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3rd Edition

Currency Trading FOR DUMMIES®

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- Apply mobile and platform trading solutions
- Use tips and hints from professionals

Kathleen Brooks

Brian Dolan

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by Kathleen Brooks and Brian Dolan

For Dummies
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Contents at a Glance

Table of Contents

Introduction

Today, millions of individual traders and investors all over the world are discovering the excitement and challenges of trading in the forex market. You don't even have to be at your desk to trade — these days, you can trade on the go using a smartphone or other handheld device.

No question about it, the forex market can be one of the fastest and most volatile financial markets to trade. Money can be made or lost in a matter of seconds or minutes. At the same time, currencies can display significant trends lasting several days to weeks and even years. Most important, forex markets are always moving, providing an accessible and target-rich trading environment.

In contrast to stock markets, which are more familiar and relatively intuitive to most investors, the forex market somehow remains more elusive and seemingly complicated to newcomers.

In this book, we show you how the forex market really works, what moves it, and how you can actively trade it. We also provide you with the tools you need to develop a structured game plan for trading in the forex market without losing your shirt. We cover the following:

- Getting a handle on the forces that drive currency movements
- Understanding forex market trading conventions and strategies
- Interpreting economic data and official statements
- Finding sources of data and market intelligence
- Gauging market psychology, sentiment, and positioning
- Identifying key traits of individual currency pairs
- Utilizing technical analysis to spot trade opportunities
- Developing a regimented and disciplined approach to trading currencies
- Focusing on risk management to minimize losses and keep more of your gains

About This Book

If you're an active trader looking for alternatives to trading stocks or futures, the forex market is hard to beat due to its sheer size (more than $5 trillion turnover per day at last count) and the depth of the market.

But as an individual trader, gaining access to the forex market is only the beginning. Just because you've got the keys to a Formula One race car doesn't mean you're ready to compete in a Grand Prix. First, you have to understand how the car works. Then you have to figure out some of the tactics and strategies the pros use. And *then* you have to get behind the wheel and practice, developing your skills, instincts, and tactics as you go.

To succeed in the forex market, you'll have to do the same. This book gives you the no-nonsense information you need, with the perspective, experience, and insight of two forex market veterans.

Whether you're an experienced trader in other markets looking to expand into currencies, or a total newcomer to trading looking to start out in currencies, this book has what you need. Best of all, it's presented in the easy-to-use *For Dummies* format. Divided into easy-to-follow parts, this book can serve as both your reference and troubleshooting guide.

Note: Trading foreign currencies is a challenging and potentially profitable opportunity for educated and experienced investors. However, before deciding to participate in the forex market, you should carefully consider your investment objectives, level of experience, and risk appetite. Most important, don't invest money you can't afford to lose. The leveraged nature of forex trading means that any market movement will have an equally proportional effect on your deposited funds; this may work against you as well as for you. (To manage exposure, employ risk-reducing strategies such as stop-loss or limit orders.) Any off-exchange foreign exchange transaction involves considerable exposure to risk, including, but not limited to, leverage, creditworthiness, limited regulatory protection, and market volatility that may substantially affect the price or liquidity of a currency or currency pair. Using the Internet to trade also involves its own risks, including, but not limited to, the failure of hardware, software, and Internet connection.

Finally, this book is a reference. You don't have to read it from beginning to end, in order; instead, you can use the table of contents and index to find the information you need right now. *Sidebars* (text in gray boxes) and anything marked with the Technical Stuff icon are skippable — they're interesting but not essential to your understanding of the topic at hand. Also, within this book, you may note that some web addresses break across two lines of text. If you're reading this book in print and you want to visit one of these web pages, simply key in the web address exactly as it's noted in the text, pretending as though the line break doesn't exist. If you're reading this as an e-book, you've got it easy — just click the web address to be taken directly to the web page.

Foolish Assumptions

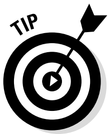
Making assumptions is always a risky business, but knowing where we're coming from may help put you at ease. Obviously, not all these assumptions will apply to you, but at least we'll have it all out in the open. In writing this book, we assume the following:

- You've heard about currency trading, and you're looking to find out more about what's involved before you try it.
- You're intrigued by the international dimensions of the forex market, and you want to find out how to profit from currency movements.
- You're seeking to diversify your trading activities or hedge your investments.
- You want to discover more about technical analysis and how it can be used to improve trading results.
- You understand that trading currencies carries the risk of losses.
- You're prepared to devote the time and resources necessary to understand what's involved in currency trading.
- You have the financial resources to pursue margin trading, meaning that you'll never risk more than you can afford to lose without affecting your lifestyle.
- You aren't gullible enough to believe the infomercials that promise easy money by trading currencies.
- You understand that there is a big difference between gambling and speculating.

These assumptions should serve as a healthy reality check for you before you decide to jump into currency trading actively. A lot of it is similar to being a weekend golfer and being disappointed when your play doesn't reach pro-level scores. But when you think about it, why should it? The pros are out there practicing and playing all day, every day — it's their full-time job. Most people can only hope to get a round in on the weekend or get to the driving range for a few hours a week. Keep your perspective about what's realistic for you, and you'll be in a much better position to profit from actively trading.

Icons Used in This Book

Throughout this book, you see icons in the margins, highlighting certain paragraphs. Here are the icons we use and what they mean:



Theories are fine, but anything marked with a Tip icon tells you what currency traders *really* think and respond to. These are the tricks of the trade.

Paragraphs marked with the Remember icon contain the key takeaways from this book and the essence of each subject's coverage.

Achtung, baby! The Warning icon highlights potential errors and misconceptions that can cost you money, your sanity, or both.

You can skip anything marked by the Technical Stuff icon without missing out on the main message, but you may find the information useful for a deeper understanding of the subject.

Beyond the Book

In addition to the material in the print or e-book you're reading right now, this product also comes with some access-anywhere goodies on the web. Check out the free Cheat Sheet at `www.dummies.com/cheatsheet/currencytrading` for tips on choosing a broker for currency trading, the fundamentals of currency rates, and more.

You can find articles on trading forex with other asset classes, determining what kind of trader you are, and more at `www.dummies.com/extras/currencytrading`.

Where to Go from Here

This book is set up so you can jump right into the topics that are of greatest interest to you. If you're an absolute newcomer to trading in general and currencies in particular, we recommend reading Parts I and II to build a foundation for the other topics. If you have more experience with trading, use the table of contents and index to find the subject you have questions about right now. This book is a reference — keep it by your computer, and turn to it whenever you have a question about currency trading.

Part I

Getting Started with Currency Trading

For Dummies can help you get started with lots of subjects. Visit www.dummies.com to learn more and do more with *For Dummies.*

In this part . . .

- Get a comprehensive overview of the forex market and how it works.
- Find out what moves currencies.
- Get acquainted with the main players in the forex market.
- Understand the motivations behind trading decisions and simple strategies to get started.
- Find out why the world's biggest market is the most fascinating market.
- Get an introduction to trading plans.

Chapter 1

Currency Trading 101

In This Chapter

- Looking at currency trading as a business
- Getting a sense of what moves currencies
- Developing trading strategies to exploit opportunities
- Implementing the trading plan

The forex market has exploded onto the scene and is the hot new financial market. It's been around for years, but advances in electronic trading have now made it available to individual traders on a scale unimaginable just a few years ago.

We've spent our professional careers in the forex market and we can't think of a better traders' market. In our opinion, nothing quite compares to the speed and exhilaration of the forex market or the intellectual and psychological challenges of trading in it. We've always looked at our work as essentially doing the same thing every day, but no two days are ever the same in the forex market. Not many people can say that about their day jobs and we wouldn't trade it for the world, no pun intended.

What Is Currency Trading?

At its heart, currency trading is about speculating on the value of one currency versus another. The key words in that last sentence are *speculating* and *currency.* We think that looking at currency trading from those two angles — or two dimensions, if you allow us to get a little philosophical — is essential.

On the one hand, it's speculation, pure and simple, just like buying an individual stock, or any other financial security, in the hope that it will make a profitable return. On the other hand, the securities you're speculating with are the currencies of various countries. Viewed separately, that means that currency trading is both about the dynamics of market speculation, or trading, and the factors that affect the value of currencies. Put them together and you've got the largest, most dynamic and exciting financial market in the world.

Throughout this book, we approach currency trading from those two perspectives, looking at them separately and blending them together to give you the information you need to trade in the forex market.

Speculating as an enterprise

Speculating is all about taking on financial risk in the hope of making a profit. But it's not gambling and it's not investing. Gambling is about playing with money even when you know the odds are stacked against you. Investing is about minimizing risk and maximizing return, usually over a long time period. Speculating, or active trading, is about taking calculated financial risks to attempt to realize a profitable return, usually over a very short time horizon.

To be a successful trader in any market requires

- Dedication (in terms of both time and energy)
- Resources (technological and financial)
- Discipline (emotional and financial)
- Decisiveness
- Perseverance
- Knowledge

REMEMBER

But even if you have all those traits, there's no substitute for developing a comprehensive trading plan (see Chapters 11, 12, and 13). You wouldn't open up a business enterprise without first developing a business plan (at least we hope not!). So you shouldn't expect any success in trading if you don't develop a realistic trading plan and stick to it. Think of trading as if it were your own business, and approach it as you would a business enterprise, because that's what it is.

TIP

Above all, try not to take your trading results too personally. Financial markets are prone to seemingly irrational movements on a regular basis, and the market doesn't know or care who you are and what your trade idea is.

Currencies as the trading vehicle

If you've heard anything at all about the forex market, it's probably that it's the largest financial market in the world, at least in terms of daily trading volumes. To be sure, the forex market is unique in many respects. The volumes are, indeed, huge, which means that liquidity is ever present. It also operates around the clock six days a week, giving traders access to the market any time they need it. (In Chapter 2, we give you a sense of the scale of the forex market and how it operates on a daily basis. In Chapter 3, we look at who the major forex players are.)

Few trading restrictions exist — no daily trading limits up or down, no restrictions on position sizes, and no requirements on selling a currency pair short. (We cover all the mechanics and conventions of currency trading in Chapter 4.)

Selling a currency pair short means you're expecting the price to decline. Because of the way currencies are quoted and because currency rates move up and down all the time, going short is as common as being long.

Most of the action takes place in the major currency pairs, which pit the U.S. dollar (USD) against the currencies of the *Eurozone* (the European countries that have adopted the euro as their currency), Japan, Great Britain, and Switzerland. There's also plenty of trading opportunities in the minor pairs, which see the U.S. dollar traded against the Canadian, Australian, and New Zealand dollars. On top of that, there's cross-currency trading, which directly pits two non-USD currencies against each other, such as the Swiss franc against the Japanese yen. Altogether, there are anywhere from 15 to 20 different major currency pairs, depending on which forex brokerage you deal with. (See Chapters 5 and 6 for a look at the fundamental and market factors that affect the most widely traded currency pairs.)

Most individual traders trade currencies via the Internet — on a desktop, tablet, or even smartphone — through a brokerage firm. Online currency trading is typically done on a margin basis, which allows individual traders to trade in larger amounts by leveraging the amount of margin on deposit.

One of the key features of the forex market is trading with leverage. The *leverage,* or margin trading ratios, can be very high, sometimes as much as 200:1 or greater, meaning a margin deposit of $1,000 could control a position size of $200,000. (***Note:*** Margin rules can vary by country.) Trading on margin is the backdrop against which all your trading will take place. It has benefits, but it carries its own rules and requirements as well. Leverage is a two-edged sword, amplifying gains and losses equally, which makes risk management the key to any successful trading strategy (see Chapter 13).

Before you ever start trading, in any market, make sure you're only risking money that you can afford to lose, what's commonly called *risk capital.* Risk management is the key to any successful trading plan. Without a risk-aware strategy, margin trading can be an extremely short-lived endeavor. With a proper risk plan in place, you stand a much better chance of surviving losing trades and making winning ones. (We incorporate risk management throughout this book, but especially in Chapters 11, 13, and 19.)

Downturns don't affect the forex market as they do other financial markets. Selling a currency pair is normal in the forex market. This is different from other markets — for example, stock markets, where retail investors rarely sell physical stocks due to the financial risks involved. Because selling is so common in the forex market, the forex market is fairly immune to downturns. You trade one currency against another, so something is always going up, even in times of financial crisis. (We talk more about risk on and risk off and what this means for currencies in Chapter 2.)

What Affects Currency Rates?

In a word — information. Information is what drives every financial market, but the forex market has its own unique roster of information inputs. Many different cross-currents are at play in the currency market at any given moment. After all, the forex market is setting the value of one currency relative to another, so at the minimum, you're looking at the themes affecting two major international economies. Add in half a dozen or more other national economies, and you've got a serious amount of information flowing through the market.

Fundamentals drive the currency market

Fundamentals are the broad grouping of news and information that reflects the macroeconomic and political fortunes of the countries whose currencies are traded. (We look at those inputs in depth in Chapters 7 and 9.) Most of the time, when you hear someone talking about the fundamentals of a currency, she's referring to the economic fundamentals. Economic fundamentals are based on:

- Economic data reports
- Interest rate levels
- Monetary policy
- International trade flows
- International investment flows

There are also political and geopolitical fundamentals (see Chapter 7). An essential element of any currency's value is the faith or confidence that the market places in the value of the currency. If political events, such as an election, a war, or a scandal, are seen to be undermining the confidence in a nation's leadership, the value of its currency may be negatively affected.

Gathering and interpreting all this information is just part of a currency trader's daily routine, which is one reason why we put dedication at the top of our list of successful trader attributes (see "Speculating as an enterprise," earlier in this chapter).

Unless it's the technicals that are driving the currency market

The term *technicals* refers to *technical analysis,* a form of market analysis most commonly involving chart analysis, trend-line analysis, and mathematical studies of price behavior, such as momentum or moving averages, to mention just a couple (see Chapter 10).

We don't know of too many currency traders who don't follow some form of technical analysis in their trading. Even the stereotypical seat-of-the-pants, trade-your-gut traders are likely to at least be aware of technical price levels identified by others. If you've been an active trader in other financial markets, chances are, you've engaged in some technical analysis or at least heard of it.

If you're not aware of technical analysis, but you want to trade actively, we strongly recommend that you familiarize yourself with some of its basics (see Chapter 10). Don't be scared off by the name. Technical analysis is just a tool, like an electric saw — you don't need to know the circuitry of the saw to know how to use it. But you do need to know how to use it properly to avoid injury.

Technical analysis is especially important in the forex market because of the amount of fundamental information hitting the market at any given time. Currency traders regularly apply various forms of technical analysis to define and refine their trading strategies, with many people trading based on technical indicators alone. (See Chapters 14, 15, and 16 for how traders really use technicals.)

Or it may be something else

We're not trying to be funny here. Honest. What we are trying to do is get across the idea of the many cross-currents that are at play in the forex market at any given time. Earlier in this chapter, we note that currency trading is just one form of market speculation, and that speculative trading involves an inherent market dynamic (see "What Is Currency Trading?" earlier in this chapter).

Call it what you like — trader's instinct, market psychology, sentiment, position adjustment, or more buyers than sellers. The reality is that the forex market is made up of hundreds of thousands of different traders, each with a different view of the market and each expressing his view by buying or selling different currencies at various times and price levels.

That means that in addition to understanding the currency-specific fundamentals, and familiarizing yourself with technical analysis, you also need to have an appreciation of the market dynamic (see Chapter 8). And that's where trading with a plan comes in (see the following section).

Developing a Trading Plan

If your email inbox is anything like ours, you probably get inundated with random penny-stock tips or the next great Chinese stock initial public offering (IPO). (If you're not, please send us your spam filter.)

Those are about the only times you're going to get a message telling you how to trade. The rest of the time you're going to be on your own. But isn't that what speculative trading is all about, anyway?

Don't get us wrong, we're not trying to scare you off. We're just trying to make it clear that you're the only one who knows your risk appetite and your own trading style. And very likely, you may not have even settled on a trading style yet.

Finding your trading style

Before you can develop a trading plan, settling on a trading style is essential. (See Chapter 10 for more on trading styles.) Different trading styles generally call for variations on trading plans, though there are plenty of overarching trading rules that apply to all styles.

What do we mean by a *trading style?* Basically, it boils down to how you approach currency trading in terms of

- **Trade time frame:** How long will you hold a position? Are you looking at short-term trade opportunities (day trading), trying to capture more-significant shifts in currency prices over days or weeks, or something in between?

- **Currency pair selection:** Are you interested in trading in all the different currency pairs, or are you inclined to specialize in only one or two?
- **Trade rationale:** Are you fundamentally or technically inclined? Are you considering creating a systematic trading model? What strategy will you follow? Are you a trend follower or a breakout trader?
- **Risk appetite:** How much are you prepared to risk and what are your return expectations?

We don't expect you to have answers to any or all of those questions, and that's exactly the point. As you read this book, we hope you'll be thinking about what trading style you'd like to pursue. Feel free to experiment with different styles and strategies — that's what *practice accounts,* or demo accounts, are for. (See Chapter 2 for the best way to utilize practice accounts.)

At the end of the day, though, zeroing in on a trading style that you feel comfortable with and that you can pursue on a consistent basis helps. Your own individual circumstances (including work, family, free time, finances, temperament, and discipline) will be the key variables, and you're the only one who knows what they are.

Planning the trade

Whatever trading style you ultimately choose to follow, you won't get very far if you don't establish a concrete trading plan and stick to it (see Chapter 10). Trading plans are what keep small, bad trades from becoming big, bad trades and what can turn small winners into bigger winners. More than anything, though, they're your road map, helping you to navigate the market after the adrenaline and emotions start pumping, no matter what the market throws your way.

We're not telling you that currency trading is any easier than any other financial market speculation. But we can tell you that trading with a plan will greatly improve your chances of being successful in the forex market over time. Most important, we want to caution you that trading without a plan is a surefire recipe for disaster. You may survive a few close calls, but a day of reckoning comes for any trader without a plan — it's just what happens in markets.

The starting point of any trading plan is to identify a trading opportunity (see Chapter 12). No one is going to give you a call or shoot you an email telling you what and when to trade. You have to devote the effort and gray cells to spotting viable trading opportunities yourself.

Throughout this book, we offer our own observations on how the forex market behaves in various market conditions. We think there are plenty of kernels for spotting trade opportunities in those observations. (In Chapter 12, in particular, we show you a number of concrete ways to look at the market with a view to spotting trade opportunities.) Above all, be patient and wait for the market to show its hand, which it always does, one way or the other.

Executing the Trading Plan from Start to Finish

The start of any trade comes when you step into the market and open up a position. How you enter your position, how you execute the first step of your trading plan, can be as important as the trade opportunity itself. (More on getting into a position in Chapter 14.) After all, if you never enter the position, the trade opportunity will never be exploited. And probably nothing is more frustrating as a trader than having pinpointed a trade opportunity, having it go the way you expected, but having nothing to show for it because you never put the trade on.

The effort and resources you invest in researching, monitoring, and analyzing the market come to a concrete result when you open a trade. This process is made easier by formulating a personal trading system, with trigger points and setups to help you enter the trade. Placing the trade is just the beginning.

Just because you have a trading plan doesn't mean the market is necessarily going to play ball. You need to be actively engaged in managing your position to make the most of it if it's a winner and to minimize the damage if the market is not going in your favor (see Chapter 15).

REMEMBER

Active trade management is also critical to keeping more of what you make in a trade. In our experience, making money in the forex market is not necessarily the hard part. More often than not, keeping what you've made is the *really* hard part.

You need to stay on your toes, and keep thinking about and monitoring the market while your trade is still active. The market will always be moving, sometimes faster than at other times, and new information will still be coming into the market. In Chapter 15, we look at several different ways you can monitor the market while your trade is open, as well as how and when you should adjust your trade strategy depending on events and time.