Forex Patterns and Probabilities

Trading Strategies for Trending and Range-Bound Markets

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Forex Patterns and Probabilities
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To Mom, who taught me that anything is possible.

To Dad, who taught me the value of hard work.
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Preface

Most books on trading deal with general concepts and shy away from specifics. There are plenty of books about the origins and history of currency trading, but very little in the way of useful, practical trading information. *Forex Patterns and Probabilities* provides readers with a rare sense of clarity about the specific mechanics of currency trading—real world strategies that tell the student when to enter, when to exit, and how to manage trades.

This book provides traders with step-by-step methodologies that are based on real market tendencies. The strategies in this book are presented clearly in great detail, so that anyone who wishes to can learn how to trade like a professional. It is written for the new or experienced trader who needs specific, useful information to trade the Forex market.

*Forex Patterns and Probabilities* begins with a whirlwind tour of life on a Wall Street trading desk, as the reader is transported to the exhilarating world of professional trading. Then, the author explains the “playing field” of the forex market, using powerful metaphors that relate trading scenarios to situations in everyday life.

Now that the reader has been sufficiently prepared, Ed unleashes several specific trading strategies designed for trending markets. Trends create some of the most highly profitable trading situations, and the reader is given an arsenal of specific techniques to profit from them. Ed's detailed explanations, backed by over 160 chart images, will leave no doubt in the mind of the reader exactly what the author is doing, and why he is doing it. Ed shares every part of his thought process, leaving nothing to the imagination.

Next, the book delves into a variety of trading techniques, all based on unique market tendencies. The author introduces the reader to the Ultimate Indicator, and the Keys to Intraday Breakouts. He then explains the proper usage of Triangles and Filters, and demonstrates the correct way to trade consolidation patterns such as Flags and Pennants. The dozens of chart examples and explanations allow the reader to “look over the shoulder” of a professional trader, hard at work at his craft.
Next, Ed introduces the volatility-based “Squeeze Play,” and two day-trading techniques called the “Round Trip” and the “Boomerang.” Yet another strategy, the “Interest Rate Edge,” shows the reader how to trade like a hedge fund, revealing the techniques and philosophies used by the “smart money” to make fortunes.

Armed with this impressive arsenal of strategies and techniques, the reader is now presented with the means to turn this knowledge into power—and profit. In “How to Achieve Spectacular Gains,” Ed shows exactly how professional traders make big money consistently, year after year. He then demonstrates the practical use of game theory in forex trading—a subject of immense importance, and a key to trading success.

In “What You Don’t Know Can Hurt You,” Ed gives an insider’s insight into the pitfalls of forex trading and how to avoid them. Then, in “A Tale of Two Traders,” the reader learns how to emulate the behavioral patterns of successful professional traders and how to escape the mind-set of the amateur.

*Forex Patterns and Probabilities* is packed with useful information from a Wall Street pro, yet it is written in an informal, easy-to-digest style that nearly anyone can understand.
I’d like to thank everyone who helped to make the creation of this book a reality. In particular, I’d like to thank:

Kevin Commins, first for suggesting the writing of this book, and then for granting me the freedom to create something truly special and unique.

Emilie Herman, whose hard work and encouragement accentuated my strengths and concealed my weaknesses.

Josep Giró, an artist who fulfilled one of my lifelong dreams by turning me into an animated cartoon character.

And most of all, to my students, who constantly push me to be the very best forex trading instructor that I can be. Thank you one and all!
About the Author

Ed Ponsi is the president of FXEducator.com and is the former chief trading instructor for Forex Capital Markets (FXCM). An experienced professional trader and money manager, Ed has advised hedge funds, institutional traders, and individuals of all levels of skill and experience. He is a regular contributor to FXStreet.com, TradingMarkets.com, and SFO Magazine, and has made numerous appearances on television, radio, online, and in print.

Ed's claim to fame is that he pulls no punches. His dynamic and humorous style of teaching sets him apart from the suit-and-tie crowd, making him one of the most sought-after lecturers in the financial world today. His no-nonsense, irreverent demeanor has earned him the moniker “The Rock Star of Forex Trading.”

Ed's popular DVD series, “FXEducator: Forex Trading with Ed Ponsi” is now available at www.fxeducator.com and from select distributors worldwide. For more information, email us at info@fxeducator.com.
Trading the forex market is one of the most exciting and potentially profitable endeavors that you can undertake. We trade the entire world, matching the world’s economies against one another. This market is vast, much larger than any stock or futures market. There is nothing else like it on earth.

The stakes are high; fortunes can be won or lost quickly. In order to succeed in this realm, we must first learn to understand it. ...
THE WORLD’S MOST DYNAMIC TRADING MARKET

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Call me Ishmael . . .

Just kidding. I’m sure that when anyone is blessed with the task of writing a book, that person secretly (or not so secretly) wishes that it might attain the status of a classic, like Melville’s whaling tale.

You may be an experienced trader, or perhaps you’re just starting out. Either way, remember: Everyone begins at the same starting point. Every trader who ever made money in any market began as a novice. Nobody is born with a deep, innate understanding of trading.

Maybe you believe that superior intelligence is required to succeed at trading. While being bright is not a disadvantage, it is no guarantee of success. Often, very intelligent traders overanalyze trading situations.

Maybe you believe that a good formal education is required to succeed, but this is not the case. What you are about to learn is not taught in any school. Traders learn through study, through trial and error, and through intense analysis of markets, strategies, and techniques. Most of all, traders learn through experience.

Maybe you believe that you must read every trading book you can find. I’ve read dozens of books on trading, most of which are not worth your time. Most of the books that I’ve read contained a kernel of useful information, buried beneath an avalanche of filler. I decided that if I were ever asked to write a book about trading, it would be the antithesis of those books. Instead of performing a sort of “Dance of the Seven Veils,” I’d present an abundance of useful information in a way that most people could understand and appreciate.
My feeling is that the material is useless unless it is explained well, and my goal of helping you to succeed is best served by relating the concepts you are about to study to everyday life. This is a big part of my teaching technique, and you'll see it demonstrated repeatedly on these pages.

Perhaps you are wondering, “Where should I begin?”

**FROM STOCKS TO FOREX**

Like most traders in the United States, my first experiences involved stock trading. My first trade, 100 shares in a NASDAQ biotech stock, yielded a small loss.

I was lucky to have started out during the mid-1990s, during one of the most outstanding bull markets in history. In that environment, as long as a trader went with the trend, it was not too difficult to make money. It was a very forgiving market that would bail out even poor traders. The trick was to understand the difference between being good and merely being lucky. Many traders who I believed were talented began to falter when trading conditions became less than ideal. I realized that, like them, I had been a lucky trader, and that luck was transitory. I didn’t want to be lucky; I wanted to become a good trader, one who could make money in any market environment. I wanted to work on Wall Street.

**GETTING TO WALL STREET**

After sending out dozens of resumes, I was interviewed and hired by a Wall Street firm as a trader. The fact that I didn’t live in New York at the time was a minor detail, and soon I was getting up at around 4:00 A.M. to begin the trek to work.

I would exit my train beneath the World Trade Center, meet up with some coworkers for coffee, and grab copies of the *Wall Street Journal* and the *Investors Business Daily*. Once in the office, we would review dozens of charts, discuss recent market tendencies, study economic indicators—in short, we would do everything possible to prepare for the all-out war that would begin every day at 9:30 A.M.

Spending time in the Wall Street environment is an invaluable and irreplaceable experience. There were so many intelligent, driven people, with so much creative energy that you could feel it in the air like static electricity. We lived and breathed trading 24 hours per day, and learned concepts that changed the way we thought about the markets and trading, as well as the world in general. Much of what I learned in this environment would translate well to other trading markets, such as forex, and would become the basis for much of the material in this book.
Eventually, I was lured away by another firm and began working on another trading desk in Manhattan. I moved to New York City, shortening my daily commute from two hours each way to two blocks.

The new trading room was vast, with hundreds of desks and terminals. Having so many traders together, without walls or barriers to separate them, would facilitate the exchange of knowledge and information. I sought out the best traders and questioned them relentlessly, absorbing and applying the information as quickly as possible. I was introduced to concepts that went far beyond anything I had seen earlier, and the pieces of the puzzle began to fall into place. I began to achieve a level of consistency that had been missing from my earlier trading, which had been profitable but erratic.

I also learned the disadvantages of trading in this environment, as there were too many people in the room expressing too many ideas and opinions. Essentially, it was a huge room full of ambitious and highly competitive alpha males. Some of the traders had egos that were out of control, and couldn’t help but loudly express every mundane thought that rattled around their skulls. Others would merely express anger and frustration; the distinctive sound of a computer keyboard being smashed, along with the odd tinkling sound of letter keys flying through the air, is etched into my memory.

Jealousy reared its ugly head, as losing traders sought to distract and disrupt the winners. One trader took particular glee in trying to break my concentration, because he felt that my results were making him “look bad.” If he had put as much effort into improving his own trading as he did into disrupting mine, he might have succeeded. He later left the firm to take a sales position.

Eventually, the market reached a point where the easy money had already been made. One by one, the marginal traders began to disappear. The market environment was changing, and traders would have to adapt to the changes or face failure.

One of the many benefits of living and working in New York City is exposure to people and cultures from around the world. One of the “new”
concepts (at least it was new to me) to which I was exposed at this time was the currency market.

It was shocking to learn that foreign exchange trading, or forex, was tremendously popular in the rest of the world, and had been for many years. For most of the world, the forex market, not the stock market, is the market to trade. You could compare forex to football, which is the world’s most popular sport—except in the United States, where it is considerably less popular and is referred to as “soccer.” Here was a trading market that enjoyed wide popularity overseas, yet at the time it was “off the radar” in the United States.

A trader friend told me that he had decided to quit stock trading and instead switch to currencies, and that my style of trading would be perfectly suited to this new endeavor. I laughed, not knowing that soon I would make a similar move. Why on earth would I ever want to give up trading stocks?

**STOCK MARKET HEADACHES**

In life, there are certain unpleasanties with which we must learn to deal. We have to go to school, pay our bills, watch our weight, and so on. We accept these unpleasanties with thoughts such as “deal with it” or “that’s life.” After a while, we no longer think of these things as a burden; instead, they become the norm.

For equity traders, there are many unpleasant situations that are considered to be normal, just “part of the game.” Stock traders don’t think twice about these situations, because they are an ingrained part of their daily lives.

**Partial Fills**

For example, the “partial fill” is a normal occurrence in stock trading. A partial fill occurs when a trader places an order for a certain number of shares, let’s say for 2,000 shares of stock, and instead receives only a portion of the order, for example, 300 shares. This happens all the time; the most logical explanation is that perhaps there were only 300 shares available at that particular price.

In trading terminology, we say that the market is too “thin” to absorb the entire order, meaning that there are not enough shares available at that price. This can be really frustrating, especially if the trader wants to enter large orders, but it is something that equity traders accept as normal, just another hurdle to overcome on the road to success.