

SECTION TWO

CURRENCY TRADING BASICS

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Part I. What is trading?

Trading is a unique form of speculation in order to generate profit. It can be a part-time or full time business, a profession or just a lifetime passion. You can trade almost anything from various commodities, stocks, bonds and of course, currencies. Currency trading is not gambling; rather it is a game in which a trader, applying different fundamental or technical analysis, makes a risk-calculated and educated trading decision.

Making logical trading decisions and developing a sound and effective trading strategy is an important foundation of trading. Successful trading is often described as optimizing your risk with respect to your reward or upside. Any trading strategy should have a disciplined method of limiting risk while making the most out of favorable market moves.

Part II. How a Forex Trade Works?

To begin trading in the FX market, you must familiarize yourself with how currencies are handled and traded. Hard and soft currencies are traded in pairs and through ISO codes. There are five different types of transaction and six different ways to execute a trade. Additionally, it is very important to understand some common terms surrounding a trade which includes, lot sizes and margin, PIP, bid-ask spread, position trading, settlement-delivery, volume, and open interest.

ISO Codes

Currencies in the FX market are not referred to by their full names; instead, they are identified by standardized codes or ISO Codes, developed by the International Organization for Standardization. ISO abbreviations are used widely on charts and trading platforms, but they are rarely used in conversations among traders. Traders or the media may refer to the currencies by their nicknames during everyday conversations. Throughout our training materials, we interchangeably use the full names, ISO codes, and nicknames of

currencies to help you get accustomed to the trading language.

The table below depicts the ISO codes and nicknames for the most commonly traded currencies:

Currency Name	ISO abbreviation	Nickname
euro	EUR	--
Great British pound	GBP	cable
US dollar	USD	green back
Swiss franc	CHF	swissy
Japanese yen	JPY	--
Canadian dollar	CAD	loonie
New Zealand dollar	NZD	kiwi
Australian dollar	AUD	aussie

Currency Pairs

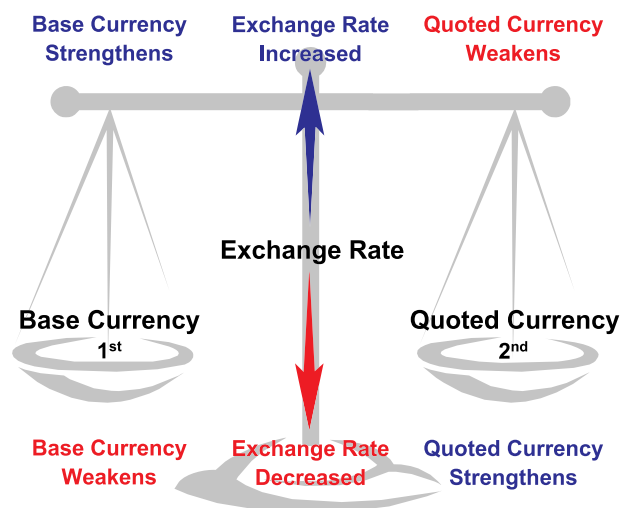
In the Forex market, currency trading is always done in currency pairs, such as USD/CAD or USD/JPY, reflecting the exchange rate between the two currencies. An exchange rate is merely the ratio of one currency valued against another currency. For instance, the USD/JPY exchange rate specifies how many US dollars are required to buy a Japanese yen, or conversely, how many Japanese yen are needed to purchase a US dollar.

In a pair of currencies, the first currency is known as the base (dominant) currency, and the second one is referred to as the counter or quoted (subordinate) currency. In the USD/JPY example, the US dollar is the base currency that we wish to trade, while the Japanese yen is the counter currency that the exchange rate is quoted in. In simple and practical terms, the currency pair is a structure that can be bought or sold. The base currency acts as the basis for all transactions, regardless if it is buying or selling. When you buy a currency pair, it is implied that you are buying the first (base) currency and selling the second (counter or quoted) currency. Alternatively, a trader sells the currency pair when he/she anticipates that the base currency will depreciate relative to the quoted currency.

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How to Calculate which Currency is Increasing or Decreasing in Value

Always remember that the simplest way to remember which currency is increasing or decreasing in value is to view rate changes from the perspective of the base currency. If we look at a chart and see an exchange rate increasing, it means that the value of the base currency is appreciating (getting stronger). Conversely, if we look at a chart and see an exchange rate decreasing, it represents that the value of the base currency is depreciating (getting weaker). The diagram below may help you to have a more lucid understanding of this relationship.



The following is a couple of examples to help you grasp these key concepts:

EUR/USD:

In the EUR/USD pair, the euro acts as the base currency while the US dollar acts as the quoted currency. Therefore, the euro (base currency) is the basis for buying and selling in trading. If you anticipate that the stock market will fall and cause the USD to depreciate, you will buy the currency pair. By buying the EUR/USD pair, you are buying euros in anticipation that the euro will appreciate against the USD. If you choose to sell the pair, you are then buying the US dollars, expecting it to climb against the euro.

USD/JPY:

In the USD/JPY pair, the US dollar acts as the base currency while the Japanese yen acts as the quoted currency. Therefore, the dollar (base currency) is the basis for buying and selling in trading. If you think that the Japanese government is going to weaken the yen in order to strengthen their export industry, you would buy the currency pair. By buying the pair, you are buying dollars in anticipation that it will increase in value against the yen. On the other hand, if you believe that Japanese investors are pulling money out of US financial markets and repatriating funds back to Japan, you would sell the pair. By selling the pair, you expect the yen to strengthen against the dollar.

Hard & Soft Currencies

Alongside the US dollar, four major currencies dominate trading in the Forex market by nature of their popularity and activity. According to a recent survey on 300 major traders by Greenwich Associates, the trading volume on the euro, Japanese yen, British pound, and Swiss franc accounts for over 70% of North American activity.

According to currency market expert, Cornelius Luca, in his book *Trading in the Global Currency Markets*, second edition, market share for the five major currencies after the introduction of the euro is estimated at:



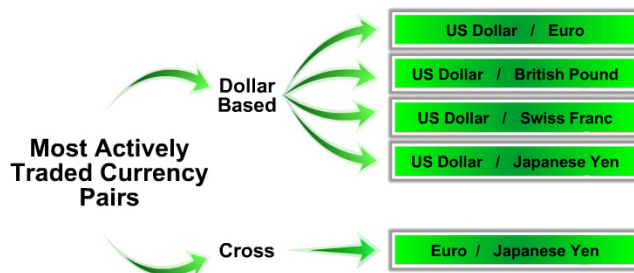
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Other tradable currencies include the Canadian, Australian, and New Zealand dollars. Each of these accounts for 3-7% of the total market volume and are often referred to as “minor” currencies. Together, the majors and minors constitute all hard currencies that are currently traded in Forex. Soft currencies are currency such as the Argentine peso, Russian ruble, Hong Kong dollar, and the Polish zloty that are not tradable or recognized outside their country of origin.

In the spot FX market, currency pairs can be divided into two categories: dollar-based currency pairs and cross-currency pairs. Dollar-based currency pairs are those that consist of the US dollar and another currency, while cross-currency pairs are those with neither of its currencies being the US dollar. The most actively traded dollar-based currency pairs are the EUR/USD, USD/JPY, GBP/USD, and the USD/CHF. The most actively traded cross-currency pair is the EUR/JPY. Normal daily movement on just these five pairs can be anywhere from 50 pips on a slow day to over 100, 200, even 300 pips on a very active day. (See definition of ‘pips’ below.)

As mentioned before, currencies are often referred to by their nicknames. Similar to currencies, it is important to familiarize yourself with the common names of the currency pairs. There is a specific trading terminology that is used frequently to describe each currency pair.

Symbol	Currency Pair	Trading Term
GBP/USD	British Pound / US Dollar	"Cable"
EUR/USD	Euro / US Dollar	"Euro"
USD/JPY	US Dollar / Japanese Yen	"Dollar Yen"
USD/CHF	US Dollar / Swiss Franc	"Swissy"
USD/CAD	US Dollar / Canadian Dollar	"Dollar Canada"
AUD/USD	Australian Dollar / US Dollar	"Aussie Dollar"
EUR/GBP	Euro / British Pound	"Euro Sterling"
EUR/JPY	Euro / Japanese Yen	"Euro Yen"
EUR/CHF	Euro / Swiss Franc	"Euro Swiss"
GBP/CHF	British Pound / Swiss Franc	"Sterling Swiss"
CHF/JPY	Swiss Franc / Japanese Yen	"Swiss Yen"
GBP/JPY	British Pound / Japanese Yen	"Sterling Yen"



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Chart Reading Basics

Charts are used to show the correlation between the value of the base and quoted currencies. The following charts are in the format in which you would see them on an actual computer screen. In these charts, the changing currency is the quoted currency.

Trends

Trend is a term used to describe the persistence of price movements in one direction over a period of time. Trends move in three directions: up, down and sideways. An uptrend signifies the strengthening of the base currency, while a downtrend represents the weakening of the base currency. A sideways trend occurs when markets bounce back and forth between support and resistance levels, resulting in less significant price movements. It is estimated that 70% of the time, markets will fluctuate randomly or move between support and resistance levels. The rest of the time, market behavior is characterized by persistent price movements – trends – that break through support and resistance levels. It is highly possible to increase your ability to capitalize on trends by locating trend signals, identifying specific entry points within the trend, and using risk management techniques to limit losses. More information on trends and strategies would be discussed in section 4: technical analysis.



Lot Sizes and Margin

The FX market attracts many new traders because currency trading can be conducted on a highly leveraged basis. Every trader should have a thorough understanding of lot sizes and margin requirements

before trading in order to employ proper risk management.

Lot Sizes

In Forex, one million dollars worth of a currency is generally accepted as a minimum round lot and is often referred to as one “dollar” or one “buck”. Single orders, in excess of a million dollars, are regularly traded by large institutions and corporations. However, smaller size orders are available to individual FX traders. For example, some dealers offer sizes in half-dollar (.5) and quarter-dollar increments (.25), while others offer sizes of approximately \$200,000 USD (.2), \$100,000 USD (.1), \$50,000 USD (.05), and even \$10,000 USD (.01).

An advantage of currency trading is that most brokers will allow you to trade 100 times the value of your deposit. Therefore, if you deposit \$2,000 into your account, you would be able to trade \$200,000 worth of currency units. This is referred as trading on margin, which is also common with stockbrokers; however, stockbrokers’ leverage is typically 50% greater than your investment. Hence, if you invest \$2,000 with a stockbroker, you would be able to trade with a market value of only \$3,000.

Margin

Margin is a monetary deposit that you provide as collateral to cover any losses. All dealers establish their own margin policy based on a percentage of the lot size. Normal margins range from 1% to 5%. For example, if the margin for day trading is 1% (100:1) with a dealer that offers lot sizes of \$200,000, you may open a one-lot position with \$2,000 in your account. The requirements for margin vary with account size, and may be changed from time to time at the sole discretion of the dealing desk, based on volume traded and market conditions. As the account size and the ability to trade more lots increase, the margin percentage may also increase.

Risk Management

For the purpose of risk management, traders must have position limits. This number is set relative to the money in a trader’s account. Risk is minimized in the spot FX

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market because the online capabilities of the trading platform will automatically generate a margin call if the required margin amount exceeds the dollar value of the account as a result of trading losses. All open positions will be closed immediately regardless of the size or the nature of positions held within the account. This advanced feature is very beneficial for traders. In the futures market, on the other hand, if the price moves against your position, it may be liquidated at a large loss, making you liable for any resulting deficit in the account.

Determining Position Size

Prior to starting up your trade station, an assessment should be made of the maximum account loss that is likely to occur over time, per lot. For example, assume you have determined that the worst case scenario is to lose 20 pips on any trade. This translates into approximately \$200 per \$100,000 position size. Further assume that the \$100,000 position size is equal to one lot. Six consecutive losing trades would result in a loss of \$1,200 (6 x \$200); a difficult period but not an unrealistic one over the long run. This scenario would translate to a 12% loss for an account that has a trading capital of \$10,000. Therefore, even though it may be possible to trade 5 lots or more with a \$10,000 account, this analysis suggests that the resulting drawdown would be too great - 60% or more of the capital would be wiped out. Traders should have a sense of this maximum loss per lot and determine the amount he/she wishes to trade for a given account size that will yield tolerable drawdown.

What is a PIP?

A pip (price interest percentage) is the smallest increment a price moves and it determines the profit or loss of a trade. It is simply a base point value – to the right of the decimal point of the quoted currency – that is used to measure changes in exchange rates (the difference between the rates of the currency).

A few examples of where the pip is located within the exchange rate are listed below. The one-digit for pip values is underlined and highlighted in red for each example.

Currency Pair	Exchange Rate	Explanation
USD/JPY	120. <u>00</u>	No. of yen to buy 1 dollar
USD/CHF	1.50 <u>00</u>	No. of franc to buy 1 dollar
EUR/USD	1.10 <u>00</u>	No. of dollar to buy 1 euro
GBP/USD	1.60 <u>00</u>	No. of dollar to buy 1 pound

For instance, the US dollar moves from 1.6000 to 1.6004 in the cable/dollar pair, it has moved 4 pips. When you have an open position, each upward or downward pip movement in the market price can be either a profit or a loss, depending on which currency (base or quoted) you bought and which one you sold.

Calculating Profit/Loss

Many Forex retail brokers assign a fixed dollar value per pip that varies according to the lot size and the makeup of each currency pair. For example, the pip value may be \$10 per pip on each \$100,000 lot of cable/dollar, while only \$6.50 per pip on each \$100,000 lot of dollar/franc. Other dealers offer a floating pip value that is calculated according to the lot size of each currency pair and the fluctuating exchange rate. For example, notice how the pip value on a 15,000,000 lot of dollar/yen is calculated based on a one-pip movement from 120.00 to 120.01:

$\frac{15,000,000 \text{ yen}}{120.00 \text{ dollar}}$	=	\$125,000.00
$\frac{15,000,000 \text{ yen}}{120.01 \text{ dollar}}$	=	\$124,989.58
One Pip Difference		\$10.42

The value of a pip is determined by the currency pair and the rate at which the pair is trading. For currency pairs where the dollar is not the base currency (EUR/USD, AUD/USD, NZD/USD, GBP/USD), each pip has a fixed value of \$10. For example, if you are trading EUR/USD and the market moves 10 pips in your favor, then your profit would be exactly \$100. On the other hand, when a currency other than the dollar is the counter

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currency (USD/JPY, USD/CHF USD/CAD) the pip value in dollar terms fluctuates based on prevailing market rates.

Although most online trading platforms with reputable brokers offer live Profit/Loss tracking whereby profits and losses are calculated and re-calculated every time the exchange rate changes, it is fundamental for a trader to have an understanding of the value of a pip. The table below gives you an idea of the dollar value attached to each pip:

Currency Pair	Pip Value in \$100,000 Lot
EUR/USD	Fixed \$10
USD/JPY	Varies (about \$8)
GBP/USD	Fixed \$10
USD/CHF	Varies (about \$7)
EUR/CHF	Varies (about \$7)
AUD/USD	Fixed \$10
USD/CAD	Varies (about \$7)
NZD/USD	Fixed \$10
EUR/GBP	Varies (about \$15)
EUR/JPY	Varies (about \$8)
GBP/JPY	Varies (about \$8)
CHF/JPY	Varies (about \$8)
GBP/CHF	Varies (about \$7)
EUR/AUD	Varies (about \$6)
EUR/CAD	Varies (about \$7)
AUD/CAD	Varies (about \$7)
AUD/JPY	Varies (about \$8)

Calculating pip values when the dollar is the counter currency

If the current exchange rate for EUR/USD is 1.1460, then one euro is worth 1.1460 US dollars. Consequently, 100,000 euros are worth 114,600 US dollars. If the market price moves one pip to 1.1470, then one euro is now worth 1.1470 US dollars. This is a pretty small change in the value of the euro (one thousandth of a dollar to be exact) but this can be substantial when we are talking about a lot of euros, 100,000 Euros are now worth 114,700 dollars.

If a trader had bought 100,000 euros by selling 114,600 dollars when the market price was 1.1460, then those 100,000 Euros would be worth 114,700 dollars (10 US dollars more) when the market price

moves to 1.1470. The trader could choose to close the position out and take this \$100 profit.

Conversely, let's say the trader initially sold 100,000 euros by buying 114,600 dollars when EUR/USD was trading at 1.1460. If the market price moves to 1.1470 and the traders chooses to close the position, he/she would have to buy back the 100,000 Euros with 114,700 dollars. The loss on the trade would be \$100.

Calculating pip values when the dollar is the base currency

When the USD is the base currency, the value of a pip will fluctuate according to the exchange rate of the currency pair.

For example, if the current exchange rate for USD/CAD is 1.3300, then one dollar is worth 1.33 Canadian Dollar; hence, 100,000 dollars are worth 133,000 CAD. If the market price of USD/CAD moves up by one pip to 1.3301, then 1 dollar will be worth 1.3301 CAD; hence, one lot of 100,000 dollars equal 133,010 CAD.

In this particular case, a one pip fluctuation is valued at \$10 Canadian Dollar or \$7.52 USD when the USD/CAD price is 1.3301. The calculation is simple, since at this time $1 \text{ USD} = 1.3301$, then $10 \text{ CAD} = 7.52 \text{ USD}$. Simply divide 10 by 1.3301.

If a trader closes out a position at a one pip profit when the USD/CAD market price is 1.3301, he/she automatically locks in a 10 CAD profit which is equivalent to \$7.52 at that time. At a different market price, however, such as 1.3200, those 10 CAD will have a value of \$7.58.

Bid/Ask Spread

All FX quotes include a two-way price, the bid and ask. The bid price is always lower than the ask price. The bid is the price at which a market maker is willing to buy (and traders can sell) the base currency in exchange for the counter currency. The ask is the price at which a market maker will sell (and traders can buy) the base

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currency in exchange for the counter currency. The difference between the bid and the ask price is referred to as the spread, which can be recovered with a favorable currency movement.

Dealing Rates (Advanced)			
EUR/USD 15:08:42 ✕	USD/JPY 15:08:45 ✕		
Low:1.2669 High:1.2721	Low:116.89 High:117.68		
1.27 04	1.27 07	117 45	117 49
Sell Buy	Sell Buy		
GBP/USD 15:09:10 ✕	USD/CHF 15:09:11 ✕		
Low:1.8852 High:1.8965	Low:1.2414 High:1.2478		
1.88 84	1.88 89	1.24 39	1.24 44
Sell Buy	Sell Buy		
EUR/CHF 15:09:13 ✕	AUD/USD 15:09:26 ✕		
Low:1.5769 High:1.5824	Low:0.7473 High:0.7531		
1.58 03	1.58 10	0.75 04	0.75 08
Sell Buy	Sell Buy		
USD/CAD 15:09:30 ✕	NZD/USD 15:09:29 ✕		
Low:1.1088 High:1.1169	Low:0.6533 High:0.6616		
1.11 01	1.11 06	0.65 53	0.65 57
Sell Buy	Sell Buy		

In the above example, the bid price for EUR/USD is 1.2704, which indicates the price at which traders can sell the currency pair. The ask price is 1.2707, indicating the price at which traders can buy the currency pair. The difference between the bid and the ask price gives us a 3-pip spread in this example. The 3-pip spread represents the cost of the transaction. It is important to note that since the FX market is a decentralized market, the spreads that a trader receives for a given currency pair will vary according to the market maker one trades with. Generally, there is an average of 3-5 pips on the major currency pairs and 5-20 pips on the cross currency pairs.

Dealing Spreads			
Currency Pair	Spread	Currency Pair	Spread
EUR/USD	3 pips	EUR/CHF	7 pips
USD/JPY	4 pips	EUR/CAD	10 pips
USD/CHF	5 pips	EUR/AUD	15 pips
USD/CAD	5 pips	GBP/JPY	9 pips
GBP/USD	5 pips	GBP/CHF	15 pips
EUR/JPY	4 pips	CAD/JPY	10 pips
AUD/USD	4 pips	CHF/JPY	9 pips
NZD/USD	4 pips	AUD/CAD	10 pips
EUR/GBP	3 pips	AUD/JPY	8 pips
NZD/JPY	10 pips	AUD/NZD	13 pips
GBP/AUD	15 pips	EUR/NZD	30 pips

Position Trading

The objective of currency trading is to exchange one currency for another in the anticipation that the market rate or price will change, thus, increasing the value of the currency bought relative to the one sold. In trading language, a long position is one in which a trader buys a new currency at one price and aims to sell it later at a higher price. When a trader buys a currency and the price appreciates in value, the trader must sell the currency back in order to secure the profit. A short position is one in which the trader sells a currency in anticipation that it will depreciate. If a trader sells a currency and the price depreciates in value, the trader must buy the currency back in order to secure the profit. While a long position is to buy and a short position is to sell, an open trade or position is one in which a trader has either bought or sold a currency pair and has not sold or bought back the equivalent amount to effectively close the position.

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100K Account vs. Mini-Account

You may choose to open a regular (100K) account or a mini account. As a novice trader, we recommend that you begin trading with a mini-account once you are ready to trade live. As you have developed a disciplined trading system, you may choose to proceed to a regular account. Below is a chart that illustrates the differences between the two accounts.

100K Account Vs. Mini-Account		
Account	100K	Mini
Clientele	Active FX Trader	Novice FX Trader
Investment Capital	\$2,00 minimum initial deposit \$10,000 recommended	\$300 minimum initial deposit
Lot Size	100,000 base currency	10,000 base currency
Average Pip Value	\$10	\$1
Leverage	100:1 Maximum	200:1 Maximum
Margin	As low as 1% (\$1,000) Under \$50,000 - minimum 1% \$50,000 - \$200,000 - minimum 2% \$200,000- \$500,000 - minimum 3% Over \$500,000 - minimum 5%	As low as 1% (\$100)
Currency Pairs	18	18
Interest Rollover	Accounts with margins less than 2% Charged with interest rollover rates Accounts with 2% margins and greater Can earn positive interest	\$1
Risk Management	10:1 recommended for usable to used margin	10:1 recommended for usable to used margin
Spreads	3 pips on EUR/USD 5 on other major pairs Slightly wider spreads on less liquid pairs	3 pips on EUR/USD 5 on other major pairs Slightly wider spreads on less liquid pairs

Part III. Types of Transactions

There are several types of transactions that take place in the FX market. These transactions are Spot, Outright Forward, Futures, Swap, and Option. According to the Bank for International Settlements, market share for these five transactions are estimated at: Spot = 48%, Swap = 39%, Forwards = 7%, Options = 5%, Futures = 1%

Spot Transactions

This type of transaction accounts for almost half of all FX market transactions. The exchange of two currencies at a rate agreed on the date of the contract for delivery in two business days (except for USD/CAD, which is the next business day).

How it Works

A trader calls the dealer and asks for a quote for a currency pair -- say the cable (GBP/USD). This merely expresses interest in a potential deal, because the trader has not stated whether he/she wants to buy or sell. The dealer provides the trader with a two-way price, which indicates both the buying and selling prices. When the trader agrees to sell or buy, a transaction is confirmed. Let's say the trader buys the cable, the dealer will send pounds and the trader will send dollars. By convention, the payment is actually made two days later, however, next day settlements may also be used.

Outright Forward Transactions

One way to deal with the foreign exchange risk is to engage in a forward transaction. In this transaction, money does not actually change hands until an agreed upon future date. A buyer and seller agree on an exchange rate for any date in the future and the transaction occurs on that date, regardless of what the

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market rates are then. The date can be a few days, months, or years in the future.

Futures Transactions

Foreign currency futures are forward transactions with standard contract sizes and maturity dates — for example, 500,000 British pounds for next November at an agreed rate. These contracts are traded on a separate exchange set up for that purpose.

Swap Transactions

The most common type of forward transaction is the currency swap. In a swap, two parties exchange currencies for a certain length of time and agree to reverse the transaction at a later date. The purpose of a swap transaction is to manage liquidity and currency risk, by executing foreign exchange transactions at the most appropriate moment.

For example: selling US dollars for euros value spot and agreeing to reverse the deal at a later date - commonly 1 day, 1 week, 1 month, or 3 months. Effectively, the underlying amount in each currency is simultaneously borrowed or lent – the 'long' lent and the 'short' borrowed.

How it Works

Suppose a U.S. company needs 12 million Japanese yen for a six-month investment in Japan. This company may agree to a rate of 120 yen to a dollar to swap \$100,000 with another company that is willing to swap 12 million yen for 6 months. After 6 months, the U.S. company returns the 12 million yen to the other company and gets back \$100,000, with adjustments made for interest rate differentials.

Since currency risk is replaced by interest rate risk, such transactions are conceptually different from spot transactions. They are, however, closely linked because foreign exchange swaps are often initiated to move the delivery date of a foreign currency originating from spot or outright forward transactions to a more optimal moment in time. It is by using swaps that traders can hold a position without ever being delivered. This enables customers to trade on a margin basis, and pay

margin on a daily basis when the position is marked to the market.

Option Transaction

To address the lack of flexibility in forward transactions, the foreign currency option was developed. An option is similar to a forward transaction. It gives its owner the right to buy or sell a specified amount of foreign currency at a specified price at any time up to a specified expiration date.

For a price, a market participant can buy the right, but not the obligation, to buy or sell a currency at a fixed price on or before an agreed upon future date. The agreed upon price is called the strike price.

Depending on which—the option rate or the current market rate—is more favorable, the owner may exercise the option or let the option lapse, choosing instead to buy/sell currency in the market. This type of transaction allows the owner more flexibility than a swap or futures contract.

In all of these transactions, market rates might change. However, the buyer and seller are locked into a contract at a fixed price that cannot be affected by any changes in the market rates. These tools allow the market participants to plan more safely, since they know in advance what their FX will cost. It also allows them to avoid an immediate outlay of cash.

How it Works

Suppose a trader purchases a six-month call on one million euros at 1.17 U.S. dollars to a euro. During the six months the trader can either purchase the euros at the 1.17 rate, or purchase them at the market rate. Option can be sold and resold many times before the expiration date. Options serve as an insurance policy against the market moving in an unfavorable direction.

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Settlement and Delivery

The Spot market is traded on a two-business day value date. It requires a two-day settlement between the banks as they may be in different time zones (the only exception is the Canadian dollar, where 24 hours is the requirement). For instance, for trades executed on Monday, the value day (day of delivery) is Wednesday.

Volume & Open Interest

Volume consists of the total amount of currency traded within a specific period, usually one day. Of course, traders are more interested in the volume for a specific currency. A high trading volume suggests that there is high interest and liquidity in a market. Also, some chart patterns require heavy volume for successful development. A low trading volume is a warning sign to traders to be extra careful. In a low-volume market, rates can be all over the map and make it harder to get the price one wants.

Open interest is the net outstanding position in a specific instrument. It normally represents the difference between the outstanding long (buy) positions and the outstanding short (sell) positions.

Volume and open interest are difficult to quantify in most of the foreign exchange markets because about 97% of the markets are decentralized. Volume figures can be calculated in the foreign exchange futures markets because these transactions take place on centralized trading floors, and all trades go through clearinghouses. However, futures transactions (pure futures and options on futures) only account for about 3% of the world's foreign exchange activity. The other 97% of currency trading takes place in the spot, swap, forwards, and cash options markets, where trading is completely decentralized. Hence, volume is impossible to measure with any precision and can only be roughly extrapolated from futures market data.

Interest Rollover

Interest rollover fees are a function of the interest rates established by the various central banks and federal authorities used to regulate the official policy of the currency. Economies that are growing rapidly may encounter inflation, in which prices of goods and

services are rising rapidly. Along with rapid economic growth and inflation, interest rates may often rise as a result. In turn, raised interest rates increase the cost of the currency and thus, decrease the overall demand for goods and services. The decreased demand will inhibit prices from continuing to rise at an excessive, rapid pace. Conversely, economies facing recessionary periods may require economic stimuli to encourage consumer spending, which in turn expedites economic growth. A cut in interest rates may make money more accessible and cheaper to borrow. The decreased interest rate would enable entrepreneurs to borrow capital with less financial stress. Therefore, a cut in interest rates would ideally revitalize the economy and cease the economic recession or, to a greater extent, depression.

Rollover charges are determined by the difference between the interest rates of the two corresponding countries. The greater the interest rate differential between the currency pair, the greater the rollover charge will be. It takes place when the settlement of a trade is rolled forward to the next value date. As mentioned above, trades must be settled in two business days in the FX market. If a trader sells 100,000 euros on Tuesday, the trader must deliver 100,000 euros on Thursday, unless the position is rolled over. Traders that hold a position overnight pay interest on the currency they borrow, and earn interest on the currency they purchase. Typically, interest rollover charges are applied at 5pm (17:00) New York time (9pm GMT; 10pm GMT when New York is operating on daylight savings time from late October to late March) in coordination with the international trading day.

For the FX trader, interest rollover charges can have a small impact on their overall profit and loss from exchange rate speculation. To illustrate how interest rollover charges work, consider the following example:

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Trader A buying GBP/USD at 1.5755.

In this case, Trader A is borrowing US dollars, and hence will pay interest on the borrowed funds. Trader A is, however, earning interest on the British pounds that have been purchased. If the Bank of England – which regulates the pound – offers a higher interest rate than the Federal Reserve – which regulates the US dollar – the client has an opportunity to earn interest. Alternatively, if the Federal Reserve issues a higher interest rate on the US dollar than the Bank of England offers on the British pound, then the client will experience a net interest payment.

Because banks can lend to each other at rates different from what the central bank lends to them, the rollover calculations can never be reduced to an exact science. Like the currency exchange rate, the rollover interest rates are subject to market conditions, and hence can fluctuate as well.

How to Estimate Interest Rollover

Since interest rates raise the cost of the currency – it is more expensive to borrow currencies with a high interest rate – a central bank’s interest rate policy can be used to adjust the economy to its respective needs. However, since the interest rollover charge is generally quite small, it should not serve as the core of a trading strategy. The following is a sample calculation of interest rollover:

Suppose the Bank of England has an official interest rate of 3.5%, while the Federal Reserve has an official interest rate of 1%. Consequently, a client who is buying GBP/USD will earn interest, since he/she is only paying 1% while earning 3.5%. Because interest rates are quoted on a yearly basis, it is divided down to a daily basis that can be applied for daily interest rollover charges. Although there are 365 days in a year, financial transactions in a year are rounded off to 360 days. For instance, in the United States, 1% of the principal balance for the whole year is divided by 360.

The following is the equation to calculate the amount for interest rollover:

$$(\text{No. of Lots}) \times (\text{No. of Units per Lot}) \times (\text{Annual Interest Rate Differential} / 360) \times (\text{No. of Days})$$

GBP/USD

Country/Region	Official Interest Rate
Australia	4.75%
Canada	2.75%
Europe	2%
Japan	0 - 0.1%
New Zealand	5%
Switzerland	0.25% (aims to be 0 - 0.75%)
United Kingdom	3.5%
United States	1%

Trader A buys 2 contracts of GBP/USD on Thursday and closes them on the next day

Contract Value: GBP 100,000

Opening Price: 1.6770

Yearly Interest Rate Differential: GBP 3.5% - USD 1% = 2.5%

Calculation: $\text{GBP } 100,000 \times 2 \times (2.5\%/360) \times 1 = 13.88$

USD/JPY

Trader A sells 3 lots of USD/JPY on Monday and closes them on the next day

Lot Value: USD 100,000 or JPY 12,200,000

Opening Price: 110.00

Yearly Interest Rate Differential: USD 1% - JPY 0% = 1%

Calculation: $\text{USD } 100,000 \times 3 \times (-1\%/360) \times 1 = -8.31$

Triple Rollover on Wednesday

Since there is a two-day settlement period in foreign exchange, the transactions that are opened on Wednesday at 5 pm – which is the Thursday trading day – should not get settled until Saturday. Of course, banks are closed during the weekend, so the transaction cannot effectively be settled until Monday (which begins on Sunday at 5 pm New York time). Therefore, for positions opened and held overnight on Wednesday, rollover fee is charged for the following Monday as well, meaning an extra two days of fees for the weekend. As a result, rollover fees are tripled in the FX market on Wednesday. It is important to understand

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that every transaction has a value day. If the deal is not closed on the same day, the trade is subject to rollover charges.

Part IV. Types of Orders

When placing an order in the FX market, you can choose from the 4 different options available. This includes: market, limit, stop-loss, and entry orders.

Market Order

A market order is an order to buy or sell a currency pair at the current market price. One of the key advantages of trading in spot market is that market orders are guaranteed when dealing with a reputable broker, as the vast liquidity of the market ensures that there are always buyers and sellers.

Limit Order (Take Profit Order)

A limit order allows a client to specify the rate at which they will take profits and exit the market. Essentially, it defines the amount of profit that the trader is looking to capture on this particular trade. Let's assume a trader has an open position where he is long (meaning he has bought) GBP/USD, he would place a limit order at 1.5900; if the market reached that rate, he would be taken out of the market, and his profit from the trade would immediately be reflected in his balance.

Alternatively, a trader could place a limit order to an existing sell position.

Stop-Loss Order

A stop-loss order works like a limit order, but in an opposite fashion: it specifies the maximum loss that a trader is willing to accept on a given position. For example, if a trader is long USD/JPY at 121.50 with a limit at 121.70, he may wish to maximize the loss he is willing to accept by placing a stop-loss order at 121.30. In such a case, if the market reached 121.30, he would be stopped out of the position and would have suffered a loss no greater than 20 pips.

Entry Order

All entry orders are essentially contingent orders: they will only be filled if the market reaches that rate. For example, suppose you are trading USD/JPY, and the current quote is 120.50 – 120.55. You can place an entry order to buy at 120.15 so that your order will only be filled if the market reaches 120.15. Ultimately, there are two types of entry orders: limit entry orders and stop orders.

Limit Entry Order

Limit entry orders are classified as entry orders whereby the rate specified is either below the current market rate if it is a buy order, or alternatively, above the market rate if it is a sell order. Limit entry orders are often conducive to strategies pertaining to range-bound markets, whereby clients can place orders to buy at the bottom of the range and sell at the top.

Suppose the current market rate to sell EUR/USD is at 1.0800, and to buy is at 1.0804. There are two types of limit entry orders that a trader could place in such a situation:

1. They could place an order to sell at a price above than the current market rate, for instance, sell at 1.0820. If the sell rate in the spot market reaches 1.0820, their sell order would be activated. In this case, the trader expects that the market will reach 1.0820 and then reverse its direction.
2. Traders can place a limit entry order to buy at a price that is below the current market rate, for instance, a trader could place a limit entry order to buy at 1.0790. His order would only be activated – meaning it would only begin to affect his P/L – if the buy rate reached 1.0790. The trader is expecting a reversal of the trend after the market reaches the rate he/she specified. In other words, the trader will profit if the market bounces off the 1.0790 level.

Since both buy and sell limit entry orders assume the reversal of a trend, they are most commonly used by traders who believe the market is trading within an

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upper and lower range, and that it will not break out of this range.

Stop Entry Order

Stop entry orders rely on rationale that is the opposite of limit entry orders. If you wish to buy at a price above the current market rate, or, alternatively, sell at a price below current market price, then you are placing a stop entry order. Stop entry orders are conducive to “breakout” strategies, whereby the trader believes that if the specified rate is reached, the trend’s movement is confirmed and thus will continue in that direction.

Suppose the current market rate for the USD/JPY is at 117.04; in other words, traders can enter the market to sell at 117.04, and can buy at 117.09.

There are two types of stop entry orders that a trader could place in such a situation.

They could place an order to sell at a price below the current market rate. So, for instance, they could place an order to sell at 116.75; if the sell rate in the spot market reaches 116.75, their sell order would be activated. In this case, the trader expects that the market will reach this level; it will break out and continue in this direction.

Traders can place a stop entry order to buy at a price that is above the current market rate. For instance, if the trader placed an order to buy at 117.85, his order would only be activated – meaning it would only begin to affect his P/L – if the buy rate reached 117.85. In this example, the trader is expecting a breakout if the market reaches the rate he/she specified. In other words, the trade will break through the 117.09 level.

Since both buy and sell stop entry orders assume a breakout, they are most commonly used by traders who believe the market will make a big move.

Part V. Proper Phone Etiquette

Although most trades are placed online, traders always have the option of calling the dealing desk to place an order. It is important for spot traders to get their point across quickly and accurately, leaving no room for interpretation or error. Let’s take a look at a typical spot trade:

Please give me a price on USD/JPY (or USD/CHF, or EUR/USD, or GBP/USD) for (the number of lots you want to trade) lot(s).

Example:

Trader says, “Please give me a price on USD/JPY for 3 lots”.

The dealer will respond with a 2-way price quote. For example, he may quote USD/JPY at: 125.10-125.15 (but he will probably just say 125.10-15).

Dealer replies, “125.10-15”.

So you can either buy USD/JPY at 125.15, or you may sell USD/JPY at 125.10.

To buy USD/JPY you can say any of the following: “15”, “I buy”, “I buy at 15”, “mine”, or “mine at 15”.

To sell USD/JPY, you can say any of the following: “10”, “I sell”, “I sell at 10”, “yours”, or “yours at 10”.

Trader states, “I buy at 15”.

You would normally have 3-5 seconds to respond (sometimes more, sometimes less) prior to a price change, depending on market volatility. If no response is given and the price changes, the dealer will say “change”, “price change”, “off”, or “your risk”. In this case, you may ask for a price again. If you do respond with a buy or sell, the dealer will say, “done” or indicate to you that your trade is executed. You can also state to the dealer that you would like your stop-loss at _____, and a limit at _____.

Dealer responds, “Done”.

Trader says, “Place a stop-loss at 124.80 and a limit at 126.00”.

Dealer answers, “Got it”. The dealer will hang up.

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Below is another example of sentences that may be used in a telephone conversation with the dealer.

	"John, it's Cynthia in New York. May I have a price on twenty cable?"	"John, it's Cynthia in New York. I am interested in either buying or selling 20 million British pounds."
	"Sure. One seventy-five, twenty-thirty."	"Sure, I will buy them from you at 1.7520 dollars to each pound or sell them to you at 1.7530 dollars to each pound."
	"Mine Twenty."	"I'd like to buy them from you at 1.7530 dollars to each pound."
	"All right. At 1.7530, I sell you twenty million pounds."	"All right. I sell you 20 million pounds at 1.7530 dollar per pound."
	"Done"	"The deal is confirmed at 1.7530."
	"What do you think about the Japanese yen? It's up 100 pips."	"Is there any information you can share with me about the fact that the Japanese yen has risen one-one hundredth of a yen against the US dollar in the past hour?"
	"I saw that. A few German banks have been buying steadily all day...."	"Yes, German banks have been buying the Japanese yen all day, causing the price to rise a little...."

Part VI. Fundamental Analysis vs. Technical Analysis

There are two primary approaches of analyzing financial markets: fundamental analysis and technical analysis. Fundamental analysis is based on economic theories that examine underlying economic conditions. Events, such as political environments, are used in fundamental analysis to determine forces of supply and demand. On the other hand, technical analysis uses historical price

and volume data to predict future market movements. There is an ongoing debate as to which methodology is more successful. Short-term traders prefer to use technical analysis, focusing their strategies primarily on price action, while fundamental traders focus their efforts on determining a currency's proper current as well as future valuation. One clear point of distinction is that fundamental analysis studies the causes of market movements, while technical analysis studies the effects of market movements.