

2. Three Easy Ways to Trade Currencies

No two people are alike. We all have different tastes, styles, and temperaments. Fortunately, when it comes to trading, we don't have to limit ourselves to a single strategy. There are many ways to trade the currency market, and in this report, we have focused on 3 specific styles that take advantage of the key drivers of currency trading—fundamentals, technicals, and market sentiment.

News Moves Markets

What moves currency markets? News. Economic news, political news, and commentary from monetary officials that is at odds with market expectations can all have a massive impact on price. Speculation is all about sentiment, and news can either reinforce that sentiment or completely turn it around.

One of the common mistakes that many novice traders make is assuming that all news is discounted in the price the moment it hits the computer screen. Not so at all. The currency market is enormous. In fact, it is the largest, deepest, most liquid financial market in the world, trading more than \$3 trillion of volume a day. In this market, it is impossible for prices to adjust instantly to major news surprises. When large players such as multi-national corporations or multi-billion dollar hedge funds react to the latest changes in the economic or political landscape, price can sometimes take days to fully adjust to the new reality.

Following the flow is what reactive trading is all about. There's no need to guess the result beforehand, which is often difficult for traders without a strong economic background. Instead, we sit and observe. If the piece of economic data is considerably worse or better than the forecast, then a good reactive opportunity may present itself. There is, however, one key rule that we follow in all reactive trades: We are either right or we are out. If the price has not reacted as expected to a given piece of news and has in fact retraced all the way to pre-news levels—why be in the trade? The market has clearly decided that the news does not matter enough, so we take a small loss and move on. In those cases when we are right, however, we try to milk our profits for as much as we can.

Each week, our *Trading the News* report teaches you exactly how to trade reactively. We pick the most market moving data of the week and give you clear entry and exit levels ([Sample Report](#)).

Stay With a Trend

Trade with the trend is an old maxim that has helped many traders earn millions of dollars in the currency market (conversely, they can also lose millions of dollars). Generally, currencies tend to develop very strong and persistent trends. Unlike stocks, which can be impacted by a myriad of unforeseen variables—from the overall state of the economy to the sudden surprising resignation of a key executive—currencies are primarily driven by larger macro-economic issues such as the country's growth and interest rate policy. Therefore, like a large ship at sea, once they have established a direction, currencies tend to follow it.

However, it's not always clear what that direction may be. On a day-to-day basis, economic and political news or speculative positioning can temporarily knock currencies off course, making trend trading more difficult than you may think. Fortunately, we have the benefit of technical analysis at our disposal to help us distinguish true trend from random noise. One of our favorite ways to gauge trend is through Bollinger Bands. Bollinger Bands are one of the most popular technical indicators for traders in any financial market—stocks, bonds, or foreign exchange. Many traders use them primarily to determine overbought and oversold levels, selling when price touches the upper Bollinger Band and buying when it hits the lower Bollinger Band.

We, however, have a unique way of using Bollinger Bands to create dynamic price channels that help us to stay on the right side of the trend. At the core, Bollinger Bands measure deviation. This

is the reason why they can be very helpful in diagnosing trend. By generating two sets of Bollinger Bands—one set using the parameter of "1 standard deviation" and the other using the typical setting of "2 standard deviation"—we can look at price from a fresh perspective. In the chart below, we see that whenever price channels between the upper Bollinger Bands +1 SD and +2 SD away from mean, the trend is up; therefore, we can define that channel as the "buy zone." Conversely, if price channels within Bollinger Bands -1 SD and -2 SD, it is in the "sell zone." Anywhere in between is what we call "no man's land."

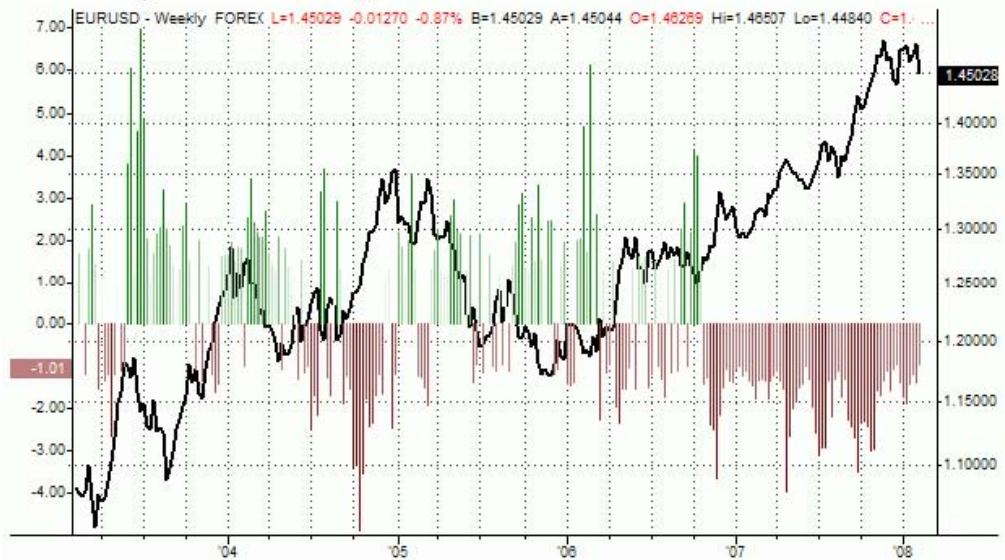
One of the other great advantages of Bollinger Bands is that they adapt dynamically to price expanding and contracting as volatility increases and decreases. Therefore, the Bands naturally widen and narrow in sync with price action, creating a very accurate trending envelope.



Fading Sentiment

One of the most common trading strategies in the currency market is to try to pick tops and bottoms, but using traditional technical analysis can be frustratingly difficult. However, fading sentiment has proven to be a useful way to time tops and bottoms. Once a week, we publish our FXCM Speculative Sentiment Index, which measures the positioning of a subset of exceedingly speculative traders. This Index relies on traders who are always caught on the wrong side of the market and always trying to pick tops and bottoms at the wrong time. When they give up is the exact time when a turn usually occurs.

Here is a link to a sample of the [Speculative Sentiment Index](#). The black line is the price of the EUR/USD while the bars represent the ratios of long to short positions. As a rule of thumb, when positioning is short, the contrarian signal is to buy EUR/USD in this case. When it is long, the signal is to sell the EUR/USD. When the ratio flips from short to long, expect a top relatively soon; and when it flips from long to short, expect a bottom.



Technical Analysis for the Currency Market: Basics

A basic definition of technical analysis is "a study of price action (charts) in order to forecast future price action." Those that apply technical analysis assume two things (among others): markets trend and history repeats itself. Trend is an important concept because many technical approaches rely on identifying a trend and trading in the direction of that trend. "History repeats itself" is another way of saying that the same patterns occur over time, and that these patterns indicate either bullishness or bearishness.

So, how can you identify trends, and what are some common patterns that indicate directional setups?

The simplest and most common technical tools include basic indicators such as the Simple Moving Average (SMA), RSI (Welles Wilder's Relative Strength Index), and chart patterns such as head and shoulders and triangles.

The example below is of a EUR/USD daily bar chart from approximately October 2004 to October 2006. The red line plotted with the bars is a 200-day Simple Moving Average (SMA). A Simple Moving Average is just what it sounds like: the average of a specific body of data. In this case, each value along the 200-day SMA is the average of the last 200 closing prices. The 200-day SMA is a common tool used to identify the long-term trend. The trend is considered up when price is above the moving average and down when price is below the moving average. The blue oscillator plotted below the price bars and moving average is a 14-period RSI (14 is the most common input—a smaller input such as 9 will yield a more volatile indicator and a larger input such as 21 will yield a less volatile indicator). Price is considered "overbought" when the indicator is above 70 (upper-dashed line) and "oversold" when price is below 30 (lower-dashed line). Traditionally, a cross above 30 is a buy signal and a cross below 70 is a sell signal. By combining the 200-day SMA and RSI during the October 2004 – 2006 period, you could have made a lot of money in the EUR/USD!

EURUSD - Daily FOREX L=1.45861 0.00032 0.02% B=1.45861 A=1.45876 C=1.45829 H=1.45877 Lo=1.45312 C=1.45861 V=0 Mov Avg 1 Line (Close,200,0) 1.40750



Chart patterns indicate whether price is likely to continue in the direction (continuation patterns) of the trend or reverse (reversal patterns). A common continuation pattern is the triangle pattern. The triangle shown below is a contracting triangle since the two lines that form the triangle converge. In this specific case, the EUR/USD rallied from 1.1757 to 1.2460 (4/26/04 – 7/16/04) before forming the triangle. The triangle gave way to a bullish breakout in late September. A common reversal pattern is a head and shoulders pattern. A well-defined inverse head and shoulders pattern unfolded from early July 2005 to early April 2006. For an inverse head and shoulders, there is:

1. a downtrend into point A;
2. a corrective rally to point B;
3. a drop to a new low in point C;
4. an advance that approaches the B peak, which is point D;
5. a third decline that does not reach the head, which is point E;
6. a close above the "neckline" (a line that connects points B and D), which is point F and the buy point.

*Leveraged foreign exchange trading carries a high level of risk, and may not be suitable for all investors. The possibility exists that you could sustain a loss of some or all of your initial investment and therefore you should not invest money that you cannot afford to lose.

This inverse head and shoulders signaled the 2006 low and the beginning of a major EUR/USD bull run.



Both of these chart patterns led to superb EUR/USD-long trades. Still, trading is all about confidence, and the more signals you have that a market will move in a specific direction, the more confidence you have in trading that market. In other words, combine patterns with indicators, such as moving averages, in order to find the absolute best trades. The breakouts from the aforementioned patterns occurred when the EUR/USD was crossing above its 200-day SMA. You would have more confidence with this knowledge and be more likely to increase the size of your trade.

*Leveraged foreign exchange trading carries a high level of risk, and may not be suitable for all investors. The possibility exists that you could sustain a loss of some or all of your initial investment and therefore you should not invest money that you cannot afford to lose.

