets of indicators, depending on your broker. Some come with just the basics, while others come equipped with all sets of tools and advanced studies to help you with your trading decisions.

In a way, that's where the beauty of MT4 lies–it's highly customizable! Think of it as the PC of trading platforms (sorry, Apple fanboys!); you can run all sorts of indicators and EAs, tweak their settings in almost any way you want, and even create your own from scratch!
In this lesson, we're gonna get you started to getting the most out of MetaTrader 4. Knowing how to enter and exit trades isn't enough. You have to know how to use your platform's various tools to the fullest, and you have to know how to customize them to your needs.

If you've ever wondered how other traders get all those fancy indicators and thingamajigs on their charts, then this lesson is for you!

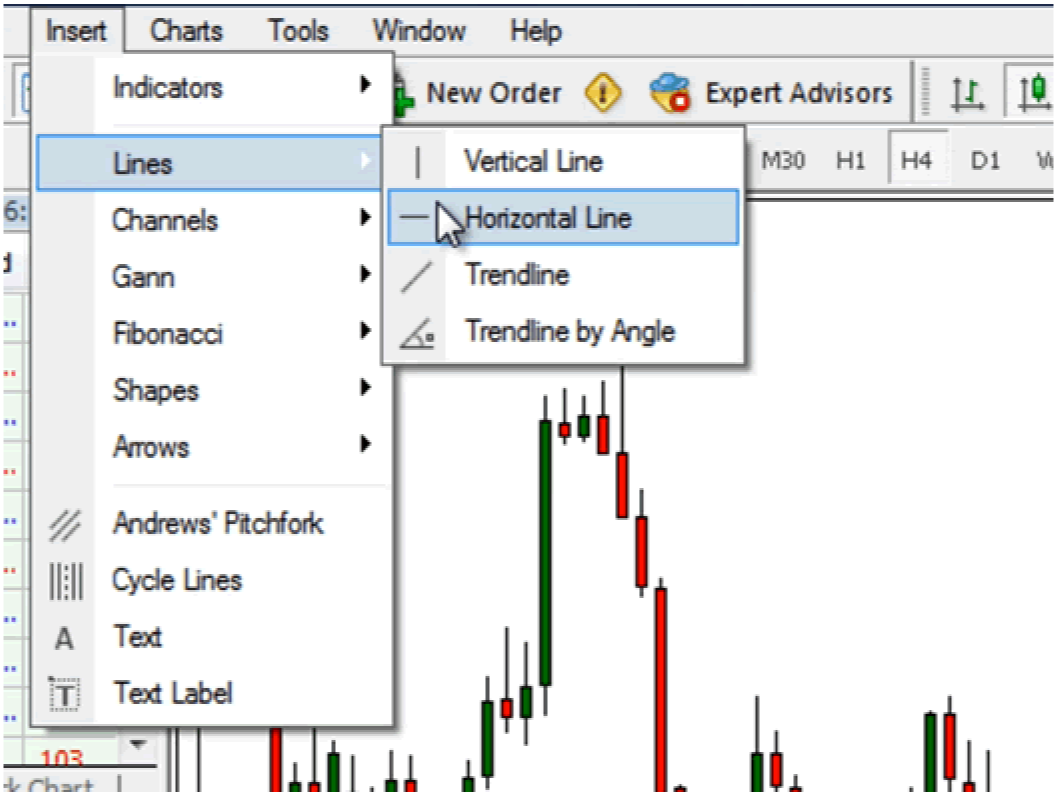
After watching the video below, you'll learn how to:

- draw lines on your charts
- add indicators
- modify an indicator's parameters

Hang in there, boys and girls… enlightenment is just a 2-minute video away!

Adding chart objects

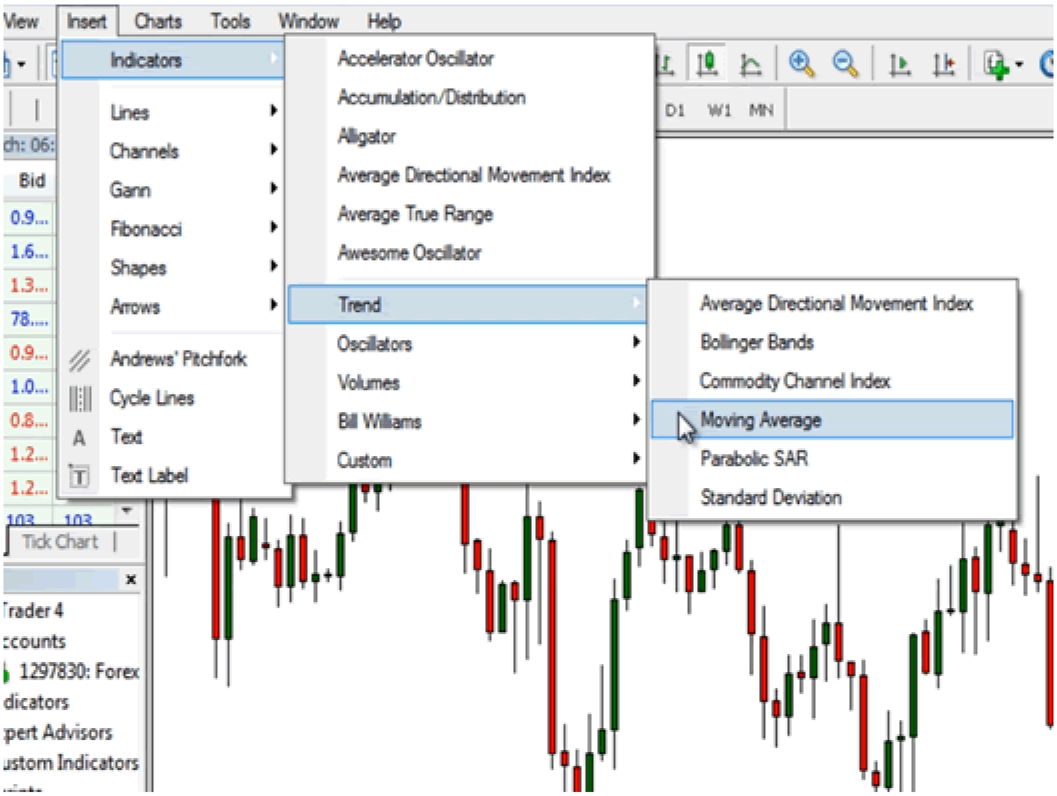
1. Click on the **Insert** menu.
2. Choose an object to add to the chart (ex. lines, shapes, arrows, Fibonacci).



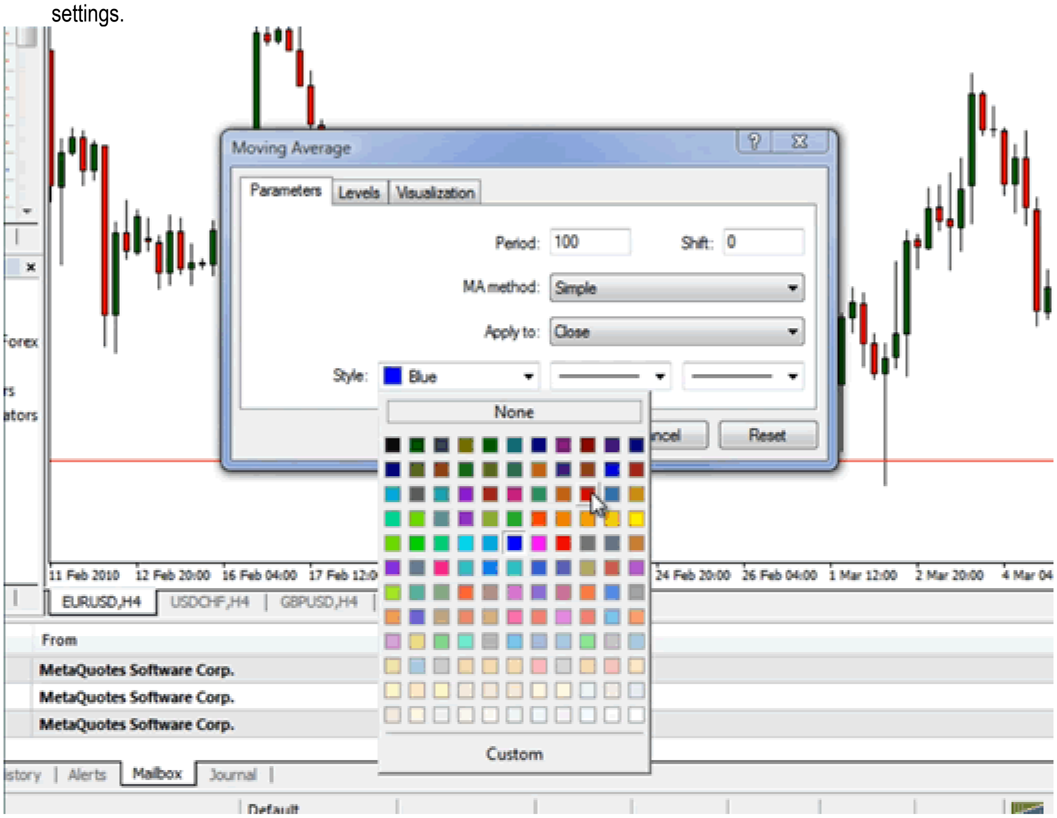
3. Click the chart area where you want the object to appear.

Adding indicators

1. Click on the **Insert** menu.
2. Choose an indicator that you want to add. Indicators are usually grouped according to their type. In this example, the **moving average** indicator is under the **Trend-following** section.

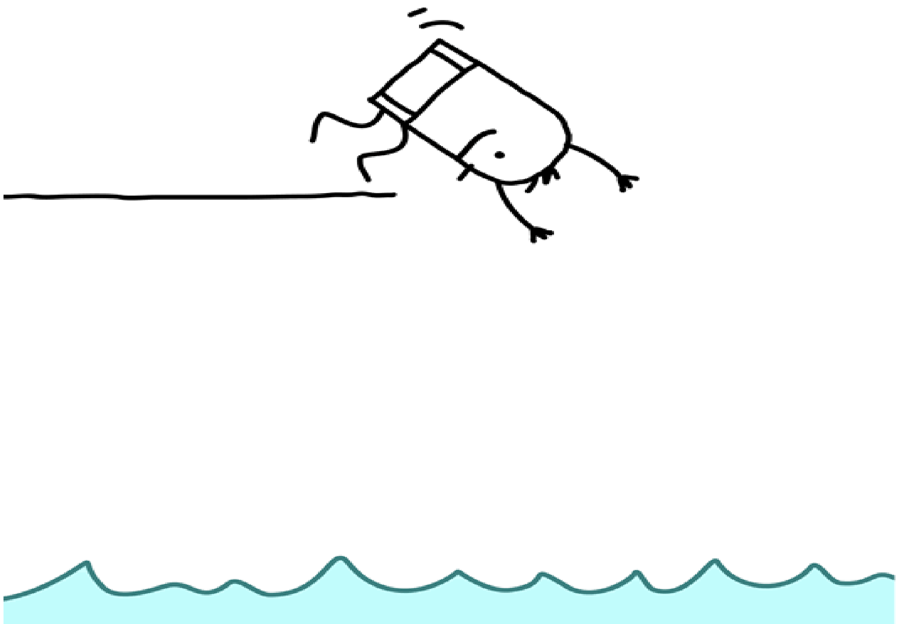


3. After choosing an indicator, you will be prompted to set its parameters. You can also edit the indicator's color, line style, and other settings.



4. Click **OK** once you're done tweaking the parameters and settings. And now the indicator is good to go!

What Is Risk Management?

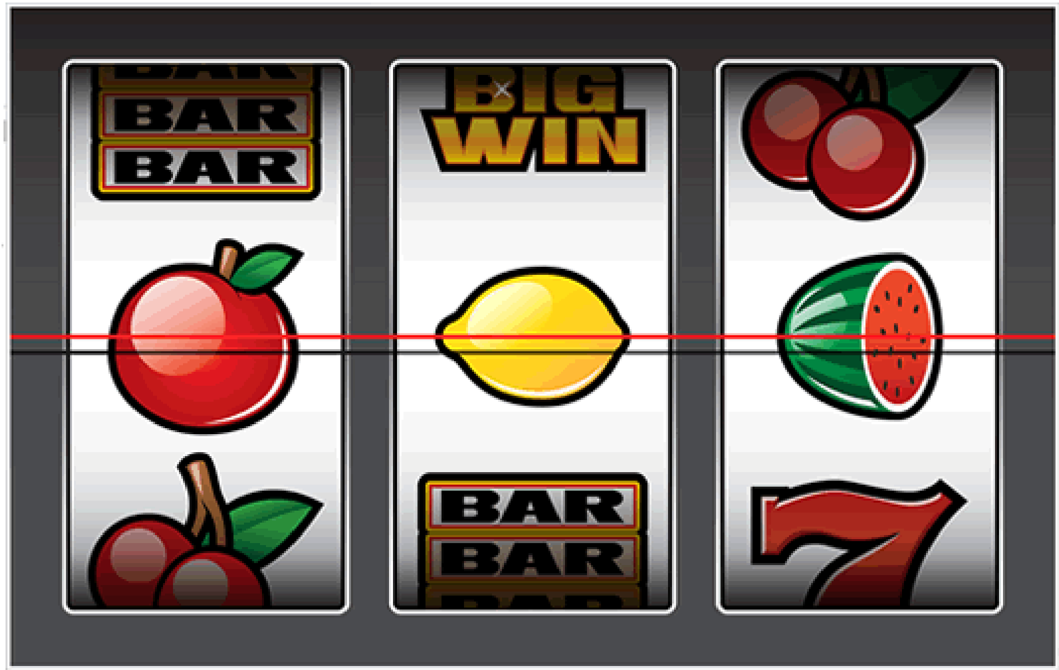


Risk management is one of the most important topics you will ever read about trading.
Why is it important? Well, we are in the business of making money, and in order to make money we have to learn how to manage risk (potential losses).

Ironically, this is one of the most overlooked areas in trading. Many forex traders are just anxious to get right into trading with no regard for their total account size.

They simply determine how much they can stomach to lose in a single trade and hit the "trade" button. There's a term for this type of investing….it's called…

GAMBLING!



When you trade without risk management rules, you are in fact gambling.

You are not looking at the long term return on your investment. Instead, you are only looking for that “jackpot.”

Risk management rules will not only protect you, but they can make you very profitable in the long run. If you don’t believe us, and you think that “gambling” is the way to get rich, then consider this example:

People go to Las Vegas all the time to gamble their money in hopes of winning a big jackpot, and in fact, many people do win.

So how in the world are casinos still making money if many individuals are winning jackpots?

The answer is that while even though people win jackpots, in the long run, casinos are still profitable because they rake in more money from the people that don’t win. That is where the term “the house always wins” comes from.

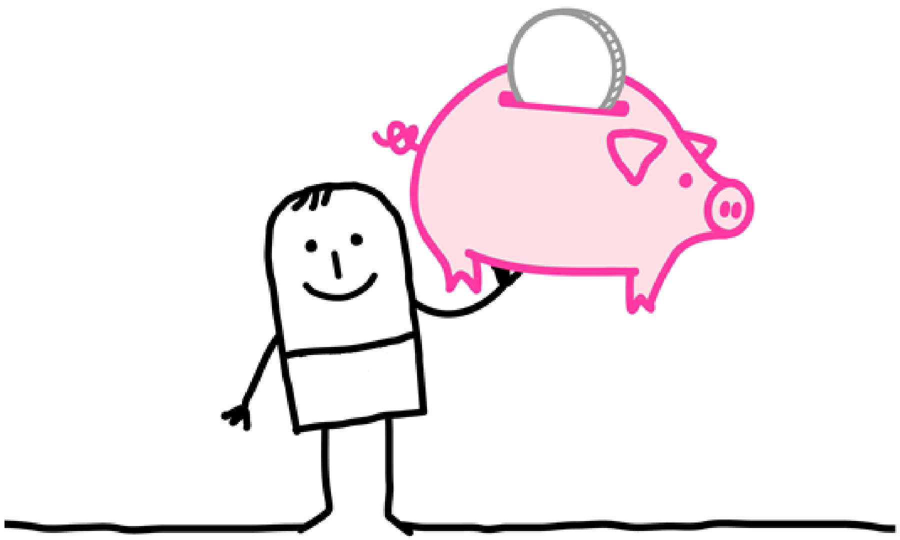
The truth is that casinos are just very rich statisticians. They know that in the long run, they will be the ones making the money–not the gamblers.

Even if Joe Schmoe wins a $100,000 jackpot in a slot machine, the casinos know that there will be hundreds of other gamblers who WON’T win that jackpot and the money will go right back in their pockets.

This is a classic example of how statisticians make money over gamblers. Even though both lose money, the statistician, or casino in this case, knows how to control its losses. Essentially, this is how risk management works. If you learn how to control your losses, you will have a chance at being profitable.

In the end, forex trading is a numbers game, meaning you have to tilt every little factor in your favor as much as you can. In casinos, the house edge is sometimes only 5% above that of the player. But that 5% is the difference between being a winner and being a loser.
You want to be the rich statistician and **NOT** the gambler because, in the long run, you want to “always be the winner.”
So how do you become this rich statistician instead of a loser? Keep reading!

How Much Trading Capital Do You Need For Forex Trading?



It takes money to make money. You need **trading capital**. Everyone knows that, but how much does one need to get started in forex 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 (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.
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 forex 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 forex 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. Retail forex brokers offer minimum account deposits as low as $25, but that doesn't mean you should enter immediately! This is a capitalization mistake, which often leads to failure. Losses are part of the game, and you need to have enough capital to weather these losses.

So how much trading capital do you need? Let's be honest here, if you're consistent and you practice proper risk management techniques, 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 of trading capital that you can afford to lose, be patient, save up and learn to trade the right way until you are financially ready.

Drawdown and Maximum Drawdown Explained

So we know that risk management will make us money in the long run, but now we'd like to show you the other side of things. What would happen if you didn't use risk management rules?

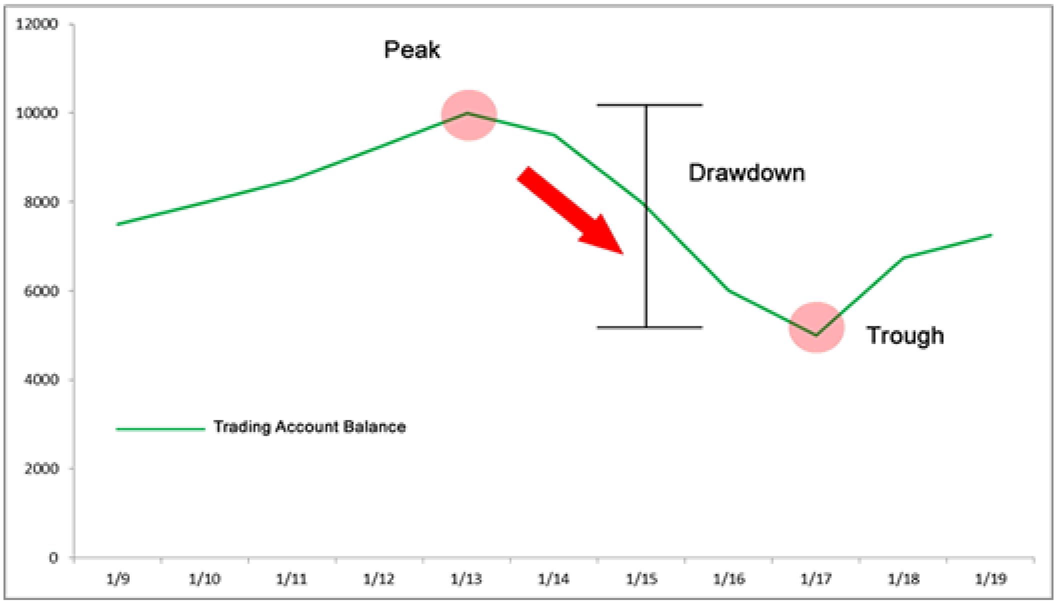
Consider this example:

Let's say you have a $100,000 and you lose $50,000. What percentage of your account have you lost?

The answer is 50%.

Simple enough.

This is what traders call a **drawdown**.
A drawdown is the reduction of one's capital after a series of losing trades. This is normally calculated by getting the difference between a relative peak in capital minus a relative trough. Traders normally note this down as a percentage of their trading account.



Losing Streak

In trading, we are always looking for an edge. That is the whole reason why traders develop systems. A trading system that is 70% profitable sounds like a very good edge to have. But just because your trading system is 70% profitable, does that mean for every 100 trades you make, you will win 7 out of every 10?
Not necessarily! How do you know which 70 out of those 100 trades will be winners?

The answer is that you don't. You could lose the first 30 trades in a row and win the remaining 70. That would still give you a 70% profitable system, but you have to ask yourself, "Would you still be in the game if you lost 30 trades in a row?"

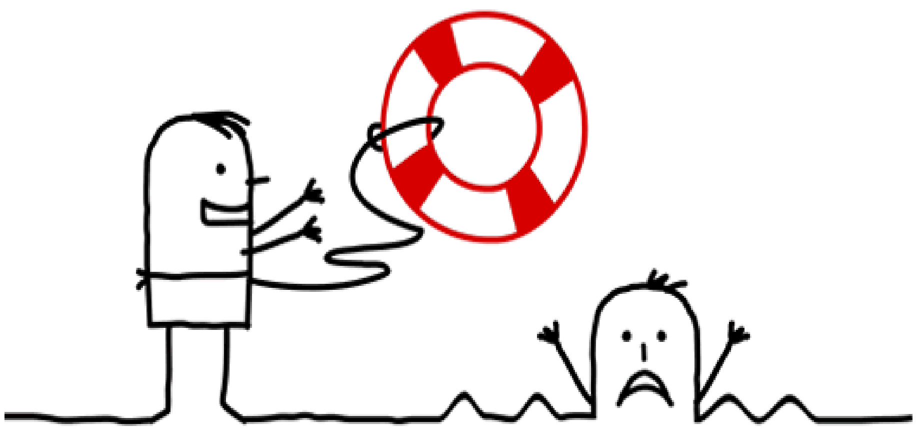
This is why risk management is so important. No matter what system you use, you will eventually have a losing streak. Even professional poker players who make their living through poker go through horrible losing streaks, and yet they still end up profitable.

The reason is that the good poker players practice risk management because they know that they will not win every tournament they play. Instead, they only risk a small percentage of their total bankroll so that they can survive those losing streaks.

This is what you must do as a trader. Drawdowns are part of trading. The key to being a successful forex trader is coming up with trading plan that enables you to withstand these periods of large losses. And part of your trading plan is having risk management rules in place. Only risk a small percentage of your "trading bankroll" so that you can survive your losing streaks. Remember that if you practice strict money management rules, you will become the casino and in the long run, "you will always win."

In the next section, we will illustrate what happens when you use proper risk management and when you don't.

Never Risk More Than 2% Per Trade



How much should you risk per trade?

Great question. Try to limit your risk to 2% per trade.

But that might even be a little high. Especially if you're newbie forex trader.

Here is an important illustration that will show you the difference between risking a small percentage of your capital per trade compared to risking a higher percentage.

Trader Risks 2% vs. 10% Per Trade

Trade #	Total Account	2% risk on each trade	Trade #	Total Account	10% risk on each trade
1	$20,000	$400	**1**	$20,000	$2,000
2	$19,600	$392	**2**	$18,000	$1,800
3	$19,208	$384	**3**	$16,200	$1,620
4	$18,824	$376	**4**	$14,580	$1,458
5	$18,447	$369	**5**	$13,122	$1,312
6	$18,078	$362	**6**	$11,810	$1,181
7	$17,717	$354	**7**	$10,629	$1,063
8	$17,363	$347	**8**	$9,566	$957
9	$17,015	$340	**9**	$8,609	$861
10	$16,675	$333	**10**	$7,748	$775
11	$16,341	$327	**11**	$6,974	$697
12	$16,015	$320	**12**	$6,276	$628
13	$15,694	$314	**13**	$5,649	$565
14	$15,380	$308	**14**	$5,084	$508
15	$15,073	$301	**15**	$4,575	$458
16	$14,771	$295	**16**	$4,118	$412
17	$14,476	$290	**17**	$3,706	$371
18	$14,186	$284	**18**	$3,335	$334
19	$13,903	$278	**19**	$3,002	$300

You can see that there is a big difference between risking 2% of your account compared to risking 10% of your account on a single trade!

If you happened to go through a losing streak and lost only 19 trades in a row, you would've went from starting with $20,000 to having only $3,002 left if you risked 10% on each trade.

You would've lost over **85%** of your account!
If you risked only 2% you would've still had $13,903 which is only a **30%** loss of your total account.

Of course, the last thing we want to do is to lose 19 trades in a row, but even if you only lost 5 trades in a row, look at the difference between risking 2% and 10%. If you risked 2% you would still have $18,447. If you risked 10% you would only have $13,122. That's less than what you would've had even if you lost all 19 trades and risked only 2% of your account!

The point of this illustration is that you want to setup your risk management rules so that when you do have a drawdown period, you will still have enough capital to stay in the game.
Can you imagine if you lost 85% of your account?!!

You would have to make 566% on what you are left with in order to get back to break even!

Here is a chart that will illustrate what percentage you would have to make to breakeven if you were to lose a certain percentage of your account.

Loss of Capital	% Required to get back to breakeven
10%	11%
20%	25%
30%	43%
40%	67%

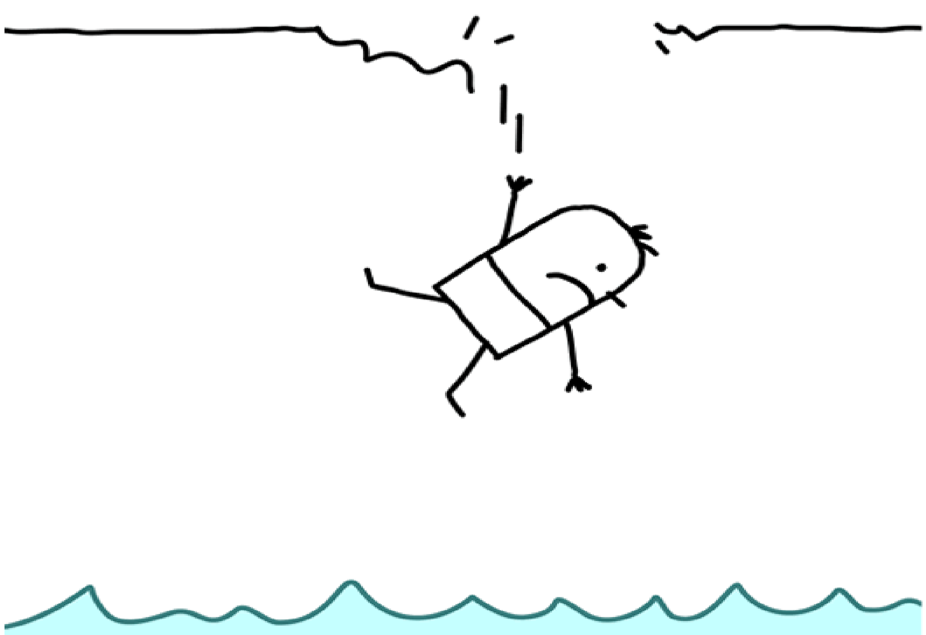
50%	100%
60%	150%
70%	233%
80%	400%
90%	900%

You can see that the more you lose, the harder it is to make it back to your original account size. This is all the more reason that you should do everything you can to PROTECT your account.

By now, we hope you have gotten it drilled in your head that you should only risk a small percentage of your account per trade so that you can survive your losing streaks and also to avoid a large drawdown in your account.

Remember, you want to be the casino… NOT the gambler!

Reward-to-Risk Ratio



Another way you can increase your chances of profitability is to trade when you have the potential to make 3 times more than you are risking. If you give yourself a 3:1 **reward-to-risk ratio**, you have a significantly greater chance of ending up profitable in the long run.
Take a look at this chart as an example:

10 Trades	Loss	Win
1	$1,000	
2		$3,000
3	$1,000	
4		$3,000
5	$1,000	

6		$3,000
7	$1,000	
8		$3,000
9	$1,000	
10		$3,000
Total	$5,000	$15,000

In this example, you can see that even if you only won 50% of your trades, you would still make a profit of $10,000. Just remember that whenever you trade with a good risk to reward ratio, your chances of being profitable are much greater even if you have a lower win percentage.

BUT…

And this is a big one, like Jennifer Lopez's behind… setting large reward-to-risk ratio comes at a price. On the very surface, the concept of putting a high reward-to-risk ratio sounds good, but think about how it applies in actual trade scenarios.

Let's say you are a scalper and you only wish to risk 3 pips. Using a 3:1 reward to risk ratio, this means you need to get 9 pips. Right off the bat, the odds are against you because you have to pay the spread.
If your broker offered a 2 pip spread on EUR/USD, you'll have to gain 11 pips instead, forcing you to take a difficult 4:1 reward to risk ratio. Considering the exchange rate of EUR/USD could move 3 pips up and down within a few seconds, you would be stopped out faster than you can say "Uncle!"

If you were to reduce your position size, then you could widen your stop to maintain your desired reward/risk ratio. Now, if you increased the pips you wanted to risk to 50, you would need to gain 153 pips. By doing this, you are able to bring your reward-to-risk ratio somewhere nearer to your desired 3:1. Not so bad anymore, right?
In the real world, reward-to-risk ratios aren't set in stone. They must be adjusted depending on the time frame, trading environment, and your entry/exit points. A position trade could have a reward-to-risk ratio as high as 10:1 while a scalper could go for as little as 0.7:1.

Summary: Risk Management

Be the casino, not the gambler!
Remember, casinos are just very rich statisticians!

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 trading business. It varies person to person.

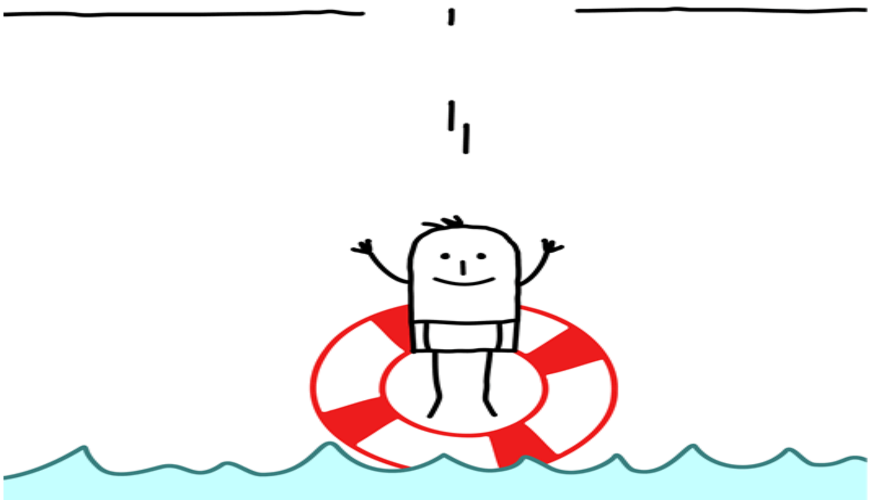
Drawdowns are a reality and WILL happen to you at some point.
The more you lose, the harder it is to make it back to your original account size. This is all the more reason that you should do everything you can to protect your account.

We hope that it’s been drilled into your head that you should only risk a small percentage of your account on each trade so that you can survive your losing streaks and also to avoid a large drawdown in your account.

The less you risk on a trade, the less your maximum drawdown will be. The more you lose in your account, the harder it is to make it back to breakeven.

This means you should only trade only a small percentage of your account. The smaller the better.

Less is more.



2% or less is recommended.

“2% or less” per trade is a highly recommended guideline for everyone to follow. We stress “**guideline”** because it depends on other factors besides your experience like your trading system–mainly how often it takes a trade.
The more currency trades you take per timeframe that your focus on, the less you want to risk per trade. Also, don’t forget to factor in changing market volatility and any adjustments to your entries and exits.

Ignoring Leverage: Why Most New Forex Traders Fail

Hello. My name is Leverage. Now die!

Most professional forex 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 forex 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. Heck, some even allow you to open accounts with just $25.

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.

ZOMG!!! I should have opened a demo account!

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.

Of course, open an account only when you are consistently good.

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 have $1, find a job.

If you don't remember anything else in this lesson, 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 $25 does NOT mean you should.

Here's why:

We 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, we guarantee that you will blow your trading account.

Leverage and Margin Explained

What is leverage?

We know we’ve tackled this before, but this topic is so important, we felt the need to discuss it again.

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, to control a $100,000 position, your broker will set aside $1,000 from your account. 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. The broker only had to put aside $1,000 of your money, so your return is a groovy 100% ($1,000 gain / $1,000 initial investment).

Now we 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 we 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-edged sword." or "Leverage is a two-way street." As you can see, these clichés weren't lying.

What is margin?

So what about the term "margin"? Excellent question.

Let's go back to the earlier example:

For example, in forex, to control a $100,000 position, your broker will set aside $1,000 from your account. 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 within the interbank network.
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.

This leverage tastes so yummy! Time to get crunk!

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
5.00%	20:1
3.00%	33:1
2.00%	50:1
1.00%	100:1
0.50%	200:1
0.25%	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 we will try our best to define each term:

Margin required: This is an easy one because we just talked about it. It is the amount of money your broker 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: You get this when the amount of money in your account cannot cover your possible loss. It happens when your equity falls below your used margin. If a margin call occurs, some or all open positions will be closed by the broker at the market price.

Margin Call Explained

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.

Usable Margin

You will also see that the “Used Margin is “$0.00”, and that the “Usable Margin” is $10,000, as pictured below:

Balance	Equity	Used Margin	Usable Margin
$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.

Balance	Equity	Used Margin	Usable Margin
$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 adrenaline-junkie, chop-socky retired spy that you are) got extremely confident and bought 79 more lots of EUR/USD for a total of 80 lots of EUR/USD because that's just how you roll.

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:

Balance	Equity	Used Margin	Usable Margin
$10,000.00	$10,000.00	$8,000.00	$2,000.00

With this insanely risky position on, you will make a ridiculously large profit if EUR/USD rises. But this example does not end with such a fairy tale.

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

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! EUR/USD can move that much in its sleep!

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

Balance	Equity	Used Margin	Usable Margin
$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 and 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:

Balance	Equity	Used Margin	Usable Margin
$8,000.00	$8,000.00	$0.00	$8,000.00

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%

I don't feel well. I might be overleveraged.

In reality, it's normal for EUR/USD to move 25 pips in a couple seconds during a major economic data release, and definitely that much within a trading day.

Oh we almost forget…we didn't even factor in the SPREAD!
To simplify the example, we didn't even factor in the spread, but we 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 could happen if you don't understand the mechanics of margin and how to use leverage.

The sad fact is that most new traders don't even open a mini account with $10,000.

Because you had at least $10,000, you were at least able to weather 25 pips before his margin call.

If you only started off with $9,000, you would have only been able weather a 10 pip drop (including spread) before receiving a margin call. 10 pips!

Be Careful Trading On Margin

Trading currencies on margin lets you increase your buying power.

This means that if you have $5,000 cash in a margin account that allows 100:1 leverage, you could trade 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

Margin called.

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).

In the event that money in your account falls below margin requirements (usable margin), your broker will close some or all open positions. This can help prevent your account from falling into a negative balance, even in a highly volatile, fast moving market.

Margin calls can be effectively avoided by monitoring your account balance on a very regular basis and by utilizing stop loss orders on every open position to limit risk.
The topic of margin is a touchy subject and some argue that too much margin is dangerous. It all depends on the individual and the amount of knowledge and training he or she has.

If you are going to trade on a margin account, it's vital that you know what your broker's policies are on margin accounts and that you understand and are comfortable with the risks involved.

You should also know that most brokers require a higher margin during the weekends. This may take the form of 1% margin during the week and if you intend to hold the position over the weekend it may rise to 2% or higher.

See How Leverage Can Quickly Wipe Out Your Account

Leverage Overdose

Let the image above haunt you about the negative effects of using too much leverage and running out of margin.

Hopefully, we've done our job and you now have a better understanding of what "margin" is. Now we 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. We 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 us illustrate with 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 value 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, but 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 $10,000, the Used Margin is $5,000, and the Usable Margin is $5,000. For one standard lot, each pip is worth $10.

Balance	Equity	Used Margin	Usable Margin
$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 pips ($5,000 Usable Margin divided by $50/pip).

This would mean the price of EUR/USD would have to move from 1.0000 to .9900 – a price change of 1%.

After the margin call, your account balance would be $5,000. You lost $5,000 or 50% and the price only moved 1%.

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 win against McDonald's because your legs got burned and you didn't know the coffee was hot. To make a long story short, 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:

Balance	Equity	Used Margin	Usable Margin
$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 .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.

Balance	Equity	Used Margin	Usable Margin
$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 look like:

Balance	Equity	Used Margin	Usable Margin
$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.

Low Leverage Allows New Forex Traders To Survive

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

Leverage	% Change in Currency Pair	% 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	% Change in Account
100:1	$1,000	+100%
50:1	$2,000	+50%
33:1	$3,000	+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	% Change in Account
100:1	$1,000	-100%
50:1	$2,000	-50%
33:1	$3,000	-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 mini 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 mini 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 mini 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 mini 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 a margin call. 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 #	Starting Account Balance	# Lots of Used	Stop Loss (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	3	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, sentiment analysis, building a system, are important, we 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 not only lets you sleep at night, but 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 pairs that he normally trades moves anywhere from 70 to 200 pips on a daily basis. In order to protect himself, he uses tight 30 pip stops. If prices goes 30 pips against him, he will be stopped out for a loss of $300.00. Bill feels that 30 pips is reasonable but he underestimates how volatile the market is and finds himself being stopped out frequently.

After being stopped out four times, Bill has had enough. He decides to give himself a little more room, handle the swings, and increases his stop to 100 pips.

Bill’s leverage is no longer 20:1. His account is down to $3,800 (because of his four losses at $300 each) and he’s still trading one $100,000 lot. His leverage is now over 26:1.

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 over 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 has 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 traders?

I'm not feeling well.
I better deleverage.

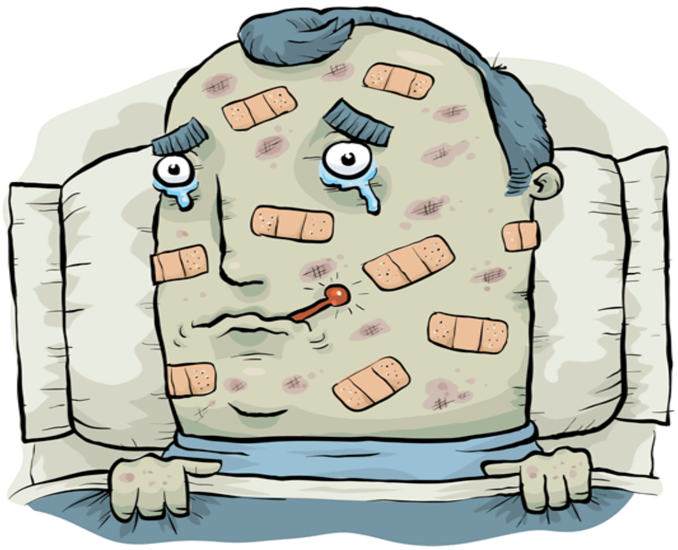
How Leverage Affects Transaction Costs

Besides amplifying your losses, leverage also has another way of killing you. It’s a much slower kind of death though, kinda like dying by a thousand cuts.

Most forex 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 costs of using high leverage.**

Not only does leverage amplify your losses, it also amplifies your transaction costs as a percentage of your account.



These transaction costs are killing me.

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 5 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 eat 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.

This is why transactions costs is one of the six most important factors when choosing a broker.
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	Cost as % of Margin Required
200:1	$50	10.00%
100:1	$100	5.00%
50:1	$200	2.50%
33:1	$330	1.50%
20:1	$500	1.00%
10:1	$1,000	0.50%
5:1	$2,000	0.25%

3:1	$3,300	0.10%
1:1	$10,000	0.05%

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.

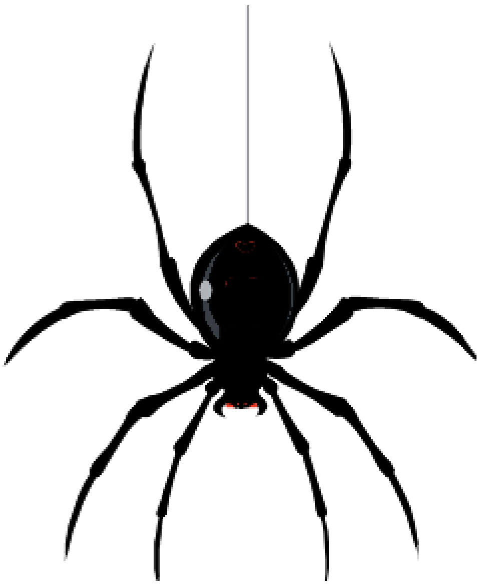
Never Underestimate Leverage

Don't get greedy. Watch yo leverage son!!!

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!

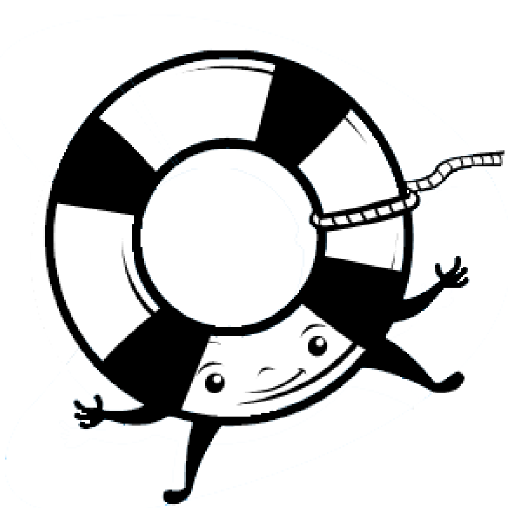
Leverage is a very powerful tool but both old and new traders use it to destroy their trading capital simply because they take its destructive force too lightly or ignore it altogether. It's a pity, but the more of them there are, the easier it is for us smart traders to make money. Sad but true.

Always keep in mind these words from a famous superhero: With great power comes great responsibility. Or something to that effect. Come on, we know you've seen that movie. Here's a clue:



Get it?

Anyway, 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 also know that you could easily be killed by huge leverage as well.



Safety first!

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 consistently make more pips more than you lose then, 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.

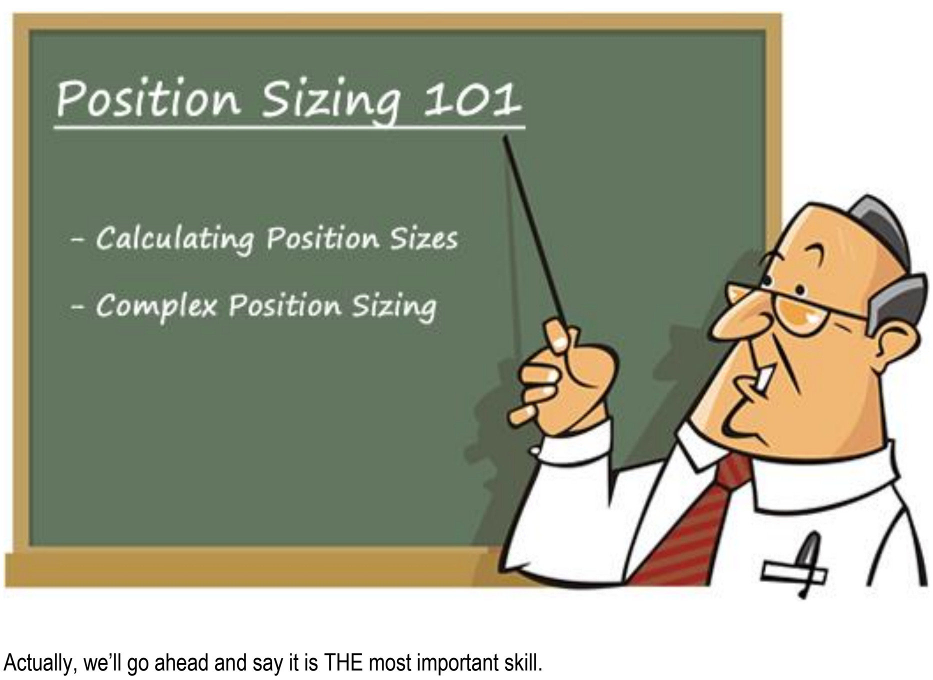
If you don't, you will die.

Okay, not really, but your account will die

Position Sizing

Now that we've learned the hard lesson of trading too big, let's get into how to correctly use leverage using proper "position sizing."

Position sizing is setting the correct amount of units to buy or sell of currency pair.
It is one of the most crucial skills in a forex trader's skill set.



Actually, we'll go ahead and say it is THE most important skill.

Traders are "risk managers" first and foremost, so before you start trading real money you should be able to do basic position size calculations in your sleep… or at least after you wake up, still groggy, and try to trade the NFP report!

Finding the position size that will keep you within your risk comfort level is relatively easy…and we use the phrase "relatively easy" loosely here. Besides, if Pipcrawler, who can't tell his pinkies from his toes, can do it, then you can too!
Depending on the currency pair you are trading and your account denomination (is your account in dollars, euros, pounds, etc??), a step or two needs to be added to the calculation.

Now, before we can get our math on, we need five pieces of information:

1. Account equity or balance
2. Currency pair you are trading
3. The percent of your account you wish to risk
4. Stop loss in pips
5. Conversion currency pair exchange rates

Easy enough right? Let's move on to a few examples.

Calculating Position Sizes

To make things easier for you to understand, as usual, we'll be explaining everything with an example.

This is Newbie Ned.

Long time ago, back when he was even more of a newbie than he is now, he blew out his account because he put on some enormous positions.

It was as if he was a gun slinging cowboy from the Midwest – he traded from the hip and traded BIG.

Ned didn't fully understand the importance of position sizing and his account paid dearly for it.

In the following examples, we'll show you how to calculate your position size based on your account size and risk comfort level.

Your position size will also depend on whether or not your account denomination is the same as the base or quote currency.

Account Denomination the same as the Counter Currency

Newbie Ned just deposited USD 5,000 into his trading account and he is ready to start trading again. Let's say he now uses a swing trading system that trades EUR/USD and that he risks about 200 pips per trade.
Ever since he blew out his first account, he has now sworn that he doesn't want to risk more than 1% of his account per trade. Let's figure how big his position size needs to be to stay within his risk comfort zone.

Using his account balance and the percentage amount he wants to risk, we can calculate the dollar amount risked.

USD 5,000 x 1% (or 0.01) = USD 50

Next we divide the amount risked by the stop to find the value per pip.

(USD 50)/(200 pips) = USD 0.25/pip

Lastly, we multiply the value per pip by a known unit/pip value ratio of EUR/USD. In this case, with 10k units (or one mini lot), each pip move is worth USD 1.

USD 0.25 per pip * [(10k units of EUR/USD)/(USD 1 per pip)] = 2,500 units of EUR/USD

So, Newbie Ned should put on 2,500 units of EUR/USD or less to stay within his risk comfort level with his current trade setup.

Pretty simple eh? But what if your account is the same as the base currency?

Account Denomination the same as Base Currency

Let's say Ned is now chilling in the euro zone, decides to trade forex with a local broker, and deposits EUR 5,000.

Using the same trade example as before (trading EUR/USD with a 200 pip stop) what would his position size be if he only risked 1% of his account?

EUR 5,000 * 1% (or 0.01) = EUR 50

Now we have to convert this to USD because the value of a currency pair is calculated by the counter currency. Let's say the current exchange rate for 1 EUR is $1.5000 (EUR/USD = 1.5000).

All we have to do to find the value in USD is invert the current exchange rate for EUR/USD and multiply by the amount of euros we wish to risk.

(USD 1.5000/EUR 1.0000) * EUR 50 = approx. USD 75.00

Next, divide your risk in USD by your stop loss in pips:

(USD 75.00)/(200 pips) = $0.375 a pip move.

This gives Ned the "value per pip" move with a 200 pip stop to stay within his risk comfort level.

Finally, multiply the value per pip move by the known unit-to-pip value ratio:

(USD 0.375 per pip) * [(10k units of EUR/USD)/(USD1 per pip)] = 3,750 units of EUR/USD

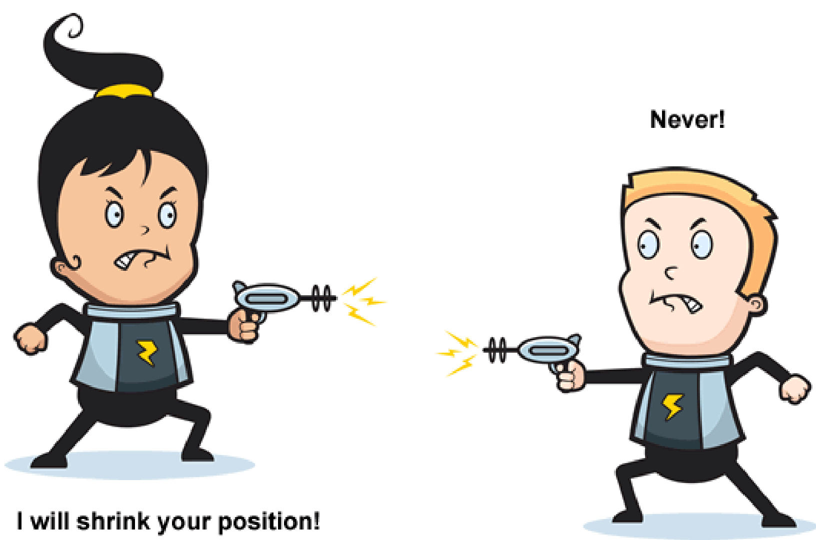
So, to risk EUR 50 or less on a 200 pip stop on EUR/USD, Ned's position size can be no bigger than 3,750 units.

Still pretty simple, eh?

Well now it gets slightly more complicated.

Don't worry though. The FX-Men got yo' back and we'll explain everything so it'll become as easy as baking a cake.

Complex Forex Position Sizing



In this lesson, we'll teach you how to calculate for pairs in which your account denomination isn't one of currencies in the pair currency pair that you wanna trade.

Account Denomination is not in the Currency Pair traded, but the same as the Conversion Pair's Counter Currency.

Ned is back in the U.S., (we think that he's actually a super spy just like Forex Ninja, traveling and saving the world in his free time) and today he decides to trade EUR/GBP with a 200 pip stop. To find the correct position size, we need to find the value of Ned's risk in British Pounds. Remember, **the value of a currency pair is in the counter currency.**
Okay let's straighten things out here. He's back trading with his U.S. broker selling EUR/GBP and he only wants to risk 1% of his USD 5,000 account, or USD 50.

To find the correct forex position size in this situation, we need the GBP/USD exchange rate. Let's use 1.7500 and because his account is in USD, we need to invert that exchange rate to find the proper amount in British Pounds.

USD 50 * (GBP 1/USD 1.7500) = GBP 28.57

Now, we just finish the rest the same way as the other examples. Divide by the stop loss in pips:

(GBP 28.57)/(200 pips) = GBP 0.14 per pip

And finally, multiply by the known unit-to-pip value ratio:

(GBP 0.14 per pip) * [(10k units of EUR/GBP)/(GBP 1 per pip)] = approximately 1,429 units of EUR/GBP

Ned can sell no more than 1,429 units of EUR/GBP to stay within his pre-determined risk levels.

Account Denomination is not in the Currency Pair traded, but the same as the Conversion Pair's Base Currency.

Ned decides to go snowboarding in Switzerland, and in between a couple of double black diamond runs, he opens up his trading account on his super spy phone with a local forex broker. He sees a great setup on USD/JPY, and he has decided that he will get out of the trade if it goes beyond a major resistance level–about 100 pips against him. Ned will only risk the usual 1% of his CHF 5,000 account or CHF 50.
First, we need to find the value of CHF 50 in Japanese yen, and since the account is the same denomination as the conversion pair's base currency, all we have to do is multiply the amount risked by CHF/JPY exchange rate (85.00):

CHF 50 * (JPY 85.00/ CHF 1) = JPY 4,250

Now, we just finish the rest the same way as the other examples. Divide by the stop loss in pips:

JPY 4,250/100 pips = JPY 42.50 per pip

And finally, multiply by a known unit-to-pip value ratio:

JPY 42.50 per pip * [(100 units of USD/JPY)/(JPY 1 per pip)] = approximately 4,250 units of USD/JPY

Shabam! There you have it!

Ned can trade no more than 4,250 units of USD/JPY to keep his loss at CHF 50 or less.

Summary: Position Sizing

After journeying across the globe with Newbie Ned, and through some basic position sizing examples, you're well on your way to becoming a seasoned risk manager.

Now knowing how to set the correct position sizes is only a part of what it takes to become a pro at risk management.

The other part is ***discipline***.
Stick to your stops and pre-determined risk comfort levels and you'll be sure to have enough after your losses to take advantage of profitable opportunities.

Finally, we know that you won't always have a calculator handy or a position sizing feature included with your trading platform, so we here at BabyPips.com have decided to take it upon ourselves and have built a handy-dandy position sizing calculator for you!
Bam! Aren't we cool? C'mon… Time to start a slow clap… Okay, nevermind.

Use the calculator if you need it…

Actually, use it first every single time you decide to put a trade on.

As the old adage goes, “Better be safe than sorry!”

4 Types Of Stop Losses

Why does my stop loss keep getting hit!

Let’s face it. The market will always do what it wants to do, and move the way it wants to move. Every day is a new challenge, and almost anything from global politics, major economic events, to central bank rumors can turn currency prices one way or another faster than you can snap your fingers.

This means that each and every one of us will eventually take a position on the wrong side of a market move.

Being in a losing position is inevitable, but we can control what we do when we’re caught in that situation. You can either cut your loss quickly or you can ride it in hopes of the market moving back in your favor.

Of course, that one time it doesn’t turn your way could blow out your account and end your budding trading career in a flash.

The saying, **“Live to trade another day!”** should be the motto of every trader on Newbie Island because the longer you can survive, the more you can learn, gain experience, and increase your chances of success.
This makes the trade management technique of “stop losses” a crucial skill and tool in a trader’s toolbox.

Having a **predetermined point of exiting a losing trade** not only provides the benefit of cutting losses so that you may move on to new opportunities, but it also eliminates the anxiety caused by being in a losing trade without a plan.

Less stress is good, right? Of course it is, so let’s move on to different ways to cut ’em losses quick!

Now before we get into stop loss techniques, we have to go through the first rule of setting stops.

Your stop loss point should be the **“invalidation point”** of your trading idea.
When price hits this point, it should signal to you **“It’s time to get out buddy!”**
In the next section, we’ll discuss the many different ways of setting stops.

There are four methods you can choose from:

1. Percentage stop
2. Volatility stop
3. Chart stop
4. Time stop

Ready? Let's get started!

How To Set A Stop Loss Based On A Percentage Of Your Account

Let's start off with the most basic type of stop: the percentage-based stop loss.

The percentage-based stop uses a **predetermined portion of the trader's account,** say 2%, that a trader is willing to risk on a trade.
The percentage risk can vary from forex trader to forex trader -more aggressive ones risk up to 10% of their account while less aggressive ones usually have less than 2% risk per trade.

Once the percentage risk is determined, the forex trader uses his position size to compute how far he should set his stop away from his entry.

This is good right?

A trader is putting a stop, which is in accordance with his trading plan.
This is good trading right?

WRONG!!!

You should always set your stop according to the market environment or your system rules, and not how much you want to lose.
We bet you're thinking right now, "Huh? That doesn't make any sense. I thought you said that we need to manage risk."

We agree that this sounds confusing, but let us explain with an example. You remember Newbie Ned from your Position Sizing lesson don't you?
Newbie Ned has a mini account with $500 and the minimum size he can trade is 10k units. Newbie Ned decides to trade GBP/USD, as he sees that resistance at 1.5620 has been holding.

As per his risk management rules, Ned will risk no more than 2% of his account per trade.

At 10k units of GBP/USD, each pip is worth $1 and 2% of his account is $10. So, the largest stop Ned can put on is 10 pips, which is what he does on this trade by putting his stop at 1.5630.

But GBP/USD moves over 100 pips a day! He could easily get stopped out at the smallest move of GBP/USD. Because of the position limits his account is set to, he is basing his stop solely on how much he wants to lose instead of the given market conditions of GBP/USD.

Let's see what happens next.

And bam! Ned got stopped out right at the top, because his stop loss was too tight! And aside from losing this trade, he missed out on a chance to grab over 100 pips!

From that example, you can see that the danger with using percentage stops is that it forces the forex trader to set his stop at an arbitrary price level.

Either that stop will be located too close to entry, like in Newbie Ned's case, or at a price level that doesn't take technical analysis into account. For all you know, you could be setting your stop right at that level where the price could turn and head your way (who hasn't seen that before?). But because you already got stopped out, you wouldn't be able to bag those pips! Darn it!

The solution for Ned is to find a broker that suits his trading style and starting capital.

In this case, Ned should trade with a forex broker that allows him to trade micro or even custom lots. At 1k of GBP/USD, each pip is worth $0.10.

In order for Ned to stay within his risk comfort level, he can set a stop on GBP/USD to 100 pips before losing 2% of his account. He now has the ability to set his stop to the market environment, trading system, support & resistance, etc.

How To Set A Stop Loss Based On Support And Resistance From Charts

A more sensible way to determine stops would be to base it on what the charts are saying.

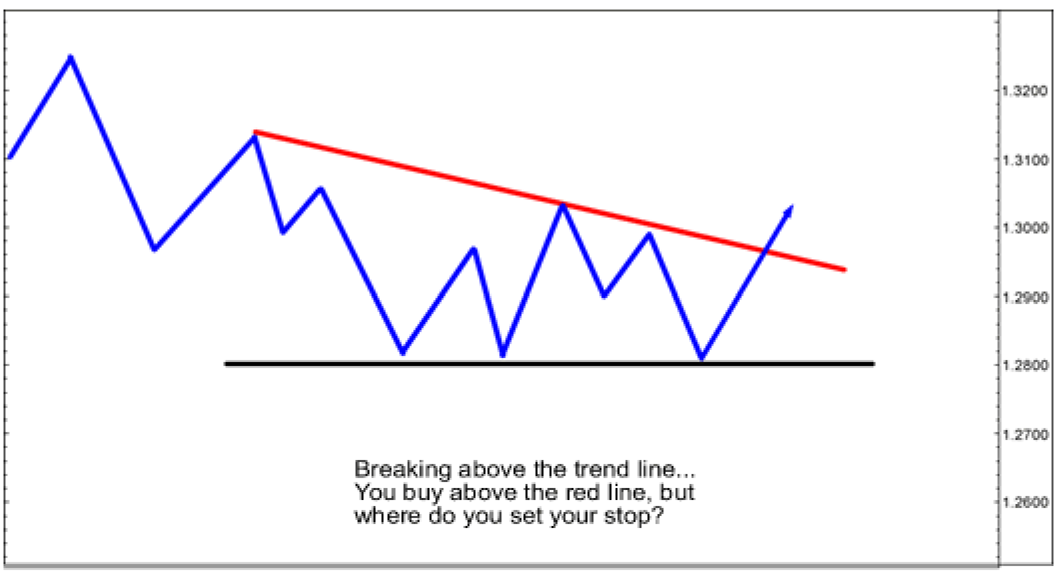
Since we're trading the markets, we might as well base our stops on what the markets are showing us… Makes sense, right?

One of the things that we can observe in price action is that there are times when prices can't seem to push or break beyond certain levels.

Often times, when these areas of support or resistance are retested, they could potentially hold the market from pushing through once again.

Setting stops beyond these levels of support and resistance makes sense, because if the market does trade beyond these areas, then it is reasonable to think that a break of that area will bring in more traders to play the break and further push your position against you.

Or, if these levels **DO** break, then there may be forces that you are unaware of suddenly pushing the market one way or another.
Let's take a quick look at a way to set your stops based on support and resistance:



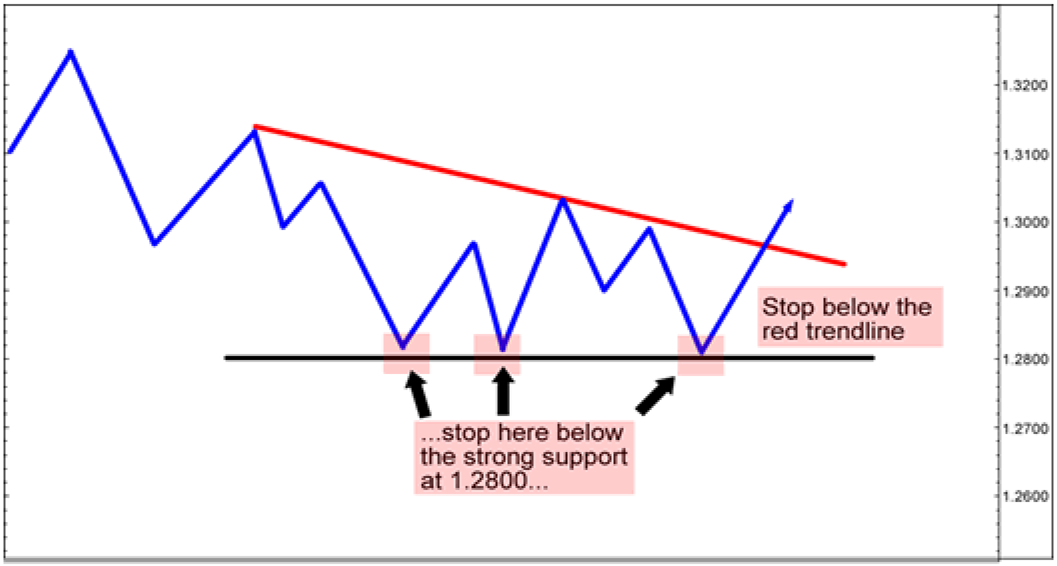
On the chart above, we can see that the pair is now trading above the falling trend line.

You decide that this is a great breakout trade setup and you decide to go long.

But before you enter you trade, ask yourself the following questions:

Where could you possibly set your stop?

What conditions would tell you when your original trade idea is invalidated?



In this case, it makes the most sense to set your stops below the trend lines and support areas.

If the market moves into these areas, that means the trend lines drew no support from buyers and now sellers are in control.

Your trade idea was invalidated and it's time you to suck it up, exit the trade, and accept the loss.

If you want a real life example, take a look at Huck's trend line play on EUR/USD!

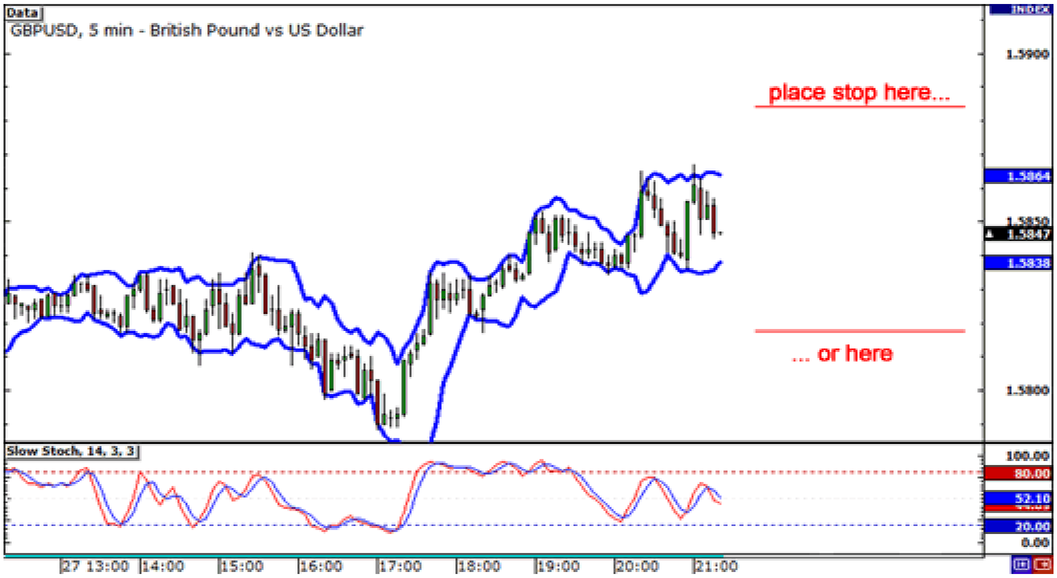
How To Set A Stop Loss Based On Price Volatility

To put it in simple terms, volatility is the amount a market can potentially move over a given time.
Knowing how much a currency pair tends to move can help you set the correct stop loss levels and avoid being prematurely taken out of a trade on random fluctuations of price.

For instance, if you are in a swing trade and you know that EUR/USD has moved around 100 pips a day over the past month, setting your stop to 20 pips will probably get you stopped out too early on a small intraday move against you.

Knowing the average volatility helps you set your stops to give your trade a little breathing room and a chance to be right.

As we explained in a previous lesson, one way to measure volatility is by using Bollinger Bands. You can use Bollinger bands to give you an idea of how volatile the market is right now.
This can be particularly useful if you are doing some range trading. Simply set your stop beyond the bands. If price hits this point, it means volatility is picking up and a breakout could be in play.



Another way to find the average volatility is using the Average True Range (ATR) indicator. This is a common indicator that can be found on most charting platforms, and it's really easy to use.
All the ATR requires is that you input the "period" or amount of bars, candlesticks, or time it looks back to calculate the average range.

For example, if you are looking at a daily chart, and you input "20" into the settings, then the ATR indicator will magically calculate the average range for the pair over the past 20 days.

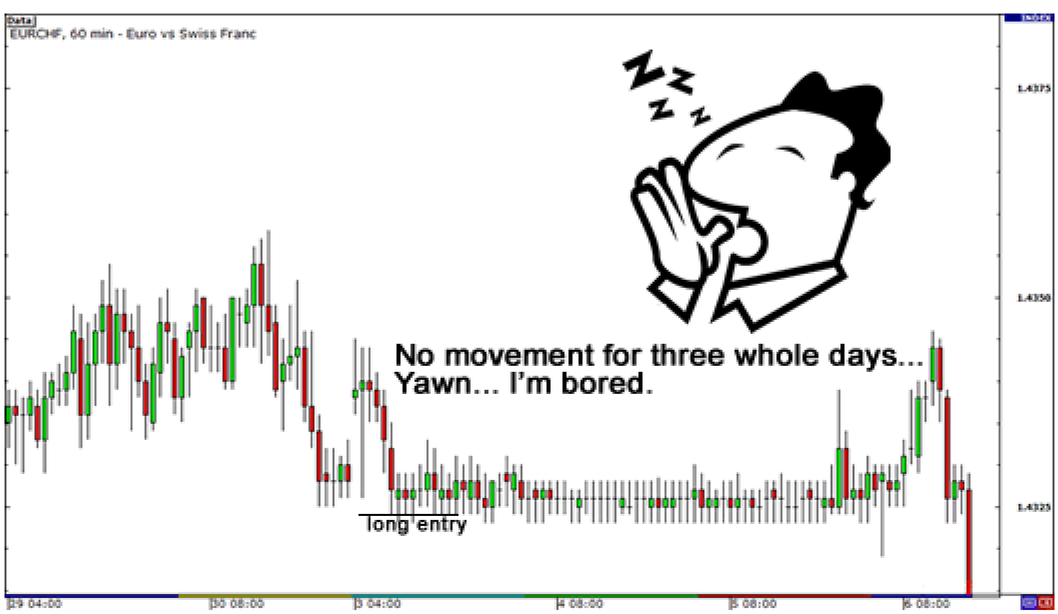
Or if you are looking at an hourly chart and you input 50 into the settings, then the ATR indicator will show you the average movement of the last 50 hours. Pretty sweet, huh?

This process can be applied by itself as a stop or in conjunction with other stop loss techniques.

The point is to give your trade enough breathing room for fluctuations here and there before it heads your way… and hopefully it does.

How To Set A Stop Loss Based On A Time Limit

Time stops are stops you set based on a **predetermined time in a trade**. It could be a set time (open limit time of hours, days, weeks, etc.), only trade during specific trading sessions, the market's open or active hours, etc.
For instance, let's say you are an intraday trader and you've just put on a long trade on EUR/CHF and it hasn't gone anywhere. We're talking real snoozeville here!



Why keep your money locked up in this trade when you can use it to take advantage of this one…

More movement, more pips! Yeah baby!

Because of your predetermined rules and the fact you do not like to hold trades overnight you have decided to close the position at 4:00 pm, when you're usually done for the day and go off to your bi-weekly poker tournament.

Or maybe you are a swing trader and you decided to close your positions on Friday to avoid gaps and weekend event risk.
Also, having some margin tied up in a dead trade could be costing you an opportunity in another great trade setup somewhere else.
Set a time limit and cut off that dead weight so that money can do what it is meant to do… Make more money!

4 Big Mistakes Traders Make When Setting Stops

In this section, we'll talk about the common mistakes traders make when using stops. Sure, it's one way to practice proper risk management but when used incorrectly, it could lead to more losses than wins. And you don't want that, do ya?

1. Placing stops too dang tight.

The first common mistake is placing stops tighter than those leather pants that Big Pippin used to wear back in the retro days.They're so tight that there ain't no room to breathe!
In placing ultra-tight stops on trades, there won't be enough "breathing room" for the price to fluctuate before ultimately heading your way.

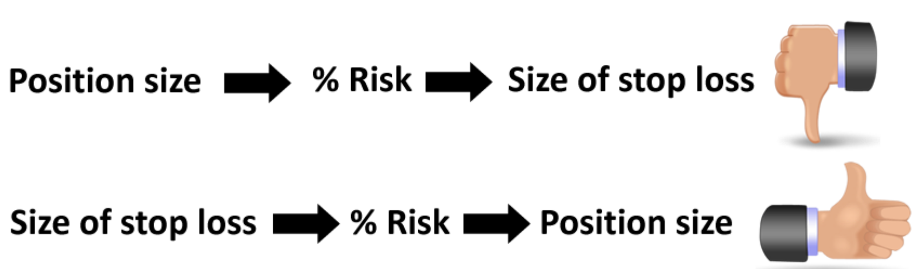
Always remember to account for the pair's volatility and the fact that it could dilly-dally around your entry point for a bit before continuing in a particular direction.
For instance, let's say you went long GBP/JPY at 145.00 with a stop at 144.90. Even if you are right in predicting that the price would bounce from that area, it's a possibility that the price will still dip 10-15 pips lower than your entry price before popping higher, probably until 147.00.

But guess what?

You weren't able to rake in a 200-pip profit because you got stopped out in a jiffy. So don't forget: Give your trade enough breathing room and take volatility into account!

2. Using position size like "X number of pips" as a basis for stops.

We've mentioned this earlier in the lesson already: Using position size like "X number of pips" or "$X amount" instead of technical analysis to determine stops is a BAD idea. We learned that from Newbie Ned, remember?
As we discussed, using position sizing to calculate how far your stop should be has nothing to do with how the market is behaving. Since we're trading the market, it'd make much more sense to set stops depending on how the market moves.
After all, you picked your entry point and targets based on technical analysis so you should do the same for your stop.



We're not saying that you should forget about position size completely. What we're recommending is that **you should decide where to place your stops first BEFORE calculating your position size.**

3. Placing stops too far or too wide.

Some traders make the mistake of setting stops way too far, crossing their fingers that price action will head their way sooner or later. Well, what's the point of setting stops then?

What's the point of holding on to a trade that keeps losing and losing when you can use that money to go for a more profitable one?

Setting stops too far increase the amount of pips your trade needs to move in your favor to make the trade worth the risk.

The general rule of thumb is to place stops *closer* to entry than profit targets.
Of course you'd want to go for less risk and bigger reward, right? With a good reward-to-risk ratio, say 2:1, you'd be more likely to end up with profits if you're right on the money with your trades at least 50% of the time.

4. Placing stops *exactly* on support/resistance levels.

Setting stops too tight? Bad. Setting stops too far? Bad. Where exactly is a good stop placed then? Well, not exactly on support or resistance levels, we can tell you that. How come?
Didn't we just say that technical analysis is the way to go when determining stops? Sure, it's helpful to note nearby support and resistance levels when deciding where to place stops.

If you're going long, you can just look for a nearby support level below your entry and set your stop in that area. If you're going short, you can find out where the next resistance level above your entry is and put your stop around there.

But why isn't it a good idea to put it right smack on the support or resistance level? The reason is that the price could still have a chance to turn and head your direction upon reaching that level.

If you place your stop a few pips beyond that area then you'd be more or less sure that the support or resistance is already broken and you can then acknowledge that your trade idea was wrong.

3 Rules To Follow When Using Stop Loss Orders

Once you've done your homework and created an awesome trade plan that includes a stop out level, you now have to make sure that you execute those stops if the market goes against you.

There's two ways to do that. One is by using an **automatic stop** and another through a **mental stop**.
Which one is best suited for you?

Here's where the hard part comes in as the answer to this question lies in your level of discipline.

Do you have the mental toughness and self-control to stick to your stops?

In the heat of battle, what often separates the long-term winners from the losers is whether or not they can objectively follow their predetermined plans.

Traders, especially the more inexperienced ones, often question themselves and lose that objectivity when the pain of losing kicks in and brings in negative thoughts like, “Maybe the market will turn right here. I should hold a bit longer and then it will go my way.”

Wrong!

If the market has reached your stop, your reason for the trade is **no longer valid** and it’s time to close it out… No questions asked!

This is why the almighty forex gods invented limit orders. New forex traders should always use **limit orders** to automatically close out a losing trade at predetermined levels.

This way you won’t give yourself the chance to doubt your plan and make a mistake. You won’t even have to be sitting in front of your trading station to execute the order.

How awesome is that?!

Of course, the more trades and experience you have under your belt, the more you will hopefully have a better understanding of market behavior, your methods, and the more disciplined you will be.

Only then would mental stops be okay to use, but we still **HIGHLY** recommend limit orders to exit the majority of your trades.

Manually closing trades leaves yourself open to making mistakes (especially during unforeseen events) such as entering the wrong price levels or position size, a power outage, a coffee binge induced bathroom marathon, etc.

Don’t leave your trade open to unnecessary risk so always have a limit order to back you up!

Because stops are never set in stone and you have the ability to move them, we will end this lesson with 3 rules to follow when using stop loss orders.

1. **Don’t let emotions be the reason you move your stop.** Like your initial stop loss, your stop adjustments should be predetermined before you put your trade on. Don’t let panic get in the way!
2. **Do trail your stop.** Trailing you stop means moving it in the direction of a winning trade. This locks in profits and manages your risk if you add more units to your open position.
3. **Don’t widen your stop.** Increasing your stop only increases your risk and the amount you will lose. If the market hits your planned stop then your trade is done. Take the hit and move on to the next opportunity. Widening your stop is basically like not having a stop at all and it doesn’t make any sense so to do it! Never widen your stop!

These rules are pretty easy to understand and should be followed religiously, especially rule number 3!

Want us to repeat it again?

DO NOT WIDEN YOUR STOP!

Always remember to plan your trade ahead and figure out what to do in each scenario so that you won’t panic and do something you’d probably regret later on.

Summary: Setting Stops

Well there you have it… BabyPips.com’s awesome primer to setting stop losses. Now let’s review the things you need to remember about stop losses.

1. Find a broker that allows you to trade position sizes that suits the size of your capital and risk management rules.
2. We use the word “predetermined” a lot in this lesson because you should ALWAYS know when to get out before you open a position. Once you are already in a trade and it’s turned into a loser, you lose the ability to make a decision to exit the trade with a clear head. That could be very bad for your account balance!
3. Set stops to the current market environment, framework, or trading method. **Do not set your exit levels to how much you are willing to lose**. The market does not know how much you have or how much you’re willing to lose. Quite frankly, it doesn’t care. Find the stop levels that **prove your trade wrong** first and then manage your position size according to it.

4. Use limit orders to close out your trade. Mental stops should only be used by those with a bazillion trades recorded in their journal. Even then, limit orders are still the way to go: emotionally unbiased and can be automatically executed while you are taking in some sun on the beach and sipping on virgin margaritas, Pip Surfer's favorite!
5. **Only move your stop in the direction of your profit target**. Trailing stops are good, widening stops are very, very bad!

Like anything else in trading, setting stop losses is a science and an art.

Markets are dynamic, volatility is well… volatile, and a rule or condition that works today may not work tomorrow.

If you continually practice the correct way to set stops, record and review your thought processes and trade outcomes in your journal, then you'll be one step closer to becoming a professional risk manager!

Scaling In And Out Of Positions

Now that you know how to set proper stops and calculate the correct position size, here's a lesson on how you can get a little creative in your trading.

For those trading **multiple position sizes**, you can get really flexible and creative on how you manage your risk by "scaling" in and out of your positions.
What is "scaling" and why would you use it?

Scaling in doesn't mean weighing yourself before, during and after a trade (although it doesn't hurt to monitor that too!).

Scaling basically means adding or removing units from your original open position.
This technique can be incorporated into your original trade plan OR for the more experienced trader, if the conditions of your trade changes then you can add or remove from your position in the middle of your trade.

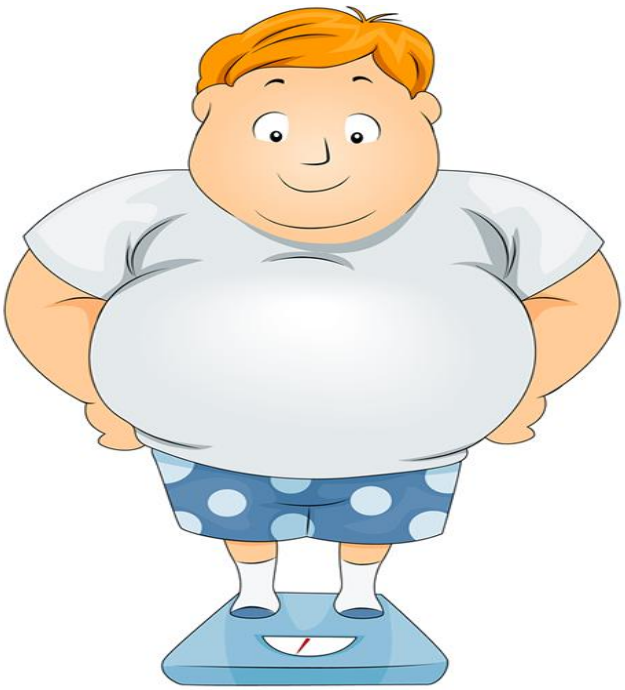
Scaling can help you to adjust your overall risk, lock in profits, or maximize your profit potential. Of course, when you add or remove from your position, there are potential downsides to be aware of as well.

In the following lessons, we'll teach you all about the benefits and drawbacks of scaling in and out of trades. We'll teach you the **CORRECT** way to do this so that you don't go crazy because you took on too much risk and blew out your account.

Benefits

The biggest benefit is a psychological one.

Scaling in and out of your position takes away the need to be absolutely perfect in your entry or exit.



I'm scaling in the pound nicely.

Let's face it – no one can consistently predict price action or the exact turning point of a market. It's way too difficult to keep expecting to get the best entry possible all the time. You are setting yourself up for a lot of heartache.

The best we can do is identify an "area" of potential support/resistance, reversal, momentum change, breakout, etc. You can enter your position in bits and pieces around those areas and/or take your trade off at different levels to lock in profits.
How much easier would it be on you psychologically if you didn't have to accurately pinpoint exactly where to get in or out of the market? A lot easier right?! Plus you don't have to be a accurate like a sniper and catch a move from its inflection point (ooohhh, big word!) to grab some pips!

It also takes a lot of weight off of your shoulders anytime you can reduce risk right? How about locking in profits? Properly executed with a trailing stop, scaling out of winning positions can help you protect your profits just in case price suddenly reverses.

Finally, if you add more to your open position, and the market continues to go your way, your bigger position size will increase the amount you will make for every pip.

Drawbacks

The major drawback of scaling is when you add more to your position. Can anyone guess what that drawback is?

You got it….YOU INCREASE YOUR OVERALL RISK!!

Remember, traders are "risk managers" first, and if done incorrectly, "scaling in" can wipe out your account!!

Lucky for you, we'll explain how to SAFELY add to an open position.

The second drawback is when you remove portions of your open position, you reduce your max potential profit. Who wants to do that? Well, in markets as fast and dynamic as the foreign exchange market, it may benefit you to reduce your risk and "take some off the table."

In the next few sections, we will go through some basic examples of the BabyPips.com way to scale in or out of a trade.

How To Scale Out Of Positions

As mentioned earlier, **scaling out** has the obvious benefit of reducing your risk as you are taking away exposure to the market…whether you are in a winning or losing position.
When used with trailing stops, there is also the benefit of locking in profits and creating a "nearly" risk-free trade. We'll go through a trade example to show you how this can be done.

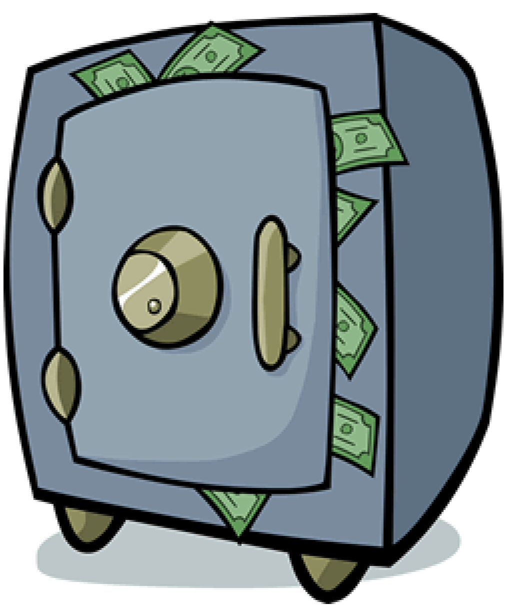
Scaling Out Example:

Let's say you have a $10,000 account and you shorted 10k units of EUR/USD at 1.3000. You placed your stop at 1.3100 and your profit target is 300 pips below your entry at 1.2700.

With 10k units of EUR/USD (pip value of this position is $1) and a stop of 100 pips, your total risk is $100, or 1% of your account.

A few days later, the EUR/USD has moved lower to 1.2900, or 100 pips in your favor. This means you have a total profit of $100, or 1% gain.

All of a sudden, the Fed releases dovish comments that may weaken the USD in the short term.



You think to yourself, "This may bring dollar sellers back into the market, and I don't know if EUR/USD will keep going down… I should lock in some profits."

You decide to close half of your position by buying 5k units of EUR/USD at the current exchange rate of 1.2900.
This locks in $50 of profit into your account [at 5k units of EUR/USD, 1 pip is valued at $0.50…. you have closed a profit of 100 pips (100 pips x $0.50 = $50)]

This leaves you with an open position of 5k units short EUR/USD at 1.3000. From here, you can adjust your stop to breakeven (1.3000) to create a "risk-free" trade.

If the pair moves back higher and triggers your adjusted stop at 1.3000, then you close out the remaining position with no loss, and if it moves lower then you can just ride the trade to more profits.

Obviously, the trade-off for "taking some off the table" is that your original max profit is reduced.

Now, if EUR/USD ended up falling to 1.2700 and you had caught the 300-pip move with a 10k unit position of EUR/USD, then your profit would be $300.

Instead, you closed 5k units at a 100-pip gain for $50, and then you closed your remaining 5k at a 300-pip gain for a $150 gain ($0.50 per pip * 300 pips = $150). Together, this makes a $200 gain versus your original $300 max profit.

The decision to take some profit off the table is always up to you… you just have to weigh the pros and cons.

In this example, the trade-off is a better profit versus the peace of mind of a smaller locked-in profit and creating a risk-free trade.

Which is better for you?

50% more profit or being able to better sleep at night?

Remember, there is the possibility of the market moving beyond your profit target and adding more bling-bling to your account.

There's always much to consider when adjusting trades, and with practice over many trades, you'll find a process of taking off trades most comfortable to you.

Next up, we'll teach you how to scale into positions.

You may be asking, "Why? Why would I wanna scale into a trade?"

Scaling into positions, if done correctly, will give you the benefit of increasing your max profit.

But as they say, "Higher reward means higher risk."

If done incorrectly, the value of your account could drop faster than you can even think about clicking the close button on your trade. Before you know it, you'll be staring at your computer screen, eyes wide open watching your account get margin called.

Now we don't want that to happen right?

So pay attention in class!

What separates "the correct way" from "the incorrect way" is the profitability of your open position when you add, how much more you add, and how you adjust your stops.

In the next two sections, we'll teach you two potential scenarios for scaling into a position. Since traders are "risk managers" first, we'll also touch upon the "No, No's" of adding to an open position.

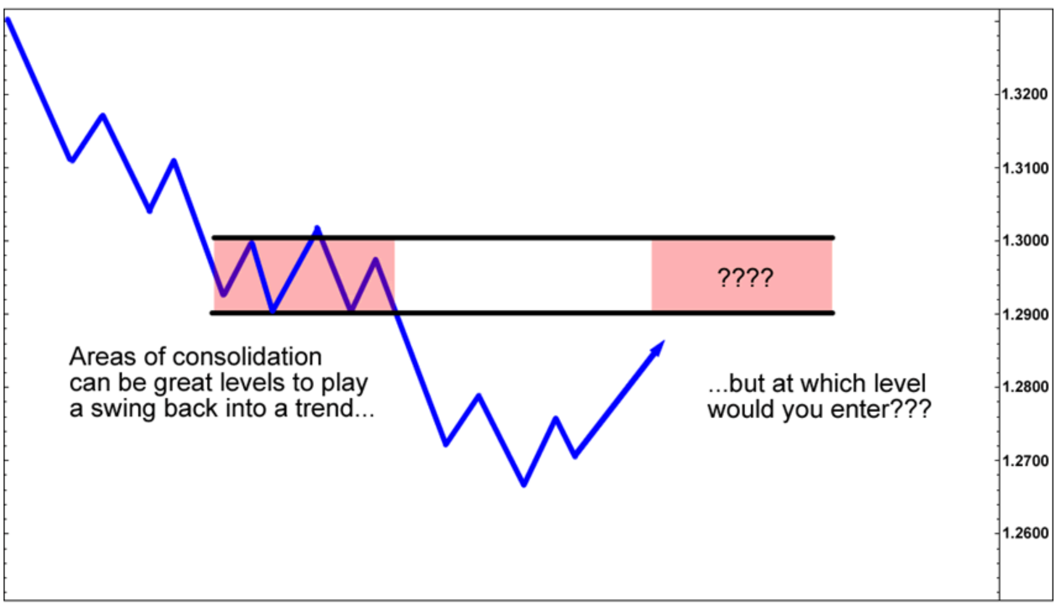
How To Scale In Positions

The first scenario involves adding to your positions when your trade is going against you. Adding more units to a losing position is tricky business and in our view, it pretty much should never, ever be done by a new trader. If your trade is clearly a loser, then why add more and lose more??? Doesn't make any sense right?

Now we say "pretty much" because if you can add to a losing position, and if the combination of risk of your original position and the risk of your new position stays within your risk comfort level, then it is ok to do so. To make this happen, a certain set of rules has to be followed to make this trade adjustment safe. Here are the rules:

1. A stop loss is necessary and MUST be followed.
2. The levels of position entry must be pre-planned before the trade was put on.
3. Position sizes must be pre-calculated and the total risk of the combined positions is still within your risk comfort level.

Let's take a look at simple trade example of how to do this:



From the chart above, we can see that the pair moved lower from 1.3200, and then the market saw a bit of consolidation between 1.2900 to 1.3000 before breaking lower. After bottoming out around 1.2700 to 1.2800, the pair retraced to the area of recent consolidation. Now let's say you think that the pair will return to the down side, but you're not confident of picking an exact turning point. There are a few scenarios of how you could enter the trade:

Short at the broken support-turned-resistance level of 1.2900, the bottom of the consolidation level. The downside of entering at 1.2900 is that the pair may move higher, and you could have potentially gotten in at a better price.

Wait until the pair reaches the top of the consolidation area, 1.3000, which also happens to be a psychologically significant level – potentially great resistance level. But if you do wait to see if the market reaches 1.3000, then you run the risk of the market not making it all the way up there and it drops back down lower, and you'd miss the return to the downtrend.

You can wait until the pair tests the potential resistance area, then moves back below 1.2900 into the downtrend before entering. This is probably the most conservative play as you get a confirmation that sellers are back in control, but then again you miss out on getting in the downtrend at a better price.

What to do? Why not enter at both 1.2900 and 1.3000? That's doable right? Sure it is! Just as long as you write this all down before the trade and follow the plan!

Let's determine our stop level. For simplicity, let's say you pick 1.3100 as the level that signals you were wrong and that the market will continue higher. That is where you exit your trade.

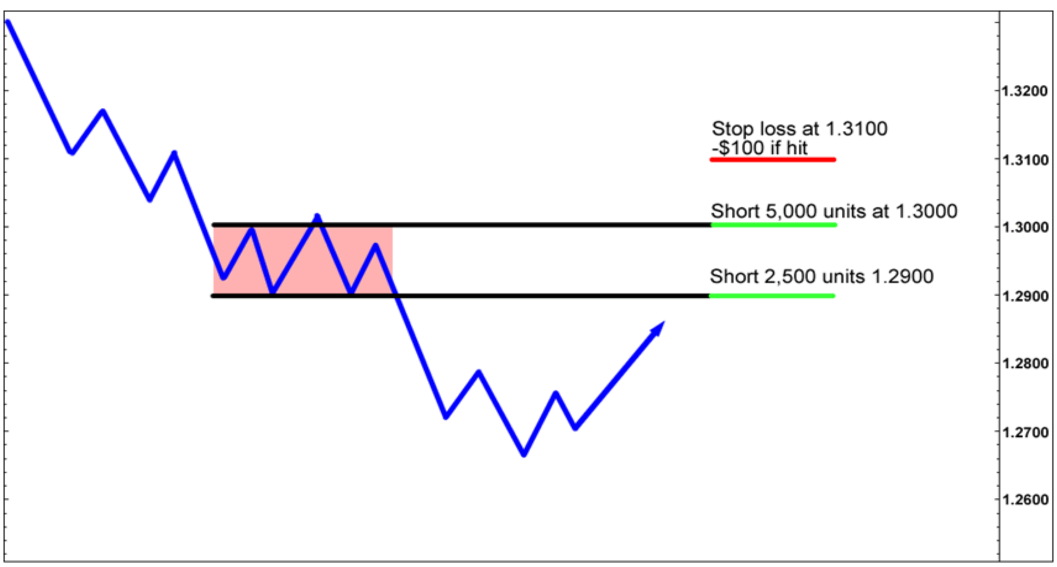
Second, let's determine our entry levels. There was support/resistance at both 1.2900 and 1.3000, so you'll add positions there.

Third, we will calculate the correct position sizes to stay within the comfortable risk level.

Let's say you have a $5,000 account and you only want to risk 2%. That means you are comfortable risking $100 ($5,000 account balance x 0.02 risk) on this trade.

Here is one way to setup this trade: Short 2,500 units of EUR/USD at 1.2900. According to our pip value calculator, 2,500 units of EUR/USD means your value per pip movement is $0.25. With your stop at 1.3100, you have a 200 pip stop on this position and if it hits your stop that is a $50 loss (value per pip movement ($0.25) x stop loss (200 pips)).

Short 5,000 units of EUR/USD at 1.3000. Again, according to our pip value calculator, 5,000 units of EUR/USD means your value per pip movement is $0.50. With your stop at 1.3100, you have a 100 pip stop on this position and if it hits your stop that is a $50 loss (value per pip movement ($0.50) x stop loss (200 pips)).
Combined, this is a $100 loss if you are stopped out.



Pretty easy right? We have created a trade where we can enter at 1.2900, and even if the market went higher and created a losing position, we can enter another position and stay safely within normal risk parameters.

And just in case you were wondering, the combination of the two trades creates a short position of 7,500 units of EUR/USD, with an average price of 1.2966, and a stop loss spread of 134 pips.

If the market went down after both positions were triggered, then a 1:1 reward-to-risk profit ($100) would be achieved if the market hit 1.2832 (1.2966(avg. entry level) – 134 pips (your stop)). Because the bulk of your position was entered at the "better" price of 1.3000, EUR/USD doesn't have to fall too far from the resistance area to make a great profit. Very nice!!!

How To Add To Winning Positions

Now on to the fun stuff. If you catch a great trending move, scaling into it is a great trade adjustment to increase your max profit.

Again, just like Peter Parker, with greater reward, there is great risk, so there are rules to follow to safely add to open position. Let's go over those rules.

Rules to safely add to winning positions:

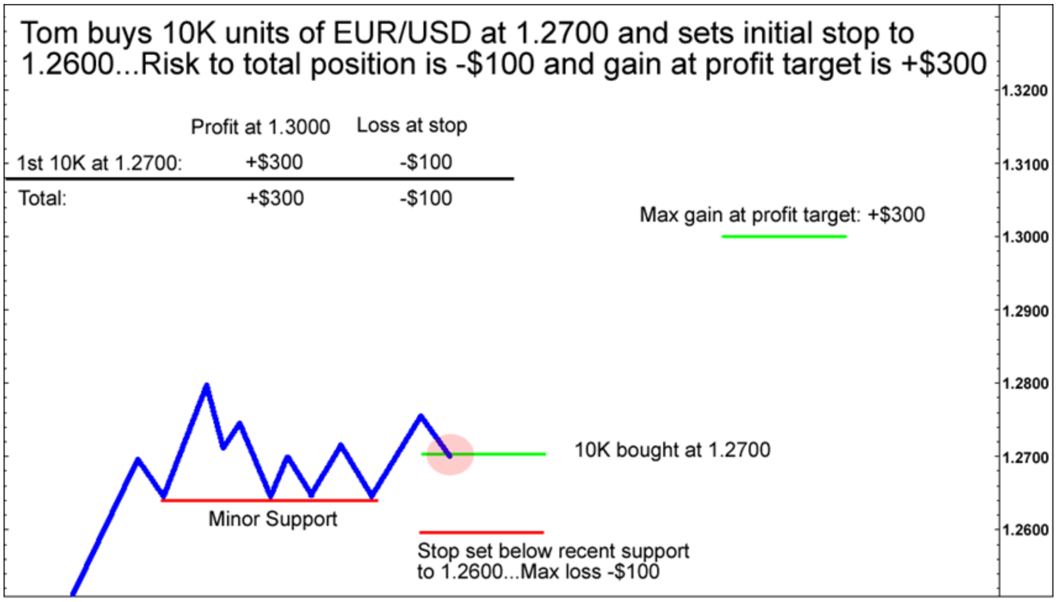
1. Pre-determine levels entry for additional units.
2. Calculate your risk with the additional units added.
3. Trail stop loss to keep growing position within comfortable risk parameters.

To explain this strategy a little better, let's go through a simple trade example…shall we????

We have Tom the "trend trader" closely watching EUR/USD, and after a bit of consolidation he thinks traders will push the pair higher which leads him to plan to on buying some euros against the U.S. dollar at 1.2700.

First, he sees that recent consolidation never really traded below 1.2650, so he decides his stop will be below that level at 1.2600.

Tom also thinks that because it is a psychologically significant resistant level, 1.3000 would be a great level to take profits because a rally may stall there.



With a 100 pip stop and a 300 pip profit target, his risk-to-reward ratio is 1:3. Pretty awesome right?

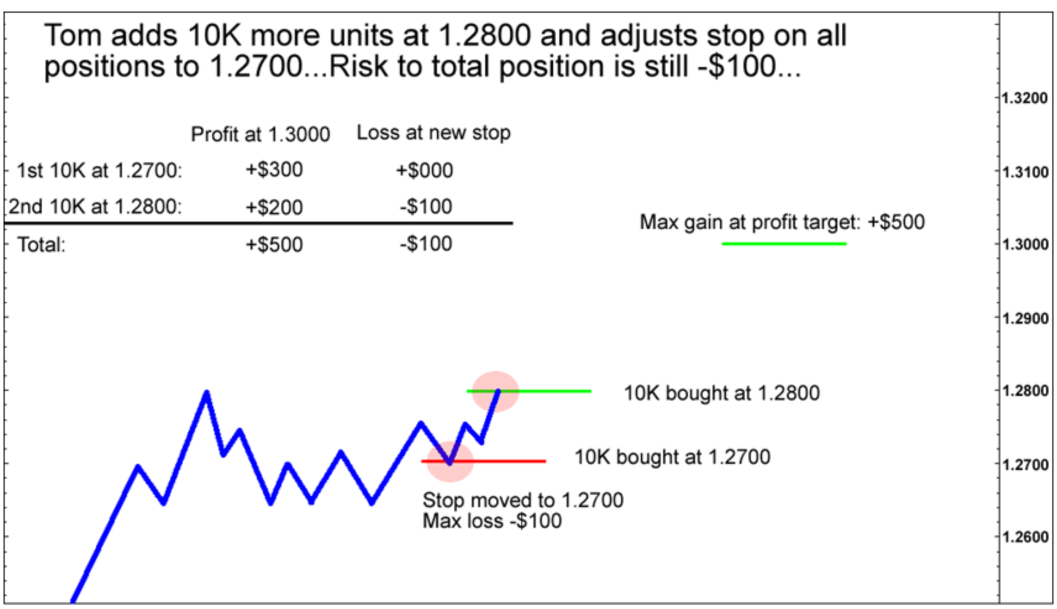
He usually only risks 2% of his account per trade, but this time he's really confident with this trade and with the great risk-to-reward ratio, he decides he will add more if the market moves in his favor.

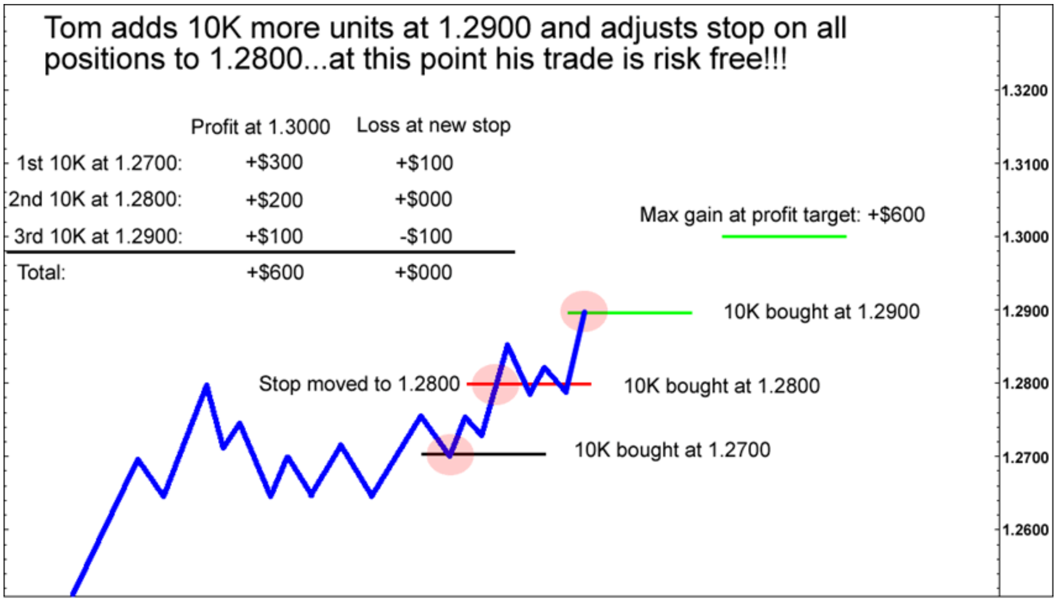
He decides that he will add more units every 100 pips and trail his stop 100 pips. Because he plans on adding more units, he decides to start with an initial risk of 1%.

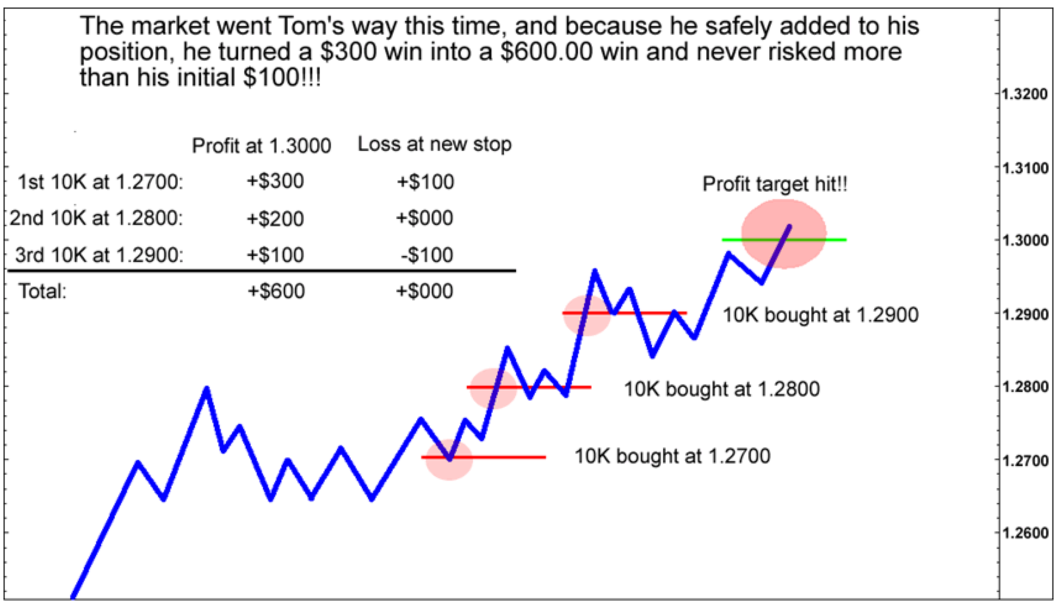
With a starting account balance of $10,000, Tom's initial risk will be $100 ($10,000 x 0.01).

With a 100 pip stop and $100 risk, he has determined his initial position size to be 10,000 units (position sizes can be calculated with our position sizing calculator), he will add 10,000 units every 100 pips, and trail his stop every 100 pips.

Let's take a step-by-step look at the change in risk-to-reward with each addition.







This simplified example shows the basic technique of how to safely add to winning positions and how effective it can be to maximizing your profits.

Now before you go pressing up every winning position you have, you have to be aware that adding to winning positions may not be the best tool for every market environment or situation.

In general, scaling into winning positions is best suited for trending markets or strong intraday moves.
Because you are adding to a position as it goes your way, your average opening price moves in the direction of the move as well. What this means is that if the market pulls back against you after you have added, it doesn't have to move as far to get your trade into negative territory.

Also, you should know that scaling into winning positions in range bound markets or periods of low liquidity leaves you open to being stopped out often.
Lastly, by adding to your position, you are also using up any available margin. This eats up into margin that can be used for other trades! You have been warned!!

Summary: Scaling In and Out Trades

There we have it… the coolest guide **EVER** on scaling in and out of your trades. Let's see how much you of this information you have soaked into your noggin.
Here's a quick review of the rules to safely scale in and out of trades.

- Always use stops.
- Only add to losing positions if the risk of your COMBINED positions is within your risk comfort level
- If you add to winning positions, always trail your stop to control the added risk a bigger position size brings.
- Calculate the correct position sizes and where you will add to/remove from your position BEFORE you enter the trade.
- Scaling into winning trades is best applied to trending markets. Scaling out works well in range bound markets.

So now you know the correct way of scaling in and out of trades. Always follow the rules and sooner or later, you will catch that one move that will bank you some serious money!

Currency Correlation Explained

Have you ever noticed that when a certain currency pair rises, another currency pair falls? Or how about when that same currency pair falls, another currency pair seems to copy it and falls also?

If the answer is "yes," you've just witnessed currency correlation in action!

If you answered "no," you need to stop doing less important things like sleeping, eating, playing Candy Crush or Angry Birds, and instead spend more time watching charts.
But no worries because we're going to start with the basics and break it down yo…

Currency. Correlation.
The first half… easy. Currency. No explanation needed.

The second half. Still easy. Correlation: a relationship between two things.

What is Currency Correlation?

In the financial world, correlation is a statistical measure of how two securities **move in relation to each other.**
***Currency* correlation**, then, tells us **whether two currency pairs move in the same, opposite, or totally random direction**, over some period of time.
When trading currencies, it's important to remember that since currencies are traded in pairs, that no single currency pair is ever totally isolated. (Did we just confuse you with our "currencies" tongue-twister sentence there?)

Unless you plan on trading just one pair at a time, it's crucial that you understand how different currency pairs move in relation to each other, especially if you're not familiar with how currency correlations can affect the amount of risk you're exposing your trading account to.

If you don't know what the heck you're doing when trading multiple pairs simultaneously in your trading account, you can get KILLED! Murdefied! Destroyed! We can't stress this enough.

In this lesson, you'll learn what currency correlation is and how you can use it to help you become a smarter trader and make more responsible risk management decisions.

Correlation is computed into what is known as the correlation coefficient, which ranges between -1 and +1.

Perfect positive correlation (a correlation coefficient of +1) implies that the two currency pairs will move in the *same* direction 100% of the time.
Perfect negative correlation (a correlation coefficient of -1) means that the two currency pairs will move in the *opposite* direction 100% of the time.
If the correlation is 0, the movements between two currency pairs is said to have uh ZERO or NO correlation, they are completely independent and *random from each other*. We have no idea how one pair will move in relation to the other.

How To Read Currency Correlation Tables

Are you a visual learner? Do you like looking at sexy women or hunky men? If so, perfect!

Take a look at the following tables.

Each table shows the *relationship* between each main currency pair (in orange) and other currency pairs (in white) over various time frames.
Remember, currency correlation is presented in decimal format by a correlation **coefficient**, simply a **number** between **-1.00 and +1.00**. A coefficient near or at +1 indicates that the two pairs have strong positive correlation and will likely move in the same direction.
In the same respect, a coefficient near or at -1 indicates that the two pairs still have strong correlation, but a negative one, resulting in the pairs moving in opposite directions.

A coefficient near or at zero indicates a very weak or random relationship.

EUR/USD Correlations

EUR/USD	USD/JPY	USD/CHF	GBP/USD	USD/CAD	AUD/USD	NZD/USD	EUR/JPY	EUR/GBP
1 week	-0.23	-1.00	0.94	-0.98	0.98	0.93	0.93	0.86
1 month	0.63	-0.98	0.13	-0.90	0.90	0.96	0.91	0.86
3 month	-0.62	-0.92	0.83	0.14	0.63	0.42	0.61	0.75
6 month	-0.62	-0.85	0.31	-0.35	0.61	0.65	0.28	0.71
1 year	-0.69	-0.98	0.88	-0.93	0.95	0.96	0.66	0.02

USD/JPY Correlations

USD/JPY	EUR/USD	USD/CHF	GBP/USD	USD/CAD	AUD/USD	NZD/USD	EUR/JPY	EUR/GBP
1 week	-0.23	0.22	-0.21	0.07	-0.22	0.07	0.14	-0.20
1 month	0.63	-0.52	-0.35	-0.58	0.46	0.64	0.89	0.77
3 month	-0.62	0.52	-0.62	-0.40	-0.30	0.09	0.24	-0.35
6 month	-0.62	0.78	0.14	0.43	-0.70	-0.63	0.58	-0.68
1 year	-0.69	0.74	-0.51	0.67	-0.69	-0.69	0.09	-0.20

USD/CHF Correlations

USD/CHF	EUR/USD	USD/JPY	GBP/USD	USD/CAD	AUD/USD	NZD/USD	EUR/JPY	EUR/GBP
1 week	-1.00	0.22	-0.95	0.98	-0.99	-0.95	-0.93	-0.83
1 month	-0.98	-0.52	-0.24	0.89	-0.93	-0.94	-0.87	-0.79
3 month	-0.92	0.52	-0.79	0.14	-0.78	-0.57	-0.62	-0.67
6 month	-0.85	0.78	-0.07	0.66	-0.88	-0.86	0.06	-0.74
1 year	-0.98	0.74	-0.87	0.96	-0.98	-0.98	-0.58	-0.01

GBP/USD Correlations

GBP/USD	EUR/USD	USD/JPY	USD/CHF	USD/CAD	AUD/USD	NZD/USD	EUR/JPY	EUR/GBP
1 week	0.94	-0.21	-0.95	-0.90	0.94	0.87	0.88	0.64
1 month	0.13	-0.13	-0.24	-0.26	0.31	0.20	-0.10	-0.39
3 month	0.83	-0.62	-0.79	0.21	0.70	0.49	0.41	0.26
6 month	0.31	0.14	-0.07	0.17	-0.02	-0.16	0.49	-0.45
1 year	0.88	-0.51	-0.87	-0.89	0.87	0.86	0.69	-0.45

USD/CAD Correlations

USD/CAD	EUR/USD	USD/JPY	USD/CHF	GBP/USD	AUD/USD	NZD/USD	EUR/JPY	EUR/GBP
1 week	-0.98	0.07	0.98	-0.90	-0.98	-0.98	-0.97	-0.88
1 month	-0.89	-0.58	0.89	-0.26	-0.96	-0.96	-0.83	-0.70
3 month	0.14	-0.40	0.14	0.21	-0.41	-0.56	-023	-0.02
6 month	-0.35	0.43	0.66	0.17	-0.83	-0.77	0.16	-0.45
1 year	-0.93	0.67	0.96	-0.89	-0.97	-0.96	-0.59	0.13

AUD/USD Correlations

AUD/USD	EUR/USD	USD/JPY	USD/CHF	GBP/USD	USD/CAD	NZD/USD	EUR/JPY	EUR/GBP
1 week	0.98	-0.22	-0.99	0.94	-0.98	0.95	0.92	0.83
1 month	0.90	0.46	-0.93	0.31	-0.96	0.94	0.76	0.67
3 month	0.63	-0.30	-0.78	0.70	-0.41	0.87	0.48	0.28
6 month	0.61	-0.70	-0.88	-0.02	-0.83	0.91	-0.23	0.58
1 year	0.95	-0.69	-0.98	0.87	-0.97	0.99	0.59	-0.0

NZD/USD Correlations

NZD/USD	EUR/USD	USD/JPY	USD/CHF	GBP/USD	USD/CAD	AUD/USD	EUR/JPY	EUR/GBP
1 week	0.93	0.07	-0.95	0.87	-0.98	0.95	0.98	0.83
1 month	0.96	0.64	-0.94	0.20	-0.96	0.94	0.90	0.79
3 month	0.42	0.09	-0.57	0.49	-0.56	0.87	0.61	0.17
6 month	0.65	-0.63	-0.86	-0.16	-0.77	0.91	-0.09	0.72
1 year	0.96	-0.63	-0.98	0.86	-0.96	0.99	0.61	0.00

EUR/JPY Correlations

EUR/JPY	EUR/USD	USD/JPY	USD/CHF	GBP/USD	USD/CAD	AUD/USD	NZD/USD	EUR/GBP
1 week	0.93	0.14	-0.93	0.88	-0.97	0.92	0.98	0.81
1 month	0.91	0.89	-0.84	-0.10	-0.83	0.76	0.90	0.90

3 month	0.61	0.24	-0.62	0.41	-0.23	0.48	0.61	0.58
6 month	0.28	0.58	0.06	0.49	0.16	-0.23	-0.09	-0.09
1 year	0.66	0.09	-0.58	0.69	-0.59	0.59	0.61	-0.20

EUR/GBP Correlations

EUR/GBP	EUR/USD	USD/JPY	USD/CHF	GBP/USD	USD/CAD	AUD/USD	NZD/USD	EUR/JPY
1 week	0.86	-0.20	-0.83	0.64	-0.88	0.83	0.83	0.81
1 month	0.86	0.77	-0.79	-0.39	-0.70	0.67	0.79	0.90
3 month	0.75	-0.35	-0.67	0.26	-0.02	0.28	0.17	0.58
6 month	0.71	-0.68	-0.74	-0.45	-0.45	0.58	0.72	-0.09
1 year	0.02	-0.20	-0.01	-0.45	0.13	-0.03	0.00	-0.20

Previous LessonMark Lesson Complete

Are You Doubling Your Risk Without Knowing It?

When you are simultaneously trading multiple currency pairs in your trading account, **always make sure you're aware of your RISK EXPOSURE**.

You might believe that you're spreading or diversifying your risk by trading in different pairs, but many pairs tend to move in the same direction.

Let's look at an example involving two highly correlated pairs within a **one week** period: the EUR/USD and GBP/USD.

EUR/USD	USD/JPY	USD/CHF	GBP/USD	USD/CAD	AUD/USD	NZD/USD	EUR/JPY	EUR/GBP
1 week	-0.23	-1.00	0.94	-0.98	0.98	0.93	0.93	0.86
1 month	0.63	-0.98	0.13	-0.90	0.90	0.96	0.91	0.86
3 months	-0.62	-0.92	0.83	0.14	0.63	0.42	0.61	0.75
6 months	-0.62	-0.85	0.31	-0.35	0.61	0.65	0.28	0.71
1 year	-0.69	-0.98	0.88	-0.93	0.95	0.96	0.66	0.02

Based on the table, with a sexy correlation coefficient of 0.94, there's obviously a high correlation in this particular pair. EUR/USD is peanut butter to GBP/USD's jelly! Like oil and water. Like Ben & Jerry's!

Okay you get the picture. The point is that the two pairs hold hands, sing "Kum Bay Yah", and skip together. To prove to you that the numbers don't lie, here are their 4-hour charts. Notice how they both moved in the same direction…down.

Returning to the subject of risk, we can see that opening a position in both the EUR/USD and the GBP/USD is the same as doubling up on a position.

For example, if you bought 1 lot of EUR/USD and bought 1 lot of GBP/USD, you're basically buying 2 lots of EUR/USD, because both the EUR/USD and GBP/USD would move in the same direction anyway.

In other words, you are INCREASING your risk. If you buy EUR/USD and GBP/USD, you don't get two chances to be wrong! All you get it is one chance because if EUR/USD falls and you get stopped out, GBP/USD will most likely fall and stop you out also (or vice versa).

You also wouldn't want to buy EUR/USD and sell GBP/USD at the same time because if EUR/USD skyrockets, then GBP/USD would probably skyrocket also and where does this leave you?

If you think your profit or loss will always be zero, then you're wrong. EUR/USD and GBP/USD have different pip values and just because they are highly correlated doesn't mean they always move in the same exact pip range.

Volatility within currency pairs is fickle. EUR/USD can skyrocket 200 pips, while GBP/USD only goes up 190 pips. If this happens, the losses from your GBP/USD trade (because you were short), will eat up most, if not all, of the gains from your EUR/USD trade.

Now let's imagine that EUR/USD was the pair that moved up 190 pips, and GBP/USD had the bigger move of 200 pips. You would've definitely had a LOSS!

Going long one currency pair and going short another currency pair that are highly correlated is extremely counterproductive.

More than paying for the spread twice, you minimize your gain because one pair eats into the other pair's profits. And even worse, you could end up losing due to the different pip values and ever-changing volatility of currency pairs.

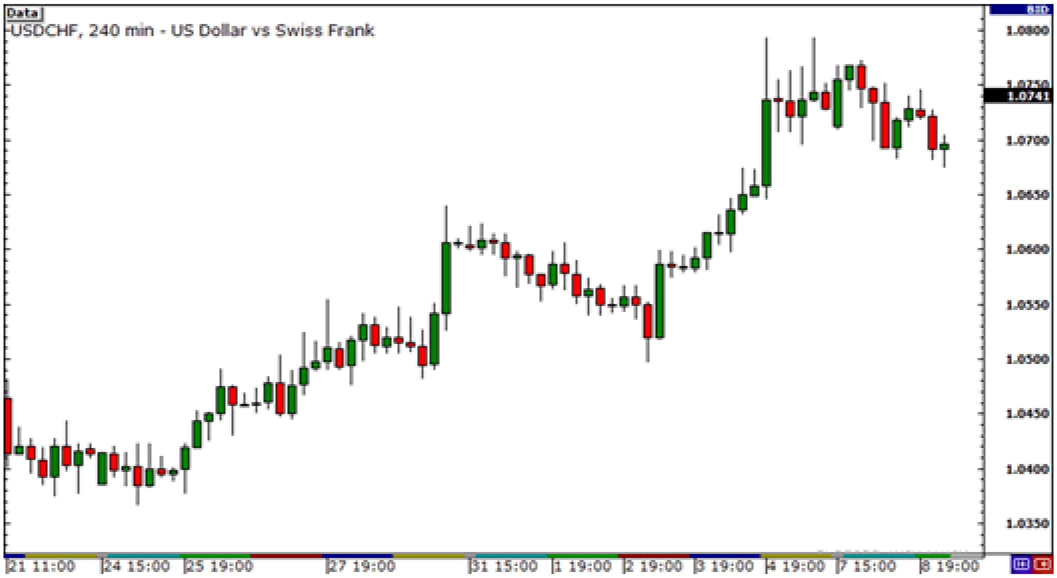
Let's take a look at another example. This time with the EUR/USD and USD/CHF.

While we just saw a strong positive correlation with the GBP/USD, the EUR/USD has a very negative correlation with the USD/CHF.

If we look at its one week correlation, it has a perfect correlation coefficient of -1.00. It doesn't get any more opposite than this folks! Instead of Ben & Jerry's, they're Tom and Jerry!

EUR/USD and USD/CHF are like fire and water, Bugs Bunny and Elmer Fudd. Superman and kryptonite, Boston Celtics and Los Angeles Lakers, Manchester United and Liverpool.

These two pairs totally move in the opposite directions. Check out the charts:



Taking **opposite** positions on the two negatively correlated pairs would be similar to taking the **same** position on two highly positive correlated pairs.

Buying EUR/USD and selling USD/CHF would be the same as doubling up on a position.

For example, if you bought 1 lot of EUR/USD and sold 1 lot of USD/CHF, you're basically buying 2 lots of EUR/USD, because if EUR/USD goes up, then USD/CHF goes down, and you'd be making money on both pairs.

It's important to recognize though that you have INCREASED your risk exposure in your trading account if you do this. Returning to the example with you being long EUR/USD and short USD/CHF, if EUR/USD actually dropped like a rock, most likely both of your trades would be stopped out resulting in two losses.

You could've minimized your loss by simply deciding to go long EUR/USD *OR* go short USD/CHF, instead doing both.

On the other hand, buying (or selling) both EUR/USD and USD/CHF at the same time is usually counterproductive since you're basically **cancelling** each trade out.

Because the two pairs move in opposite directions like they hate each other's guts, one side will make money, but the other will lose money. So you either end up with little gain because one pair eats into the other pair's profits.

Or you could simply end up with a loss due to each pair's different pip values and volatility ranges.

How To Use Currency Correlation In Your Trading

Use the following table as a guide for interpreting the different currency correlation coefficient values.

-1.0	Perfect inverse correlation
-0.8	Very strong inverse correlation
-0.6	Strong, high inverse correlation
-0.4	Moderate inverse correlation
-0.2	Weak, low inverse correlation
0	No correlation. Totally random.
0.2	Very weak, insignificant correlation

- **0.4** Weak, low correlation
- **0.6** Moderate correlation
- **0.8** Strong, high correlation
- **1.0** Perfect correlation

So now you know what currency correlation is and how to read it off a fancy chart. But we bet you're wondering how using currency correlations will make your trading more successful? Why do you need this wondrous skill in your trader's tool bag?
There are several reasons:

1. Eliminate counterproductive trading

Utilizing correlations can help you stay out of positions that will cancel each other out. As the previous table and example explains, we know that EUR/USD and USD/CHF move in the opposite direction 100%.

Opening a position long EUR/USD AND long USD/CHF is, then, pointless and sometimes expensive. In addition to paying for the spread twice, any movement in the price would take one pair up and the other down.

We want our hard work to pay off with something!

2. Leverage profits

…Or losses. You have the opportunity to double-up on positions to maximize profits. Again, let's take at look at the 1 week EUR/USD and GBP/USD relationship from the previous example.

These two pairs have a strong positive correlation with GBP/USD following behind EUR/USD virtually step for step.

Opening a long position for each pair would, in effect, be like taking EUR/USD and doubling your position. You'd basically be making use of leverage! Mucho profit if all goes right and mucho losses if things go wrong!

3. Diversify risk

Understanding that correlations exist also allows you to use different currency pairs, but still leverage your point of view. Rather than trading a single currency pair all the time, you can spread your risk across two pairs that move the same way.

Pick pairs that have a strong to very strong correlation (around 0.7). For example, EUR/USD and GBP/USD tend to move together. The imperfect correlation between these two currency pairs gives you the opportunity to diversify which helps reduce your risk. Let's say you're bullish on USD.

Instead of opening two short positions of EUR/USD, you could short one EUR/USD and short one GBP/USD which would shield you from some risk and diversify your overall position.

In the event that the U.S. dollar sells off, the euro might be affected to a lesser extent than the pound.

4. Hedge risk

Although hedging can result in realizing smaller profits, it can also help to minimize losses. If you open a long EUR/USD position and it starts to go against you, open a small long position in a pair that moves opposite EUR/USD, such as USD/CHF.

Major losses averted!

You can take advantage of the different pip values for each currency pair.

For example, while EUR/USD and USD/CHF have an almost perfect -1.0 inverse correlation, their pip values are different. Assuming you trade a 10,000 mini lot, one pip for EUR/USD equals $1 and one pip for USD/CHF equals $0.93.

If you buy one mini lot EUR/USD, you can HEDGE your trade by buying one mini lot of USD/CHF. If EUR/USD falls 10 pips, you would be down $10. But your USD/CHF trade would be up $9.30.

Instead of being down $10, now you’re only down $0.70!

Even though hedging sounds like the greatest thing since sliced bread, it does have some disadvantages. If EUR/USD rallies, your profit is limited because of the losses from your USD/CHF position.

Also, the correlation can weaken at any time. Imagine if EUR/USD falls 10 pips, and USD/CHF only goes up 5 pips, stays flat, or heck, falls also! Your account will be bleeding more red then you will like.

So be careful when hedging!

5. Confirm breakouts and avoid fakeouts

You can use currency correlations to confirm your trade entry or exit signals.

For example, the EUR/USD appears to be testing a significant support level. You observe the price action and are looking to sell on a breakout to the downside.
Since you know EUR/USD is positively correlated with GBP/USD and negatively correlated with USD/CHF and USD/JPY, you check to see if the other three pairs are moving in the same magnitude as EUR/USD.

You notice that GBP/USD is also trading near a significant support level and both the USD/CHF and USD/JPY are trading near key resistance levels.

This tells you that the recent move is U.S. dollar-related and confirms a possible breakout for EUR/USD since the other three pairs are moving similarly. So you decide you will trade the breakout when it occurs.

Now let's assume the other three pairs are NOT moving in the magnitude as EUR/USD. The GBP/USD is holding not falling, USD/JPY is not rising, and USD/CHF is sideways.

This is usually a strong sign that the EUR/USD decline is not U.S. dollar-related and most likely driven by some kind of negative EU news.

Price may actually trade below the key support level you've been monitoring but because the other three correlated pairs aren't moving in proportion with EUR/USD, there will be lack of any price follow-through and price will return back above the support level resulting in a fakeout.

If you still wanted to trade this setup, since you didn't get any "correlation confirmation" from the other pairs, you could play it smart by reducing your risk and trading with a smaller position size.

Be Careful! Currency Correlations Change!

The forex market is a like a schizophrenic patient suffering from bipolar disorder who constantly eats chocolates, experiences extreme sugar highs, and has volatile mood swings all day long.

We're not even exaggerating.

Although currency correlations between currency pairs can be strong or weak for days, weeks, months, or even years, they *do* eventually change and can change when you least expect it.
The strong currency correlations you see this month may be totally different next month.

Have a look at Table 1.

USD/JPY	EUR/USD	USD/CHF	GBP/USD	USD/CAD	AUD/USD	NZD/USD	EUR/JPY	EUR/GBP
1 week	-0.23	0.22	-0.21	0.07	-0.22	0.07	0.14	-0.20
1 month	0.63	-0.52	-0.35	-0.58	0.46	0.64	0.89	0.77
3 month	-0.62	0.52	-0.62	-0.40	-0.30	0.09	0.24	-0.35
6 month	-0.62	0.78	0.14	0.43	-0.70	-0.63	0.58	-0.68
1 year	-0.69	0.74	-0.51	0.67	-0.69	-0.69	0.09	-0.20

Compare the coefficients for a given pair across the different time frames.

Do you notice anything?

For the most part (thanks, USD/JPY!), they're different across the board, changing from one time frame to another. And they change in all directions.

The lesson here is that currency correlations do change, and they change frequently.
And they can change by a drastic measure in a short time frame, as is apparent by looking at EUR/USD at the 1 Month and 3 Month interval.

That's a big swing!

Because of the constant sentiment shifts of the currency market, make sure you're aware of the current currency correlations.

For example, over a one week period, the correlation between USD/JPY and USD/CHF was 0.22. This is a very low correlation coefficient and would indicate that the pairs have an insignificant correlation.

However, if we look at the three-month data for the same time period, the number increases to 0.52 and then to 0.78 for six months and finally to 0.74 for a year.

In this example, you can see that these two pairs had a “break-up” in their long-term correlation relationship. What was once a strongly positive association in the long run has extremely weakened in the short-term.

If they were a real couple and had only dated a month or less, they would’ve thought they were incompatible. Little do they know, the passion will start heating up later!

If you look at EUR/USD and GBP/USD, here’s example of the extent to which currency correlations can change and jump around.

The one-week period shows a very strong correlation with a 0.94 coefficient!

…But this relationship severely deteriorates in the one-month period, dropping to 0.13, before improving again for its three-month period to a solid 0.83, then deteriorating again to a weak correlation in its six-month trailing period.

EUR/USD	USD/JPY	USD/CHF	GBP/USD	USD/CAD	AUD/USD	NZD/USD	EUR/JPY	EUR/GBP
1 week	-0.23	-1.00	0.94	-0.98	0.98	0.93	0.93	0.86
1 month	0.63	-0.98	0.13	-0.90	0.90	0.96	0.91	0.86
3 month	-0.62	-0.92	0.83	0.14	0.63	0.42	0.61	0.75
6 month	-0.62	-0.85	0.31	-0.35	0.61	0.65	0.28	0.71
1 year	-0.69	-0.98	0.88	-0.93	0.95	0.96	0.66	0.02

Here’s a crazy example on how dramatic currency correlations can change. Let’s take a look at USD/JPY and NZD/USD…

USD/JPY	EUR/USD	USD/CHF	GBP/USD	USD/CAD	AUD/USD	NZD/USD	EUR/JPY	EUR/GBP
1 week	-0.23	0.22	-0.21	0.07	-0.22	0.07	0.14	-0.20
1 month	0.63	-0.52	-0.35	-0.58	0.46	0.64	0.89	0.77
3 month	-0.62	0.52	-0.62	-0.40	-0.30	0.09	0.24	-0.35
6 month	-0.62	0.78	0.14	0.43	-0.70	-0.63	0.58	-0.68
1 year	-0.69	0.74	-0.51	0.67	-0.69	-0.69	0.09	-0.20

Their one year correlation coefficient was -0.69. This indicates a moderate to strong correlation. But if you look at their one month correlation, the correlation coefficient essentially flip flopped! So be careful.

Currency correlations change for many different reasons. These can include anything from a country changing interest rates, to shifting monetary policies, or any collection of economic or political events reshaping traders’ sentiment on a currency.

How To Calculate Currency Correlations With Excel

As you've read, correlations will shift and change over time. So keeping on top of current coefficient strengths and direction becomes even more important.

Lucky for you, currency correlations can be calculated in the comfort of your own home, just you and your most favorite spreadsheet application.

For our explanation, we're using Microsoft Excel, but any software that utilizes a correlation formula will work.

A. We're assuming that you won't be magically creating the daily price data out of thin air, but rather, will be getting it somewhere online. So, Step 1, do that! Obtain your data, say, for the last 6 months. Remember, you want data containing daily closing prices.
B. Open Excel.
C. Copy and paste your data to an empty spreadsheet or open the exported data file from Step 1. Get the last 6 months!

	A	B	C	D	E	F	G
1	Date	EUR/USD Close	USD/JPY Close	USD/CHF Close	GBP/USD Close		
2	8/3/2009	1.4408	95.31	1.0601	1.6922		
3	8/4/2009	1.4388	95.27	1.0615	1.6919		
4	8/5/2009	1.4425	94.95	1.0605	1.7016		
5	8/6/2009	1.4341	95.44	1.066	1.6775		
6	8/7/2009	1.4169	97.59	1.0828	1.6668		
7	8/10/2009	1.4132	97.04	1.0855	1.6461		
8	8/11/2009	1.4148	96.02	1.0818	1.6481		
9	8/12/2009	1.4212	96.13	1.0759	1.6513		
10	8/13/2009	1.4274	95.27	1.0703	1.6563		
11	8/14/2009	1.4174	94.87	1.0746	1.6508		
12	8/17/2009	1.4083	94.48	1.0781	1.634		
13	8/18/2009	1.4142	94.64	1.075	1.6577		
14	8/19/2009	1.4237	93.92	1.0648	1.6539		
15	8/20/2009	1.4266	94.14	1.0621	1.6519		
16	8/21/2009	1.4346	94.31	1.0568	1.6495		
17	8/24/2009	1.4289	94.51	1.0623	1.6399		
18	8/25/2009	1.4311	94.18	1.0607	1.6352		
19	8/26/2009	1.4241	94.14	1.0682	1.6242		
20	8/27/2009	1.4372	93.45	1.0572	1.6287		
21	8/28/2009	1.4296	93.59	1.06	1.6282		
22	8/31/2009	1.4322	92.99	1.059	1.6266		
23	9/1/2009	1.4213	92.94	1.0662	1.6162		
24	9/2/2009	1.4268	92.15	1.0603	1.6269		
25	9/3/2009	1.425	92.55	1.0623	1.6323		
26	9/4/2009	1.4311	92.99	1.0593	1.6395		
27	9/7/2009	1.4329	92.88	1.06	1.6328		
28	9/8/2009	1.4507	92.2	1.0453	1.6503		
29	9/9/2009	1.4542	92.12	1.0424	1.653		
30	9/10/2009	1.4574	91.78	1.0392	1.6654		
31	9/11/2009	1.4594	90.58	1.037	1.6679		
32	9/14/2009	1.4615	90.82	1.0354	1.6575		
33	9/15/2009	1.4675	91.04	1.0334	1.6501		
34	9/16/2009	1.4731	90.83	1.0304	1.6505		
35	9/17/2009	1.4744	91.16	1.0284	1.6443		
36	9/18/2009	1.4722	91.38	1.0288	1.6268		
37	9/21/2009	1.4676	92.06	1.0326	1.6208		
38	9/22/2009	1.4799	91.18	1.0233	1.6365		
39	9/23/2009	1.4744	91.32	1.026	1.636		
40	9/24/2009	1.4652	91.26	1.0303	1.6063		
41	9/25/2009	1.4669	89.83	1.0295	1.5934		
42	9/28/2009	1.4599	89.65	1.0337	1.5872		
43	9/29/2009	1.4571	90.22	1.0376	1.5948		
44	9/30/2009	1.4632	89.77	1.0364	1.5983		
45	10/1/2009	1.4522	89.75	1.0418	1.5936		
46	10/2/2009	1.4571	89.74	1.0352	1.5914		
47	10/5/2009	1.4652	89.55	1.0319	1.5941		

Currency Correlations BP Excel

A. Now arrange your data to look like the following or something similar. Colors and fonts are up to you! Have fun with this. Yellow might not be the best option though!

	A	B	C	D	E
111		EUR/USD Close	USD/JPY Close	USD/CHF Close	GBP/USD Close
112	1/1/2010	1.4318	93.08	1.0348	1.6166
113	1/4/2010	1.4411	92.54	1.0298	1.6099
114	1/5/2010	1.4366	91.65	1.0334	1.5993
115	1/6/2010	1.4412	92.32	1.0275	1.6023
116	1/7/2010	1.4319	93.27	1.0335	1.5936
117	1/8/2010	1.4411	92.59	1.0238	1.6029
118	1/11/2010	1.4526	92.06	1.0151	1.6108
119	1/12/2010	1.4487	90.95	1.0182	1.6162
120	1/13/2010	1.4506	91.45	1.0181	1.6283
121	1/14/2010	1.4496	91.11	1.0184	1.6323
122	1/15/2010	1.4375	90.81	1.0269	1.6258
123	1/18/2010	1.4386	90.76	1.0245	1.6326
124	1/19/2010	1.4304	91.07	1.0311	1.6372
125	1/20/2010	1.4102	91.23	1.0439	1.6287
126	1/21/2010	1.4098	90.36	1.0416	1.6208
127	1/22/2010	1.414	89.87	1.0411	1.611
128	1/25/2010	1.4153	90.21	1.0392	1.6232
129	1/26/2010	1.4076	89.66	1.0458	1.614
130	1/27/2010	1.4018	89.96	1.0499	1.6158
131	1/28/2010	1.3971	89.85	1.0515	1.6128
132	1/29/2010	1.3867	90.27	1.0604	1.6
133					
134					

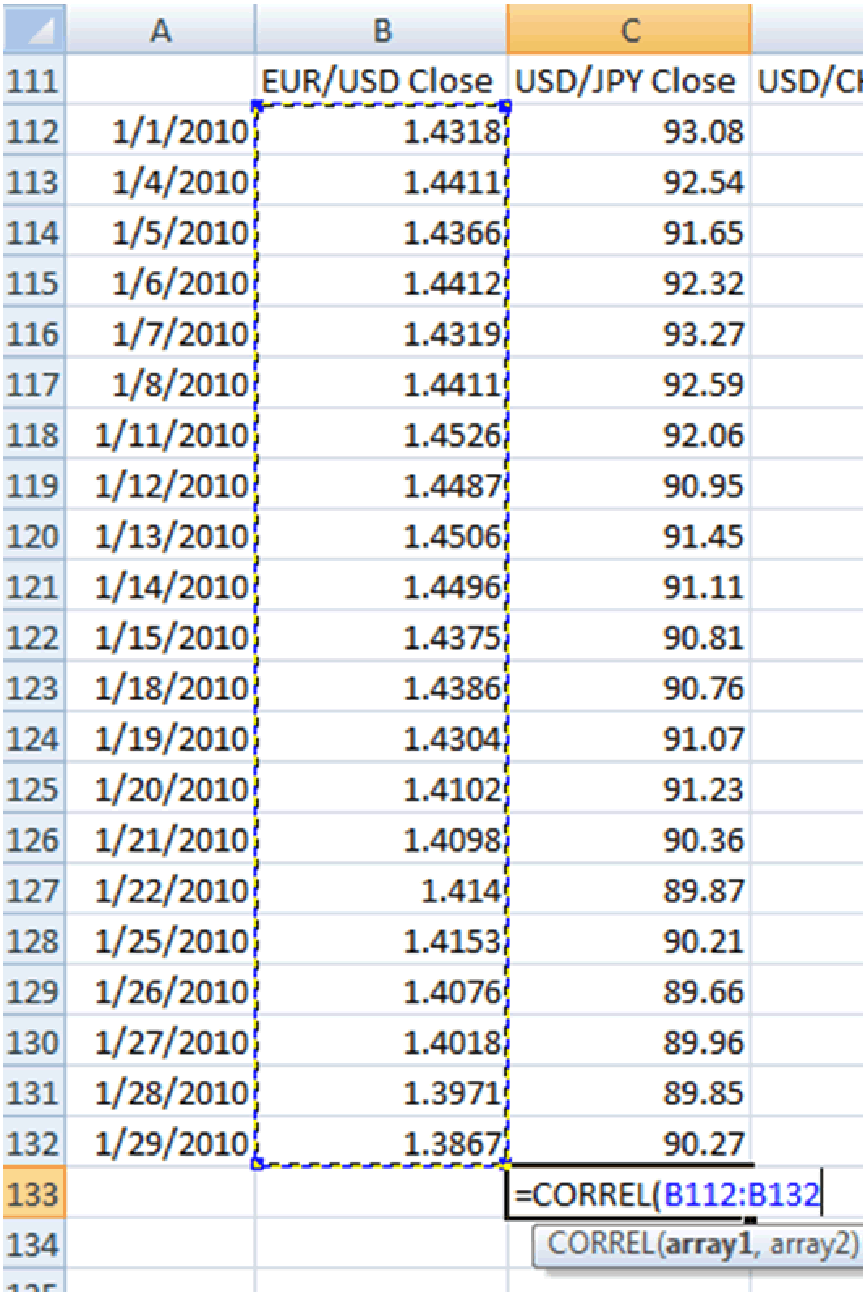
A. It's time to decide on a time frame. Do you want last week's currency correlation? Last month? Last year? The amount of price data you have will dictate this, but you can always get more data. For this example, we're using the last month.

	A	B	C	D	E	F
118		EUR/USD Close	USD/JPY Close	USD/CHF Close	GBP/USD Close	
119	1/1/2010	1.4318	93.08	1.0348	1.6166	
120	1/4/2010	1.4411	92.54	1.0298	1.6099	
121	1/5/2010	1.4366	91.65	1.0334	1.5993	
122	1/6/2010	1.4412	92.32	1.0275	1.6023	
123	1/7/2010	1.4319	93.27	1.0335	1.5936	
124	1/8/2010	1.4411	92.59	1.0238	1.6029	
125	1/11/2010	1.4526	92.06	1.0151	1.6108	
126	1/12/2010	1.4487	90.95	1.0182	1.6162	
127	1/13/2010	1.4506	91.45	1.0181	1.6283	
128	1/14/2010	1.4496	91.11	1.0184	1.6323	
129	1/15/2010	1.4375	90.81	1.0269	1.6258	
130	1/18/2010	1.4386	90.76	1.0245	1.6326	
131	1/19/2010	1.4304	91.07	1.0311	1.6372	
132	1/20/2010	1.4102	91.23	1.0439	1.6287	
133	1/21/2010	1.4098	90.36	1.0416	1.6208	
134	1/22/2010	1.414	89.87	1.0411	1.611	
135	1/25/2010	1.4153	90.21	1.0392	1.6232	
136	1/26/2010	1.4076	89.66	1.0458	1.614	
137	1/27/2010	1.4018	89.96	1.0499	1.6158	
138	1/28/2010	1.3971	89.85	1.0515	1.6128	
139	1/29/2010	1.3867	90.27	1.0604	1.6	
140						
141						

A. In the first empty cell below your first comparison pair (I'm correlating EUR/USD to the other pairs, so I'm starting with EUR/USD and USD/JPY), **type: =correl(**

130	1/27/2010	1.4018	89.96	1.0499	1.6158
131	1/28/2010	1.3971	89.85	1.0515	1.6128
132	1/29/2010	1.3867	90.27	1.0604	1.6
133			=CORREL(		
134			CORREL(**array1**, array2)		

A. Next, select the range of cells for EUR/USD's price data, followed by a comma. You'll be surrounding this range with a box.



	A	B	C	
111		EUR/USD Close	USD/JPY Close	USD/CI
112	1/1/2010	1.4318	93.08	
113	1/4/2010	1.4411	92.54	
114	1/5/2010	1.4366	91.65	
115	1/6/2010	1.4412	92.32	
116	1/7/2010	1.4319	93.27	
117	1/8/2010	1.4411	92.59	
118	1/11/2010	1.4526	92.06	
119	1/12/2010	1.4487	90.95	
120	1/13/2010	1.4506	91.45	
121	1/14/2010	1.4496	91.11	
122	1/15/2010	1.4375	90.81	
123	1/18/2010	1.4386	90.76	
124	1/19/2010	1.4304	91.07	
125	1/20/2010	1.4102	91.23	
126	1/21/2010	1.4098	90.36	
127	1/22/2010	1.414	89.87	
128	1/25/2010	1.4153	90.21	
129	1/26/2010	1.4076	89.66	
130	1/27/2010	1.4018	89.96	
131	1/28/2010	1.3971	89.85	
132	1/29/2010	1.3867	90.27	
133			=CORREL(B112:B132	
134			CORREL(**array1**, array2)	

A. After the comma, select USD/JPY's price data range just like you did for EUR/USD.

	A	B	C	D
111		EUR/USD Close	USD/JPY Close	USD/CHF Close
112	1/1/2010	1.4318	93.08	1.0348
113	1/4/2010	1.4411	92.54	1.0298
114	1/5/2010	1.4366	91.65	1.0334
115	1/6/2010	1.4412	92.32	1.0275
116	1/7/2010	1.4319	93.27	1.0335
117	1/8/2010	1.4411	92.59	1.0238
118	1/11/2010	1.4526	92.06	1.0151
119	1/12/2010	1.4487	90.95	1.0182
120	1/13/2010	1.4506	91.45	1.0181
121	1/14/2010	1.4496	91.11	1.0184
122	1/15/2010	1.4375	90.81	1.0269
123	1/18/2010	1.4386	90.76	1.0245
124	1/19/2010	1.4304	91.07	1.0311
125	1/20/2010	1.4102	91.23	1.0439
126	1/21/2010	1.4098	90.36	1.0416
127	1/22/2010	1.414	89.87	1.0411
128	1/25/2010	1.4153	90.21	1.0392
129	1/26/2010	1.4076	89.66	1.0458
130	1/27/2010	1.4018	89.96	1.0499
131	1/28/2010	1.3971	89.85	1.0515
132	1/29/2010	1.3867	90.27	1.0604
133			=CORREL(B112:B132,C112:C132	
134			CORREL(array1, array2)	

A. Click the Enter key on your keyboard to calculate the correlation coefficient for EUR/USD and USD/JPY.

131	1/28/2010	1.3971	89.85
132	1/29/2010	1.3867	90.27
133			0.629644119
134			

A. Repeat Steps 5-9 for the other pairs and for other time frames. When you're done, you can take your new data and create a cool looking table just like this. Man, that's pro-status!

134					
135	EUR/USD Close	USD/JPY Close	USD/CHF Close	GBP/USD Close	
136	1 Week	-0.23	-1.00	0.94	
137	1 Month	0.63	-0.98	0.13	
138	3 Months	-0.62	-0.92	0.83	
139	6 Months	0.29	0.33	0.37	
140					

The one-week, one-month, three-month, six-month, and one-year trailing periods provides the most complete view of the correlations between currency pairs. But it's up to you to decide which or how many time periods you want wish to analyze.

While it might be overkill to update your numbers every single day, unless you're a currency correlation addict, updating them at least every other week should be enough.

If you find yourself manually updating your currency correlation tables every hour on Excel, you might need to get out more and pick up a hobby.

Summary: Currency Correlations

Like synchronized swimmers, some currency pairs move in tandem with each other.

And like magnets of the same poles that touch, other currency pairs move in opposite directions.

When you are simultaneously trading multiple currency pairs in your trading account, the most important thing is to make sure you're aware of your **risk exposure.**
You might believe that you're spreading or diversifying your risk by trading in different pairs, but you should know that many of them tend to move in the same direction. By trading pairs that are highly correlated, you are just magnifying your risk!

Correlations between pairs can be strong or weak and last for weeks, months, or even years. But always know that they can change on dime.

Staying up-to-date with currency correlations can help you make better decisions if you want to leverage, hedge or diversify your trades.

A few more points to remember

- Coefficients are calculated using daily closing prices.
- Positive coefficients indicate that the two currency pairs are positively correlated, meaning they generally move in the same direction.

- Negative coefficients indicate that the two currency pairs are negatively correlated, meaning they generally move in the opposite directions.
- Correlation coefficient values near or at +1 or -1 mean the two currency pairs are highly related.
- Correlations can be used to hedge, diversity, leverage up positions, and keep you out of positions that might cancel each other out.

Examples of same direction moving currency pairs

- EUR/USD and GBP/USD
- EUR/USD and AUD/USD
- EUR/USD and NZD/USD
- USD/CHF and USD/JPY
- AUD/USD and NZD/USD

Typical inversely moving pairs

- EUR/USD and USD/CHF
- GBP/USD and USD/JPY
- USD/CAD and AUD/USD
- USD/JPY and AUD/USD
- GBP/USD and USD/CHF

When you find yourself wanting to trade two pairs that are highly correlated, its okay if you take both setups. Just make sure you have rules in place when you traded correlated pairs and always stick to your risk management rules!

Forex Managed Accounts

Don’t have time to learn how to trade forex? Want to be part of the Billionaire’s Club?

If you answered “yes” to these two questions, the forex managed accounts scam is the fraud for you!

You can call our hotline at 1-800-4XFRAUDS!

This scam operates by having an investor “invest” with a “professional” trader, who trades the investor’s capital for a percentage of the profits.

This can sound appealing, especially to beginners who have no idea what they are doing or don’t have the time to learn.

They figure, “Well, he’s a ‘professional’ – he must know what he’s doing! It’s 100 times better than if I traded by myself!”

The problem with this is that the user is placing complete trust of his/her money into the hands of a complete stranger.

In a way, it’s like taking candy from a baby.

In many cases of managed accounts, the manager actually appropriates funds towards unrelated luxury items such as cars, islands, and castles.

When finally caught, the manager is not able to pay back the whole amount of stolen capital resulting in unhappy clients and multi-million dollar lawsuits. Yes, we know it seems extreme but, more often than not, it happens and people can lose their entire investment.

Not ALL forex managed accounts are bad though. Some do have many years of trading experience and are well-qualified in trading real money, but that’s more the exception than the norm.

Some trading platforms even offer an option to let traders act as managers using the account structure of the broker.

This prevents an individual from taking funds to spend on New York Knicks tickets, trips to the Bahamas, or a Porsche Cayenne.

While this is a safer option compared to letting an independent manager trade your money, you still lose out on the priceless knowledge and experience gained through studying forex trading.

If there is one thing we want to stress to traders, it is education. There is simply no replacement for experience gained through personal studying and trading.

In the end, the only surefire way to be profitable in the forex market is to be **knowledgeable, practice, and stay disciplined**.
We'll leave you with just one question.

Would you trust your hard-earned money with a complete stranger?

If you're still itching to try out forex managed accounts, make sure you do your homework and find a CREDIBLE manager.

Forex Scams

"Buy my 'End of the Rainbow' system and you'll be able to make at least 100,000,000%!!!"

It's like finding the end of a real rainbow but easier!! Guaranteed profit worth a hundred pots of gold with absolutely no risk!

Don't be a sucker!
You've probably heard or seen something similar on TV ads, online pop-ups, or even from your next-door neighbor.

I know what you're thinking… This is too good to be true! I mean I do believe in leprechauns and I do feel lucky when I eat my Lucky Charms cereal but I don't know about this system.

Nine and a half times out of ten….

IT'S A SCAM!!!

One of the first things you must learn about the forex market is that although it is enjoyable and exciting, there is no magic button that will instantly turn your pennies into millions of dollars.

You may have already heard about forex scams that are littering the forex world.

They're everywhere! Dishonest people are constantly trying to swindle people like every single day.

With the relatively new availability of the forex market, people aren't as familiar with currencies are as they are with stocks and bonds.

This makes it easier for conniving companies and scheming individuals to mislead people into thinking that making money trading forex is as easy as clicking a button with their "End of the Rainbow" system.

There is good news and bad news. Bad news first.

Scams DO exist. They are real and they sucker people who think they can't be misled. If caught in a scam, you can and may lose all the money that you "invested."

However, there is very good news!

Through this lesson, we will teach you about the different types of scams out there, how to prepare yourself, and what you can do in case you encounter a scam.

We will also describe the regulatory agencies that have jurisdiction in scam cases.

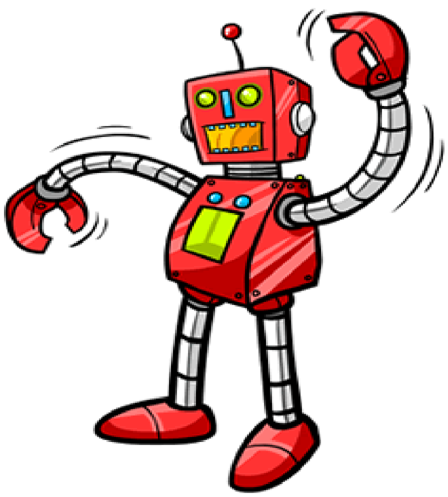
Remember, not all forex companies are bad. Just do your research and you'll be fine.

Forex Robots

These scams encompass Expert Advisors (also famously known as EAs) and other automated trading systems.

What is a forex robot?

In the forex world, a "robot" is a program that strictly uses technical signals to enter in trades and lets the human sleep in a hammock on a beach while he "makes" money.



With a push of a button, the forex robot runs continuously, making trades signaled by mathematical algorithms applied to past price history. In order words, they run automated mechanical systems, whether or not the user is in front of the computer or not.

The problem is that forex robots and their pre-wired thinking do not compensate for ever-changing market conditions.

Market behavior is dynamic, constantly moving in an infinite variation of three movements: up, down, or sideways.

Most robots are not programmed for all environments, or to recognize a change in the trading environment. As a result, losses occur and they can be huge if not closely watched or managed.

Now, the scam isn't the forex robot itself but how they are marketed. Scammers will often try to sell these robots and automated systems as the "holy grail" of trading, promising you'll retire sometime next week. And they sell them at "human affordable" prices ranging from $20 to $5000.

OMG!! Only $20?? For the chance to make ridiculous money??? That sounds like a bargain!

All right, stop. Collaborate and listen.

If the creator is making big bucks with the system, why would he/she try to sell it and share the profit?

And why for only $20?! You can barely get a decent meal at Chick-fil-A for you and your sweetums with $20!

The only real profit for these fraudulent people is the revenue generated from the sales of their forex “R2-D2s.”

The scammer will try to entice you with historical data and back-testing logs.

DOUBLE OMG!! It’s back-tested!! It must work!!! And it’s only $20!! That’s less than a PS3 game!

All right, stop. Collaborate and listen. Again.

Sure, it might look highly profitable. However, in the forex market, there is no such thing as a consistent market. Conditions are changing all the time. The past has little effect on the future in a changing market.

We don’t know for certain that what happened in past will happen again in the future. There are too many variables to consider. Plus, you don’t know if these scammers are making up the results anyways. They could just input random numbers into an excel file as most people wouldn’t bother checking if they are accurate or not.

Our advice?

Stay away from automated systems and robots until you become a master trader AND programmer.

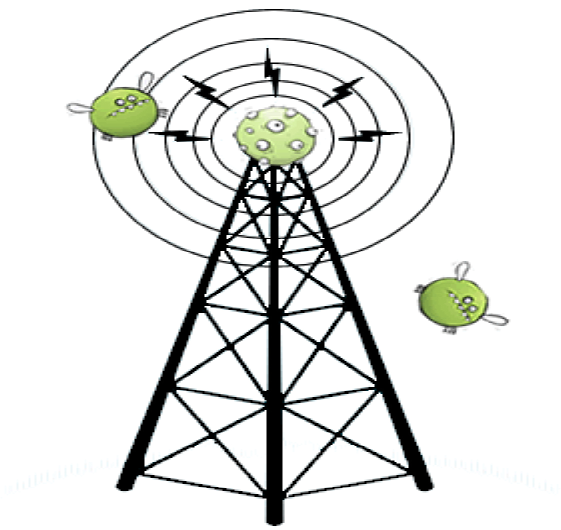
Beginners know nothing about trading or how forex markets behave, so they will not understand how the robot works, what environments they are best suited for, or how to tweak and adjust the system. It is best to actually learn how to trade consistently before you make the decision to let a program do it for you.

Think about it this way: Would you give a total stranger (with no brain to boot!) your hard earned money to invest without having a clue on what he/she was doing? Didn’t think so!

Forex robots can be a great tool, but let’s be real -there is no perfect “one” that will work in all environments, all the time. Shoot, even the quant funds and algorithmic traders on Wall Street can lose money, and they have PhD mathematicians and financial engineers creating their programs!

Forex Signals

Forex signal services do everything a robot does except the actual execution of trade entries. Besides possibly using an automated program, a "professional" trader may generate trading signals (for a fee, of course) for clients to act upon.



However, you may be paying for a signal in which you do not know the causes for and how the "professional" came up with it.

You have no idea what the basis for the trade is, just that the "professional" is telling you that it's a good time to buy or sell.

In the end, you are relying on the analysis of a third-party sources that is not your own.

In a typical forex signal service, the programmer creates a set of technical indicators and rules and the program runs to those specifications.

If price action satisfies the conditions of the signal service, then an alert or pop-up will show up for the user to react.

It is ultimately up to the user to decide whether or not to take the signal and trade it.

While this may sound more beneficial as you have a choice on whether or not to take a trade, the signal service is still programmed to a constant set of rules.

Like we mentioned earlier, the forex market is in a constant state of change. While the forex signal service might have been profitable in the past, there is no guarantee that it will be profitable in the future.

One other thing to think about is if the forex signal service is so profitable, why would the creator want to share the profit?

Like forex robots, the scam isn't the service itself, but the way it's marketed.

You may see ads from scammers that promise you'll make a bajillion dollars with their signals.

Many traders will look at the a and think, "A bajillion dollars!? I could do anything I want with a bajillion dollar!"

Now stop. Think about it.

If that were true, they most likely wouldn't be running a forex signals business. Instead, they would focus on trading and make a bajilion dollars for themselves.

Forex Broker Scams

Did you know that even certain brokers were scammers?

Believe it or not, there are some brokers who "cheat" their clients.

One way they do so is by **manipulating bid/ask spreads**.
Normal spreads between brokers would be around 2-3 pips but scammers would have spreads around 7-8 pips.

Seven pips might not seem like a lot, but it does add up.

Imagine each time a client trades, he has to pay a spread of 7 pips. Imagine if he takes a just a few trades per day.

Multiply that with hundreds of other clueless clients, you'd be rakin' in the dough!

Another way is by **stop hunting**.
Remember, brokers know where clients place their stops.

Sometimes, they'll make a run for those stops, causing their clients' positions to close out.

Fortunately, many, but not all, broker shenanigans are considered old school.

Thanks to new rules from regulatory agencies such as the Commodities Futures Trading Commission and the National Futures Association, these old scams have been cracked down upon.
You should choose a forex broker that is registered with a regulatory agency.

In the U.S., check out brokers registered as a Futures Commission Merchant (FCM) with the CFTC and a NFA member. Be wary of those brokers that are not regulated by the CFTC and the NFA.

You should know that the CFTC and NFA were made to protect the public against fraud, manipulation, and abusive trade practices.

Be careful, it's often difficult to distinguish between regulated and unregulated forex brokers!

According to the NFA Web site, there are about 2,000 retail forex brokerages and solicitors of accounts that are not subject to the new rules.

Out of that 2,000, the NFA has only 24 registered member firms! If you do the math, that's just 1% of all forex brokerages!

You can verify CFTC registration and NFA membership status of a particular broker and check their disciplinary history by phoning NFA at (800) 621-3570 or by checking the broker/firm information section (BASIC) at the NFA's website!
If you're trading forex outside the US, you're in luck! Other countries have regulatory agencies as well and protect individuals as well. More will be mentioned about them later.

If the broker in question is not registered or regulated by any national agency, then **DO NOT** deposit your money with them. We warned ya, so don't complain to us if you don't get your money back!
Stay away from non-regulated firms!

U.S. Regulatory Agencies

Commodities Futures Trade Commission (CFTC)

In the United States, we like to call the CFTC… Big Brother.

This agency was developed in 1974 to protect individuals (average cool dudes like you and the FX-Men) in futures and commodities trading. Since futures include the currency market, the CFTC "naturally" protects forex traders as well.

From 1974 to the present, the CFTC has undergone many changes in hopes of improving trading conditions and creating a level playing field for everyone. The CFTC is also responsible for publishing the Commitments of Traders Report (COT) every Tuesday.
Five commissioners appointed by the President, the offices of the Chairman, and the agency's operating units make up the Commission. The Commission has 3 offices along with HQ located in Washington, D.C. – Chicago, Kansas City, New York.

Futures exchanges are also located in these cities. So if you have a problem with them, you can make your way over there and bust out your uzis and spray them. Just kidding. Don't do that – they're the good guys. They're here to help you.

Imagine if there was no organization out there to protect you. There would be a lot more scammers, and brokers would cheat their clients in a heartbeat. The CFTC provides order in a market that would otherwise be chaotic.

The mission of the CFTC is to protect market users and the public from fraud, manipulation, and abusive practices related to the sale of commodity and financial futures and options. In the "unregulated" forex market, this regulatory agency will help you determine if a forex company is reliable or trustworthy.

The CFTC's Website can be found here:

http://www.cftc.gov/index.htm

If you need to file a complaint or report suspicious activities:

http://www.cftc.gov/consumerprotection/redressreparations/index.htm

National Futures Association (NFA)

The NFA is an industry-wide self-propelling organization created in 1982 that regulates the futures market in the United States. By self-propelling, we mean that the NFA collects dues in order to sustain itself without having to rely on taxpayers' dollars.

If the CFTC is Big Brother, then we like to call the NFA….Little Big Brother. NFA's activities are overseen by the Commodity Futures Trading Commission (CFTC), the government agency responsible for regulating the U.S. futures industry.

The NFA's mission is to:

- Ensure futures industry integrity
- Protect market participants
- Enforce NFA members to meet their regulatory responsibilities

Virtually every firm or individual who conducts futures or options on futures business with the public must be registered with the CFTC and a Member of NFA. NFA performs the registration process on behalf of the CFTC.

NFA Member categories include: Commodity Trading Advisors (CTA), Commodity Pool Operators (CPO), Futures Commission Merchants (FCM) and Introducing Brokers (IB).

In order to conduct any business in the futures market, you would have to be a member of the NFA. To be a member of the NFA, an organization would have to pass a screening done by the NFA and comply with NFA standards and regulations.

These rules and regulations provide market integrity and a level playing field for all, and not just for investors.

Over time, they have been making significant progress. In order to resolve futures-related issues, the NFA began an arbitration method in 1983. In 1991, a mediation program was developed as a faster way to resolve disputes.

In late 2001, the NFA started to accept claims online. Members could also start registering online in 2002.

In 2004, the NFA started to submit digital images of fingerprint cards to the FBI enabling quicker background checks and shorter registration times. What an active organization! This goes to show that they keep up with the times. Who knows, they might just make their own iPad app. Ha!

Along with the CFTC, the NFA provides investors and individuals with security and protection from fraud and scams.

The NFA's website can be found at http://www.nfa.futures.org/index.asp.

Foreign Regulatory Agencies

UK: The FCA and PRA

If you live in the U.K., the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA) are for you! On April 1, 2013, both of these agencies replaced the Financial Services Authority (FSA) as the financial industry's regulatory bodies.

The Financial Conduct Authority is a non-government agency funded by the firms they regulate, and they are accountable to a Board appointed by the Treasury. Their goal is to protect consumers, ensure industry stability, and promote healthy competition in the financial services industry through the regulation of financial advisers, asset managers, or any firm not covered by the PRA.

FCA website: http://www.fca.org.uk
The Prudential Regulation Authority is a part of the Bank of England, and their main role is to promote a healthy UK financial system through the regulation and supervision of banks, credit unions, major investment firms, and insurers.

PRA website: http://www.bankofengland.co.uk/pra

Finanstilsynet

The Danish FSA was formed in January 1988 and was charged with supervising financial activities in Denmark. Members of the FSA are monitored in attempt to protect investors and prevent market abuse.

Finanstilsynet's website: http://www.dfsa.dk/en.aspx

Swiss Federal Department of Finance

The Federal Department of Finance or FDF was formed in 1848. While the FDF is the overseer of financials in Switzerland, it is the Swiss Financial Market Supervisory Authority or FINMA that regulates the banks, securities dealers, and stock exchanges. FINMA acts like the big brother in Switzerland and does pretty much the same as the other regulatory agencies.

FDF's website: http://www.efd.admin.ch/index.html?lang=en
FINMA's website: http://www.finma.ch/e/Pages/default.aspx

Association Romande des intermediares financiers

This organization is similar to FINMA in that they are both from Switzerland, but this body is based on the French speaking part of Switzerland. ARIF was formed in 1999. It too acts as a regulatory agency with members abiding by certain rules and laws.

ARIF's website: http://www.arif.ch/en/index.htm

Hong Kong Securities and Futures Commission

The Hong Kong Securities and Futures Commission (SFC) was formed in May 1989 due to ineffective efforts of two regulating bodies. With a combined single organization, the SFC took charge. It monitors all futures and securities-related activities in Hong Kong.

SFC's website: http://www.sfc.hk/sfc/html/EN/index.html

Australian Securities and Investments Commission

Founded in 1991, the Australian Securities and Investments Commission (ASIC) acts as a corporate regulator in Australia. ASIC regulates companies, financial markets, and financial service organizations as well as insurance, and credit. The organization aims to maintain fairness in the market environment.

ASIC's website: http://www.asic.gov.au/asic/asic.nsf

How To Protect Yourself From Forex Scams

So what have we learned?

Scams ARE real!

Yes! Really bad people are out there trying to make a dishonest living. However, unlucky for them, you are smart! You know that the only way to succeed in currency trading is to learn from square one and build trading experience!

Now say this three times out loud:

“I will not fall for no-risk robots! I will not succumb to guaranteed returns! Lastly, I will not be lazy and let someone else trade me lucky charms *cough* I mean my money for me!”

Now that we have that over with, let’s close out with some questions our viewers have asked us countless times!

Q: How can I protect myself from fraud?

A: Easy. Be educated. Be smart. Know what a scam looks like. Anything that seems too good to be true usually really isn’t true.

Q: How do I choose a forex broker?

A: First and foremost, make sure the broker is regulated by a national agency. Research, research, and do more research! And for reference use our Broker Guide!

Q: Can forex managed accounts be trusted?

A: If your forex manager is yourself, yes! If not, I’d exercise extreme caution. But if you’re persistent and want to find out the hard way, do a background check and make sure the person has proper licenses and certifications.

Q: Are forex robots profitable?

A: It’s possible, but because they’re usually built for a specific set of conditions, their profitability and how long it may be profitable depends on the market. Like human traders, they can go on long profitable runs, have a long string of losing trades in a row, or see-saw somewhere in-between. If you take anything away from the school about them, just don’t think they’re a “set-and-forget” solution to trading; they must be monitored closely as well.

Q: Who do I contact if I suspect fraud?

A: There are specific organizations depending on your location.

United States:
CFTC: http://www.cftc.gov/ConsumerProtection/RedressReparations/index.htm
NFA: http://www.nfa.futures.org/basicnet/Complaint.aspx
United Kingdom:
ActionFraud – the UK’s national fraud and Internet crime reporting centre: http://www.actionfraud.police.uk/
Australia:
Scamwatch: http://www.scamwatch.gov.au/content/index.phtml/tag/reportascam#h2_10

Q: Where can I capture me a leprechaun?

A: Look for a unicorn. Where you’ll find a unicorn, you’ll find a leprechaun!

So remember, forex scams DO exist. Be wary of them and hold onto your hard earned money. The good news is that there ARE legitimate forex companies out there. Make sure you do thorough research on a company if you are thinking about giving them a shot.

What Are Options?

Before we dive into binary options, it's important to get a basic understanding of what options are and how they work.
Traditionally, an "option" contract gives the holder the right to buy or sell an asset at a predetermined price within a certain period of time (or by an expiration date). Note that the holder is not obligated to buy or sell at the predetermined price, he merely has the option to do so if he wishes to. That's why they're called options, yo!

There are two kinds of options: calls and puts. And for this brief overview, we'll only quickly cover the mechanics of option buying.

A **CALL** option allows an investor to **BUY** the underlying asset at a predetermined price, dubbed the "strike price." If an investor expects the underlying asset to rise above the strike price before the contract expires, he would purchase a call option.

On the other hand, purchasing a **PUT** option gives the buyer the right to **SELL** an asset at their chosen strike price. So, if he thinks the market price of an asset will drop below the strike price before the contract expires, he would buy a put option.

The purchase price of an option is also called the “premium,” and when buying options, the premium is the most you will risk or can possibly lose. So, the profit from an option trade is the amount the market has gone beyond the strike price minus the premium at the contract expiration.

For example, let’s say you want to buy a piece of land that is currently worth $100,000. You think it will rise in value by another $30,000 one year from now, but you don’t want to tie up $100,000 for a year in that investment.

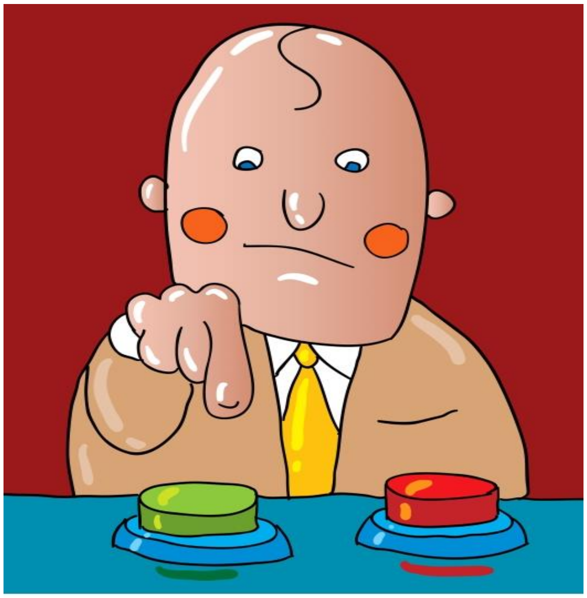
The seller of the land offers to sell an option contract to you to purchase the land for $100,000 (strike price) one year from now. The seller offers the contract at a $5,000 premium. You agree, pay the $5,000 to the seller for the contract and wait to see if the value rises.

Let’s say in one year, the land value increases to $130,000. You decide to exercise your right to purchase the land at the agreed price (the strike), pay the owner the $100,000 contract price and now you own the land. Your profit on the land is the current value, $130,000, minus the purchase price (strike) plus the contract premium: $130,000 – ($100,000 + $5,000) = $25,000.

Alternatively, let’s say that in one year, the land falls in value to $80,000. You are not obligated to exercise the contract and you obviously decide not to buy the land because it has fallen in value. Your only loss is the premium paid ($5,000) to the option seller. As you can see, options are a great alternative to play your market ideas with very limited risk.

Now that you have a basic idea of how options work, we can now take a look at binary options.

What Are Binary Options?



With binary options, it's all or nothing!
You're either right or you're wrong!

Don’t be intimidated! Its name may sound complicated, but binary options are arguably a simpler way to trade than traditional options or currencies.

Just like traditional options, binary options have a premium, a strike price, and an expiration.
The difference is that, with binary options, the “premium” amount for the option is chosen by the trader (usually determined by the market with traditional options) and the expiration timeframes are much shorter.

Traditional options have an expiration range of a week to a couple of years, while binary options have an expiration range of less than a minute to a few days.

These variations bring about the biggest difference, which is how a profitable trade is calculated. But before we cover the ka-ching ka-ching, let’s take a look at how binary option trades work.

With a binary option trade, the broker will pay out a percentage of the premium at risk if the conditions of the contract are met (e.g., the market price is at or beyond your target strike at expiration with a call option).

Basically, you receive a predetermined fixed profit, regardless of how far the market moves beyond the strike price or met the conditions of the contract.

Whether it’s by 1 pip or 1,000 pips, it’s the same profit payout at contract expiration; there is no middle ground. This is why binary options are also known as “all-or-nothing” options.

How To Make Money Trading Binary Options

Now that we have a basic idea on how binary option trades work, let's take a look at a simple example.

Let's say, you decide to trade EUR/USD with the assumption that price will rise. The pair's current price is 1.3000, and you believe that after one hour, EUR/USD will be higher than that level.

You then look at your trading platform and see that the broker's payout is 79% on a one hour option contract with a target strike of 1.3000. After much deliberation, you finally decide to buy a "call" (or "up") option and risk a $100.00 premium. You could say it's similar to going "long" on EUR/USD on the spot forex market.

Ending Scenarios After Entering a CALL Option	**Gain/Loss**
Expiry price is above the strike price (in-the-money)	$100.00 x 79% = $79 $100.00 + $79.00 = $179.00 You gain $179.00 on your account.
Expiry price is equal to or below the strike price (out-of-the-money)	You lose your stake and your account declines by $100.00.

As you can see from the calculations above, the risk you take is limited to the premium paid on the option. You cannot lose more than your stake. Unlike in spot forex trading, where your losses can get bigger the further the trade goes against you (which is why using stops are crucial), the risk in binary options trading is absolutely limited.

Payouts in Binary Options

Now that we've looked at the mechanics of a simple binary trade, we think it's high time for you to learn how payouts are calculated.

More often than not, the payout will be determined by the size of your capital at risk per trade, whether you're in- or out-of-the-money when the trade is closed, the type of option trade, and your broker's commission rate.

In the example given above, you bet $100 that EUR/USD will close above 1.3000 after an hour with your broker offering a 79% payout rate. Let's say that your analysis was spot on and your trade ends up being in-the-money. You would then get a payout of $179.

$100 (your initial investment) + $79 (79% of your initial capital) = $179

Easy peasy, right? Don't get too excited just yet! You should know that there's no one-size-fits-all formula for calculating payouts. There are a few other factors that affect them.

Factors in Payout Calculations

Each broker has its own payout rate. For starters, Forex Ninja's intel shows that most brokers offer somewhere between 70% and 75% for the most basic option plays while there are those who offer as low at 65%. Various factors come into play when determining the percentage payout.

The underlying asset traded and the time to expiration are a couple of big components to the equation. Normally, a market that is relatively less volatile and an expiration time that is longer usually means a lower percentage payout.

Next, the broker's "commission" is also factored into the payout rate. After all, brokers are providing a service for you, the trader, to play out your ideas in the market so they should be compensated for it. The commission rate does vary widely among brokers, but since there are so many binary options brokers out there (and more coming along), the rates should become increasingly competitive over time.

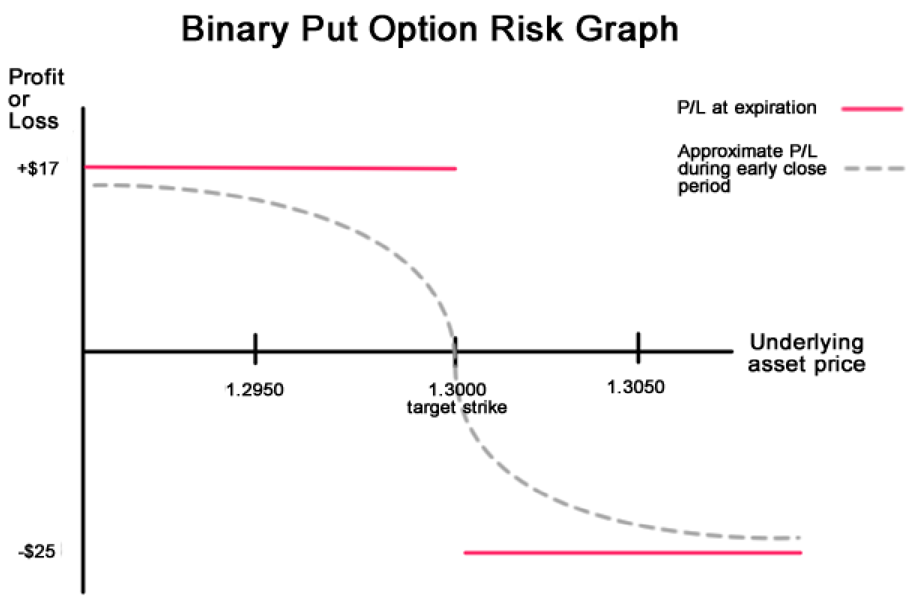
When a Binary Option Trade is Closed

As mentioned before, binary options are typically "all-or-nothing" trading instruments in that the payout or loss is only given at contract expiration, but there are a few brokers that allow you to close a binary option trade ahead of expiration.

This usually depends on the type of option, and usually it's only available within a certain timeframe (e.g., available 5 minutes after an option trade opens, up until 5 minutes before an option expiration). The trade-off for this flexible feature is that brokers who do allow early trade closure tend to have lower payout rates.

When trading with a binary option broker that allows early closure of an option trade, the value of the option tends to move along with the value of the underlying asset.

For example, with a "put" (or "down") option play, the value of the option contract increases as the market moves below the target (strike) price. This means that, depending on how far it has moved passed the strike, the closing value of the option may be more than the risk premium paid (but never greater than the agreed maximum payout).



Conversely, if the underlying market moved higher, further out-of-the-money, the value of the option contract decreases and the option buyer would be returned much less than the premium paid if he/she closed early.

Of course, in both cases, the broker commission is factored into the payout of an option trade when closed early.

So before you decide to jump head first into trading binary options, make sure you do your research and find out what your broker's payout rates and conditions are!

3 Types Of Binary Options

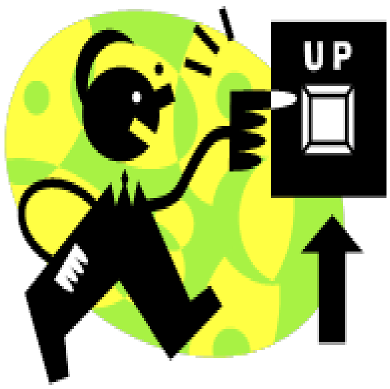
The main factor when talking about payouts is the type of binary option traded.

The option trade example given in the previous section is a type of an "up/down" option and is considered the simplest kind. Predicting if a currency pair would be above or below the strike price before it expires pays the lowest return. This averages between 70%-90% depending on your broker.

Meanwhile, the are more complicated kinds of options like the "touch and range" binary options, which have higher payouts since winning such trades tends to be harder. From what we've gathered, brokers usually offer payouts around 200%-400% and a few can even go as high at 750%!

Up/Down Options

An **Up/Down option** can go by a few different names: High/Low, Above/Below, and Over/Under. It is the simplest and most common type of binary option.



Traders simply purchase a “call” option if they believe that the closing price will be above the strike price when the contract expires, or buy a “put” option if they think that market will close below the strike price at expiration. The EUR/USD trade example given in the previous section illustrates how an Up/Down option typically works.
Easy enough, eh? The simplicity of this option is why Up/Down options usually have the lowest payouts.

Up/Down options typically expire within an hour or a day, but some brokers are offering options that expire in minutes. Heck, some even expire in seconds! Of course, this could either do your account a lot of good or it can cause a whole lot of damage. Make sure you manage your risk properly!

Touch Options

One Touch option trades don’t require the market to be above or below a certain level at expiration. Instead, it just needs to TOUCH the strike price at least once during the option contract period for it to be profitable.
No-Touch trades, on the other hand, require that the market price DOES NOT TOUCH the strike price during the life of the contract for a trader to make profits.
Touch trades are offered during certain times of the day, and some brokers offer touch trades during weekends that usually offer higher payouts (around 250%-400% of your risk premium) than a simple Up/Down option trade.

For example, let’s say that EUR/USD closed at 1.3100 on Friday. Over the weekend your broker offers a call option where you will profit if EUR/USD touches 1.3450 at least once next week and a put option where you will profit if the pair touches 1.2750 at least once in the same period.

You decide to take the call option. You find that during the option period EUR/USD had reached a high of 1.3600 before it closed at 1.3050. Since the market reached the call option’s strike price (1.3450) within the option period, you would have won the trade even if it didn’t close above the level.

On the contrary, those who took a No-Touch option on the same price would have lost their trades since the pair DID touch the strike price.

Touch trades typically work out well when volatility picks up while no-touch trades are ideal for pairs that have a tendency to consolidate.

Still not exciting enough for ya? You can also try out **Double Touch/Double No-Touch** options! They are just like Touch/No-Touch options, only with two strike prices. The asset’s price has to touch (or not touch) two different levels for a trader to win the trade.

Range Options

Trading Range/Boundary/Tunnel options is a lot like playing the Super Mario underwater level wherein Mario cannot touch both the top and the bottom of the screen.

For **In Range** trades, the market price must stay within a predetermined range and avoid touching the two strike prices within the option period in order for your trade to be in-the-money.
Some brokers offer **Out of Range** options where traders can profit if price breaks out of the predetermined range within the option period.
For example, EUR/USD is currently trading at 1.3300 and the ECB interest rate decision is minutes away. Your broker is offering a range option between 1.3280 and 1.3320 that expires in one hour. You think that the ECB's decision is a non-event so you bought an "in-range" option.

If price doesn't reach 1.3280 or 1.3320 within the option period, then you would have won your trade. That should be awesome news for you because range options usually have the highest payouts with a few brokers offering between 200%-750%!

Range options are best used when volatility is low, although some brokers offer the option to take risk on the idea that price WILL break out of the predetermined range. Alternatively, a few brokers also offer options on predetermined ranges that are far from the current market price.

Market Analysis For Binary Options

Remember back when you enrolled yourself into the School of Pipsology, we talked about "The Big Three" types of market analysis. In case you forgot, they are:

1. Fundamental Analysis
2. Technical Analysis
3. Sentiment Analysis

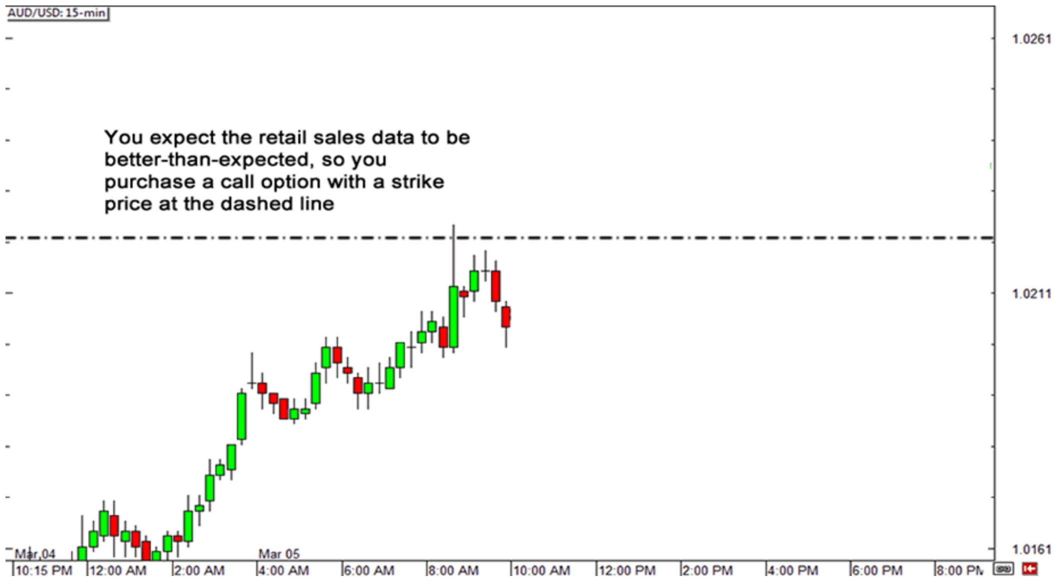
Why are we bringing this up again? Well, the good news is that these building blocks of analysis can also be used when trading binary options!

Fundamental Analysis

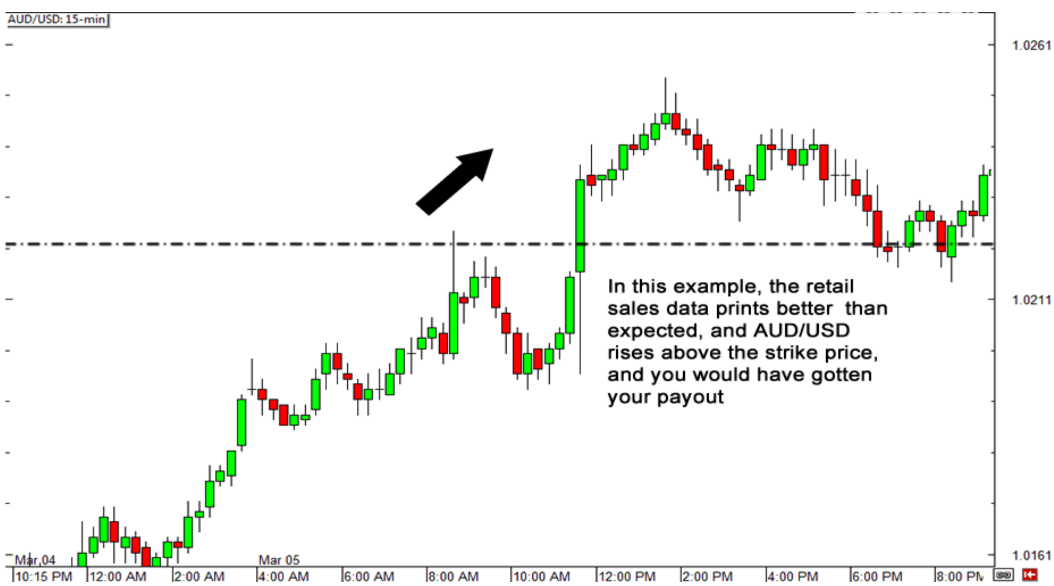
Trading the News

One way to make use of fundamental analysis would be to go with a trade-the-news strategy. If you've gone through our lesson on this trading strategy, you would know that this is best applied to those events that usually cause a ton of volatility. The spike in volatility tends to lead to fast moves which can send price rocketing higher or plunging lower.
For binary options, this can be particularly effective when you trade simple Up/Down options. After all, you would simply need to get an idea how price may react to better/worse than expected data and how strong the reaction may be. You just have to be confident that price can reach the strike price of the option that you bought.

For example, you plan to trade the Australian retail sales report. Let's say you have a bullish bias on the results. Chances are that a better-than-expected result will spur the Aussie to new highs, so you would look to buy a "call" option on AUD/USD.



Now let's say that, as you expected, we saw a better-than-expected result. Luckily, AUD/USD also rose, rising above the strike price. Paycheck time, baby!



Of course, there are a couple of factors to take into consideration when playing the news.

First is the potential for volatility. When playing a news report and buying a binary option, you have to be fairly confident that the event will spark enough volatility so that price can reach the strike price and stay above/below that level. If you try trading a report that rarely causes a ripple, you'll be throwing money down the drain.

Second, you have to factor in the time component of binary options. Remember, for the simple Up/Down options, price has to be above or below the strike price at the expiration date.

When trading binary options and implementing a trade-the-news strategy, you may also want to consider going with one-touch options since price would only have to touch and not necessarily close at a particular level.

You can also try the Out of Range options if you expect the price to move with strong momentum away from its previous range. With this option you don't have to pick a direction, just decide whether or not the market will move big time in one direction or another.

Technical Analysis

Love using those fancy-schmancy indicators like moving averages, Bollinger bands, and Stochastic? Don't be afraid to slap these indicators on your trading charts when you plan to trade binary options!
Remember, these indicators help you gauge where price action may be headed next. These are used across all sorts of trading markets and not just spot currencies. Just make sure you have a good understanding of how each indicator works before incorporating it into your analysis.

Studying technical levels and inflection points may also prove helpful when you trade binary options.

Let's take a look at this example on GBP/USD.

Price has just broken down from a double top. With this behavioral pattern, price normally continues to trade lower at a distance equivalent to the height of the double top.

One way you could play this is by taking a One-Touch trade. If the strike price that your broker offers is somewhere between 1.5450-1.5550, which is within the height of the double top, buying a "put" option might be a setup worth considering.

Sentiment Analysis

Sentiment analysis is the task of measuring the market's current "feeling" with regards to broad risk flows. Are traders confident in buying up risky assets or would they rather reduce risk by buying safe-haven assets or going into cash? This type of analysis will prove to be particularly useful when trying to hop on trends.

Will EUR/USD break for new highs? Or do you think the trend is overdone and there's not enough momentum? You can use sentiment analysis to gauge how the market is feeling.

If it seems that risk appetite is still at a high with no potential changes to the market themes in sight, then the chances are we could see the trend continue. If you're fairly confident that market sentiment will favor a risk-on environment, you could consider purchasing a "call" option on a risk currency or asset (e.g., Australian or New Zealand Dollar, Equities, Commodities, etc.)
On the flip side, if you think a reversal in sentiment is in play and depending on how overdone you believe the move is, you could consider purchasing a "put" option on those same risk currencies or assets.

Combination

Just as in spot forex trading, it's not necessarily a case of choosing which type of analysis you're going to use because they're not mutually exclusive.

In fact, you can combine all of these types of analysis to form the basis of any trade that you take. Fundamentals can help give you a bias as to what direction you want to take, while technical analysis will help determine the chances of the market reaching, breaking and finding support/resistance at a certain price. Meanwhile, sentiment analysis may let you know whether the market is in a risk-on or risk-off mood.

In the end, the key is for you to learn from all your mistakes and gain experience. Over time, this process will help you fine tune your analysis and help you develop good trading practices.

Are Binary Options Regulated?

Binary options trading is the new kid on the block, gaining the attention of regulators only recently as it is now being offered by many brokers, both old and new to the industry.

Unlike spot forex trading, which is overseen by the CFTC, NFA, or other foreign regulatory agencies, there aren't a lot of regulators overseeing binary options trading at the moment.

Of course, with binary options gaining popularity, the ball is starting to roll on creating regulations for this relatively new way to trade. Cyprus Securities and Exchange Commission (CySEC) was the first regulatory body to consider binary options trading as a financial instrument back in May 2012.

In the U.S., one of the top binary options broker, Banc de Binary, made an initiative to seek regulation from the CFTC for its operations. Other binary options brokers are expected to follow suit.

Across the globe, other regulatory agencies are also starting to keep a closer eye on binary options trading. The Japanese Financial Services Authority is drafting its regulations for Japan, the largest market for the product.

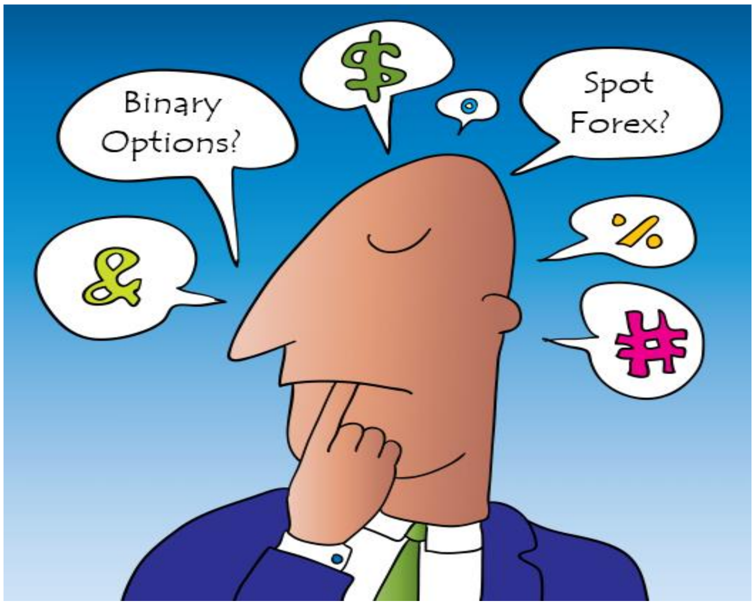
Over in Malta, the Maltese Financial Services Authority (MFSA) is making arrangements to take charge of regulating binary options brokers in the country.

In line with this, brokers will undergo an application procedure and a strict due diligence process to secure its license to operate. Among the possible application requirements are that binary options brokers fall under the Investment Services Category 3 license and will be subject to a minimum capital requirement of €730,000.

If you're planning to open a binary options account, make sure you do so with a regulated broker. Regulated brokers are usually held to higher operating standards, and if you do have issues (e.g., trade execution, withdrawing funds, etc.), you have a higher power to help you resolve those issues with the broker.

Although unregulated brokers shouldn't automatically be viewed as scammers, trading with them could entail risks such as a lack of guarantees that the firm's operating funds are kept separate from client funds. Plus, there will be no one to hear your case and take action on your behalf if you have an issue.

Binary Options Vs. Forex



Binary options trading has long existed over-the-counter, only experiencing a massive growth spurt in the last few years. Now, approximately 90 companies (including those who white label their products) offer some sort of binary options trading service.

So okay, it's a growing industry… But why should you involve yourself in it? Why should you learn a whole new type of trading when you're already learning spot forex? Isn't it better to something you already know?
There are many advantages and disadvantages to both binary options and spot forex. We'll touch upon a few and hopefully, you can determine which trading instrument may be right for your trading style.

Max Risk

One of the great things about binary options trading is that you always know the exact maximum gain or loss in advance. The trader controls the premium at risk to enter the binary option trade, and that is the only amount that can absolutely be lost. Most binary option brokers even allow you to cut your max loss by "folding" your trades ahead of expiration after certain types of trade conditions have been met.

In contrast, with spot forex, even with a stop loss order set, you cannot be 100% certain that you will lose only the pre-calculated amount that you risked. While improbable, there's always the chance that certain issues may affect your final max risk like slippage, lack of liquidity to execute a stop order at the desired price, a broker's trading platform goes down, etc.

Trade Management Flexibility and Maximizing Reward

Aside from High/Low options, many of the binary option plays are only available at certain times of the day or week, and most times the strike prices are set by the broker.

Even if you have an idea of how a market might behave within a certain time frame, you may not have the best option available to you to play your idea. With spot forex, you are able to enter limit orders for any price or execute a market order at any time during open market hours.
In terms of exiting open trades, some binary options brokers allow you to close options trades early, but usually only after a predetermined amount of time has pass after the option trade has opened and before it closes.

And as mentioned before, the value that is returned to the trader is based on whether the market is in-the-money or out-of-the-money and of course, with a piece going to the broker.

In spot forex, you can close your trade at any time (except on weekends with most brokers). Even if it's one second into the trade, you can get out and book profits or reduce losses.

Finally, if you think there's going to be a long trend and you want to maximize your profit on it by holding it as long as possible, you can do so in the spot market using scaling in and trailing stop techniques. With a binary option, the expiration date and cap on profits limits you; you're out of the trade as soon as you close or the option expires.

Depending on your risk and trade management preferences, either trading instrument can be good or bad depending on how much time you want to spend in front of your trading platform, how active you want to be, or what you expect the market may do.

Transaction Costs

In binary options trading, there are no additional transaction costs other than what is normally factored into the final payout.

In spot forex, the transaction cost comes in the form of a spread, a commission, or both. We've already discussed this in a previous chapter, but feel free to revisit the lesson and read up on it again.

Trade Choices

Another great thing about binary options trading is that you aren't limited to just currency pairs like with most retail forex brokers. While currency pairs are the most common assets you can trade, with some binary options brokers, you may also have the opportunity to trade your ideas on a limited number of individual stocks, stock indices, and even commodities.

Volatility Risk

Surprise volatility is not usually an issue in binary options trading. Any trade you take can weather the volatility caused by certain events. Provided that your view turns out to be correct, you don't need to worry about the market's knee-jerk reactions. The max risk is still set, but so is the max reward.
In spot forex, however, sharp swings can affect the value of a position greatly and very quickly, which makes the additional task of setting up proper risk management processes very important.

Trader Error

The margin for error when entering a trade is very small in binary options trading. This is due to the fact there are only two actions to take with binary options: open and close.

There are no limit orders to keep track of, or to close or adjust. In spot forex, an inattentive trader may forget to place exit and/or adjustment orders, potentially creating a loss greater than he/she intends.

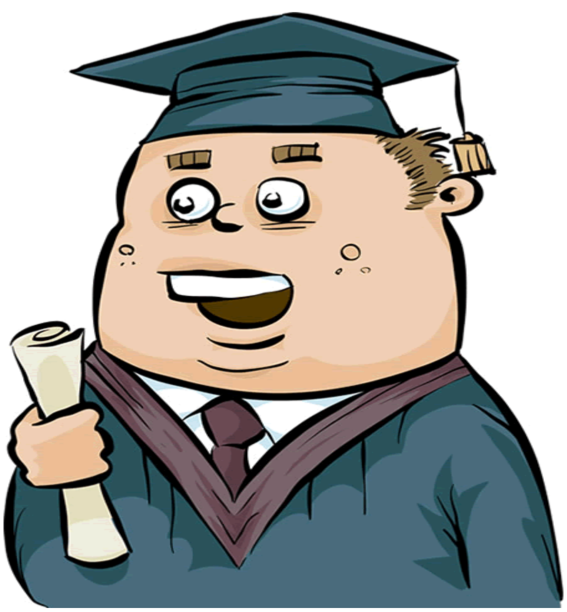
Quiz: Which Trading Style Is Best For You?

In our Junior Year, we learned that each forex trader is unique and that various trading styles fit different types of personalities. If your personality doesn't match your style of trading, you could wind up hurting your account and your ego. This quiz can help you find out whether you are better off as a scalper, a day trader, a swing trader, or a position trader.

Which Trading Style Is Best for You?

Disclaimer: Take the results with a grain of salt. The results you get are just recommendations based on your answers and are meant to get you onto the right path. As you get better, keep an open mind to all new experiences and realities to help you evolve and grow your trading abilities.

Congratulations! You Made It!



You made it!

You've read all six gazillion pages of the School of Pipsology and now you have everything you need to conquer the forex world, retire in a year or two, and then go travel the world in your Gulfstream jet, right?

Think again noob!

Sorry to burst your bubble, but you have just barely scratched the surface.

We're not going to sugarcoat things. We told you early on that it was going to be difficult.

If you're a noob and just finished the School, you're most likely going to be horrendously bad at trading.

But that's okay. Unlike noodles, there's no such thing as an instant expert currency trader. Anything that's worth learning well takes time. That's why instant noodles taste disgusting.

Going straight into the markets and trading a live account would be like trying out for the NBA just right after reading "Basketball for Dummies". You'd probably get out-smarted, out-hustled, out-muscled, and out-maneuvered. You just haven't developed the skills or mental/physical conditioning enough to hang with the pros yet.

It's the same thing with the forex markets.

The currency world is dynamic and complex. It's ruled by brainiacs with PhDs and MBAs from Ivy League Schools, who have huge amounts of capital, and all the technological toys money can buy.

When you enter the forex trading world, you have be ready to dive in and wrestle with the biggest sharks. And they love feasting on noobs.

Are you scared now?

Good!

We just did that to make sure you understand that even though you've got to have fun in everything you do, forex trading is serious business and you have to approach it that way.

With all that said, anyone with the passion and commitment to learn this business has the chance to get their small piece of a very, very big pie and then some.

Yes, you can make it, but before beginning your forex trading adventure, here are a few lessons we've learned that we'd like to share to help you get started on the right path.

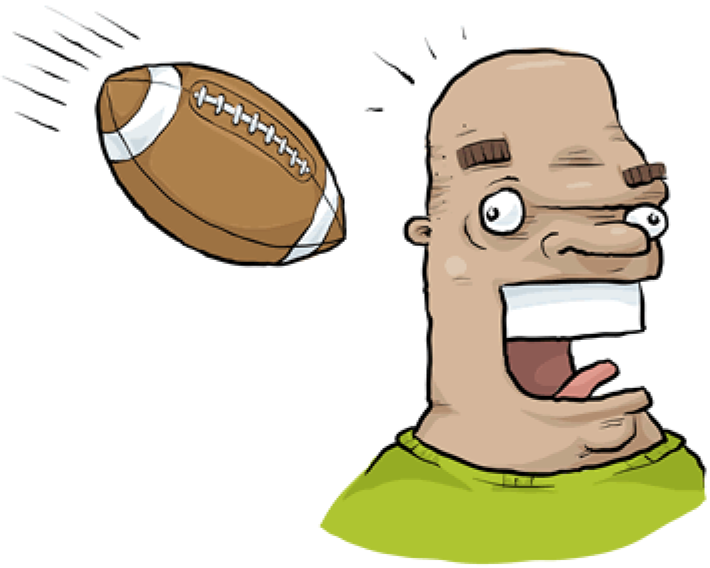
Focus on the Process. Not on the Profits.

Why do I keep thinking about the money?
I must focus on the process!

We've made the School of Pipsology as easy and fun as we could to help you learn and understand the basic tools and good practices used by forex traders all over the world, but remember that a tool and technique is only as good as its handler.

A painting does not become a beautiful masterpiece by the brush alone. It's the vision and skillful hand of a painter that creates a work of art.

A football doesn't find its way to the end zone by itself. It is the quarterback's ability to read a defense, position his players accordingly, and send the football to the right spot at the right time.



It's not the "ridiculously awesome" indicator, the Cowabunga system, or the "super duper" forex strategy that gets your account in the black at the end of the year.
It's your ability to read the market, execute the correct strategy for that particular situation, and consistently apply proper risk management techniques that hopefully gets you more profitable wins than losses in the long run.

Like in art, sports, or any performance endeavor, forex trading is a multi-faceted skill. The tools alone won't make you successful.

A dedicated effort towards education and application of what you learn, as well as the constant review of your performance is the only path to success.

In the beginning, that **process** of learning and *deliberate practice* should be your main focus, NOT the profits.

Continuing with the basketball analogy, if your goal was to reach the NBA, would you get to the level of performance you desired by playing games only?

Or would you develop faster by focusing on physical conditioning, developing different skills (a jumpshot, dribbling, footwork, passing, etc.) in practice, as well as playing games?

Probably the latter right?

If you went straight to the NBA without any training, do you think you'll score many points or win games?

Nope. We didn't think so.

Learn the market. Learn forex trading techniques and high probability setups/systems.

Learn how to manage risk with proper position sizing and stop losses to limit risk and maximize reward.

Learn how to put it all together in DEMO.

Then record and review your progress constantly at MeetPips.com.

Over time, this process will lead you to a forex trading method or system that works for YOU and that's when your winning trades begin to outweigh your losing trades.

Holy Cow! There's No Holy Grail!

This must be the Holy Grill!

Ask any quant on Wall Street (the super geeky math and physics PhDs who create complex algorithmic trading strategies) why there is no "holy grail" indicator, method, or system to pull profits 100% of the time. He or she will give you these two reasons:

1. You can't predict the future.

Is there anyway to know what a central bank president will say during a speech? Or maybe what a super famous investor or hedge fund manager says during a random TV interview?

Do you know when the next terrorist attack will hit and cause risk aversion?

How about a natural disaster like an earthquake or tsunami?

The list of unforeseen market moving catalysts is infinite and when they happen, they can rock the markets and your forex trading system.

Understand that this is part of trading and the best you can do is be prepared to limit your losses if they occur.

Be ready to have your world rocked. And we don't mean that in the way you think it means.

2. Data doesn't move the market. Humans do.

There will be times when data or market themes do not mesh with price action.

Why is that?

Maybe the outcome was priced in ahead of time? Maybe forex traders weren't focused on the data that was released? Maybe there was an institution covering a huge position that was on the wrong side of the market?

Would all players in the market react to an unforeseen catalyst the same way?

Whatever the price behavior may be, the decisions that lead an forex trader to take action aren't always logical or congruent to the information out there.

When you multiply this by the millions of players with different goals/strategies and different sized trading accounts, it becomes impossible to tell where the overall market will go every single time.

You can't quantify or calculate human behavior and unknown future events into an elegant mathematical equation to completely get rid of risk.

There will always be some level of uncertainty and there will be times when you will be on the wrong side of a currency market move.

Actually….there will be MANY times when you will be on the wrong side of a currency market move.

Perfectionists should probably stay away.

For those of you who always feel the need to be correct, we must warn you now…

Nobody can perfectly predict the market every single time.

Nobody.

All hope is not lost though if you decide to stubbornly not listen and continue your search for the Holy Grail.

Rumor has it that if you can find a pink unicorn standing under a rainbow, you will come across an invisible leprechaun who will give you the Holy Grail. And the iPhone 6! Good luck.

Be Patient. Stay Disciplined.

Patience.

It's a virtue…Especially with forex trading.

Arnold H. Glasgow, an American humorist, once said, "The key to everything is patience. You get the chicken by hatching the egg, not by smashing it."

Developing your currency trading plan will take time. Developing skills will take time.

Waiting for the right trade opportunities requires patience. Entering and exiting a trade at the right moment requires patience.

Discipline.

Discipline is also a virtue, and it means doing the things you need to do to progress and get better….even if you don't want do it.

This means preparing for each forex trading day or week with research and chart study.

If you're a mechanical or automated trader, this means back testing systems and constantly trying different settings and strategies as the environment changes.

And of course, don't forget about keeping a trade journal and reviewing every single day you trade.
Journaling is the one trading task that separates the wannabe traders from the real deal traders. Unfortunately, most newbies won't do it.

Forex trading concepts and techniques are simple and easy to learn. What's hard to learn is how to be patient and disciplined to do the right things and make good trading decisions. Truthfully, it will be one of the most difficult endeavors you will ever take on.

To a newbie, sitting on the sidelines and watching the markets move while you wait for your best setups means you're missing out on profits.

This way of thinking leads to a failure of patience and discipline and causes some of the most notorious trading mistakes in the book:

- Impulse trades
- Letting losers run too long
- Cutting winners too quickly
- Revenge trades

These actions will kill your account!

Remember that your job as a newbie is to learn how to make good trading decisions and **SURVIVE**!
The best thing you can do to stay patient and disciplined is to look at your career as a trader as a **marathon** and NOT a sprint.
This is not an overnight, get-rich-quick scheme.

This is a commitment to build skills that will allow you to profitably trade in any environment the market will throw at you at any time.

And essentially, free you from the chains of the "Man." Fight the Power!!

If you stay patient, maintain discipline, and commit to constant improvement, then your results today as a forex noob will probably be nothing compared to the results of the trader you will become after years grinding it out in the markets.

Another thing….

Always remember that opportunities for good trades occur ALMOST EVERY SINGLE DAY!

No need to rush into bad currency trades. They will only set you back from reaching your goals.

Stick to your best ideas and setups, and if they don't come that session, just wait for the next.

Unless the world stops trading currencies (knock on wood) then there will always be opportunities around the corner.

Love The Forex Game

NBA champ and MVP Kobe Bryant MAKES 1,000 shots a day in practice to increase his chances of making the 20-30 shots a game he takes. Along with team practice, Peyton Manning (NFL champ and MVP) watches hours and hours of tapes of opposing teams every day (even during the offseason) to develop his uncanny ability to read defenses and score against them in one 60-minute game a week.
Tiger Woods wins golf tournaments for a living. He has won 14 major golf tournaments and 79 PGA tour events – more than any active golfer. He practiced religiously every day for 15 years before winning his first pro event at the tender age of 18.

The obvious commonality between these champions is that not only do they work their butts off, but they also love with they do. They love the challenge and the competition.

Their passion for the game is so strong that it gets them through the hours upon countless hours of tedious tasks that others may not enjoy like tape watching, suicide drills, weight training, putting drills, etc.

To them, these things are fun!

Again, we're not gonna sugar coat things. You're all big boys and big girls.

There will be days when trading SUCKS!

It will get to the point where you think "Gosh darnit! &#$(*&!! I wanna quit now."

There will be days when you will be totally clueless. You won't understand why the market is not moving with the news or why your mechanical system is getting chopped up.

There will be days when you will feel extremely lazy. You won't feel like journaling. You won't feel like reviewing your trades.

Trust us, you will experience a lot of these days. Especially in the beginning.

On days like these, it's the "love of the game" that will keep you doing the things you need to do to become a good trader.

To become a good forex trader, it doesn't take a genius IQ, an Ivy League pedigree, or the need to have three arms and three eyes.

It will take hours, LOTS of hours of market study, chart time, and *deliberate practice* to trade well. If you embrace the challenges of trading the currency market and have fun picking it apart, your chances of surviving and thriving will be improved immensely!
Okay, that's it. Thanks for listening and completing My Forex Trading Bible.

We really appreciate that you decided to begin your forex trading journey with us.

Grind it out.
Never quit improving every day and you could change your life for the better.

Good luck and good trading!

School's Over! Now What?